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ONTARIO BUDGET 2013

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Some good news but balanced budget still years away

While today's budget was the first for new Ontario Finance Minister Charles Sousa (and new Premier Kathleen Wynne), it did not represent a departure from budgets of the past four years in terms of the general fiscal plan. Minister Sousa maintained his government's go-slow approach to eliminating the deficit, still aiming to balance the books by 2017/18. As in past budgets, the 2013 vintage fleshed out the roadmap for the next three years in details but left the back end of the plan – fiscal years 2016/17 and 2017/18 – more 'aspirational' in nature. The updated plan is mostly unchanged from the one presented in Budget 2012 (April version). Only the current 2013/14 fiscal year deficit was revised lower to $11.7 billion from $12.8 billion previously. The projected deficits of $10.1 billion in 2014/15, $7.2 billion in 2015/16 and $3.5 billion in 2016/17, and the small surplus of $0.5 billion in 2017/18 remain.

Last week's good news: lower-than-expected 2012/13 deficit of $9.8 billion
The bigger revision (and good news) was announced last week. In a speech, Minister Sousa revealed that the 2012/13 deficit was now estimated at $9.8 billion, fully $5.0 billion lower than the initial $14.8 billion projected in Budget 2012, and $2.1 billion below the third quarter estimate of $11.9 billion released less than four months ago. Nearly half of the improvement came from one-time items, however, including a $1.1 billion corporate income tax gain arising from re-assessments for years prior to 2011 and $1.1 billion savings arising from the elimination of sick-day banking, retirement gratuities and grandfathering retiree health benefits for education sector workers. The increase of the projected deficit to $11.7 billion in 2013/14 relative to the lower estimated deficit of $9.8 billion in 2012/13 essentially reflects the fact that the government does not expect these one-time windfalls to re-occur.

The Ontario Way: set modest deficit goals and over-deliver?
'Beating' last year's projected deficit highlights another trait of the Ontario government's approach to budgeting. The plan may go slowly towards eliminating the deficit but, at least, the government so far 'over-delivered' consistently in the past four years. The 'Ontario Way' appears to be setting modest deficit reduction goals and striving to do better than plan. Time will tell whether Budget 2013, with a new finance minister and premier at the helm, will be a continuation of this way of budgeting in the province. Given the track record to date, we believe there are good chances that it will in the short term.

Longer-term targets still a tremendous challenges
As for the longer term, however, we must reiterate our scepticism expressed last year about the government's ability to achieve the (very) ambitious program expenditure restraint targets. Returning to balance by 2017/18 depends heavily on tightening the screw on program expenditures the most since the 1996/97 to 1998/99 interval, a period marked by substantial public sector restructuring in Ontario. In particular, the plan counts on an aggressive cumulative decline of 0.7% in nominal program spending in its last two years (2016/17 and 2017/18) but does not provide details as how and where it will do so.

Debt profile lower but indebtedness position still deteriorating
As a final overview note, we are somewhat encouraged to see that Ontario's debt last year also came in better than expected (largely because of the downward revision to the 2012/13 deficit). The main benefit is that the projected trajectory of net debt – expressed in both level terms and as a share of GDP – is lower than it was in Budget 2012. Our enthusiasm is tempered, however, by the fact that the rate of increase in net debt has been revised higher throughout the mid-term plan. With its net debt set to climb by another 20% in the next three years – after ballooning by

30% in the past three – Ontario's indebtedness position will continue to erode for a few more years.

Budget highlights

Revenues

Total revenues are forecasted to rise by 2.3% in 2013/14, to $116.8 billion. This follows a strong 4.1% increase in 2012/13, which included a one-time boost to corporate income tax revenues. The 2013 budget projects a 5.8% drop in corporate income tax revenues in 2013/14; however, this will be more than offset by increases of 5.7% in personal income tax revenues and 3.8% in provincial sales tax revenues. The primary drivers of the increase to personal income tax revenues are previously announced tax measures (such as the introduction of a new $500k top income tax bracket in Budget 2012) while sales tax revenue growth relies upon an improvement in consumer spending. Over the course of the entire fiscal plan (to 2017/18), total revenues are projected to average 3.3% per year – this is slightly more conservative than the 3.7% average rate projected in last year's plan and 4.5% average over the past 10 years.

