The 2005-06 Ontario Budget

Fiscally prudent, but few carrots for business

Jointly prepared by

The Ontario Chamber of Commerce

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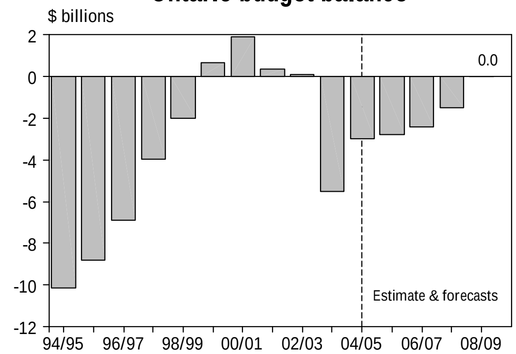
The 2005-06 Ontario Budget scored high marks for fiscal prudence while targeting sorely needed investments in education and infrastructure. It simultaneously addressed several core policy priorities of the Ontario Chamber of Commerce that are reviewed in this paper after presenting an overall assessment of the budget. Notwithstanding such deserved accolades, it was disappointing that the government is not making any progress towards restraining health care expenditures that will still grow at double the rate of inflation and population growth. Freeing up such resources is vital to being able to address a high and inefficient tax burden, and investing more in other priority areas.

Chart 1

Ontario budget balance



Source: Ontario Ministry of Finance

Balance within the mandate is in reach

The Ontario government presented a credible plan for financing major investments in health, education and infrastructure without hiking taxes or selling major assets while holding forth the significant potential to achieve balance within the McGuinty government's present electoral mandate. The government's base-case projection targets fiscal balance by no later than 2008-09 and steady improvements in the ratio of net debt-to-GDP.

A significant disappointment, however, is that in contrast to last year's budget, the Ontario government has virtually thrown in the towel when it comes to attempting to restrain health spending. This is materially restricting the potential for more aggressively challenging key structural barriers to long-run growth.

The table below outlines the government's fiscal plan through to 2008-09. The deficit came in at $3 billion for the just-completed fiscal year 2004-05 and is forecast to decline steadily to balance by 2008-09. The prudent practice of using reserves continues, such that if they are not needed, budgetary balance is achievable by 2007-08. Furthermore, because economic growth assumptions are rather modest this year, revenues are likely poised for a material upside surprise. Lastly, if recently offered federal transfers actually come through, then balance may even arrive as soon as FY2006-07, or within two fiscal years from now.

The Province of Ontario's net debt position is projected to decline steadily throughout the forecast period. Indeed, if balance is achieved before plan, the ratio of net debt-to-GDP should decline at a materially faster than projected pace.

Massive revenue surprise

Virtually all of the credit for a better than expected fiscal position in 2004-05 goes to revenue surprises. Revenues came in about $2.7 billion higher than expected in last year's budget, mostly due to a $1.2 billion positive surprise on corporation taxes, the $824 million received under the First Ministers' Health Agreement, and $274 million higher than expected personal income taxes. There are two material revenue initiatives that impact Ontario businesses. One is targeted investment in a variety of film industry tax credits, and another concerns the alignment of CCA

Ontario fiscal plan

($ billions)	Actual	Actual	Actual	Prelim.	Budget	Budget	Budget	Budget
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Total revenues	66.5	68.9	68.4	77.1	81.7	84.8	88.5	92.2
Total expenditures	66.2	68.8	73.9	80.1	83.5	85.7	88.5	90.7
Program spending	53.9	57.2	62.1	67.6	71.0	73.3	75.9	77.9
Capital spending	1.9	1.9	2.2	2.9	2.7	2.5	2.1	2.1
Interest on public debt	10.3	9.7	9.6	9.6	9.8	10.0	10.4	10.7
Surplus/(Deficit) before reserve	0.4	0.1	(5.5)	(3.0)	(1.8)	(0.9)	0.0	1.5
Reserve	-	-	-	-	1.0	1.5	1.5	1.5
Surplus/(Deficit)	0.4	0.1	(5.5)	(3.0)	(2.8)	(2.4)	(1.5)	0.0
Net provincial debt	132.1	132.6	138.6	142.2	146.0	149.7	152.6	153.8

Source: Ontario Ministry of Finance

rates of depreciation with the useful life of assets and similar Federal Government plans which in turn is dependent upon the successful adoption of existing Federal Budget proposals.

Path to balance marked by prudent economic assumptions

To its credit, the Ontario government is taking a careful and prudent approach to a balanced budget. Cognizant of the many downside risks to Ontario's economic outlook, a gradual approach to balance is necessary so as not to add fiscal drag to an already long list of challenges. With major drivers of growth such as auto production and new home construction either near or already beyond their cyclical peaks, the last thing the economy needed was to have fiscal drag added for political reasons.

Table 2 compares the key economic assumptions made by the Ontario Ministry of Finance in formulating this year's budget to our own forecasts. The government's underlying assumptions err significantly on the conservative side in FY2005-06, although less so the year after. This means that there is significant potential to be positively surprised on revenue growth during the next year such that if reserves are not needed and if revenues come in higher than anticipated, fiscal balance within the mandate is still not out of the question for the McGuinty government.

