## 2016 ONTARIO BUDGET

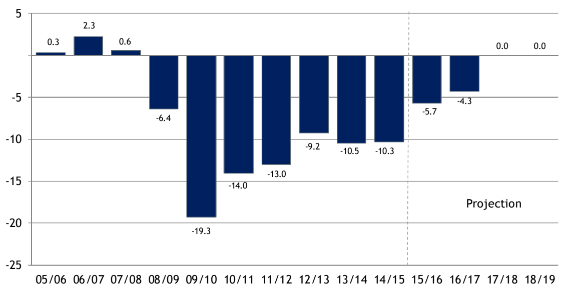
February 25, 2016

# Progress on the long journey to balancing the books

- The Ontario government projects to cut its budget deficit by almost 42% in FY16/17 to $4.3 billion (or 0.4% of GDP).
- The long-standing target is maintained: the deficit will be entirely eliminated by FY17/18.
- Deficit reduction will be achieved by a mix of new revenue sources (e.g. carbon cap-and-trade auction proceeds), asset sales, steady economic growth and expenditure restraint.
- The government revised its FY15/16 deficit materially lower to $5.7 billion from $8.5 billion forecasted at the time of Budget 2015.
- Ontario's net debt is slated to rise further by 4.1% to $308 billion at the end of FY16/17; however, it will stabilize as a share of GDP (at 39.6%)—after ballooning in the previous eight years (from 26.0% in FY07/08)—and begin to ease in FY17/18.
- The government expects to collect $0.5 billion in FY16/17—increasing to $1.9 billion by FY17/18—from its new carbon cap-and-trade system.

**Ontario budget balance**

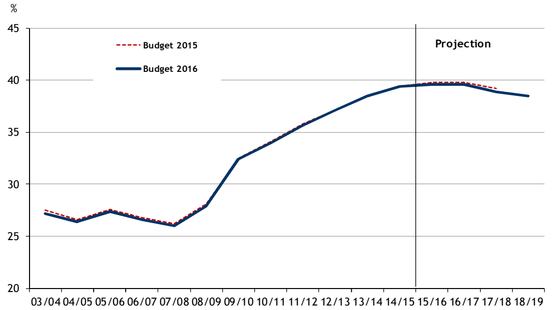
Billions of C$




Source: Ontario Ministry of Finance, RBC Economics Research

**Ontario's net debt-to-GDP ratio**

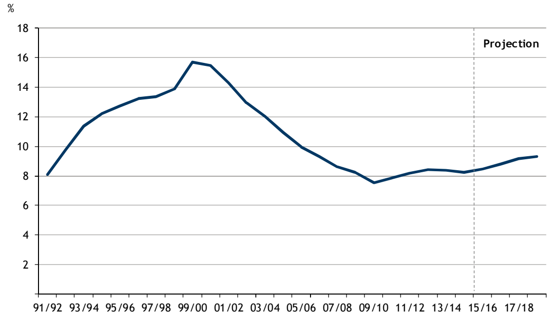
%




Source: Ontario Ministry of Finance, RBC Economics Research

**Ontario interest on public debt as % of total expenditures**

%




Source: Ontario Ministry of Finance, RBC Economics Research

### Encouraging results in FY15/16

The setup for Budget 2016 arguably was the best in years with the province's bottom line now projected to improve to a deficit of $5.7 billion FY15/16, the lowest since FY07/08. This updated projection is down from the $10.3-billion shortfall recorded in FY14/15 and a deficit of $8.5 billion for FY15/16 anticipated in Budget 2015. Stronger-than-expected revenues contributed $2.2 billion of the $2.8 billion improvement since Budget 2015 (half of which came from 'asset optimization' and the rest split between stronger taxation revenue and higher contribution from government business enterprises), while lower debt service expense contributed $0.2 billion and a reduction in the contingency reserve yielded $0.9 billion. A $0.4 billion increase in program expenses provided some negative offset.

### Provincial deficit to be cut further in FY16/17...

Ontario Finance Minister Charles Sousa today announced that his government is set to further reduce the provincial budget deficit by 42% in FY16/17 to $4.3 billion, and remains firmly on track to completely eliminate it by FY17/18. The $4.3 billion projected deficit for FY16/17 represents a downward revision from the $4.8 billion anticipated in Budget 2015. This improvement reflects a $1.2 billion upward revision to revenues (including a $0.7 billion increase in federal funds and $0.5 billion in cap-and-trade proceeds), as well as lower expected debt service expense (due to downwardly revised interest rate assumptions) and a reduction in the contingency reserve, contributing $0.7 billion and $0.2 billion, respectively. Partly offsetting these improvements, however, was an upward revision of $1.6 billion in program expense (in part due to the inclusion of cap-and-trade investments)

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**Economic growth assumptions**

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|
| **Real GDP growth (%)** | | | | | | |
| Budget 2016 | 2.7 | 2.5 | 2.2 | 2.4 | 2.2 | 2.0 |
| Private sector average* | 2.2 | 2.0 | 2.3 | 2.5 | 2.3 | 2.1 |
| RBC | 2.7 | 2.1 | 2.5 | 2.7 | - | - |
| **Nominal GDP growth (%)** | | | | | | |
| Budget 2016 | 4.1 | 3.6 | 4.0 | 4.6 | 4.2 | 4.0 |
| RBC | 4.1 | 3.7 | 3.8 | 4.4 | - | - |

*As of Feb. 25, 2016

Source: Ontario Ministry of Finance, RBC Economics Research

### ...thanks to a mix of strong revenue growth and spending restraint

The significant projected decline in the deficit in FY16/17 will continue to rest on a mix of solid revenue growth and restrained expenditure growth. Revenues are forecasted to increase by 3.2% from FY15/16 led by a 7.4% rise in federal funds and 6.3% rise in personal income tax. The introduction of a carbon emission cap-and-trade system in the province will contribute $0.5 billion in extra revenue in FY16/17. On the expenditure side of the ledger, program spending growth will be limited to 1.0%, or less than half the rate of increase of 2.3% in FY15/16. Health spending is slated to rise by 2.0% and education by 3.2%. Spending on all other programs, combined, will fall by 1.3%. Interest on debt, projected to grow by 5.4%, will continue to be among the faster rising budget items.

