



Office of the Auditor General of Ontario

# **The Auditor General's Review of the 2011 *Pre-Election* Report on Ontario's Finances**







Office of the Auditor General of Ontario

To the Honourable Speaker  
of the Legislative Assembly

I am pleased to transmit *The Auditor General's Review of the 2011 Pre-Election Report on Ontario's Finances* for submission to the Assembly in accordance with the provisions of subsection 10(3) and section 13 of the *Fiscal Transparency and Accountability Act, 2004*.

A handwritten signature in black ink, appearing to read 'Jim McCarter'.

Jim McCarter, FCA  
Auditor General

June 28, 2011

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# Table of Contents

<b>Synopsis</b>	<b>5</b>
<b>The Auditor General's Statement on the <i>2011 Pre-Election Report on Ontario's Finances</i></b>	<b>8</b>
<b>Background</b>	<b>9</b>
<b>Review Objective and Scope</b>	<b>10</b>
<b>Review Results</b>	<b>11</b>
<b>REVENUE ESTIMATES</b>	<b>11</b>
Reasonableness of Revenue Estimates and Assumptions	<b>11</b>
Personal, Sales, Corporations, and Health Taxes	<b>13</b>
Other Revenues	<b>14</b>
Risks Relating to Revenue Forecasts	<b>15</b>
<b>EXPENSE ESTIMATES</b>	<b>17</b>
Reasonableness of Expense Estimates and Assumptions	<b>17</b>
Salary Increases	<b>19</b>
Public Demand for Services	<b>19</b>
Cost of Goods and Services	<b>21</b>

<b>Expense Estimates by Sector</b>	<b>21</b>
Health Sector	<b>21</b>
Education Sector	<b>28</b>
Post-secondary and Training Sector	<b>29</b>
Children's and Social Services Sector	<b>30</b>
Justice Sector	<b>33</b>
<b>Large One-time Expenditures</b>	<b>34</b>
<b>Contingency Funds</b>	<b>35</b>
<b>Interest on the Public Debt</b>	<b>35</b>
Risks Relating to Interest Estimates	<b>36</b>
<b>THE RESERVE</b>	<b>37</b>



# The Auditor General's Review of the *2011 Pre-Election Report on Ontario's Finances*

## Synopsis

The government tabled its *2011 Pre-Election Report on Ontario's Finances* on April 26, 2011, as required by the *Fiscal Transparency and Accountability Act, 2004* (Act). Under the Act, I am responsible for reviewing this report to determine whether it is reasonable and for providing a statement describing the results of my review.

The Act requires that the pre-election report provide an estimate of Ontario's revenues and expenses, by major component, for the 2011/12, 2012/13, and 2013/14 fiscal years. A stated principle in the Act is that the government's fiscal policy should be based on cautious and prudent assumptions.

We concluded that the government based its estimates of revenues and interest on the public debt on prudent and cautious assumptions. However, we concluded that many of the assumptions underlying its estimates for program expenses (that is, expenses excluding interest on the public debt and reserves) were optimistic and aggressive rather than cautious.

Program expenses have increased at an average annual rate of 7.2% over the last eight years. The program-expense estimates in the pre-election report reflect a 1% average growth rate over the

next three years. However, if large one-time expenditures—such as auto-sector support payments and infrastructure stimulus spending—are excluded, the comparable growth rates are 6.9% per year for the past eight years and 1.8% per year for the pre-election report years. The government assumes that it will be able to contain certain costs to achieve the decrease in future growth rates. We felt that, for a number of these costs, this assumption was based on an optimistic or aggressive outlook. For example:

- Compensation costs (salaries, wages, and benefits) account for more than 50% of program spending. The government has indicated that it will not provide any additional funding to ministries and broader-public-sector organizations such as hospitals, school boards, and Children’s Aid Societies if they are not able to negotiate a 0% compensation increase for the first two years of future collective agreements with unionized workers. In past negotiated settlements, public-sector salary increases have often exceeded the inflation rate. Even after the government’s announcement in 2010 that it would not fund such increases, most collective agreements negotiated since have still resulted in wage increases. We believe it is optimistic to assume that there will be no net compensation increases in the public sector and broader public sector in the next two years.
- Health-care costs make up about 42% of total program expenses. The government is projecting that, over the next three years, these costs will grow annually at only half the rate that they have grown in the last eight years. As just mentioned, the government indicated that it will not fund any compensation increases in the health-care system. The government also anticipates that it will find billions of dollars in health savings to slow overall growth in health spending despite continuing demand for the whole spectrum of health services—from visits to physicians to patient stays in hospitals



and from home care for seniors to long-term-care beds. In light of Ontario's growing and aging population, we consider this to be an aggressive rather than a cautious outlook.

Because the pre-election report makes a forecast about future events, actual results will undoubtedly differ from the report's estimates. Given that many of the assumptions underlying the expense projections are optimistic rather than cautious, there is a heightened risk that actual expenses will be higher than estimated. Unless revenue growth is higher than planned, annual deficits may also turn out to be higher than planned. In that case, the government will need to consider additional changes in policy or operations to achieve its fiscal targets.

My formal review statement is presented on the next page, followed by details on my observations and conclusions.



### **The Auditor General's Statement on the *2011 Pre-Election Report on Ontario's Finances***

To the Legislative Assembly of the Province of Ontario:

I am required by subsection 10(3) of the *Fiscal Transparency and Accountability Act, 2004* (Act) to review and report on the reasonableness of the government's pre-election report on the province's finances. Accordingly, I am reporting on the consolidated statement of estimated revenue, expense, and reserve prepared by the Ministry of Finance for the three fiscal years ending March 31, 2012; March 31, 2013; and March 31, 2014 as contained in the *2011 Pre-Election Report on Ontario's Finances* tabled in the Legislative Assembly of Ontario on April 26, 2011.

