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ECONOMIC VIEWPOINT

Five Takeaways from Mid-Year Updates in Canada's Provinces

What to Expect for Provincial Finances During Next Year's Recession and Beyond

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Summary

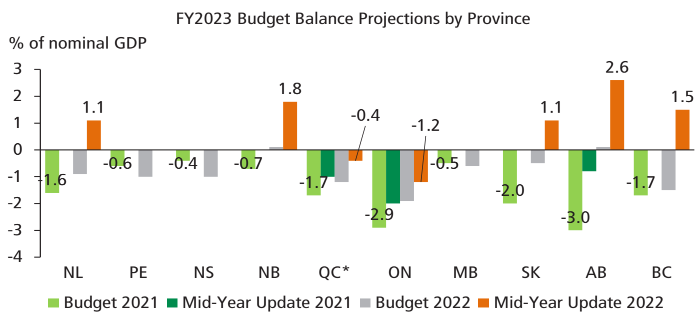
- Another round of revenue windfalls drove further fiscal improvements in this year's round of mid-year updates, and many provinces now find themselves in even better fiscal shape than before the COVID-19 pandemic.
- We're more bearish than most private sector forecasters, particularly on the housing market, but this downside risk looks unlikely to undo the strength of the windfalls seen so far.
- The largest of the pandemic-fuelled spending increases look to be behind us. There's some upside risk on this front from public sector wage increases and potential economic support measures during the coming downturn.
- Affordability measures announced since the spring budget season add up to 0.4% of nominal GDP in FY2023 and should boost national real GDP growth by about 0.1 ppts in 2022. These policies became more targeted with time; Quebec has so far been the most generous.
- Provinces must be prudent and targeted with new spending and revenue measures going forward. Inflation looks to have peaked, and new fiscal room should be devoted to weathering the coming economic storm and addressing long-run demographic pressures on government finances.

Introduction

To say that government finances have improved in Canada over the last year would be a massive understatement. In early 2021, as Canadian provinces released their first multi-year, pandemic era fiscal plans, the situation was dire. At the time, most projected huge extended deficits, and severe blowouts in public debt as the total economic shutdown slashed revenue forecasts and prompted costly policy support. Now, after mid-year fiscal updates for FY2023, many provinces foresee large surpluses (graph 1). Some also expect decades-low debt burdens.

In this note, we discuss the five takeaways from the latest round of provincial updates and what to expect for government finances as the Canadian economy goes into recession next year.

GRAPH 1
Another Round of Updates, Some Huge Fiscal Improvements

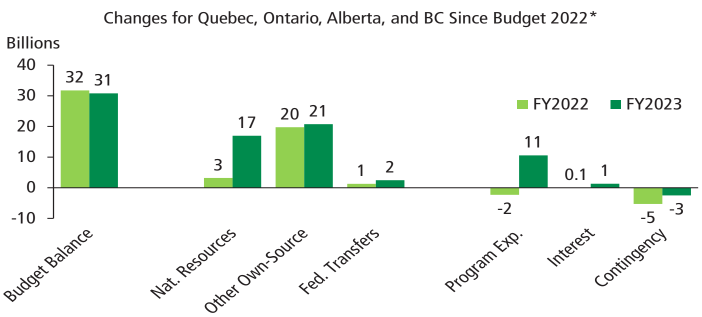


* Before Deposits into the Generations Fund, use of Stabilization Reserve
Sources: Provincial budget documents and Desjardins Economic Studies

1. Huge Revenue Windfalls Are Unlikely to Continue

The boost to provincial government finances has been almost entirely a revenue-side story. In fact, the $38B own-source revenue windfall in FY2023 in Canada's four largest provinces since Spring 2022 dwarfs the $31B balance improvement. Some $17B is from natural resources royalties, but income taxes have also contributed handsomely to the provinces' aggregate bottom lines (graph 2). This reflects a stronger-than-anticipated economic recovery from the pandemic, a surge in commodity prices, and persistent inflation that has boosted nominal GDP.

GRAPH 2
Revenue Windfalls Drive Massive Fiscal Improvement



* FY2023: government forecasts
Sources: Provincial budget documents and Desjardins Economic Studies

In line with stronger bottom lines since budget season 2022, provincial borrowing requirements have been revised down a combined $24.9B for these provinces so far for FY2023.

