2014 ONTARIO BUDGET

May 1, 2014

Still committed to balancing the books but higher deficits in the interim

With a provincial election quite possibly hanging in the balance, the 2014 Ontario budget presented today was a much telegraphed affair with effectively all its contents either officially announced or unofficially circulated in the news in recent days, weeks and months. The document delivered to the Ontario legislature by Finance Minister Charles Sousa confirmed that his minority government remains committed to balancing its books by 2017/18 (the long-standing end-point of the province's fiscal plan) but will miss its deficit targets in the intervening three years (by $2.4 billion, $1.7 billion and $1.8 billion, respectively). Veering off the deficit path marks a departure for his government, which in the past five years prided itself in consistently 'beating' its targets—it is likely to do so again in 2013/14, albeit by the slightest of margins.

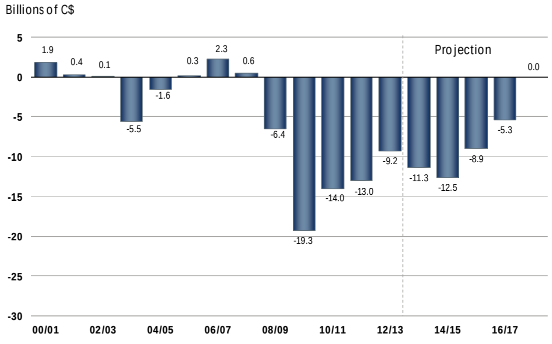
Easing off on short-term spending restraint

Upward revisions to deficit forecasts in the next three years partly reflect a lower revenue baseline—an issue also plaguing several other provinces—but are also due to stronger program spending in the short-term. As he stated on several occasions since last fall's mid-year update, Minister Sousa opted to ease off on expenditure restraint in the short term. This is clearly in evidence in the 2013/14 interim results showing a 3.7% increase in program spending—this compares to forecasts for 2013/14 of 3.0% in Budget 2013 and 1.0% in Budget 2012. Similarly, Budget 2014 boosts program spending growth in 2014/15 to 2.6% from previous targets of 1.1% in last year's budget and 0.8% in the 2012 budget. The fiscal plan presented today still maintains very ambitious program spending restraint for the years 2015/16 to 2017/18 (averaging zero growth!); however, delivering the back-end of the plan will require tremendous resolve as it would constitute the most intense stretch of fiscal austerity in the province since 1996-1999, a period marked by substantial public sector restructuring in Ontario. The higher deficit path charted in Budget 2014 may be designed to reduce short-term pressure on the provincial economy but it will not make things any easier in the later years

Rising debt likely to come into focus

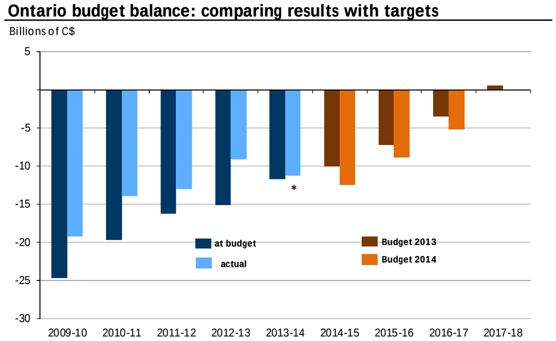
Running higher deficits in the short term necessarily has negative implications for Ontario's debt. The provincial debt will likely come into focus in the period ahead as rating agencies pass judgment on Ontario's credit risk. The province is under review by one of these agencies (Standard & Poor's) for a possible downgrade. Any decisions may await the passage of the budget in the provincial legislature, however.

