Global Economic Research

February 15, 2012

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Fiscal Pulse

The Commission On The Reform Of Ontario's Public Services

— A Downsizing Framework for Ontario

The breadth and depth of the Commission's recommendations for stepped-up fiscal repair in Ontario offer a solid starting point for the Province to develop a credible, multi-year, expenditure restraint strategy, reflecting the government's priorities. The outline of such a strategy plus near-term restraint measures potentially await Ontario's upcoming spring *Budget.*

The Conference Board's recent report and now the Commission's forecasts indicate that balancing Ontario's books by fiscal 2017-18 (FY18) will require reining in annual program spending growth to less than 1.0% through FY18, compared with the *Budget* projection of 1.4% increases. The Commission acknowledges the substantial, and often wrenching, service changes it is advocating. Nevertheless, it sees the current fiscal squeeze as an opportunity spurring Ontario to become a more efficient and effective service provider, through FY18 and thereafter, hence the report's subtitle — "A Path to Sustainability and Excellence".

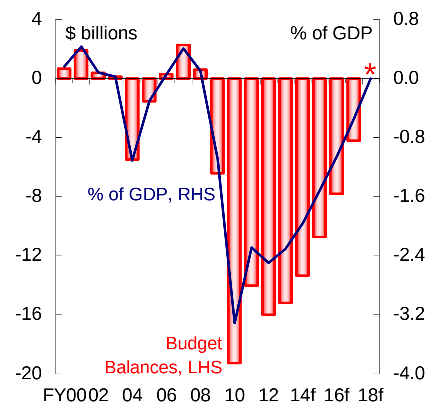
Overview

The unequivocal recommendation of the Commission, chaired by Don Drummond, is a comprehensive restructuring of Ontario's government to provide quality services at an affordable cost going forward. Ontario's immediate imperative, as underlined by the rating agencies, is to stay on the path outlined by the government for deficit elimination by FY18 (*bottom chart*). The Commission's mandate also encompassed ensuring black ink after FY18 to address Ontario's elevated debt burden as the growth of its workforce slows and its Seniors cohort expands. The challenge, therefore, is achieving strategic reforms that do not give way to catch-up spending.

Relying on provincial growth for substantive deficit reduction is considered unrealistic by the Commission, given Ontario's ongoing industrial adjustments, accelerated by the recession, and the softening in mid-term global growth prospects since Ontario's *2011 Budget* last March*.* For its two scenarios, the Commission uses the government's Fall update assumption of Ontario's annual real GDP growth averaging 2.2% from 2011 to 2014. For 2015 to 2018, cautious about slower labour force growth and modest productivity gains, annual real growth of just 2.0% is projected. For nominal GDP, annual gains are assumed to average 4.2% to 2014 and 3.9% for the following four years. For Ontario's total revenues, this translates from FY11 to FY18 to annual increases averaging 3.2% in the Commission's Status Quo scenario and 3.4% in its Preferred scenario, relative to the 4.3% pace projected in Ontario's *2011 Budget.*

The Commission credits the Ontario government with slowing annual program spending growth to a trend of 3.5%, from an annual 7.6% pace over the decade to FY11. Yet this growth significantly exceeds the government's *2011 Budget* plan that assumes program spending growth will be held to 1.4% annually from FY11 to FY18 *(table, p.2)* The Commission's Status Quo scenario, using the 3.5% program spending trajectory through FY18 with no government policy changes, results in a $30.2 billion deficit by FY18, given annual increases of 11.0% for the debt service and 4.2% for total spending. Net debt under this scenario is forecast to climb to just over half of provincial GDP by March 2018 from 35.0% in March 2011, sharply higher than the 39.7% *Budget* estimate *(chart, p.2).*

Ontario's Balanced Budget Plan



*FY18: balanced books.
Source: Ontario Finance.

The Commission's Preferred scenario, to balance Ontario's books by FY18 without new or increased taxes, relies on curtailing annual growth in total spending to 1.4%, with increases of 0.8% for program spending and 7.1% for the debt service. Net debt under this scenario is expected to be only 37.0% of GDP by March 2018.

The Preferred scenario's stepped-up spending restraint, however, implies very substantial service changes. It would scale back annual increases through FY18 to 2.5% for Health, 1.0% for Education, 1.5% for Post-secondary Education (excluding training), 0.5% for Social Services and -2.4% for all other programs *(chart, p.3)*. In absolute dollar terms, total program spending from FY11 to FY18 would rise by only $6.3 billion, with increases of $8.4 billion for Health, $1.6 billion for Education, $0.7 billion for Post-secondary Education, and $0.5 billion for Social Services, but outlays for all other programs would be $4.0 billion lower. In this residual category, for everything other than fixed items, spending would drop 27%. On a real per capita basis, the Preferred scenario implies 2.5% annual declines in program spending, considerable restraint on top of the real per capita federal program expenditure declines anticipated in the upcoming federal *Budget*. The Commission dismisses the option of eliminating Ontario's deficit earlier than FY18 as neither practical nor desirable.

