ECONOMIC VIEWPOINT

Ontario Budget 2024 Preview

Will Provincial Budget Season Trends Be Ontario's Friends?

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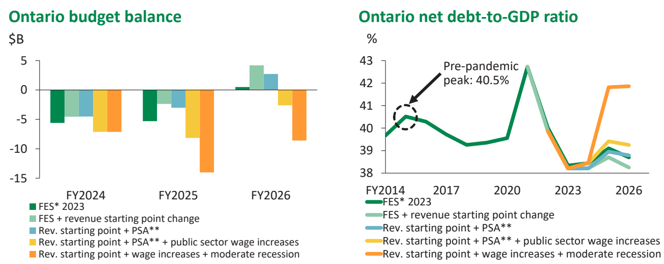
Highlights

- Ontario's 2024 budget will be released on March 26, and uncertainty abounds. The full effects of interest rate hikes haven't yet been felt and there are questions about how public sector wage increases could impact the bottom line. At the same time, the tax base has once again been adjusted higher. All of this comes after Canada's largest province delayed its plans to balance the books just five months ago in its Fall Economic Statement (FES).
- Using four possible scenarios for Ontario's public finances, we find that putting government ledgers back in the black may take some more time. But that's only true if a number of things—such as a persistent shock to spending, further downward revenue revisions and even a recession—go wrong. Similarly, the province's net debt burden appears unlikely to exceed pre-pandemic highs (graph 1).
- Still, Ontario will need to juggle multiple competing objectives this budget season. These include presenting a credible plan to address the new spending pressures created by population growth and aging. The province will also have to manage high debt levels amid potentially higher-for-longer interest rates.
- Meeting these challenges could require difficult trade-offs, and Budget 2024 should tell us something about how the government plans to manage these trade-offs over time.

Graph 1
Possible Budgetary Scenarios in Canada's Largest Province



* *Fall Economic Statement* ** Private sector forecast average
Statistics Canada, Ontario Ministry of Finance and Desjardins Economic Studies

Introduction

Another year has passed, and uncertainty about Ontario's budget outlook remains. It's now early 2024, and the full effects of sharply higher interest rates still haven't hit the province's highly indebted households, let alone the broader Canadian economy. Tax base adjustments have once again clouded the revenue picture. And if fiscal year 2024–25 (FY2025) plans released to date by other provincial governments are any indication, higher public sector spending, deteriorating budget balances and bigger debt loads could be on the horizon. All of this comes after Canada's largest province delayed its plans to balance the books less than five months ago.

In this note, we discuss four possible scenarios for Ontario's public finances in the leadup to the province's 2024 budget. Based on information available now, we find that putting government ledgers back in the black may take some more time. But that's only if a number of things—such as a persistent shock to spending, further downward revenue revisions and even a

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recession—go wrong. Similarly, the province's net debt burden appears unlikely to exceed pre-pandemic highs.

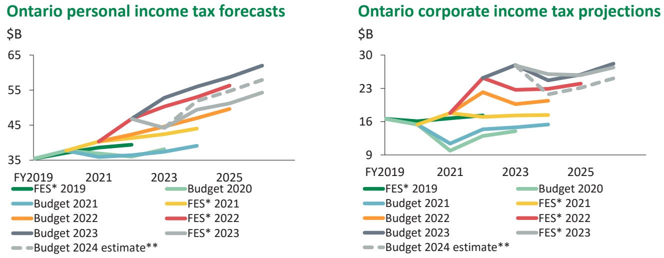
Scenario 1: Revenue Adjustments

Tax base adjustments have been a big fiscal story for over a year now, but their impacts have been particularly striking in Canada's largest province. One year ago, upward revisions by the Canada Revenue Agency resulted in a massive windfall in Ontario, prompting the government to forecast a return to balance by FY2025—three years ahead of schedule. The province's FY2023 Public Accounts then showed that, in fact, this windfall didn't fully materialize. Following that downward revision, Ontario was essentially forced to delay its plans to achieve a surplus for one year in the November 2023 FES. Then, in this fiscal year's third-quarter update, a fresh round of revisions lifted personal and sales tax projections for FY2024. This increase was only partially offset by lower-than-anticipated corporate income receipts.

