In today’s budget, the minority Liberal government has nudged up its deficit targets for fiscal 2014-15 and 2015-16 while maintaining a commitment to eliminate its $11 billion shortfall by fiscal 2017-18.

In spite of a continued challenging fiscal environment, the government has forged ahead with some big-ticket initiatives – marking somewhat of a departure from the unusually low key affairs of the past few budgets. Funding for transportation infrastructure, unveiling a new public pension plan and increased support to lower-income families and to attract business investment topped the docket.

Still, the government has not adjusted its longer-term goal to hold program spending growth to a minimal rate. Many of the initiatives are moderate in scope, will come at little direct cost to the treasury (i.e., enhanced pensions), or will be phased in over the longer haul as part of a newly-unveiled “Ontario’s Decade: A 10-Year Plan for the Economy”. There was further attention paid to containing public-sector wage and benefit costs and implementing some additional recommendations from the Drummond Commission that aim to secure efficiencies. Achieving the extended period of spending restraint will continue to be the government’s most pressing challenge.

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The plan to gradually restore budget balance while funding the new measures will also hinge on faster revenue gains. Economic growth is assumed to run at a healthy clip over the next four years. Tax rates on higher-income individuals, tobacco and aviation fuel will be hiked. Lastly, proceeds from a number of asset sales will be directed towards transportation infrastructure priorities. While these revenue enhancements will reduce pressure to tap the bond markets for funding, the government’s already-lofty debt-to-GDP ratio is still set to edge up further over the next couple of years.

With virtually all of the major contents leaked in advance, today’s budget should come as little surprise. In the coming days, we will know whether the budget, in its current or revised form, will pass or whether Ontarians will soon head to the polls.

Changes to fiscal targets

There were some notable changes made to the government’s longer-term deficit profile relative to past announcements. Last year’s estimated deficit was adjusted lower by $400 million – to $11.3 billion – relative to estimate in the Fall Fiscal Update. This downgrade brought the government’s streak in undershooting its annual deficit target to five years. Despite this improvement relative to the autumn, the estimated deficit still represents a widening from the $9.2 billion shortfall registered in fiscal 2012-13.

The upward revision of $1.5-$2.5 billion in its fiscal 2014-15 and fiscal 2015-16 budget deficit targets was partly pinned on weaker prospects for economic growth and revenues compared to assumptions made in last year’s budget. In 2013, nominal GDP growth underperformed expectations...
laid out in the 2013 budget while private-sector forecasters have since reduced their expected out-turn for 2014. Consistent with these moves and some other factors, the outlook for revenues (excluding new measures) for the upcoming year 2014-15 was slashed by about $3.5 billion relative to the 2013 budget. Of that amount, $1.3 billion was due to lower-than-expected federal transfers.

Despite the higher near-term deficit, the government has stuck to its guns and predicted a return to balance by fiscal 2017-18. Post-2014, economic growth is predicted to rebound with somewhat more punch than the government had anticipated a year ago. Accordingly, the ground lost in the near-term is expected to be made up over the medium term. In light of this development – together with some new revenue measures and a continued underlying focus on spending restraint – the deficit elimination timetable has been maintained.

**Plenty of new measures to chew on**

While last year’s budget was somewhat of a snoozer in terms of new measures, this year’s budget was significantly meatier. That said, virtually all of the measures hit the airwaves in dribs and drabs leading up to today’s budget.

Some of the more noteworthy announcements surrounded providing financial assistance to lower-income families and workers. The Ontario Child Benefit will be increased this year and indexed to inflation, beginning in 2015. Social assistance rates will be bumped up as part of a broader reform of social services. Other initiatives include providing wage hikes for early childhood education and personal support workers. The government has also opted to remove the Debt Retirement Charge from residential electricity bills, saving all Ontario households about $70 per year.

Perhaps the most ambitious initiative was today’s unveiling of a new Ontario Retirement Pension Plan (ORPP) – a defined-benefit plan that will be modelled after the Canada Pension Plan (CPP) and managed by an arms-length entity. Enrolment by both employees and employers who do not have existing registered pension plans would be mandatory beginning in 2017 and will be implemented gradually. Contribution rates are proposed to reach a maximum of 1.9% for employers and employees (3.8% combined) on earnings of up to $90,000. The aim of the program would be to replace about 15% of pre-retirement earnings, bringing total estimated replacement with the CPP and other savings vehicles to roughly 40%. Since this would still fall short of the 60-70% replacement rate that is commonly cited, the ORPP is not expected to be a full solution. As such, the government also plans to supplement this move with the introduction of the pooled retirement pension plans (PRPPs), which is a private savings vehicle.

