Sector Overview:

Fiscal Trends

Ministry of Finance, Treasury Board Secretariat
and the Ontario Financing Authority

May 2018

SECTION 1: OVERVIEW

This sector overview focuses on Ontario's fiscal outlook. It provides historical information on the major components of the fiscal outlook (revenue, expense, and debt), outlines key characteristics of the fiscal outlook and planning process, and discusses the Province's longer-term fiscal sustainability.

SECTION 2: KEY FACTS AND TRENDS

Ontario's Fiscal Decision-Making and Reporting is Governed by Legislation

Ontario's fiscal decision-making and financial reporting framework is governed by two core pieces of legislation:

- The Financial Administration Act (FAA): The FAA stipulates requirements for financial management, disbursement of public money, public debt and civil liability, including the preparation of the Public Accounts at the end of each fiscal year to provide a picture of how well the provincial finances were managed. It also outlines the roles and responsibilities of the Treasury Board/Management Board of Cabinet and Ministry of Finance.

- The Fiscal Transparency and Accountability Act (FTAA): Enacted in 2004, the FTAA sets out the requirements for public reporting of the fiscal plan and provides guidelines for preparing the Budget, Quarterly Finances, Ontario Economic and Fiscal Review (mid-year review), Long-Term Report and Pre-Election Report.

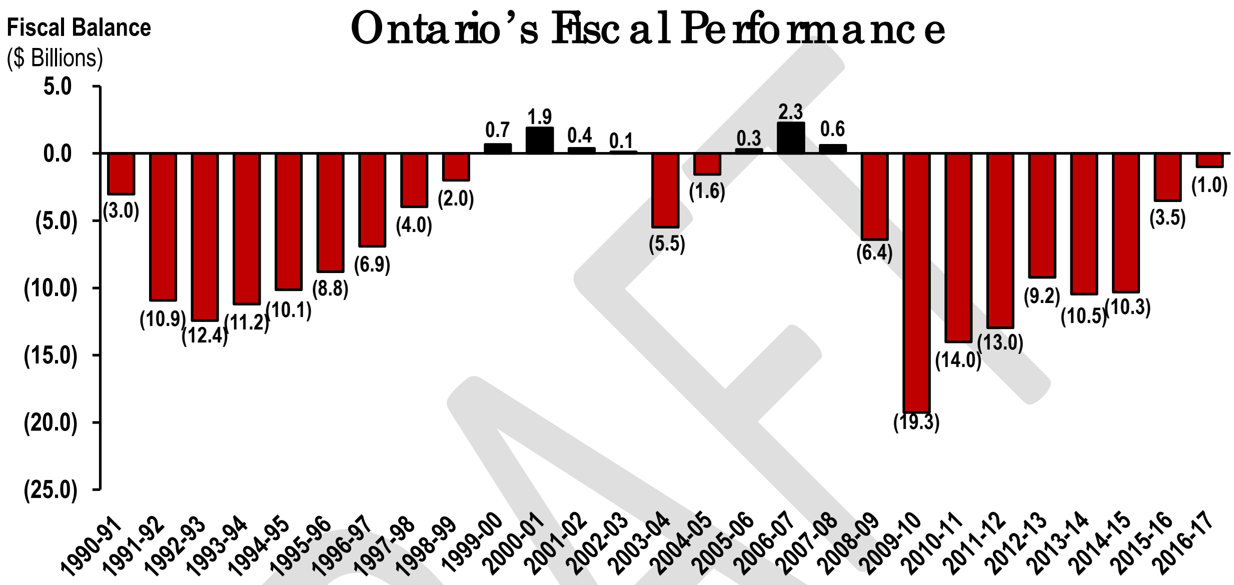
Ontario's Fiscal Plan is Approximately Half the Size of the Federal Fiscal Plan

With a population of 14.2 million, Ontario is home to about 2 in 5 Canadians and generates approximately 39 per cent of the national gross domestic product (GDP). As of 2016–17, Ontario's fiscal plan was almost half the size of the federal fiscal plan ($142 billion vs. $311 billion in total expenses). It also comes close in size to the next two largest Canadian jurisdictions combined, Quebec ($99 billion) and British Columbia ($49 billion).

Over the Past 25 Years, Ontario Has Typically Been in a Deficit Position

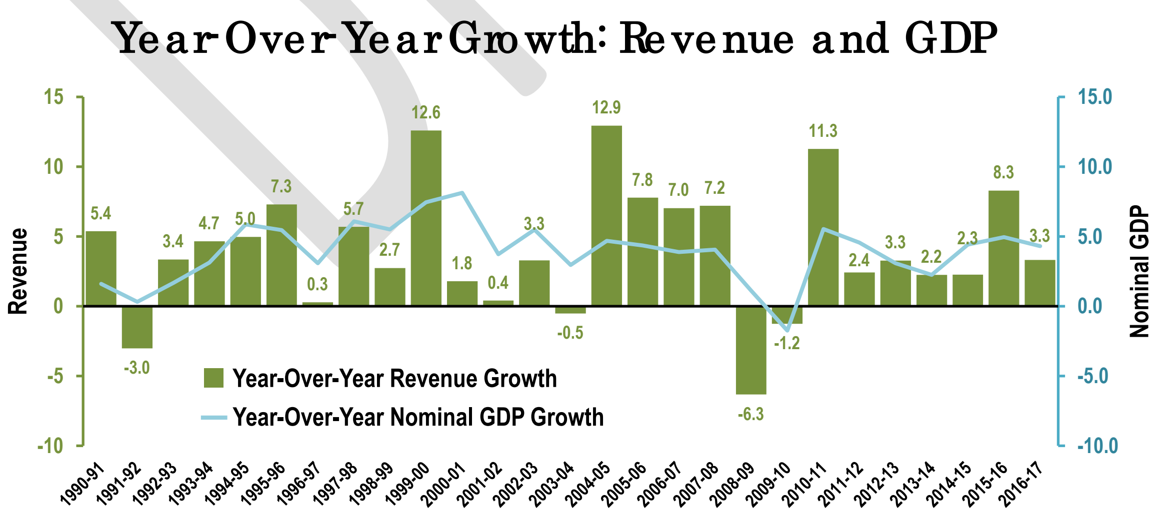
Longer Term Trends: 1990–91 to 2016–17

Ontario has been in deficit in 20 of the last 27 years, with cumulative deficits of $164 billion and cumulative surpluses of $6 billion.



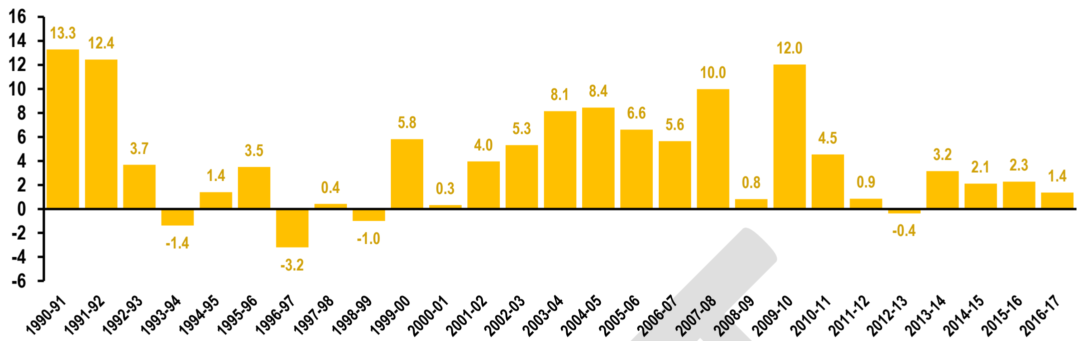
Source: Ontario Ministry of Finance.

Average annual growth in revenue and program expense from 1990–91 to 2016–17 was 3.9 per cent and 3.7 per cent, respectively. Large variations in year-over-year revenue and program expense growth have been mainly due to recessions and recoveries.



Note: Amounts have not been restated for BPS line-by-line consolidations.

