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The 2009 Ontario Budget: The Seven-Year Hitch

The economic context surrounding the delivery of the 2009 budget season is particularly challenging in Ontario. The recession, more severe in Canada's largest province than elsewhere in the country, hits many key sectors: automotive, residential construction, steel, transport, retail trade, and so on. Well aware of this challenging economic environment, Finance Minister Dwight Duncan shows considerable effort to mitigate the severity of the recession, investing $34 billion over two years. The centrepiece, a $32.5-billion infrastructure plan, is a hefty dose representing slightly more than 5% of Ontario's GDP. New Brunswick, Quebec, and Ottawa also tabled considerable infrastructure plans, but Ontario's plan is by far the biggest. Most funding will go towards public transportation projects such as public transit and roads.

Major Tax Reform: Retail Sales Tax Blending and Business Tax Relief

The 2009 Ontario Budget is more than an infrastructure budget. The McGuinty government decided to unveil a major tax reform package aiming at attracting investment in the long run. Once fully implemented, the tax reform will cut Ontario's marginal effective tax rate on new capital investment in half – from 33% in 2009 to 16% in 2018.

The blending of the outdated 8% provincial retail sales tax (RST) and the 5% GST for a 13% single sales tax is certainly one key measure of the tax reform. This "tax wedding" shifts the burden from business (the winners) to consumers (the losers). The business community will applaud this measure since it removes tax payments for purchases of inputs such as machinery and equipment. The good news is that business tax relief does not stop here. For example, starting July 2010, the general CIT will be cut from 14% to 12%; the small business CIT from 5.5% to 4.5%; and the CIT small business deduction surtax eliminates. Overall, the budget proposes $4.5 billion in tax relief for the business community over three years.

For consumers, the retail sales tax harmonization does remind the introduction of the controversial health premium in 2003. The tax base will be larger starting in July 2010, applying to more products. For example, Ontarians will have to pay more taxes on items previously exempted from the PST such as heating fuel, fast-food meals, and transportation fares. To cover the higher tax burden emerging from the harmonization, the budget proposes $10.6 billion in temporary and permanent tax relief. Families earning less than $160,000 will receive three cheques totalling $1,000 by June 2011. Note that a few items will be exempt such as children's clothing and new homes costing less than $400,000. Other measures part of the tax reform includes a reduction in the first bracket tax rate from 6.05% to 5.05% and a permanent $260 refundable sales tax credit for low- to middle-income individuals.

Federal Finance Jim Flaherty will be pleased with this announcement. He urged Ontario in the past to modernize its tax system. The sales tax base was harmonized a long time ago in Quebec, N&L, NB and NS as well as in most OECD countries. Provinces in Western Canada and PEI should consider stepping up to the plate like Ontario just did. Overall, *LBS Economics Research* thinks the implementation of a value-added sales tax structure, harmonized with the federal GST is a smart move by the Ontario government. Also keep in mind that the harmonization will affect CPI figures in July 2010. While tax reform will make the headlines, the budget also contains a section on pension plan reform. Following the report of the Expert Commission on Pensions, the government notably allows plan sponsors to spread their solvency payments over 10 years, a significant relief. A detailed package of pensions reforms is expected in the fall of 2009.

The plan: 7 years in red ink

For quite some time already, Finance Minister Dwight Duncan prepared the public and investors to the inevitable: sizeable deficits. To begin with, the shortfall in FY 2008-09 ending March 31st is now estimated at $3.9 billion, a figure much worse than the $500 million figure forecast in last fall's economic update. The decline in total revenue is estimated at a massive 4%.

According to the new fiscal recovery plan, FY 2008-09 basically marks the first of seven consecutives years in red ink. Deficits are not rare in Ontario. What is different this time is their size. A lower revenue take, combined with a robust capital-spending program, enlarges the deficits in the years ahead. For example, Ontario faces a $14.1 billion shortfall in FY 2009-10. It represents a substantial 2.4% of GDP, a figure higher than other provinces for the same period, and roughly the same as Canada (2.2%). FY 2009-10 could simply be the largest deficit ever registered in the province in absolute terms, but not as a share of GDP. Back in the early 1990s recession, deficits were in the tune of $10-12 billions, close to a large 4% of GDP. What is more important to say is that a combined deficit of $57 billion is projected between FY 2008-09 and FY 2014-15. This streak of planned deficits resembles the one seen in the 1990s on an absolute dollar basis. Deficits totalling $69 billion were registered between FY 1990-91 and FY 1998-99. As a share of GDP, the shortfalls were at least larger back then.