### Provincial debt accumulation slowing down

Lower-than-expected deficits will help moderate the pace of Ontario's rapid debt accumulation in recent years. After ballooning at an average rate of 7.1% annually between 2010 and 2015, the province's net debt is projected to rise by 4.1% in both FY15/16 and FY16/17, reaching $296 billion at the end of FY15/16 and $308 billion a year later. As a share of GDP, net debt is projected to peak at 39.6% in FY15/16 and remain at that level in FY16/17 before gradually easing in subsequent years to 38.5% by FY18/19. This represents a marginally lower profile than presented in Budget 2015 when the peak in the net debt-to-GDP ratio was projected to be 39.8% in FY15/16. It is imperative that the province bring down the weight of its debt in the coming years if it is to maintain its credit rating and ensure that debt service expenses remain under control.

### New cap-and-trade system

While announced several months ago, Ontario's new cap-and-trade system to be launched in 2017 easily represents Budget 2016's main new initiative. The budget document estimates that the system will generate $0.5 billion in new revenues FY16/17 and $1.9 billion in FY17/18 after a full year in operation. Based on the current forecast for the price of carbon, the government believes that the system would result in an increase of 4.3 cents per litre of gasoline and 3.3 cents per cubic metre of natural gas (costing approximately $5/month for an average household). The government commits all proceeds to investments in 'green projects'. Budget 2016 shows that the government already invested $325 million through a new Green Investment Fund in FY15/16.

### Ontario Retirement Pension Plan

The budget reiterates the government's commitment to implement a new pension plan scheme—the Ontario Retirement Pension Plan (ORPP)—to address what it perceives as a retirement savings gap for certain groups of working Ontarians. As it indicated last week, however, the government is delaying the first round of implementation (affecting larger employers without registered workplace pension plans) by one year to January 2018 in order to "ensure a successful and smooth implementation". In the interim, the Ontario government announced that it will pursue discussions with the federal government and other provinces to explore ways to achieve the same retirement plan objectives as the ORPP within an 'enhanced' Canada Pension Plan (CPP) framework.

### Reasonable economic assumptions

The government assumes that Ontario's economy will grow by 2.2% in 2016 and 2.4% in 2017, before moderating slightly to 2.2% in 2018 and 2.0% in 2019, which we find appropriately conservative (RBC's most recent forecast shows growth rates of 2.5% and 2.7%, in 2016 and 2017, respectively).

Nominal GDP growth assumptions, however, are slightly more optimistic than our forecast, although still form a reasonable basis for the fiscal plan.

**Downwardly revised deficits mean lower borrowing requirements**

Downward revisions to budget deficits in FY15/16 and FY16/17 have reduced the province's estimated financing requirements. Budget documents show that total funding requirements will be $31.9 billion in FY15/16, down $4.0 billion from the amount estimated in Budget 2015. Total funding requirements are expected to decline further to $30.3 billion in FY16/17 and $23.3 billion in FY17/18. Total long-term public borrowing is now forecasted at $30.1 billion in FY15/16, $26.4 billion in FY16/17 and $23.3 billion in FY17/18.

**Commentary**

It is heartening to see that now in its eighth consecutive year of deficit, the Ontario government is showing material progress in its long journey to balancing its books. We argued following last year's budget that crunch time had arrived for Ontario to reduce its deficit meaningfully and we are pleased to acknowledge that it has made significant headway, while it remains committed to finish the task in FY17/18 as promised back in Budget 2010. Perhaps the rating downgrade of the province's debt in the past year (with the threat of further such action still pending) may have added to the government's resolve. The path to balance no doubt will remain challenging (especially in making sure that it is sustainable) and will require the government to stay focused on the issue. Increasingly, however, we would like to see some of the focus shifting toward Ontario's debt. Specifically it would be wise for the government to explicitly target a lower net debt-to-GDP ratio over the medium to longer term. Doing so would ensure that debt service expenses would remain under control for future generations to come.

**Ontario's fiscal plan**

| ($ billions) | Actual | | Interim | Plan | Outlook | |
|---|---|---|---|---|---|---|
| | 2013/14 | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 |
| **Total revenues** | 115.9 | 118.5 | 125.6 | 130.6 | 137.7 | 141.9 |
| **Total expenditures** | 126.4 | 128.9 | 132.1 | 133.9 | 136.6 | 140.7 |
| **Program spending** | 115.8 | 118.2 | 120.9 | 122.1 | 124.2 | 127.6 |
| **Interest on public debt** | 10.6 | 10.6 | 11.2 | 11.8 | 12.5 | 13.1 |
| **Reserve** | - | - | 0.2 | 1.0 | 1.1 | 1.2 |
| **Surplus/(Deficit)** | (10.5) | (10.3) | (5.7) | (4.3) | 0.0 | 0.0 |

Source: Ontario Ministry of Finance