OBSERVATION

TD Economics

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DRUMMOND RECOMMENDS A MAJOR OVERHAUL OF ONTARIO PUBLIC SERVICES THROUGH AN ECONOMIST'S LENS

The Commission on the Reform of Ontario Public Service (CROPS) – chaired by former TD Chief Economist Don Drummond – released its much-awaited report, which featured a sobering assessment of Ontario's fiscal prospects and outlined some 400 recommendations aimed at placing the Province's finances on a more sustainable footing. About one third of these recommendations were targeted at the health care system alone – the so-called Pac-Man of provincial government finances which has been absorbing almost half of the provincial budget. But while health care received the most attention, few stones were left unturned, with sweeping overhauls proposed to education, social assistance, business subsidy programs and government business enterprises among a host of others. The recommendations are designed to lower the trend rate of program spending growth to less than 1 per cent per year in order to better position the government to eliminate its deficit as promised by fiscal year 2017-18.

The case for action

The Commission report's point of departure is an eyebrow-raising discussion on the Province's current fiscal path. Since 2003, Ontario has confronted a number of headwinds that have conspired to weaken the economy's growth rate, including a high Canadian dollar, rising energy prices and a thickening in the Canada-U.S. border. More recently, the double-whammy of a significant recession and the stimulus undertaken to support the economy sent the deficit (and debt load) on a steep upward trajectory. While a partial recovery in revenues has pulled down the deficit off its peak, it is still running at a hefty $16 billion (2.4% of GDP) in the current year. Still, focusing on the deficit alone hides the true extent of the challenge. Ontario's net debt to GDP ratio – which includes the budget deficit, capital spending and non-cash adjustments – continues to rise steadily. In fiscal year 2011-12, the net debt is estimated at about 37% of GDP, more than 10 percentage points higher than its level prior to the 2008-09 crisis.

With intensifying demographic pressures adding to the slate of structural economic challenges, the CROPS builds the case that Ontario's rate of economic expansion is likely to continue to run at a sluggish 2 per cent per year in real terms over the longer term, which is in line with the view of TD Economics. In contrast, most other forecasters have been projecting a higher long-term economic cruising speed at 2.5% or higher, although it appears that in recent months, these expectations have started to come down.

To clearly illustrate the monumental task facing the Ontario government and its citizens, the report contains a "status-quo" scenario, which lays out the Province's medium-term fiscal path if no actions are taken to restrain spending from its recent trend rate and revenue assumptions are downgraded to reflect the likelihood of economic growth remaining on that modest 2 per cent track. Under this scenario, the "status quo" planning deficit is set to rise to an alarming $30 billion (3.7% of GDP) by fiscal year 2017-18 and the net debt would surge to $411 billion or 51% of GDP. This path assumes that health spending

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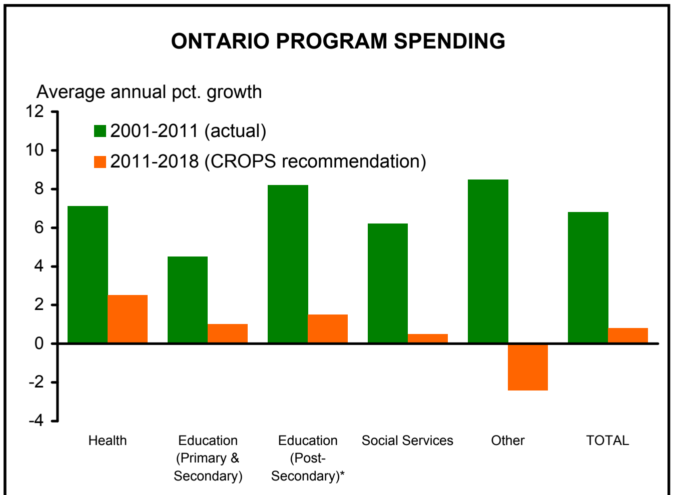
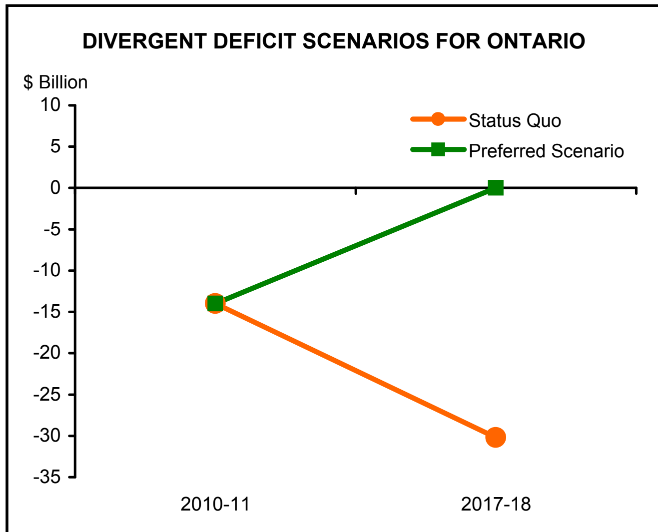
advances persist at about 5-6 per cent per year while interest charges on the debt climb sharply in tandem with the higher projected debt-load. In addition, revenue growth is assumed to run at a modest 3.2% on an annual average basis, considerably lower than the rate of 4.3% assumed in the 2011 budget.