Another centerpiece of today’s budget was confirmation of a $29 billion transportation fund over the next 10 years, with about half the money directed towards transit development in the GTHA region and the rest being deployed for transportation projects in other parts of the province. As shown in the chart, the government has elected to fund about two-thirds of this initiative through dedicated existing taxes (primarily gas tax and HST revenues on gas and fuel diesel) that will be re-channeled from general coffers. Provincial debt issuance, including through a newly-established green bond program, is expected to raise about one quarter of the total proceeds.

Today’s budget also confirmed that an important part of transportation infrastructure needs will be funded through the “asset optimization”. This would entail either outright asset sales or improving the financial performance of public assets. Government holdings of General Motors shares and the headquarters of the LCBO and OPG will be disposed of, raising about $900 million-$1 billion in each of the next two years. Those funds will be earmarked to a new Trillium Trust, which must be used exclusively to fund transportation. Further public asset sales may be on the table. In particular, an advisory council, chaired by outgoing TD Bank CEO Ed Clark, will be tasked to “maximize the full value” of government business enterprises.

Another pillar of the government’s budget plan was focused on improving business innovation. Among the handful of better targeting the small business deduction, increased tax on aviation fuel, and restricting the fuel tax exemption for road-building machines

**Sources of $29B for Transportation Infrastructure Funding**

- **Provincial Borrowing**: $7.2 billion
- **Federal Building Canada Plan**: $2.6 billion
- **Dedicated repurposed gas tax and HST revenue, $14.5 billion**
- **Asset optimization**: $3.2 billion
- **Proposed targeted revenue measures**, $1.5 billion

*Source: 2014 Ontario Budget; Ontario Ministry of Finance*
of measures, the most newsworthy is a $2.5 billion Jobs and Prosperity fund was unveiled, which will provide financial incentives to encourage business investments in the region. In addition, a number of programs will be ramped up aimed at helping businesses manage their electricity costs.

With the redeployment of gas tax and HST revenues on gasoline and diesel sales towards transportation infrastructure, a hole was created in government revenues. Today’s budget moves to plug this hole in part through some revenue enhancements. It was announced that personal incomes from $150K to $220K will be subject to a 1 percentage-point hike in the provincial tax rate – from 11.16% to 12.16%, while the threshold at which the top rate applies will be lowered from $514K to $220K. In addition to PIT, increases were announced on tobacco and aviation fuel. On the business side, while no changes were made to the general corporate income tax rate, the small business deduction will no longer be made available to larger businesses. Together, these measures are expected to raise about $2 billion per year.

Restraint still the watchword

While the government has signaled a desire to push less firmly on the brakes after reining in expenditures over the past few years, success in holding program spending growth to a minimal rate will be critical to eliminating the deficit. In recent budgets, the government has targeted wage and benefit restraint within the public sector and sought savings across departments. In the Fall Update, it was announced that more recommendations in the 2012 Drummond Commission report would be considered, since only 60% of the proposals in that report (many of those the lower hanging fruit) had been implemented. In today’s budget, the government announced that it would work to increase this ratio to 80%. Moving public-sector pension and other benefits more in line with the private sector continued to be emphasized. Furthermore, no compensation increases are built into ministerial budget plans, so that any increases will need to be offset by improved productivity. In the budget, gains in health and education spending are projected to run at a modest rate of slightly more than 2% per year over the next four years, while outlays for other areas combined are poised to be reduced on net.

Rising net debt a vulnerability

While dedicated tax revenues and asset sales will take some pressure off the need to borrow, the government still faces a major challenge on the debt front. Indeed, in recent years, the Province’s net debt has been growing considerably more rapidly than the budget deficit, largely reflecting a surge in borrowing related to capital spending. Simply put, large funding needs associated with capital spending impacts the province’s debt immediately, but those costs only get captured gradually over time in the operating budget as the capital stock gets depreciated over its useful life.

The expected path of net debt-to-GDP ratio has been reduced slightly in today’s budget relative to last year’s. The ratio is assumed to rise until fiscal 2015-16, then begin to edge down thereafter – albeit at levels almost 50% higher than were recorded 5-10 years ago. While interest rates have been low, debt has remained affordable. Even then, almost 10 cents of each revenue dollar goes to servicing the debt.