Year-Over-Year Growth: Program Expense



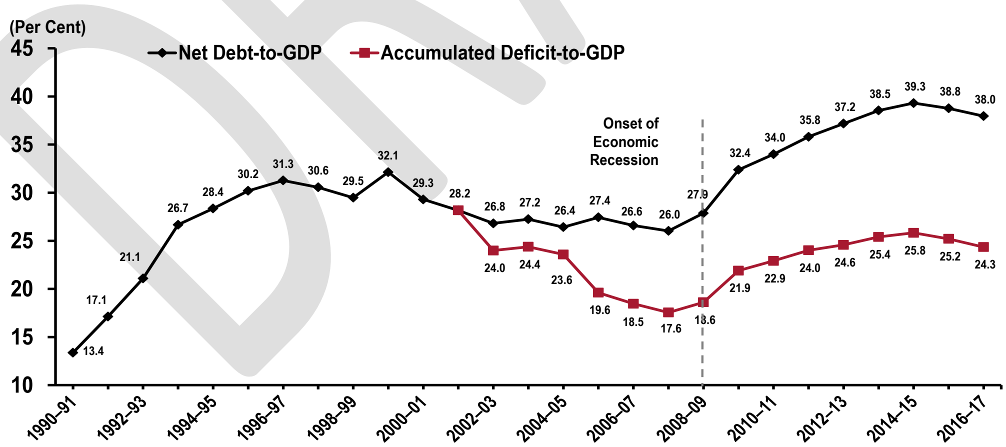
Note: Amounts have not been restated for BPS line-by-line consolidations.

Historically, Net Debt-to-GDP Has Increased Significantly During Recessions

Net debt is the difference between total liabilities and financial assets. The accumulated deficit is the difference between total assets and total liabilities and can be thought of as the sum of all previous surpluses and deficits. Since the 1990s, the net debt-to-GDP ratio has increased significantly on two occasions, both times as a result of a recessionary period. The first steep increase was in the early 1990s, the ratio then plateaued until the next recession hit in 2008–09.

Since peaking in 2014–15, the net debt-to-GDP ratio has been on a declining track as a result of Ontario's economic growth and reduced deficits.

Net Debt-to-GDP and Accumulated Deficit-to-GDP



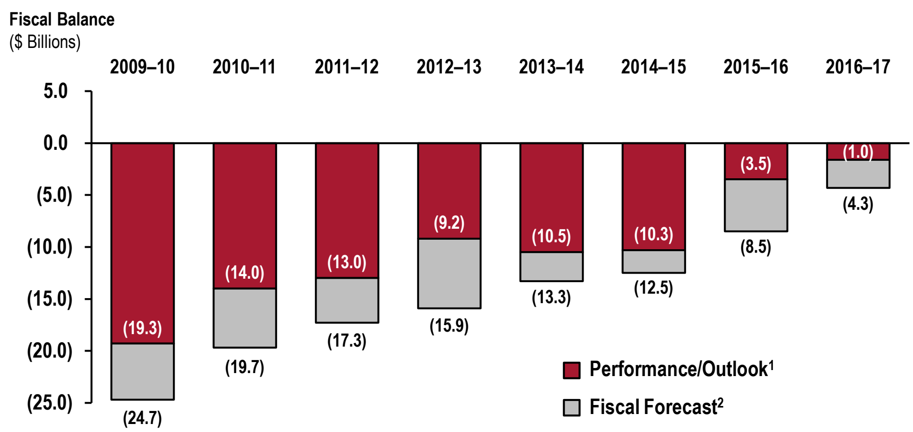
Note: Net Debt has been restated to include broader public sector net debt, starting in 2005–06.
Source: Ontario Ministry of Finance.

Ontario's Fiscal Position Has Been Improving Since the 2008–09 Global Recession

In 2008–09, the global recession hit and the government ran deficits. During the recessionary period, GDP in Ontario declined at a faster pace than in the rest of Canada causing significant declines in revenue, while the government increased spending through stimulus investments, resulting in the deficit peaking at $19.3 billion in 2009–10.

Under the FTAA, if the government plans for a deficit in a fiscal year, it must also develop and release a recovery plan for achieving a balanced budget in the future. For example, in the 2010 Budget, the government projected that the budget would be balanced by 2017–18.

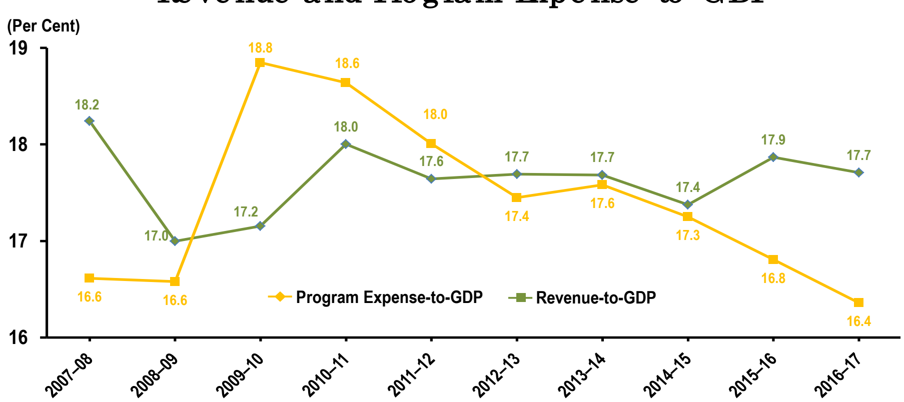
Ontario's Fiscal Performance



[1] For 2009–10 to 2016–17, actual results are presented.
[2] Forecast for 2009–10 is based on the *2009 Ontario Economic Outlook and Fiscal Review;* forecasts for 2010–11 to 2013–14 are based on the *2010 Budget*; forecast for 2014–15 is based on the *2014 Budget*; forecast for 2015–16 is based on the *2015 Budget;* and forecast for 2016–17 is based on the *2016 Budget*.

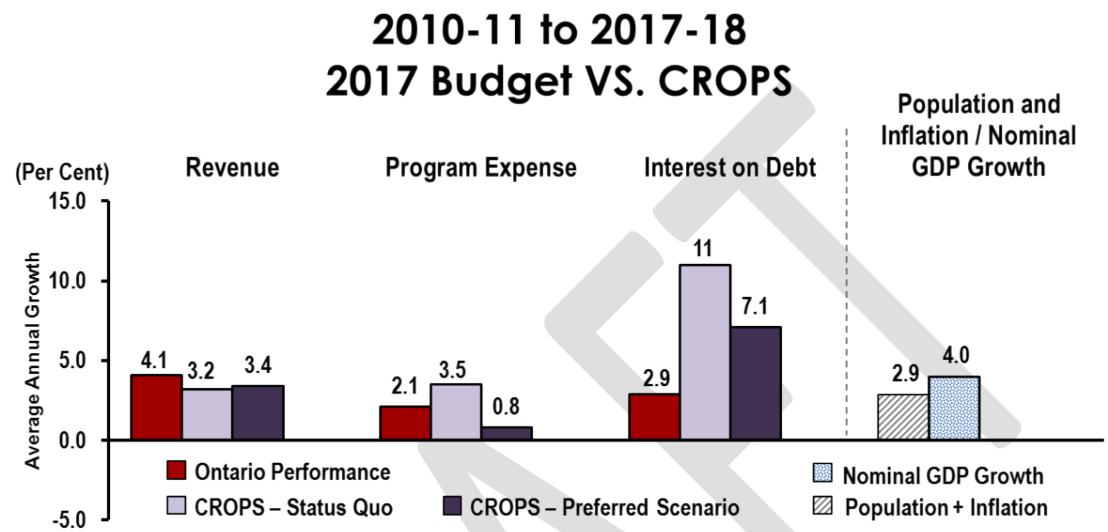
Measuring fiscal performance relative to GDP allows for comparisons over time against the size of Ontario's economy. Efforts to manage growth in program spending have resulted in the program expense-to-GDP ratio declining to its pre-recession level. Over the past 10 years, the share of revenue to GDP has been fairly stable, with revenues growing at a rate consistent with the capacity of the economy.

Revenue and Program Expense-to-GDP



Sources: Statistics Canada and Ontario Ministry of Finance.

In 2012, the government established the Commission on the Reform of Ontario's Public Services (CROPS), chaired by Don Drummond. The Commission's report had more than 360 recommendations and indicated that slowing the rate of growth in program spending to 0.8 per cent was essential to balance the budget by 2017–18. The report also projected that in the absence of measures to slow growth in spending, program expense would grow at an average annual rate of 3.5 per cent.



Note: Ontario amounts based on the published 2017 Budget, and are not restated for BPS line-by-line consolidations for comparability.
Source: Ontario Ministry of Finance.

The chart above compares the CROPS status quo projections and its "preferred" return to balance scenario, with Ontario's actual performance. From 2010–11 to 2017–18, growth in program spending was constrained to 2.1 per cent, below inflation and population growth. Stronger revenue growth and lower interest rates — resulting in lower interest on debt costs — over this period helped to reduce deficits, notwithstanding that program spending grew at a faster rate than the Commission recommended.