Ontario budget balance



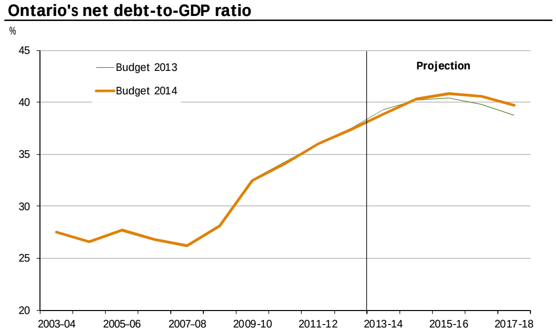
Source: Ontario Ministry of Finance, RBC Economics Research

Ontario budget balance: comparing results with targets



* Interim result
Source: Ontario Ministry of Finance, RBC Economics Research

Ontario's net debt-to-GDP ratio



Source: Ontario Ministry of Finance, RBC Economics Research

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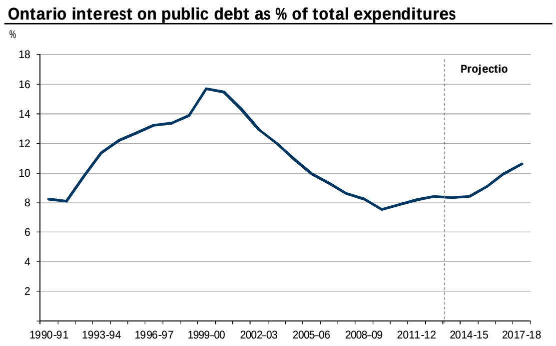

Source: Ontario Ministry of Finance, RBC Economics Research

Beyond the possible repercussions for the debt rating, a rising debt level will have undeniable implications for future budgetary choices, as servicing the debt increasingly will divert provincial moneys away from other uses. Interest on public debt will be the fastest rising expenditure item over the next four years (growing at an annual rate of 7.9%). By 2017/18, interest on public debt will represent nearly 11% of total expenditures in the province (up from 7.5% in 2009/10), and still growing rapidly. Further deterioration would significantly complicate the task of future governments that will face ever increasing pressures on core programs such as healthcare due to an aging population.

Budget 2014 includes a number of major policy announcements

Given the Liberal government's minority status in the provincial legislature, a defeat of the budget bill cannot be ruled out, which would plunge the province into an election. In this context, the budget document contains several major policy proposals aimed at addressing longer-term issues in the province (and which could form the policy platform of the governing Liberal Party should an election be called). These proposals include a provincial pension plan targeting workers without an employer sponsored plan; multi-billion dollar transportation infrastructure funds; and another multi-billion dollar fund that the government would use to provide monetary incentives to attract "global anchor investments". The budget does not raise taxes on businesses; however, it introduces a number of tax measures affecting individuals, including higher taxes on earnings of $150,000 and above. We provide more details on major policy initiatives below.

Fiscal performance in 2013/14 slightly better than projected

Last month, Finance Minister Sousa revealed that the latest estimate of the 2013/14 deficit is now $11.3 billion, just slightly better than the $11.7 billion projected in last year's budget. This would be the fifth straight year in which the Ontario government delivered a lower deficit than originally projected. Excluding the $1 billion reserve, however, the deficit would have been $600 million higher. Growth in revenues (2.0%) was slower than projected (2.3%); on the other hand, growth in total expenditures was stronger (3.6% versus the 2.9% forecasted in Budget 2012). The deficit did not deteriorate because of the lower expenditure base set in the final 2012/13 audited numbers released last fall.

Higher deficits ahead

The era of over-delivering on deficit reductions came to an end in Budget 2014. Minister Sousa announced that deficits are now projected to be $12.5 billion in 2014/15, $8.9 billion in 2015/16 and $5.3 billion in 2016/17, up from $10.1 billion, $7.2 billion and $3.5 billion, respectively. To be sure, the government is being challenged by a lower revenue path; however, higher deficits also reflect stronger growth in program spending in 2014/15 (2.6% versus 1.1% in Budget 2012) and 2015/16 (0.6% versus 0.4% previously).