I have examined the support provided by the government for its estimates of revenues and expenses and for the assumptions it made in preparing these estimates. My examination was made in accordance with the standards for assurance engagements established by the Canadian Institute of Chartered Accountants. I have no responsibility to update this report for events and circumstances occurring after the date of my report.

In my opinion:

- The *2011 Pre-Election Report on Ontario's Finances* includes the fiscal information required under the Act and complies with the presentation and disclosure standards established by the Canadian Institute of Chartered Accountants for future-oriented financial information.
- The assumptions relating to estimated revenues and interest on provincial debt for the next three fiscal years are suitably supported, are consistent with the plans of the government of Ontario, and provide a reasonable basis for forecasting revenues and debt interest, keeping in mind that the degree of uncertainty with respect to assumptions increases the further in the future the estimates relate to.
- Although a key principle of the Act is that Ontario's fiscal policy be based on cautious assumptions, many of the assumptions underlying the expense estimates are not cautious in nature. Rather, they take an optimistic perspective with respect to the government's ability to constrain future costs. This is especially the case for compensation costs and costs associated with the demand for health care. Together these costs constitute a major portion of total expenses.

Because the revenue, expense, and annual deficit estimates are based on assumptions regarding future events, actual results will vary from the information presented, and the variations may be material. Accordingly, I express no opinion as to whether these estimates will be achieved.

Jim McCarter, FCA  
Auditor General  
Licensed Public Accountant

Toronto, Ontario  
June 9, 2011

## Background

The *Fiscal Transparency and Accountability Act, 2004* (Act) established a number of legislative requirements for both Ontario's fiscal policies and its fiscal plan. The Act states that Ontario's fiscal policy should be based on cautious assumptions. The Act also requires that the Ministry of Finance (Ministry) release a pre-election report about Ontario's finances, to be reviewed by my Office. The pre-election report is required to include the following:

- the macroeconomic forecasts and assumptions that were used to prepare the fiscal plan and a description of any significant differences from those forecasts and assumptions;
- an estimate of Ontario's revenues and expenses, including estimates of the major components of the revenues and expenses set out in the plan;
- details about the reserve required to provide for unexpected adverse changes in revenues and expenses; and
- information about the ratio of provincial debt to Ontario's gross domestic product.

The Act specifies that the circumstances governing the release of the pre-election report may be prescribed by regulation. On March 14, 2011, the government filed a regulation requiring that the report be released within 30 days of the 2011 Budget motion—the day on which the Budget bill is introduced and read for the first time. The government introduced its Budget bill on March 29, 2011, and released the *2011 Pre-Election Report on Ontario's Finances* on April 26, 2011.

The Act specifies that the pre-election report should provide an update to the most recent fiscal plan, which in this case was contained in the 2011 Budget. The government concluded that no

changes were needed to the Budget, so the fiscal projections presented in this report are the same as those contained in it.

## Review Objective and Scope

The objective of our review is set out in section 10(3) of the Act, which states, “The Auditor General shall promptly review the pre-election report to determine whether it is reasonable, and shall release a statement describing the results of the review.”

Auditors usually review information relating to financial transactions that have already occurred. In contrast, the pre-election report provides the government’s estimates of future fiscal results. We therefore conducted our review using the guidance relating to future-oriented financial information issued by the Canadian Institute of Chartered Accountants (CICA). In addition, we reviewed the guidance provided by the American Institute of Certified Public Accountants relating to the preparation and examination of financial forecasts and projections. This guidance calls for forecasts of future-oriented financial information to be based on reasonable, supportable, and internally consistent assumptions that management believes reflect the most probable set of economic conditions and planned courses of action.

Our review consisted of inquiry, analysis, and other procedures, including examination of the government’s supporting documentation for the estimates and for the key assumptions underlying them. We also reviewed the government’s results-based planning and budget processes, assessed historical trend data, and met with Ministry of Finance officials as well as officials from other ministries regarding the government’s expenditure forecasts and related assumptions. In addition, because the government develops the estimates for its future taxation revenues using forecasting

techniques based on underlying economic data—such as growth in the gross domestic product, inflation, consumer spending, and wage and salary levels—we engaged an independent expert in the area of econometric forecasting to assist us in our review of certain revenue estimates.

## Review Results

### REVENUE ESTIMATES

#### Reasonableness of Revenue Estimates and Assumptions

The pre-election report segregates expected revenues for the next three fiscal years by the following four components:

- taxation revenues (approximately 70%);
- transfers from the government of Canada (20%);
- revenues from government enterprises, such as income from the Liquor Control Board of Ontario, the Ontario Lottery Corporation, Ontario Power Generation, and Hydro One (4%); and
- other revenues, such as those received for vehicle and driver registration fees and electricity debt retirement charges (6%).

Figure 1 outlines the government's estimated revenues for the fiscal year ending March 31, 2011, and for the next three years.

The reasonableness of the revenue forecast, particularly for taxation revenues, depends primarily on the government's assumptions regarding the outlook for Ontario's economy. Key economic assumptions include Ontario's projected real gross domestic product (GDP), employment, and inflation.

