

Ontario Budget

Comments on the 2006 Ontario Budget

**Investing in infrastructure
before eliminating the deficit**



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Highlights:

The Ontario Minister of Finance, Dwight Duncan, today tabled his first budget, the third of the McGuinty government. While the previous budget contained massive investments in education, the 2006 Budget puts the emphasis on investment in the province's transportation infrastructure and on the growth of health care spending. Despite revenues much greater than anticipated, the Ontario government has chosen not to accelerate its deficit elimination plan.

Here are some highlights:

- The preliminary results show a deficit of \$1.4 billion for the 2005-2006 fiscal year, an improvement of only \$200 million in relation to the previous year. Expenditures and revenues grew at a sustained pace during the past year.
- The government anticipates limited growth of 2.1% in revenues and expenditures in 2006-2007 and a deficit of \$2.4 billion. However, this deficit includes an annual contingency reserve of \$1 billion. If it is unnecessary to use this reserve, as was the case last year, the deficit will remain at \$1.4 billion.
- The elimination of the deficit is still forecast for the 2008-2009 fiscal year at the latest. If the reserves are not used, Ontario will balance its budget one year earlier, in 2007-2008.
- In 2005, economic growth exceeded the expectations of the private sector and the Ministry of Finance. This translated into substantial additional revenues for the province, mainly through the income tax. The Ontario government decided to allocate over 60% of the additional funds available to new investments in the province's infrastructure.
- The government thus announced a new investment of \$1.2 billion, through Move Ontario, in the province's public transit networks and road infrastructure. \$838 million will go to the expansion and modernization of public transit in the Greater Toronto Region, of which \$670 million will serve to fund the Toronto subway extension to the York Region. However, this project will call for the financial participation of the municipal and federal administrations.
- Acting on its commitment to the municipalities, the provincial government will increase the share of the gasoline tax they receive to fund public transit to 2 cents a litre.
- The growth of costs related to health care, one of the McGuinty government's major priorities, continues at a breakneck pace. Spending in this sector will increase by \$1.9 billion to reach \$35.4 billion in the 2006-2007 fiscal year, for 46% of all program spending. The increase in education spending will be more limited, at \$424 million.
- The budget does not contain any tax increase. The only significant reduction concerns the capital tax applied to businesses. The current tax rate will decrease by 5% (from 0.3% to 0.285%) effective January 1, 2007, two years sooner than anticipated. The government intends to eliminate the capital tax completely in 2010, if the financial context allows it.
- Ontario's net debt will reach \$146.8 billion at the end of the 2006-2007 fiscal year and will continue to grow thereafter. The Budget does not contain a debt repayment plan. Nonetheless, net debt as a percentage of the gross domestic product (GDP) should decline, falling below the 25% mark in 2008-2009.

Table 1
Summary of budgetary transactions

In millions of \$	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006f-2007f	2007f-2008f	2008f-2009f
. Total revenues	66,534	68,891	68,400	77,841	83,939	85,730	90,300	94,000
- Ann. var. in %	0.4	3.5	-0.7	13.8	7.8	2.1	5.3	4.1
. Total expenses	66,159	68,774	73,883	79,396	85,308	87,080	90,300	92,500
- Ann. var. in %	2.7	4.0	7.4	7.5	7.4	2.1	3.7	2.4
. Reserves	---	---	---	---	---	1,000	1,500	1,500
. Surplus/(deficit)	375	117	-5,483	-1,555	-1,369	-2,350	-1,500	0
. Net debt	132,121	132,647	138,557	140,662	142,961	146,763	149,800	151,200
. Accumulated deficit	132,121	118,705	124,188	125,743	113,053	115,403	116,900	116,900
. Total expenses as a % of GDP	14.6	14.4	15.0	15.3	15.7	15.3	15.2	14.9
. Surplus/(deficit) as a % of GDP	0.1	0.0	-1.1	-0.3	-0.3	-0.4	-0.3	0.0
. Net debt as a % of GDP	29.1	27.7	28.1	27.2	26.2	25.8	25.2	24.3
. Accumulated deficit as a % of GDP	29.1	24.8	25.2	24.3	20.8	20.3	19.7	18.8

Sources: Ministry of Finance of Ontario and Desjardins, Economic Studies

f: forecasts

Prudent economic assumptions

As was the case last year, the Ontario government is using prudent economic assumptions in this budget. Thus, the real economic growth of 2.3% forecast this year is significantly lower than our 2.8% forecast. The 2.7% growth forecast in 2007 is similar to our scenario. According to the estimates of the Ministry of Finance, a 1% increase in real growth in relation to the budget assumptions translates, on the average, to a \$645 million rise in the province's revenues.

