FAO COMMENTARY

August 17, 2017

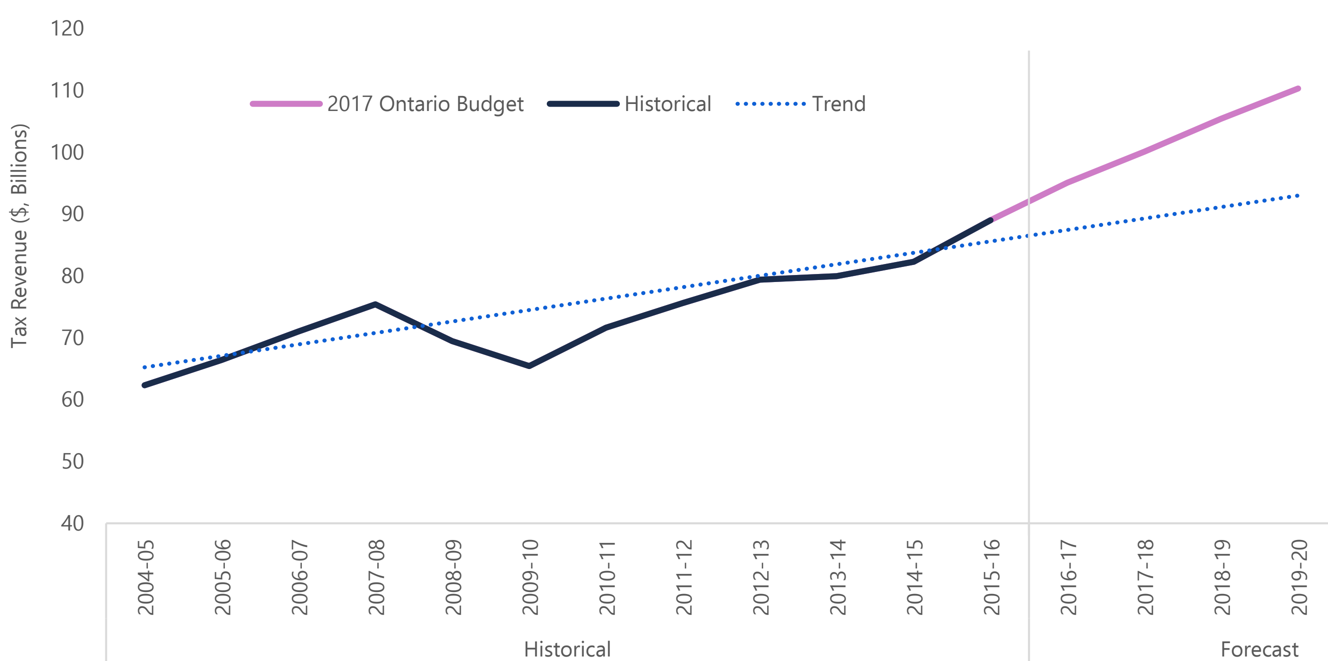
Optimistic Revenue Projection Underpins Government's Balanced Budget Plan

The 2017 Ontario Budget projects balanced budgets beginning in 2017-18 and continuing over the next two years. Given the government's spending plans,[1] maintaining a balanced budget relies critically on an optimistic revenue forecast – and in particular, on very strong growth in tax revenues. However, when compared to either recent historical experience or the FAO's projections, there appears to be significant downside risk to the government's forecast.[2] As a result, the FAO expects that staying in balance after 2017-18 will require additional fiscal policy measures – that is, new revenues or lower than projected spending.

2017 Budget Forecasts Surprisingly Strong Tax Revenue Growth

After removing the impact of one-time tax revenue in 2015-16,[3] the 2017 Budget forecasts tax revenue growth of 5.5 per cent per year on average from 2016-17 to 2019-20 -- significantly above the historical pace of 3.3 per cent since 2004-05.

Budget Projects Above Trend Growth in Tax Revenue*



* Tax Revenue is adjusted in 2015-16 to remove the effect of a one-time tax deferred benefit resulting from the initial sale of Hydro One equity.
Note: The historical trend is calculated using data from 2004-05 to 2015-16, excluding the recession and recovery years of 2008-09 to 2010-11.
Source: Ontario Budgets, Statistics Canada and FAO.