No new significant revenue initiatives…

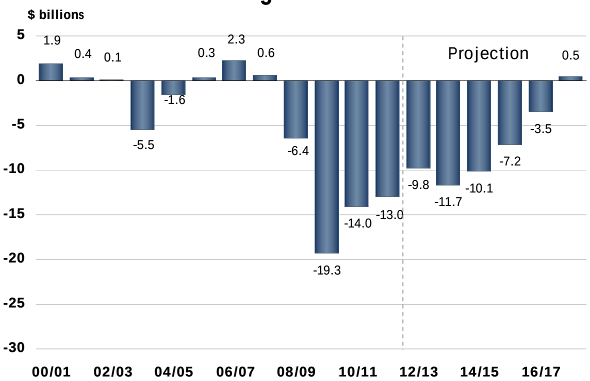
Noticeably absent from the budget were any new revenue initiatives (such as a new gasoline tax, regional sales tax or parking fees) to support The Big Move transit plan, a regional strategy for transportation and public transit. Instead the government stated its intentions to address possible revenue tools after it receives a full report on proposed measures from Metrolinx, expected in June. The government however did confirm its commitment to extending the use of high-occupancy vehicle (HOV) lanes for single-occupancy drivers' use under a toll structure. New HOV lanes are also planned for a number of the major 400 series highways in the Greater Toronto and Hamilton area to support the plan. While the implementation of such a program will take time, the government aims to have a plan proposed by the end of 2013.

…but some new policy initiatives

The budget did include a number of new policy initiatives, including some to address requests from the New Democratic Party opposition (the governing Liberal party is in minority position and needs support from at least one of the opposition parties to pass this budget). One such measure announced previously is the proposed "cost and rate-reduction" strategy that aims to reduce average auto insurance rates in the province by 15% within a period of time. Estimated to save the average driver $225/year, this proposal is part of a mandated reduction in profits for insurance companies. Another initiative is the Youth Employment fund, part of a Youth Jobs Strategy that aims to invest $295 million to support employment, entrepreneurship and innovation for youth in the province. The fund of $195 million over 2 years will provide hiring incentives and employment and training services for Ontario's youth. Other initiatives include an extension of the accelerated Capital Cost Allowance for manufacturing and processing machinery and equipment through to 2015, an initiative that parallels the recent federal budget proposal.

In collaboration with the federal government, the province aims to enhance corporate tax compliance and close tax loopholes to generate incremental revenues (these initiatives are expected to generate $300 million over four years). The government also expects to follow the federal budget proposal to change the treatment of tax dividends dis-

Revised Ontario Budget Balance



Source: Ontario Ministry of Finance, RBC Economics Research tributed from corporate income taxed at less than the general corporate tax rate, beginning in 2014. Additional proposals include a program review of the Ontario Clean Energy Benefit, a 10% hydro rebate currently available to all ratepayers, while income-testing of the Ontario Drug Benefit program will come into effect in August 2014 resulting in high-income seniors paying a larger share of their prescription drug costs. While consultations are forthcoming, the budget proposes to update and strengthen securities legislation to enable the Ontario Securities Council to become a “more efficient and responsive regulator”.

Measures affecting business

Minimal changes have been proposed with respect to the cost of tax support to business including an increase to the Employer Health Tax Exemption from $400k to $450k, resulting in a savings of up to $975 per employer in the small business sector. Beginning January 1, 2014, however, the exemption is expected to be eliminated for private-sector employers with annual payrolls over $5 million, offsetting the cost of the former initiative. Additional tax initiatives include eliminating the biodiesel exemption from the 14.3 cent per litre tax under the Fuel Tax Act as of April 2014, resulting in a small savings of $4 million. To address the effectiveness and sustainability of refundable tax credits, the budget is building upon recommendations from the Jobs and Prosperity Councils’ report “Advantage Ontario” to form a technical panel to provide direction on whether such credits should be restructured, discontinued, maintained or replaced with grants. Moreover, the panel will be charged with finding savings of 25% in the administration of such programs.

Pooled Registered Pension Plans consultations

With an initial announcement in last year’s budget, Budget 2013 confirmed the implementation of a pooled asset management framework to allow smaller public-sector pension plans to benefit from lower investment management costs, improved access to alternative investments and enhanced risk management. A detailed implementation plan is expected later this year building upon recommendations of a November 2012 report that estimated savings could total $75 million to $100 million annually. Pension innovation also extended to the discussion of the possibility for implementing Pooled Registered Pension Plans. Despite outlining a number of its concerns in last year’s budget, Budget 2013 presented PRPPs as a “cost-effective employee benefit option”, particularly for small businesses and self-employed individuals. The government will undertake consultations with third parties to determine how the plans could be implemented prior to introducing legislation.

Expenditures

After growing by just 0.9% in 2012/13 because of one-time savings in the Ministry of Education, **program expenditures** are projected to rise by 3.0% in 2013/14, to $117.0 billion. This reflects increases of 2.3% in health and education, 7.6% in education, 3.6% in community and social services and 4.1% in post-secondary education and training; all other program expenditures areas will see a decline of 2.7%. Over the course of the entire fiscal plan (to 2017/18), program expenditure growth is expected to average 0.8% annually – the same growth rate recommended by the Drummond report issued last year. The plan is heavily back-loaded, however: program expenditures are scheduled to grow by an average of 2.0% per year in the first two years of the plan, but to shrink by an average of 0.1% in the last three years.

