BUDGET ANALYSIS

Ontario: 2022 Economic Outlook and Fiscal Review

Fiscal Forecasts Upgraded as Recession Looms

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HIGHLIGHTS

- Ontario's Economic Outlook and Fiscal Review (EOFR) for fiscal year 2022–23 (FY2023) revised this year's deficit $7B smaller than projected in Budget 2022 to $12.9B (1.2% of nominal GDP), and its net debt to GDP path is expected to come in about 3% lower than previously outlined through FY2025.
- Calendar year 2022 and 2023 economic growth forecasts were revised considerably lower, with notable downgrades in the housing market.
- Yet, as expected, own-source revenue forecasts were raised to a permanently higher trajectory following last year's $11B windfall.
- Topline spending plans were largely unchanged from Budget 2022.
- New policy included a series of incremental tax and revenue measures designed to assist with the rising cost of living. At first blush, these appear reasonably targeted and unlikely to spur significant further price pressures.
- Long-term public borrowing is forecast to total $32.2B in FY2023, $38.4B in FY2024, and $32.3B in FY2025—respective reductions of $9.3B, $6.2B and $6.6B versus Budget 2022 projections.
- In the short- to medium-term, we expect Ontario's bond market movements to be driven by global macroeconomic developments. But in the longer-run, adherence to plan and further improvements in the fiscal trajectory could result in lower market supply and tighter spreads against Government of Canada benchmarks.

The Bottom Line

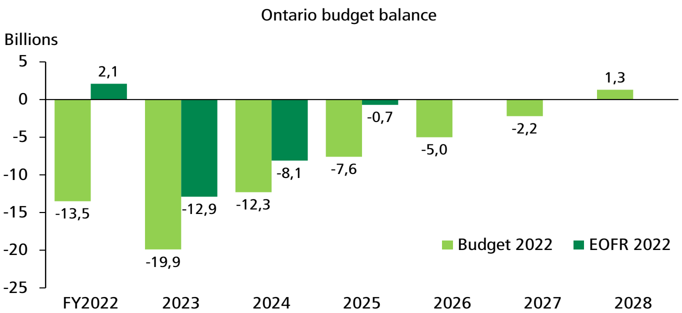
This was a positive, but not surprising report for Ontario, which projected a much-improved financial position with assistance from prior years' revenue windfalls. Though our economic forecasts for Ontario are more bearish than those of the province itself, the updated fiscal plan has clearly taken heed of the more downbeat economic environment in which we now find ourselves. The province also looks to have kept affordability measures reasonably targeted to those most impacted by the rising cost of living, which reduces the risk of exacerbating inflationary pressures. Near-term economic conditions are uncertain and plans for outer-year spending restraint may prove challenging. However, ultimately, adherence to the plan over the longer run should help provincial spreads trade tighter to Canadian benchmarks and reduce pressure on borrowing costs.

Balances, Debt, Borrowing All Reduced

In its mid-year fiscal update for FY2023, Canada's largest province projected substantial improvements in its budget balances and net debt through FY2025. This year's deficit was revised $7B lower to $12.9B (1.2% of nominal GDP), and fiscal shortfalls are then expected to decline steadily to just $700M (0.1%) by FY2025 (graph 1 on page 2). The government projects that net debt will hover between 38% and 39% of output through FY2025. That path is about 3% lower than the one outlined in the April 2022 Budget (graph 2 on page 2).

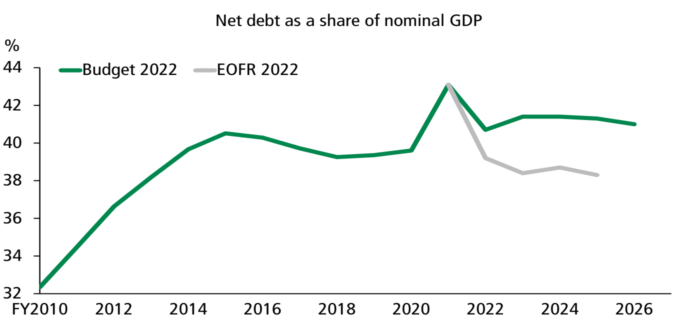
With revised deficit and debt forecasts, Ontario also cut borrowing projections. Long-term public borrowing is forecast to total $32.2B in FY2023, $38.4B in FY2024, and $32.3B in FY2025—respective reductions of $9.3B, $6.2B and $6.6B versus

GRAPH 1
Ontario Budget Balances Much Improved As Expected



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

GRAPH 2
Ontario's Debt Load Expected to Trend Lower



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Sources: Ontario Ministry of Finance and Desjardins, Economic Studies

the Budget 2022 projection. This fiscal year's $32.2B is helped by $10.3B in pre-borrowing conducted in FY2022. In FY2023, 80% of borrowing has been completed in Canadian dollars, via 18 syndicated issues and a Green Bond, at the very top of the 65–80% target issuance range. The average term to maturity of government debt has edged higher to 11.3 years in FY2023, a length of time that should mitigate risks related to refinancing at higher rates. The government still plans is to maintain the term of Ontario's debt at the level it has been at since 2014–15.