A "preferred scenario" is also shown, which incorporates the expected impact of the lengthy list of recommendations. In this case, the significant budget shortfall as shown in the status-quo scenario is wiped out by fiscal 2017-18 if program expenditures are reduced to just 0.8 per cent annually. Achieving this targeted growth rate would require gains in health expenditure being held at 2.5 per cent per year, education at 1 per cent, social services at 0.5 per cent and all other areas combined would need to shrink by 2.4 per cent. Calculating the cut in the level of real per-capita spending by 2017-18 relative to the status-quo at a sizeable 16 per cent, the Commission notes that this would represent the most prolonged period of restraint in the Canadian post-war period. At the same time, however, Ontarians would ultimately be paid back through a higher standard of living down the road. In contrast, high (and rising) debt loads mortgage the province's future and threaten the long term delivery of public services. A growing debt load would eventually unsettle financial markets, which in turn could trigger a viscous cycle of rising borrowing costs, rising deficits and further investor unease. While the risks of such a nasty outcome have been growing, the Commission is careful to point out that Ontario is not currently in a Greek-style fiscal crisis, but warned that the province would need to take dramatic action in order to avert such a crisis.



Source: Commission on the Reform of Ontario's Public Services
* 2011-18 excludes training



Source: Commission on the Reform of Ontario's Public Services

Recommendations

The Commission's recommendations were grouped by themes and ranged from the very generic to the very specific. As a reminder, the Commission's mandate did not include tax policy – program reform was the focus. Still, as described further below, while the Commission steered clear of discussing tax rates, it put much consideration on user fees and tax expenditures. Proposals were assessed through the lens of whether they would not only generate savings but also offer the potential to boost productivity and growth over the longer haul. Another key theme is the need to better target government assistance to those in Ontario that need it the most. While an exhaustive list of the proposals would take many pages, we provide some of the key highlights below.

Health

It came as no surprise that nearly half the document discussed Ontario's health care system. Just like in other provinces, health care in Ontario is the largest spending item for the government, as well as the fastest-growing one. This file is made even more complicated by the importance of federal financing and the fact that demographics are slowly turning the health care system from an acute care one into a long-term care one.

An important recommendation consists of a near re-engineering of the fourteen Local Health Integration Networks (LHINs). These fairly recent regional health authorities, which had been somewhat under-utilized so far, are called on to play a major role in efficiently allocating resources and coordinating the system. In particular, they can assist in directing patients to the health resource the most appropriate for their needs, both from a medical and a cost standpoint. This recommendation had already been announced prior to the report's release by the Minister of Health.

Much closer to the patient/user, the report recommends that Family Health Teams (FHTs) become the "new normal" for the patient's interaction with the health system. FHTs should comprise just enough health professionals with diverse expertise to provide the population with a "one-stop shopping" experience, especially if their activities are combined or linked with Community Care Access Centres (CCACs), a well-functioning network of organizations focused on long-term and home care.

The CROPS also recommends "full scope of practice" – that is, that health services be shifted to lower-cost caregivers wherever possible. For instance, nurses and pharmacists should be allowed to give routine shots to patients so that doctors are freed for work of a more urgent nature.

