FAO's 2018 Spring Economic and Fiscal Outlook

ISSUE

On May 2, 2018 the Financial Accountability Office will release its '2018 Spring Economic and Budget Outlook' report. The report **adopts the AG's accounting treatment** of both the Fair Hydro Plan and net pension assets and indicates that the government is facing **persistent budget deficits over the medium-term** that will continue to grow well into the government's deficit recovery phase, unless spending growth slows dramatically beginning in 2021–22. It also suggests that the **deficit cannot be eliminated by economic growth alone, but will require fiscal policy changes to raise revenue or reduce spending**.

KEY MESSAGES

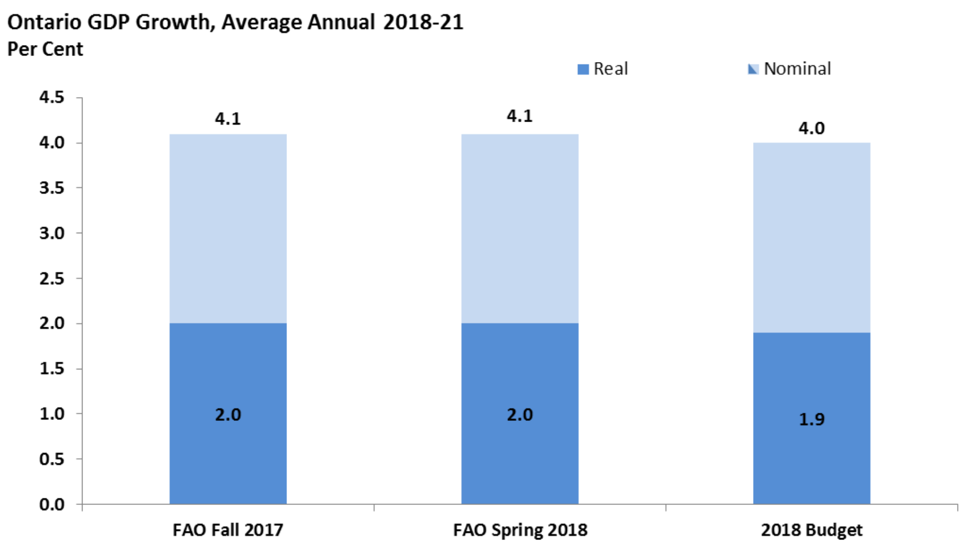
- **I would like to thank the Financial Accountability Officer (FAO) for releasing his spring economic and budget outlook for Ontario. We value the FAO's independent assessment of the province's fiscal and economic outlook.**
- **I think it's important to acknowledge where the FAO and the government's Budget are in alignment.**
- **First of all, the FAO notes that the Ontario economy has shown significant strength over the past number of years -- the report hails Ontario's robust economy and the surge in employment that has reduced the unemployment rate to its lowest level since 2000.**
- **Second, the FAO also notes the important difference that the 2018 Budget investments will make for the province. The Report specifically notes that the Budget's investments in early childhood education and childcare, the proposed reforms and new investments in social assistance and additional funding for health care, will provide "significant social and economic benefits for Ontarians."**
  - **We agree these investments are important –that the best way to deliver prosperity to more people is by continuing to invest in the economy, and in public services that promote greater fairness and opportunity across the province.**
- **Third, like the FAO's Report, the Budget talked about the same risks to Ontario's economic outlook. While the possibility of stronger U.S. growth could boost Ontario's economy, protectionist trade policies in the U.S., and associated business uncertainty, could place Ontario at a competitive disadvantage. As well, high levels of household debt have left Ontario households vulnerable to rising interest rates.**
- **The FAO's deficit projections include the Auditor General's interpretation of how the government should be accounting for net pension assets and the Fair Hydro Plan. The disagreement in accounting is the main driver of the difference between the FAO's medium-term projections and the 2018 Budget.**
- **We acknowledge that the path to balance will be a difficult one that will require leadership and difficult trade-offs.**
- **And while there is uncertainty in any future-oriented forecast, what we do know is that this government has a strong track record of beating its fiscal targets. As outlined in the *2018 Budget*, the government is projecting a surplus of $600 million for 2017–18, beating its fiscal target for the ninth year in a row.**

