ECONOMIC VIEWPOINT

Good News and Bad News: Five Questions in the Leadup to the 2023 Ontario Budget

By Marc Desormeaux, Principal Economist

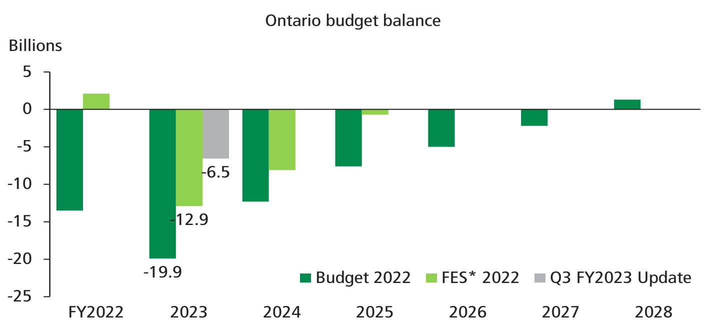
- In this note, we discuss five questions that should be on your radar when Ontario releases its fiscal year 2023–24 (FY2024) budget on March 23.
- The latest FY2023 revenue windfall, which significantly eroded the province's deficit projection (graph 1), could carry into outer years.
- But the data suggests that Ontario's economy is weakening in response to sharply higher interest rates. Longer-term forecasts will provide insight into how Ontario sees the evolution of its housing market, and related risk exposure.
- The province could ease expenditure restraint last forecast for FY2024. It did so after past instances of revenue outperformance, and new federal funding unlocks more spending room.
- Outer-year borrowing program timelines could conceivably change significantly given a Q3 FY2023 boost to pre-funding, major project delays witnessed across Canada, and infrastructure and housing supply priorities.
- Bond spreads should eventually be impacted by fiscal performance and contingency allocations, but overall risk sentiment will rule the day in the shorter-term.

1. A Persistent or Short-Lived Revenue Handoff?

The key change in Ontario's third quarter fiscal update was a nearly $10B revenue windfall that roughly halved the projected FY2023 deficit. We noted in both our preview of and commentary on the 2022 Fall Economic Statement (FES) that large outperformance in government receipts tends to boost later-year revenue forecasts as well.

But outer-year impacts may be smaller this time because more than $8B of the latest windfall stemmed from federal-level adjustments to the tax base in prior years (graph 2 on page 2). To the extent that this reflects taxes paid on federal pandemic benefits, some of the windfall may not carry forward. We saw a similar dynamic at play in BC's 2023 budget, which penciled in significant revenue declines in FY2024 following a huge prior-year tax adjustment for FY2023 reported in November 2022.

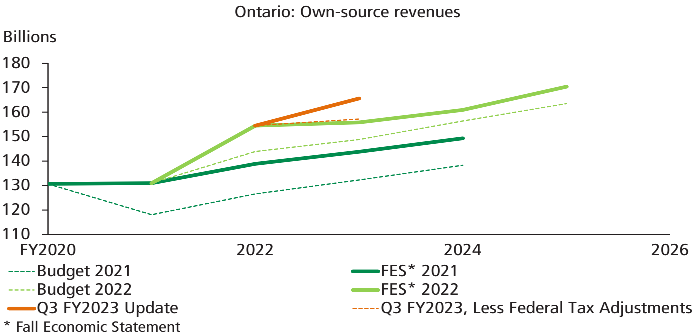
GRAPH 1
Ontario's Fiscal Outlook Once Again Improved



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

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

GRAPH 2
Latest Revenue Windfall Could Boost Fiscal Trajectory Once Again



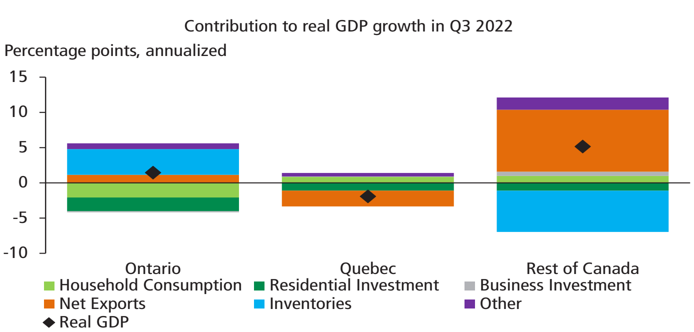
Sources: Ontario Ministry of Finance and Desjardins Economic Studies

