Ontario's Challenging Budget Math

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Highlights

- In the coming weeks, the PC government is expected to release its fall fiscal update. What is typically a staid affair will be anything but this time around, as the picture has changed significantly since the previous government's spring budget.
- The Independent Commission of Inquiry - set up by the PC government to investigate the state of Ontario's finances - pegs this fiscal year's deficit at $15 billion – more than double the originally reported shortfall.
- The government has committed to reducing the deficit. From a credibility perspective, the sooner the province gets its fiscal house in order, the better. However, based on several scenarios where we analyze Ontario's fiscal path under different revenue and expenditure growth assumptions, this will be a difficult task.
- Election promises exacerbate the fiscal challenge, as does the prospect of slower economic growth and rising interest rates.
- The upcoming fiscal update will provide a huge opportunity for the government to signal how it plans to slay the deficit monster. However, the path back to balance will be fraught with tough decisions.

In the coming weeks, Ontario's newly-minted PC government is expected to release its fiscal update. These fall updates are typically staid affairs with the emphasis on the evolution of the economy and the implications for the province's fiscal path. However, expectations for this particular update are ramped up. The fiscal picture has changed significantly since the previous government's spring budget. Indeed, the starting point for the deficit was pegged at $15 billion in this fiscal year by the Independent Commission of Inquiry, which was set up by the new government to investigate the state of Ontario's finances. This is more than double the previously-estimated $6.7 billion shortfall. The PC's have committed to reducing the province's sizeable deficit, although considerable uncertainty remains as to how, and at what speed, this will occur. In light of this uncertainty, the sooner the government provides some clarity, the better.

Based on our math, the government is facing an enormous fiscal challenge. In order to bring the deficit down over time, gains in revenue need to run faster than spending. Yet, revenues will likely be constrained by moderate economic growth and slower increases in federal transfers. At the same time, debt service costs on Ontario's relatively high debt load are slated to rise. And the final challenge comes from campaign promises – both on the tax and spending sides – that could run as high as $9 billion annually when fully implemented. In this note, we analyze the evolution of Ontario's fiscal path under different scenarios, each of which highlights the difficult task ahead of balancing the budget.

Weak starting point, though better than revealed in Commission's report

After their election win, the PC Ontario government established the Independent Financial Commission of Inquiry in order to assess the province's financial situation ahead of the release of the 2017-18 public accounts. They were also tasked with providing an opinion on Ontario's budgetary position in order to establish a baseline for future planning.

For this fiscal year, the Commission estimates Ontario's deficit to be $15 billion, significantly larger than the previously reported shortfall and a much tougher starting point from which to achieve balance. The difference between the two deficits can be partly chalked up to lower revenue expectations on the part of the Commission and a slightly larger reserve allowance. However, the majority of the gap comes on the expenses side of the ledger. In their report, the Commission accepts the Auditor General's proposed accounting treatment for certain jointly-sponsored pension assets and for global adjustment refinancing, which is a major component of the province's Fair Hydro Plan. This accounting shift adds about $5 billion to expenses. In addition, citing lack of evidence, the Commission reversed $1.4 billion in cost-cutting measures included by the previous government (Table 1).

Our analysis suggests that the government deficit will likely fall shy of this new mark, but still be larger than the earlier reported figure. For starters, the Commission set a relatively cautious bar for economic growth that is likely to be surpassed. Second, their estimates include the prior government's spending plans, some of which will not be pursued. For example, the PC government cancelled the Basic Income Pilot, scrapped funding for three new university campuses in the GTA, will cap social assistance spending and will reign in coverage under OHIP+. We assume these cuts will result in $2 billion of less spending this fiscal year. Moreover, the government will likely allow some pre-existing program spending to lapse. We assume an additional savings of $1 billion from this source.

On the other hand, tax cuts promised on the campaign trail could add to the deficit. For example, the pledge to cut gas taxes by 10 cents per litre will weigh on revenues. The PC platform also promised additional spending on several measures. However, judging how much of this spending will accrue this fiscal year is a difficult task. The government's decision to cancel the cap and trade program represents an increase in the deficit. Based on analysis done by the Financial Accountability Office, the lost revenue from abandoned auctions outweighs savings from cancelled spending related to the program. Also, the federal government is almost certain to introduce some tax relief measures in its upcoming update, notably full expensing. A matching at the provincial level would put upward pressure on the province's deficit, though its too early to tell by how much.

