

# 2015 ONTARIO BUDGET



## TD Economics

April 23, 2015

### STAYING ON COURSE

#### Highlights

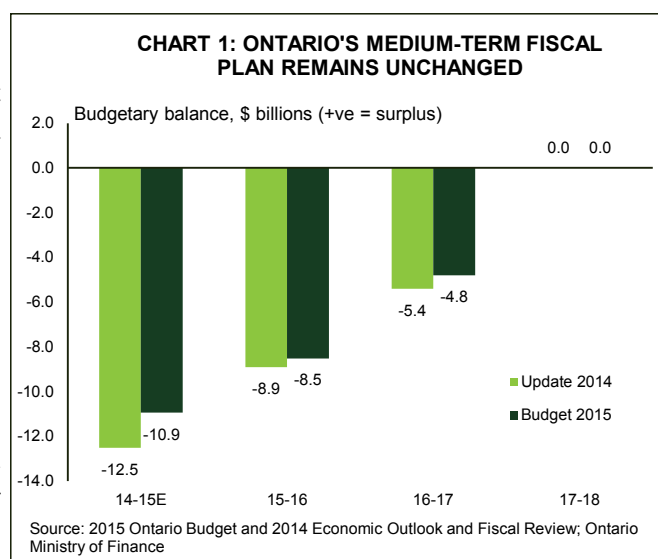
- The Ontario government estimates a \$10.9 billion deficit (1.5% of GDP) in fiscal 2014-15, lower than the \$12.5 billion shortfall projected in Fall Economic Update. Below-target spending combined with a one-time revenue windfall of \$240 million offset a downside surprise in revenues, while the \$1 billion reserve was put towards the deficit.
- The broad strokes of the fiscal plan remain relatively unchanged from Budget 2014, with the budget set to return to balance in fiscal 2017-18. Deficits of \$8.5 and \$4.8 billion are anticipated over the next two years, respectively, around \$1 billion ahead in total of what was projected a year ago.
- The government posted a lower-than-expected net debt-to-GDP ratio, which is now expected to plateau in fiscal 2015-16 at 39.8%, before moving slightly lower towards 2017-18.
- A healthier economic growth profile is expected to support revenue intake over the medium term. Gains from asset optimization are expected to offset a lower tax base. Program spending will be kept in check, held to 0.3% growth on average over the next three fiscal years.
- With a return to balance the priority, there was limited fiscal room for new initiatives in this budget. However, no future revenues were booked from the government's announced cap and trade system, which are intended to be put towards public transit, green innovations and increased energy efficiency.

In the second year of its majority mandate, the Government's 2015 budget was a progress report on the plans set out last year, rather than announcing any major new direction. Last spring, the Ontario government laid out a fiscal plan that targeted a return to balance in fiscal 2017-18, and included many new revenue-raising measures to help fill the fiscal hole and support major spending on infrastructure spending and a Jobs and Prosperity Fund.

Budget 2015 stays the course on eliminating the deficit by 2017-18 (see Chart 1), and provides more detail on how the government intends to get there. A stronger economy and previously announced asset optimization will help on the revenue side of the ledger, while growth in expenditures is tightly controlled. The planned sale of up to 60% of Hydro One over the coming years will be relied upon to potentially generate up to \$9 billion in funds that will be used to address the debt and help fund infrastructure spending.

#### Slightly smaller deficits on the road to balance

Thanks in part to lower-than-expected interest rates, the government is projecting slightly smaller deficits on its road to a balanced budget in 2017-18. Lower interest rates result in smaller debt servicing payments, which allowed the government to raise



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its program spending profile very slightly. Top-line revenue forecasts are unchanged from those shown in the fall statement, as higher-than-budgeted revenues from asset optimization (\$2.6 billion) are expected to offset slightly lower tax revenues.