In our first scenario, we accounted for this latest round of tax base revisions by assuming that personal, sales, and corporate taxes evolve in line with the starting point adjustments seen in prior fiscal updates. The result is a $6.5 billion boost to own-source revenues combined over FY2025 and FY2026, with gains in personal income tax receipts more than making up for losses in corporate taxes (graph 2). This effect would bring Ontario closer to balance in FY2025 and lead to a bigger surplus in FY2026.

Graph 2
Adjustments Suggest Upside for Personal Taxes, Downside for Corporate Taxes

Ontario personal income tax forecasts — Ontario corporate income tax projections



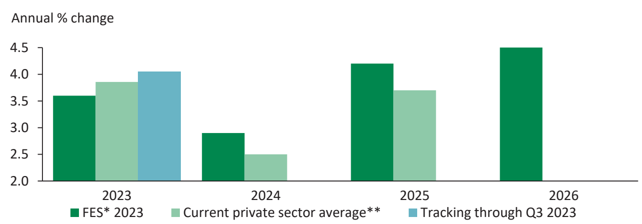
* *Fall Economic Statement* ** Based on projections from Ontario's Q3 FY2024 fiscal update
Ontario Ministry of Finance and Desjardins Economic Studies

That said, at this stage, we can't rule out further upward or downward revisions in the months ahead. For one thing, last year's budget announced tax base adjustments beyond those unveiled in the FY2023 third-quarter update. So it's possible that we could see changes in addition to those detailed just a few weeks ago. Other provincial plans have also included meaningful prior-year adjustments in this year's budget season. More broadly, budget revenue forecast updates in most provinces are almost always finalized without complete information. Last year's Ontario Public Accounts, for instance, stated that personal and corporate income tax receipts for calendar year 2023 wouldn't be finalized until December 2024.

Scenario 2: Softening Economic Backdrop

Of course, government revenues also depend on the strength of the economy. Private sector forecasts released since the FES suggest the outlook for calendar year 2024 has weakened slightly, though 2023 growth has so far advanced slightly faster than anticipated back in November (graph 3). Ontario budgets usually incorporate the average private sector forecast into their projections, and we suspect that the government will wisely base its assumptions on even weaker-than-average growth.

Graph 3
Ontario Economic Forecasts Have Weakened since November
Nominal GDP projections



* *Fall Economic Statement* ** Average for big five Canadian banks, National Bank, Laurentian Bank, and Desjardins
Ontario Ministry of Finance, Canadian financial institutions and Desjardins Economic Studies

Our second scenario applies the tax base adjustment from Scenario 1, then lowers tax revenue according to the private sector average and the FY2024 sensitivity presented in Budget 2023. That sensitivity associated every 1 percentage point in nominal GDP growth with about $1.3 billion in tax revenues. Under these conditions, we estimate that combined FY2025 to FY2026 revenues would come in about $2 billion lower than in Scenario 1, but about $4 billion higher than assumed in the FES. That would keep plans to achieve balance by FY2026 intact.

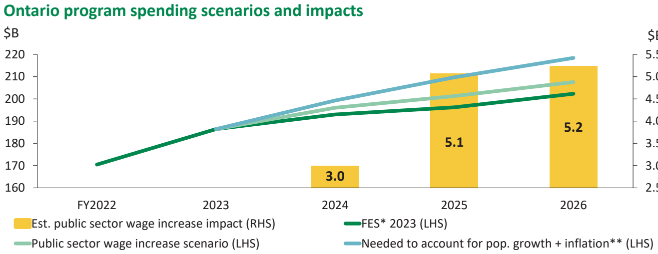
Scenario 3: Public Sector Wage Increases

However, the big question for Ontario this year—and the big driver of deteriorating fiscal balances in other provinces this budget season—is how public sector wage increases will impact the bottom line. We have incomplete information on this front, but the repeal of Bill 124—which would have restrained salary boosts in the health and education sectors—will likely come at a price for the province. More broadly, these potential cost increases for provincial governments—responsible for administering health and education services—are something we've been highlighting as a risk for many years now.

