

In Harmony with Business

Fiscal Year 09/10**Robert Kavcic**
Economist**March 26, 2009**
4:00 pm

The Province of Ontario served up an aggressive budget against the worst economic backdrop since at least the early-90s, providing a mix of tax relief for individuals and businesses, infrastructure investment and still-strong growth in program spending. The Province's pre-announced two-year, \$18 bln deficit will be split between \$3.9 bln in FY2008/09 and \$14.1 bln in FY2009/10, with a long-term plan to return to balance by FY2015/16. Overall, this budget addresses the near-term need for economic stimulus, while taking some steps to improve the province's medium-term competitive position.

The Province's \$3.9 bln deficit in FY2008/09 represents a sharp deterioration from the \$500 mln shortfall estimated in the fall and the balanced budget projected last year. Revenues were reduced 3.6% from year-ago projections to \$93.4 bln, with weaker corporate income tax receipts (down \$3.7 bln) doing most of the damage. Meantime, program spending was revised up 1.2% from last year's estimate, with across-the-board increases.

Revenue is expected to rise 2.7% to \$96 bln in FY2009/10, as higher Federal transfers offset slightly lower tax receipts. The weak economic environment will continue to weigh on personal and corporate income tax revenue, but both will see only modest further declines this coming fiscal year. The headline measure is a proposed harmonization of the PST with the Federal GST starting in July, 2010 (*see Addendum for details*). To help ease the increased tax burden, the budget provides more than \$10 bln of temporary and permanent tax relief through FY2012/13.

Personal tax relief is provided by a 1 ppt cut to the lowest income tax rate (currently up to \$36,848) to 5.05% from 6.05%, starting in 2010. This would reduce an individual's personal income tax bill by \$205, and cost the Province about \$1.2 bln per year starting in FY2010/11. Other personal tax measures include higher sales and property tax credits for low income individuals. Total permanent personal tax relief will be \$1.8 bln in FY2010/11, and rise to \$2.4 bln by FY2012/13. Additionally, there is temporary relief

(rebate cheques) totaling \$4 bln to help individuals absorb the new Harmonized Sales Tax.

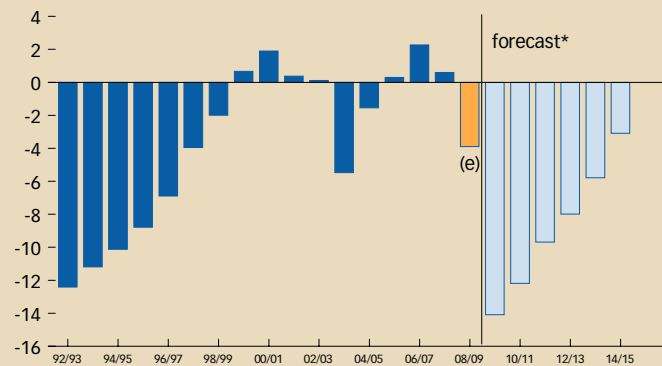
Corporate income tax relief will total \$1 bln in FY2010/11 and rise to \$1.9 bln by FY2012/13. The biggest measure is a gradual cut in the general corporate income tax rate from 14% to 12% in July, 2010, and then to 10% by 2013. This would make Ontario's corporate tax rate among the lowest in Canada. Meantime, the small business tax rate will be cut 1 ppt to 4.5% in July, 2010. All told, the HST and corporate tax cuts are significant steps toward lowering the cost of doing business in Ontario—the Province estimates the marginal effective tax rate on new capital will fall from 32.8% to 18.6% in 2010, and to 16.2% by 2018.

Highlights

- Budget deficits of \$3.9 bln in FY2008/09; \$14.1 bln in FY2009/10.
- Harmonization of the provincial sales tax with the Federal GST; personal and corporate income tax cuts.
- Infrastructure spending program of \$27.5 bln over the next two years.
- GDP decline of 2.5% in 2009 followed by a 2.3% rebound in 2010.
- Budget deficit until FY2015/16.

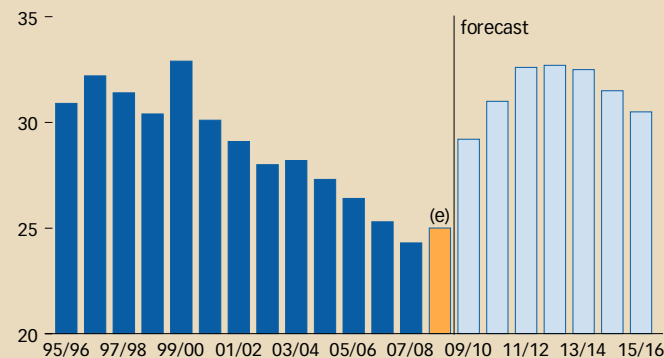


Budgetary Balance
(\$ billions)



Source: Provincial forecasts e = estimate *Before reserve allowance

Net Debt/GDP
(percent)



Source: Provincial forecasts e = estimate

Fiscal Outlook
(C\$ m millions)

| | estimate | | — forecast — | |
|-------------------|----------|----------|--------------|---------|
| | 08/09 | 09/10 | 10/11 | 11/12 |
| Revenues | 93,427 | 95,980 | 103,600 | 104,400 |
| Expenditures | 97,317 | 108,880 | 114,600 | 112,900 |
| Operations | 88,463 | 99,579 | 104,700 | 101,900 |
| Debt Service | 8,854 | 9,301 | 9,900 | 11,100 |
| Budget Balance | | | | |
| Before Reserve | (3,890) | (12,900) | (11,000) | (8,500) |
| Reserve Allowance | 0 | 1,200 | 1,200 | 1,200 |
| Budget Balance | (3,890) | (14,100) | (12,200) | (9,700) |

() = deficit Note: Totals may not add due to rounding.