Based on recent trends, we estimate that a full carry-forward of the Q3 FY2023 windfall would lift FY2024 revenues $7–8B higher than forecast in the 2022 FES. Absent changes to current spending plans, that would bring the province close to balanced budget territory in the coming fiscal year. If money only persists in the revenue categories unaffected by prior-year adjustments, gains are only about $1B versus plan. That amount alone isn't likely to alter the province's timeline to balance.

2. What Will the Consumer and Housing Market Look Like?

Despite the strength of revenues and hiring to begin 2023, the data suggests that Ontario's economy is weakening in response to sharply higher interest rates. The highly indebted household sector reduced expenditures by almost 4% (q/q annualized) in the third quarter of 2022. That weighed on economic growth (graph 3). Other than during the pandemic, that was the worst quarterly decline since 1992. It also resulted in a sharp rise in the household saving rate, which we argued could be a harbinger of a pronounced economic downturn. We estimated in November 2022 that a normal recession would reduce FY2024 revenues by more than $8B versus plan. That would wipe out the effect of the windfall in the persistent revenue scenario.

GRAPH 3
Interest-Sensitive Sectors Dragging on Ontario's Economy



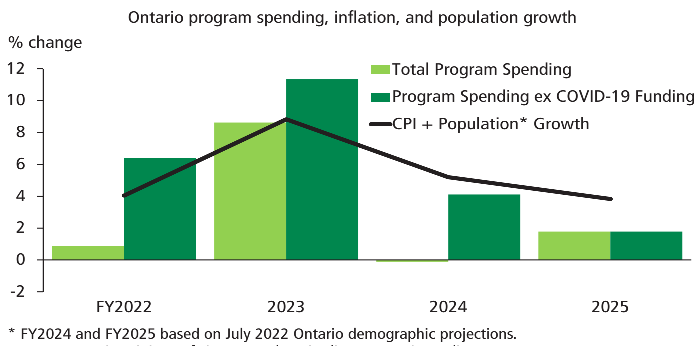
Sources: Statistics Canada, Institut de la Statistique du Quebec, Ontario Ministry of Finance, and Desjardins Economic Studies

Updated home price projections are also of interest. Ontario's plunge in residential investment continues to outpace that in the rest of Canada, and home values have fallen by more than in any other province to date. Our latest projection put the average sale price of a home in Ontario at 25% below the pandemic peak by the end of 2023. In its recent budget, BC did not anticipate a return to last year's mean sales price until 2027.

3. Will Spending Restraint be Relaxed?

We anticipate that Ontario will at least partially ease prior plans for expenditure restraint. Despite expectations of still-high inflation and surging population growth, it penciled in base program spending increases of just 4% in FY2024 and 1.8% in FY2025 in the FES. Including a planned drawdown in COVID-19 funding, FY2024 program expenditures were set to fall (graph 4).

GRAPH 4
Latest Plan Built on Spending Restraint for Next Two Years



* FY2024 and FY2025 based on July 2022 Ontario demographic projections.
Sources: Ontario Ministry of Finance and Desjardins Economic Studies

New spending room reflects new federal money as well as a potential starting point boost to own-source revenues. Ontario was one of the first provinces to agree to terms set out in the new federal-provincial healthcare agreement. Assuming a share of the Canada Health Transfer (CHT) top-up consistent with its population, Ontario would receive about an additional $800M in funds from Ottawa.

We suspect that much of any new funding will be directed towards healthcare priorities given well-established capacity constraints that have emerged since the start of the pandemic. But the money could also be devoted to other programs or debt repayment so long as Ontario meets the core healthcare provision requirements of the Canada Health Act. Indeed, movement in Ontario health spending has not tended to closely follow that of the CHT over time.