<u>Ontario's Revenue Comes from Several Sources, with Federal Transfers Growing the Fastest over the Past 10 Years</u>

Key Drivers of Revenue Growth over the Past 10 Years

Taxation Revenue

Taxation revenues grew at an annual average rate of 2.9 per cent over the past 10 years compared to nominal GDP growth of 3.6 per cent. Slow growth in taxation revenue over this period was largely due to the global recession.

Government of Canada

Government of Canada transfers grew at an annual average rate of 5.7 per cent over the past 10 years largely driven by higher transfers for major federal funding programs (Canada Health Transfer, Canada Social Transfer, and Equalization), as well as funding for labour market programs, infrastructure projects, and direct transfers to the Broader Public Sector (e.g., hospitals, school boards and colleges).

Income from Government Business Enterprises (GBEs)

Net income from GBEs grew at annual average rate of 2.9 percent over the past 10 years mainly due to higher net income of the Ontario Lottery and Gaming Corporation and the Liquor Control Board of Ontario, partially offset by lower net income of Hydro One.

Other Non-Tax Revenue (NTR)

Revenue from other NTR grew at an annual average rate of 2.0 per cent over the past 10 years. This increase was driven by revenues from asset sales, revenues from fees, licenses and permits including fees, donation and other revenues from the Broader Public Sector. Revenues from Ontario's initial five carbon allowance auctions will be booked in 2017–18 as other Non-Tax Revenue and are legislated to be spent on greenhouse gas (GHG) reduction initiatives.

*Numbers may not add due to rounding

Personal Income Tax is income tax collected from individuals. Changes in the government's personal income tax revenue are mainly attributable to changes in employment and wages.
$2,194 per capita | 22 per cent of total revenue

Sales Tax includes the provincial portion of the Harmonized Sales Tax and continuing Retail Sales Tax. Changes in the government's revenues from sales tax are mainly attributable to changes in consumer spending.
$1,771 per capita | 18 per cent of total revenue

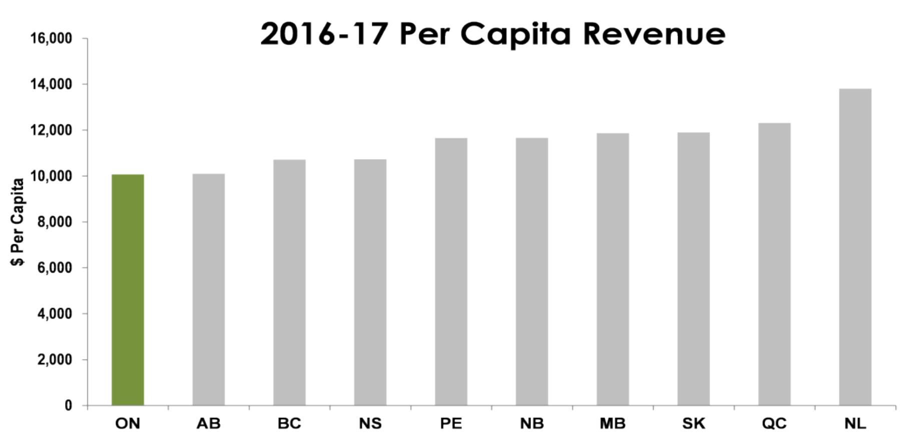
Corporations Tax includes revenue collected through corporate income taxes and the insurance premiums tax. Changes in the government's corporations tax revenue are mainly attributable to changes in corporate profits.
$1,064 per capita | 11 per cent of total revenue

All Other Taxes includes taxes such as Education Property Tax, Ontario Health Premium, Employer Health Tax, Gasoline Tax, Land Transfer Tax and Tobacco Tax. Changes in these taxes come from a variety of sources including changes in the compensation of employees, nominal GDP and sales in the real estate market.
$1,721 per capita | 17 per cent of total revenue

Government of Canada Transfers includes payments transferred from the federal government such as the Canada Health Transfer, the Canada Social Transfer, Equalization payments, transfers for infrastructure, labour market and various other programs.
$1,756 per capita | 17 per cent of total revenue

Government Business Enterprises revenue includes net income from Crown corporations, mainly, the Ontario Lottery and Gaming Corporation, Liquor Control Board of Ontario, Ontario Power Generation and Hydro One.
$398 per capita | 4 per cent of total revenue

Other Non-Tax Revenue includes carbon allowance proceeds, asset sales, sale or rental of Crown property, provincial fees, licences and permits etc.
$1,165 per capita | 12 per cent of total revenue



On a per-capita basis, revenues for the province were $10,069 in 2016–17, the lowest of all other Canadian provinces.

Provincial Revenues Are Dependent on Government Decisions as Well as External Economic Factors

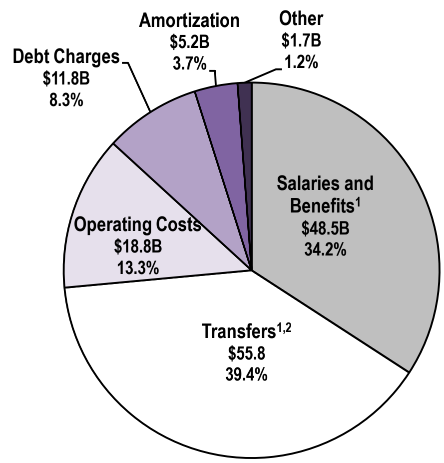
The following table highlights some of the key risks and sensitivities to the fiscal plan that could arise from unexpected changes in economic conditions. The risks included are those that could have the most material impact on Ontario's largest revenue sources.

Selected Economic and Revenue Risks and Sensitivities[1]		
Economic Factors	**Revenue Sources**	**2017–18 Sensitivities***
Nominal GDP	Total Taxation Revenue	$690 million revenue change for each percentage point change in Nominal GDP Growth
Compensation of Employees	Personal Income Tax, Ontario Health Premium and Employer Health Tax	$425 million revenue change for each percentage point change in growth in Compensation of Employees
Household Consumption Expenditures	Harmonized Sales Tax	$190 million for each percentage point change in growth of Household Consumption Expenditures
Net Corporations Operating Surplus	Corporations Tax	$145 million revenue change for each percentage point change in growth of Net Corporations Operating Surplus
Housing Resales and Resale Prices	Land Transfer Tax	$26 million for each percentage point change in growth of either the number or prices of Housing Resales
*Can vary significantly, depending on composition and source of changes in the underlying economic driver. [1] As published in the 2017 Budget (adjustments for line-by-line presentation may have marginal impacts on some of the sensitivities).		

Major Categories of Government Expenditures Include Operating Costs, Salaries and Benefits, and Transfers

The government's total spending is made up of operating and capital expenses, and interest on debt. Operating costs pertain to service, supplies, non-depreciable equipment and other sundry expenses incurred in the year relating to direct delivery of services by the government. Salaries and benefits include costs for provincial employees and organizations consolidated as part of the government's financial statements, including hospitals, school boards and colleges. Transfers include payments to a variety of non-consolidated service providers, such as universities and municipalities, to support their activities in the delivery of public services on behalf of government, as well as transfers to support infrastructure investments. Transfers from the Province are not the only source of funding for these organizations. Capital expense also includes amortization expense of tangible capital assets owned by the Province and its consolidated organizations. Other expenses include various items, including losses on disposal of capital assets and loan forgiveness.

2016-17 Spending by Type of Expense ($141.7 billion)



[1]Compensation related costs for non-consolidated entities (e.g., municipalities, long-term care homes, universities) and payments to doctors for physician services are included in Transfers.
[2]Transfers includes operating and capital transfer payments to non-consolidated organizations
Note: Numbers and percentages may not add due to rounding.

Demographic Trends and Demand for Health, Education and Social Services Are Key Drivers of Expense Growth

Health Sector

A number of key drivers have affected the demand for, and cost of, health care services over the years, such as demographics (population growth and aging), population health status, compensation and technology.

Ontario's growing and aging population has created pressures in the health sector. As the complexity of care is increasing, so is the need to increase health system capacity. Investments in major hospital projects were made to address increased demand due to population growth, shifting demographics, aging hospital facilities and the need for modernized models of care.

Public expectations and societal influences are other factors that have affected demand for health care. Support for technologies that allow people to live more active lives may have driven up system costs, while the reduced social acceptability of smoking may have lowered costs.