Lastly, we assumed that $1 billion will be set aside in reserve and that the Commission's recommendations regarding the treatment of pension assets and global adjustment refinancing will be adopted by the government. All told, our assumptions result in a deficit of $12.5 billion, or 1.4% of GDP, for this fiscal year.

Fiscal outlook under the "status quo"

In table 2, we show our 5-year "status-quo" outlook for

Table 1: Estimates of Ontario's Deficit for FY 2018-19
($, Billions)

	Prior Government	Commission	Difference
Revenues	152.5	150.9	-1.5
Expenses	158.5	164.9	6.4
Reserve	0.7	1.0	0.3
Deficit	**-6.7**	**-15.0**	**-8.3**

Source: Report of the Independent Financial Commission of Inquiry, Budget 2018
Note: Some components do not add to totals due to rounding

Ontario's finances that assumes the following:

- Own source revenue grows at nominal GDP as projected by TD Economics. We expect moderate but sustainable growth of 3.4% - 4.3% over the forecast horizon.
- Federal transfer payments slow significantly in the near-term as equalization payments go to zero next year. This is consistent with an analysis done by the Parliamentary Budget Office[1] as well as Ontario's 2018 budget, which noted that the province will soon stop receiving equalization payments
- Program spending is kept constant in real per capita terms. This is based on TD Economics' inflation forecast and population growth projections made by the Ministry of Finance.
- Debt service costs are driven off the level of debt and an assumption around the effective interest rate. The effective rate is likely to grind higher as interest rates rise, though the lengthy average term of Ontario's debt maturity helps to offset this impact. Still, elevated debt helps drive a significant increase in debt service costs
- No significant changes are made to planned infrastructure spending

Under these assumptions, the province's shortfall and the debt-to-GDP ratio continue to rise over the fiscal horizon. At this point, it should be noted that under our "status quo" scenario, we are not trying to predict the actual outcome of the deficit, since we assume no changes in policy in the coming years, which has a zero probabil-

Table 2: Ontario Government Fiscal Position - Status Quo Scenario

[C$ millions of dollars, unless otherwise noted]

	17-18	18-19F	19-20F	20-21F	21-22F	22-23F
Revenues	**150,600**	**149,700**	**154,700**	**160,300**	**165,800**	**171,600**
% change	n/a	-0.6	3.3	3.6	3.4	3.5
% of GDP	18.1	17.3	17.2	17.2	17.2	17.2
Own-Source	125,700	124,400	129,700	134,200	138,800	143,600
% change	n/a	-1.0	4.3	3.5	3.5	3.4
% of GDP	15.1	14.4	14.4	14.4	14.4	14.4
Transfers	24,900	25,300	25,000	26,100	27,000	28,000
% change	n/a	1.6	-1.2	4.4	3.4	3.7
% of GDP	3.0	2.9	2.8	2.8	2.8	2.8
Expenditures	**154,300**	**161,200**	**168,200**	**175,000**	**181,300**	**187,800**
% change	n/a	4.5	4.3	4.0	3.6	3.6
% of GDP	18.6	18.7	18.7	18.8	18.8	18.8
Programs	142,400	148,700	154,200	159,600	164,800	170,000
% change	n/a	4.4	3.7	3.5	3.3	3.2
% of GDP	17.1	17.2	17.1	17.1	17.1	17.0
Debt charges	11,900	12,500	14,000	15,400	16,500	17,800
Balance	**-3,700**	**-11,500**	**-13,500**	**-14,700**	**-15,500**	**-16,200**
% of GDP	-0.4	-1.3	-1.5	-1.6	-1.6	-1.6
Reserve	0	1,000	1,000	1,000	1,000	1,000
Budget Balance	**-3,700**	**-12,500**	**-14,500**	**-15,700**	**-16,500**	**-17,200**
% of GDP	-0.4	-1.4	-1.6	-1.7	-1.7	-1.7
Acc. Deficit	209,000	221,500	236,000	251,700	268,200	285,400
% of GDP	25.2	25.6	26.2	27.0	27.8	28.6
Net Debt	323,800	348,850	374,370	400,880	427,650	454,270
% of GDP	39.0	40.4	41.6	43.0	44.3	45.5

Source: Ontario Ministry of Finance; post 2017-18 forecasts made by TD Economics.

ity of coming to pass. However, what this exercise does show is the sizeable challenge faced by the government.

