2015 Ontario Budget

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Economics

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Ontario On Track

by Avery Shenfeld and Nick Exarhos

Highlights

Ontario remains right on track towards its plan to balance the budget by 2017/18, and has reduced its deficit target for the coming year to $8.5 bn. Spending restraint, asset sales and better economic growth, will support this year's bottom line. Infrastructure spending is a key budget theme. Gross and net bond issuance will be easing off in the coming year and beyond, while debt to GDP will begin to edge lower after 2016/17.

A budget entitled "Building Ontario Up" was also centred on knocking Ontario's deficit down. We're one more year on the long road to balance, but we're only now getting into the steepest part of the fiscal challenge. The prior year came in better than expected, but the deficit was still larger than it was two years earlier. That leaves the province facing a few years of tight control on program spending, while still in a period of heightened infrastructure plans.

Economic Backdrop Has Brightened

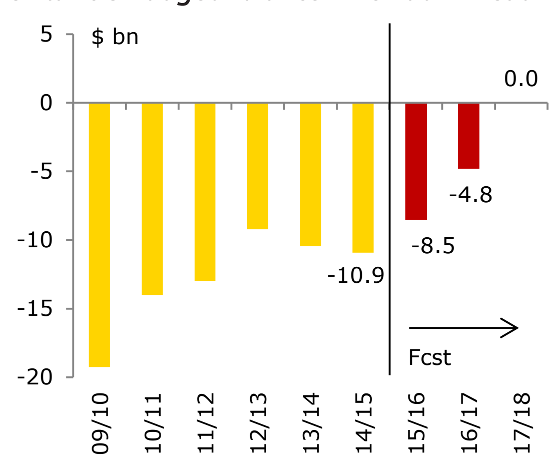
The province's plan to get most of its deficit reduction after 2014 was based on a view that what was still a sluggish economy in 2013, in which real GDP growth came in at only 1.3%, was the wrong time to sharply retrench fiscally. As then envisaged, the clouds seem to have lifted for Ontario, as the province has been running ahead of the national average on most major growth indicators.

As a result, the more optimistic projections for growth presented in the 2014 budget now appear to be generally on track. Last year's budget was built on a 2014 real and nominal GDP forecast that was a decimal place below the 2.2% and 3.6% respective figures actually realized, despite a slightly weaker-than-expected pace for the US.

For 2015, the province is looking for real GDP growth to accelerate to 2.7%, in line with CIBC's 2.8% call, with 2016 easing slightly to a 2.4% pace, which lies below our 2.8% forecast but is close to consensus. Exports should be lifted by solid growth in the US economy in the next few quarters and the competitive benefits of a cheaper Canadian dollar. Housing starts will climb to catch up with the trend in household formation, and job gains and lower oil prices will help real consumption.

Chart 1

Ontario's Budget Balance: The Path Ahead



http://research.cibcwm.com/res/Eco/EcoResearch.html

Table 1
Ontario's Economic Outlook

Y/Y % Chg	2014	2015	2016	2017-18
Economic Assumptions				
Real GDP	2.2	2.7	2.4	2.2
Private Sector Consensus	-	*2.8*	*2.5*	*2.3*
Nominal GDP	3.6	4.2	4.2	4.2
Employment	0.8	1.1	1.3	1.4
Unemployment Rate (%)	7.3	6.9	6.7	6.4
Real HH Consumption	2.5	2.6	2.4	2.3
Retail Sales	4.8	4.2	4.2	3.8
Housing Starts (K)	59.1	61.0	65.0	69.5
Corporations Net Op. Surplus	8.0	5.0	4.8	4.6
Consumer Price Index	2.4	1.2	2.0	2.0
Financial Assumptions				
3-month T-Bills (%)	0.9	0.6	1.1	3.0
10-year GoC Bonds (%)	2.2	1.8	2.7	4.0
Exchange Rate (US¢/C$)	90.5	79.5	80.0	87.0
WTI (US$/bbl)	93	55	70	82

Note: 2017-18 is two-year average

Nominal GDP, which has the closest ties to government revenue, is assumed to advance by 4.2% this year and next, very close to what had been assumed in the prior year's medium-term outlook. Note that as a non-oil producer, Ontario's GDP price index did not see the crash registered in the national deflator this year. Overall, moving from a sub-par performer to a likely first-place ranking in economic growth this year is a key factor brightening the fiscal outlook.

