BUDGET ANALYSIS

Ontario: Fall Economic Statement 2023

Plans for Balance Intact, but Delayed

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HIGHLIGHTS

- Ontario's 2023 Fall Economic Statement (FES) maintains plans to balance the books but now aims to do so in fiscal year 2025–26 (FY2026) rather than next year. With increased fiscal shortfalls forecasted this year and next, it anticipates that its net debt burden will peak at just above 39% of GDP next year and then decline. Table 1 below summarizes key fiscal indicators.
- Mirroring increased deficit projections, the province forecasts an increase in borrowing requirements relative to the March 2023 budget plan. Table 2 on page 4 provides more detail.
- As expected, the federal reassessments of prior-year tax receipts that drove weaker-than-anticipated revenues in Ontario last year will carry forward. The impact on the bottom line will be partly offset by a reduction in outer-year fiscal plan contingencies.
- The signature new policy measures were the removal of the provincial sales tax on new purpose-built rental construction, and extension of gas and fuel tax cuts. The costs aren't likely to undermine the fiscal trajectory on their own. Prior spending and infrastructure targets were otherwise largely kept intact.
- Amid heightened economic uncertainty, we like the province's decision to keep its powder dry and keep its debt load on a sustainable trajectory. But a surging population will create new spending pressures later, and smaller buffers in the outer years of the plan could make the path to balance more challenging.

TABLE 1
Updated Ontario Fiscal Forecasts

IN $B (UNLESS OTHERWISE INDICATED)	2022–23		2023–24		2024–25		2025–26	
	Bud. 2023	Actual	Bud. 2023	FES* 2023	Bud. 2023	FES* 2023	Bud. 2023	FES* 2023
Total Revenues	200.4	192.9	204.4	201.8	213.0	206.7	226.0	220.0
% change	*8.3*	*4.2*	*2.0*	*4.6*	*4.2*	*2.4*	*6.1*	*6.4*
Own-Source Revenues	169.1	161.6	169.6	166.7	177.9	171.3	188.9	183.0
% change	*9.5*	*4.6*	*0.3*	*3.2*	*4.9*	*2.8*	*6.2*	*6.8*
Federal Transfers	31.3	31.3	34.8	35.1	35.1	35.4	37.1	37.0
Total Spending	202.6	198.8	204.7	206.4	210.8	210.5	217.5	217.5
% change	*10.7*	*8.6*	*1.0*	*3.8*	*3.0*	*2.0*	*3.2*	*3.3*
Program Spending**	189.2	186.4	190.6	193	196.4	196.2	202.5	202.3
% change	*11.0*	*9.4*	*0.7*	*3.5*	*3.0*	*1.7*	*3.1*	*3.1*
Debt Servicing	13.4	12.4	14.1	13.4	14.4	14.3	15.1	15.2
% of revenues	*6.7*	*6.4*	*6.9*	*6.6*	*6.8*	*6.9*	*6.7*	*6.9*
Reserve	—	—	1.0	1.0	2.0	1.5	4.0	2.0
Budget Balance	**-2.2**	**-5.9**	**-1.3**	**-5.6**	**0.2**	**-5.3**	**4.4**	**0.5**
% of GDP	*-0.2*	*-0.6*	*-0.1*	*-0.5*	*0.02*	*-0.5*	*0.4*	*0.04*
Net Debt (% of GDP)	*37.8*	*38.3*	*37.8*	*38.4*	*37.7*	*39.1*	*36.9*	*38.7*
Nominal GDP (% change)	9.4	**9.2**	2.8	**3.6**	3.6	2.9	4.6	4.2
Real GDP (% change)	*3.7*	*3.7*	*0.2*	*1.1*	*1.3*	*0.5*	*2.5*	*2.0*
Infrastructure Spending	17.4	16.3	20.6	20.7	25.8	26	27.0	27.1

* *Fall Economic Statement*

** Includes COVID-19 funding and one-time expenses

Sources: Ontario Ministry of Finance and Desjardins Economic Studies

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Our Take

Ontario came into today's update facing significant economic uncertainty, while seeking to balance fiscal sustainability and a need to address its pressing longer-run affordability challenges. We would argue that it has struck the right balance for the moment, but the road ahead may be challenging.

Maintaining plans to balance the books looks feasible and should be well-received by creditors. There will of course be attention devoted to the delay in the return to the black, particularly following an unexpected preponement of the budget balance target in March. However, adherence to the prior timeline likely wasn't viable given the size of the downward revision to last year's tax revenues. And despite the marginal increases in the debt burden penciled in for the next two years, Ontario should be able to keep its debt-to-GDP ratio below the pre-pandemic peak. Its targets will also stay below the 40% fiscal sustainability threshold it set for itself so long as there isn't a deterioration of economic conditions far worse than the one already baked into the base case forecast. Forecast reserves were reduced versus large Budget 2023 allotments, but plenty of prudence remains.