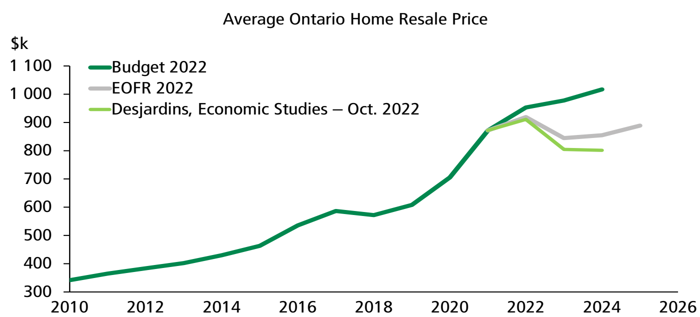
The province's infrastructure plans were largely unchanged. FY2023–25 Capital Plan outlays are still forecast to total $62B.

Base Case Economic Forecast Does Not Include Recession

One key question coming into this update was the extent to which a recession would be baked into government projections. While it doesn't receive a mention, the base case economic forecasts suggest a significant slowdown. Ontario now expects real GDP growth of just 2.6% in 2022 and 0.5% in 2023, substantial downgrades from Budget 2022. Gains near 4% (q/q annualized) in the first two quarters of this year suggest a meaningful slowdown in the coming quarters. Still, next year's figure is stronger than Desjardins Economics Studies' October projection of a -0.3% real economic contraction in 2023, which assumes a housing-induced economic downturn in Canada's largest province.

With respect to housing, the government's projections are far less sanguine than in April, but more optimistic than our own. This year, Ontario expects home sales to plunge by 32% versus a prior forecast of an 11% fall. The average home resale price is expected to fall by 8% in 2023. Beginning in 2024, Ontario expects a return to steady growth in both sales and prices (graph 3). Our call is for a more prolonged housing downturn that extends through at least 2023; clearly, that possibility presents downside risk for the province's economy and finances.

GRAPH 3
Housing Price Forecasts



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

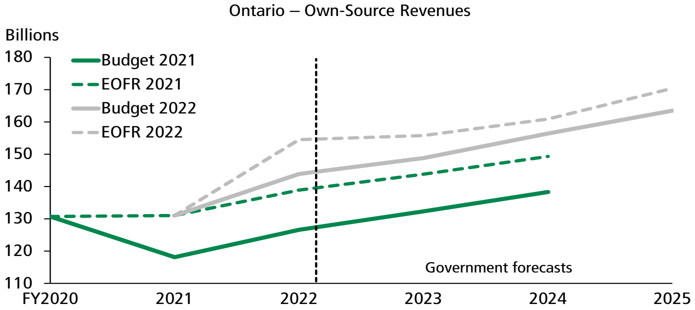
Other risks noted by the government include a sharper-than-anticipated slowdown in US and global activity, and persistent inflation that prompts more aggressive rate hikes. In Budget 2022, Ontario associated every 1 percentage point variation in US growth with $850M in revenues, and every 100 bp variation in bond yields with $700M in debt servicing costs. Contingencies of $1B to $1.5B in each year of the forecast period provide a degree of protection against downside risks.

A faster-than-baseline scenario would see the province balance the books in FY2025. A more pessimistic growth scenario outlined in the EOFR has the province running deficits of $13.9B in FY2024 and $8.5B in FY2025.

Revenues Increased How Much?

As expected, the massive own-source revenue windfall reaped last year translated into a persistent bump to government receipts throughout the forecast period. We highlighted this dynamic in More Money, More Problems: What a Recession Could Mean for Ontario's Budget Balance. However, the gap between current and previous projections diminishes over time (graph 4 on page 3). This likely reflects the more muted economic growth forecasts and new tax and revenue measures, described below.

GRAPH 4
Post-Budget Windfall Boosts Revenues, New Measures Close Gap



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

Affordability Measures Stepped Up, Look Reasonably Targeted

Another key question coming into the EOFR was whether Ontario would follow other provinces and deploy revenue windfalls to measures to combat affordability. The province appears to have done so, but kept measures reasonably targeted to Ontarians whose purchasing power is most impacted by elevated inflation.