We engaged an independent expert in econometric forecasting to help us review the government's assumptions and estimates for several of the more significant tax revenues. Our expert advised us

**Figure 1: Estimated and Forecasted Revenues (\$ billion)**

Source of data: 2011 Ontario Budget

Source of Revenue	Estimated	Pre-election Report Forecast		
	2010/11	2011/12	2012/13	2013/14
<b>Taxation Revenue</b>				
personal income tax	23.8	25.5	26.9	28.5
sales tax	19.0	20.1	21.1	22.2
corporations tax	8.3	8.9	9.1	9.4
Ontario Health Premium	3.0	3.1	3.2	3.4
education property tax	5.8	5.7	5.7	5.6
all other taxes	11.5	12.0	12.2	12.6
<b>Total Taxation Revenue</b>	<b>71.3</b>	<b>75.3</b>	<b>78.2</b>	<b>81.7</b>
government of Canada	23.0	21.7	21.8	23.1
income from government business enterprises	4.4	4.5	4.8	5.2
other non-tax revenue	7.5	6.9	6.9	7.0
<b>Total Revenue</b>	<b>106.2</b>	<b>108.5</b>	<b>111.7</b>	<b>117.0</b>

that the government's outlook on overall economic performance indicators was consistent with those projected by private-sector forecasters. He noted more specifically that the projections for overall economic growth—and thus for the main tax bases—were slightly more cautious than those of the private-sector forecasters. For instance, as seen in Figure 2, the government's forecast of Ontario's real GDP growth is slightly below the private-sector average for each of the forecasted years.

We also noted that several private-sector organizations reached similar conclusions on the government's economic assumptions. For instance, the Conference Board of Canada concluded: "The Ontario Ministry of Finance's economic projections for 2011 and 2012 are consistent with the Conference Board's economic outlook." An analysis released by the TD Bank Economics Department after the release of the 2011 Budget stated the following:

## Figure 2: Private-sector and Pre-election Report Forecasts of % Growth in Ontario's Real GDP, 2011–13

Source of data: 2011 Ontario Budget

	2011	2012	2013
private-sector survey average	2.6	2.8	2.8
pre-election report	2.4	2.7	2.7

Consistent with the improved economic performance at the tail end of 2010, forecasters have been marking up their 2011 real GDP growth forecasts to about 3%. The government has used a significantly lower 2.4%. Accordingly, the revenue intake has only been upgraded by a modest \$1 billion since last year's budget, leaving room to surprise on the upside. Beyond next year, there is considerably less prudence built into the economic growth and interest rate projections, but overall we believe them to be reasonable.

The Ontario Economic Forecast Council, an advisory body consisting of private-sector economists, was established under the *Fiscal Transparency and Accountability Act, 2004*. The Act requires that the Council give the Minister of Finance advice relating to macro-economic forecasts and assumptions to be used to prepare the Budget and the fiscal plan. The members of the Council reviewed the Ministry of Finance's economic assumptions in March 2011. All three members found the assumptions to be reasonable and reported this to the Ministry.

### Personal, Sales, Corporations, and Health Taxes

Our independent expert provided us with a report on the province's estimates of personal income tax, the harmonized sales tax, corporations tax, and the Ontario Health Premium. These four

sources of taxation revenue account for \$57.6 billion of estimated provincial revenue in 2011/12, or 76.5% of total expected taxation revenues for that fiscal year. He concluded that “the forecasts for the Personal Income Tax, Ontario Health Premium, Corporations Tax, and the Ontario Sales Tax are reasonable.” He further stated that his conclusions were based on his assessment of the reasonableness of the underlying economic and other assumptions, the appropriateness of the revenue models used to project revenues, and the overall reasonableness of the forecasts for the growth of the specific revenue sources considered in relation to the combined economic growth forecast.

We also assessed whether the average annual increase over the next three years of 6.2% for personal income tax, 5.3% for sales tax, and 4.2% for corporations tax seemed reasonable for an economy coming out of a recession. When we considered the growth rates for these same taxes following the last two recessions, these projected growth rates appeared reasonable.

### Other Revenues

Other primary sources of taxation revenue are employer health tax, education property tax, gasoline tax, land transfer tax, and tobacco tax. The estimates for these revenues were largely arrived at using tax-forecasting models. We reviewed the reasonableness of the assumptions used, the support for these assumptions, and the methodologies for applying the forecasting models to arrive at the tax-revenue estimates. We noted that the methodologies used were consistent in each of the years covered in the report. As well, we considered the reasonableness of the Ministry’s explanations for the changes in expected taxation revenues from year to year.

Transfers from the government of Canada include Canada Health Transfers, Canada Social Transfers, and equalization payments. These three sources of federal revenue account for



\$17.5 billion in estimated provincial revenue in 2011/12, or 80% of the total estimated federal revenue for that fiscal year. Our assessment of these estimated revenues primarily consisted of ensuring that the formulas and assumptions used for estimating Ontario's share of these federal transfers were reasonable and applied correctly.

Government business enterprises provided the Ministry with their net income estimates over the next three fiscal years. We compared these estimates with historical trends and conducted additional work to investigate any significant variances from one year to the next. We also reviewed the business plans of the larger organizations to ensure that their internal projections were consistent with the amounts forecasted in the pre-election report.

For the larger non-tax revenue streams—such as vehicle driver and registration fees, electricity debt retirement charges, and power sales—we also reviewed the supporting documentation for the estimates and analyzed changes in revenue amounts from one year to the next.

## Risks Relating to Revenue Forecasts

Our independent expert advised us that, even though the government's revenue estimates in the pre-election report can be considered reasonable, economic and revenue forecasting is still far from an exact science. The underlying economic forecasts are subject to many risks. Members of the Economic Forecast Council also echoed this sentiment, noting that instability in the Middle East, higher energy prices, and the appreciation of the Canadian dollar were factors that could adversely affect the revenue outlook.

Our expert also noted that, given Ontario's heavy dependence on exports to the United States, the large and growing debt arising from record deficits in the United States, as well as other G-7 countries, was one of "many risks clouding economic prospects." In the

United States especially, “it is still far from clear that the required steps will be taken to deal appropriately with the situation” and “the risk is that foreign lenders will at some point be no longer willing to finance the U.S. deficit at current interest rates and that interest rates could increase substantially, undercutting the recovery.” He went on to say that “to the extent that inflation increases in China and other lending countries, they could also respond with interest rate increases that could impact the availability of funding for all borrowers including the United States Government and precipitate interest rate increases in the United States, which would undercut growth.”

