BUDGET ANALYSIS

Ontario: Budget 2023

Balancing the Books in Two Years… If the Economy Rebounds Strongly

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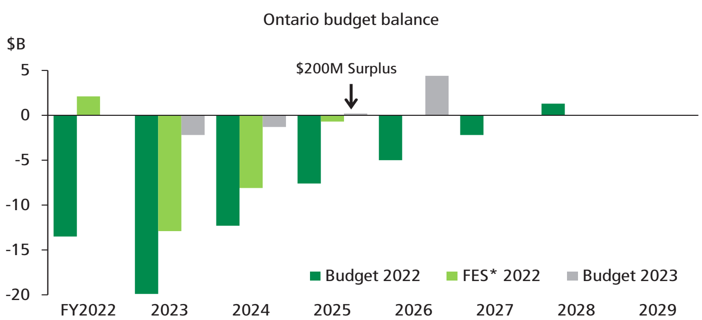
HIGHLIGHTS

- Ontario expects to balance the books in FY2025, three years ahead of the timeline presented in last year's budget (graph 1).
- Financial projections were helped by another starting point boost to revenues since the Fall Economic Statement (FES), and expectations of strong economic gains following a slowdown in 2023.
- In line with expected budget balance improvements, borrowing requirements were revised lower beyond FY2023. The province now forecasts long-run total borrowing of $27.5B in FY2024, $28.7B in FY2025, and $33.4B in FY2026.
- The province anticipates that its debt-to-GDP ratio will ease from 37.8% this fiscal year to 36.9% by FY2026. The new trajectory is 0.5–1 percentage point lower than expected in the FES in each year of the plan.

GRAPH 1
Balanced Books Three Years Earlier Than Expected Last Year



* *Fall Economic Statement*
Sources: Ontario Ministry of Finance and Desjardins Economic Studies

- Spending projections were raised versus the prior plan. This includes increases of more than 7% for both health and education spending in FY2024, with 4% annual gains thereafter.
- New tax measures were incremental to prior plans. The headliner was the much-publicized Ontario Made Manufacturing Investment Tax Credit offering a 10% refundable tax credit of up to $2M per year for spending on buildings, machinery and equipment.
- Bond spreads tightened immediately after the release, indicating that the significant fiscal improvement was well-received by creditors. Hefty contingencies may limit the extent of spread tightening in the event of outperformance.

Our Takeaways

Ontario came into Budget 2023 grappling with significant challenges in both the shorter and longer term, and addressed some of each today.

For the current inflation and affordability challenges enveloping the country, we think the province did well to keep supports incremental and targeted. We've long held that now is not the moment to offer broad-based financial support. This risks inflaming consumer demand, spurring further inflation, and prompting a more aggressive monetary policy response. The signature tax move targets a key sector in Ontario's economy and encourages productivity-enhancing investment. It should be welcomed by small businesses, which we've argued are most likely to be hit hard in the coming economic downturn.

Economic forecasts for the next two years are generally in line with our own, though there is some uncertainty about the province's trajectory beyond then. Government projections rightly acknowledge the myriad risks facing this province in an environment of financial market volatility, sharply higher borrowing costs, and a soft US expansion. The rate of revenue growth needed to balance the books in the last two years of the projection window is certainly strong relative to the last decade. Yet, sizeable contingency reserves provide a margin for error.

Bond investors should find the sheer magnitude of the fiscal improvement hard to ignore. After all, it was just two years ago that Canada's largest province thought it wouldn't balance the books until FY2030, and was trying to cap its debt-to-GDP ratio at 50%. Going forward, hefty forecast reserves may lead investors to assume outperformance versus plan, limiting compression of bond spreads in the event of good fiscal news.

