ECONOMIC VIEWPOINT

Don't Let Ontario's New Budget Challenges Curb Your Fiscal Enthusiasm

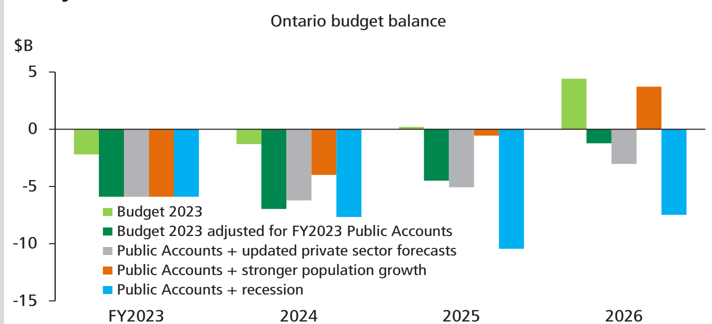
Six Questions in the Lead-Up to the Province's 2023 Fall Economic Statement

By Marc Desormeaux, Principal Economist

Summary

- As Ontario prepares to release its 2023 Fall Economic Statement, we discuss six questions that should be on your radar. We also estimate four possible paths for the province's finances.
- Ontario can still achieve the slim fiscal year 2024–25 (FY2025) surplus predicted in Budget 2023. But uncertain economic conditions and much weaker than anticipated revenues last year suggest a longer period of red ink is also possible (graph 1). Notably, for personal income tax receipts to hit their Budget 2023 target for this year, they would need to rise at almost twice the highest growth rate seen in any prior fiscal year.
- With population growth now expected to come in much stronger over the next several years, Ontario policymakers face a conundrum: the surge will boost economic activity and government revenues but also increase spending pressures.
- Nevertheless, Ontario looks likely to maintain its existing fiscal advantages. These include a declining debt load that stays low relative to recent history except under the worst-case economic scenario, a large and liquid borrowing program, and prudent issuance practices that limit exposure to higher interest rates.
- Going forward, fiscal policy will need to strike a fine balance. The province must exercise restraint to avoid exacerbating inflation and keep its finances sustainable. But it also needs to relentlessly work towards meeting housing supply and infrastructure investment targets.

GRAPH 1
A Weaker Starting Point and Uncertain Economic Backdrop Could Delay Plans to Balance the Books



Sources: Ontario Ministry of Finance and Desjardins Economic Studies

Introduction

As Ontario prepares to release its 2023 Fall Economic Statement (FES), the outlook for its budget balance and debt is highly uncertain, just as it was last year. Revenue base adjustments have again meaningfully changed the starting point for projections—this time for the worse. Near-record population growth has stimulated economic expansion but could also put upward pressures on spending going forward. And while a Canada-wide recession has yet to materialize, that risk remains, particularly if

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.
IMPORTANT: This document is based on public information and may under no circumstances be used or construed as a commitment by Desjardins Group. While the information provided has been determined on the basis of data obtained from sources that are deemed to be reliable, Desjardins Group in no way warrants that the information is accurate or complete. The document is provided solely for information purposes and does not constitute an offer or solicitation for purchase or sale. Desjardins Group takes no responsibility for the consequences of any decision whatsoever made on the basis of the data contained herein and does not hereby undertake to provide any advice, notably in the area of investment services. Data on prices and margins is provided for information purposes and may be modified at any time based on such factors as market conditions. The past performances and projections expressed herein are no guarantee of future performance. Unless otherwise indicated, the opinions and forecasts contained herein are those of the document's authors and do not represent the opinions of any other person or the official position of Desjardins Group. Copyright © 2023, Desjardins Group. All rights reserved.

interest rates stay higher for longer. These challenges come after a spring 2023 budget in which the province predicted it would balance the books two years earlier than previously scheduled, a development that bond markets cheered.

In this note, we discuss six questions that should be top of mind in the lead-up to the 2023 FES and estimate four possible paths for Ontario's public finances.

1. How Will Last Year's Revenue Underperformance Carry Forward? (Scenario 1)

The most consequential development in Ontario's FY2023 Public Accounts was arguably a nearly $9B downward revision to personal income tax (PIT) revenues versus Budget 2023 projections. The province stated that despite solid economic growth in recent months, lower-than-expected tax assessments from the Canada Revenue Agency for prior years resulted in much weaker than expected tax receipts.