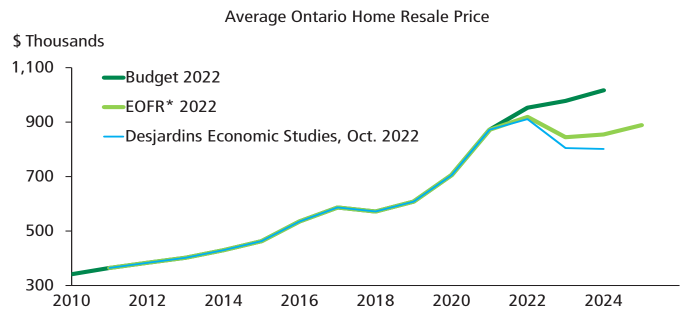
We do not see this trend continuing in the coming fiscal years. Desjardins Economic Studies projects a recession in Canada next year as interest rate hikes bite and global demand slows. Inflation looks to have peaked and seems to be heading lower. And commodity prices, particularly oil, are weakening, though the risk of further Russia-Ukraine-related supply disruptions remains.

2. Recession Risk Is Somewhat Underestimated, but Unlikely to Undo Pandemic Era Revenue Windfalls in the Short Run

Many projections were downgraded in the mid-year updates, but we still see some downside risk to government baseline projections.

Our base case forecast builds in a real estate-led economic downturn in Canada, one area where we think risks may not have been fully considered. Though both Ontario (graph 3) and BC recently revised their housing price forecasts lower, their views remain more optimistic than the ones we published in October. A related issue is population growth, which has spurred huge revenue gains in Atlantic Canada. Our last provincial outlook assumed much more moderate migration from other provinces to the region in 2023. In that context, population growth forecasts—likely to be updated in next year's budget plans—will be crucial for those provinces' fiscal prospects.

GRAPH 3
Housing Price Forecasts



* *Economic Outlook and Fiscal Review*
Sources: Ontario Ministry of Finance and Desjardins Economic Studies

Major project activity is another risk area, which could also impact the timing of debt and borrowing. Many provinces reported delays in publicly funded capital ventures due to elevated input costs and acute labour shortages. Even as inflation and commodity prices cool, these factors should remain in place to some extent going forward.

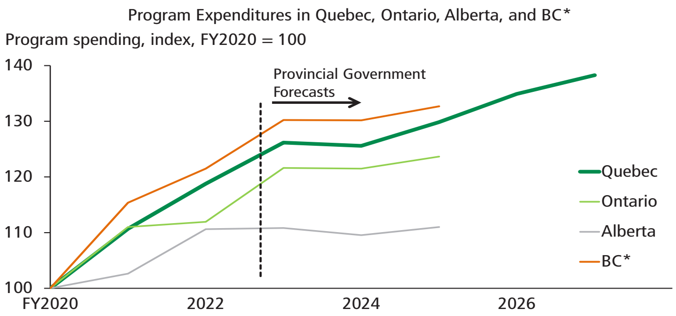
Yet it's not clear that these risks would unwind massive FY2023 starting point improvements. In More Money, More Problems: What a Recession Could Mean for Ontario's Budget Balance, we linked a typical downturn with $8B in lost revenues over two years. That's less than the own-source revenue windfall of over $10B recorded in Ontario just between April and September 2022! Similarly, a recession scenario outlined in the Quebec government's pre-election report predicted an $8.3B plunge in receipts in five years versus nearly $5B in unforeseen FY2022 revenues plus $2B in FY2023 contingencies. And Alberta's doubling of non-renewable resource receipt forecasts since February means WTI would likely have to average less than US$70/barrel next year to prevent a surplus in FY2024.

3. The Largest Pandemic Spending Rises Are Behind Us, But There is Some Upside Risk for Expenditures Near-Term

Provinces still plan to spend far more than before COVID-19 and will use some newfound revenues to smooth expenditure plans, but we've likely reached the peak growth rate (graph 4 on page 3).

Still, there remains some risk to provincial spending pressures as inflation could persist and drive up public sector wages. Some governments explicitly forecast that wages would catch up with inflation in the coming quarters, and wage negotiations are ongoing in some other provinces. Indeed, we saw wage gains outstrip inflation for several years after the tightening cycles of the early 1980s and early 1990s.

GRAPH 4
Peak Spending Growth Looks to be Behind Us



* Used Q1-FY2023 forecast for Mid-Year Update 2022
Sources: Provincial budget documents, Finance Canada, and Desjardins Economic Studies

If the recession does become severe, governments may opt to provide economic supports to affected workers and businesses, further hurting the bottom line.

While the rate paid on outstanding debt has sharply increased amid rapidly rising interest rates, we see relatively little upside risk for debt servicing costs. These were largely unchanged from budget plans across most provinces as debt reductions from improved fiscal positions offset higher rates. The provinces are broadly less exposed to rollover risk than the federal government because the term-to-maturity of their outstanding debt is higher.