Further upsides to Ontario revenues hinge on federal politics. The Ontario government has not included any assumptions regarding recent promises for enhanced funding from the federal government. The exact amounts involved, and their timing, are open to considerable interpretation.

Good news on education and infrastructure

There is a strong effort to address education and infrastructure spending shortfalls. An additional $6.2 billion in extra education funding spread out between 2005-06 and 2009-10 will be focused on $1.5 billion in increased financial aid for low- and middle-income students, $4.3 billion in operating grants to colleges and universities to fund greater enrolment space at the post-secondary level and a 15% rise in medical education spaces and an extra $366 million mostly targeted towards training and apprenticeship programs.

The government states that this is the largest multi-year commitment to education funding in 40 years. About $683 million is earmarked for 2005-06 and when completed by 2009-10, overall increases will amount to a 39% rise from today.

A proposed five-year $30 billion infrastructure investment plan is a serious attempt to address concerns about the state of Ontario's crumbling infrastructure. During the past 10 years, Ontario has ranked near the bottom of the pack among all provinces and U.S. states on total capital spending by sub-federal levels of government. The investments are targeted towards hospitals, schools, an expanded affordable housing program, new power supply projects, a variety of transportation and border related projects, and increased funding of a variety of other municipal projects.

Funding this bill will be a challenge. Ontario residents will be offered Infrastructure Renewal Bonds for sale later this year. They will represent a material off-balance sheet liability. What is missing is greater detail on what's new and exactly how the projects will be funded.

In addition, in line with increased federal funding, Ontario will be spending $1.1 billion more on child care by 2007-08 compared to 2003-04. Outside of health and education, spending in other ministries will be cut or grow at the rate of inflation.

Throwing in the towel on health spending

This year's budget suggests either that the Ontario government has learned from last year or has completely thrown in the

Ontario economic outlook

	2003	2004	2005		2006		2007	2008
			RBC	OMF	RBC	OMF		
Real GDP growth (%)	1.6	2.6	2.4	2.0	3.0	2.8	3.4	3.3
Nominal GDP growth (%)	3.1	4.7	4.6	3.9	5.1	4.6	5.3	5.3
Inflation (% change)	2.7	1.9	1.7	2.1	2.0	1.9	1.8	1.8
Unemployment rate (%)	7.0	6.8	6.6	6.7	6.0	6.5	6.3	6.1
Interest rates (%, 10-year bond)	4.80	4.60	4.64	4.60	5.14	5.20	5.7	6.0

OMF = Ontario Ministry of Finance, a = actual, e = estimate, f = forecast
Source: RBC Financal Group, Ontario Ministry of Finance

towel on expenditure controls as they relate to health spending. Total program expenditures are projected to rise by 5% in FY2005-06, while total expenses are forecast to grow by 4.2% due to lower capital spending and a modest projected rise in interest expenses. Of the $3.4 billion in new program spending for FY2005-06, $1.8 billion is targeted towards health care.

In last year's budget, growth in health spending was supposed to have been in line with only inflation and population growth. That should have translated into growth of just over 3%, whereas health spending actually grew by about 11%. It is clear where the money from revenue surprises went.

The budget makes little attempt at restraining growth in health spending going forward with health spending projected to grow by 5.9% in FY2005-06 and a cumulative $4.8 billion by 2007-08 from today's level. Health spending will soak up 46% of this year's total program spending and will rise to about 47.3% of program spending by 2007-08. Much of the rise in health spending in recent years has been focused outside of hospital operating budgets that comprise only about 30% of total public health spending in Ontario and which have been flat as a share of GDP for many years now.

Explosive growth outside of hospital operating budgets only continues with this budget and there is scant evidence that initiatives such as Local Health Integration Networks have been successful at containing costs when applied in other jurisdictions. This is a material issue because it means that opportunities to pursue tax relief or greater spending on education and infrastructure are being passed over in favour of failing to restrain health spending.

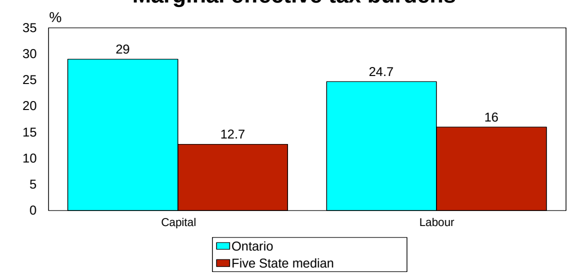
Indeed, compared to other countries with similar income levels and universal health care programs, Canada spends between 20% and 50% more on health care on a per capita basis properly adjusted using purchasing power parity exchange rates. Canada is a relatively high-cost producer of such services.