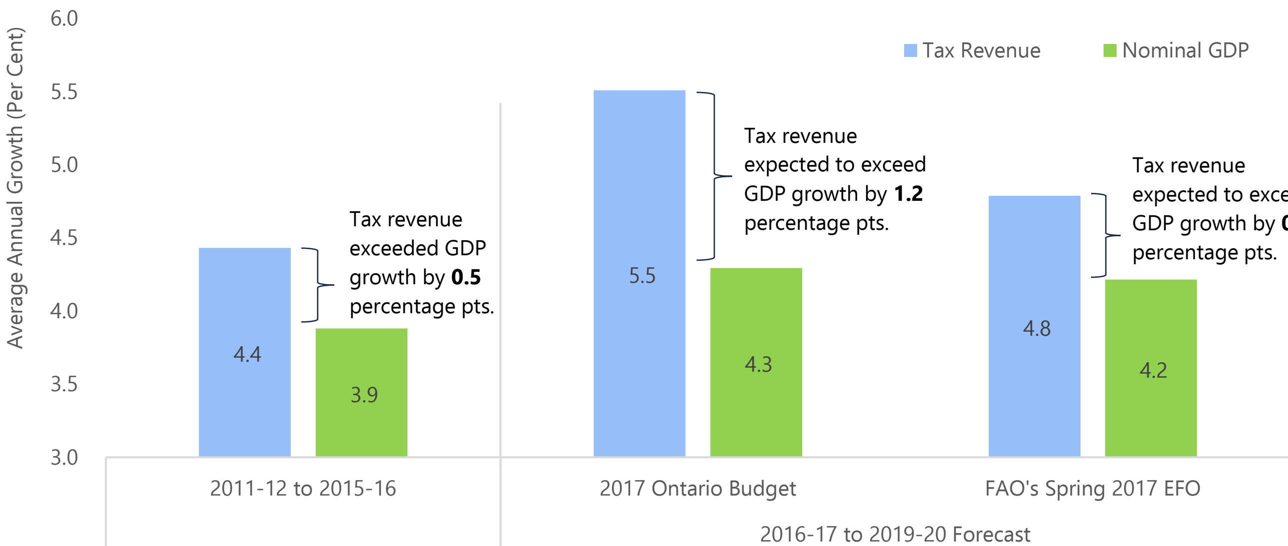
[1] From 2016-17 to 2019-20 the government is planning to increase program spending by an average of 2.9 per cent year.
[2] See Appendix for a comparison of the revenue forecasts in the 2017 Ontario Budget and the FAO's *Economic and Fiscal Outlook, Spring 2017*.
[3] The sale of Hydro One resulted in a tax deferred benefit of $2.6 billion and $200 million in additional 'payments-in-lieu of taxes', amounting to a one-time revenue gain of $2.8 billion in 2015-16. This one-time gain is reported on the Electricity Payments-in-Lieu of Taxes line of the Budget. https://news.ontario.ca/mei/en/2015/10/asset-optimization---broadening-ownership-of-hydro-one.html

The Budget's forecast for tax revenue growth also seems very strong when compared to the projection for economic growth. Over the past five years, tax revenues increased at the relatively strong average pace of 4.4 per cent, 0.5 percentage points above the average growth in nominal GDP.[4] Over the next four years, the Budget is calling for average tax revenue growth of 5.5 per cent, 1.2 percentage points above the forecast for average nominal GDP growth.

In contrast, in the *Spring 2017 Economic Fiscal Outlook* (EFO), the FAO is forecasting tax revenue growth of 4.8 per cent on average over the next four years, 0.6 percentage points faster than nominal GDP growth. Importantly, the stronger tax revenue growth projected in the 2017 Budget results in an additional $3.0 billion in tax revenues by 2019-20, relative to the FAO projection.

If the government maintains the spending plans laid out in the 2017 Budget, a large shortfall in future tax revenues relative to the Budget projection could lead to renewed deficits.[5]

2017 Budget Forecast Projects Tax Revenue Growth* to Far Exceed Economic Growth



* Tax Revenue is adjusted in 2015-16 to remove the effect of a one-time tax deferred benefit resulting from the initial sale of Hydro One equity.
Source: Ontario Budgets, Statistics Canada and FAO.