To estimate how raising public sector wages would increase potential spending, we used information from the Financial

Accountability Office of Ontario's (FAO) third-quarter Expenditure Monitor for Q3 FY2024. That report estimated that, as of Q3, spending on health and education would increase to $1.1 billion and $2.5 billion more than the FES had planned for FY2024, in large part because of Bill 124 pressures. In our third scenario, we assumed that health and education spending would keep exceeding FES plans at the same rate in the fourth quarter, resulting in respective overages of $1.5 billion and $3.3 billion for all of FY2024, and applied the assumptions from Scenarios 1 and 2. Health and education expenditures then advanced at the rates forecast for FY2025 and FY2026 in November. Note that this scenario raises program spending in FY2025 and FY2026 by more than $5 billion per year versus the FES forecast. This represents a larger percentage rise than the acceleration outlined in Quebec's 2024 budget. That said, even if Ontario's spending increases by that much, its rate of expansion would still lag the combined pace of population growth and inflation (graph 4).

Graph 4
Spending Could Rise

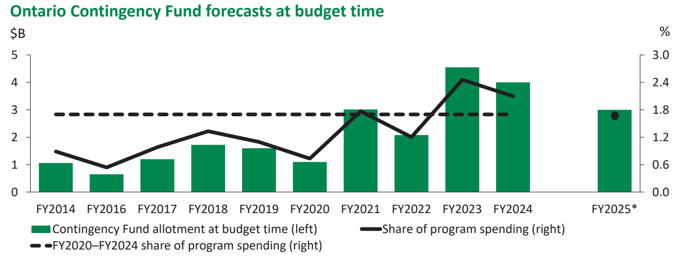


* Fall Economic Statement ** Based on FES 2023 total inflation forecasts and 2023 Ontario demographic projections
Ontario Ministry of Finance, Financial Accountability Office of Ontario and Desjardins Economic Studies

Under our third scenario, Ontario would continue to run deficits in FY2026, but other factors could help cover that shortfall. On its own, the $2 billion forecast reserve in the FES for FY2026 would absorb most of the $2.6 billion deficit that Scenario 3 predicts for that fiscal year. But Ontario also builds prudence into its spending plans via its Contingency Fund. In fact, as of its third-quarter update, Ontario planned to use more than $2 billion in already earmarked FY2024 contingencies to absorb the cost of health sector wage increases. We won't get information on Contingency Fund allocations until next week's budget, and even then, the budget will only provide detailed information for FY2025. But if prior years' trends are any indication, a fiscal buffer in the neighbourhood of $3 billion or 1.7% of program spending—which would be in addition to the forecast allowance for the FY2024—looks reasonable (graph 5).

Impacts from Ottawa's recently announced cap on international student permits are also worth monitoring. So far, Ontario has announced a total of $1.2 billion in funding over three years to help universities and colleges address the resulting financial shortfalls. But our work has shown that the Ontario education

Graph 5
Contingency Fund Could Be Used to Cover Fiscal Shortfalls



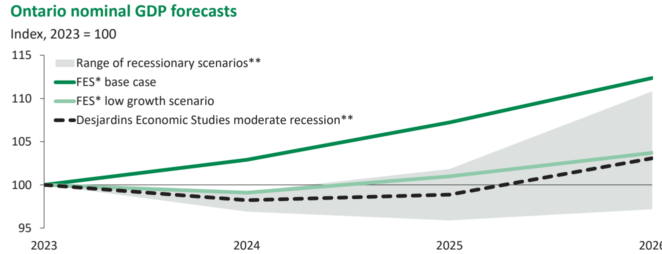
* Assuming allocation in line with FY2020–FY2024 average
Ontario Ministry of Finance and Desjardins Economic Studies

system is highly reliant on international student tuition fees. As such, the effects of the federal policy could be felt over several years.

Scenario 4: Recession

Our fourth and final scenario takes the revenue boost from Scenario 1 and the higher spending from Scenario 3, but assumes the Ontario economy enters a moderate recession beginning in the first quarter of 2024. Like prior recessionary scenarios we've developed, we assume that Ontario's nominal GDP evolves in line with the trajectory observed during the 1980s and 1990s downturns and the Global Financial Crisis (GFC) of 2008–2009. This would push Ontario's nominal GDP below even the weak-growth scenario outlined by the government in the FES (graph 6). We then reduced government receipts per the tax revenue sensitivity estimate from Budget 2023 (described above).