- **Ontario's fiscal policy is based on cautious assumptions and recognizes the need for flexibility to respond to changing circumstances. During this period of rapid economic change, the fiscal plan considers the impact of today's choices on different groups within the province and on future generations.**
- **While Ontario's economy has been growing steadily, the government knows that more must be done to ensure that the benefits of a solid economy are being shared equally by all Ontarians.**

BACKGROUND

Economic Outlook

- The FAO economic forecast is very similar to that presented in the *2018 Ontario Budget.*
- The FAO forecast for real GDP growth to average 2.0 percent annually between 2018 and 2021. This is 0.1 percentage point above the *2018 Ontario Budget* forecast of 1.9 percent.
- The FAO forecast is consistent with the 2018 Ontario Budget and private sector economists' view that housing and consumer spending growth will slow over the next four years while exports and business investment will grow at a faster pace.
- The FAO recognizes similar economic risks identified in the *2018 Ontario Budget*. The possibility of stronger U.S. growth could boost Ontario's economy. However, protectionist trade policies in the U.S., and associated business uncertainty, could place Ontario at a competitive disadvantage. As well, high levels of household debt have left Ontario households vulnerable to rising interest rates.
- Over the extended period 2021 to 2025, FAO's long-term economic outlook is similar to the unpublished Ontario Ministry of Finance projection. In particular, the FAO projects Ontario nominal GDP growth of 3.9 percent annually, on average, between 2021 and 2025, 0.1 percentage points lower than the *2018 Budget* recovery plan projection of 4.0 percent.



Sources: Financial Accoutability Office, Ontario Ministry of Finance

Fiscal Outlook

- The FAO is projecting a deficit of $3.6B in 2017–18, rising to $12.7B by 2020–21. The FAO projects the deficit to further deteriorate over the government's recovery plan period, reaching $16.6B by 2025–26 under a 'status quo' scenario of 3.5 per cent program expense growth. However, the report suggests balanced budget is possible by 2025–26 if the government constrains program spending to 2.1 per cent beginning in 2021–22.
- Unlike its Fall report, the FAO is now only presenting projections that include the impact of the Auditor General's (AG) recommended accounting treatment for both the Fair Hydro Plan and the net pension assets of jointly sponsored pensions plans.
    - Taken together, the adjustment for these two accounting differences add between $4B and $6B to the deficit in each year.

Interim and Medium-Term (2017–18 to 2020–21)

- The FAO is projecting a deficit of $3.6B in 2017–18 and deficits of between $11B and $13B over the medium term.
    - The FAO's **revenue forecast** is approximately $1B lower than the government's in each year of the medium-term outlook, mainly due to a lower outlook for personal income tax revenue.
    - Similar to past reports, the FAO adopts the *2018 Budget* **program expense outlook** (other than the accounting treatment differences).
    - Similar to past reports, the FAO also continues to project **interest on debt expense** that is slightly below the government's projection over the medium-term – by between $0.1B and $0.2B per year.
- Overall, the difference between the FAO's and government's medium-term outlook is largely driven by the impact of the AG's recommended accounting treatment for both the Fair Hydro Plan and the net pension assets of jointly sponsored pensions plans.

