Special Report

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HIGHLIGHTS

- The 2011 Ontario budget will be tabled on March 29th, 2011.
- Moderate upgrades to provincial economic growth are consistent with a better fiscal picture than the forecast last fall.
- With a fall election, the government could choose to announce new measures in its upcoming budget. But, we build the case that any unanticipated fiscal leeway should be applied directly to paying down the deficit.
- The future is rife with risks. If another crisis were to happen tomorrow, the province's sizeable fiscal burdens would give it less room to maneuver.
- Large deficits have led to a sizeable increase in net debt. It equals about 40% of GDP.
- Debt servicing costs crowd out the government's ability to provide public services. As interest rates inch up, these costs will further erode spending room.
- Multi-year fiscal plan places the government in a vulnerable position in the event of a negative surprise.
- We hope to see a status-quo 2011 budget with no new tax or spending initiatives. A concerted effort on deficit reduction would have the best longer-term pay off for Ontarians.

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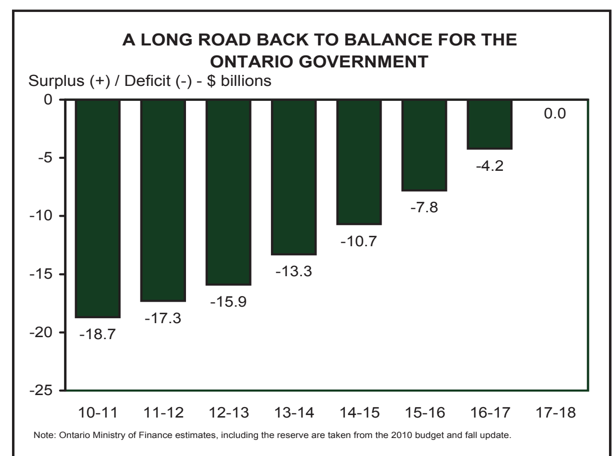
BETTER ECONOMY, (HOPEFULLY) LOWER DEFICIT IN ONTARIO

Ontario's economy has been perking up just in time for the release of the 2011 budget on March 29th. Indeed, last week, TD Economics revised up its Ontario real growth outlook for 2011 to 3%, about a half a percentage point stronger than in its previous forecast just three months ago. And other forecasters have for the most part followed suit with moderate upgrades to the near-term outlook. An upgrade of this sort typically should relate to additional budgetary revenues, consistent with a moderately better fiscal picture compared to that shown in the government's fall update. Recall that this publication revealed a deficit forecast of $17.3 billion (2.8% of GDP) for FY 11-12, with the government setting its sights on deficit elimination in seven years time.

What should the government do with any unanticipated fiscal leeway generated by an improving economy? The government could take any additional room and speed up the pace of deficit reduction. Or, alternatively, it could recycle the incremental resources to new spending or tax initiatives, thus leaving the deficit targets intact. Our choice would be the deficit paydown option. Yet, it is tax and spending announcements that usually resonate within the public. This sentiment is reinforced by current opinion polls that show that the deficit is not something that Ontarians are very fussed about. Part of this apathy reflects comfort in the fact that the government has a longer-term plan in place and is set on staying the course.