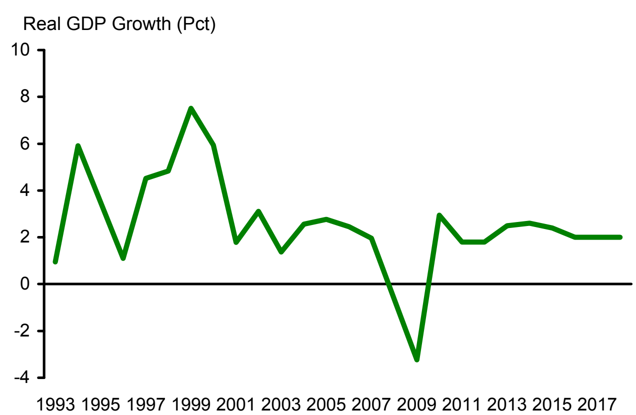
Perhaps more controversial is the proposal to income test the Ontario Drug Benefit (ODB). Currently, all Ontario seniors or social assistance recipients qualify for this benefit. Over the years, many previously universal programs have moved to an income testing approach in order to save money.

Overall, in the words of the report, "important as it is, health care must not be allowed to run roughshod over every other priority."

Education and PSE

In primary and secondary education, one of the report's main recommendations is the cancellation of the full-time kindergarten program which had just started being put in place. However, the report acknowledges that this is an important piece of policy for the current government and suggests that if not cancelled, the program should reduce its costs by adopting a less expensive format, such as larger groups with one educator in charge instead of two. Another important government policy that the CROPS deems unaffordable is the commitment to keep 90% of primary grade class sizes at 20 or fewer. It recommends keeping the principle of the policy in place but increasing the maximum size to 26 or 24 depending on the age group.

MODEST GROWTH THE NEW NORMAL FOR ONTARIO



Source: Commission on the Reform of Ontario's Public Services

At the post-secondary level, the report recommends a switch from a reduced tuition approach to a full-tuition one with better grants. It also proposes better integration between colleges and universities, especially in terms of credit recognition.

Labour

Early on the report features a very positive message about the importance of keeping and attracting the best staff possible to the Ontario Public Service (OPS). However, it doesn't take long before the tone changes and the authors take a very firm position on wage negotiations not only with the overall OPS, but also with health care professionals, teachers and professors. In a nutshell, the report advocates budgeting a zero wage increase, the use of performance incentives wherever possible, and the adoption of alternate service delivery (often called "backdoor privatization" by some) to reduce costs.

Other Key Reforms

Outside of the three major themes listed above, here are a few more notable recommendations:

- The adoption of real market prices in the management of the government's real estate holdings as an incentive to use them in a cost-efficient way.
- Ending the 10% rebate on electricity bills introduced in 2010.
- Treating tax expenditures originating from fully refundable business tax credits as direct expenditures to be assumed by the ministry from which they originate.

With respect to asset sales, the Drummond Commission argued that the government take a look at its portfolio of assets in order to assess whether it would make sense to privatize some of them based on whether a net public benefit can be derived. It warned that asset sales can merely result in a future income stream being brought forward as a one-time benefit.

What's Next?

The Premier has indicated that the Commission's report serves only as advice. But given that the government has committed to eliminating a major budget shortfall (estimated as high as $30 billion on a status-quo basis) by fiscal 2017-18, and in light of the government's desire to achieve it largely on the back of savings from government programs, it has already indicated a desire to consider them carefully ahead of the March 2012 budget.

In a number of areas, such as health care, the reforms already build on changes already in motion. For example, Health Minister Matthews has already indicted a desire to reorganize the management of hospitals and expand the use of primary health care teams. Many proposals that involve new or increased user fees are also likely to see the light of day, in part because adding on some revenue raising measures helps to achieve the "balanced" strategy that Finance Minister Duncan has referred to in recent speeches. On the flip side, the government has ruled out a few recommendations outright, including cancelling all day kindergarten and selling the Niagara Casino. In the same vein, the fact that the Commission did not come out with a major endorsement of asset sales reduces the likelihood that many of the larger entities (such as the LCBO and OLG) will be sold, at least over the next few years.

While there were few figures provided in the Commission report on the benefits of the various approaches to taxpayers, there is no shortage of potential for these recommendations to provide significant long-term savings. But as usual, success boils down to how effectively the reforms are executed. And as noted in the report, few countries around the world have been able to hold health spending growth down on a sustained basis even after undertaking significant reforms.

Finally, uncertainty with respect to the ultimate tack taken by the government is heightened by the minority situation in the legislature. Additional support from another party will be required to pass the budget. Minister Duncan indicated after the report's release that tax increases will indeed be on the table as it plans its 2012 budget. And in this vein, he indicated a willingness to consider the NDP's proposal to cancel the last installment of the reduction in corporate income tax rates (scheduled to be reduced to 10 per cent this year).

Financial markets and bond rating agencies will be watching intently in the coming days and weeks for signals for what to expect in the upcoming budget.

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