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Ontario's fall economic statement

Record deficits!

While the broad economic picture in the earlier-released March budget was already dismal for Ontario – overall activity was projected to contract by 2.5% this year, the most since 1991 – developments since then have shown an even grimmer reality for the province. Indeed, in the first quarter fiscal update released in July, the Ontario government further downgraded the economic projection to a decline of 3.3% in light of the severity of the downturn during the first half of the year, as well as the extreme turbulence experienced by its key auto sector. The resulting greater-than-expected loss of revenues and financial aid to the auto sector had prompted a revision in July to the projected deficit for this fiscal year from \$14.1 billion in the budget to \$18.5 billion. Additionally, the closing of the books on 2008-09 last month revealed a much higher deficit for that year (\$6.4 billion versus \$3.9 billion as previously estimated).

It is against this backdrop of generally poor economic conditions and a weaker “hand-off” from last year that the Ontario government provided its fall update on the economy and its fiscal situation. Given the context, expectations going into the update were clearly skewed towards further downward revisions (upwards in the case of the deficit). Indeed, Finance Minister Dwight Duncan today confirmed that due to a combination of sharper-than-expected drop in revenues and a stronger rise in expenses, the deficit will balloon to \$24.7 billion in 2009-10, or more than 75% higher than the original projection.

Furthermore, in a somewhat unusual step for a mid-year update – although quite understandable given the magnitude of the revisions – Minister Duncan also provided new projections for fiscal years 2010-11 and 2011-12. In both cases, the deficit is now expected to be much higher: \$21.1 billion in 2010-11 and \$19.4 billion in 2011-12, from earlier projections of \$12.2 billion and \$9.7 billion, respectively. Cumulatively, the string of deficits this fiscal year and in the next two has surged by more than 80% relative to budget.

The \$24.7 billion deficit this year is the highest on record for the province both in absolute dollar terms and relative to GDP (measuring 4.4%), where it even exceeds the previous modern-day record deficit posted in 1992-93 (4.3%). It is worth recalling that the 1992-93 budget followed two years (1990 and 1991) of severe economic contraction in the province that saw cumulative losses in real GDP of 4.7% (including the offsetting effect of a small growth in 1992). This time, the downturn that started last year is projected to cause a cumulative drop in real GDP of 3.5% according to our forecast.

The upwardly revised deficit for the current fiscal years reflects both lower revenues and higher expenditures than previously projected. Relative to budget, the new total revenue estimates for this year (\$90.2 billion) are down \$5.8 billion or 6.0% (they are also 0.3% lower than in 2008-09). The decline is due to lower-than-expected receipts from corporate income taxes (\$2.6 billion), personal income taxes (\$2.4 billion) and retail sales tax (\$500 million).

On the other side of the ledger, total expenditures this fiscal year (\$113.7 billion) are now projected to be \$4.8 billion above budget (a 4.4% increase), resulting primarily from the \$4 billion one-time expense to support the automotive sector, a \$650 million one-time expense for the Province's response to the H1N1 virus and a \$812 million increase to core program

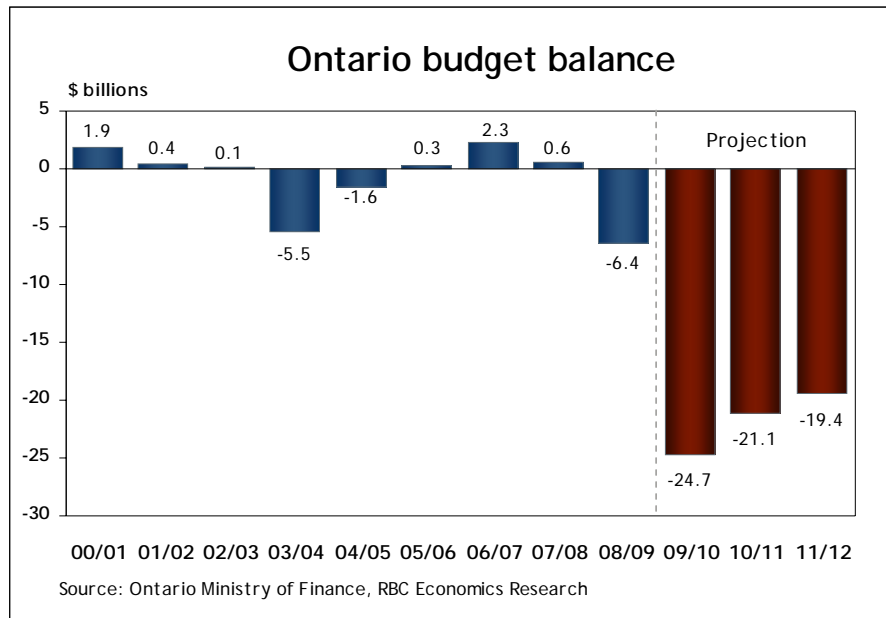
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funding. These charges are partially offset by a \$1.3 billion drawdown from the Operating Contingency Fund.

The weakening in the fiscal position can only be partly blamed on a further downgrade in the projected economic performance of the province. The Ministry of Finance now forecasts real GDP growth at -3.5% in 2009, 2.0% in 2010 and 3.0% in 2011, all weaker relative to the budget projections (-2.5%, 2.3% and 3.3%, respectively). However, these are relatively small changes, especially compared with those presented in the first-quarter fiscal update in July. Rather, the surge in deficits is more symptomatic of a breakdown in the traditional relationships between economic growth and revenues and expenditures.



With the fiscal hole far deeper than previously anticipated, climbing out of it will be that much more challenging. While the current focus is and should be on bringing the Ontario economy back on a growth track, the need will quickly arise for the government to articulate its “exit strategy” once the recovery is well established, which in our view will become clearly apparent next year. Some of the answers should come in the spring of next year with the release of Budget 2010.

To be sure, the major tax reform announced in the March budget and that features the implementation next July 1 of a Harmonized Sales Tax (HST) as its centerpiece does offer the long-term promise of improving the performance of the Ontario economy. The HST will result in certain products and services being taxed that are currently exempt. However, moving to a single, value-added sales tax structure will make the tax system more progressive and economically efficient. Among other benefits, the HST will remove the tax on business inputs and effectively eliminate embedded sales tax on exported goods, helping to make Ontario-produced goods more competitive abroad. The beneficial impact on the economy of such a system will accrue over the medium- to longer-term.

Ontario's fiscal plan

(\$ billions)	Actual	Actual	Actual	Actual	Actual	March Budget	October update		
							2004/05	2005/06	2006/07
Total revenues	77.8	84.2	90.4	97.1	90.5	96.0	90.2	99.3	100.0
Total expenditures	79.4	83.9	88.1	96.5	96.9	108.9	113.7	119.2	118.2
Program spending	70.0	74.9	79.3	87.6	88.3	99.6	104.3	108.6	106.3
Interest on public debt	9.4	9.0	8.8	8.9	8.6	9.3	9.4	10.6	11.9
Reserve	-	-	-	-	-	1.2	1.2	1.2	1.2
Surplus/(Deficit)	(1.6)	0.3	2.3	0.6	(6.4)	(14.1)	(24.7)	(21.1)	(19.4)
Accumulated deficit as % of GDP	24.4	20.3	19.1	18.1	19.3	21.3	24.4	26.4	28.3

Source: Ontario Ministry of Finance, RBC Economics Research