



Mary Webb (416) 866-4202
mary_webb@scotiacapital.com

Fiscal Pulse

Ontario's 2009-10 Mid-Year Update — Widening Deficits Alongside Economic Restructuring

With Ontario particularly vulnerable to the economic downturn and the Province's ongoing commitment to discretionary stimulus to sustain the current recovery, the projected deficit for fiscal 2009-10 (FY10) again is revised wider to \$24.7 billion, \$10.6 billion larger than the March *Budget* estimate. The forecast FY11 shortfall is broadened by \$8.9 billion to \$21.1 billion and the FY12 gap by \$9.7 billion to \$19.4 billion.

Ontario estimates an increase of almost \$31 billion (+20%) in its net debt. The long-term public borrowing requirement for FY10 is raised to \$42.6 billion, \$3.4 billion higher than the revised Q1 estimate, and requirements for both FY11 and FY12 now are expected to exceed \$39 billion. To October 7, Ontario had borrowed \$24 billion, a healthy 56% of its expanded requirement, with 48% raised from international markets. Short-term borrowing in FY10 will be \$4.7 billion above *Budget*, but will remain less than 9% of Ontario's total debt.

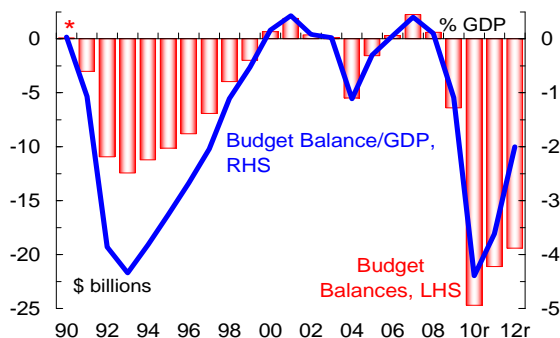
DBRS, after downgrading Ontario's long-term credit rating from AA to AA (low) and its short-term rating from R-1 (high) to R-1 (middle), has stated that all trends are now stable. Details of a strategic expenditure review and the Province's plan to return to balanced books await the spring *Budget*.

Since Ontario's Q1 report, the \$6.2 billion widening of the projected FY10 deficit splits almost evenly between a downward revision to revenues and an upward adjustment to expenditures. Relative to *Budget*, FY10 federal transfers remain unchanged but Ontario's own-source receipts are a dramatic \$5.8 billion lower, while program outlays are \$4.7 billion higher and the debt service \$0.1 billion higher.

Ontario's *Budget* gap continues to widen, with FY10 revenues now forecast to fall 7.1% from FY08 and expenditures to rise 17.8%. A larger-than-expected 8.3% fall in own-source receipts in FY09 resulted in a narrower revenue base entering FY10 and a further 4.0% decline in own-source receipts is forecast for this year. As indicated in the table below, the correction in Ontario's income tax receipts over FY09-FY10 is forecast to be steeper than Ottawa's. A 16% jump in federal transfers this year, however, will result in total FY10 revenues just 0.3% below FY09.

Acknowledging current uncertainties, the prudence embedded in the revised Q2 estimates is raised from Q1. The \$1.2 billion annual reserve remains intact for FY10 to FY12, and the Operating Contingency Fund, restated to \$1.9 billion, plus the \$0.2 billion Capital Contingency Fund offer a further \$2.1 billion cushion for FY10. As well, the *Budget* estimates build in a provincial real GDP decline of 3.5% in 2009, with a modest 2.0% rebound in 2010, more conservative than the average estimates of -3.3% and +2.4% from Ontario's survey of private-sector forecasters. Under the government's assumptions, Ontario's GDP will not return to pre-recession levels until Q2 2011, while provincial employment will not fully recover until late 2011. Remaining risks include a stronger Canadian dollar and higher oil prices than the Province has assumed, but the turnaround anticipated for the Ontario economy during the latter half of 2009 as motor vehicle production ramps up to replenish North American inventories is encouraging.

Ontario's Revised Fiscal Outlook



* FY90 surplus of \$90 million.
 Source: Ontario Finance; GDP forecasts: Scotia Economics.

Fiscal Fortunes Reverse

	Ontario	Federal
	% ch., FY10 vs FY08	
Personal Income Tax	-7.3	-3.9
Corporations Tax*	-54.8	-41.4
Retail Sales Tax/GST	0.7	-13.8
Total Tax Revenue	-13.7	-13.4
Other Own-Source Revenue	-1.8	3.8
Total Own-Source Revenue	-7.1	-10.7

* For federal government, corporate income tax only.

Ontario is proceeding with scheduled personal tax relief for 2010 that should help to support household spending. Led by a drop in the lowest-bracket personal income tax rate from 6.05% to 5.05% in January 2010, representing over \$1 billion of annual tax savings, the first of three Ontario Sales Tax Transition Benefits totalling \$4.0 billion will be paid in June 2010. As well, the Ontario Sales and Property Tax Credits will be separated and enhanced for lower- and middle-income residents.