The government had a commitment to keep overall spending increases to 1% below GDP growth until the net debt ratio returns to the pre-recession level of 27%. Based on a back of the envelope calculation, it would likely take about a decade to achieve this target; based on expected GDP gains of about 4% annually in nominal terms and spending at 3% per year (we assume tax rates remain steady). Keep in mind that 3% annual spending is still well below the average rate that was recorded since the early 2000s.

In its borrowing plan, Ontario intends to tap the debt market for $35 billion in fiscal 2014-15. This forecast was revised down by $1.7 billion versus the estimate in the 2013 budget. It is also lower than the $36 billion requirement in fiscal 2013-14. In recent years, the weighted-average term to maturity has been significantly extended to 13.6 years, partially protecting the province in the event of near-term spike in interest rates.
Parting thoughts

Up until now, the government has focused deficit reduction on getting spending growth down below that of revenues, avoiding new revenue initiatives and keeping overall budget measures to a fairly small, targeted list. From that standpoint, today’s plan does represent a shift from the status-quo.

Among the more noteworthy items, the funding plan surrounding transit and transportation infrastructure is a positive move. In particular, today’s announcement marks a major step forward in addressing congestion in the GTHA and the resource potential in the north. Likewise, the pension proposal takes aim at helping as many as 3 million Ontarians not currently covered by a workplace pension plan. Although there have been concerns that the mandatory employer contributions could significantly dampen hiring, this challenge would be mitigated by the gradual phase-in period and/or significant lead time. In addition, the government has timed the new contributions with the expected decline in EI premium rates built into the federal budget.

The tax increases unveiled today were not unexpected. In light of the announced move today, income earners of between $150,000 and $220,000 would see their combined federal-provincial marginal tax rate increase from 46.4% to 48.0%, while the top rate of 49.5% would apply to earners over $220,000. Ontario’s top marginal PIT rate now ranks third highest among the provinces, only fractionally behind Quebec and Nova Scotia (see table). In other provinces, comparable rates range from 39% in Alberta to 46-47% in Manitoba, New Brunswick and P.E.I. In contrast, the decision to maintain the general corporate income tax rate at 11.5% leaves the province in a competitive position.

We were pleased to see the push towards “asset optimization” – or objectively reviewing its assets in order to determine which public assets add value and where changes can be made to extract greater long-term value for Ontarians. A careful review assessing what assets are appropriate for continued public ownership, what assets capture the most value for taxpayers and how best that value can be deployed in the public interest is good public policy. The state of the province’s public infrastructure is vital to longer-term economic success, but it will also come at a hefty price tag. There are significant opportunities within the government’s large portfolio of assets of financial holdings, real estate, other infrastructure and government business enterprises (which is pegged at as much as $175 billion) to help address its longer-term fiscal challenges.

While we have no major quibbles with the underlying economic assumptions used for the budget and acknowledge the government’s recent track record in beating its targets, the usual risks surrounding the path of Ontario finances persist. The medium-term spending targets are ambitious and the drawn out deficit elimination timetable leaves the province vulnerable to a nasty economic surprise. While rating agencies will no doubt be comforted by the province’s track record in beating its targets, they will remain concerned about the province’s debt-load.

Attention will now shift to implementing many of the items announced today. The government’s minority status requires the support of at least one party to help pass the budget. Additional measures and/or a change in the some of the items included in today’s budget may have to be put on the negotiating table for political support. We should know more in this regard over the next few weeks.

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| Top Combined Federal and Provincial Marginal Tax Rate For Individuals¹ (2014) |
|------------------|--------|
| Nova Scotia      | 50.0   |
| Quebec           | 49.97  |
| Ontario          | 47.97/49.53 |
| P.E.I.           | 47.37  |
| New Brunswick    | 46.84  |
| Manitoba         | 46.4   |
| B.C.             | 43.7/45.8 |
| Saskatchewan     | 44.0   |
| Newfoundland & Labrador | 42.3 |
| Alberta          | 39.0   |

¹. For provinces with a top bracket above the top federal bracket, a second rate has been added to the table. The top bracket kicks in at $150,000 in B.C. and Nova Scotia, or on income above $220,000 in Ontario

Source: KPMG Mar. 31, 2014 and 2014 Ontario Budget