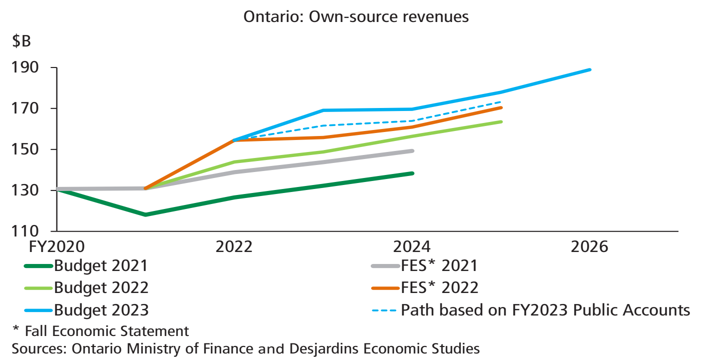
That huge downward revision is significant not only in that it drove a larger-than-anticipated deficit last year, but also because of its implications for FY2024 and beyond. PIT revenue totalled $44.2B in FY2023. For it to reach the $56B previously forecast for FY2024, it would have to climb by 27%. That's highly unlikely to materialize, given that it would be almost twice the highest growth rate seen in any prior fiscal year. The downward revision also stands out because it's a sharp reversal of the trend observed since early in the pandemic, when upward revisions to federal tax assessments contributed to several windfalls. We've seen similar adjustments in other provinces, though none have been as large so far.

To estimate potential longer-term bottom-line impacts of the much lower revenue starting point, we looked at how past revisions to government receipts have carried through into later years. This is the first of our four provincial fiscal scenarios mentioned in the introduction. We've noted multiple times that in recent Ontario fiscal plans, when there are significant changes to own-source revenue starting points, outer-year projections tend to be altered by similar amounts (graph 2). Based on those experiences, we forecast that combined FY2024 and FY2025 own-source receipts would come in a combined $10B weaker than anticipated in Budget 2023.

Results from the starting point change alone suggest the province may not return to a balanced budget until after FY2026. That assumes no changes to the March 2023 spending plans or forecast reserves even though expenditures also ultimately came in lower than budget forecasts in FY2023. However, applying program spending growth rates from Budget 2023 beyond FY2023 still delays a return to balance.

It's also possible that as more tax returns are processed, windfalls in other revenue streams could boost this year's numbers. But the Public Accounts results for these streams do not suggest much

GRAPH 2
The Recent Revenue Underperformance Follows Successive Windfalls



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

deviation from Budget 2023 projections so far, and updates may not come until after the FES is released. Ultimately, if recent history is any guide, it's clear that the softer starting point for PIT receipts represents meaningful downside risk to the bottom line.

2. What Do Private Sector Forecasts Tell Us about the Province's Fiscal Outlook? (Scenario 2)

The weak starting point won't be the only factor impacting revenues: changes to the economic outlook will also play a role. Since last fall, while the Canadian economy skirted recession, Ontario's real economic growth outpaced the national average. It's also tracking much stronger than the near-zero growth rate assumed for calendar year 2023 in the spring budget. That bodes well for government revenues in FY2024. However, most private sector economists—us included—now expect the economic downturn to occur later. And Ontario could still be expected to feel the pinch more than most other provinces because of high household debt and the economy's reliance on housing.

Our second scenario applies the starting point effect and adjusts Ontario own-source revenues further according to changes in the economic projections published by Canada's large financial institutions. These will likely account for the bulk of changes in the average private sector forecast, which is a key input into government revenue assumptions. Budget 2023 provided a fiscal sensitivity of $1.295B in tax revenues for every percentage point difference in the change in nominal GDP. Accordingly, the better-than-average expansion this year is associated with about $750M in additional revenues in FY2024. However, weaker-than-previously-anticipated output in calendar year 2024 would generate a drag on revenues in FY2025 that outweighs the revenue upside in this fiscal year. The result: deficits would extend until at least FY2026.

3. What Impact Could Ontario's Recent Population Surge Have? (Scenario 3)

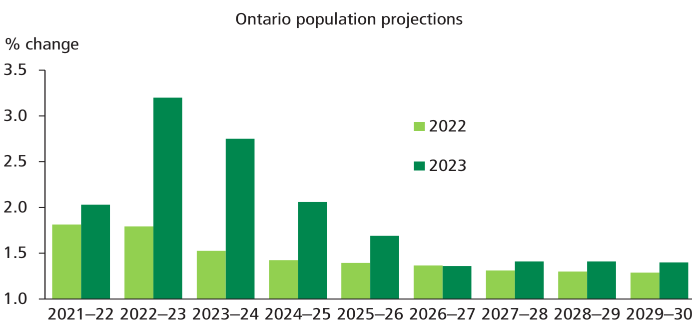
Near-record population growth is another important trend we've seen across Canada since the spring. In response, Ontario's

Ministry of Finance significantly boosted its projections for headcount gains. Advances in Ontario's population are now poised to far outpace expectations from just last summer (graph 3).