In 2014/15, spending will increase noticeably in a number of departments, including economic development, trade and employment (up 16.1%), transportation (up 9.0%), children and youth services (up 4.9%), and training, colleges and universities (up 3.1%). Spending on health and long-term care will rise by 2.6%. The government estimates that program review will generate $250 million in savings and that year-end savings will total $1.1 billion. These savings will provide a partially offset to rising departmental spending.

The remainder of the fiscal plan shows significantly slower program expenditure growth—even a small decline in 2017/18! The department-by-department spending details for the back-end of the plan (i.e. for 2015/16 and beyond) were not provided in the budget, as is usual practice. Therefore, it remains unclear what form spending restraint will take and where it will be focused.

On the revenue side of the ledger, lower federal government transfers this year will keep total revenue growth subdued at 2.8% in 2014/15; however, sustained growth in the provincial economy (the Ministry of Finance forecasts real GDP to grow by 2.1% in 2014, 2.5% in 2015, 2.5% in 2016 and 2.6% in 2017, which we find are a reasonable basis for the budget) and revenue initiatives will boost it to 4.7% in 2015/16 and an average of 4.1% in the following two years. Over the course of the entire fiscal plan (to 2017/18), total revenues are forecasted to rise by an annual average of 3.9% which is modestly higher than the 3.6% average rate projected in last year's plan and 2.6% average over the past three years.

Major policy initiatives in Budget 2014

Introducing the Ontario Retirement Pension Plan (ORPP)

After floating the idea around for months, Minister Sousa officially presented his government's answer to address the retirement savings gap that some believe has or will emerge for certain income classes: the Ontario Retirement Pension Plan. The Plan will be mandatory to all Ontario businesses that do not offer a pension plan (offering comparable benefits) to their employees. Self-employed workers will not be automatically enrolled, however. The Plan is similar in design to the Canada Pension Plan (CPP) but meant to be complementary (could be integrated if the CPP is enhanced in the future). Contributions to the ORPP will be made equally by employers and employees at a rate not exceeding 1.9% (combined 3.8%). The earnings replacement rate of the Plan is set at 15%, and will apply to a maximum pre-retirement income of $90,000. Pension benefits will be indexed to inflation.

The ORPP will be administered at arm's length from the Ontario government with no explicit mandate to invest funds in Ontario. Minister Sousa intends to introduce the Plan in 2017 to coincide with expected reductions in Employment Insurance premiums and will implement it in stages, beginning with larger organizations and then smaller employers. Contribution rates are also expected to be phased-in to allow time for employers and employees to adjust. To ensure a "seamless implementation", the government will consult with employers in the province as well as work with the federal government. Overall, the government believes the ORPP will affect 3 million Ontario workers and generate $3.5 billion in retirement savings annually in the province.

Legislative framework for Pooled Registered Retirement Plans on the way

In addition to the ORPP proposal, the province will introduce a legislative framework for Pooled Registered Retirement Plans in the fall of 2014 based on the model introduced by the federal government (voluntary participation by employers and automatic enrolment of employees). The government also intends to begin consultations to develop a regulatory framework for multi-employer target benefit plans as well as initiate a review of current funding rules for defined benefit plans in the province to ensure the long-term sustainability of these plans.

Creation of two major infrastructure funds

The Ontario government's 10-year plan for the economy contains $130 billion in public infrastructure investments in the province to support its Moving Ontario Forward plan. To address the specific funding needs of the provincial transportation infrastructure, the government will create two dedicated funds totaling nearly $29 billion. One fund will focus on addressing congestion in the Greater

Toronto and Hamilton Area (GTHA) and the other on projects outside the GTHA. The government will allocate $15 billion to the GTHA fund, which will target exclusively public transit priorities (including expansion of GO Transit service). The other fund will be given $13.9 billion and a wider mandate to finance roads and bridges in addition to public transit projects. The government indicated that this latter fund will be the source for financing the construction of road access to the Ring of Fire mining project in Northern Ontario; however, the development would be contingent on the federal government matching the province's projected $1 billion investment.