Sizeable upside revenue surprises are considered unlikely by the Commission through FY18. Policy decisions already taken, such as the reduction of the general corporate income tax rate to 10% by mid-2013 and the phasing in of full Input Tax Credits under the Harmonized Sales Tax for larger corporations after mid-decade, result in an annual revenue decrease by FY18 larger than $4 billion.

A range of non-tax revenue-raising measures are proposed to raise almost $2 billion by FY18. Suggested revenue integrity measures include limiting aggressive interprovincial and international tax avoidance and restraining the underground economy. Also proposed is regularly reviewing fees with respect to indexation and full cost recovery. Included in this additional revenue are suggestions for boosting government business enterprise income, reported at $4.6 billion in FY11, by $0.5 billion by FY16. For example, the Commission suggests that the Liquor Control Board use its purchasing power to improve its mark-ups. As well, the Commission suggests that the Ontario Lottery and Gaming Corporation close one of its two head offices in Toronto or Sault Ste Marie and one of its two casinos in Niagara Falls and end its subsidization of lottery terminal purchases and provision to point-of-sale locations. Fully or partially divesting of one or all of Ontario's government business enterprises is not recommended unless the long-term benefit to Ontario is considerable.

The Commission's underlying assumptions may prove somewhat conservative, but the cumulative consequences of a slightly weaker economic expansion over time can be significant. For example, annual growth slipping from 2.4% to 2.0% trims a four-year output gain from 10.0% to 8.2%. In addition, in the Commission's scenarios, the Province's static $0.7 billion contingency reserve in the first year and $1.0 billion annually thereafter is replaced with a dynamic reserve that assumes growth was overestimated by 0.2% annually, raising the contingency reserve to $1.9 billion by FY18. A recent Conference

Budget Scenarios for Ontario

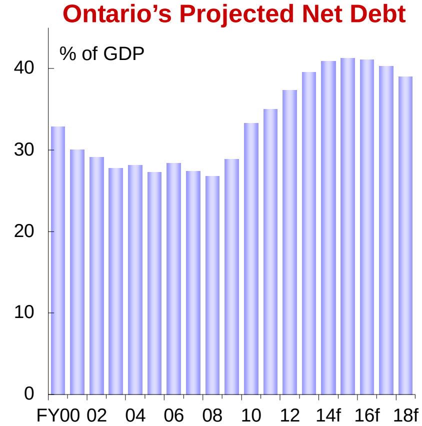
2011 Budget	FY11-FY18f		FY11-FY18f real ($2010) per capita	
Ontario	Total % ch.	Ann.% ch.	Total % ch.	Ann.% ch.
Revenue	**33.9**	**4.3**	**6.2**	**0.9**
Program Spending	10.2	1.4	-12.6	-1.9
Debt service	70.7	7.9	35.4	4.4
Total Expense	**14.9**	**2.0**	**-8.8**	**-1.3**
	FY11	**FY18f**	**FY11**	**FY18f**
Budget Balance, $bn	-16.7	0.0	–	–
Net Debt, $bn	217.3	322.5	–	–
Net Debt / GDP, %	35.5	39.7	–	–

Status Quo	FY11-FY18f		FY11-FY18f real ($2010) per capita	
Ontario	Total % ch.	Ann.% ch.	Total % ch.	Ann.% ch.
Revenue	**24.5**	**3.2**	**-1.3**	**-0.2**
Program Spending	27.2	3.5	0.9	0.1
Interest on Debt	107.5	11.0	64.6	7.4
Total Expense	**33.5**	**4.2**	**5.9**	**0.8**
	FY11	**FY18f**	**FY11**	**FY18f**
Budget Balance, $bn	-14.0	-30.2	–	–
Net Debt, $bn	214.5	411.4	–	–
Net Debt / GDP, %	35.0	50.7	–	–

Preferred Scenario	FY11-FY18f		FY11-FY18f real ($2010) per capita	
Ontario	Total % ch.	Ann.% ch.	Total % ch.	Ann.% ch.
Revenue	**26.3**	**3.4**	**0.2**	**0.0**
Program Spending	5.6	0.8	-16.2	-2.5
Interest on Debt	61.8	7.1	28.4	3.6
Total Expense	**10.0**	**1.4**	**-12.7**	**-1.9**
	FY11	**FY18f**	**FY11**	**FY18f**
Budget Balance, $bn	-14.0	0.0	–	–
Net Debt, $bn	214.5	300.1	–	–
Net Debt / GDP, %	35.0	37.0	–	–

Source: Commission on the Reform of Ontario's Public Services, February 15, 2012.