Employment in this sector has seen consistent growth since the end of the 1990s, with salaries and wages accounting for 27 per cent of spending in 2016–17 (not including payments to doctors for physician services through OHIP).

From 2011–12 to 2016–17, Ontario's overall health care budget was held to an average annual growth rate of 2.3 per cent, down from an annual average of 6 per cent in the preceding decade, the lowest since 1997. This slowing of growth was driven by a shift towards care provided in the home and community while stabilizing the hospital system. Major cost drivers noted above, such as a growing and aging population, as well as increases in the cost of services due to inflation and compensation increases, will increase pressure on health care spending.

Education Sector

Student enrolment trends declined year-over-year from 2002–03 to 2016–17. Since 2016–17, enrolment has increased and 2018–19 is the first year since 2001–02 in which both elementary and secondary enrolment is expected to grow. Over the next five years, most school boards in Ontario are expected to experience continued enrolment growth.

Compensation is a key cost driver for the education sector. The most recent collective agreements with education sector workers are valid from September 2017 to August 2019. The agreements include staggered salary increases ranging from 0.5 per cent to 1.5 per cent over two years. The agreements also include additional funding to support initiatives including more staff to support students at risk, such as students with special education needs, as well as more teachers and early childhood educators to reduce class sizes.

Postsecondary Sector

Postsecondary institutions have seen increases in enrolment since 2000, in part because of demographics, but also as a result of efforts aimed at raising Ontario's postsecondary attainment rate. Over the last three years, student enrolment has remained relatively stable.

Starting in fall 2017, the Province discontinued the Ontario tuition and education tax credits and reinvested funding into a single Ontario Student Grant that replaced most existing Ontario Student Assistance Program (OSAP) grants. This grant is available for all types of students, including mature and married students. From 2016–17 to 2017–18, the total number of OSAP awards increased by 16 per cent to about 420,000 recipients.

Demand for employment and training programs has been lower than forecasted in recent years as labour market conditions evolve. Costs are driven mainly by changing labour market conditions and economic downturns, as well as by changes to program design and federal labour market agreements.

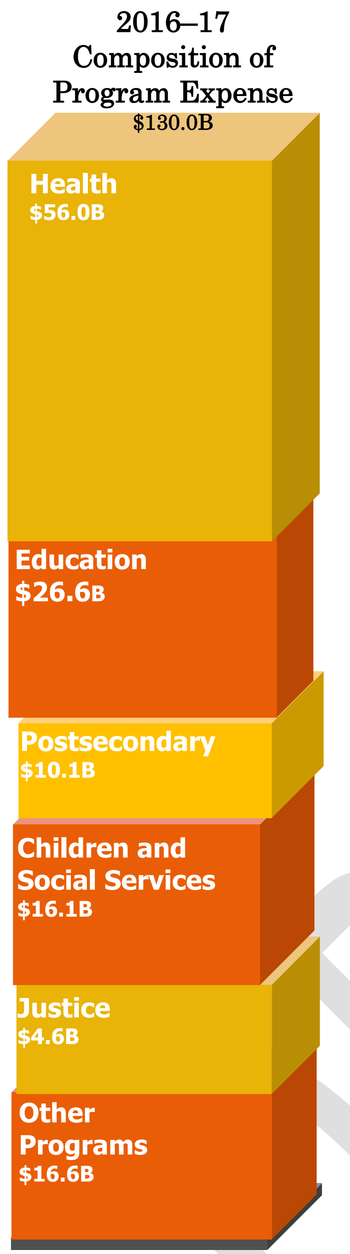
Children and Social Services Sector

Expenditures in this sector have been driven mainly by economic conditions (in particular labour market conditions) and social and demographic factors. For example, the expenditures for social assistance programs increased significantly during the 2008–09 recession, primarily due to an increase in the unemployment rate that resulted in increased demand for financial supports and other services. Other factors, such as increased diagnosis of mental illness, have driven the demand for social programs that support Ontarians with disabilities. As of January 2018, the Province uploaded the cost of all social assistance benefits as part of the Provincial-Municipal Fiscal and Service Delivery Review. Municipalities continue to play a key role in delivering Ontario Works (OW) in their communities and share the OW administration costs with the Province.

In this sector, 95 per cent of expense can be accounted for as transfer payments to non-consolidated entities that deliver services on behalf of the government, including salaries and benefits for employees of these service providers.

Other Government Expenses

This sector includes investments in economic development, transportation, transit, justice, environment and natural resources and other government programs. Some of these programs are demand driven, whereas others are mandated by statutory or regulatory requirements. Demographic changes and the performance of the Ontario economy have continued to be key drivers of demand for government programs. Expenditures on GHG reduction initiatives (funded from carbon allowance proceeds) will also drive growth in this sector. Salaries and wages account for 24 per cent of spending in the other government expenses sector.



*Numbers may not add due to rounding

Health Sector programs include payments to physicians, the operation of hospitals, provincial drug programs and funding for long-term care homes. Government spending in this sector is driven by increased demand for spending on hospitals and drug programs.
$4,003 per capita | 43 per cent of program expense

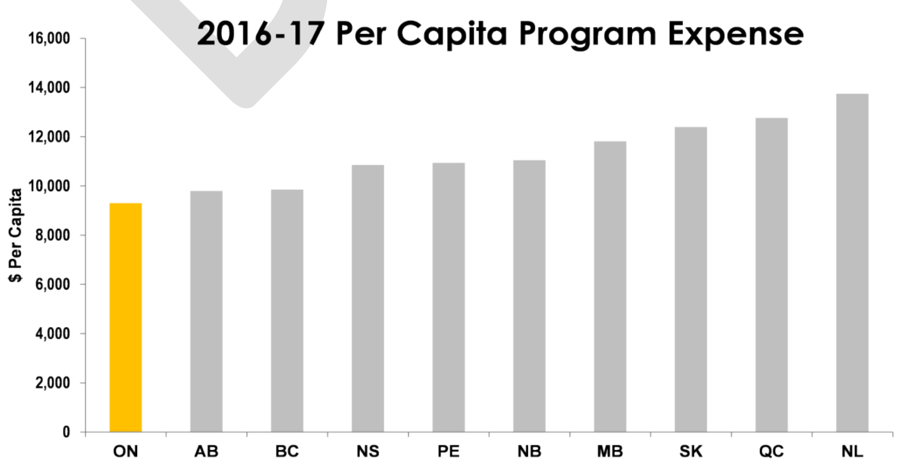
Education Sector expense primarily consists of funding for Ontario's publicly funded elementary and secondary schools, including full-day kindergarten. Changes in program expense in the education sector are mainly driven by changes in enrolment rates in elementary and secondary schools.
$1,902 per capita | 20 per cent of program expense

Postsecondary Sector expense includes support for Ontario's public universities and colleges, student financial assistance and employment and training programs. Changes in program expense in the postsecondary sector are attributable to factors including changes in postsecondary enrolment and uptake of student financial assistance programs
$725 per capita | 8 per cent of program expense

Children and Social Services Sector programs include payments through Ontario Works, the Ontario Disability Support Program, Child Protection Services, Developmental Services and the Ontario Child Benefit. Changes in program expense in the children and social services sector are mainly due to changes in the case load of the Ontario Works and Ontario Disability Support programs.
$1,150 per capita | 12 per cent of program expense

Justice Sector programs include various expenses such as criminal, civil and family court services, justice sector agencies (e.g., Legal Aid Ontario), the operation of provincial correctional facilities, funding for the Ontario Provincial Police and community safety initiatives. Changes in the program expense of the justice sector are driven by several factors, such as changes in the complexity of cases and demand for legal aid services. Criminal prosecutions have become more complex, lengthier and resource intensive due in part to increased utilization of digital evidence. In addition, demand for legal aid services has increased due to the expansion of legal aid eligibility thresholds and increases in the number of refugees in Ontario.
$330 per capita | 4 per cent of program expense

Other Programs Sector include agriculture programs, various funding to municipalities, environmental programs, funding for natural resources and northern development, along with transportation programs such as the maintenance of provincial highways and support for public transit.
$1,193 per capita | 13 per cent of program expense



On a per-capita basis, program expense for the province was $9,303 in 2016–17, the lowest of all other Canadian provinces.

A One Per Cent Change in Health Sector Spending Has the Most Significant Impact on Program Expenses

The following table provides a summary of key expense risks and sensitivities that could result from unexpected changes in economic conditions and program demands.