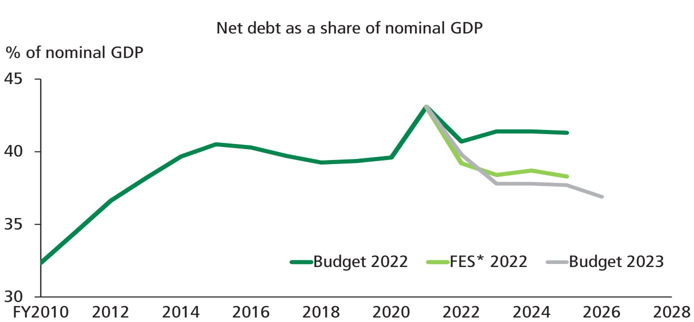
Over the long run, providing sufficient public services and affordable housing remains challenging, particularly as Ontario's population continues to advance at a rapid clip. Infrastructure program increases, if they go ahead on time, should help alleviate some of these pressures. But housing affordability challenges are not going away anytime soon. We estimate that Canada needs about 100k more housing starts on average annually in 2023 and 2024 relative to our baseline in order to align housing supply and demand over the long run. And affordability pressures are increasingly spreading beyond Ontario's largest cities. For this reason, it's of vital and increasing importance that the province deliver on the targets in its Housing Supply Action Plan.

Surplus in Two Years

Ontario expects to balance the books in FY2025, three years ahead of the timeline presented in last year's budget. Balances are now forecast at -$2.2B (-0.2% of nominal GDP) in FY2023, -$1.3B (-0.1%) in FY2024, +$200M (0.002%) in FY2025, and +$4.5B (0.4%) in FY2026. The first two years' forecasts represent respective improvements of $10.7B and $6.8B versus the FES.

In line with the reduced deficit profile, net debt projections were lowered as well. The province anticipates that its debt-to-GDP ratio will ease from 37.8% this fiscal year to 36.9% by FY2026. The new trajectory is 0.5–1% lower than expected in the FES in each year of the plan (graph 2) and would put Ontario's burden just below that of Quebec in FY2026.

GRAPH 2
Ontario's Debt Load Expected to Trend Even Lower



* *Fall Economic Statement*
Sources: Ontario Ministry of Finance and Desjardins Economic Studies

Borrowing requirements were revised lower beyond FY2023. The province now expects long-run borrowing of $27.5B in FY2024, $28.7B in FY2025, and $33.4B in FY2026. The figure for FY2024 is net of a $14.5B offset via pre-borrowing conducted in FY2023 (table 1). In FY2023, 88% of borrowing was completed in Canadian dollars, above the target range of 65–80%; in FY2024, Ontario will aim for a range of 75–90%. The province has continued to extend the term of its debt in order to reduce refinancing risk. Going forward, it intends to keep the term of debt no lower than the level seen since FY2015, and reduce liquid cash reserves to pre-pandemic levels. Ontario plans to issue multiple Green Bonds in each fiscal year of the plan.

TABLE 1
Updated Ontario Borrowing and Economic Projections

$ B (UNLESS INDICATED)	2022–23	2023–24	2024–25	2025–26	2026–27
Long-Term Public Borrowing					
Q2 FY2023 Update	32.2	38.4	32.3	—	—
Budget 2023	**32.1**	**27.5**	**28.7**	**33.4**	**—**
Pre-Borrowing					
Q2 FY2023 Update	-3.0	-3.0	—	—	—
Budget 2023	**14.5**	**-14.5**	**0**	**0**	**0**
Real GDP Growth (%)*					
Q2 FY2023 Update	2.6	0.5	1.6	2.1	—
Budget 2023	**3.7**	**0.2**	**1.3**	**2.5**	**2.4**
Nominal GDP Growth (%)*					
Q2 FY2023 Update	9.2	3.5	3.8	4.1	—
Budget 2023	**9.4**	**2.8**	**3.6**	**4.6**	**4.5**

* FY2024 corresponds to calendar year 2023 and so on.
Sources: Ontario Ministry of Finance and Desjardins Economic Studies

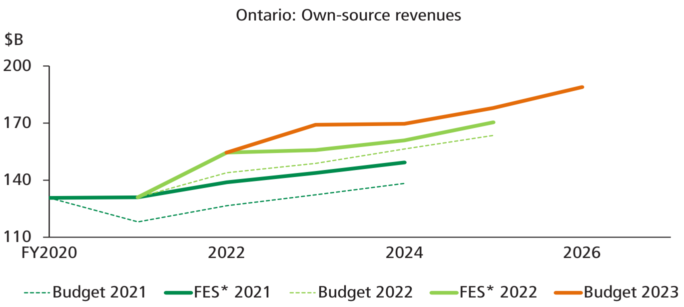
Another Revenue Windfall, Another Starting Point Boost

The revenue windfall that we highlighted in our Budget 2023 preview put Ontario government receipts on a much stronger trajectory than in the 2022 FES. Building on the third quarter fiscal update, the province anticipates that FY2023 own-source revenues will come in over $13B higher than forecast just four months ago. Most of the windfall reported at Q3 related to federal adjustments to the size of Ontario's tax base. Since then, strong hiring to begin calendar year 2023 has led the province to revise its near-term employment and wage growth forecasts higher. Own-source receipt forecasts flatten in FY2024 (graph 3 on page 3), but are still almost $9B higher than in the FES.

