ECONOMIC VIEWPOINT

More Money, More Problems

What a Recession Could Mean for Ontario's Budget Balance

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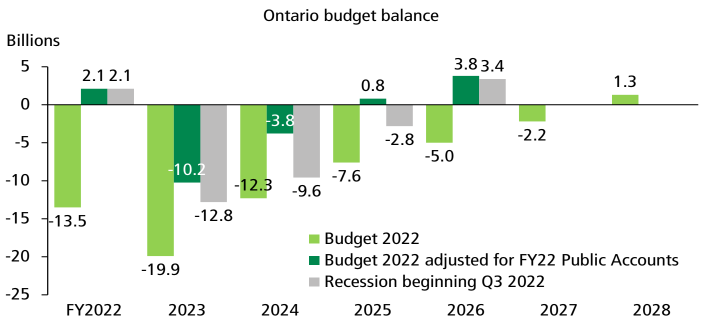
Summary

- Ontario policymakers are at a crossroads as the province releases its Fall Economic Statement (FES) on November 14. This note assesses the province's fiscal prospects and priorities ahead of that release.
- Bolstered by a second consecutive annual revenue windfall more than $10 billion relative to budget projections, Ontario ran its first surplus since before the Global Financial Crisis (GFC) in fiscal year 2021–2022 (FY2022). Our analysis suggests that while the province will likely return to the red this year, that improved starting point alone could put the government in position to sustainably balance the budget three years ahead of schedule in FY2025 (graph 1).
- But the province is also staring down the barrel of a recession, which we estimate would drain more than $8 billion in revenues from government coffers over the next two fiscal years. That would mean larger deficits and a nearly 2% rise in the net debt-to-GDP ratio from now until FY2024, with surplus attained in FY2026.
- With outperformance versus the last plan possible even under a more downcast economic scenario, we could see new measures to address cost of living concerns as in other provinces.
- Any new policy to improve affordability must target lower-income Ontarians most impacted by elevated inflation. The government could also consider outlining plans for future revenue windfalls, in the event they occur again in the coming fiscal years.

GRAPH 1
Ontario Budget Balances to Improve Under Different Scenarios



Sources: Ontario Ministry of Finance and Desjardins, Economic Studies

Fiscal Policymakers at a Crossroads

Ontario fiscal policymakers are at a crossroads. On the one hand, the last two years' revenue windfalls versus budget projections appear to offer new fiscal room. In FY2022, the province recorded its first surplus since before the GFC and its lowest net debt-to-GDP ratio in nearly a decade. On the other hand, the outlook is deteriorating rapidly. Ontario's economy is highly reliant on the housing market, which is now correcting quickly amid surging interest rates and diminished affordability. It's also grappling with decades-high inflation and is exposed to slowing US growth. The province has now lost jobs in four consecutive months for the first time since before the GFC, and we're forecasting a contraction in real GDP in 2023.

This note assesses Ontario's fiscal prospects as it prepares to release an FY2023 mid-year update with an economic downturn looming. We first incorporate the colossal revenue boost reported in the FY2022 Public Accounts, then estimate the potential impacts of an economic downturn.

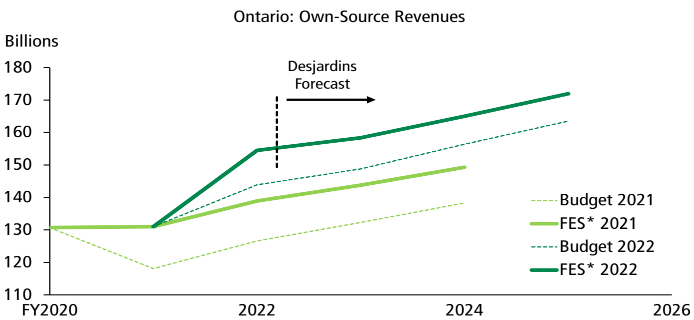
According to our analysis, a recession in line with historical trends could unwind much of the improvement we've seen in the province's financial fortunes over the last two years. However, the starting point improvement may still be large enough for the government to outperform its Budget 2022 targets. That, in turn, could create pressure to offer new policies to address stretched affordability, particularly amid elevated inflation and rising interest rates. But it is of critical importance that policymakers forego broad-based fiscal measures that could further stimulate price pressures. They must also plan for and appropriately communicate risks—both to the downside and the upside.

Revenue Windfall Drives Another Huge Starting Point Boost ...