Selected Expense Sensitivities[1]		
Program/Sector	**2017–18 Assumptions**	**2017–18 Sensitivities**
Health Sector	Average annual growth of 3.3 per cent	One per cent change in health spending: $538 million
Hospitals Sector Expense	Annual growth of 3.1 per cent	One per cent change in hospitals sector expense: $237 million
Drug Programs	Annual growth of 8.4 per cent	One per cent change in program expenditure of drug programs: $42 million
Long-Term Care Homes	78,229 long-term care home beds. Average provincial annual operating cost per bed in a long-term care home: $52,861	One per cent change in number of beds: approximately $41 million
Home Care	Approximately 29 million hours of personal support services Approximately 8.7 million nursing and therapy visits and 2.1 million nursing shifts	One per cent change in hours of personal support services: approximately $9.7 million One per cent change in all nursing and therapy visits: approximately $8.4 million
Elementary and Secondary Schools	Approximately 1,969,000 average daily pupil enrolment	One per cent enrolment change: approximately $165 million
Ontario Works	248,877 average annual caseload	One per cent caseload change: $27 million
Ontario Disability Support Program	358,079 average annual caseload	One per cent caseload change: $51 million
Interest on Debt	Average cost of 10-year borrowing in 2017–18 forecast to be approximately 3.0 per cent	The impact of a 100 basis-point change in borrowing rates is forecast to be approximately $300 million
[1] As published in the 2017 Budget. Adjustments for line-by-line presentation may have marginal impacts on some of the sensitivities.		

Ontario's Expense Plan Includes Significant Capital Spending

Ontario's public infrastructure portfolio is funded by various levels of government. The government develops its long-term capital plan over a 10-year period, as mandated by the Infrastructure for Jobs and Prosperity Act, 2015.

Actual infrastructure spending over the last three years is approximately $33 billion. This amount reflects investments made primarily in priority projects such as hospitals, schools, transit, bridges and roads.

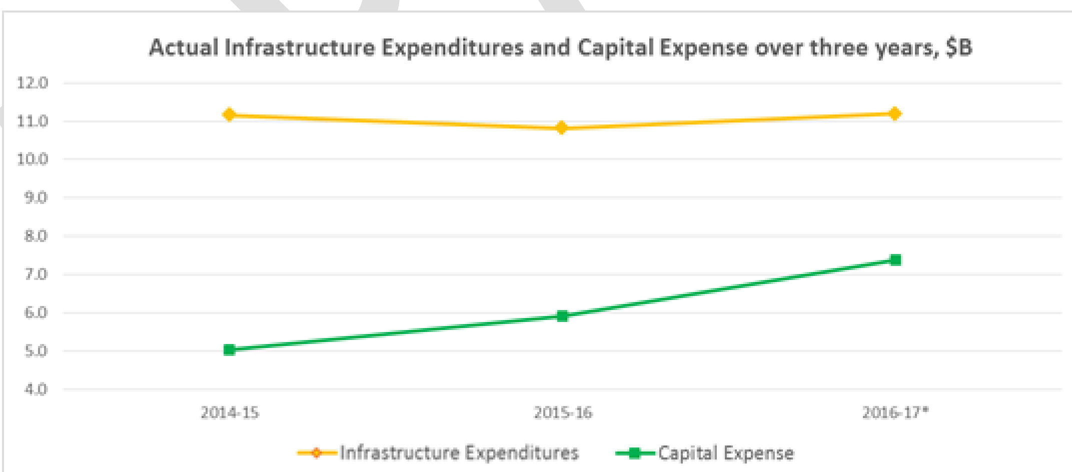
Investments in infrastructure are accounted for in two ways.

- Infrastructure Expenditures – the amount spent on a government-owned and/or consolidated assets leading up to being ready for use (e.g., planning, procurement and/or construction).
- Capital Expense – the full cost of the government-owned and/or consolidated project spread over the life of the asset once it is completed and ready for use.

Both Infrastructure Expenditures and Capital Expense include transfer payments the government provides to municipalities, universities and other non-consolidated entities.

Capital Expense is expected to continue growing beyond 2016–17 primarily from amortization growth associated with Infrastructure Expenditures investments that have been made to date and new assets being put into service.

The chart below outlines the actual Infrastructure Expenditures as well as Capital expense from 2014–15 through 2016–17:



**As a result of a recent accounting policy change, the 2016-2017 Amortization Expense numbers also include amortization from the Broad Public Sector (Hospitals, Colleges and Schools) for the assets acquired through the third-party funding sources. This amortization increase is fiscally neutral and fully offset by the corresponding increase in the Provincial Revenues.*

<u>Federal Transfers Are an Important Source of Ontario Revenue, with the Canada Health Transfer Being the Largest Component</u>

Major Federal Transfers: Unconditional Block Transfers (2016–17 Share)

Canada Health Transfer (CHT)

CHT is the largest federal transfer. It is largely an unconditional block transfer allocated to provinces and territories on an equal per capita basis to help fund the costs of provincial and territorial health care. Since 2005–06, total national CHT funding grew at 6 per cent per year, however, beginning in 2017–18, growth in CHT funding moved to an escalator based on a three-year moving average of national nominal GDP growth, with funding guaranteed to increase by at least 3 per cent per year.

$13.9 billion | 57 per cent of the total revenues from the federal government

Beginning in 2017–18, the Government of Canada will provide additional, time-limited health funding outside of the CHT, which will be targeted towards home care services and mental health services. Ontario will receive $4.2 billion over 10 years.

Canada Social Transfer (CST)

CST is an unconditional federal block transfer that grows at 3 per cent per year, allocated to provinces and territories on an equal per capita basis. It supports provincial and territorial expenditure on postsecondary education, social assistance and social services, including early childhood development, and early learning and child care services.

$5.1 billion | 21 per cent of the total revenues from the federal government

Equalization

Equalization is the Government of Canada's transfer program for addressing fiscal disparities between provinces. The purpose of the program is entrenched in the Constitution Act, 1982. Ontario has qualified for Equalization payments since 2009–10.

$2.3 billion | 9 per cent of the total revenues from the federal government

Specific Purpose and Conditional Transfers

The federal government funds a number of joint programs operated by provincial governments, usually according to federal guidelines and standards. In return, the federal government provides funding that covers a portion of provincial costs.

Labour Market Transfers Agreements (LMTAs)

Under the LMTAs, the federal government provides Ontario with funding for employment and skills training programs and services. Historically providing over $900 million annually, Ontario uses this federal funding to cover over 70 per cent of its expenditures on skills and training programming.

Early Learning and Childcare (ELCC)

The ELCC transfer provides support for early learning and child care including investments in regulated early learning and child care programs and services for children under age six. The Canada-Ontario ELCC Agreement allocates $439 million from 2017–18 to 2019–20.

Infrastructure Funding

Infrastructure funding to Ontario supports the construction, renewal, improvement and expansion of the Province's physical capital. In 2016, the federal government introduced an infrastructure funding plan that was to be implemented in two phases.

The Phase 1 infrastructure funding agreements include Public Transit Infrastructure Fund; Clean Water Wastewater Fund; Social Infrastructure Fund; and Post-Secondary Strategic Investment Fund.

The Phase 2 funding commits $81.2 billion over 11 years, beginning 2017–18 nationally where $33 billion will be allocated to provinces and territories to support five key areas: Public transit; Rural and northern communities; Green infrastructure (includes the Canada Infrastructure Bank); Trade and transportation; and Social infrastructure (which includes community, culture and recreation bilateral agreement, the National Housing Strategy and the ELCC).

Housing

Currently, Ontario receives federal funding for housing largely through two main transfers: (1) the **Social Housing Agreement** transferred administration and responsibility of the previously federally administered social housing to Ontario and funding currently supports operating costs related to existing social housing stock; and (2) the **Investment in Affordable Housing** provides funding for capital related investments, and funding is provided to each province on an equal cost-matching basis.

Recently, the federal government has announced a new National Housing Strategy that proposes to build on the Social Housing Agreement, and replace the Investment in Affordable Housing agreements, in addition to a number of federal direct investments.

Low Carbon Economy Fund (LCEF)

Starting in 2017–18, a new federal $2 billion Low Carbon Economy Fund over five years will be delivered in two parts: (1) a **'leadership' fund** of $1.4 billion nationally to support new or expanded provincial projects that materially lower GHG emissions where Ontario's share of this funding is $420 million, with an Ontario cost-share of $420 million required; and (2) a **'challenge' fund** of $600 million nationally, where Ontario's eligibility for funding is unknown at this point and is based on projects submitted by Ontario.