Our expert pointed out that, even in the absence of adverse international risks, the Canadian economy faces domestic risks that could undermine economic performance. These include the recent increases in government and private-sector debt relative to GDP and the relatively high levels of housing prices. A sharp decline in housing prices, coupled with the high level of household debt, could lead to a slowdown in consumer spending, which again would undermine economic growth. These developments could be exacerbated by any spike in interest rates precipitated by international developments. There is also a risk that the federal government, in dealing with its own deficit, might decide to cut transfers to Ontario as various federal–provincial agreements come up for renewal.

On the other hand, it is also possible that the province could receive more revenue than has been forecast. Our expert noted that factors that could result in such a situation “include a stronger global recovery, and the usual tendency for an economy to experience a period of stronger-than-average growth following a recession.”

Overall, our expert was of the opinion that it is best “to build a medium-term fiscal plan on prudent economic assumptions, which call for slower than average economic growth.” On the basis of our

work and that of our expert, we determined that the pre-election report reflects these assumptions. Therefore, we concluded that the government's revenue forecasts for the next three fiscal years and the assumptions underlying them were reasonable, keeping in mind that the degree of assurance we can provide declines the further in the future the time period in question is.

## EXPENSE ESTIMATES

### Reasonableness of Expense Estimates and Assumptions

In preparing its expense estimates for the next three years, the government could make assumptions that range from prudent and cautious on the one hand to optimistic and aggressive on the other. The Act, however, states that Ontario's fiscal policy should be based on cautious assumptions. We therefore reviewed the key assumptions underlying the government's expense forecasts against this principle, and we concluded that the assumptions underlying its expense estimates reflect an optimistic or aggressive perspective.

As seen in Figure 3, the government has planned for overall average annual growth of only 1.8% in program expenses (that is, total expenses excluding large one-time expenditures and interest on the public debt) over the next three years. This is significantly below the 6.9% average annual growth in comparable program expenses that the government has experienced over the past eight years. Moreover, this is even slightly less than the government's projection for the average annual inflation rate for the next three years of 2.1%.

We considered the following factors in assessing the reasonableness of such a significant decline:

- Salaries and benefits account for more than one-half of total program spending. Therefore, any pay increase that staff in ministries and organizations in the broader public sector such

**Figure 3: Actual and Projected Average Growth in Program Expenses by Major Sector and Overall (%)**

Sources of data: Public Accounts, 2011 Ontario Budget

Major Program Area	Actual	Projected
	Average Growth 2003/04–2010/11	Average Growth 2011/12–2013/14
health	7.1	3.6
education	4.8	3.0
post-secondary and training	8.6	2.4
children's and social services	6.7	3.2
justice	5.8	(1.6)
other programs	9.6	(5.6)
<b>Total</b>	<b>6.9</b>	<b>1.8</b>

Note: Percentages exclude large one-time expenditures

as hospitals, school boards, colleges, and universities receive over the next three years could have a significant impact on the public sector's ability to reduce historic expenditure growth rates.

- Expenses for public services provided by the government are directly related to the quantity of services that the public is entitled to or demands. Such services range from those that the government has less control over (such as social-service benefits and medical services) to those that are more discretionary in that, at least to some extent, the government can decide how much funding it makes available for them (such as long-term-care beds, home care for seniors, and post-secondary enrollment funding).
- The cost of goods and services purchased from the private sector can be expected to rise as a result of inflation.

## Salary Increases

The government has indicated that its fiscal projections do not provide for compensation increases. For non-unionized workers, the government recently passed legislation to this effect. For unionized workers, the government announced in the 2010 Budget that there would be no funding for compensation increases in the first two years of any future collective agreements. However, the collective agreements that the government has negotiated in the past eight years with the two main ministry unions—OPSEU and AMAPCEO—included pay increases that in most cases exceeded the rate of inflation. This was also the case with past negotiated wage settlements for the OPP and across the broader public sector. Teachers, nurses, university and college professors, and members of other large groups have also often been successful in negotiating pay increases above the inflation rate. Even since the Budget announcement, across-the-board wage increases have been awarded to some of these workers, with some increases being significantly more than 2%.

Given historical as well as recent salary increases awarded to public-sector workers, we believe that the assumption that public-sector pay increases can be held to 0% is optimistic.

## Public Demand for Services

Many services are entitlements—that is, once a person qualifies for the service, the service must be provided. Examples include patient visits to doctors and hospital emergency rooms, child-protection services provided by Children's Aid Societies, disability support benefits, and Ontario Works benefits. In other areas—such as classroom sizes, long-term-care beds, and community mental and physical disability support—the quantity and level of services provided is more dependent on the amounts that the government budgets for them.

With respect to health care, one of the key factors affecting demand is Ontario’s aging population. Figure 4 shows that the government’s health-care spending per person rises significantly after age 65, with the highest amount of spending on health care occurring within the last few years of life.

Over the next decade, the percentage of the population aged 65 and over is expected to increase at three times the growth rate of the general population. Specifically, the seniors population increased from 13.2% of Ontario’s total population in 2007 to 13.7% in 2009 and is expected to increase to 14.1% in 2011 and to 16% in 2016. As Figure 4 illustrates, as the population ages, average per-person health-care spending will also rise.

The government believes that the impact of aging on health-care costs will be negligible over the next three years. However, our view is that, given the health demands of a growing and aging population and an average growth rate in health expenses of 7.1% per year over the past eight years, assuming that health-care costs will rise much more slowly in the next three years cannot be considered cautious.