The fiscal plan relies on an uptick in economic activity in 2015, with real GDP growth forecast to average 2.6% over the 2015-16 period, before decelerating slightly to 2.2% over the final stretch of the plan. Stronger economic growth in the U.S. is projected to be a key driver of stronger momentum in Ontario. Nominal GDP is projected to average 4.2% over the 2015-2018 period, a notable uptick in activity from the sub-4% gains recorded over the previous 10 years (see Chart 2). That said, nominal GDP growth is not expected to return to the +5% gains recorded over the 1993-2003 period implying that a massive boost to revenues is not around the corner, underscoring the necessity of expenditure restraint.

Once again, the government has beat its fiscal target in 2014-15, recording a smaller deficit of \$10.9 billion in contrast to the \$12.5 billion deficit projected in the fall update. That better-than-expected performance can be chalked up close to \$600 million in program spending reductions, debt servicing costs that were \$335 million lower than planned, and a boost from the sale of GM shares and other one-time

ONTARIO ECONOMIC PLANNING ASSUMPTIONS					
Annual, percent change (unless otherwise noted)					
	2014E	2015	2016	2017	2018
<b>Real GDP Growth</b>					
2014 Fall Update	1.9	2.4	2.4	2.4	--
2015 Budget	2.2	2.7	2.4	2.2	2.1
TD Economics**	2.4	2.8	2.5	2.2	1.8
<b>Nominal GDP Growth</b>					
2014 Fall Update	3.5	4.4	4.4	4.4	--
2015 Budget	3.6	4.2	4.2	4.2	4.1
TD Economics**	4.0	3.8	4.7	4.2	3.8
<b>Canadian Dollar (US\$ per C\$)</b>					
2014 Fall Update	90.5	89.5	91.0	92.0	--
2015 Budget	90.5	79.5	80.0	85.0	89.0
TD Economics**	90.5	78.8	80.3	85.0	85.0
<b>3-month Treasury Bill Rate* (%)</b>					
2014 Fall Update	0.9	1.2	2.0	3.0	--
2015 Budget	0.9	0.6	1.1	2.5	3.4
TD Economics**	0.9	0.7	0.8	1.5	2.4
<b>10-yr Gov't Bond Rate* (%)</b>					
2014 Fall Update	2.2	2.9	3.5	4.2	--
2015 Budget	2.2	1.8	2.7	3.8	4.2
TD Economics**	2.2	1.7	2.3	2.8	3.3

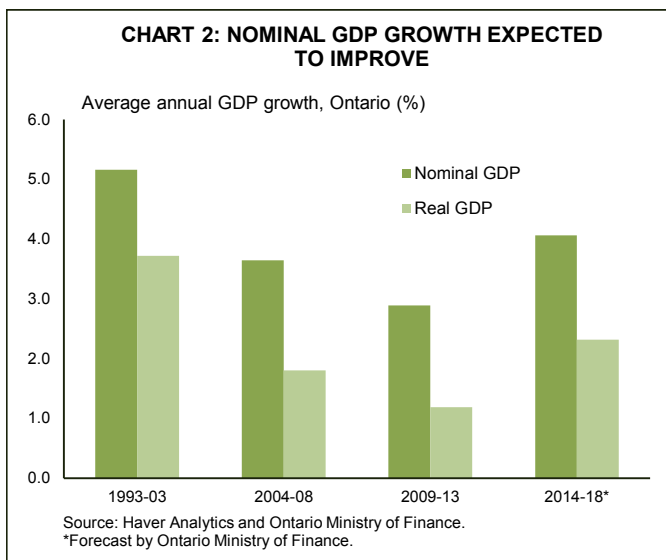
Notes: \*Government of Canada securities; \*\*As at Apr. 2015.  
Sources: Ontario Ministry of Finance; TD Economics.

revenues.

