ONTARIO BUDGET 2012

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One-third of the way there

This was supposed to be the Big One. Ontario's Budget 2012 was built up as one of the toughest budget exercises in the province's history that would provide the answers to many questions left hanging in the previous two budgets. And, Budget 2012 went some way toward addressing the most important question – 'how will the Ontario government balance its books by 2017/18?' – but its focus on the next three years stopped it short of offering a complete answer. What today's budget provided was a detailed road map to reduce the provincial deficit to $10.7 billion by 2014/15 – a nearly one-third improvement from the $15.3 billion deficit now estimated in 2011/12. Beyond that, the details for the remaining two-thirds of the journey toward a balanced budget are not much clearer today than they were before the budget because they fell outside the typical budgetary timeframe.

To his credit, Finance Minister Dwight Duncan found $22.1 billion worth of measures cumulatively over the next three years (including $13.1 billion in 2014/15) — involving several tough decisions such as freezing compensation in the public sector — that will keep his government on the deficit reduction path outlined previously. He followed many – although not all – of the recommendations made by economist Don Drummond, who was commissioned last year to review Ontario's public service. While the efforts to reduce the deficit in the next three years are commendable, even greater challenges await past 2014/15. Those challenges are significant because program spending targets are even more ambitious between 2015/16 and 2017/18 than they are in the three years covered in the budget.

We will be looking forward to further details on the longer term in future budgets.

Budget highlights

For the fiscal year ending this March 31, the Ontario government now projects a deficit of $15.3 billion, which is $0.7 billion lower than projected in the Fall 2011 update and $1.0 billion lower than the 2011 budget. Relative to last year's budget, the improvement reflected the removal of the $0.7 billion contingency reserve and downward revisions to both program expenditures ($161 million) and interest on debt ($193 million). While the revenue projection for the year is essentially unchanged, some offsetting variations among revenue sources nonetheless took place. Of note were downward revisions to taxation revenues ($638 million) and federal transfers ($372 million) that were entirely offset by higher non-tax revenues ($1.1 billion) that included the Chrysler loan repayment ($468 million).

The deficit projected for 2012/13 is $15.2 billion, unchanged from the Fall 2011 update estimate. The deficits in subsequent years are also unchanged from the previous plan – $13.3 billion in 2013/14, $10.7 billion in 2014/15, $7.8 billion in 2015/16, $4.2 billion in 2016/17 and zero in 2017/18.

For the first time, this year's budget contained a "status quo" projection, showing the evolution of revenues and expenditures prior to measures contained in the budget. This projection showed that in the absence of policy action, the deficit would rise to $24.6 billion by 2014/15, $13.1 billion higher than planned. The budget contained measures to reduce the path of deficits over the next three years to their original targets. Measures on the expenditure side are projected to be worth $17.7 billion cumulatively over the three years, while revenue measures are expected to contribute $4.4 billion. This translates into $4 in expenditure cuts for every $1 in additional revenue raised.

Program expenditures are expected to rise by 1.1% in 2012/13, to $115.8 billion. This reflects a 2.3% increase in health and education expenditures, a 3.7% increase in community and social services and a 4.9% increase in post-secondary education in training; all other program expenditures areas will see a decline of 1.4%. Over the course of the fiscal plan, program expenditure growth is expected to average 0.5%, in line with the recommendation from the Drummond report. The plan is heavily back-weighted, however: program expenditure growth averages 1.0% in the first three years of the plan, but just 0.3% in the last three years.

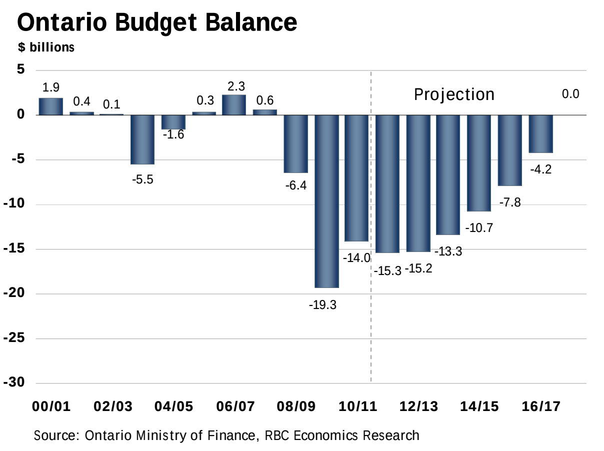
To get to the program expenditure growth target outlined for 2012/13 through 2014/15, the government announced a number of program cuts and policy changes, outlined in a special addendum to the budget. The bigger measures included cuts to business support programs beginning in 2014/15, closing of under-utilized schools and jails, capping the Ontario Clean Energy Benefit for large users, and divestment of the Ontario Northland Transportation Commission. Together, the proposals outlined in the addendum will save $2.2 billion by 2014/15. A further $3.0 billion savings is expected to come from lower compensation. The budget plan contains no funding for compensation increases for new collective agreements; in addition, it freezes wages for hospital, school and other public-sector executives and MPPs. The government pledged to take 'administrative or legislative' action if upcoming collective agreement negotiations do not produce results consistent with the fiscal plan. Beyond these measures, the government is counting on a further $5.2 billion in 'cost avoidance' by 2014/15 to meet its expenditure growth target. The details of these cost avoidance measures were not specified in the budget documents.