**Figure 4: Health Spending per Person by Age, 2007 (Current Dollars)**

Sources of data: Canadian Institute for Health Information, Statistics Canada

Age	Share of Population (%)	Spending per Person (\$)
<1	1.1	9,188.0
1-4	4.4	1,292.6
5-14	12.0	1,047.6
15-44	42.8	1,706.3
45-64	26.5	2,823.6
65-74	6.9	6,883.1
75-84	4.7	11,843.7
<b>65+</b>	<b>13.2</b>	<b>10,330.7</b>
<b>85+</b>	<b>1.6</b>	<b>20,702.4</b>
<b>Overall Average</b>		<b>3,127.0</b>

## Cost of Goods and Services

Normally, suppliers of goods and services tend to keep any price increases to a minimum during a recession. This has been the case over the past few years. However, the economy is coming out of a recession, and the prices of commodities and other raw materials are generally increasing. Private-sector suppliers will be striving to pass such cost increases on to their customers.

The government undoubtedly has purchasing clout. But we question whether that clout is sufficient to enable the government to keep the prices it pays for private-sector goods and services from growing more slowly than they have in the past eight years—especially in an economy emerging from the recent recession. Savings already achieved from various supply-chain initiatives implemented in recent years may be difficult to replicate in the future. It will therefore be a challenge for the government to hold the prices it pays for goods and services to less than the inflation rate.

## Expense Estimates by Sector

To further assess the overall reasonableness of the government's assumptions and plans for managing expenditure growth, we reviewed the specific assumptions the government has made for particular program sectors, as well as the government's plans to deal with the known factors that impact costs in these program areas.

### Health Sector

Health-sector costs are largely driven by the public's demand for health care and the prices paid for services provided.

Specific factors that drive up costs include population growth, aging of the population, increases in utilization (that is, the number of times a person accesses the health care system), and general

inflationary cost increases. Figure 5 shows the annual increases in these factors projected by the government in 2005 as well as two more recent private-sector organizations’ projections of the impact of these cost drivers. The government’s 2005 projection was that, over the long term, these factors would drive up health-care costs by 5.9% annually, while more recent estimates indicate that these factors will result in annual increases in the 6%–7% range. A May 2011 report by the Health Council of Canada noted that annual health spending across Canada increased by 6.7% between 2004 and 2010.

As Figure 3 shows, the pre-election report projects an average annual increase in health-care expenses of only 3.6% over the 2011/12–2013/14 period, or about half the average annual growth of 7.1% over the last eight years.

To state the obvious, no one wants to become ill, get injured, or contract heart disease or cancer. In an ideal world, the only health-sector costs would be for preventive care, but our health-care needs are far greater. And health-care services are largely

**Figure 5: Projected Annual Percentage Increases in Health-sector Cost Drivers**

Sources of data: Ontario Ministry of Finance; *Charting a Path to Sustainable Health Care in Ontario*, TD Economics Special Report by Don Drummond and Derek Burleton; *Chronic Healthcare Spending Disease: A Macro Diagnosis and Prognosis*, C.D. Howe Institute

Cost Driver	Annual Percentage Increase in Health Costs as Projected by:		
	Government of Ontario (2005)	TD Economics (2010)	C.D. Howe Institute (2011)
utilization/demand	1.5	2.0	
population aging	1.1	1.0	
population growth	1.1	1.0	
inflation	2.2	2.5	
<b>Total</b>	<b>5.9</b>	<b>6.5</b>	<b>6.4</b>



non-discretionary—when people get sick or injured, they need, and the government must provide, the services.

In summary, health-care costs are affected by a wide range of factors, and many are beyond the government's control. But they all must be taken into account in forecasting how much costs will rise in the future. It is not unreasonable to assume that, unless there are changes in the kinds of health-care services the government funds or there are significant cost inefficiencies in the health-care system that the government can address, the past trend of annual increases in health-care costs of about 7% may well continue. The government's view, however, is that it can implement strategies and policy changes to mitigate the impact of health-care cost drivers and cut the annual average growth rate of the past eight years in half.

To assess the reasonableness of this view, we examined the expense estimates for five individual health-care programs with annual operating expenditures of more than \$1 billion. Total annual expenditures in these five areas in 2010/11 were \$37.3 billion, more than 80% of total annual expenditures in the health sector. Figure 6 summarizes the annual growth in expenditures for each over the past eight years compared to the forecasted growth rates for the next three years.

### Hospitals

The actual growth in hospital expenditures has averaged 6% per year over the past eight years. Over the 2011/12–2013/14 period, the government has budgeted for these expenditures to grow at an average of a little more than half that rate, or 3.3% per year. The expense estimates assume that the hospital sector will achieve savings totalling \$1 billion between 2011/12 and 2013/14. Some of the strategies that the Ministry of Health and Long-Term Care informed us it would use to realize these savings include:

## Figure 6: Actual and Projected Growth in Expenditures for Five Areas of the Health Sector

Source of data: Ministry of Finance

Area	Estimated Expenditures 2010/11 (\$ billion)	Average Annual Growth in Expenditures (%)	
		Actual 2003/04– 2010/11	Projected 2011/12– 2013/14
hospitals	15.6	6.0	3.3
Ontario Health Insurance Plan (OHIP)	11.9	8.0	3.9
drug programs	4.3	6.7	3.5
long-term-care homes	3.5	8.6	4.2
Community Care Access Centres	2.0	7.2	2.3
<b>Total</b>	<b>37.3</b>		

- relieving pressure on hospital acute care by strengthening community care (that is, long-term care-homes and home care for seniors through Community Care Access Centres);
- implementing the provisions of the *Excellent Care for All Act, 2010*, which include establishing quality committees, putting annual quality improvement plans in place, and linking executive compensation to the achievement of quality improvement targets;
- continuing to require hospitals to sign accountability agreements, under which service delivery is based on set performance measures;
- linking hospital funding to the population or type of patients a hospital serves; and
- rolling out eHealth (electronic health care) to enable better sharing of health information and create a more cost-effective health-care system.

