Fedeli **Focus on Finance**

Why Ontario's Spiraling Debt Matters

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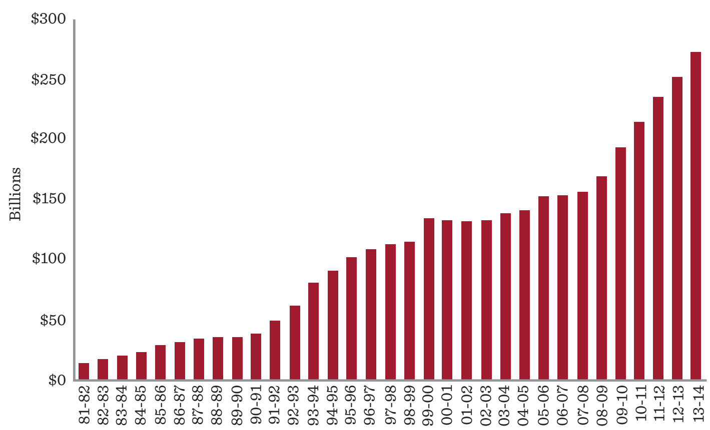
Ontario's fiscal problem is much deeper, and much harder to solve, than most people understand.

The debt is rising exponentially. In the last decade alone, it has doubled in size from $139 billion in 2003 to $273 billion in 2013. While it's understandable that a global financial crisis can push a government into debt, five years later we have to stop the pattern of overspending before it gets even further out of control. There is a common misconception that the current Ontario deficit is temporary because it was the result of "stimulus spending" that will soon disappear. However, the so-called "stimulus" of 2009 never went away. It simply got built into annual spending outlays, which are projected to continue indefinitely. As a result, Ontario's rapidly increasing debt will lead to rapidly increasing interest payments. We are likely to face rising interest rates in the coming years, which will make this problem worse. If we don't take action to address this problem, interest payments will soon crowd out core programs Ontarians care about.

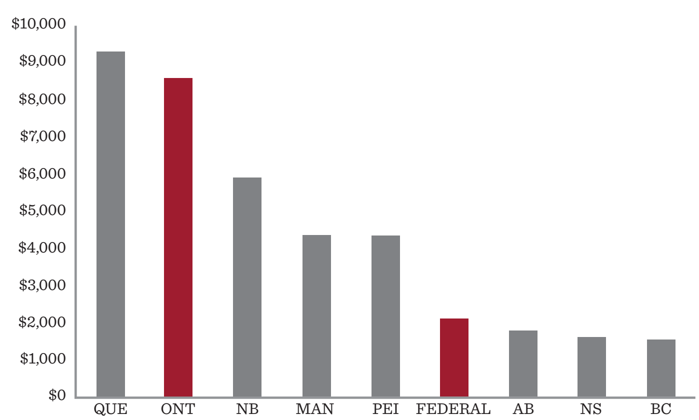
Ontario Debt



Source: RBC Economics, Provincial Fiscal Tables, October 22, 2013

It's true that Ontario isn't the only province adding to its debt. The recession that spanned 2008 - 2009 caused a number of provinces to go into the red. But the amount of debt Ontario accumulated during this time is anything but typical. The government has no plan to address the debt problem. Without quick action, Ontario is heading towards a classic debt spiral.

Increase in Debt per Capita since 2003



Source: RBC Economics, Provincial Fiscal Tables, October 22, 2013

The government is adding an astonishing $20 billion to the debt this year alone. This includes the $12 billion deficit projected for 2013-14 plus capital expenses like infrastructure. This figure is little changed from the $24 billion added to the debt in 2009, when the Liberals tabled their massive "stimulus" spending budget. In other words, the government has barely slowed down the rate of piling on debt since the height of the financial crisis. "One-time" stimulus spending has become baked in as baseline spending.

An enormous amount of debt means we pay an enormous amount in debt interest. Currently, we pay about $10.4 billion every year just to cover our debt interest costs.

AT $10.4 BILLION, OUR YEARLY DEBT PAYMENTS ARE LARGER THAN:

What we spend on Community and Social Services ($10.2 billion)

What we spend on Training, Colleges and Universities ($7.7 billion)

What we spend on the Ministries of Energy ($340 million), Labour ($305 million), Environment ($495 million), Infrastructure ($350 million), Municipal Affairs and Housing ($789 million), Natural Resources ($715 million), Northern Development ($725 million), and so on.

(Source: Budget 2013, page 223)

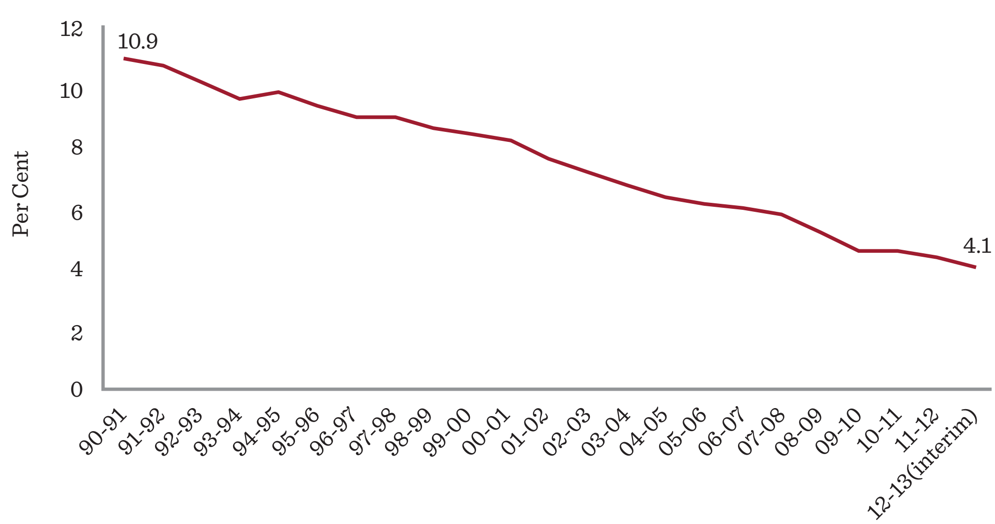
The most concerning issue about interest payments is the risk. What happens when interest rates go up? The 2013 budget gives us an indication of the consequences.