The starting point for own-source revenues is critically important to any fiscal forecast. That's why many government financial blueprints frequently list changes to the tax base as a risk to their plans.

Accordingly, the massive own-source receipt windfall reported in Ontario's FY2022 Public Accounts should significantly shift its underlying revenue trajectory, just as a similar gain did last year. In the 2021 Fall Economic Statement, own-source revenues were bumped up by more than $11 billion for FY2022 through FY2024. This followed a $12.9 billion windfall in FY2021 compared to the forecast in Budget 2021. We assume a similar jump in the starting point in the updated forecasts for FY2023 through FY2025 (graph 2). In that context, if there were no changes to the Budget 2022 spending plans, the province would return to surplus in FY2025—three years earlier than projected in the April 2022 budget.

GRAPH 2
The FY2022 Post-Budget Windfall Suggests a Persistent Revenue Boost



* Fall Economic Statement. Post-2022 is before potential recession impacts
Sources: Ontario Ministry of Finance and Desjardins, Economic Studies

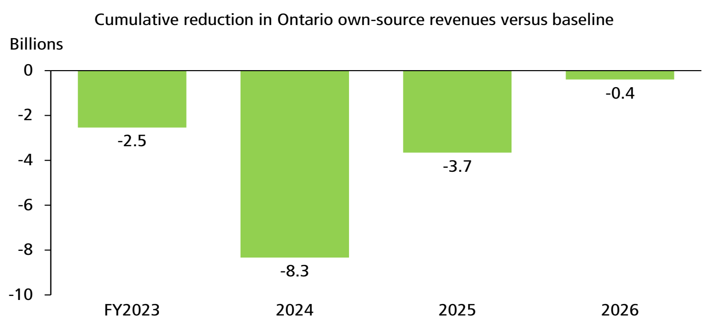
...But a Recession Would Undo Those Gains

Yet the economic outlook has also changed significantly since April. Our latest forecasts assume a recession in Canada in the first half of 2023, with Ontario expected to bear the brunt of that downturn.

To estimate the potential impacts of an economic downturn on the province's fiscal position, we devised a scenario in which four economic variables evolved in line with prior recessions. We chose the Ontario recessions of 1982–1983, the early 1990s and 2008–2009. This is similar to the approach taken in the Pre-election Report on the State of Québec's Public Finances published in August. The variables used were nominal GDP, employee compensation, corporate net operating surpluses and nominal household consumption, which Ontario fiscal plans link to key tax revenue categories with sensitivity estimates. By applying these sensitivities, we were able to compare the fiscal outcomes in our recession scenario to those in the post-FY2022 Public Accounts baseline forecast.

Using that approach, we estimate that Ontario's deficit would reach nearly $13 billion (1.2% of GDP) in FY2023 and about $10 billion (0.9% of GDP) in F20Y24 before returning to surplus in FY2026 (graph 1 on page 1). This assumes a recession-induced drop in government revenues of more than $8 billion over the next two fiscal years (graph 3). While deficits near 1% of GDP over the next two years would represent a significant erosion of the gains generated by the revenue windfall described above, they would still be better than the targets outlined in Budget 2022.

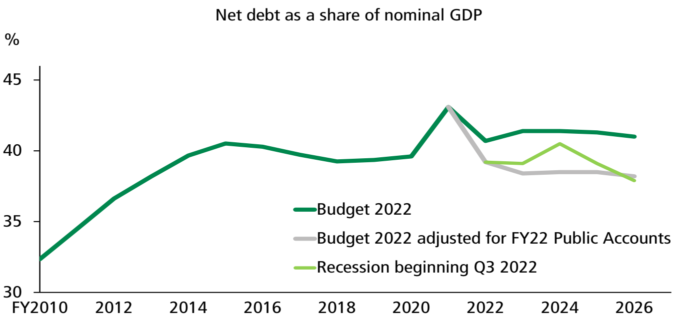
GRAPH 3
A Recession Would Hit Ontario Revenues Hard



Sources: Ontario Ministry of Finance and Desjardins, Economic Studies

By the same token, Ontario's net debt-to-GDP ratio would spike to about 41% in FY2024 instead of modestly declining from the FY2022 rate of 39.2% assumed in our base case. Though a rising ratio is undesirable from a fiscal sustainability perspective, the debt-to-GDP path would still beat the forecasts penciled in at budget time (graph 4 on page 3).