As part of its dedicated revenue funding strategy, the Ontario government will re-direct proceeds from 7.5 cents of the existing provincial gasoline tax to the funds beginning in 2014/15. In addition to the anticipated $14.5 billion in revenues as a result of this measure, the funds will be supported by proceeds of future provincial asset sales ($3.6 billion), and $1.5 billion from various targeted revenue measures (e.g. increased tax on aviation fuel, reduced fuel tax exemption for road-building machines). Overall, the government intends to fill two-thirds of the combined $29 billion funds with dedicated provincial revenue sources. The remaining one-third will come from borrowing ($7.2 billion) and the federal government's Building Canada Plan ($2.6 billion).

A new tool to attract major private-sector investments: the Jobs and Prosperity Fund

The Ontario government will establish a new $2.5 billion Jobs and Prosperity Fund over 10 years to attract global "anchor investments". The Fund will be built up from general revenues and was earlier announced by Premier Wynne at an Empire Club speech in April. Resulting from recommendations of the Jobs and Prosperity Council, the Fund is expected to target key business areas including advanced manufacturing, agri-food and agri-products processing and the Information and Communications Technology sector. Financial support by the province for large investments announced by Cisco and Open Text in recent months will draw from the Fund. Any agreement to financially support a major investment by a private company will come with strings attached and stipulate job creation guarantees to ensure that investments "result in economic growth, innovation and jobs".

New tax initiatives…

Budget 2014 offers a number of tax initiatives, including increases on tobacco products ($3.25 per carton) and aviation fuel (one cent per litre for four years) as well as affirming earlier announced changes to the dividend tax rates and surtax calculations. The government also complemented these initiatives with proposals to review several tax programs currently in place including the training tax credits for large businesses and tax incentives for research and development in the province.

…including some targeting the "rich"

As was done in other provinces in recent years (e.g. Nova Scotia and Quebec), the Ontario government introduced a new tax bracket that will apply to personal income of $150,000 or more starting in the 2014 tax year. The government also proposes to reduce the taxable income threshold for high income earners to $220K from its current $514,090, with the two changes collectively affecting 2% (about 220,000) of the province's tax filers. The marginal tax rate for the $150K threshold will be set at 12.16% and unchanged at 13.16% for the highest income group. Unlike current taxable income thresholds, the new limits will not be adjusted for inflation each year and are expected to bring in an additional $630 million in revenue annually.

No change to business tax

Despite its being a key revenue tool recommended by the Transit Investment Strategy Advisory Panel, an increase to corporate income taxes was not a part of Budget 2014. Instead the government affirmed its promise of Budget 2012 to keep the general CIT rate at its current 11.5% until the budget is balanced in 2017/18. One could argue, however, that mandatory employer contributions to the newly established ORPP will represent a new levy on many businesses in the province. As well, an exception to the unchanged business tax structure is the phasing out and elimination of the small business deduction for large Canadian-controlled private corporations with more than $10 million in taxable capital employed in Canada. The revenues from this initiative will be directed towards funding public transit and transportation infrastructure in the province.

Elimination of the debt retirement charge

As earlier announced, the government will remove the debt retirement charge from residential users' electricity bills after December 31, 2015. The charge will remain on all other electricity users' statements until the residual expense is paid off. With a balance of $3.9 billion as of March 31, 2013, this debt is forecasted to unwind by the end of 2018.

Provincial assets will be "optimized"

The establishment of the Premier's Advisory Council on Government Assets was announced leading up to the budget release with the aim to review and "optimize the full value" of Crown corporations including the LCBO, Hydro One and Ontario Power Generation. This 'asset optimization' is expected to result in the sale of certain provincial assets including the province's General Motors shares as well as the Queens Quay headquarters of the LCBO and the University Avenue offices of the OLG. Funds from such asset sales will be allocated into a proposed Trillium Trust to fund future investments in public infrastructure and are not to be directed towards offsetting government budget shortfalls.