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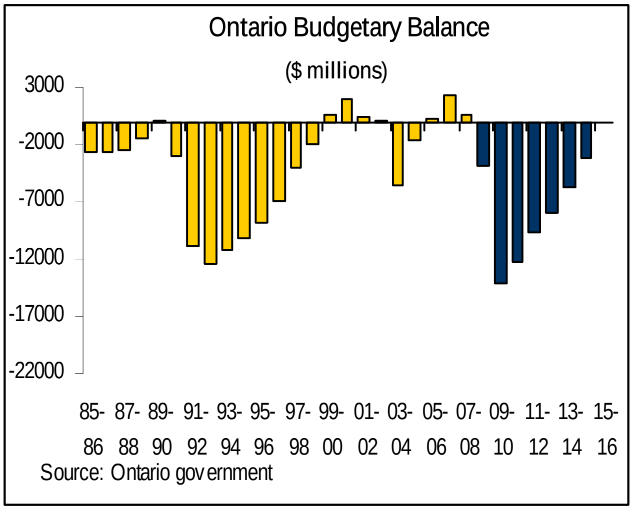

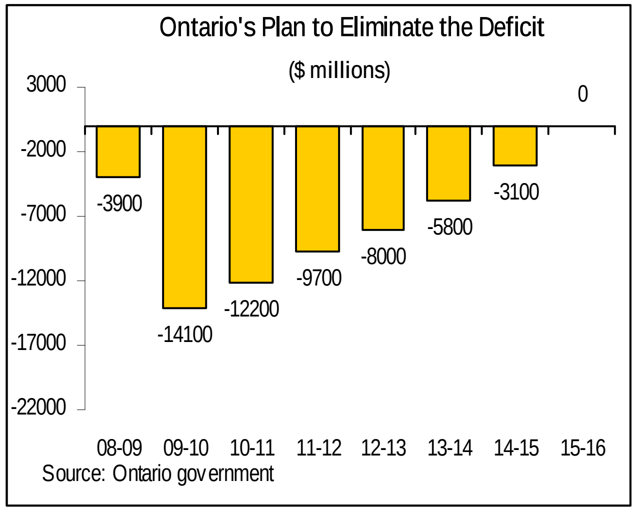

A "very" long-term deficit reduction plan

One interesting quote in the budget documents is "*The government has a plan to balance the budget no later than 2015-16*". This is actually much longer than what other provinces have planned. Basically, the government is asking everyone to be very patient. By today's standards, six years is a long time coming.

So, aiming at balancing the books in FY 2015-16 is more like a roadmap than a plan. And, when we look down the road on that map, we realize it is rather bumpy and foggy. Put simply, many risks have to be considered. The government admits "*an unusual degree of uncertainty remains regarding the outlook*". First, the automotive-oriented manufacturing sector, the bread and butter of Ontario, is going through a long transformation process. The outcome of on-going negotiations between the big 3 US automakers, unions, Washington, Ottawa and Queen's Park will have a considerable impact on the overall income growth picture in years ahead. In our view, the robust 3.3% real GDP growth forecast imbedded in Ontario's budget for 2011 is somewhat optimistic. *LBS Economic Research* is more prudent, expecting the pace of economic expansion to stay in sub-par mode even when the recession is in the rear mirror.

Another risk to consider in the medium-term fiscal outlook is the money coming from Ottawa. Ontario has been unfortunately "short-changed" for years. And the tiny equalization payments of $347,000 the province is expected to receive in FY 2009-10 is not enough. For example, the province is a large net contributor to some federal programs such as Employment Insurance even though its jobless rate is considerably higher than in the rest of the country. Overall, let's face it, a roadmap has been tabled today to eventually balance the books, but there is considerable fog once we start to look further down that road.

Belt tightening on the spending front

On top of the hefty infrastructure plan and the considerable tax reform, another focus of this budget is to bring greater discipline on the spending front. With the significant loss in taxation revenues, the era of large hikes in expenditures is over (since 2003, expenses jumped $23 billion, a bold 36%). Over the course of the next six years, the government plans to hold the average annual rate of growth in core program expenses to less than the growth in total revenue. Notably, the government will identify $1 billion in efficiencies in FY 2011-12 and reduce the size of the public service staff by 5% over three years.