Because the Ministry is still working on these strategies, it was unable to provide detailed plans or quantify the savings that it hoped would result from each of them.

One of the government's key assumptions is that hospitals can limit their expenditure growth to about 3% per year by holding unionized hospital workers to a 0% increase in compensation. Given past wage settlements—such as the Ontario Nurses' Association's recent three-year contract awarding nurses an average annual pay raise of about 1.5% and increases in their benefits—we believe such an expectation is optimistic rather than cautious.

The government has indicated that it will be up to hospitals to operate within their funding allocation regardless of how they manage the savings and compensation pressures they face. Therefore, if hospitals do not find \$1 billion in savings and do not succeed in freezing compensation, they will likely run deficits or may have little alternative but to cut services.

### **Ontario Health Insurance Plan (OHIP)**

OHIP is a demand-driven program in that the payments that the government must make to physicians and other health-care professionals are driven by insured Ontarians' demand for the wide range of covered health-care services these professionals provide. The growth in OHIP payments has averaged 8% per year over the past eight years. Over the 2011/12–2013/14 period, the government is planning on limiting this growth to half that, or an average of 3.9% per year.

One of the government's key assumptions is that it will provide no additional funding for compensation increases in future agreements with the Ontario Medical Association (OMA). This is expected to limit the growth in estimated OHIP payments by \$500 million in 2012/13 and by another \$1 billion in 2013/14. However, since 2000, the OMA has generally been successful in negotiating fee increases for Ontario's doctors in excess of the

inflation rate. That there will be no increase for health-care professionals when the current OMA agreement comes up for renewal in April 2012 is clearly an aggressive rather than a cautious assumption.

As with hospitals, it will be up to the Ministry of Health and Long-Term Care to find other savings within the funding allocated for OHIP to offset any fee increase. One strategy is the promotion of family health teams as an alternative to fee-for-service OHIP billings. Another cost-containment strategy that governments have used in the past is to cap the amount physicians can bill in a given year. However, such a cap could well result in an overall reduction in services (for example, longer wait times for surgeries and physicians providing fewer services and reducing office hours).

The Ministry advised us that it expects to achieve further savings in OHIP of \$550 million over the next three years through such initiatives as restricting Vitamin D testing, eliminating the requirement for pre-operation electrocardiograms for cataract and certain other types of elective surgery, and restricting the use of sleep studies. However, the Ministry could not provide us with adequate support for its estimated savings from such initiatives.

### Drug Programs

On average, drug program costs have grown by nearly 7% per year over the past eight years. The government is planning to limit this growth over the next three years to about half this rate, or 3.5% per year.

In contrast to what we found with most of the other major areas of the health sector, the government did have more definitive plans for containing drug program costs. It first began to reform the provincial drug system in April 2006. The centrepiece of these reforms was the expanded use of generic drugs, which cost less than brand-name drugs. The reforms enabled the government to reduce the costs of the largest program, the Ontario Drug Benefit

Program, by almost \$800 million by 2009/10. In June 2010, the government announced a further package of reforms that included setting generic drug prices at 25% of brand-name prices. It estimates that these recent reforms will reduce Ontario Drug Benefit Program costs by an additional \$250 million over the 2011/12–2013/14 period.

Given the cost-containment actions taken to date and currently under way, we concluded that the government's projection that the annual increase in drug costs will be half that of the past eight years was reasonable.

### Long-term-care Homes and Community Care Access Centres

The expenses incurred by both long-term-care homes and Community Care Access Centres (CCACs) are largely related to providing services to seniors. Most residents of long-term-care homes are seniors, while CCACs provide nursing and other home-care services to enable seniors and others to live at home.

Long-term-care home costs have increased an average of 8.6% per year over the past eight years. Over the 2011/12–2013/14 period, the government plans to hold growth in expenditures to an average of 4.2% per year, or about half of the past growth rate. The growth in CCAC expenditures has averaged 7.2% per year over the past eight years. The government's forecast for the 2011/12–2013/14 period assumes that growth in CCAC expenditures will average 2.3% per year, or only about one-third of the past growth rate.

While the other major areas of the health sector discussed previously are primarily entitlement-based, in that patients/recipients are entitled to be funded if certain eligibility or other conditions are met, the funding of long-term-care homes and CCACs is much more at the discretion of the government. So at least theoretically, it should be easier to stay within spending targets. However, as discussed in the Hospitals section, we were advised that a key

strategy for containing growth in hospital expenditures is increasing community home-care support and long-term-care availability to enable more acute or alternative levels of care for patients discharged from hospitals. Because this will increase demand and therefore expenses for both long-term-care homes and CCACs, which currently already have wait lists, we concluded that the government's assumption that both programs will be able to significantly reduce their annual expenditure growth rates is optimistic rather than cautious.

### Education Sector

The annual growth rate in education-sector expenditures over the past eight years has averaged 4.8%. The government plans to reduce this growth rate to an average of 3% per year over the next three years.

Two key factors drive education expenses:

- student enrollment (both at elementary schools—including enrollment in the recently instituted full-day kindergarten program—and at secondary schools); and
- teacher and support-staff compensation (excluding teacher pension benefits), which makes up about 80% of total education-sector expenses of \$22 billion.

We reviewed the data on which the Ministry of Education's enrollment projections for the next three years were based. We concluded that the Ministry's assumptions were realistic, reflecting a very gradual but consistent decline in enrollment.

Compensation—the other major cost driver in the education sector—make up most of the \$14 billion in operating grants provided annually to elementary and secondary school boards. Over the last eight years, the average growth rate in operating grants to school boards was 5.8%. The government plans to limit this growth rate to an average of 1.8% over the next three years. To

help achieve this, the government assumes that, when the current collective agreements with teacher and other unions expire in August 2012, school boards will be able to negotiate a 0% increase in compensation for the next two years. Under their current agreement, most teachers are receiving a 3% annual salary increase.