Looking ahead, the government projects revenues to average 4.3% growth over the remainder of the fiscal plan, very similar to what was presented in the fall statement. In contrast to last year's budget, there was a scarcity of new

GOVERNMENT OF ONTARIO FISCAL POSITION								
[ C\$ billions of dollars, unless otherwise noted ]								
Fiscal Year	Actual					2015 Budget Plan		
	10-11	11-12	12-13	13-14	14-15E	15-16	16-17	17-18
<b>Revenues</b>	<b>107.2</b>	<b>109.8</b>	<b>113.4</b>	<b>115.9</b>	<b>118.5</b>	<b>124.4</b>	<b>129.4</b>	<b>134.4</b>
% change	11.3	2.4	3.3	2.2	2.2	5.0	4.0	3.9
% of GDP	17.0	16.7	16.7	16.7	16.4	16.6	16.5	16.5
<b>Expenditures</b>	<b>121.2</b>	<b>122.7</b>	<b>122.6</b>	<b>126.4</b>	<b>129.5</b>	<b>131.9</b>	<b>133.0</b>	<b>133.2</b>
% change	4.9	1.3	-0.1	3.1	2.4	1.9	0.8	0.2
% of GDP	19.3	18.6	18.0	18.2	18.0	17.6	17.0	16.3
Programs	<b>111.7</b>	<b>112.7</b>	<b>112.2</b>	<b>115.8</b>	<b>118.8</b>	<b>120.5</b>	<b>120.6</b>	<b>120.0</b>
% change	4.5	0.9	-0.4	3.2	2.6	1.4	0.1	-0.5
% of GDP	17.7	17.1	16.5	16.6	16.5	16.0	15.4	14.7
Debt charges	<b>9.5</b>	<b>10.1</b>	<b>10.3</b>	<b>10.6</b>	<b>10.7</b>	<b>11.4</b>	<b>12.4</b>	<b>13.2</b>
% of rev.	9.0	9.2	9.1	9.1	9.0	9.2	9.6	9.8
<b>Reserve</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0.0</b>	<b>1.0</b>	<b>1.2</b>	<b>1.2</b>
<b>Balance</b>	<b>-14.0</b>	<b>-13.0</b>	<b>-9.2</b>	<b>-10.5</b>	<b>-10.9</b>	<b>-8.5</b>	<b>-4.8</b>	<b>0.0</b>
% of GDP	-2.2	-2.0	-1.4	-1.5	-1.5	-1.1	-0.6	0.0
<b>Net Debt*</b>	<b>214.5</b>	<b>235.6</b>	<b>252.1</b>	<b>267.2</b>	<b>284.1</b>	<b>298.9</b>	<b>311.5</b>	<b>319.5</b>
% of GDP	34.1	35.8	37.1	38.4	39.4	39.8	39.8	39.2

Note : Numbers may not add due to rounding. Source: Ontario Ministry of Finance.



tax measures raised today. However, the government did not book any revenues from its previously announced participation in the Western Climate Initiative’s cap and trade system. The province indicated how these future revenues would be used, so looking ahead the government will likely have more money to spend on public transit, research and development of green technology solutions and increased energy efficiency in homes, buildings and automobiles.

Other notable announcements included:

- Maintaining its focus on infrastructure investment, adding \$2.6 billion to its Moving Ontario Forward plan as a result of a higher target from the province’s asset optimization plan.
- Boost in its Jobs and Prosperity Fund from \$2.5 to \$2.7 billion over the next ten years.
- Increasing funding for the Ontario Youth Jobs Strategy by \$250 million over the next two years.
- Moving forward on the Ontario Retirement Pension Plan (ORPP) introduced in Budget 2014. The foundation of the plan was laid out in the proposed ORPP Act in December 2014. The government also undertook a consultation process in order to address key design questions surrounding the plan pertaining to three issues: (1) scope (2) minimum earnings threshold and (3) supporting the self-employed. The government is in the process of considering feedback from these consultations and will address these issues in the near future, with a view to establishing the ORPP by January 2017.

