

Mary Webb (416) 866-4202  
[mary\\_webb@scotiacapital.com](mailto:mary_webb@scotiacapital.com)

Nathan Joshua (416) 866-5338  
[nathan\\_joshua@scotiacapital.com](mailto:nathan_joshua@scotiacapital.com)

# Fiscal Pulse

## Ontario's 2011-12 Mid-Year Update

### ... Preparing for Slower Growth

After substantially beating its deficit targets since the March 2010 *Budget*, current uncertainty and a softer economic outlook complicate a similar outperformance for Ontario in FY12 and are expected to make the path to balanced books by FY18 more difficult. To stay on track, the government commits to prioritizing economic and jobs growth and financing new or unforeseen spending from savings in other areas, as it reforms its services to curtail program spending growth. The Province is fortunate in having largely replenished its health, education and social services before the economic downturn; it has already regained roughly all the output and jobs lost during the recession; and, Ontario embarked on FY12 with much improved FY11 final results.

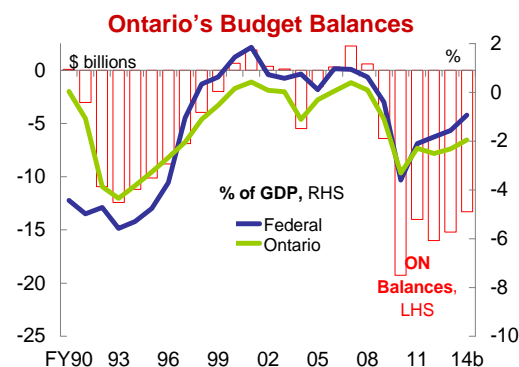
**Similar to other jurisdictions, Ontario is lowering its economic growth assumptions.** Annual real GDP growth of 1.8% is now built in for 2011 and 2012, down from the average of 2.6% used in the March *Budget*, followed by advances of 2.5% and 2.6% in 2013 and 2014 (*table p.2*). Nevertheless, the projected deficit for fiscal 2011-12 (FY12) remains unchanged at the Q1 level of \$16.0 billion, and the shortfalls thereafter match the March 2011 *Budget* estimates, with budget gaps of \$15.2 billion and \$13.3 billion forecast for FY13 and FY14 (*graph below*).

**Revenues from FY12 through FY14 are revised down a cumulative \$2.1 billion**, lowering average annual growth to 2.9% from the March *Budget* estimate of 3.1% (*table, p.3*). Reflecting the slower growth forecast, tax receipts over the three years are trimmed a cumulative \$1.8 billion, and due to an adjusted federal calculation, Equalization payments are cut by a cumulative \$0.7 billion. Net revenues received from government business enterprises are forecast to rise by an average 4.4% annually from FY12 to FY14, boosted by the government's 2011 *Budget* request to deliver an additional \$200 million in efficiencies.

**After revenues surged 11.3% in FY11**, the FY12 gain is trimmed to 1.5%, with revenues revised \$778 million lower since Q1. Ontario's own-source receipts in FY12 are now forecast to rise 3.7%, but federal transfers drop 6.4% with the completion of Ottawa's stimulus measures and the Equalization recalculation. Provincial tax receipts in FY12, estimated in Q1 to be slightly above *Budget*, are now expected to drop \$650 million below *Budget*, driven by decreases in personal income and corporate taxes of \$721 million and \$129 million that are only partially offset by a \$125 million gain in the Land Transfer Tax due to the recent strength in Ontario's housing market. Net income from government business enterprises is forecast to weaken in FY12 as income from the Ontario Lottery and Gaming Corporation falls 11% with the First Nations' receiving 1.7% of gross gaming receipts as of 2011. Trimming the net revenue loss since the March *Budget* to \$443 million is the \$468 million Chrysler loan repayment, reported in Q1.

**Relative to *Budget*, the projected savings on interest charges** for FY12 are \$0.2 billion less than the anticipated in-year revenue decline, but for FY13 and FY14, the reduction in the debt service matches the drop in receipts. The effective interest rate on total debt is estimated to average 4.4%, down from a 9.8% average in FY95.

**Program spending growth in FY12** is now expected to rise 2.5%, with outlays \$72 million less than *Budget*. The operating contingency fund is being drawn down to cover the \$175 million expense of emergency forest firefighting and a \$52 million advance on the construction of the Pan/Parapan American Games athletes' village. Program outlays are raised by \$300 million in FY13 and again in FY14, resulting in forecast growth of 0.8% and 1.8%, respectively. The Province's expenditures on infrastructure are virtually unchanged from *Budget*.



Source: Ontario Finance; Nominal GDP forecast: Scotia Economics.

**The Province references the considerable economic stimulus already in place**, including two further scheduled reductions to the general corporate income tax rate from 11.5% as of July 2011 to 10% by July 2013. The government has indicated that it will continue to pursue innovative policy changes when appropriate, offsetting any additional costs with savings from other areas. It proposes a *Healthy Homes Renovation Tax Credit* of up to \$1,500 annually for Seniors to assist with renovations that allow them to remain in their homes, thereby easing some of the demand pressure on long-term care facilities. For FY12, the \$60 million cost of this refundable *Credit* will be offset by lower-than-expected spending on business support programs and tax-related expenditures.