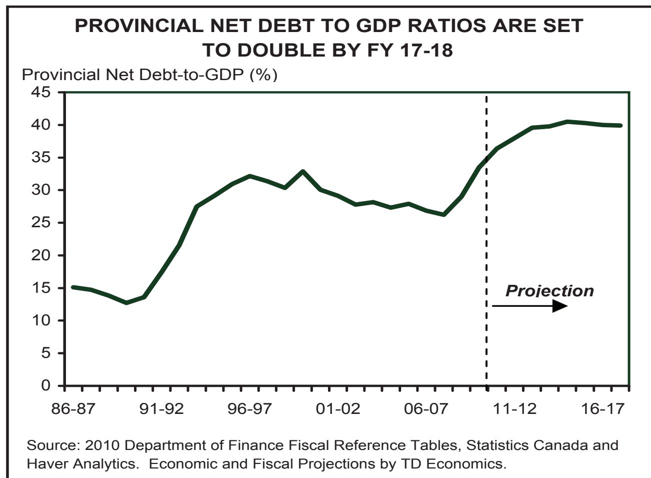


What is missed when individuals and government place lesser importance on deficit tallies and targets is the long-run implications associated with these burdens. There are inherent costs, trade-offs, and long-term risks of running significant budget shortfalls. In our view, there are four key considerations that voters and governments should take into account when assigning importance and preference towards a government move to quicken the pace of deficit reduction.

1) Debt burden rising sharply

So much attention has been placed on the province's budgetary position. This is understandable given the $88 billion cumulative deficit tally projected over the next seven years. However, the growing debt burden has gotten lost in the shuffle. It is this latter measure that acts as a constraint on future activities and choices.

In recent years, the government has ramped up its debt to cover its sizeable shortfalls. Admittedly though, a large share of the deficits incurred is attributed to



long-term infrastructure investments. These expenditures are argued by most to be long overdue given the estimated $100 billion infrastructure deficiencies and inadequacies within the province. However, an increased debt burden, not revenues, was used to pay for these infrastructure investments. As the chart above shows, net debt to-GDP ratio is set to double from FY 91-92 to FY 17-18. Going forward, reducing the magnitude and duration of the shortfalls would help to lessen the upward pressure on debt.

2) Interest costs crowding out public services

With the growing debt burden comes increasing costs to service the debt. As these costs grow faster than overall revenues, they crowd out the available funding for public services. For example, in FY 10-11, ten cents out of every dollar earned goes towards these interest payments. This leaves only ninety cents to pay for programs like health care and education.

Over the past few years, the degree of crowding out has been mitigated by extremely low interest rates. However, it is important to note that borrowing rates will not remain at these low levels forever. Higher rates on the horizon will feed through to increased debt servicing costs. In turn, under this scenario, fewer funds would be available for a whole slew of other government priorities as well as building age-related spending pressures.

Admittedly, Ontario's finances are partially protected from rising short-term interest rates. This is because the government's borrowing program is relatively concentrated to longer-term maturities. Still, this degree of protection helps only so much. About one-tenth of the current stock of debt is floating, and in turn, tied to changes in short-term rates. As well, each year, about $17 billion of the province's $240 billion in total debt obligations come up for maturity and must be rolled over at prevailing market interest rates. To the extent market rates are above the rate of the maturing bond, the overall cost of servicing the debt is boosted further.

3) Increasing vulnerability to negative surprises

In addition to the crowding out effect described in the previous section, sizeable deficits and debt burdens raise the vulnerability of public finances to any nasty surprises or economic setbacks. Even though the broad consensus among economists is that Ontario will enjoy a period of moderate and sustained expansion over the near-term, all would agree that the future is rife with risks. Examples of just some of the possible risks include: (1) high household indebtedness; (2) a sharp increase in interest rates; (3) a natural disaster; or (4) renewed global financial turbulence. Over the long-term, there is also significant debate about how an ageing population will impact provincial economic growth. Looking back, the province was well positioned financially to respond to the recent global financial slowdown. If another crisis were to happen tomorrow, the province's sizeable fiscal burdens would give it less room to maneuver.