<u>Ontario's Fiscal Plan is Developed Using Cautious Planning Assumptions and in Accordance with Public Sector Accounting Board Standards</u>

Cautious Planning Assumptions

Ontario's revenue outlook is based on reasonable assumptions about the pace and composition of growth in Ontario's economy. The Ministry of Finance consults with private-sector economists and tracks their forecasts to inform its planning assumptions. The Ministry of Finance real GDP forecast – a key driver of the revenue forecast – is pegged one tenth of a percentage point below the private sector average.

The expense outlook is based on detailed ministry-submitted business plans that take into account demand for existing programs, which are then reviewed through the government's annual planning process.

Interest on debt is forecasted based on a debt management strategy that accounts for a potential rise in interest rates.

Prudence

The reserve and contingency funds are included in the fiscal plan to help the Province meet its fiscal targets.

- **Reserve:** the FTAA requires Ontario's fiscal plan to incorporate a reserve to protect the fiscal outlook against adverse changes in the Province's revenue and expense. Since the requirement was introduced in 2004, the reserve published in the Budget has averaged $0.9 billion in the plan year and $1.2 billion in the two out years.

- **Contingency Funds:** help to offset new expenses that would otherwise impact Ontario's fiscal performance. The fiscal plan has both a capital and operating contingency fund.

Accounting Standards

The government prepares its financial statements in accordance with the accounting standards issued by the Public Sector Accounting Board (PSAB).

In the Public Accounts, the government reflects the assets, liabilities, revenues and expenses of all of the entities which it controls for accounting purposes. Through its consolidation of these organizations, the amounts reported as transfer payments to these entities are eliminated and the actual expenses of these entities are reported as provincial expenses. Such organizations include hospitals, colleges and school boards, as well as Crown agencies and other organizations that have balances significant enough to meet the Province's threshold of materiality.

As of the 2016–17 Public Accounts, a line-by-line presentation of the annual operating results for hospitals, school boards and colleges on the Statement of Operations was introduced. This recent change increases transparency and is consistent with PSAB standards and reporting practices of other Canadian governments. While this shift in presentation increases both revenues and expenses, it does not affect the annual deficit, net debt or accumulated deficit.

All other transfer payments to non-consolidated entities, such as municipalities and universities, as well as other government direct spending (e.g., salaries and benefits) are reported in the financial statements on an accrual basis of accounting under public sector accounting standards.

<u>Borrowing for Investments in Capital Assets Has Continued in Years of Fiscal Balance or Surplus; Ontario's Total Debt is Currently Close to $350 Billion</u>

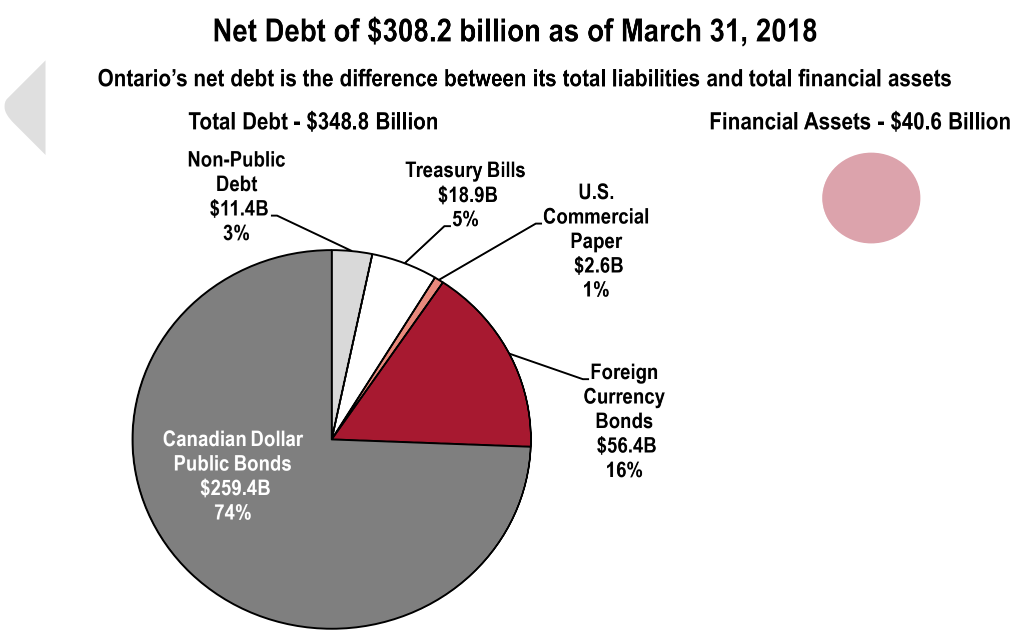
Debt Profile and Financing

The Province conducts its borrowing program with the objective of minimizing interest on debt costs while ensuring continued, uninterrupted access to financial markets. This is necessary to provide funding not only for deficits, but for capital investments and to be able to refinance an average of approximately $25 billion annually in maturing long-term debt over the next three years. Therefore, the Province needs to continue to borrow even during years of fiscal balance or surplus.

Debt Composition

The three commonly used indicators of a government's financial and debt position are net debt, total debt, and accumulated deficit. Credit rating agencies and investors place the greatest emphasis on net debt.

Net debt is the difference between the Province's total liabilities and financial assets. Ontario's net debt has been forecast to increase from $301.6 billion as of March 31, 2017 to $308.2 billion as of March 31, 2018.



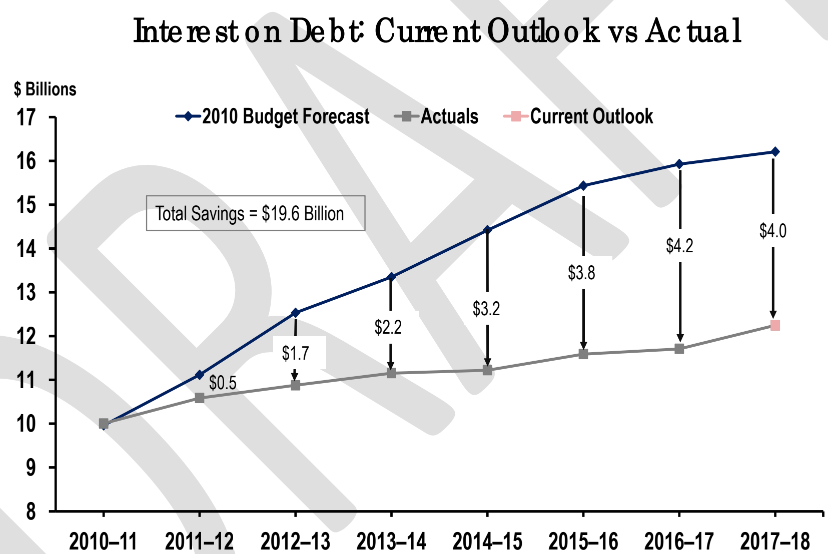
Total debt is the sum of the Province's total borrowings. Total debt consists of bonds issued in the public capital markets, non-public debt, treasury bills and U.S. commercial paper. Total debt is projected to be $348.8 billion as of March 31, 2018. Canadian-dollar denominated debt represents 83 per cent of the total debt as of March 31, 2018.

Accumulated deficit represents the sum of all deficits and surpluses since Confederation. Accumulated deficit is projected to be $192.4 billion as of March 31, 2018. The projected difference of $115.8 billion between net debt and accumulated deficit is mainly due to the Province's investment in infrastructure.

Cost of Debt is Increasing, but at Slower Pace Due to Lower Deficits and Interest Rates

Cost of Debt

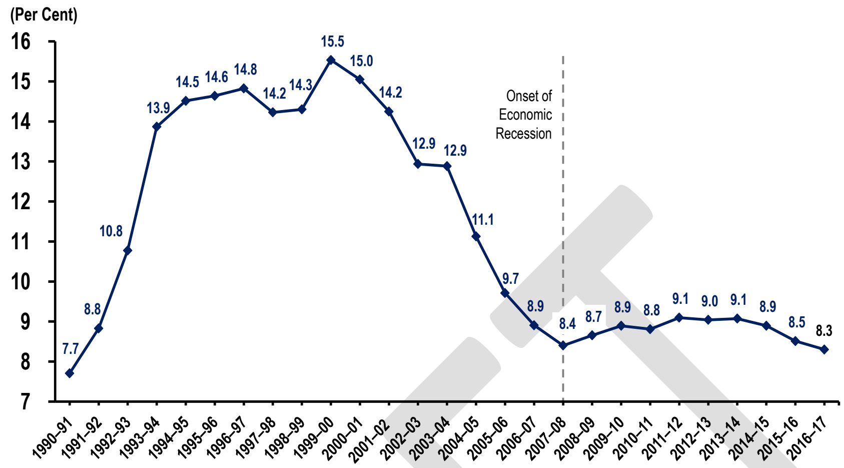
Over the past 10 years, interest on debt expense has increased at an average annual rate of 2.5 per cent and totalled $11.7 billion in 2016–17.