In our optimistic third scenario, we combined these upward revisions to population growth projections with the effects of the weaker revenue starting point from scenario 1. We estimated the boost to nominal GDP growth from a larger population over 15 years of age using our in-house econometric framework of Ontario's economy. That framework is described here and here. It linked the recent upward revision to Ontario's population forecasts alone with an additional $17B in nominal GDP and $2B in tax revenues by calendar year 2025.

Our third scenario delays the return to balance by one year to FY2026—though the province would come very close in FY2025—but it comes with a key caveat. Absent changes to spending plans, such strong headcount gains would be tantamount to a real per capita expenditure reduction. In fact, we estimate that the province would need to raise program spending by at least $2B per year over the next three years to maintain the per-person amounts forecast in Budget 2023. And Budget 2023 had already included program spending rates below the combined population and total CPI growth rate beginning this fiscal year. Without an increase in spending, the stronger demographic gains suggest a bigger gap (graph 4).

GRAPH 3
Ontario's Surging Population Could Drive Higher Revenues

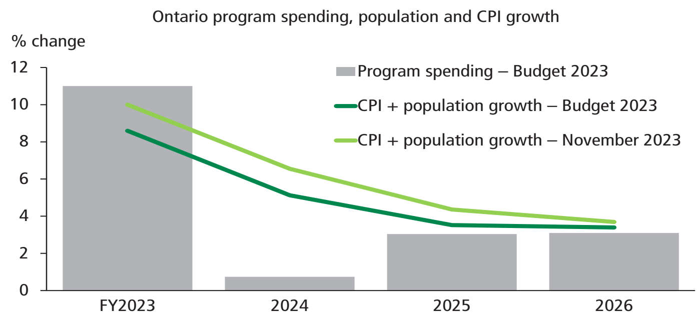


Sources: Ontario Ministry of Finance and Desjardins Economic Studies

4. What Could a Recession Do to Budget Balances? (Scenario 4)

Our pessimistic fourth scenario applies the weaker revenue starting point and assumes that a recession begins in the third quarter of this year. This recession was set to play out like prior downturns. As in the analysis we published last year, we chose the Ontario recessions of 1982–1983, the early 1990s and 2008–2009. We looked at how nominal GDP, employee compensation, corporate net operating surpluses and nominal household consumption evolved, then linked them to key tax revenue categories using sensitivity estimates from Budget 2023. Note that our base case economic forecasts already assume a mild recession at the national level. This scenario looks at what might happen in the event of a downturn more in line with Ontario's historical norms.

GRAPH 4
Spending Growth Will Lag Inflation and Population Growth This Fiscal Year and Beyond



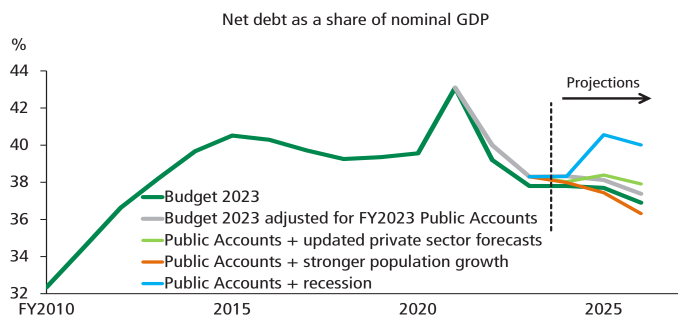
Sources: Ontario Ministry of Finance, Statistics Canada and Desjardins Economic Studies

According to this approach, own-source revenues would fall by a combined $29B versus Budget 2023 forecasts from FY2024 to FY2026. That figure does not include any potential spending increases to offer economic supports during the recession, which would further weaken the bottom line.

5. Is Ontario's Debt Load Sustainable?

The good news is that in most scenarios, the bottom line doesn't deteriorate enough to undermine the expected improvements across some key debt metrics. Net debt relative to the size of the economy is arguably more important than budget balances for credit rating agencies and organizations like Canada's Parliamentary Budget Office that assess fiscal sustainability at the provincial level. Only in the recession plus weak starting point scenario does Ontario's net debt-to-GDP ratio climb meaningfully over time or reach the pre-pandemic peak of 40%+ (graph 5). In all other scenarios, it continues to trend generally lower and remains below levels recorded in the last decade. As of