In discussing the reasonableness of assuming a 0% compensation increase, the government informed us that, as is the case with hospitals, school boards will be expected to operate within their funding allocation regardless of the result of their compensation negotiations with teacher and other unions. Operating agreements between school boards and the province do not allow school boards to run deficits, so if school boards cannot hold teacher and other unionized employee compensation increases to 0%, they will have to find other ways of saving money to offset the amount of any compensation increase. The government estimates that a 1% increase in teacher salaries would add \$160 million more each year to education costs. If offsetting savings cannot be achieved through efficiencies, school boards will be forced to reduce services.

The government's statement that health care and education are two of its most important priorities and its statement in the 2011 Budget that deficit reduction measures will not be achieved "by putting vital public services at risk" will put school boards and the government under pressure to maintain current service levels to students. In light of this, we believe the assumption that either future school-board collective agreements will result in 0% compensation increases or that school boards will be able to find savings elsewhere to offset any compensation increases, without making service cuts, is optimistic.

### **Post-secondary and Training Sector**

Programs providing grants for university and college operating expenses account for more than 65% of post-secondary and

training-sector expenditures. Grants under these programs have grown by an average of 7.3% per year for universities and 6.5% per year for colleges over the past eight years. The government plans to reduce average growth in these grant program expenditures over the next three years to 2.2% per year for universities and 3.6% per year for colleges.

Post-secondary operating grants are discretionary—the government has leeway in deciding how much funding to provide the province’s 20 public universities and 24 public colleges. Universities and colleges, in turn, base the enrollment spaces they make available to students on the funding they receive and the tuition fees they charge. The planned expenditure growth rates given in the pre-election report are intended to fund enrollment increases of about 2.2% per year over the next three years, resulting in new spaces for more than 60,000 students by 2015/16.

The expenditure growth rate of 7.3% over the past eight years included the effect of the elimination of Grade 13 in 2002. This created a double cohort of undergraduate students that significantly increased the need for additional enrollment spaces and funding and helps account for the disparity between the historic and projected expenditure growth rates. Given that the double cohort was a one-time event and that spending on colleges and universities is discretionary, we believe that the government’s projection of a significant decline in expenditure growth rates for the post-secondary sector is reasonable.

### **Children’s and Social Services Sector**

Children’s and social-services-sector expenditures have grown on average by 6.7% annually over the past eight years. The government plans to reduce this growth rate to half that or to an average of 3.2% per year over the next three years.



Social assistance and child protection services make up the bulk of program expenditures in this sector. Such programs are largely of an entitlement nature—the government is obligated to make payments to individuals that meet program eligibility requirements. Three specific programs represent more than half of total expenditures in the sector. Two are social assistance programs—the Ontario Disability Support Program (ODSP) and Ontario Works—and the third is Child Protection Services (provided primarily by Children’s Aid Societies).

### Social Assistance Programs

ODSP and Ontario Works provide benefits such as basic needs allowances, shelter allowances, special diet allowances, and dental benefits to eligible recipients. The main factor that affects program costs is the number of eligible recipients, which makes up program caseloads.

Figure 7 shows the average annual increases in total benefit costs and caseloads for both programs, comparing past actual percentages to future projected percentages.

**Figure 7: Actual and Projected Growth in Social-assistance Expenditures and Caseload (%)**

Sources of data: Ministry of Community and Social Services, Public Accounts

	Actual	Projected Annual Growth		
	Average Growth	2011/12	2012/13	2013/14
	2003/4–2010/11	2011/12	2012/13	2013/14
<b>ODSP</b>				
social-assistance expenditures	6.9	8.8	3.5	2.1
caseload	4.0	6.4	2.8	1.5
<b>Ontario Works</b>				
social-assistance expenditures	4.6	7.2	3.2	0.0
caseload	3.4	5.5	1.0	(4.5)

By 2013/14, the expenditure growth for both programs is targeted to be significantly lower than that experienced over the past eight years—about a 70% reduction in the ODSP expenditure growth rate and down to a zero expenditure growth rate for Ontario Works. Caseload growth rates for both programs are also projected to decline significantly—by more than 60% for ODSP and, for Ontario Works, to an actual decrease in individuals entitled to benefits.

The Ministry of Community and Social Services initially based its projections on expected changes in demand—driven by, for example, Ontario’s growing population and declining unemployment as the economic outlook improves. However, the Ministry then reduced the initially projected growth rates on its assumption that savings will result after 2012, when a committee reviewing the province’s social assistance programs is to issue recommendations aimed at making these programs more financially sustainable. Assuming that any future recommendations will result in reduced caseload growth rates for both ODSP and Ontario Works is aggressive rather than cautious.

On the other hand, demand for Ontario Works benefits, in contrast to that for ODSP, tends to be more short-term and fluctuates with Ontario’s economy. Therefore, while the significant reduction in ODSP caseload growth rates will be more challenging to achieve, some decline in Ontario Works growth rates is a reasonable expectation.

### **Child Protection Services Program**

The Ministry of Children and Youth Services is required by legislation to help any child or youth at risk of being abused or neglected. Child Protection Services Program costs have grown over the past eight years by an average of 5.3% per year. The Ministry plans to reduce growth over the next three years to a much lower 0.7% per year.

The salaries of employees of child- and youth-sector agencies and boarding costs for children under protective custody account for more than 85% of child protection expenditures. The projected estimates assume no additional funding to child and youth agencies for compensation increases in the first two years of their next collective agreements. However, 14 of the 23 agreements negotiated since the compensation restraint measures were announced in 2010 resulted in wage increases.