However, there's also no denying the longer-term challenges facing this province (and most others). These include the Canada-wide affordability crisis and the sluggish productivity growth that has weighed on per-capita GDP and tax revenue. Ontario has taken some steps towards addressing these today while being mindful of the public purse. But the surge in newcomer arrivals and rapidly aging population raise the stakes for the province's housing, health care, infrastructure, and economic growth agenda. Continuing to strike the right balance won't be easy, particularly if a recession materializes as expected. The good news is that Ontario is in better fiscal shape than it might otherwise have been heading into potentially difficult period.

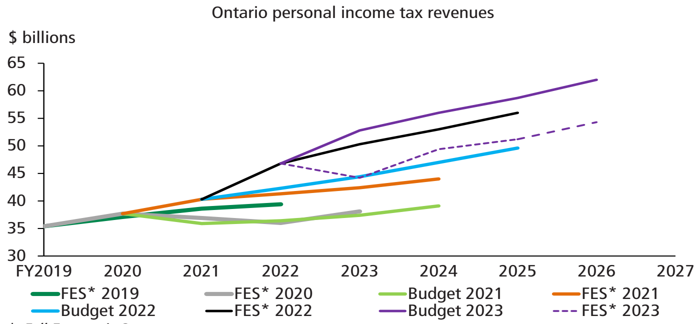
Federal Tax Reassessments Weaken Revenue Outlook

Last year's nearly $9B underperformance in personal income tax (PIT) receipts—which drove a larger-than-anticipated deficit last year—will carry forward. We highlighted this as a risk in our FES preview. The government expects PIT to come in a combined $21.8B lower than forecast for the FY2024 to FY2026 period at Budget time (graph 1). It noted that this was "mainly due to lower-than-expected revenues from the processing of 2022 and prior years' tax returns." The reduction comes despite the fact that the economic outlook has improved for calendar year 2023 following the stronger-than-forecast growth in the first half of the year.

The updated fiscal blueprint is built on somewhat softer growth beyond FY2024, but still bakes in strong GDP and revenue gains in the final year of the plan as it did in the March budget. Updated economic growth projections are in line with our own view that the slowdown will occur in early 2024 rather than this year. But the nearly 7% annual expansion in own-source revenues penciled in for FY2026 is not common other than in the periods following deep economic contractions. This plan assumes a more modest downturn by historical standards. A weaker-growth scenario projects a combined FY2024 to FY2026 budget balance $17.5B weaker than in the base case, with deficits extending until at least the last year of the forecast window.

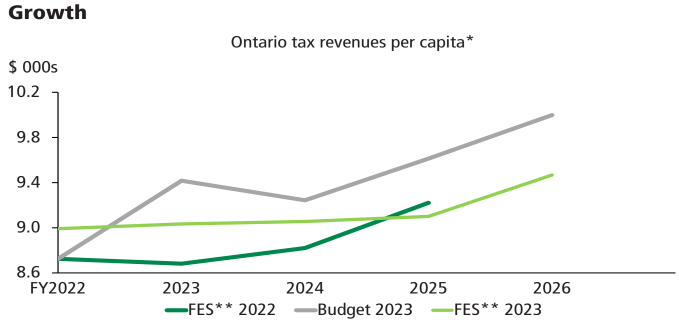
The torrid headcount gains witnessed across Canada have been arguably the biggest economic news story of the past year, and featured in Ontario's updated fiscal outlook. After significantly upgrading its demographic forecasts for the next several years (which we described here), the province noted that the recent "record-breaking" rates of population growth have stimulated household spending. That said, following downgrades to revenues and upgrades to population, Ontario's projected tax revenues per capita are now on track to come in below forecasts from Budget 2023 (graph 2). This mirrors the fall in per-person GDP that we've witnessed at the national level.

GRAPH 1
In-Year Personal Income Tax Changes Carry Forward in Ontario



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

GRAPH 2
Like GDP, Tax Revenues Aren't Keeping Up With Population Growth



* Based on annual Ontario demographic projections
** *Fall Economic Statement*
Sources: Ontario Ministry of Finance and Desjardins Economic Studies

Keeping a Lid on Spending

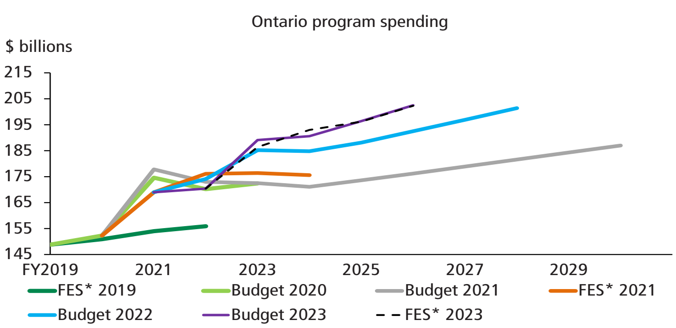
With a softer revenue trajectory in place, the province opted to only incrementally increase spending. FY2024 spending was increased by $2.4B, while FY2025 to FY2026 plans were generally in line with the targets laid out in Budget 2023 (graph 3).