The single most costly measure in the EOFR was the extension of the Temporary Gas Tax and Fuel Tax Cuts. These are expected to reduce revenues by $305M in FY2023 and $990M in FY2024. We noted in our piece The Impact of Inflation on Different Income Levels in Canada that before the pandemic, private transportation costs were primarily incurred by higher-income households. Still, these measures should provide a degree of relief from one of the key components of the rising cost of living in the current context.

The government will also increase the phase-out rate for eligible taxable capital under its small business Corporate Income Tax regime. This is forecast to reduce government tax revenues by $360M this year and $165M next year. As we outlined in Small Business is Big Business in Ontario, small and medium-sized businesses tend to bear the brunt of any economic downturn. As such, attention to their cost structure in the current environment appears prudent.

Topline Program Spending Largely Unchanged from Budget

Unlike prior pandemic era plans, the province did not increase program spending projections (graph 5). Budget 2022 and the

GRAPH 5
Little Change to Spending Despite Revenue Windfall

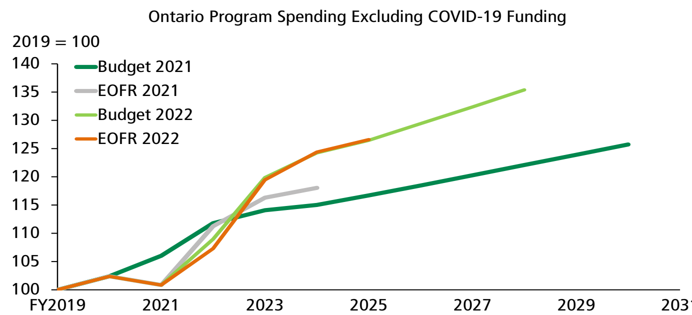


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TABLE 1
Summary of transactions

	2021–2022	2022–2023		2023–2024	2024–2025
IN $B (EXCEPT IF INDICATED)	Actual	Budget 2022	EOFR 2022	EOFR 2022	EOFR 2022
Total revenues	185.1	179.8	186.8	192.9	204.1
Change (%)	*12.2*	*3.6*	*0.9*	*3.3*	*5.8*
Own-source revenues	154.5	148.8	155.8	160.9	170.4
Change (%)	*17.9*	*3.5*	*8.3*	*3.3*	*5.9*
Federal Transfers	30.6	31.0	31.0	32.0	33.7
Total spending	183.0	198.6	198.8	199.5	203.2
Change (%)	*0.9*	*6.2*	*6.3*	*0.4*	*1.9*
Program spending	170.5	185.2	185.2	185.0	188.3
Change (%)	*0.8*	*6.4*	*6.4*	*-0.1*	*1.8*
Debt charges	12.6	13.5	13.6	14.5	14.9
% of total revenues	*6.8*	*7.5*	*7.3*	*7.5*	*7.3*
Reserve	0.0	1.0	1.0	1.5	1.5
Budgetary balance	2.1	-19.9	-12.9	-8.1	-0.7
% of GDP	*0.2*	*-1.9*	*-1.2*	*-0.7*	*-0.1*
Net Debt (% of GDP)	39.2	41.4	38.4	38.7	38.3

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Sources: Ontario Ministry of Finance and Desjardins, Economic Studies

EOFR both pencilled in an increase of near 10% for program spending in FY2023 (excluding COVID-19 measures).

New spending measures were modest this year and will be absorbed via drawdown of the standard contingency fund. Direct supports to parents to assist with catchup related to school activities, announced late this summer, will add $365M to expenses in FY2023. For the Ontario Disability Support Program, the monthly earnings exemption threshold will be increased, while core monthly allowances were increased by 5% as of September 2022.

Beyond this fiscal year, spending targets may become more challenging to meet. Health spending is expected to grow by just 0.6% in FY2025, while total education expenses are set to rise by only 2.4% that year. Government forecasts that inflation will stay above the BoC's 2% target throughout the projection horizon, a growing population, and only modest gains in federal transfers imply that it will be challenging to maintain a consistent level of services over that year. That is against a backdrop of ongoing capacity pressures in the health care system and plans to implement subsidized early childhood education by the middle of the decade.

Bond Market Notes

In the short- to medium-term, we expect Ontario's bond market movements to be driven more by global macroeconomic developments than by province-specific policy decisions. Global trends that could impact the outlook include the course of global inflation, US monetary policy, and developments related to the Russia-Ukraine conflict. Indeed, spreads were largely unchanged in the immediate aftermath of the EOFR release.

In the longer-run, adherence to plan and further improvements in Ontario's fiscal trajectory could result in lower market supply and tighter spreads against Government of Canada benchmarks. In All Canada's provinces to feel fight against inflation, some will go into recession,we noted that long bonds for the other three large provinces have all traded through those of Ontario for most of 2022.