Program expenditures are forecast to jump 18% in FY10. Much of the surge is one-time outlays such as \$4.0 billion for automotive sector support, \$650 million for H1N1 flu preparation, \$295 million for additional training programs for displaced workers and \$254 million for increased social assistance during the downturn. Hikes in core program expenses topped \$800 million, dominated by a \$700 million rise in health costs.

Progress on Ontario's various stimulative measures includes approval of more than 2,600 joint infrastructure projects with Ottawa, with 30% already under construction. A two-year \$1.2 billion investment in social housing also is jointly funded, plus \$5 million annually from the Province to stabilize the Rent Banks' funding. Among Ontario's colleges and universities, over 36,000 new spaces will be created by 2011, including 2,300 new apprenticeship positions. In addition to the joint \$1.5 billion of post-secondary capital funding, Ontario is providing \$115 million for facilities renewal and eight strategic projects. In total, Ontario's plans remain unchanged to raise its infrastructure outlays a hefty 54% in FY10 to \$12.7 billion. Passage of the *Green Energy and Green Economy Act* and implementation of the Feed-in Tariff program in October is expected to spur further investment in renewable energy, prompting \$2.3 billion of power transmission and distribution projects over the next three years.

Responding to industrial restructuring, the March *Budget* announced two-year funding topping \$750 million for new and enhanced skills training, supported by Canada-Ontario labour market agreements. The Rapid Re-employment and Training Service, for example, has offered counselling assistance to over 110,000 dislocated workers since 2007. Targeted aid for industry was expanded with a \$0.1 billion enhancement to the Ontario Production Services Tax Credit as of July to support the film and television sector.

Following the steeper revenue decline in FY10, receipts for FY11 and FY12 are now expected to be \$4.3 billion below the March *Budget* estimates, with \$2.3 billion of the decline due to the narrower FY09 revenue base and \$2.0 billion a result of the weaker economic outlook. The government's estimates recognize that several of Ontario's largest sectors have substantial tax loss carryforwards that will restrain the recovery of Ontario's corporate tax receipts for several years. Conversion to a Harmonized Sales Tax (HST) in July 2010, however, is expected to generate \$1.7 billion of additional revenues in FY11. For a full fiscal year, the revenue boost in FY12 is expected to be \$2.2 billion, trending steadily higher. As the provincial economy restructures under the strain of a stronger Canadian dollar, a major positive factor is the Province's drive towards a more competitive corporate tax structure. As discussed in our review of Ontario's March *Budget*, for the business sector, the introduction of an HST will reduce tax compliance, operating and capital costs. Combined with the removal of the Province's corporate capital taxes in July 2010, the reduction of the general corporate income tax rate from its current 14% rate to 10% by mid-2013 and small business tax reform, the new tax framework should stimulate business investment going forward.

Details of a revised path to balanced books are anticipated in the spring *Budget*, when the recommendations from the strategic spending review conducted by the Treasury Board/Management Board of Cabinet will form a "plan of action" to place the Province's spending on a more sustainable track as its population ages. The government also will work with its broader public-sector partners to prioritize spending and reviews are promised for all agencies, boards and commissions. The stakes are high for these spending reviews. In addition to other spending pressures, the debt service, currently constrained by a decline in the effective interest rate on total debt from 5.17% as of March 2009 to 4.85% at September 30, will eventually be impacted by significantly higher market interest rates down the road.

Ontario's Budget Arithmetic
\$ millions except where noted

	FY09	FY10	
	Actual	Budget	Q2
Personal Income Tax	24,727	25,170	22,735
Corporations Tax	6,748	8,518	5,868
Retail Sales Tax	17,267	17,600	17,100
Ontario Health Premium	2,776	2,829	2,704
Other Taxes	10,877	10,739	10,649
Tax Revenue	62,395	64,856	59,056
Gov't Bus.Ent. - Income	4,042	4,267	4,267
Other Own-Source Rev.	7,444	7,611	7,611
Total Own-Source Rev.	73,881	76,734	70,934
Federal Transfers	16,591	19,246	19,246
Total Revenue	90,472	95,980	90,180
Program Spending	88,315	99,579	104,290
Debt Service	8,566	9,301	9,406
Total Expenditure	96,881	108,880	113,696
Contingency Reserve	0	1,200	1,200
Surplus (Deficit)	-6,409	-14,100	-24,716
Annual Change, %			
Personal Income Tax	0.8	1.8	-8.1
Corporations Tax	-48.1	26.2	-13.0
Retail Sales Tax	1.7	1.9	-1.0
Total Tax Revenue	-8.8	3.9	-5.4
Total Own-Source Rev.	-8.3	3.9	-4.0
Federal Transfers	0.0	16.0	16.0
Total Revenue	-6.8	6.1	-0.3
Program Spending	0.8	12.8	18.1
Memo Items, %			
Own-Source Rev./GDP	12.6	13.6	12.6
Program Spending/GDP	15.0	17.7	18.5
Debt Service/Revenue	9.5	9.7	10.4

Source: Ontario Finance; GDP forecasts: Scotia Economics.

Scotia Economics

Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia_economics@scotiacapital.com