Source: Provincial forecasts

Program spending is expected to rise a hefty 12.5% to \$99.6 bln in FY2009/10, amid gains in health care, education and infrastructure. Among the key initiatives are a phased-in increase in the Ontario Child Benefit from \$600 to \$1,100 per child, beginning in July, and higher spending on social housing.

Running with the torch lit by the Federal Government, **Ontario will spend \$27.5 bln on infrastructure over the next two years**. This is expected to be topped up with an additional \$5 bln in federal funding for a total of \$32.5 bln in stimulus spending—that’s nearly 3% of GDP, and up from \$8.5 bln spent in FY2008/09. Transportation is the main focus, receiving \$9 bln, while health care (\$7 bln) and education (\$4 bln) will also be important recipients.

Ontario’s total borrowing requirements are expected to be \$34.8 bln in FY2009/10, up from \$28.7 bln in FY2008/09, and should average slightly more than \$30 bln per year through FY2011/12. Meantime, net debt is expected to rise to \$170 bln this year from \$149 bln in FY2008/09. The net debt-to-GDP ratio will rise to 29.2% in FY2009/10 from 25% in FY2008/09, and peak at 33% in FY 2012/13.

Ontario faces the worst economic conditions since at least the early-1990s as much of the world fights through a painful recession. This budget is based on the assumption that real GDP will contract 2.5% this year before rebounding 2.3% in 2010, a shade more optimistic than our call of a 2.9% decline and 2.1% rebound next year (which may prove high). The auto sector is ground zero, with production nearly coming to a halt to start the year as sales have plummeted—the impact has been plant closures, layoffs and production delays. This has contributed to 75,000 lost jobs in the Ontario manufacturing sector since the start of 2008, and with support from the service and construction sectors crippled by the recession, the unemployment rate has jumped to nearly 9%. Ontario’s challenges, however, are not just

cyclical as it has been shedding manufacturing jobs for about six years. Indeed, post-recession policy will still be challenged by the need to make Ontario an attractive and cost-effective place to do business—this budget is a start.

Addendum: An Economic Perspective on the HST

A headline measure of the FY2009/10 budget is a proposal to combine the 8% Provincial Sales Tax (PST) with the 5% Federal Goods and Services Tax (GST), creating a new Harmonized Sales Tax (HST). Under the new system, a single 13% HST would be charged and collected by the Federal CRA, with the appropriate amount then paid back to the Province.

Businesses are the immediate winners under the HST system, as the PST previously charged on inputs and capital would now be a deduction against taxes collected on sales—in other words, the HST is a pure value added tax. In addition, the reporting and accounting requirements are significantly reduced, with only one tax collected and remitted to one level of government. Small businesses with revenues up to \$500,000 will also receive a transition credit of up to \$1,000 to help adopt changes to their accounting system.

Actions to simplify the tax system and improve the cost of doing business in Ontario are much needed, and the HST does both by reducing the administrative burden and lowering the after-tax cost of inputs and capital.

Consumers will face an increased tax burden under the HST, as items not currently charged the PST will see their tax rate rise. However, the Province will offset some of this:

- A one-time rebate will be paid to families with a combined annual income of less than \$166,700 (individuals less than \$82,000). This would be paid in three installments over the course of one year. Individuals will get a maximum of \$300, and families \$1,000.
- The exemption on a selection of necessity items will be maintained: Books, children's clothing and footwear, car seats, diapers and feminine hygiene products.
- New home purchases under \$400,000 will be allowed a 6% rebate, which will be reduced for homes priced up to \$500,000. New homes costing more than \$500,000 will be subject to the full 13% HST versus the 5% GST that is currently applied.

Since the HST will lower the after-tax cost of business inputs, it is reasonable to expect at least partial pass-through of these savings to consumers. For example, while a new home priced above \$500,000 will be taxed at a higher rate, the net cost of constructing that home (through lower taxes on building materials) will fall. In a competitive market, some of those savings will likely be passed on to the homebuyer.

The net revenue benefit to the Province of the HST will be \$1.7 bln in FY2010/11, rising to \$2.3 bln by FY2012/13. However, the benefits in the first two years (\$3.8 bln) will be fully offset by the transition rebates, totaling \$4 bln. Longer-term, other personal income tax reduction measures are expected to fully offset the higher burden imposed by the HST. For example, in FY2012/13, the HST will add \$2.3 bln to Provincial revenue, but announced permanent personal tax cuts will subtract \$2.4 bln.

The bottom line: Ontario faced long-term economic challenges before the recession clouds moved in, and will continue face them once the skies clear. The HST is a step in the right direction toward making Ontario a more attractive place to do business. Still, the timing of such a major tax change—in the middle of a deep recession—leaves much to be desired.



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