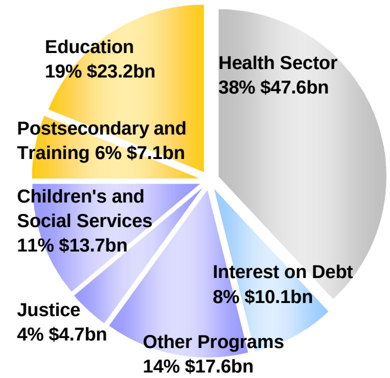
Ontario's Projected Net Debt



Source: Ontario Finance.

Board report looking out to FY31 for Ontario arrived at a broadly similar conclusion to the Commission — that Ontario's current program spending path appears unsustainable, with annual increases of less than 1.0% required to achieve balanced books by FY18.

Ontario's Expenditure Mix, FY12



Source: Ontario Finance.

Principles Governing the Commission's Recommendations

The principles guiding the Commission's recommendations provide an important framework. Strategic restructuring that will not be unwound as the deficit diminishes cannot rely upon short-term "fixes", across-the-board spending reductions or major downsizing without a strategic plan. Instead of setting specific civil service reductions, the size of Ontario's eventual civil service should be determined by the government's priorities as its value-for-money adjustments are implemented. Programs should emphasize investing in the future rather than serving the status quo and policy development should be evidence-based, an occasionally contentious condition for some social service areas. Boundaries between public- and private-sector activities should be reduced. Collaboration between the sectors is valuable and the Commission recommends that the Province privatize assets and shift to private service delivery when it is feasible and there is little benefit from the service remaining in the public domain.

The Commission recommends making the program spending reforms quick, given the deficit imperative, and broad-based, so that all sectors and groups bear some of the burden of the required fiscal repair. According to Drummond, critical to the success of a comprehensive restraint program, once it is determined by the government, is a formal document laying out the goal and the road map to the goal, both to inform the public and to communicate to all government entities how they will fit into the multi-year reform process. The Commission correctly maintains that the alternative — piecemeal measures over an extended period — has proven in the past to be painful and less effective, and it will not sufficiently address Ontario's current fiscal challenge. During the restructuring process, the hope is for common themes to emerge across the multiple expenditure reforms, facilitating communication and economies of scale.

The need to set clear objectives, metrics and accountability underlines the Commission's caution to ensure beforehand that adequate internal resources and processes are in place to plan and implement the reforms. Ideally, each government entity will have some flexibility in conducting its reforms, but the Premier's Office and the Cabinet Office should be fully involved, and represented, along with Finance, on an overall Steering Committee.

As in the UK government's reforms, this Commission highlights the critical role of the civil service and its leadership, urging the enhancement of appropriate incentives, with compensation more closely tied to outcomes and productivity. That said, for employees across Ontario's broader public sector, the Commission endorses zero net compensation increases, with any salary or benefit improvement fully offset by additional productivity gains. Upcoming contract negotiations with the doctors are expected to set an example of the government's shift to a stiffer stance.

Health

For health care, the scale of the proposed reforms is vast, albeit within the *Canada Health Act* and our large single-payer public model. The Commission's Preferred scenario halves the 4.9% annual increases in its Status Quo scenario through FY18, delivering real per capita spending declines averaging 0.8% annually. The changes sought include a shift towards health promotion from the current norm of "after-the-problem" treatment, a system centred not on hospitals but on patients across a broad continuum of care and new approaches to dealing with the minority of patients requiring intensive care.

The regional integration of all health services will be centred on Ontario's 14 Local Health Integration Networks (LHINs) reconstituted for their new role. This will likely be a contentious proposal for some stakeholders and regions given resulting expansion of the LHINs' role in allocating budgets, holding stakeholders accountable and setting incentive systems. For hospitals, presently paid on the basis of average costs across the province, a new compensation framework that incents efficiency is proposed. To guide the reforms, Drummond urges the creation of a health commission, as well as the development of a 20-year health plan.

