ECONOMIC VIEWPOINT

2022 Ontario Budget Preview: Higher Revenues Put Ontario's Finances in a Good Place Leading into the Budget

By Randall Bartlett, Senior Director of Canadian Economics

Canada's 2022 budget season will soon come to a close with the release of the Ontario government's pre-election budget. As has been the case in other provinces, we expect a substantially-improved outlook. Revenues are likely to have surprised on the upside as they have elsewhere, which will boost the overall outlook for budget deficits and net debt. But risks abound, most pronounced of which include Ontario's housing market and rising borrowing costs.

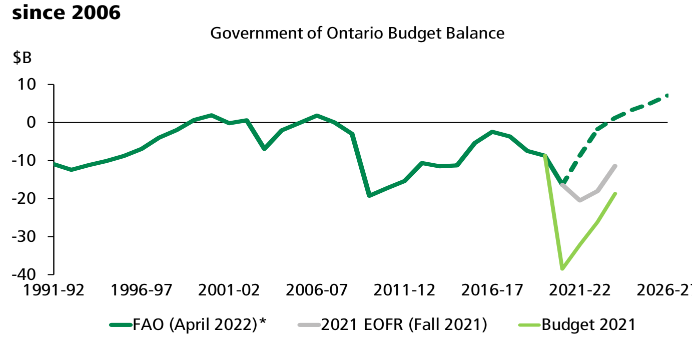
If the 2022 budget season could be summed up by one thing, it would be substantially higher revenues boosting governments' bottom lines. This has been the case not only at the federal level, but across all provincial governments as well. Greater economic activity and high inflation have increased the tax take, reducing projected deficits and debt ratios in the process. On April 28, the Government of Ontario will be the last to pop the champagne. We expect it will have much to celebrate.

From Unprecedented Deficit to Possible Surplus

The outlook for the Government of Ontario's finances is expected to improve dramatically in the 2022 budget. This was clear from the province's 2021–22 Third Quarter Finances, which showed the in-year deficit estimate shrinking from $32.1 billion to $12.1 billion, entirely as a result of projected revenues coming in $22.6 billion higher on the year.

This improved the starting point for the rest of the outlook. According to the Financial Accountability Officer's (FAO's) Spring 2022 Economic and Budget Outlook, the Government of Ontario could post a budget surplus as soon as the 2023–24 fiscal year—the first surplus since before the 2008–09 financial crisis (graph 1). For comparison, the 2021 Ontario Budget and the 2021 Ontario Budget and the 2021 Ontario Economic Outlook and Fiscal Review (EOFR) included forecasts of sustained deficits over the duration of the forecast period. This change of fortune can almost entirely be chalked up to an improved revenue outlook, which can be attributed to the sharp rebound in growth and employment as well as the elevated pace of inflation.

GRAPH 1
The Government of Ontario could soon post its first surplus since 2006

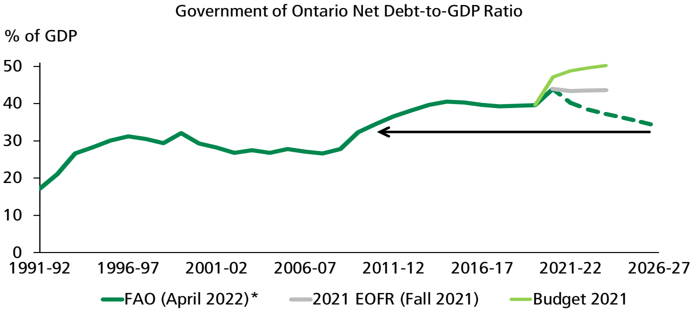


*FAO is the Financial Accountability Officer. ** EOFR is the Economic Outlook and Fiscal Review
Sources: FAO, Ontario Ministry of Finance and Desjardins, Economic Studies

Improved Balances Point to a Falling Debt-to-GDP Ratio

The improved forecast for the Ontario government's fiscal balance will have clear positive implications for the province's outlook for net debt. Barring any substantial new revenue or spending measures, the FAO projects that the province's net debt-to-GDP ratio could gradually fall from its recent peak of 43.9% in the 2020–21 fiscal year to 33.9% in the 2026–27 fiscal year (graph 2 on page 2). This would mark the lowest level of net debt-to-GDP since the 2009–10 fiscal year. In contrast, the 2021 budget projected a sustained rise in the debt-to-GDP ratio over the outlook while the 2021 EOFR pointed to a flat profile going forward.