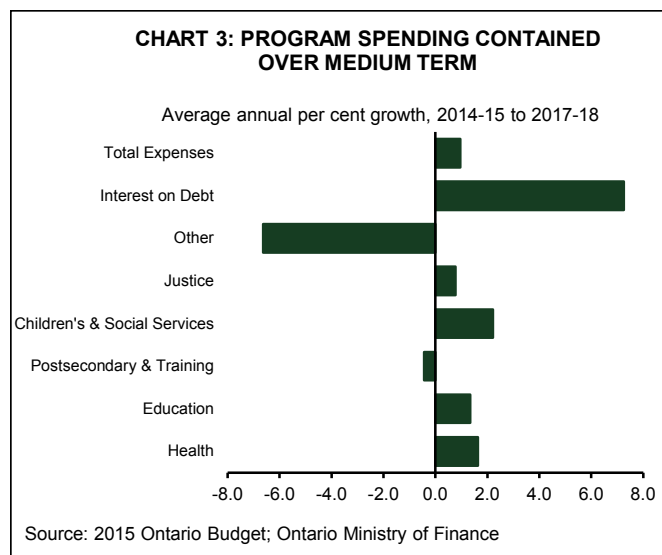
### Program spending restraint still lies ahead

Holding program spending to a very slim 0.3% on average over the next three years will be critical to eliminating the deficit. The government has already held average annual program spending growth to 1.5% over the last four years, so it must now tighten its grip even further on the spending reins over the remainder of the plan.

The government intends to restrain spending through strictly managing compensation growth in the public sector and its program review, renewal and transformation process, which is a bottom-up examination of how every dollar is spent, rather than across the board cuts. The initiative is targeting \$500 million per year in annual savings. The Budget highlighted a few initiatives as part of the government’s Program Review, Renewal and Transformation planning process which are expected to shave roughly \$600 million in 2015-16.

Program spending growth by ministry is expected to be very slim indeed, which health spending expected to be contained to 1.6% on average from 2014-15 to 2017-18, and many departments will see outright spending declines (see Chart 3). The one area of spending with the strongest growth is debt servicing charges, which are expected to grow at 7.2% on average over the same period, constraining expenditures on other priorities.

The government also intends to restrain compensation growth in the public sector, including doctors, teachers and other public service employees by taking a “net zero” approach to any bargaining process. That means that any wages increase must be offset elsewhere. This is key to balancing the books, because wages and salaries account



for over half of government spending. The government has also made progress in managing public sector pension costs in line with the recommendations outlined in the 2012 Drummond Report.

### Details on asset optimization

While fiscal coffers are forecast to receive a boost from the expected pick-up in economic activity, the commitment to investing in infrastructure has led the government to turn to asset sales in an effort to take pressure off the trend growth in net debt. Last week, the Premier's Advisory Council on Government Assets chaired by former TD Bank CEO Ed Clark, tabled its final reports concerning the divestiture of Hydro One as well as addressing the retailing and distribution of beer in Ontario.

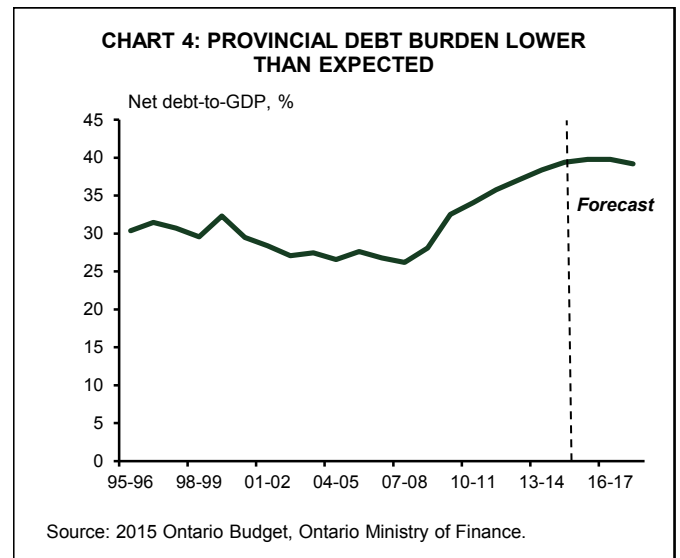
Based on the Council's recommendations, the government is planning on selling up to 60% of Hydro One over the coming years. In fiscal 2015-16, the government expects to launch a 15% initial public offering. Net gains from these sales will be dedicated towards the Trillium Trust, with the book value of these assets helping to count against the gross debt. Using the Council's estimates of a market value of up to \$15 billion for Hydro One, this translates into a potential \$9 billion in sales – with approximately \$5 billion being earmarked towards the debt and \$4 billion channeled towards the Trillium Trust.