**A 30% rebate on college and university tuition** also is planned for families with incomes less than \$160,000. With respect to the federal Scientific Research and Experimental Development (SR&ED) tax incentive program, Ontario asks Ottawa to consult with the Provinces on any changes to this program or federal R&D expenditures. To strengthen its financial management and transparency, Ontario will adopt the Public Sector Accounting Board standard for tax revenues and begin to treat transfers through the tax system as expenses.

**To help maintain the FY12 deficit at \$16.0 billion**, the reserve in the *Budget* estimates is trimmed from \$700 million to \$200 million, the Operating Contingency Fund falls from \$600 million to \$360 million and the \$100 million Capital Contingency Fund is reduced by two-thirds. These reserves are indeed set aside for "rainy days", but paring them back from the budgeted \$1.4 billion total to \$592 million limits the final bottom line improvement possible if these reserves had remained largely untouched. With respect to prudence, Ontario, as customary, assumes in its *Budget* estimates real GDP growth below the private-sector forecast average, shaving 0.2 percentage points from the 2011 estimate and 0.1 percentage points each year from 2012 to 2014. Also for FY13 and FY14, the \$1.0 billion reserve specified in the March *Budget* remains intact.

**Ontario plans to trim its long-term public borrowing program** for FY13 by \$1.4 billion to \$37.2 billion and for FY14 by \$2.2 billion to \$40 billion, smoothing its financing requirements after \$35 billion in FY12 and potentially taking advantage of current historically low longer-term interest rates. Given higher cash reserves entering FY12 from the substantially narrower-than-expected FY11 deficit, the Province plans to buy back \$3.2 billion of debt maturing in FY13 and FY14 over the remainder of FY12 if such debt is available at a 'fair' price and the accounting treatment is appropriate. If it is not cost effective to buy back this debt, higher cash reserves at the end of FY12 will still have the same impact in reducing Ontario's net debt. This plan contains considerable flexibility, with the timing of the buybacks subject to adjustment with financial market changes, the government's borrowing position relative to plan and the government's assessment of fair value.

**Ontario's FY12 long-term public borrowing as of November 15 was \$24.3 billion**, about 70% of the \$35 billion FY12 requirement. To reduce refinancing risk and the possible expense of rising interest rates down the road, Ontario continues to extend the term to maturity of its debt, with an average term of 11.6 years for FY12 to mid-November, 12.8 years for FY11 and 8.1 years for FY10. The net interest rate resetting exposure has fallen from 15.6% as of March 2008 to 5.8% as of September, 2011. Of the FY12 debt issued to mid-November, \$18.2 billion (almost 75%) has been done in the Canadian market. For all of FY12, the domestic share is expected to remain over 70%, well above the 60% *Budget* target.

**Economic and Interest Rate Assumptions**  
annual % change except where noted

	2011f	2012f	2013-14f
<b>Ontario: Real GDP</b>			
Mar. 2011 <i>Budget</i>	2.4	2.7	2.7
Nov. 2011 <i>Update</i>	1.8	1.8	2.6
Scotia Economics Nov.3	2.0	1.5	n.a.
<b>Nominal GDP</b>			
Mar. 2011 <i>Budget</i>	4.6	5.1	4.7
Nov. 2011 <i>Update</i>	4.0	3.7	4.5
Scotia Economics Nov.3	4.3	2.5	n.a.
<b>Employment</b>			
Mar. 2011 <i>Budget</i>	1.7	1.8	1.8
Nov. 2011 <i>Update</i>	1.8	1.1	1.5
Scotia Economics Nov.3	1.8	0.8	n.a.
<b>T-Bills, 3-month, %</b>			
Mar. 2011 <i>Budget</i>	1.4	2.6	4.0
Nov. 2011 <i>Update</i>	0.9	1.1	2.4
Scotia Economics Nov.3	0.9	1.0	n.a.
<b>Bonds, 10-year, %</b>			
Mar. 2011 <i>Budget</i>	3.5	4.1	4.8
Nov. 2011 <i>Update</i>	2.8	2.5	3.7
Scotia Economics Nov.3	2.8	2.5	n.a.
<b>Canadian Dollar, US cents</b>			
Mar. 2011 <i>Budget</i>	100.0	99.7	98.7
Nov. 2011 <i>Update</i>	101.1	100.1	101.4
Scotia Economics Nov.3	101	101	n.a.
<b>WTI Oil, US\$/barrel</b>			
Mar. 2011 <i>Budget</i>	99.7	102.2	100.4
Nov. 2011 <i>Update</i>	93.6	89.7	89.4
Scotia Economics Nov.3	92	92	n.a.
<b>United States - Real GDP</b>			
Mar. 2011 <i>Budget</i>	3.1	3.3	3.2
Nov. 2011 <i>Update</i>	1.8	2.1	2.9
Scotia Economics Nov.3	1.8	1.7	n.a.