GRAPH 5
Debt Loads Will Differ under Various Scenarios

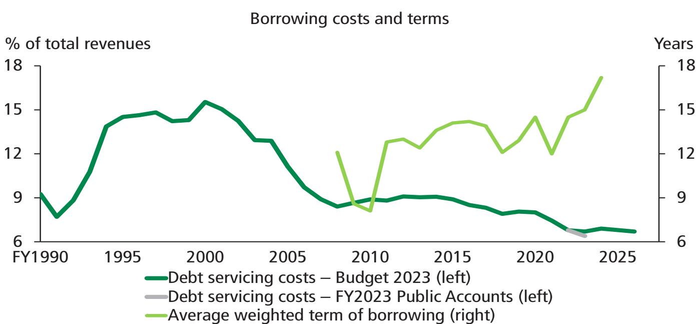


Sources: Ontario Ministry of Finance and Desjardins Economic Studies

Budget 2023, the province's interest cost-to-revenue ratio was also expected to remain well below historical norms (graph 6). Ontario's efforts to reduce its debt burden and extend the term of its debt have helped to contain debt costs and limit rollover risk in a higher borrowing rate environment.

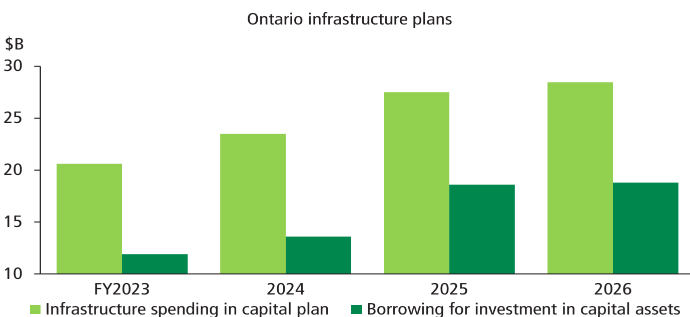
Any changes in the timing of infrastructure spending will impact Ontario's debt and borrowing levels as well as its economic outlook. Investment in capital assets accounted for almost 60% of planned net borrowing in Budget 2023. If fiscal plan updates and guidance from other provinces are any indication, factors such as sustained high interest rates, labour shortages and elevated material costs could shift infrastructure outlays into later years of the forecast period. However, concentrating Budget 2023 spending in the later years of the plan leaves some time for a catch-up following delays (graph 7).

GRAPH 6
Longer-Dated Issuance Reduces Risks from Higher Rates



Sources: Ontario Ministry of Finance, Ontario Financing Authority and Desjardins Economic Studies

GRAPH 7
Infrastructure Spending and Borrowing Are Concentrated in Later Years



Sources: Ontario Ministry of Finance and Desjardins Economic Studies

6. Where Are Bond Spreads Going?

We expect Ontario bond spreads to continue to be driven primarily by risk sentiment during the coming year. The province's yields have increased relative to Canadian benchmarks in recent weeks, mirroring the volatility observed across global financial markets. If a widespread risk-off mood increasingly pervades, however, Ontario's large, liquid and diversified borrowing program should mitigate potential spread blowout versus other Canadian jurisdictions.

Of course, relative fiscal performance will affect spreads over time as well, and we're also seeing signs of new revenue weakness and cost pressures in other provinces. Alberta is one exception to that rule so far, its fiscal outlook having improved following the rebound in WTI prices. That has driven some compression of Wild Rose Country's spreads versus those of Ontario.

Final Thoughts

A weaker-than-anticipated starting point for revenues and an uncertain economic backdrop suggest it will be challenging for Ontario to achieve surplus by FY2025 as planned without trade-offs. Our scenarios all assume the level of spending restraint planned in Budget 2023 is upheld, and they maintain the $7B in combined contingencies penciled in for the three fiscal years to FY2026. Ontario could conceivably draw these allocations down to improve the bottom line, an approach we've seen taken in some provinces and at the federal level. But doing so could come at the expense of credibility down the road, as the contingencies offer a buffer for a province whose economic outlook is subject to many risks.

That said, the data highlight many of Ontario's fiscal advantages, which look likely to remain intact except under the worst-case scenario. These advantages include a declining debt load relative to GDP that should remain low relative to recent history, a large and liquid borrowing program, and good, strategic issuance practices. Collectively, these factors limit the risks from higher borrowing costs despite the sharp increase in interest rates since the start of last year.

Going forward, fiscal policy will need to strike a fine balance. The province must exercise restraint to avoid exacerbating inflation and keep its finances sustainable. But it also needs to relentlessly work towards meeting housing supply and infrastructure spending targets. We would argue that in the 2023 FES, the province should keep its fiscal powder dry. That's the best way to prepare for any coming economic downturn and demonstrate commitment to fiscal sustainability in the face of new headwinds. But the depth of the current housing affordability challenges, speed at which the population is growing and potential implications of major project delays are striking. These attest to the need to build flexibility into long-run plans and move before it's too late. It won't be an easy balance, but if Ontario is to remain a welcoming, affordable and prosperous place to live and do business, it's one it will need to get right.