Recall, the Trillium Trust was set up to channel the dedicated net proceeds from the sale of qualifying assets to support the Province's infrastructure spending priorities – including transportation. As of fiscal 2014-15, the current value of the Trillium Trust is pegged at around \$1.4 billion. In total, the government has set its asset optimization target to \$5.7 billion over 10 years – a \$2.6 billion increase over Budget 2014.

### Debt burden remains

With net debt estimated at \$284 billion – or nearly 40% of GDP in fiscal 2015-16, Ontario has the second largest debt burden relative to the size of its economy in Canada (trailing only Quebec). Indeed, the Province's net debt has been growing faster than the budget deficit in recent years, largely reflecting a surge in borrowing related to capital spending. The government is clearly cognizant of this vulnerability in its efforts to wean itself off debt financing, and fund its transportation infrastructure spending through assets sales.

The expected path of net debt-to-GDP ratio has been reduced slightly in today's budget relative to last year's. The



ratio is assumed to rise in fiscal 2015-16, where it peaks at 39.8% of GDP, and then moves lower by fiscal 2017-18 to 39.2% (see Chart 4). While interest rates have been low, debt has remained affordable. Still, almost 10 cents of each revenue dollar goes to servicing the debt, and interest charges on the debt are expected to be the fastest growing spending area over the next couple of years. The government has restated its commitment to return the net debt ratio returns to the pre-recession level of 27%.

That said, Ontario tapped the debt market for \$39.8 billion in fiscal 2014-15. That is higher than the \$35 billion set out in Budget 2014 as the government took advantage of the low interest rate environment and pre-funded \$4.8 billion of its 2015-16 requirements. Therefore, its total long-term borrowing requirement is expected to be lower in 2015-16 at \$31.1 billion. The province plans to issue its second green bond during fiscal 2015-16. Borrowing requirements continue to decline to \$30.4 billion in 2016-17 and \$24.4 billion in 2017-18. The government points out that three-year borrowing requirements are about \$20 billion lower over the next three years than in Budget 2014 as a result of the government's pre-funding activities, lower deficits and the government's expected asset optimization activities. In recent years, the weighted-average term to maturity has been significantly extended to 14.1 years, partially protecting the province in the event of near-term spike in interest rates.

### Bottom Line

Abstracting from some of the high-profile announcements on asset recycling, Budget 2015 can still be characterized as stay the course, with the deficit still set to be eliminated by 2017-18. Lower interest rates and asset sales

helped the province beat its fiscal target in 2014-15 and the latter is expected to enhance revenues in the coming years. In recent months, credit rating agencies have highlighted that the lack of detail on expenditure control in the outer-years of the fiscal plan was a risk. The government has demonstrated that can meet its expenditure restraint targets and that it will help restrain growth in net debt by using asset sales to help fund its infrastructure priorities rather than issuing debt. However, the toughest expenditure restraint still lies ahead. Negligible program spending growth over the next three years is a tall order for a growing economy and the years ahead will continue to be challenging for Ontario's public sector.

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