The Ministry plans to achieve other savings by consolidating 21 of the 53 Children's Aid Societies across the province. However, the expected savings from this initiative total only about \$9 million and would not materialize before 2013/14.

The Ministry advised us that, as with other organizations charged with providing services to the public, it will be up to Children's Aid Societies to fulfill their child protection responsibilities within the funding they have been allocated. At the same time, Children's Aid Societies are required by law to provide their services to every child needing them. We noted that, in 2010/11, only 18 of the 53 Children's Aid Societies were able to provide the required services within their funding allocation. Given that Children's Aid Societies are legally required to provide child protection services, we again felt that the assumption that expenditure growth can be constrained to an average rate of only 0.7% per year over the next three years was on the optimistic side.

### Justice Sector

Most justice-sector expenditures are for correctional services, provincial policing, and legal aid. Justice expenditures relating to these areas have grown by an average of 5.8% per year over the past eight years. The government has planned for expenditures in this sector to actually decline by an average of 1.6% per year.

Expenditures over the past eight years have included a number of capital projects, such as the building of correctional facilities. These projects are near completion and will no longer require funding after 2012/13. Such capital-project costs are treated as an expense in the justice sector, so the windup of these capital projects accounts for much of the projected decline in the justice-sector expenditure growth rates. However, investment in such assets is treated differently in the province's financial statements. The result is that, from a bottom-line perspective, the windup of these projects has little impact on total provincial expenses as estimated in the pre-election report.

In the justice sector, salary expenditures account for 50% of total expenditures and will increase in the next three-year period. For instance, Ontario Provincial Police (OPP) officers will receive an 8.5% wage increase starting in 2014, and the correctional officers' collective agreement is up for renewal in 2013. Although the government plans for a zero salary increase in the next agreement, there is a risk that this will not occur. As well, the 2014 OPP wage increase was not included in the government's 2013/14 expense estimate. Nevertheless, we estimated that these committed and potential wage increases will not significantly affect the projected decline in expenditure growth.

### Large One-time Expenditures

One of the most significant areas where the government is planning to control expenditure growth is time-limited or one-time expenses. Major one-time expenses are projected to decline from \$3.6 billion in 2010/11 to \$1 billion by 2013/14. Recent examples of such expenses are infrastructure stimulus spending to help the province emerge from the global recession and auto industry support. The most significant of these—stimulus spending—is being phased out because of the improving economic environment. In

light of this, we believe that it is reasonable to assume that spending in this area can be substantially decreased from the levels of the recent past.

## Contingency Funds

Program expenses also include a contingency fund in each year to cushion the impact of unfavourable variances from the fiscal plan's assumptions. In each of the next three fiscal years, the government has included \$700 million for such contingencies, or a total of \$2.1 billion.

In the last pre-election report, the government set aside considerably more contingency funding—a total of \$3.3 billion. While \$700 million per year will help mitigate some of the risks associated with the government's assumptions, we believe that a much larger contingency fund will be needed to fully mitigate the risks associated with what we believe to be a generally optimistic set of expense assumptions.

## Interest on the Public Debt

In contrast to program expenses, which reflect the costs of delivering services to the public, interest on the public debt is primarily based on the province's growing debt burden and market forces that largely determine the interest rates that the government must pay.

The government's estimate of the cost to service its debt in 2010/11 is \$9.5 billion. The government is forecasting that this cost will grow by nearly 10% per year, rising to \$10.3 billion in 2011/12, \$11.4 billion in 2012/13, and \$12.6 billion in 2013/14. We reviewed the forecasting methodology used to make these estimates, examined the supporting documentation, and reviewed the

forecasting model and assumptions used with senior staff at the Ontario Financing Authority.

Interest expense for the province’s existing debt, most of which is long-term, is projected using the interest rates the province is committed to pay until the debt matures. Interest expense for the province’s 2011/12 and 2012/13 projected borrowings is estimated using interest-rate forecasts of private-sector economists for the 2011 and 2012 calendar years. The interest expense for the province’s 2013/14 projected borrowings is based on the historical 10-year average of interest rates.

Figure 8 shows that the government’s forecasts of interest expense have been on the prudent side over the last four years—actual interest costs have been below the costs forecasted each year.

We acknowledge the government’s track record of being prudent in its past forecasts of interest expense, and we believe that the assumptions underlying the government’s interest expense projections for the next three years are reasonable given the current economic outlook.

### Risks Relating to Interest Estimates

The government estimates in the pre-election report that a 1% change in 2011/12 borrowing rates would impact interest expense by \$500 million in that year. Even though we believe that the

**Figure 8: Estimated and Actual Interest Expense (\$ million), 2007/08–2010/11**

Source of data: Public Accounts

	2007/08	2008/09	2009/10	2010/11
estimated	9,123	8,891	9,301	9,961
actual	8,914	8,566	8,719	9,527
over-estimated amount	209	325	582	434

government's forecast of future interest rates is reasonable, interest rates are driven largely by economic factors that are outside the control of government. A sudden unforeseen spike in global interest rates would significantly increase the government's interest expense.

## **THE RESERVE**

The Act requires that the government's fiscal plan include a reserve. In contrast to contingency funds, which are meant to offset the consequences of the fiscal plan's assumptions not being borne out, the purpose of the reserve is to offset the impact of unexpected and adverse future events of the magnitude of, for example, a SARS outbreak (such as that in 2003) or a global recession (such as that in 2008). The government's fiscal plan includes a reserve of \$0.7 billion in 2011/12 and \$1 billion in each of 2012/13 and 2013/14.

Given that the reserve has been established to respond to unexpected future events, it is not possible to conclude on the appropriateness of the amount. We therefore note only that the government has complied with the Act by including a reserve in its fiscal plan and that the total reserve of \$2.7 billion is roughly comparable to the \$3 billion reserve in the 2007 pre-election report.



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