4. Affordability Measures Will Nudge Growth Higher, Could Inflame Inflation

If there was a single unifying theme of mid-year update season, it was affordability relief. Following what was largely a smattering of smaller measures in their spring budgets, many provinces stepped up transfers to households to blunt inflation's impacts. Measures announced for FY2023 make up about 0.4% of GDP and range from 0.1% to 1% of output at the provincial level (table 1).

TABLE 1
FY2023 Affordability Measures Announced Since Budget 2022

Province	FY2023 Amount ($ M)	% Nominal GDP	Description
NL	194	0.5	$500 for those earning ≤ $125k
New Brunswick	140	0.3	➢ Broad-based income tax cuts ➢ Tax cut for non-owner-occupied properties
Quebec	5,091	1.0	➢ New household transfers ➢ 3% cap on tax rate inflation indexation ➢ Increase in payments to seniors 70+
Ontario	735	0.1	➢ School catchup payments ➢ Gas tax cut extension
Saskatchewan	450	0.5	$500 to every resident aged 18 or older
Alberta	2,287	0.5	➢ Electricity rate rebates ➢ Income tax bracket re-indexation ➢ Transfers for households earning ≤ $180k
BC*	1,100	0.3	➢ Temporary hydro rate reduction ➢ One-time tax credit, phased out @ $79k
TOTAL	**9,997**	**0.4**	

* Does not include $800M for public sector wage increases
Sources: Statistics Canada, provincial budget documents, Desjardins Economic Studies

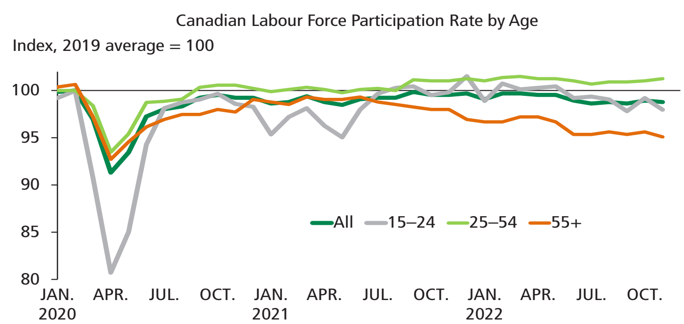
Using work done by the Bank of Canada and the Parliamentary Budget Officer, we estimate that these measures will boost the national annual growth rate by about 0.1 ppt in 2022. The risk remains that these measures exacerbate or prolong inflationary pressures. See our commentary on the Alberta and Ontario mid-year updates for details. However, more recent policies have been more targeted towards lower-income households whose purchasing power tends to be most impacted by inflation. The broadest measures in Quebec and Saskatchewan were announced earlier this year when inflation was more severe. Quebec then scaled back plans for affordability assistance in its mid-year fiscal update (see our commentary Inflation Continues to Influence Budgetary Choices). More recently, BC announced supports limited to individuals earning $79k per year or less.

5. Longer-Run Challenges are Significant, and Governments Need to be Prudent Now

The challenges presented by Canada's demographics are well known. With a rapidly aging population and one of the lowest birth rates among G7 nations, Canada and its provinces face the prospect of slowing economic growth and much higher health care costs.

What has changed of late is the rate at which labour force participation is falling among older cohorts. We discussed this trend in the Canadian and Quebec context in The Great Resignation: A Distinctly American Phenomenon. While there's no firm evidence of a spike in quitting rates as sudden as what we observed in the US during the pandemic, a downward trend in participation among older workers appears to be advancing across the provinces (graph 6). The pandemic looks at least partly responsible for the shift.

GRAPH 5
Labour Market Exits Led by Older Cohorts



Sources: Statistics Canada and Desjardins, Economic Studies

The risk of a shrinking labour pool will remain a pressing issue for provinces going forward, and provincial policy will need to play a role in addressing it. Efforts on this front could include further targeting provincial immigration policy or efforts to encourage workforce participation among older workers. Following the pandemic, it also means that capacity issues in the health care system will remain front and centre.

This also means that discussions between the provinces and the federal government about increasing the Canada Health Transfer (CHT) will continue. A common point of contention is that the CHT should increase from 22% to 35% of provincial health care expenditures. Based on the provinces' calculations, such a move would increase federal transfer payments by nearly $30B, with about $11B to Ontario and $6B to Quebec in addition to current payments. A unilateral move to boost the CHT this fiscal year is not feasible. Yet the size of those numbers and the united negotiating front presented by the provinces speak to the depth and potential staying power of the issue.

Other long-term challenges exist outside the health care sector. These include climate disruptions of increasing severity, and meeting the infrastructure needs and housing supply needs of a growing, albeit aging, population. Ultimately, to keep the fiscal room necessary to help address these pressures after the coming recession, provincial governments should aspire to avoid costly short-term measures and keep their powder dry.