Note: Numbers may not add due to rounding.
Source: Ontario Financing Authority.

Interest on debt-to-revenue is considered a key measure of affordability of debt. This ratio measures how many cents of every revenue dollar received goes toward paying interest. The ratio peaked in the late 1990s and as of 2016–17, it has declined to 8.3 cents in interest for every dollar of revenue.

Interest on Debt-to-Revenue Ratio



Note: 2005–06 to 2019–20 have been restated for broader public sector line-by-line presentation.
Source: Ontario Financing Authority.

The global decline in interest rates over the last 25 years has begun to reverse moderately. To reduce the impact of higher interest rates, the Province has continued to lock in historically low rates by extending the term of its debt. Going back to the beginning of the 2010–11 fiscal year, Ontario has issued $71.3 billion of bonds longer than 30 years to lock in low rates.

As a result, the weighted-average term of the debt portfolio has been extended from 9.7 years in 2009–10 to 10.7 years by 2017–18.

<u>Ontario's Debt is Rated by Four Credit Rating Agencies</u>

Credit ratings express an agency's opinion about the ability and willingness of an issuer to meet its financial obligations in full and on time. Ontario's debt is rated by four credit rating agencies, which typically publish an annual update of their view on the credit worthiness of the Province's debt based on the budget and other financial statements.

Rating agencies generally focus on a number of factors when assessing the creditworthiness of provinces and determining the Province's ratings. These include economic structure and performance, fiscal management, debt and liquidity management and intergovernmental relations. In order to evaluate these factors, the rating agencies use a number of key ratios: Deficit-to-Revenue; After-Capital Deficit-to-Revenue; Net Debt-to-GDP; Debt-to-Revenue; and Interest on Debt-to-Revenue.

The rating agencies have noted that a return to budget deficits, during a period in which economic and revenue growth have been robust, may result in negative pressure on the province's rating. The rating agencies have also noted that risks to Ontario's credit rating include: high debt burden; elevated household debt; correction in housing prices; higher-than-expected rise in interest rates; and whether the debt issued under the plan to reduce electricity costs is self-supporting.

	Long-Term Rating	Most Recent Review
Moody's	Aa2 (N)	2017 Negative Outlook April 17, 2018
DBRS	AA (low)	Confirmed April 24, 2018
Fitch	AA–	Confirmed June 20, 2017
S&P	A+	Confirmed June 15, 2017

The rating agencies use slightly different rating scales when rating debt. This table provides a comparison of the scales used by the four rating agencies.

Rating	S&P	Moody's	DBRS	Fitch	Definition
Triple A	AAA	Aaa	AAA	AAA	Highest rating possible; capacity to pay interest and repay principal extremely strong.
Double A	AA+	Aa1	AA (high)	AA+	Has a very strong capacity to pay interest and principal and differs from triple A only in a small degree.
	AA	Aa2	AA	AA	
	AA-	Aa3	AA (low)	AA-	
Single A	A+	A1	A (high)	A+	Has a strong capacity to pay interest and principal, but more susceptible to adverse developments than higher rated categories.
	A	A2	A	A	
	A-	A3	A (low)	A-	

Ontario's Rating

<u>The Government's Fiscal Plan is Subject to Independent Review by Two Legislative Officers</u>

The Financial Accountability Officer (FAO) was created in 2013 with a mandate to provide independent analysis of the Province's finances — including its Budget and Fall Economic Statement — and respond to requests for analysis from committees or members of the Legislative Assembly related to provincial finances.

The Auditor General has a mandate to conduct value-for-money and financial audits of the government's ministries, agencies, and the broader public sector. This includes reviewing the government's consolidated financial statements through the Public Accounts each year, as well as the Pre-Election Report, when published. The Auditor General reports findings to the Legislature.

Recently, the Auditor General reiterated two issues with the Province's 2018 Pre-Election Report, which had first been raised in the 2016-17 Public Accounts:

- In Fall 2016, there was a dispute between the Province's professional accounting staff and the Auditor General's Office on the interpretation of public sector accounting standards with respect to the recognition of a proportionate share of assets of Ontario's jointly sponsored pension plans: the Ontario Teachers' Pension Plan (OTPP) and the Ontario Public Service Employees Union Pension Plan (OPSEUPP). An independent advisory panel concluded that both the OTPP and OPSEUPP should continue to be recognized as an asset in the Province's financial statements – which the government accepted. However, the Auditor General has continued to provide a qualified opinion of the Province's books based on this interpretation.

- In the 2016–17 Public Accounts, the Auditor General also raised concerns with respect to the proposed accounting presentation of the government's plan to reduce electricity costs. The government issues its financial statements in accordance with generally accepted accounting principles for government as issued by the Public Sector Accounting Board of CPA Canada. With the support of external advisors, it has been determined that the accounting presentation for the government's plan to reduce electricity costs, under the guidance provided for rate regulated entities under U.S. GAAP, is appropriate under Canadian public sector accounting standards (PSAS). However, the Auditor General does not agree with the assessment that rate regulated accounting is allowed under PSAS, and has indicated that the application of rate regulated accounting will result in a material misstatement of the annual surplus/deficit and net debt in the government's financial statements. As a result, the Auditor General has indicated an audit qualification is highly likely on this matter.

External Reviewers Have Raised Concerns about Ontario's Long-Term Fiscal Sustainability

Fiscal sustainability is the degree to which a government can maintain its existing financial obligations — its service commitments to the public and its financial commitments to creditors, employees and others — without increasing the debt or tax burden *relative to the economy in which it operates*.

Over the longer-term, Ontario's economy is expected to be affected largely by the province's aging population and advances in technology.

- Ontario's population is projected to continue to grow but at a moderating pace. With low fertility rates and an aging population, net migration is expected to become an important factor to sustaining population growth in the near future. Slower growth in the working-age population is also expected have a moderating effect on Ontario's economic growth.

- The fiscal outlook will face the largest pressure from increased demand for health care and education.

    - With the number of seniors in the province growing (from more than two million today to 4.5 million by 2040), the government's capacity to deliver health care services will place a burden on the government's fiscal plan.

    - According to a forecast by the Conference Board of Canada, provincial health care expenditures are projected to grow in line with the demands of an aging population and inflation – at an average annual rate of 5.2 per cent per year out to 2035. The following breaks down health spending according to the baseline scenario of the Conference Board of Canada, from 2015 to 2035:

Conference Board Projections	%
Population growth	0.92
Inflation in the health care sector	2.43
Impact of populating aging	1.01
Increased access to the system and continued improvements in the system	0.84
Annual average growth	**5.2**

- Additional pressures from increased enrolment in elementary and secondary schools will begin to take place as children from the baby boom echo move out of this age group and are replaced by the children of younger families.

- Key external risks to Ontario's fiscal and economic outlook relate to uncertainty about U.S. economic policies, including restrictive changes to U.S. trade and immigration policy, and potential U.S. tax reforms. Domestically, high levels of household debt have left Ontario households sensitive to rising interest rates which would lead to slowing consumer spending and housing market sales.

A key sustainability indicator is the ratio of net debt-to-GDP. If net debt-to-GDP continuously rises, fiscal policy is not sustainable. Ontario has been in deficit in 40 of the last 50 years; as a result, Ontario's net debt has grown to $301.6 billion as of 2016–17. The growth of Ontario's debt has exceeded growth in the economy, leading to increasing net debt-to-GDP levels, which peaked in 2014–15.