Deficit Bettered the 2014/15 Target

Ontario's 2014/15 deficit was still marginally higher than in the prior year, but came in significantly better than last year's budget expectation. That wasn't on the revenue side, where despite on-target economic growth, there was a $0.4 bn shortfall, equally divided between own source and federal transfer inflows. The own source discrepancy came from adjustments to the prior year's tax base on which the growth estimates were made.

But, as announced in the lead-up to this budget, the deficit for 2014/15 was able to come in at $10.9 bn, versus a planned $12.5 bn, as the province didn't need to use the contingency reserve set aside for adverse shocks, and ran programs a bit under the budget assumptions.

Hewing Close to Plan Ahead

Since there wasn't a revenue windfall behind the 2014/15 outperformance, the *status quo* outlook entering the current fiscal year was essentially unchanged. And this budget therefore has no big surprises to unveil in terms of the deficit targets ahead, and how they are to be achieved. The projection for an $8.5 bn deficit in 2015/16 and $4.8 bn in 2016/17 are each roughly a half-billion below what was laid out a year ago, with no change to the target for a balance come 2017/18.

On the revenue side, absent any new action, own source revenues would have been slated to be lower than in the previous medium-term plan, due to the softer base set from 2014/15 and a downward adjustment to Ontario's take from the prior year's corporate tax pool that has to be repaid to Ottawa this year. But the province now expects to reap a total of $1.6 bn from asset sales, some $0.6 bn above earlier estimates, keeping the revenue path on track. The revenue tally will see a smaller $1 bn per year from asset sales in both 2016/17 and 2017/18, so the province will not be counting on accelerating the pace of such deals to drive the remaining improvements in the budget balance.

Table 2
Fiscal Summary

$Billions	2013/14 Actual	2014/15 14 Budget	2014/15 15 Budget	2014/15 Change	2015/16 15 Budget	2016/17 15 Budget	2017/18 15 Budget
Revenue	**115.9**	**118.9**	**118.5**	**-0.4**	**124.4**	**129.4**	**134.4**
Own Source	93.6	97.0	96.8	-0.2	101.5	105.4	109.6
% change	*2.1*	*3.6*	*3.4*	*-0.2*	*4.9*	*3.8*	*4.0*
Federal Transfers	22.3	21.9	21.7	-0.2	22.9	24.0	24.8
Expenditures	**126.4**	**130.4**	**129.5**	**-0.9**	**131.9**	**133.0**	**133.2**
Programs	115.8	119.4	118.8	-0.6	120.5	120.6	120.0
% change	*3.2*	*3.1*	*2.6*	*-0.5*	*1.4*	*0.1*	*-0.5*
Public Debt Charges	10.6	11.0	10.7	-0.3	11.4	12.4	13.2
Less: Reserve	0.0	1.0	0.0	-1.0	1.0	1.2	1.2
Budgetary Balance	**-10.5**	**-12.5**	**-10.9**	**1.6**	**-8.5**	**-4.8**	**0.0**

Having implemented some revenue raising measures in the last two budgets, the 2015 budget was very quiet on the tax side. Not in the budget, but announced to the media today, was the intention to phase in higher taxes on beer, adding $100 mn per year by 2019. The government pared back some business credits that it felt were ill targeted, but overall, the revenue line for this year and the subsequent two was not materially affected.

Program spending will however, be in crunch time, held to 1.4% this year, *en route* to an outright decline by 2017/18. The ministerial budgets included for 2015/16 still show outrights cuts to only a handful of generally smaller departments. But there's a further $1.5 bn in savings that will be found by not spending leftover allocations at the end of the year, and by the Program Review process underway.

Note that the province faced the same $1.5 bn task last year and managed to bring program spending in $0.6 bn below plan, and this year's 1.4% target is essentially in line with what the province has achieved on average since 2010/11. If the economy performs as expected, there's also a $1 bn in a contingency reserve that will lapse unspent. Among the spending priorities mentioned in the budget are those that address youth mental health, youth skills, and a jobs and prosperity fund to promote business investment. The document also talked about a number of policy areas outside the tax-and-spending field, including its plans for an Ontario pension plan and auto insurance issues.