TABLE 1
Ontario's Borrowing Program

$ BILLIONS	FY2023 FES* 2022	FY2023 Q3 FY2023	FY2024 FES 2022*	FY2025 FES* 2022
Deficit/(Surplus)	12.9	6.5	8.1	0.7
Investment in Capital Assets	13.4	13.3	13.6	15.0
Non-Cash & Cash Timing Adjustments	(17.7)	(17.7)	(9.6)	(10.5)
Loans to Infrastructure Ontario	(0.2)	(0.2)	0.1	0.1
Other Net Loans/Investments	0.4	0.0	0.0	(0.8)
Debt Maturities/Redemptions	30.6	30.6	31.2	27.8
Total Funding Requirements	**39.5**	**32.5**	**43.4**	**32.3**
Short-Term Borrowing Decrease/(Increase)	—	—	(2.0)	—
Cash & Cash Equivalents Decrease/(Increase)	—	—	—	—
FY2022 Pre-Borrowing for FY2023	(10.3)	(10.3)	—	—
FY2023 Pre-Borrowing for FY2024	3.0	9.9	(3.0)	—
Total Long-Term Public Borrowing	**32.2**	**32.2**	**38.4**	**32.3**

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

4. How Will Capital Spending Plans Impact Borrowing?

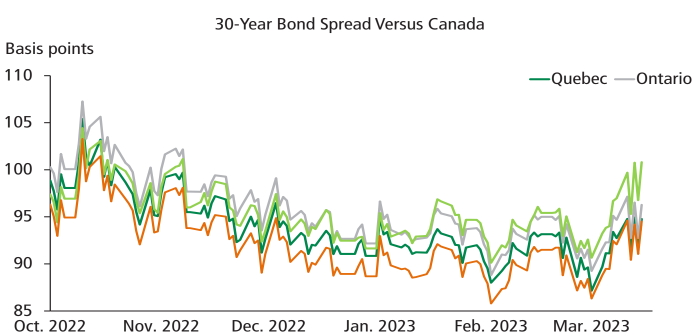
The FES stood out among mid-year provincial updates for keeping prior infrastructure spending plans intact, but we question whether this can continue. Updates to government capital expenditure numbers impact the economic outlook as well as the size and schedule of the borrowing program (table 1).

BC and Alberta have reduced FY2023 capital outlay projections. Those provinces subsequently upped their forecasts for FY2024, citing higher interest rates and project delays via labour and input product shortages, all of which are ubiquitous. Ontario also looks set to continue to target transit infrastructure and affordable housing construction amid strong population growth. A nearly $7B increase in pre-funding for FY2024 announced in the Q3 FY2023 update may help cover additional costs.

5. Where Are Bond Yields Headed?

In the near term, we expect Ontario bond spreads relative to federal benchmarks to follow risk sentiment closely. Provincial yields tightened versus Canada to begin this year amid a spate of positive economic data. Spreads then widened alongside those of other provinces in the immediate aftermath of the Silicon Valley Bank (SVB) failure that caused anxiety across financial markets. They then seesawed last week amid significant volatility (graph 5).

GRAPH 5
Volatile Week for Provincial Bond Market After SVB Collapse



Sources: Bloomberg and Desjardins Economic Studies

That said, in the event of widespread risk-off moves, Ontario's large, liquid, and diversified borrowing program should mitigate potential spread blowout. During the peak COVID-19 lockdown period, most smaller provinces' yields rose more than those of Ontario. That was also true of Alberta—whose spreads blew out in response to the plunge in crude values—but not of Quebec and BC. Those latter two provinces began the pandemic and this budget cycle with stronger finances than Ontario.

Contingency allocations could also impact spreads. We've noted several times that markets largely ignored a solid surplus in BC last year, largely because they had already assumed a bottom-line improvement via some unused contingency funds. In respect of an uncertain economic and financial market outlook, Ontario may increase the value of funds set aside to absorb unexpected cost pressures. That would follow Alberta's lead and could limit future spread tightening in the event of fiscal outperformance.

Final Thoughts

Budget 2023 comes at a time of great uncertainty. The plan should provide more insight into Ontario's exposure to various risks that dot the economic landscape, as well as how the province intends to tackle longer-run challenges.