Among the Commission's many pragmatic suggestions is providing better information to patients to facilitate self-care and following Nova Scotia's example of using emergency medical technicians for home care when not on emergency calls. Some suggestions are more radical, such as establishing a central mechanism to oversee a "spot market" for goods and discretionary services such as infusions and specialist consultations. Significant unmet needs are recognized in the report, such as the estimated $39 billion annual economic cost of mental health and addiction, with three-quarters of this expense related to productivity losses.

Elementary and Post-Secondary Education

Ontario, funding 98% of education sector expenses, has implemented over the past decade a 56% rise in per-pupil funding, in part mirroring declining student enrolment. While the Commission supports the three goals of improving student achievement, closing student achievement gaps and raising the public's confidence in the publicly funded system, its proposals, such as edging up class sizes and phasing out full-day kindergarten, would reverse some of the government's hallmark initiatives. At the very least, Drummond suggests extending the roll-out of full-day kindergarten from 2014-15 to 2017-18 and adopting a more affordable staffing model with one teacher per 20 students instead of the current allocation of a teacher and an early childhood educator for every 26 pupils. The Commission also found considerable room for increased operational efficiencies, such as School Boards consolidating their procurement and back-office functions, and taking greater advantage of opportunities to maximize the value of their capital assets.

For post-secondary institutions, the 1.5% cap on annual funding will require ongoing efficiencies because it falls short of inflation and the projected 1.7% enrolment growth. The Commission's recommendations include: establishing a mandate agreement with each university and college by 2012-13 to provide more differentiation and minimize duplication; refocusing resources and rewards on teaching; and, revising research funding structures, eliminating cross-subsidization from undergraduate tuition fees. The Commission recommends retaining the Province's 5% overall ceiling on annual tuition increases, though the framework should be simplified, and a re-evaluation of student financial assistance should aim to better target low-income families.

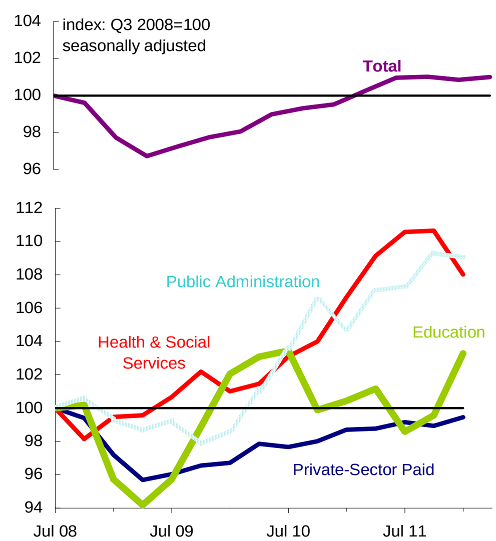
Social Services and Other Selected Recommendations

Mandated and entitlement-based programs accounted for two-thirds of Ontario's Social Services outlays in FY11. Ontario's Commission for the Review of Social Assistance is reporting later this year. The Drummond Commission's comments centred on the inefficiencies arising from benefits delivered through various service providers and funding arrangements, the scope for greater integration and automation, and the importance of directing any additional funding to removing barriers to individuals attempting to re-enter the workforce.

Across all areas, the Commission's proposals aim to conserve the Province's scarce resources. With respect to Equalization reform, it highlights that Ontario should push for the full capture of resource receipts as well as recognition of the wide variation in prices and cost-of-living among the provinces. It recommends the elimination of the Ontario Clean Energy Benefit[1], citing existing subsidies for specific customer groups and the disincentive it provides for conservation. For immigration settlement assistance, the Commission notes that Ottawa has currently underspent on its commitment to Ontario by more than $220 million, and suggests that the Province, in negotiating the next Canada-Ontario Immigration Agreement, argue for greater policy control as well as full funding support. Provincial support for municipalities, after climbing $2 billion from 2003 to 2011, is presently forecast to climb 5.2% annually through 2018. To rein in this cost area, the Commission urges an extension of the Province's $0.5 billion final upload by two years to 2020 and cautions that that the Ontario Municipal Partnership Fund should decline, as planned, to $0.5 billion by 2016.

Constraining Ontario's future risks also is key. Notably, the Commission recommends that Ontario, the only sub-sovereign with a pension benefits guarantee fund, either terminate its Fund or transfer it to a private insurer. The recent actuarial review indicated steep assessment increases for members and, in a future downturn, the Fund poses significant financial risk for the Province.

Ontario's Post-Recession Employment Recovery



Source: Ontario Finance.

[1] Implemented in January 2011, the OCEB offers to households and small businesses a benefit equal to a 10% reduction in the total cost of electricity on their bills.

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