Election promises exacerbate fiscal challenge

This becomes particularly apparent when one considers other policy developments, mainly the cost of pledged campaign commitments. Table 3 overlays these commitments on our status quo scenario, resulting in larger deficits each year. Particularly impactful are pledged cuts to corporate and personal income taxes, which cost $3.6 billion annually by year 3 of the government's mandate. Additionally, the cut in the gas tax shaves $1.2 billion off revenues each year. The cancelled cap and trade program also adds to the deficit over the fiscal horizon. On the other hand, the minimum wage will be frozen at $14/hr, instead of rising another 7% in January 2019. Businesses will likely see some savings from this policy, which could support employment and yield higher tax revenues than assumed.

In this scenario, the deficit rises even faster, as revenues are lower and expenses are higher than in the status quo. Net debt moves towards 49% of GDP by FY 2022-23. This would keep Ontario with one of the highest debt burden amongst the provinces. Debt charges would also be about $7 billion higher than in FY 2017-18 and absorb 11 cents of each revenue dollar. Worse still, this projection

Table 3: Ontario Government Fiscal Position - Campaign Pledges Imbedded

[C$ millions of dollars, unless otherwise noted]

	17-18	18-19F	19-20F	20-21F	21-22F	22-23F
Revenues	**150,600**	**149,700**	**150,700**	**154,400**	**157,700**	**163,500**
% change	n/a	-0.6	0.7	2.5	2.1	3.7
% of GDP	18.1	17.3	16.7	16.6	16.4	16.4
Own-Source	125,700	124,400	125,700	128,300	130,700	135,500
% change	n/a	-1.0	1.0	2.1	1.9	3.7
% of GDP	15.1	14.4	14.0	13.8	13.6	13.6
Transfers	24,900	25,300	25,000	26,100	27,000	28,000
% change	n/a	1.6	-1.2	4.4	3.4	3.7
% of GDP	3.0	2.9	2.8	2.8	2.8	2.8
Expenditures	**154,300**	**161,200**	**168,400**	**175,600**	**182,100**	**189,100**
% change	n/a	4.5	4.5	4.3	3.7	3.8
% of GDP	18.6	18.7	18.7	18.8	18.9	19.0
Programs	142,400	148,700	154,400	160,000	165,200	170,400
% change	n/a	4.4	3.8	3.6	3.3	3.1
% of GDP	17.1	17.2	17.1	17.2	17.1	17.1
Debt charges	11,900	12,500	14,000	15,600	16,900	18,700
Balance	**-3,700**	**-11,500**	**-17,700**	**-21,200**	**-24,400**	**-25,600**
% of GDP	-0.4	-1.3	-2.0	-2.3	-2.5	-2.6
Reserve	0	1,000	1,000	1,000	1,000	1,000
Budget Balance	**-3,700**	**-12,500**	**-18,700**	**-22,200**	**-25,400**	**-26,600**
% of GDP	-0.4	-1.4	-2.1	-2.4	-2.6	-2.7
Acc. Deficit	209,000	221,500	240,200	262,400	287,800	314,400
% of GDP	25.2	25.6	26.7	28.1	29.8	31.5
Net Debt	323,800	348,850	378,570	411,580	447,250	483,270
% of GDP	39.0	40.4	42.0	44.1	46.4	48.4

Source: Ontario Ministry of Finance; post 2017-18 forecasts made by TD Economics.

assumes continued expansion. If the economy were to fall into recession, the government would have little room to respond, not to mention a significantly higher debt burden than shown in table 3.