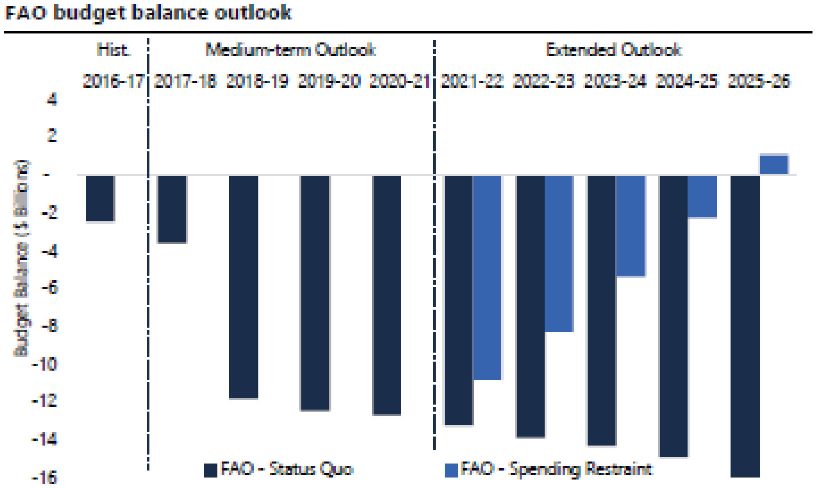
Differences Between the FAO's Fiscal Outlook and the *2018 Budget* ($ Billions)	2017–18	2018–19	2019–20	2020–21
***2018 Budget* Projected Deficits (Excl Reserve)**	**0.6**	**(6.0)**	**(5.9)**	**(5.8)**
FAO Projected Deficits (Excl Reserve)	**(3.6)**	**(11.8)**	**(12.4)**	**(12.7)**
Difference between FAO and 2018 Budget	***(4.2)***	***(5.8)***	***(6.5)***	***(6.9)***
Difference Due to Accounting	*(4.2)*	*(5.0)*	*(5.6)*	*(6.0)*
Difference Due to Other (Lower revenue offset by lower IOD)	-	*(0.8)*	*(0.9)*	*(0.8)*

- In addition to its assessment of the government's current fiscal plan, the FAO developed a "baseline" budget projection that excludes the new revenue and spending measures announced in the 2018 Budget. This baseline scenario projects budget deficits of $8.1B in 2018–19, $7.2B in 2019–20, and $6.1B in 2020–21.

Recovery Plan (2021–22 to 2025–26)

- The 2018 Budget projects a return to balance by 2024–25 and a small surplus in 2025–26. This is premised on:
  - Projected average annual growth in revenue of 3.3 per cent over the recovery plan period and managing program expense to an average annual growth rate of 2 per cent.
- In contrast, the FAO's "status quo" projection assumes program spending will grow by about 3.5 per cent per year from 2020–21 to 2025–26 resulting in deficits that reach $16.6B by 2025–26. Compared with the 2018 Budget projections:
  - The 2018 Budget medium-term revenue outlook is higher due to a higher outlook for taxes and other revenue – however, between 2022-23 and 2025-26, the FAO has a stronger overall revenue outlook compared to the 2018 Budget.
  - Given an aging and growing population and price inflation, the FAO projects program spending would need to grow at the rate of these core cost drivers, 3.5 per cent annually over the outlook, so that "the quality of public services would be maintained".
  - The IOD outlook grows faster due to the FAO's forecast of higher projected deficits leading to a larger borrowing program and larger debt interest payments.
  - The FAO is also projecting that net debt-to-GDP ratio will continue to increase over the medium-term and beyond 2020–21 reaching 44.4 per cent by 2023–24. The 2018 Budget projects that the net debt-to-GDP ratio will resume a downward trend beginning in 2022-23.
- The FAO also included a "spending restraint" scenario that holds program expense growth to 2.1 per cent beyond 2021–22, consistent with the 2018 Budget projection. Using this method the FAO projects Ontario's budget deficit would improve rapidly, reaching a small surplus by 2025–26, however they caution that this projection relies on a dramatic slow-down in spending growth and implies that the government would have to find $15B in permanent savings by 2025–26.

FAO budget balance outlook



Note: Both projections incorporate the Auditor General's recommended treatment of the Fair Hydro Plan and net pension assets.