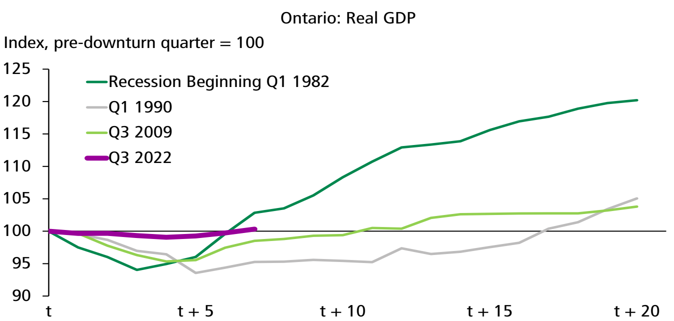
GRAPH 4
A Recession Would Push Ontario's Debt Temporarily Higher



Sources: Ontario Ministry of Finance and Desjardins, Economic Studies

Our approach comes with some caveats. The first, of course, is that no two recessions are alike. In terms of real GDP, our latest Ontario forecast calls for a far milder and shorter-lived recession than those experienced in 1982–1983, the early 1990s or 2008–2009 (graph 5). However, given our assumption that inflation will slow nationwide and that Ontario home prices will fall sharply, the initial hit to the province's nominal GDP could be more significant than in previous recessions. Looking at past recessions gives us a sense of the potential harm a more severe downturn could do to the province's fiscal situation.

GRAPH 5
Ontario's 2022–2023 Downturn Is Expected to Be Milder than Previous Recessions



Sources: Ontario Ministry of Finance and Desjardins, Economic Studies

The second caveat is that our calculations don't include the impacts of any additional spending, which could further erode the government's fiscal position. This spending could come in the form of economic support or recovery measures during the downturn or inflation-induced increases in health and education expenditures. It's too early to quantify the latter, but BC's $1.9 billion FY2023 allocation for public sector wage negotiations—outlined in its Q1 fiscal update—offers a sense of the order of magnitude.

Final Thoughts: New Policy Must Be Targeted

So far, Ontario has been more resistant than many other provinces to boosting the affordability measures announced in Budget 2022 (table). Continued attention on this front will be critical. For one thing, tax and fee relief can be costly. For another, they present inflationary upside if they stimulate consumer demand. That in turn could prompt additional monetary tightening and increase the risk of an even more severe downturn. New affordability relief measures that are incremental, time-limited and tailored to the low-income households most affected by inflation run a lower risk of exacerbating price pressures.

TABLE 1
FY23 Affordability Measures Announced since Budget 2022

Province	Amount (millions)	% of nominal GDP	Description
Newfoundland and Labrador	194 (est.)	0.5	$500 to every resident earning ≤ $125k
Quebec	5,547 (per CAQ election platform)	1.0	➢ $400–$600 per person, depending on income ➢ 3% cap on indexation of government fees ➢ Increase in payments to seniors 70+ ➢ 1% rate cut to lowest two tax brackets
Ontario	225	0.02	Direct payments to parents for school catch-up costs
Saskatchewan	450	0.5	$500 to every resident 18 or older
Alberta	600	0.1	➢ Electricity rate rebates ➢ Income tax bracket re-indexation
BC*	1,000	0.3	Spending allocation to "affordability measures"

* Doesn't include $1.9 billion in FY23 for public sector contract negotiations
Sources: Provincial budget documents, Coalition Avenir Québec election platform and Desjardins, Economic Studies

While conservative fiscal planning is prudent when recession looms, focusing exclusively on the downside can come with its own risks. Our analysis suggests that after windfalls in each of the last two fiscal years, the government could outperform its Budget 2022 targets—even in the event of a recession. When these booms take the system by surprise, unallocated funds are often spent before the end of the year without much consideration of their optimal use or longer-run policy objectives. The impulse to spend will be particularly strong this time with affordability so stretched. Accordingly, Ontario may wish to outline plans for any unexpected revenue gains. These could include accelerated debt repayment or measures to boost the economy's supply capacity, either by further growing the housing stock or increasing productivity-enhancing infrastructure.

Ultimately, the situation in Ontario should provide insights for other governments in Canada as they put together their mid-year fiscal updates and spring budgets. Ottawa and many of the provinces reported much stronger than anticipated revenues during the peak of the pandemic. Policymakers will need to balance shorter-term political pressures with fiscal sustainability, all while keeping an eye on longer-run economic challenges. No easy task with a recession at hand!