> *The 2013-14 impact of a 100-basis point change in borrowing rates is forecast to be approximately $408 million.*
>
> *-Budget 2013, page 212*

This means that if interest rates go up by one percentage point, then the yearly cost of our debt becomes $408 million more expensive. To put this amount of money in perspective, remember that the entire budget for the Ministry of Infrastructure is $350 million, and the entire budget for the Ministry of Energy is $340 million.

So far the province has been spared the real impact of rapid debt accumulation because interest rates happen to be low. In fact, interest rates are at their lowest point in 20 years. But this won't be the case forever.

Effective Interest Rate on Total Debt



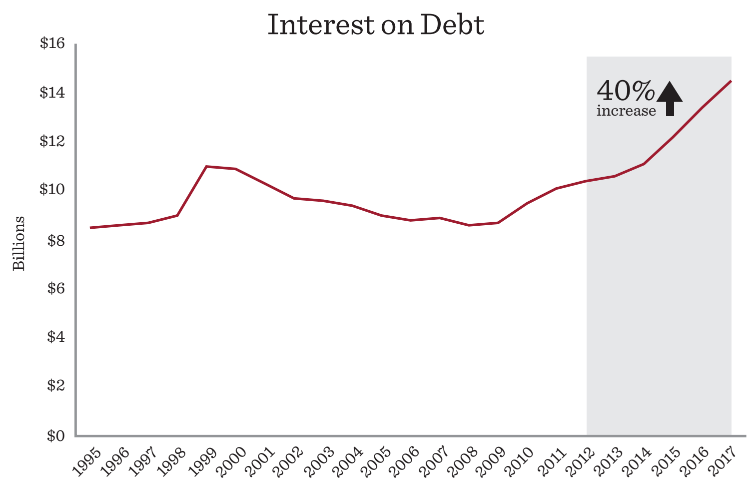
Source: Ontario Public Accounts (1991-2012) and Ontario Financing Authority

> *Debt is costly, since interest must be paid on the province's outstanding bonds and other obligations. Unusually low interest rates in recent years have allowed Ontario to borrow cheaply, but as interest rates rise to more normal levels, so will the cost of servicing the growing debt, and that will divert dollars away from public programs.*
>
> *-Drummond Report, page 2*

Even based on the government's most optimistic assumptions, debt interest costs are about to start spiking in the next few years, after remaining relatively flat for the last two decades because of low interest rates.

Debt interest will increase from $10.4 billion in 2012-13 to $14.5 billion in 2017-18, the year the government plans to balance the budget. This represents an increase of $4.1 billion, or 40 per cent in only 5 years.

As we get deeper into the debt spiral, the outlook gets even worse. That's because investors and credit rating agencies start to associate a greater risk to our debt, meaning we have to pay higher premiums in order to borrow money.



Source: Ontario Ministry of Finance

> *Given the extended period of consolidation and the ambitious expenditure targets, in Moody's view, there are significant risks surrounding the province's ability to achieve their medium-term fiscal targets and stabilize and then reverse the recent accumulation in debt.*
>
> *-Moody's Investors Service, 2012*

Why should we care what independent credit rating agencies say about our debt? As explained above, the government spends more money than it has, so it borrows the rest. Credit rating agencies like Moody's Investors Service, Standard & Poor's (S&P), Dominion Bond Rating Service (DBRS) and Fitch Ratings are all global firms that analyze the credit worthiness of a number of organizations, including government. The stronger the credit rating, the less risky it is for an investor to lend money to the government and usually the less expensive it is for the government to borrow. The weaker the rating, the more expensive it is to borrow.

RECENT ONTARIO CREDIT RATING DOWNGRADES

October 22, 2009:	**DBRS downgraded Ontario from AA to AA (low)**
October 29, 2009:	**S&P downgraded Ontario from AA to AA-**
April 26, 2012:	**Moody's downgraded Ontario to Aa2 (stable) from Aa1 (negative)**

These various downgrades wiped away years of previous progress repairing Ontario's credit rating. Under the previous government, Ontario received four upgrades to its long-term debt rating and nine rating improvements in total.

(Source: Budget 2003, page 113)

Conclusion

The current government's rapidly growing debt payments pose one of the most significant risks to the province's ability to provide core public services.

Key Questions

What is the government's current projection for the amount of debt Ontario will accumulate between now and 2017-18, the target for balancing the budget?

Does the government's fiscal plan take into account the likelihood of further credit-rating downgrades?

Does the government plan to reduce spending in other areas to offset the increased debt interest costs? Or will the government simply issue more debt to cover these costs?

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