Another risk that we did not mention in the paragraph above is the potential for a sudden shift in international investor sentiment. To recall, this is what took place in the early 1990s. During this time, the large and growing string of deficits at both the federal and provincial levels drove up borrowing requirements sharply. What resulted was an increasing reliance on foreign investors to fund the gap. As markets and investors grew concerned about ability to pay down these deficits, government credit ratings were downgraded. The lack of confidence from foreign investors

ONTARIO ECONOMIC PLANNING ASSUMPTIONS
Annual average percent change unless noted

	2010	2011	2012	2013	2014-17
Real GDP Growth					
2010 Fall Update	3.2	2.2	2.5	2.7	--
TD Economics	3.2	2.9	2.4	2.1	2.1
Nominal GDP Growth					
2010 Fall Update	5.6	4.1	4.5	4.6	--
TD Economics	5.3	5.2	4.2	4.1	4.1
Canadian Dollar (USD/CAD)					
2010 Fall Update	96.2	97.7	98.5	98.3	--
TD Economics	97.5	103.5	99.3	95.0	90.0
3-month Treasury Bill Rate* (%)					
2010 Fall Update	0.6	1.6	3.0	3.9	--
TD Economics	0.7	1.4	2.7	3.5	3.6
10-year Government Bond Rate* (%)					
2010 Fall Update	3.2	3.2	4.1	4.8	--
TD Economics	3.1	3.8	4.3	4.6	4.7

Note: * Government of Canada interest rates.
Source: Ontario Ministry of Finance; TD Economics.

led many to bail out, which resulted in even higher market interest rates. Put simply, the risk of holding Canadian public debt at that time required markets to demand an interest rate premium. Ultimately, severe cuts to programs and services and higher taxes were required to restore confidence to markets.

With a significant amount of worldwide government funding needs over the next few years, investors will soon demand additional premiums for taking on public debt. At present, there is little evidence that bond investors are getting nervous about Ontario's fiscal situation or that rating agencies are poised to downgrade the Province from its current long-term AA- rating. Still, the rising borrowing requirements and increasing reliance on foreign investors have raised the risk of a 1990s-style outcome. A change in investor sentiment at one end of country could also easily spill over into investor appetite for Ontario's debt. Paying down the deficit more quickly would better position the government to respond under such scenarios. So too would a collective effort across the country. Federal Finance Minister Flaherty has suggested FY 15-16 as a possible target for Canadian governments to return to budgetary balance.

4) Upside risk to medium-term spending plan

The province's deficit reduction timetable is currently based on an ambitious expenditure management plan that flat-lines total program spending on a real per capita basis. The province has recognized the challenge of such an undertaking and has taken several steps in the right direction. For example, recognizing the outsized costs of wages and compensation, the government has curtailed the size of the civil service. On this same front, it has frozen the salaries of Members of Provincial Parliament and the compensation structures of all non-bargained members of the broader public sector. Travel expense numbers have been cut and perks have been banned. Several crown agencies will be amalgamated or eliminated. The government also undertook a broad and extensive review last year to examine every dollar that is spent on program services.

While the above examples are a step in the right direction, they only make a dent in the cuts required. Across-the-board cuts to departmental funding alone will not work. Rather, structural reforms to key programs will be needed, especially regarding the provision of health care. In Ontario, multi-year program spending restraint of this magnitude took place for just three years under Premier Mike Harris' Common Sense Revolution. To rein in program costs, the government cut social assistance payments and added funding responsibilities for municipalities to name a few. An economic lift during that time also helped return the Province to budgetary balance.

If past efforts are any indication, the current government's seven year spending profile will be difficult to achieve. Hard choices will certainly be required especially in light of intensifying age-related cost pressures. The risk of higher than-anticipated expenditures heightens the concerns surrounding the province's ability to meet its deficit reduction targets over the next seven years. These concerns would only intensify if new tax relief or other items were added to the mix in the upcoming budget.

Bottom line

The 2011 budget will be the last before the election this fall. With this publication, the government could choose to go one of two ways. First, the budget could be a platform type of document with commitments. Under this scenario, the document would contain material and substance for the campaign trail. Another option would be a status-quo budget that does not include any new spending items, tax relief or cuts to municipal transfers. As we have argued in this report, a concerted and consistent effort on deficit reduction would bear fruit in terms of shielding the economy to risks and public services to the potential for even deeper cuts. Come March 29th, markets and Ontarians should hope to see this choice win out.

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