Flat revenue growth in FY2024 presumably incorporates some moderation of the effects that drove last year's windfall, but also mirrors a further downward revision in economic growth. The current forecast of 0.2% real GDP growth in 2023 is just above our own most recent assumption near 0%. The province's house price forecasts are also in line with our own (graph 4 on page 3).

Outer-year economic forecasts are more optimistic than ours, and mirror expectations of strong revenue advances. Budget projections are based on a quick return to growth of 1.3% in

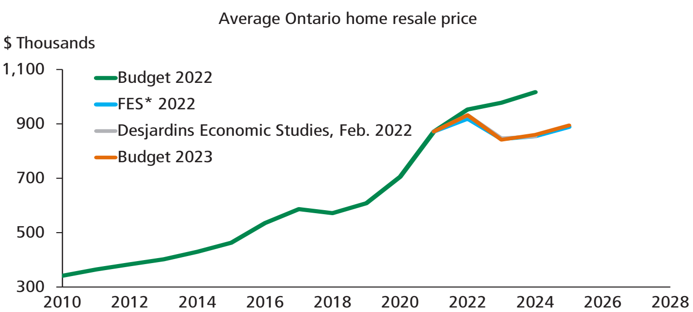
GRAPH 3
Latest Revenue Windfall Again Persists



* *Fall Economic Statement*
Sources: Ontario Ministry of Finance and Desjardins Economic Studies

2024, followed by gains averaging 2.5% during calendar years 2025 and 2026. Own-source revenues are expected to rise by 4.9% in FY2025 and by 6.2% in FY2026. The last time the province's own-source receipts saw consecutive advances over 4.5% was in the two years following the Global Financial Crisis.

GRAPH 4
Ontario Housing Price Forecasts Match Those of Desjardins



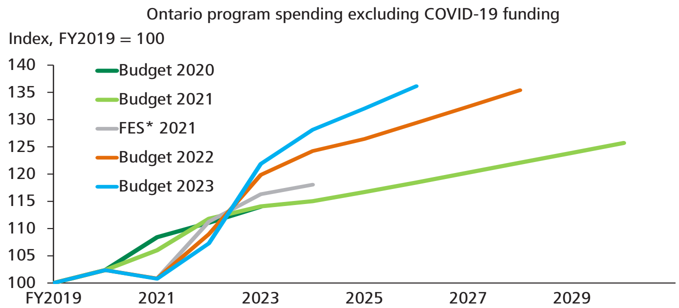
* *Fall Economic Statement*
Sources: Ontario Ministry of Finance and Desjardins Economic Studies

While there is a degree of risk to strong economic and revenue growth in the outer years of the forecast, the plan includes significant contingencies. These come to $1B in FY2024, $2B in FY2025, and $4B in FY2026, and could be used to absorb unexpected costs or cover revenue shortfalls. As well, in a slower-growth scenario in which Ontario's real GDP falls by 0.7% in 2023, deficits would be $5B–$6B in the next two years.

Spending Raised with the Benefit of New Revenues

Provincial expenditure forecasts were also raised versus the prior plan (graph 5). For FY2023 to FY2025, non-COVID-19 program spending plans were increased by between $3.6B and $8.1B in each year relative to the FES. Program expenditure is set to rise by more than 3% in both FY2025 and FY2026. That is stronger than the rate of under 2% penciled in for FY2025 in the FES. But it is just below the rate of CPI forecast in the budget plus population growth as of the latest provincial demographic projections.

GRAPH 5
Spending Lifted Again



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

Health and education spending are now both expected to rise steadily over the forecast horizon. That includes increases of more than 7% for both expenditure areas in FY2024, with 4% annual gains thereafter. That does not include a $6.3B allocation for one-time expenses in FY2023.

Budget policy measures generally fell into five key areas: economic growth, infrastructure, worker supports, affordability support, and public services.