Challenges only partly addressed

While there are encouraging elements to this year's budget, there is still much work to be done in addressing Ontario's long-run competitiveness challenges. For one thing, this budget does not at all address — or even acknowledge — a high tax burden and growing reliance on profit-insensitive levies. For example, hopes for an accelerated elimination of the province's capital tax were dashed, and the plan still calls for elimination only by 2012. Despite what the government says about being competitive on statutory tax rates, compared to a peer group of U.S. states with which the province competes for capital and jobs, Ontario taxes capital investments much more heavily when the burden is measured as corporate income taxes, sales taxes on capital inputs, and the capital tax (chart 2). This, in turn, is an impediment to productivity-enhancing investments needed to turn around a lacklustre performance on labour productivity growth and enhance the province's long run living standards.

Chart 2

Marginal effective tax burdens

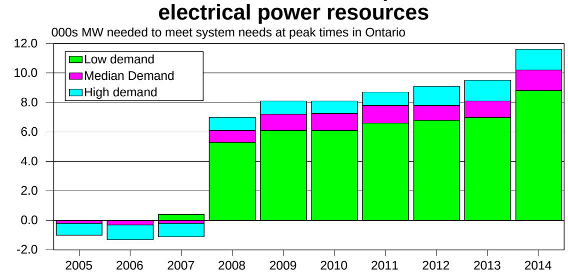


Source: "Taxing Investments: On the Right Track, but at Snail's Pace," by Duanjie Chen and Jack Mintz, 2003

Second, there is still a long way to go in addressing the looming energy challenges facing the province that will emerge by 2008 once coal plants are taken off line (chart 3).

Chart 3

Ontario's additional required electrical power resources

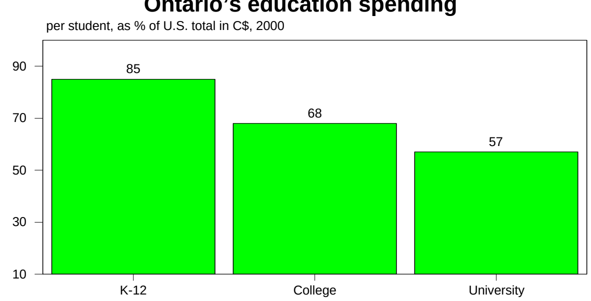


Source: Independent Electricity Market Operator

Third, even though education funding was addressed, Ontario still has a very deep hole to climb out of compared to peer U.S. states that is only partly addressed in this budget (chart 4).

Chart 4

Ontario's education spending



Source: Task Force on Competitiveness, Productivity and Economic Progress

Several OCC priorities addressed

On a more microeconomic level, it is encouraging that the Ontario Government is paying heed to several of the priority areas of the Ontario Chamber of Commerce either through the budget or other recent announcements.

Small Business Agency

This is a major acknowledgement of the longstanding concern of the Ontario Chamber of Commerce regarding the red tape burden facing Ontario businesses. The overall mission of the Small Business Agency will be to review the regulatory burden on small business with a goal aimed towards reducing red tape and providing a single contact number for all business related services provided by the Ontario government.

Accelerated rates of depreciation

The Ontario Government announced that it will match the Federal Government's initiatives to move depreciation rates in line with useful life assumptions. This initiative is contingent upon the Federal Budget successfully passing, or upon a comparable future initiative.

Education funding

The Ontario Government deserves nothing short of top marks for committing itself to major new investments in education including within the K-12 system, expanded apprenticeship programs, and greater postsecondary funding.

Apprenticeship needs

In particular, higher education spending on apprenticeship programs address a specific concern of the OCC regarding shortages in several skilled trades that are hampering growth in Ontario businesses.

Border improvements

The OCC was delighted to see that the Ontario Government has formally acknowledged our work on pointing to the $5 billion annual cost of border congestion to the Ontario economy. A number of border improvement initiatives are now underway.

Infrastructure announcements

The OCC was very encouraged that the Ontario Government plans on addressing the deep infrastructure deficit facing the provincial economy and that the private sector will be involved. What is discouraging are the reports that private sector involvement may be small for purely political reasons. Details at this point are still sketchy, but the government has noted that it will be making further announcements in the coming weeks.

National Securities Regulator

It was extremely encouraging that the Budget contained positive language surrounding the need for a common securities regulator spanning across all provinces.

Northern Development

There were a number of initiatives specifically geared towards enhancing economic opportunities in northern Ontario. In particular, the OCC was pleased that the government has announced plans to speed up construction on Highways 11 and 69.

Independent Quality Council

The idea behind this initiative is to strengthen access to health care and enhance accountability within the system, both of which are highly supported by the OCC.

Doctor shortage

In keeping with the resolution passed at this year's Annual General Meeting of the OCC, there are some encouraging initiatives in this year's budget to address the doctor shortage including enhanced medical school funding and higher enrolment targets.

Labour Market Development Agreement

This was a product of pre-budget meetings between Prime Minister Paul Martin and Premier Dalton McGuinty and is encouraging in its scope and application to the labour needs of Ontario businesses.

Research Council of Ontario

Although they are planning to announce further details in the fall, this is an encouraging first step towards consolidating all of the funding programs for R&D programs under one roof and for coordinating the effort towards more closely linking R&D and commercialization efforts.