Source: Ontario Public Accounts, 2018 Ontario Budget and FAO.

Details of Revenue Outlook

- The FAO is predicting average annual growth of total revenues of 2.7 per cent between 2017-18 and 2020-21, slightly slower than the *2018 Ontario Budget* outlook of 3.0 per cent per year.
- The FAO projections for total revenues are $1.1 billion (0.7%) lower by 2020-21 than the projections in the *2018 Ontario Budget*.
    - This is mainly to a lower outlook for Personal Income Tax (PIT) revenue which assumes significantly lower revenue yields from overall personal income growth related to minimum wages increases in 2018 and 2019.
    - The FAO is also projecting weaker revenue than the 2018 Ontario Budget from the housing resale market (Land Transfer Tax).
    - As well, the FAO is assuming weaker net income from Hydro One Limited in 2018-19 based on a potential regulatory ruling by the Ontario Energy Board.

Comparison: 2018 Ontario Budget to Draft 2018 Spring FAO Fiscal Outlook

$ Billions	Actual 2016-17	Interim 2017-18	Outlook 2018-19	Outlook 2019-20	Outlook 2020-21	Extended Outlook 2021-22	Extended Outlook 2022-23	Extended Outlook 2023-24	Extended Outlook 2024-25	Extended Outlook 2025-26	Avg. Annual Growth 17-18 to 20-21	Avg. Annual Growth 18-19 to 20-21
2018 Budget												
Taxation Revenue	94.3	99.4	103.6	108.1	112.4						4.2%	4.2%
Transfers from Gov't of Canada	24.5	25.3	26.0	25.7	26.8						1.9%	1.5%
Income from GBEs	5.6	6.1	5.3	6.0	6.6						2.4%	11.6%
Other Non-Tax Revenue	16.3	19.3	17.6	17.7	18.0						-2.3%	1.3%
Total Revenue	140.7	150.1	152.5	157.6	163.8	169.5	174.9	180.4	186.5	192.9	3.0%	3.7%
Expense												
Program Expense	130.0	137.5	145.9	150.4	155.8	159.5	162.7	166.0	169.3	172.7	4.2%	3.3%
Interest on Debt	11.7	12.0	12.5	13.1	13.8	14.9	15.5	16.3	16.5	16.9	5.0%	5.1%
Total Expense	141.7	149.5	158.5	163.5	169.6	174.4	178.2	182.2	185.8	189.6	4.3%	3.5%
Surplus/(Deficit) before Reserve	**(1.0)**	**0.6**	**(6.0)**	**(5.9)**	**(5.8)**	**(4.9)**	**(3.3)**	**(1.8)**	**0.7**	**3.3**		
Net Debt to GDP, per cent	38.0	37.1	37.6	38.2	38.6	38.9	38.6	37.7	36.8	35.5		
Change - 2018 Spring FAO Fiscal Outlook to 2018 Budget												
Taxation Revenue	-	*0.0*	*(0.5)*	*(0.8)*	*(1.0)*							
Transfers from Gov't of Canada	-	-	-	*(0.1)*	*(0.0)*							
Income from GBEs	-	-	*(0.4)*	-	-							
Other Non-Tax Revenue	-	-	-	-	-							
Total Revenue	-	*0.0*	*(0.9)*	*(0.9)*	*(1.1)*	*(0.4)*	*0.3*	*1.1*	*1.6*	*2.1*		
Expense												
Program Expense	-	-	-	-	-	*2.4*	*5.5*	*8.5*	*11.7*	*15.4*		
Interest on Debt	-	-	*(0.1)*	*(0.1)*	*(0.2)*	*(0.4)*	*(0.1)*	*0.1*	*1.0*	*1.8*		
Total Expense	-	-	*(0.1)*	*(0.1)*	*(0.2)*	*2.0*	*5.4*	*8.6*	*12.7*	*17.2*		