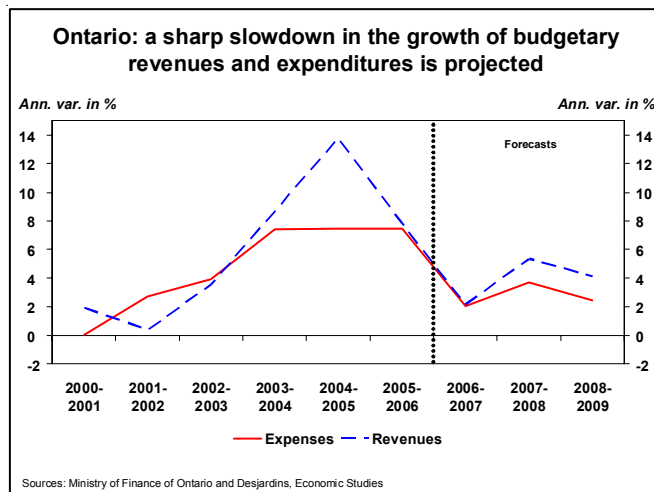
Everyone agrees that the economic context, including the strong appreciation of the Canadian dollar and the rising price of oil, hurts the Ontario economy and will continue to limit its growth in 2006 and 2007.

The financial assumptions also seem prudent. The Ministry of Finance forecasts interest rates higher than those of our scenario, particularly in 2007, which could translate into savings in relation to the interest expenses currently forecast. The Canadian dollar, however, could rise slightly more than the Ministry of Finance anticipates.

The deficit could have been eliminated

Today's budget clearly shows that the Province of Ontario's fiscal position has improved strongly in the past few years. For a second consecutive year, revenues strongly exceeded the government's expectations, thus giving it leeway to invest in its priorities.

It is regrettable, however, that the government has not taken this opportunity to eliminate the province's deficit immediately. Nonetheless, the major reinvestment in transportation infrastructure seems to be an interesting measure that will be beneficial for the province's economy in the long term. The timing of its announcement is



surprising, as are certain accounting treatments. Thus, the Move Ontario plan, a capital project, is accounted for immediately as a current expenditure, which alone explains 90% of the deficit reported for the 2004-2005 fiscal year. The McGuinty government seems to have preferred to wait for the next budget, the last before the October 2007 election, to rebalance the budget.

The accelerated reduction of the capital tax appears to be an excellent measure, in our view, and should stimulate investment and increase the competitiveness of Ontario businesses. However, one may ask whether it wouldn't have been desirable to reduce the tax burden on Ontario households and businesses a little more, at a time when the province is going through a difficult economic period.

For the next few years, the prudent assumptions and the large contingency reserve give the Ontario government substantial room to manoeuvre. However, it must be seen whether the province will succeed, as it forecasts, in limiting its annual spending growth to only 2.7% per year, on the average, over the coming budget years, compared to an average of 7.4% in the past three years.

The question of resolving the fiscal imbalance could also have a major impact on the province's budget position. The McGuinty government today reminded the public of its desire to see a reduction in the annual \$23 billion gap between Ontario's contribution to Confederation and the services and transfers received from the federal government.

Table 2
Economic and financial forecasts

	2005 Budget	2006f Budget	Desjardins Group	2007f Budget	Desjardins Group
. Ontario nominal GDP (%)	5,3	4,5	5,6	4,3	4,8
. Ontario real GDP (%)	2,7	2,3	2,8	2,5	2,6
. CPI* inflation	2,2	2,1	1,8	1,8	2,0
. Canadian Treasury bills (%)					
- 3 months	2,7	4,0	3,9	4,3	3,6
. Canadian bonds (%)					
- 10 years	4,1	4,5	4,3	4,8	4,0
. Canadian dollar (US\$/CAN\$)	82,5	87,0	88,0	87,0	90,0

* Consumer price index.

Sources: Ministry of Finance of Ontario and Desjardins Economic Studies

f: forecasts