Details aren't yet available for where the sharper knife will come down in subsequent years to keep the grand total in an unprecedented straight jacket. But there are some helping hands coming, as Ontario's clean energy benefit expires, the Pan Am games costs move into the rear-view mirror, along with earlier costs associated with bringing pension plans towards fully funded status. There will also be the revenues not yet baked into the plan from the cap-and-trade program for GHG emissions, and potential changes to LCBO operations.

The budget places a lot of emphasis on its plan to support provincial infrastructure. The total program for 2015/16, at $13.5 bn, isn't elevated much from last year's active $13.3 bn plan, and is in line with the pledge to support $130 bn in capital over a decade. To hold down borrowing volumes, the province will apply some dedicated revenues and apply the net proceeds from asset sales to a fund that will be used towards infrastructure initiatives.

Still, the longer-term plan will be one of overall restraint as the province attempts to build Ontario but not its debt-to-GDP ratio. Better economic growth and easing deficits will still see debt-to-GDP, at 39.4% at the close of the prior fiscal year, edge up to a peak of 39.8% by this year's end, before tailing off to 39.2% when the budget is balanced two years hence. That's still at the higher end of the provincial range, but jurisdictions in Canada with similar or higher debt-to-GDP loads don't have as strong a trend in population growth or GDP to help them carry the interest burden in the future.

Gross and Net Bond Issuance to Ease

Improving budget balances, including the receipts from asset sales, are expected to contribute to a material slowing in Ontario's gross and net borrowing activity over the forecast horizon.

Last year the province had a $15.8 bn net financing requirement, but that will ease off to $14.8 bn in the current fiscal year, and reach $6.7 bn two years out. Improving budget balances and higher non-cash adjustments will more than offset greater cash outlays for capital assets. Gross financing needs will also decline this year as maturities will be similar to the prior year.

Table 3
The Financing Plan

$Billions	2014/15E	2015/16F	2016/17F	2017/18F
Borrowing Requirements				
Budget (Surplus)/Deficit	10.9	8.5	4.8	0.0
Non-Cash Adjustments	-4.6	-4.9	-5.5	-5.6
Investment in Capital Assets	9.5	9.1	11.3	11.8
Net Loans/Investments	0.0	2.1	0.8	0.5
Net Financial Requirement	**15.8**	**14.8**	**11.4**	**6.7**
Maturities & Redemptions	21.7	21.2	21.6	17.7
Total	**37.6**	**35.9**	**33.0**	**24.4**
Sources of Funding				
Cash & Pre-Funding (1)	-2.2	4.8	0.0	0.0
Short-term Paper	0.0	0.0	2.5	0.0
Long-term Debt	39.8	31.1	30.4	24.4
CPP	0.0	0.0	0.1	0.0
Debt Buy-Backs	0.0	0.0	0.0	0.0
Total	**37.6**	**35.9**	**33.0**	**24.4**
Net New Issues				
Bonds & MTNs	18.4	10.0	8.8	6.8

Note: Borrowing program incorporates Ontario Electricity Financial Corp.
1. Includes impact of $4.8 bn pre-funding in 2014/15, to be drawn down in 2015/16

Borrowing activity will be further cushioned this year by the ability to draw on $4.8 bn "pre-borrowed" in the prior year. That leaves $31.1 bn to be raised in long-term debt. Assuming the province maintains a retail savings bond program of $0.5 bn, bond/MTN issuance will drop from just over $39.3 bn last year to $30.6 bn. After maturities, the net supply of bonds outstanding will still be growing, but the $10.0 bn climb this year will be well below last year's $18.4 bn, assuming the province does no pre-borrowing for the following year. A further deceleration in net issuance lies ahead for the subsequent two years.

Last year saw the province undertake its first Green Bond, with a further plan to do so in the current year. Overall, syndicated C$ bonds accounted for just under 70% of gross borrowing in the prior year, foreign currency bonds a further 21% and the remainder in floaters, auctioned term debt, green bonds and savings bonds.

While interest rates won't likely be this low forever, Ontario has been preparing for that day by extending its average term. Issuance over the past year had an average term of just over 14 years. That's up from only 8.1 years in debt issued in 2009/10. Falling rates have lowered the effective rate on outstanding debt to 3.8% in the past year. A full percent rise in 10-year rates above the budget assumptions would add only $0.4 bn to the deficit, and the province has already built in a rise of roughly that magnitude by 2016 in its debt service cost projections.