GRAPH 2
Ontario's debt-to-GDP ratio is expected to show a meaningful decline



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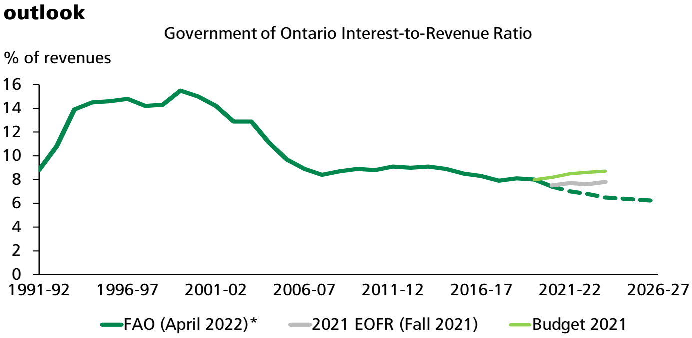
Sources: FAO, Ontario Ministry of Finance and Desjardins, Economic Studies

With smaller deficits requiring less new issuance, the pace of debt accumulation in Ontario is expected to slow relative to what was previously anticipated. This is in line with what we've seen from other provinces and the federal government during the budget season so far, so it should come as no surprise. It also implies that the total funding requirement for the current and subsequent fiscal years is likely to be predominantly composed of debt maturities and redemptions. As a result, Ontario's borrowing program for 2022–23 may come in leaner, not just compared with the two pandemic fiscal years but also relative to the pre-pandemic average.

In its Debt Management Strategy in Budget 2022, the federal government reduced its planned issuance of longer-term bonds from 45% in the 2021–22 fiscal year to a proposed 35% in the 2022–23 fiscal year. This pattern may be repeated in Ontario. If it is, it will likely reflect rising long-term interest rates and uncertainty around the interest rate outlook going forward. That said, even in the face of this uncertain outlook for rates, the FAO projects that the Government of Ontario's debt service costs will fall on the improved deficit and debt outlook (graph 3).

GRAPH 3
The FAO expects debt service costs to fall on an improved outlook



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Sources: FAO, Ontario Ministry of Finance and Desjardins, Economic Studies

Fiscal Forecasting Can Be a Risky Business

But no fiscal forecast is without uncertainty, particularly today. The war in Ukraine continues to keep commodity prices elevated while global supply chain snarls have left goods prices rising persistently for the past year. Add to this another wave of COVID-19 sweeping the province, and there's a possibility of further growth headwinds.

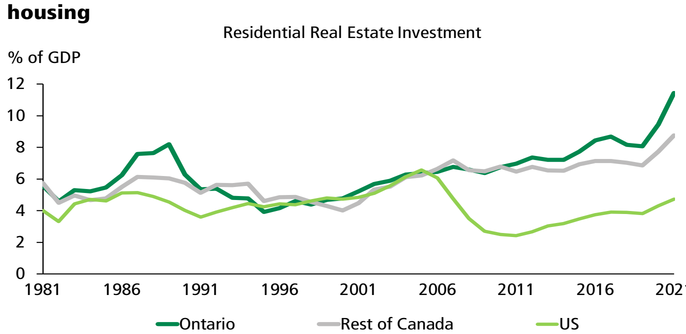
Building Concerns about the Housing Market

Concerns about the current state of the housing market abound as affordability continues to erode, leaving home ownership well out of reach for many Canadians.

But as prices and sales have skyrocketed throughout the pandemic, provincial and municipal government coffers have swelled. The Government of Ontario is no exception. Revenue from the Land Transfer Tax, which can be up to 2.5% of the value of a transaction over $2 million, is expected to have nearly doubled from $2.8 billion in the 2018–19 fiscal year to an estimated $5.5 billion in the 2021–22 fiscal year. Add to this nearly $5.7 billion in additional Education Property Tax revenues, and just shy of 10% of the Government of Ontario's estimated tax revenue last year was tied directly to housing market activity. But those are only the direct provincial revenue impacts of the surging housing market activity in recent years.

Substantial upward revisions to personal and corporate income tax revenues explain much of the improving revenue outlook, and some of this is undoubtedly linked to the housing market as well. Looking at the recently released Ontario Economic Accounts, almost 11.5% of Ontario's economic activity in 2021 can be attributed to investment in residential real estate, well above the 8.2% of GDP at the peak of the previous real estate boom in 1989 (graph 4). This is also in contrast to 8.8% in the rest of Canada and 4.7% in the US last year. And while activity has gone up in major urban centres, it has been most concentrated in communities outside of the Greater Toronto Area that aren't accustomed to the price gains they've experienced during the pandemic. As such, the likelihood of a

GRAPH 4
Ontario stands out for its share of economic activity tied to housing



Sources: Ontario Ministry of Finance, Statistics Canada, Bureau of Economic Analysis and Desjardins, Economic Studies decline in Ontario's existing home sales and sale prices isn't just possible, it's probable. This poses a meaningful downside risk to the outlook for economic growth and government revenues.