Budget math will require tough decisions

This budget math is clearly not sustainable. It would impose growing financial risks to Ontario and saddle future generations with excessive debt. A way out of this fiscal box is through offsetting revenue-raising initiatives and spending reductions relative to our status-quo profile. Yet, the government has indicated that it has no appetite for tax increases. Instead, it is placing the emphasis on finding efficiencies, commenting during the campaign that some $6 billion in savings could be found. With the recent release of the line-by-line audit of the province's finances, the government has shown that the wheels are in motion on this front.

Table 4 suggests a profile of expenditure growth that would be required to eliminate the deficit by year 4 of the government's mandate. As the table indicates, if the government plans on following through with their campaign pledges, program spending would have to be significantly weaker in order to balance the books. In fact, nominal spending would have to be essentially flat, at least, for 4 years. One would have to go all the way back to the mid-90s to find restraint of a similar magnitude. And, while the line-by-line audit had some good ideas on how to generate savings, reducing spending so drastically will be no easy feat. Program spending per capita

Table 4: Ontario Government Fiscal Position - Program Spending Growth Restrained

[C$ millions of dollars, unless otherwise noted]

	17-18	18-19F	19-20F	20-21F	21-22F	22-23F
Revenues	**150,600**	**149,700**	**150,700**	**154,400**	**157,700**	**163,500**
% change	n/a	-0.6	0.7	2.5	2.1	3.7
% of GDP	18.1	17.3	16.7	16.6	16.4	16.4
Own-Source	125,700	124,400	125,700	128,300	130,700	135,500
% change	n/a	-1.0	1.0	2.1	1.9	3.7
% of GDP	15.1	14.4	14.0	13.8	13.6	13.6
Transfers	24,900	25,300	25,000	26,100	27,000	28,000
% change	n/a	1.6	-1.2	4.4	3.4	3.7
% of GDP	3.0	2.9	2.8	2.8	2.8	2.8
Expenditures	**154,300**	**161,200**	**161,200**	**161,700**	**162,500**	**163,500**
% change	n/a	4.5	0.0	0.3	0.5	0.6
% of GDP	18.6	18.7	17.9	17.3	16.8	16.4
Programs	142,400	148,700	147,200	146,500	146,500	146,500
% change	n/a	4.4	-1.0	-0.5	0.0	0.0
% of GDP	17.1	17.2	16.3	15.7	15.2	14.7
Debt charges	11,900	12,500	14,000	15,200	16,000	17,000
Balance	**-3,700**	**-11,500**	**-10,500**	**-7,300**	**-4,800**	**0**
% of GDP	-0.4	-1.3	-1.2	-0.8	-0.5	0.0
Reserve	0	1,000	1,000	1,000	1,000	1,000
Budget Balance	**-3,700**	**-12,500**	**-11,500**	**-8,300**	**-5,800**	**-1,000**
% of GDP	0	-1.4	-1.3	-0.9	-0.6	-0.1
Acc. Deficit	209,000	221,500	233,000	241,300	247,100	248,100
% of GDP	25.2	25.6	25.9	25.9	25.6	24.9
Net Debt	323,800	348,850	371,370	390,480	406,550	416,970
% of GDP	39.0	40.4	41.2	41.9	42.2	41.8

Source: Ontario Ministry of Finance; post 2017-18 forecasts made by TD Economics.

is already amongst the lowest in Canada, suggesting little room to cut.

Outside of significant spending cuts, another option the government could choose would be to delay promised tax relief. However, even delaying these cuts and allowing the realization of efficiencies would still likely not be enough to balance the budget by year 4, especially if the government maintains their other campaign commitments.

Bottom line

The upcoming fiscal update will provide a huge opportunity for the government to signal how it plans to slay the deficit monster. From a credibility perspective, the sooner the government gets its fiscal house in order, the better. Unfortunately, rising interest rates and the prospect of slower economic growth makes the job more difficult.

As we have shown, tough decisions will be required. If the government plans to honour its campaign promises, program spending will have to be pared significantly. In turn, the impact of this needs to be dynamically included in economic growth forecasts. Importantly, revenue assumptions used in this analysis assume reasonably healthy economic growth. Should the economy take a turn for the worse, the government's job becomes exponentially harder. All told, the path to balance will be fraught with hard decisions.

Endnotes

1. Parliamentary Budget Officer: Federal Financial Support to Provinces and Territories: A Long-term Scenario Analysis, March 20, 2018