Source: Ontario Finance and Scotia Economics.

**Net debt, as measured by the Province,** is forecast to rise by almost \$24 billion during FY12, slightly less than the *Budget* increase. At a forecast \$238.4 billion as of March 2012, or 37.3% of GDP, it compares with the low of 26.8% of GDP in March 2008 and the government's projected 41.3% peak in FY15.

**The government outlines several critical issues for Ontario in the upcoming federal/provincial transfer negotiations.** For health care, it is proposing a new ten-year agreement to follow the current *Health Accord* expiring in March 2014. December 2012 is proposed as the target for completing the health discussions. In the new health agreement, Ontario would add seniors' care and home care. The Province assumes that the current 6% annual increases for the Canada Health Transfer will extend through the new agreement, whereas the federal Finance Minister has indicated their extension only to FY16, with subsequent annual hikes subject to negotiation. Ontario's other concerns include the regional bias in the Employment Insurance program and the current Equalization structure.

**A risk to Ontario's updated outlook** is that events may push harder on the updated estimates than recent consensus forecasts indicate. A lower GDP deflator in 2012, for example, could weaken Ontario's nominal GDP growth to the 3% range, while delays in U.S. federal fiscal repair could limit the 2013 rebound in Ontario's projected real GDP growth. To stay on track for balanced books by FY18 and thereafter maintain balanced budgets despite demographic pressures, the government acknowledges the need to fundamentally reform its service delivery. The government's Commission on the Reform of Ontario's Public Services (the Drummond Commission) is expected to recommend 1% annual spending growth from FY13 to FY18, and the government will consider this and other advice as it develops its 2012 *Budget*.

**Instructive, therefore, are the guiding principles proposed by the Premier for the spending restraint.** The reforms should not impair service quality in education or health care and investments in infrastructure will continue. Since spending cuts typically create pressure for catch-up funding, "across-the-board" cuts will be avoided and instead, spending will be strategically restructured. The spending reforms should result in better value per dollar spent and should not undermine the government's priority of economic growth and job creation. Once again, the government has committed that taxes will not be raised, and privatization of essential health care services will be avoided. The final report of the Drummond Commission, scheduled for early in 2012, is expected to provide recommendations for restructuring ahead of the government presenting specific reforms in the March 2012 *Budget*.

### Ontario's Budget Arithmetic

\$ billions except where noted

	FY11	FY12	
	Final	Budget	Q2
Tax Revenue	71.1	75.3	74.6
Gov't Business Ent. Income	4.6	4.5	4.5
Other Non-Tax Revenue	7.9	7.2	7.6
<b>Total Own-Source Rev.</b>	<b>83.6</b>	<b>87.0</b>	<b>86.7</b>
Federal Transfers	23.0	21.7	21.6
of which Equalization	1.0	2.4	2.2
<b>Total Revenue</b>	<b>106.7</b>	<b>108.7</b>	<b>108.3</b>
<b>Total Program Spending</b>	<b>111.2</b>	<b>114.0</b>	<b>114.0</b>
Debt Service	9.5	10.3	10.1
<b>Total Expenditure</b>	<b>120.7</b>	<b>124.3</b>	<b>124.1</b>
Reserve	0.0	0.7	0.2
<b>Surplus (Deficit)</b>	<b>-14.0</b>	<b>-16.3</b>	<b>-16.0</b>
<b>Annual Change, %</b>			
Tax Revenue	9.6	5.8	4.9
<b>Total Own-Source Rev.</b>	<b>8.4</b>	<b>4.0</b>	<b>3.7</b>
Federal Transfers	23.7	-5.7	-6.4
<b>Total Revenue</b>	<b>11.3</b>	<b>1.9</b>	<b>1.5</b>
Program Spending	4.6	2.6	2.5
<b>Total Expenditure</b>	<b>4.9</b>	<b>3.0</b>	<b>2.8</b>
<b>Memo Items, %</b>			
Own-Source Rev. / GDP	13.7	13.6	13.6
Program Spending / GDP	18.2	17.8	17.8
Budget Balance / GDP	-2.3	-2.6	-2.5
Debt Service / Revenue	8.9	9.5	9.3

\* Data have been restated for reclassification of government agencies. Source: Ontario Finance; Nominal GDP forecast: Scotia Economics.

### Scotia Economics

Scotia Plaza 40 King Street West, 63rd Floor  
Toronto, Ontario Canada M5H 1H1  
Tel: (416) 866-6253 Fax: (416) 866-2829  
Email: [scotia\\_economics@scotiacapital.com](mailto:scotia_economics@scotiacapital.com)

This report has been prepared by Scotia Economics as a resource for the clients of Scotiabank and Scotia Capital. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank Group nor its affiliates accepts any liability whatsoever for any loss arising from any use of this report or its contents.