Surplus/(Deficit) before Reserve, EXC. Adj. for Fair Hydro Plan and Pension Assets	**-**	***0.0***	***(0.8)***	***(0.9)***	***(0.8)***	***(2.4)***	***(5.1)***	***(7.6)***	***(11.1)***	***(15.1)***		
Surplus/(Deficit) before Reserve, INC. Adj. for Fair Hydro Plan and Pension Assets	***(1.4)***	***(4.2)***	***(5.8)***	***(6.5)***	***(6.9)***	***(8.4)***	***(10.8)***	***(12.9)***	***(16.1)***	***(19.9)***		
2018 Spring FAO Outlook												
Taxation Revenue	94.3	99.4	103.1	107.2	111.4	116.0	120.4	124.8	129.5	134.4	3.9%	4.0%
Transfers from Gov't of Canada	24.5	25.3	26.0	25.6	26.7	27.6	28.4	29.2	30.2	31.1	1.8%	1.4%
Income from GBEs	5.6	6.1	4.9	6.0	6.6	6.8	7.1	7.4	7.7	8.0	2.4%	16.1%
Other Non-Tax Revenue	16.3	19.3	17.6	17.7	18.0	18.7	19.4	20.0	20.8	21.5	-2.3%	1.3%
Total Revenue	140.7	150.2	151.5	156.6	162.8	169.1	175.2	181.5	188.1	195.0	2.7%	3.6%
Expense												
Program Expense	130.0	137.5	145.9	150.4	155.8	161.9	168.2	174.5	181.0	188.1	4.2%	3.3%
Interest on Debt	11.7	12.0	12.4	13.0	13.6	14.5	15.4	16.4	17.5	18.7	4.4%	4.7%
Total Expense	141.7	149.5	158.3	163.4	169.4	176.4	183.6	190.9	198.5	206.8	4.2%	3.4%
Surplus/(Deficit) before Reseve, EXC. Adj. for Fair Hydro Plan and Pension Assets	**(1.0)**	**0.7**	**(6.8)**	**(6.8)**	**(6.6)**	**(7.3)**	**(8.4)**	**(9.3)**	**(10.4)**	**(11.8)**		
Accounting Adjustments	1.4	4.2	5.0	5.6	6.0	6.0	5.7	5.3	5.0	4.8		
Surplus/(Deficit) before Reseve, Inc. Adj. for Fair Hydro Plan and Pension Assets	**(2.4)**	**(3.6)**	**(11.8)**	**(12.4)**	**(12.7)**	**(13.3)**	**(14.1)**	**(14.7)**	**(15.4)**	**(16.6)**		
Net Debt to GDP INC Adjustments, per cent	39.5	39.1	40.1	41.1	42.0	43.1	43.9	44.4	44.8	45.1		

Note: All surplus/deficits exclude the reserve. Numbers may not add due to rounding.

MEDIUM-TERM REVENUE:

- The FAO projects Personal Income Tax to be significantly lower than the 2018 Budget projections ($0.4 billion in 2018-19, $0.7 billion in 2019-20, and $0.9 billion in 2020-21).
- FAO estimates that Ontario will no longer qualify for Equalization payments after 2018-19, where as the 2018 Budget assumes Equalization ends in 2020-21.
- The FAO reduces H1 net income by $0.4 billion in 2018-19 to reflect the recent decision by the OEB to allocate a portion of tax gain to rate payers.

RECOVERY PLAN REVENUE:

- Over the recovery plan, the FAO projects significantly stronger growth (3.6%) in other non-tax revenues, compared to the 2018 Budget (2.0%).

RECOVERY PLAN PROGRAM EXPENSE:

The FAO assumes program expense to grow at 3.5% over the recovery plan (closer to population and inflation), versus the 2018 Budget projection of 2.0%.

INTEREST ON DEBT EXPENSE:

- Despite projecting larger deficits and potentially larger borrowings, the FAO's IOD grows on average by 4.7% over the medium-term, in contrast to 5.1% in the 2018 Budget.