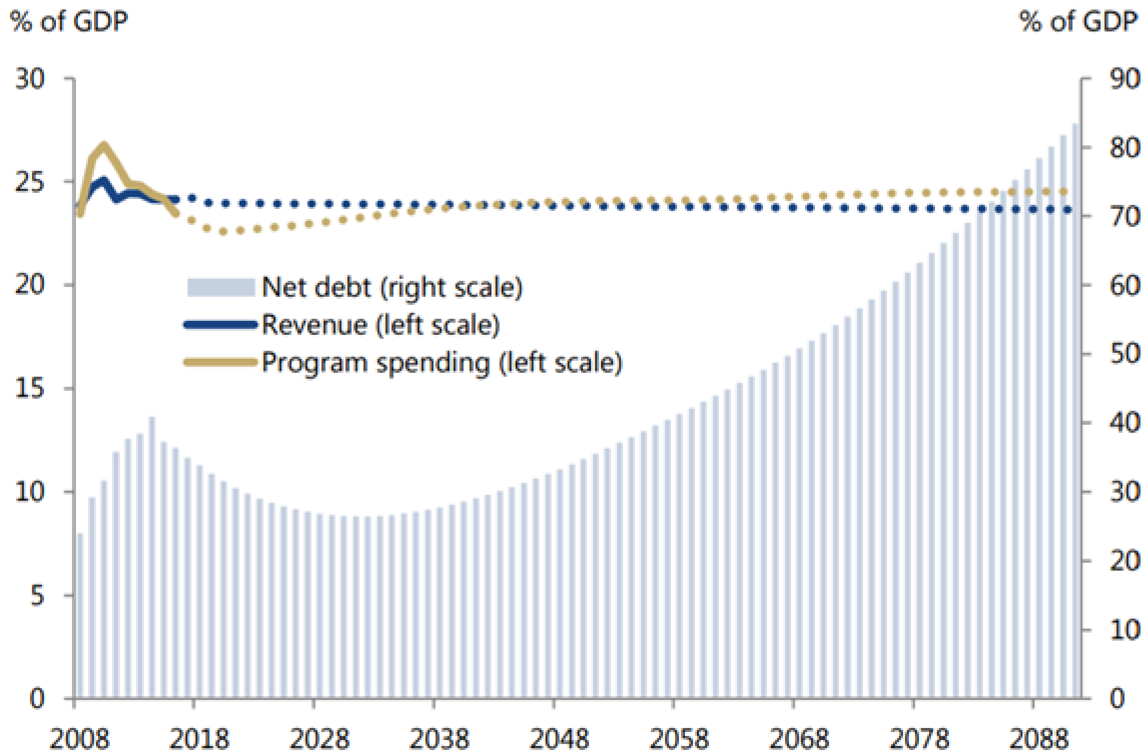
The Auditor General has noted that Ontario's fiscal plan will become less sustainable over the coming years, as a result of high debt and potentially increasing interest on debt charges, which the Auditor General contends will hinder the government's ability to be flexible and respond to changing economic circumstances.

Similarly, the FAO noted in its 2017 Long-Term Budget Outlook Report that "if current trends in fiscal policies continue, demographic changes will combine to lower tax revenue growth and raise spending, leading to large and rising budget deficits." The FAO predicts that demographic pressures on the budget will intensify in the mid-2020s. The FAO cautions that higher debt, and thus higher interest on debt payments, could leave the Province with less fiscal flexibility, and decrease the Province's ability to use deficit spending to respond to unforeseen events, including recessions. The FAO recommends permanently raising revenue or lowering spending by at least 0.75 per cent of GDP, beginning in 2018–19, to avoid shifting the burden of stabilizing the province's finances to younger Ontarians.

The Parliamentary Budget Office's (PBO) 2017 Fiscal Sustainability Report includes a section on Ontario's fiscal sustainability. The PBO's assessment concludes that:

- Ontario's current fiscal policy is not sustainable over the long term.
- Achieving fiscal sustainability would require policy actions, such as permanent tax increases or spending reductions amounting to 0.4 per cent of provincial GDP ($3.5 billion in current dollars).
- Health care spending is the key fiscal pressure.

Fiscal projection summary: Ontario



Sources: Statistics Canada and the Parliamentary Budget Officer.

Note: 2016 values are PBO estimates. The projection period covers 2017 to 2091.

Sources for information in Section 2 are based on Ontario Budgets, Ontario Public Accounts, Ontario Auditor General reports, Ontario Financial Accountability Office reports, Parliamentary Budget Office reports, the Constitution Act, 1867 as well as analysis done by the Ontario Ministry of Finance and the Ontario Financing Authority based on public information.

SECTION 3: KEY STRATEGIC QUESTIONS, OPTIONS AND POSSIBLE DIRECTIONS

Both the Auditor General and FAO have raised concerns about Ontario's fiscal sustainability given the current footprint of programs/ services relative to revenue. Is the fiscal plan sustainable?

- The Auditor General, the FAO and the federal PBO have all raised concerns around the government's fiscal sustainability. Factors cited include the high level of debt, potential for rising interest on debt costs, pressures for increased health care spending due to an aging population and limited fiscal flexibility to manage unexpected circumstances such as a recession.

- There are many measures of fiscal sustainability. One key measure widely used by governments across the world is the ratio of net debt-to-GDP, an indicator of the government's ability to repay its debt. Debt targets can serve as fiscal policy anchors to ensure that there is sufficient room in the fiscal plan to accommodate adverse shocks.

- According to the OECD, a combination of budget balance and prudent expenditure management has the potential to foster long-term growth and fiscal sustainability.

Given the strong economy, should the government be addressing debt accumulation?

- Generally accepted fiscal policy suggests that during recessions governments should run deficits to stimulate the economy, and during periods of growth governments should run surpluses and address the debt.

- In practice, however, current economic conditions are just one of many variables a government may consider when determining its fiscal outlook. It may also consider anticipated future economic conditions, overall level of debt, the need for spending (on social programs or on boosting the economy) and the ability of the revenue base to handle tax changes, etc.

- Most developed countries around the world are currently in debt. In addition, all Canadian provinces were in a net debt position in 2016–17, and all but three had net debt-to-GDP ratios in the range of 30 to 50 per cent. In 2016–17, Ontario sat in the middle of that range with a net debt-to-GDP ratio of 38.0 per cent.

Has the Province experienced structural deficits?

- A "structural deficit" is defined as the long-run imbalance of government revenues and expenditures that results in a budgetary deficit when the impacts of temporary factors are removed (i.e., the effects of the economic cycle or one off changes in revenue or expense).

- Ontario's recent history of fiscal performance suggests that the Province has been perpetually bordering on a structural deficit.
  - From 2006–07 to 2015–16, revenue grew at 3.3 per cent, below its 20-year average (3.9 per cent), however, total expense has grown at 3.8 per cent, higher than its 20-year average (3.5 per cent) and faster than revenue.

- While the government took action to invest in programs following the 2008–09 global recession to stimulate the economy, returning to historical rates of program spending growth now would make it challenging to avoid a structural deficit.

Is government spending of taxpayer dollars demand-driven or discretionary in nature? Is the government's projected expense growth sustainable?

In recent years, program expense has grown as a result of:

- Increased funding requirements for the demand driven programs, due to increased demand and/or rising costs of delivering the programs (i.e., both volume and price; as well as new initiatives and programs that have been implemented to address emerging priorities and needs).

- For both demand driven and policy driven programs, it is important to assess how these programs are performing and how effectively they meet the needs of Ontarians.

- Ontario's fiscal planning process includes efforts to improve how well programs are performing. A focus on outcomes and clients is key to making sure that publicly funded programs deliver the best possible value for money in meeting Ontarians needs and running effective programs.

The challenges associated with an aging population are expected to present significant fiscal challenges for provinces and territories. How can the Province ensure that Ontario has the ability to address future spending requirements given the division of revenues and responsibilities between provinces and the federal government?

- By constitutional design, Ontario — like other provinces in the federation — is responsible for delivering key public services such as health care, education and social services. These services are demand driven, and sensitive to demographic factors. As the population ages, provinces will be required to cover the majority of costs associated with delivering critical services and supports.

- At the same time, the federal government has a greater ability to raise revenue relative to the services it delivers. Even with the federal budget projecting deficits over the medium-term, independent experts like the Parliamentary Budget Officer have found that the federal government is in a fiscally sustainable position over the long term, while sub-national governments are fiscally unsustainable.

- This imbalance could be addressed to ensure all governments have the resources required to ensure that Canadians continue to receive the high quality services expect from their government.

- Sustainability of the federation depends on both orders of government sharing equally in the opportunities and risks facing the country. A collaborative approach could be taken based on shared principles: ensuring federal-provincial agreements are adequate, sustainable and flexible enough to respond to unique local priorities, while responding to the experience of provinces and territories.