Graph 6
Possible Paths for Ontario's Output under an Economic Downturn



* *Fall Economic Statement* ** Based on 1980s and 1990s downturns and the Global Financial Crisis
Ontario Ministry of Finance and Desjardins Economic Studies

The combination of higher spending and very weak economic activity would drive deep deficits that almost certainly could not be overcome by standard-sized contingencies. Even so, the forecast shortfalls come well short of the amounts of red ink spilled during the pandemic or following the GFC. This scenario would see the net debt-to-GDP ratio come close to—but not reach—its pandemic peak in each of the next two fiscal years.

Borrowing Program in Flux

If Ontario's FY2025 deficit is indeed larger than projected in the FES, then we can reasonably expect its borrowing program to increase as well, but there are many dynamics at play.

The province has initiated a significant amount of pre-financing activity so far in FY2024. Some investors have interpreted this as an effort by the government to smooth out a spike in FY2025 borrowing, anticipating that future budget balances will be weaker beyond the current fiscal year. But like many provinces, strong early-year issuance surely also reflected broad-based demand for credit when central bank messaging suggested we were at the top of the rate cycle.

As always, we'll be watching for updates to infrastructure spending plans, though the FES's announcement of the Ontario Infrastructure Bank (OIB) brings a new element to this year's fiscal blueprint. Ontario did not significantly deviate from its Budget 2023 plans in the FES, but we've seen other provincial budgets increase expected infrastructure expenditures in response to project delays and still-skyrocketing population growth. This could certainly help support Ontario's infrastructure ambitions—which contribute more heavily to borrowing plans in later fiscal years—but as we argued in November, the devil will be in the details.

Ontario's plan will also play an important role in benchmarking other provinces' bond spreads. Markets crowned Ontario the winner of last year's budget season after it projected an accelerated return to balance. Though it was the last provincial government to table an FY2024 fiscal blueprint—it will be the ninth of 10 this year—we saw its long bond spreads tighten significantly versus all other jurisdictions in the ensuing months. This included 30-year spreads briefly closing flat to Quebec for the first time in years and briefly trading through those of BC. That said, this year we've seen other provinces' spreads widen versus Ontario's as their budget balance forecasts were downgraded. Those gaps could narrow if Ontario's fiscal metrics also disappoint.

Final Thoughts

Set for release on March 26, Ontario's fiscal plan will be something of a culmination of the 2024 budget season. All the issues encountered by the other provinces so far—including a precarious economic outlook, the implications of surging population growth and the potentially high price of public sector wage increases—will be present to some degree.

Our analysis suggests that even though Ontario is more susceptible to the coming slowdown than most provincial economies, its finances will likely avoid the worst possible outcome. Our scenarios imply it would take a combination of adverse fiscal events to blow the current plan to balance the books by FY2026 off course. Deficit and debt burdens do not reach record highs under even our worst-case scenario. Various levels of prudence built into prior fiscal blueprints appear available to help absorb unforeseen costs. And of course, Ontario continues to administer one of the largest, most liquid, and most diversified borrowing programs of any province in Canada and is recognized by investors for doing so.

Still, Ontario will need to juggle multiple competing objectives this budget season, and for the foreseeable future. Returning to balance in a timely manner and reducing the debt burden must remain priorities. Though its net debt-to-GDP ratio doesn't look likely to break any records, it was set to rise in FY2025 as of the FES. Keep in mind that Ontario is already one of the most indebted provinces. Consequently, potentially higher-for-longer interest rates present outsized risk to its fiscal sustainability. And the rapid aging of the existing population could soon force provincial governments to choose between accepting some deterioration in health care service quality and increasing spending plans at significant cost. Meanwhile, contemporary political orthodoxy limits the scope for tax increases to raise new revenues, meaning that measures to boost productivity—at a time of persistently declining per-capita output—are a must. Meeting all these challenges could require difficult trade-offs. Budget 2024 should provide further insight into how the government plans to manage these trade-offs.