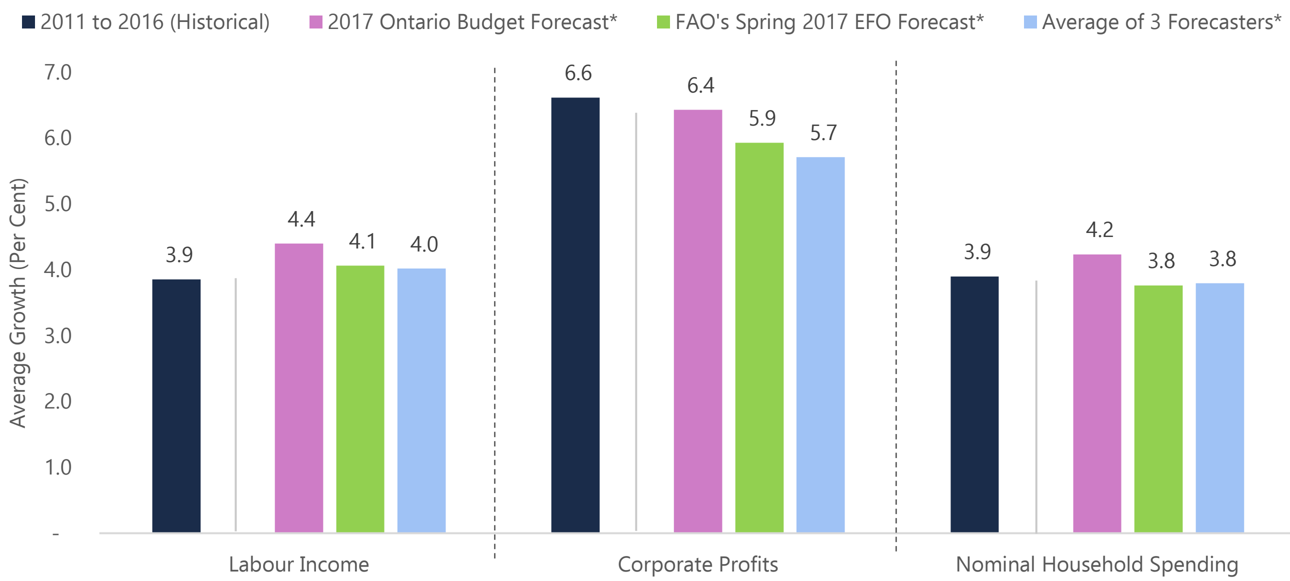
Strong Expected Growth in Incomes and Household Spending Drives Tax Revenue Forecast

The optimistic tax revenue forecast can mostly be attributed to the three largest tax revenue categories, Personal Income Tax (PIT), Corporations Tax (CT) and the Harmonized Sales Tax (HST), which together account for over 70 per cent of tax revenue. The growth in these three revenue sources are closely aligned with the growth in their underlying economic drivers: labour income; corporate profits; and nominal household expenditure.[6] The 2017 Budget forecasts

[4] Nominal GDP is the broadest measure of economy-wide incomes, a key determinant of tax revenue growth.
[5] The 2017 Budget includes a $600 million reserve in 2017-18, growing to $900 million by 2019-20, which could partially offset a shortfall in actual taxation revenue relative to the projection.
[6] These three economic concepts - compensation of employees; net operating surplus: corporations; and nominal consumption expenditure, respectively – are key indicators of the tax bases which determine the three sources of tax revenue.

significantly stronger growth in these three tax revenue drivers[7] than the FAO or the average of other economic forecasters,[8] resulting in stronger expected revenue from each of the three major tax sources.

2017 Ontario Budget Projects Strong Growth in Tax Revenue Drivers



* Average annual growth from 2017 to 2019.
Source: 2017 Ontario Budget and FAO Consensus.

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[7] Labour income and corporate profits - which make up about two-thirds of GDP -- are growing at a much faster pace than overall nominal GDP (4.2 per cent from 2017 to 2019). However, these growth rates raise questions about the underlying composition of nominal GDP. If these two categories, are growing considerably faster than nominal GDP, it implies that the other components ('Mixed Income' and 'Taxes less subsidies') are growing at much slower rates.
[8] This includes three independent model-based forecasters: the Centre for Spatial Economics, the Conference Board of Canada and the Policy and Economic Analysis Program at the University of Toronto.

Appendix – Comparing Revenue Forecasts

($, Billions)	2016-17	2017-18	2018-19	2019-20
2017 Ontario Budget Revenue	133.2	141.7	144.9	149.3
FAO's Spring 2017 EFO Revenue	132.0	140.3	141.8	145.6
Total Difference	1.2	1.4	3.1	3.8

Differences (Budget less EFO)				
Personal Income Tax	0.4	0.5	0.6	0.9
Corporations Tax	0.6	0.5	0.7	0.9
Harmonized Sales Tax	0.0	0.2	0.6	0.7
All Other Tax Revenues	0.1	0.1	0.4	0.5
Equalization[9]	0.0	0.0	0.8	0.7
All Other Revenues	0.0	0.0	0.1	0.1
Total Difference	1.2	1.4	3.1	3.8

Note: Numbers may not sum due to rounding.
Source: 2017 Ontario Budget and FAO.

[9] The FAO's lower forecast for Equalization revenue results primarily from the FAO projection that Ontario will no longer qualify for Equalization payments beginning in 2018-19 – the result of Ontario's solid economic growth relative to other provinces.