If the target to 2014/15 is realized, this would itself represent an unprecedented level of fiscal restraint in the province. Program expenditure growth has been below 1.0% in only five years out of the last 25, and never for more than two consecutive years at a time. While the budget has laid out a plan to accomplish this goal, it is less clear how the government intends to meet the even more stringent program expenditure growth targets it has set beyond 2014/15, as no details on the longer-term effects of expenditure restraint measures were provided in the budget.

Revenues are forecast to rise by 2.7% in 2012/13, to $112.2 billion. The budget included a number of revenue-raising measures, including a cancellation of the previously planned corporate income tax cut and increases in a number of user fees. These and other revenue measures are expected to provide $300 million in additional revenue in 2012/13, rising to $2.7 billion by 2014/15. The government appears to have largely adopted the long-term revenue projections contained in the Drummond report, with revenue growth projected to average 3.7% over the period 2011-12 to 2017/18.

Infrastructure spending is planned to increase by 1.0% in 2012/13, to $12.6 billion. This growth is entirely due to a 12% increase in transportation infrastructure spending, with spending in all other categories falling.

Economic assumptions used in the budget projections are reasonably conservative. The government is planning for real GDP growth of 1.7% in 2012 and 2.2% in 2013, below our forecasts of 2.5% and 2.3%, respectively. The government's forecasts for interest rates are slightly above our own, implying some downside potential to debt servicing costs. On the whole, we estimate that better-than-planned eco-



nomic performance could reduce the deficit by up to $500 million. As added prudence in the latter years of the plan the government boosted the contingency reserve to $1.2 billion in 2013/14 and $1.5 billion through the rest of the plan (up from $1.0 billion previous for each year).

Debt still going up fast for now

The Ontario government projects the province's net debt to rise from $214.5 billion at March 31, 2011, to $237.6 billion at same date in 2012 (an increase of 10.8%), $260 billion in 2013, $281 million in 2014 and $297 million in 2015. During the next three years, net debt is thus projected to rise by 25%, after ballooning by 40% in the past three years. As a ratio to GDP, net debt will climb from 37.2% at March 31, 2012, to a peak of 41.6% in 2015, before gradually decreasing to 39.4% by 2018. This end point is marginally higher than was expected in last year's budget (39.0%).

Financial requirements

The Ontario government forecasts long-term public borrowing requirements of $35.6 billion in 2012/13, which would be up from $34.9 billion in 2011/12. The budget documents indicate that the province intends to borrow at least 70% in the Canadian market in 2012/13 (in line with historical norms but down from 81% in 2011/12). Total long-term public borrowing is schedule to rise in 2013/14 to $39.6 billion before edging slightly lower to $38.7 billion in 2014/15.

Ontario's fiscal plan

($ billions)	Actual	Interim	Plan	Mid-term Outlook		Extended Outlook		
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Total revenues	106.7	109.3	112.2	116.1	121.0	126.2	131.2	135.9
Total expenditures	120.7	124.6	126.4	128.2	130.2	132.6	133.8	134.3
Program spending	111.2	114.5	115.8	117.0	117.9	118.5	118.7	118.9
Interest on public debt	9.5	10.1	10.6	11.2	12.3	14.1	15.1	15.4
Reserve	-	-	1.0	1.2	1.5	1.5	1.5	1.5
Surplus/(Deficit)	(14.0)	(15.3)	(15.2)	(13.3)	(10.7)	(7.8)	(4.2)	0.0

Source: Ontario Ministry of Finance, RBC Economics Research