Program initiatives

In addition to its cornerstones, the budget did include a number of program spending initiatives as part of its 10-year Plan for the Economy.

Following a $100 increase in the Ontario Child Benefit in July 2014, Budget 2014 proposes to index future increases in the maximum benefit to the province's rate of inflation beginning in July 2015. As well, following an increase in the minimum wage to $11.00 effective June 1, 2014, the province reaffirmed its intention to introduce legislation that would tie future increases to the rate of inflation beginning in October 2015. Additional program spending measures included (but were not limited to) $810 million over three years to support the community and developmental services sector, an expansion of the Student Nutrition Program and a 1 percentage point increase in social assistance benefits. The Ontario government also plans to expand its investments in home and community health care services by $750 million by 2016/17 with $270 million in 2014/15 as part of its Action Plan for Health Care. The rollout of full-day kindergarten to all 4 and 5 year olds is also expected to be completed by September 2014.

Public service compensation

Budget 2014 continues to assume no increase in overall public sector employee compensation budget throughout the entire fiscal plan. There will be pay increases for some employees (e.g. personal support workers and front-line child care workers); however, Minister Sousa indicated that the impact on government expenditures will be offset by actions to manage compensation costs elsewhere.

10-year infrastructure plan

The government extended its infrastructure plan to 10 years to improve the planning process of departments, agencies and municipalities that depend on provincial capital funding. For 2014/15, the government expects to spend $12.3 billion on infrastructure, representing a 13.6% increase from 2013/14. Of these allocated funds, $2.5 billion is planned for provincial highway rehabilitation and expansion projects including the Highway 407 East expansion, expected to start this year, and future projects including the earlier announced four-lane highway connecting the Kitchener-Waterloo region with Guelph. As part of its transportation strategy, the province plans to spend $3.2 billion to fund transit projects in the upcoming fiscal year resulting in total transportation investment rising 18% to $6.5 billion in 2014/15. Investment in Hospitals and Education account for 93% of the remaining infrastructure investment spending (at $3.6 billion and $1.8 billion, respectively). The former is part of $11.4 billion allocated for major hospital expansions and redevelopment projects over the next decade.

Provincial debt continuing to rise

Ontario's net debt is scheduled to climb from $269 billion in 2013/14 to $289 billion in 2014/15, $305 billion in 2015/16 and $317 billion in 2016/17. This would represent a cumulative increase of almost 18% and come on the heels of a 25% in the past three years—over this six-year period, therefore, net debt will show a surge of 48%. As a percentage of GDP, net debt is projected to increase from 38.9% in 2013/14 to a peak of 40.8% in 2015/16, and then gradually ease to 39.7 by 2017/18. This represents is slightly higher net debt-to-GDP ratio profile than shown in Budget 2012.

Borrowing program

The budget document indicates that the government intends to borrow $35.0 billion (long-term public issues) in 2014/15 or $1.0 billion less than it borrowed in 2013/14, although the 2014/15 is being reduced by $2.6 billion in preborrowing done in 2013/14. Total long-term public borrowing is forecasted to be $37.6 billion in 2015/16 and $32.9 billion in 2016/17.

Ontario's fiscal plan

($ billions)	Actual	Interim	Plan	Mid-term Outlook		Extended Outlook
	2012/13	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**2017/18**
Total revenues	113.4	115.7	118.9	124.5	129.4	134.8
Total expenditures	122.6	127.0	130.4	132.1	133.5	133.6
Program spending	112.3	116.4	119.4	120.1	120.2	119.4
Interest on public debt	10.3	10.6	11.0	12.0	13.3	14.2
Reserve	-	-	1.0	1.2	1.2	1.2
Surplus/(Deficit)	(9.2)	(11.3)	(12.5)	(8.9)	(5.3)	0.0

Source: Ontario Ministry of Finance, RBC Economics Research