Economic growth initiatives included the much-publicized Ontario Made Manufacturing Investment Tax Credit. This offers a 10% refundable tax credit of up to $2M per year for spending on buildings, machinery, and equipment by Canadian-controlled, private corporations. The fiscal hit is estimated at $780M during FY2024 to FY2026. The government continued to tout its Critical Minerals Strategy and efforts to attract investments from automakers and electric vehicle battery suppliers.

Infrastructure investment continued to focus on highway expansions, the Go transit rail network, and health care facilities. Ontario's capital plan penciled in outlays of $20.6B in FY2024, $25.8B in FY2025, and $27B in FY2026. The FY2025 figure represents a $4B increase versus the FES.

Worker supports incrementally increased funding for the Ontario Immigrant Nominee Program, and expanded immigrant credential recognition efforts and access to dual-credit opportunities in the health care sector.

New affordability support was incremental. The government will continue to offer gas tax and fuel tax cuts until the end of this year, eliminate double fares for GO transit users, expand seniors benefit payments, and allocate more funds to homelessness prevention and Indigenous housing.

For public services, the province will expand medical school class sizes and pharmacist prescription capacity, as well as offer new funding for home and community health care.

Plan Well-Received by Markets

Investors initially took notice of the plan. Ontario spreads quickly tightened 0.5bp versus both Quebec and BC in the immediate aftermath of the budget's release. Achievement of fiscal targets over time should continue to support Ontario borrowing costs.

Still, in the near term, we expect Ontario bond spreads relative to federal benchmarks to be driven primarily by overall risk sentiment. Provincial yields tightened versus Canada to begin this year amid a spate of positive economic data. They've seesawed amid significant financial volatility caused by the fallout of Silicon Valley Bank's collapse.

But in the event of widespread risk-off moves, Ontario's large, liquid, and diversified borrowing program should mitigate potential spread blowout. We saw that during the peak COVID-19 lockdown period, when most smaller provinces' yields rose more than those of Ontario.

Ontario's large contingency allocations could also impact spreads. We've noted several times that markets mostly ignored a solid surplus in BC last year, largely because they had already assumed a bottom line improvement via some unused contingency funds. Ontario's contingencies are not as large as BC's, but could nonetheless limit future spread tightening if debt or balances come in better-than-expected.

TABLE 2
Updated Ontario Fiscal Forecasts

	2021–22	2022–23		2023–24		2024–25	2025–26
IN $B (EXCEPT IF INDICATED)	Actual	FES*2022	Bud. 2023	FES*2022	Bud. 2023	Bud. 2023	Bud. 2023
Total Revenues	185.1	186.8	200.4	192.9	204.4	213.0	226.0
% change	*12.2*	*1.0*	*8.3*	*3.3*	*2.0*	*4.2*	*6.1*
Own-Source Revenues	154.5	155.8	169.1	160.9	169.6	177.9	188.9
% change	*17.9*	*0.9*	*9.5*	*3.3*	*0.3*	*4.9*	*6.2*
Federal Transfers	30.6	31.0	31.3	32.0	34.8	35.1	37.1
Total Spending	183.0	198.8	202.6	199.5	204.7	210.8	217.5
% change	*0.1*	*8.6*	*10.7*	*0.4*	*1.0*	*3.0*	*3.2*
Program Spending**	170.5	185.2	189.2	185.0	190.6	196.4	202.5
% change	*0.9*	*8.6*	*11.0*	*-0.1*	*0.7*	*3.0*	*3.1*
Debt Servicing	12.6	13.6	13.4	14.5	14.1	14.4	15.1
% of revenues	*6.8*	*7.3*	*6.7*	*7.5*	*6.9*	*6.8*	*6.7*
Reserve	—	1.0	—	1.5	1.0	2.0	4.0
Budget Balance	**2.1**	**-12.9**	**-2.2**	**-8.1**	**-1.3**	**0.2**	**4.4**
% of GDP	*0.2*	*-1.2*	*-0.2*	*-0.7*	*-0.1*	*0.02*	*0.4*
Net Debt (% of GDP)	*39.2*	*38.4*	*37.8*	*38.7*	*37.8*	*37.7*	*36.9*

* *Fall Economic Statement*
** Includes COVID-19 funding and one-time expenses
Sources: Ontario Ministry of Finance and Desjardins Economic Studies