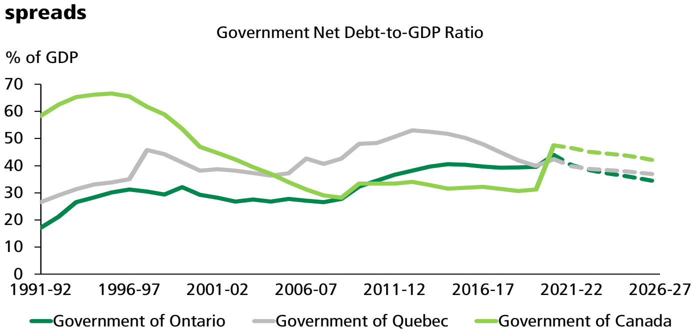
Maintaining an Interest in Interest Rates

Also central to any fiscal forecast is the outlook for interest rates. Indeed, the FAO has flagged higher interest rates as a risk to its outlook. For Canadian provinces, this involves several considerations, including yields on Government of Canada sovereign bonds (GoCs) and spreads to GOCs as a result of fiscal performance relative to other provinces.

The first factor—yields on GoCs–is beyond the control of any province. We expect yields on 10-year Government of Canada bonds to reach roughly 3% by the end of 2022, a sharp increase by any measure and well above the outlook included in federal Budget 2022. Fortunately, the federal government's debt-to-GDP ratio as laid out in Budget 2022 is on track to fall considerably, keeping yields reasonably in check.

Where provincial governments can have an impact on their borrowing costs is fiscal discipline. The Institute of Fiscal Studies and Democracy (2018) found that "…fiscal discipline measured as a low net debt-to-GDP relative to the Government of Canada has a significant negative impact on provincial yield differential." And on debt-to-GDP, Ontario looks set to perform well, even possibly relative to Quebec depending on the new tax and spending measures announced in the budget (graph 5).

GRAPH 5
Improving net debt-to-GDP ratios should support lower rate spreads

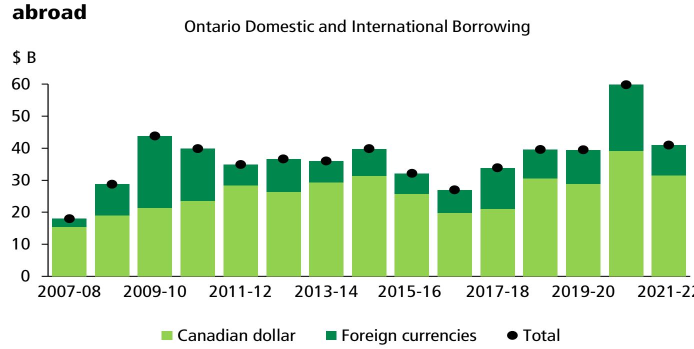


Sources: Financial Accountability Officer, Ontario Ministry of Finance, Quebec Ministry of Finance, Finance Canada and Desjardins, Economic Studies

Keeping an Eye on the Loonie's Flight Path

Finally, there are considerations around the currency that debt is issued in. The federal government issues bonds in other currencies only in that the Bank of Canada uses another country's currency to manage its foreign exchange reserves. In contrast, provincial governments issue a minority share of their debt in foreign currencies to ensure the availability of deep and liquid pools of capital if and when they need it. This strategy paid off in the depths of the 2008–09 financial crisis and the pandemic, when about half of the debt issued by the Government of Ontario was in a foreign currency, mostly US dollars (graph 6). But this strategy isn't without costs, either in the form of currency risk, as revenues earned and interest paid are in different currencies, or the cost of hedging that risk. Fortunately, high commodity prices have helped to lift the Canadian dollar well off its pandemic lows and keep it relatively stable against the US dollar lately. This despite substantial geopolitical risks and the resulting flight to safety.

GRAPH 6
In times of crisis, Ontario tends to issue a larger share of debt abroad



Sources: Ontario Ministry of Finance and Desjardins, Economic Studies

Conclusion

On balance, we believe Ontario's finances are in very good shape in the run-up to the 2022 Budget and the June 2022 election. While every party will undoubtedly propose new measures to reduce revenues and/or increase spending before the election, the evidence suggests there's ample room to dole out some goodies while keeping Ontario's fiscal outlook on a sustainable track. Of course, the outlook for Ontario's finances is not without risks given the ongoing uncertainty at home and abroad. The Government of Ontario would thus be wise to keep some powder dry and continue to build in significant prudence just in case some of these risks are realized. But even with these uncertainties in mind, the Ontario government is certainly on a better course than it was just a few short months ago.