Pay freezes in effect until 2017/18

The plan to return to budget balance continues to rely upon compensation restraint measures including public service pay freezes that are ‘built-in’ to remain in effect until the end of the plan in 2017/18, for a total period of five years – well beyond current contract agreements with negotiating units such as the Ontario Public Service Employees Union, which wage freezes for a period of only two years. The budget document does suggest that it aims to improve the effectiveness of the bargaining process going forward, however, so long as the principle of no funding for incremental compensation increases for new collective agreements in upheld.

Infrastructure spending to increase further

Infrastructure spending is planned to increase by 14.5% in 2013/14, to $13.0 billion. This growth is largely due to a 17.3% (or $930 million) rise in Transportation investment to $6.3 billion. $832 million of this increase stems from an increase in infrastructure spending related to Transit, specifically for the Toronto, Waterloo and Ottawa regions. Key projects include an extension of the Toronto subway to its northern neighbour, the city of Vaughan ($870 million) and support for the transit projects of both the Waterloo region (up to $300 million) and Ottawa (up to $600 million). Municipal and local infrastructure is projected to see a 23.6% (or $144 million) boost to $753 million to support municipal roads, bridges and other critical infrastructure while investment in postsecondary education is slated to rise 16.8% (or $82 million) to $569 million.

Usual degree of conservatism

Budget 2013 maintains the usual degree of conservatism in its underlying economic assumptions and prudence factors. In terms of the economy, the government assumes real GDP growth rates in the province of 1.5% in 2013, 2.3% in 2014 and 2.4% in each of the following two years. This is roughly in line with RBC’s forecasts of 1.6% in 2013 and 2.8% in 2014. The government’s employment, interest rate and Canadian dollar assumptions also are quite comparable to RBC’s. We believe that the government’s assumptions constitute a reasonable basis for the budget estimates and projections. In terms of prudence factors, the budget kept the usual ‘reserve’ line in its projections amounting to $1.0 billion in 2013/14, $1.2 billion in both 2014/15 and 2015/16, and $1.5 billion in

2016/17 and 2017/18. This reserve should go some way toward ensuring meeting the targets in the face of unexpected developments. Finally, the fiscal plan includes operating and capital contingency funds at the ministry levels to “help mitigate expense risks that may otherwise have a negative impact on results”. These funds will be used only if health and safety of service recipients are compromised.

Last year’s smaller-than-expected deficit helps lower the debt profile

The lower-than-projected deficit in 2012/13 helped slow the accumulation of debt last year. Ontario’s net debt increased by 7.3% to $252.8 billion at March 31, 2013 – nearly 2% lower than was forecasted in Budget 2012. Going forward, net debt growth is projected to re-accelerate by 7.9% this year and total $272.8 billion on March 31, 2014, and then grow by 6.3% and 4.8% in the subsequent two years to a level of $303.9 billion by March 2016. Thanks to the slower accumulation in 2012/13, the entire profile is now lower than it was in the 2012 budget – although annual growth in net debt has been revised upwardly from this point on. Expressed as a share of GDP, net debt was 37.5% at the end of March 2013 and is projected to peak at 40.4% in 2016 before easing to 38.8% by 2018. This, too, represents a slightly lower profile than was presented in last year’s budget (the previous peak was 41.6% in 2015). Still, the improvement in the net debt-to-GDP ratio will begin later in Ontario than in other major provinces, thereby eroding Ontario’s relative indebtedness standing in Canada.

Financial requirements

The Ontario government forecasts long-term public borrowing requirements of $33.4 billion in 2013/14, of which $1.6 billion was already done by budget day. This level of borrowing requirements would be down from $36.6 billion in 2012/13. The budget documents indicate that the province intends to borrow at least 70% in the Canadian market in 2013/14 (in line with historical norms and 72% in 2012/13). Total long-term public borrowing is scheduled to rise in 2014/15 to $37.6 billion before edging slightly lower to $37.1 billion in 2015/16.

Ontario's fiscal plan

($ billions)	Actual	Interim	Plan	Mid-term Outlook		Extended Outlook	
	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Total revenues	109.8	114.2	116.8	120.5	124.9	130.1	134.4
Total expenditures	122.7	124.0	127.6	129.5	131.0	132.1	132.4
Program spending	112.7	113.6	117.0	118.3	118.8	118.8	118.0
Interest on public debt	10.1	10.4	10.6	11.1	12.2	13.4	14.5
Reserve	-	-	1.0	1.2	1.2	1.5	1.5
Surplus/(Deficit)	(13.0)	(9.8)	(11.7)	(10.1)	(7.2)	(3.5)	0.5

Source: Ontario Ministry of Finance, RBC Economics Research