Net Debt to GDP ratio will go back above 30%

In contrast to its neighbour Quebec, Ontario has room on its credit card. Peaking at 33% in FY 1999-00, Ontario's net debt to GDP ratio fell to 25% in FY 2008-09. Slashing the debt burden in previous years provides some much-needed cushion today. The numerator, the net debt, is expected to increase by about $20 billion to $170 billion in FY 2009-10. At the same time, the denominator, nominal GDP, is expected to fall 2.4%. Result? The net debt to GDP ratio will soar to 29% in one year.

In the aftermath of the 1990s recession, the debt to GDP ratio doubled within four years (from 14% in 1990-91 to 28% in 1993-94). In comparison, the increase in the debt burden is expected to be less steep this time (from 25% in 2008-09, to a peak of 32.6% in 2011-12, before retreating to 30.5% in 2013-14). Compared to other provinces however, Ontario's debt burden is on track to increase at a faster pace in the medium-term.

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LAURENTIAN BANK SECURITIES

Provincial Budget

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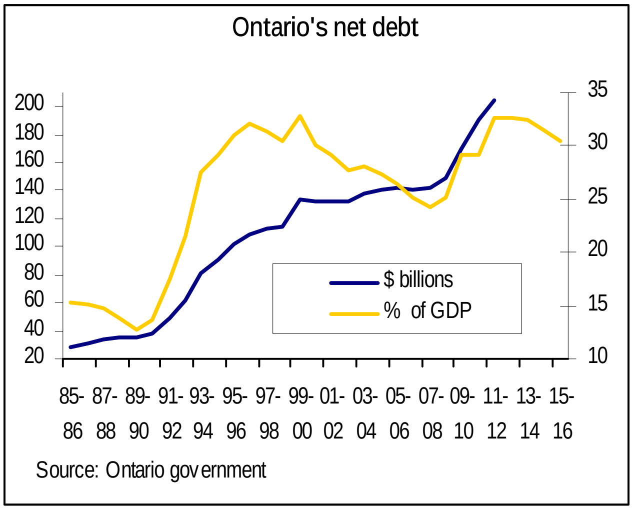
As a result of deficits and increased investments in capital assets, borrowing requirements are expected to reach an elevated $34.8 billion in FY 2009-10, a major increase from FY 2008-09 ($28.7 billion). It is worth mentioning that the province intends to move towards a *"diversification of borrowing sources in 2009-10…the province plans to borrow 35% to 50% in the international markets"*. In FY 2010-11 and FY 2011-12, borrowing requirements are projected at $34.3 billion and $32.1 billion respectively.



Ontario's net debt

Source: Ontario government

In summary, this budget makes Ontario's businesses considerably more competitive and injects a large dose of money into infrastructure. These were good fiscal actions taken today. However, the fiscal and economic outlook remains uncertain. Deeper and longer deficits are planned compared to other provinces. Fortunately, Ontario's debt burden is not too high and will remain manageable even though it will be heavier in upcoming years.

Sébastien Lavoie, Economist

Medium-Term Fiscal Plan and Outlook

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
	$ billions								
Own-Source Revenue	80.5	76.8	76.8	80.6	83.9				
Federal Transfers	16.6	16.6	19.2	23.0	20.5				
Total Revenue	97.1	93.4	96.0	103.6	104.4	109.3	114.3	119.6	125.2
% change		-3.8	2.8	7.9	0.8	4.7	4.6	4.6	4.7
Program Expenditures	87.6	88.4	99.6	104.7	101.8				
Debt Servicing	8.9	8.9	9.3	9.9	11.1	11.6	12.0	12.2	12.2
Total Expenditure	96.5	97.3	108.9	114.6	112.9	115.8	118.5	121.2	123.7
% change		0.8	11.9	5.2	-1.5	2.6	2.3	2.3	2.1
Surplus/Def. before reserve	0.6	-3.9	-12.9	-11.0	-8.5	-6.5	-4.2	-1.6	1.5
Reserve			1.2	1.2	1.2	1.5	1.5	1.5	1.5
Surplus / Deficit	0.6	-3.9	-14.1	-12.2	-9.7	-8.0	-5.8	-3.1	0.0
Net Debt	143	149	170	190	205				
As % of GDP	24.3%	25.1%	29.2	29.2	32.6		32.5		30.5

Source: The 2009 Ontario Budget

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