We've argued that at the current juncture—when economic and revenue uncertainty reign and the province is nearing the time it targeted for balancing the books—it's prudent to keep the proverbial powder dry. This plan appears to do that. But there's also no doubt that much stronger population advances expected over the next several years will increasingly create new spending pressures down the road. Indeed, the FES continues to bake in a pace of program spending growth below the combined rate of inflation plus population gains (graph 4). Total infrastructure outlays expected from FY2024 to FY2026 also didn't change materially versus plans laid out in March.

Continuing to Target Affordability

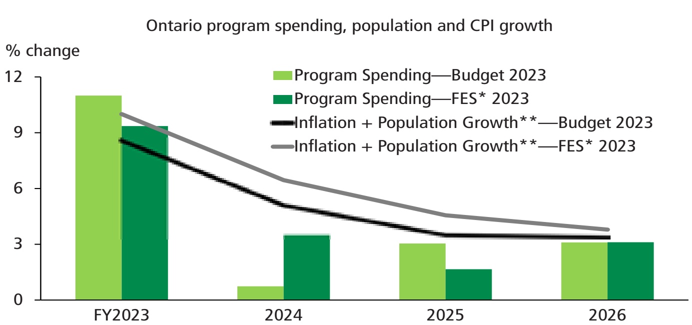
The FES's signature policy measure, the removal of the provincial sales tax on new purpose-built rental construction,

GRAPH 3
Spending Plans Largely Intact



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

GRAPH 4
Spending Growth Continues to Lag Inflation + Population Gains



* *Fall Economic Statement.* ** July 2022 projection for Budget, July 2023 projection for FES
Sources: Ontario Ministry of Finance, Statistics Canada and Desjardins Economic Studies

was well-telegraphed ahead of time, and we like it for two reasons. First, we've argued that it's a simple and effective way to encourage the building of new rental homes, acknowledging that its effects on the housing stock and affordability will take time to bear fruit. Second, it's not costly. The province estimates a fiscal hit of less than $200M combined over the next three fiscal years. On its own, that's unlikely to significantly alter Ontario's fiscal trajectory, though the costs may rise over time with more uptake.

Extension of the gas and fuel tax cuts into next year brings mixed prospects. As we showed last year, before the pandemic, private transportation costs were primarily borne by higher-income households, thus the potential savings are not necessarily targeted towards the lowest-income individuals most impacted by inflation. That said, the cut should provide a degree of relief from one of the key drivers of inflation at a time of commodity price volatility. It's also not very costly, with foregone revenues of $320M in FY2024 and $325M in FY2025.

When it comes to the new Ontario Infrastructure Bank, the devil will be in the details. Of course, the need for better infrastructure in Ontario is well-established, and will become even more pressing if major project delays continue and hefty population gains persist as planned. But to assess the efficacy that this new program may have, we'll need—at a minimum—a sense of the size of existing gaps, where investment will get the biggest bang for the buck for taxpayers, and how it will attract private-sector investment. Questions like these have plagued the progress of the Canada Infrastructure Bank since its inception, and answers to them might only become clear in the months ahead.

Forecast Reserve Reduced, but Plenty of Buffers Remain

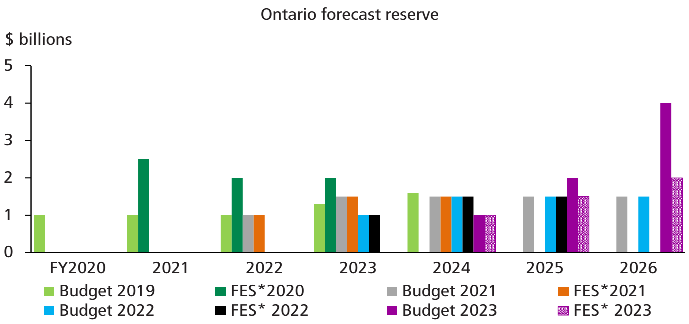
Ontario's fiscal projections characteristically include three layers of prudence.

The first is an economic forecast more conservative than the private-sector average. That average likely explains the strong outer-year revenue growth penciled into the plan, but plans based on it still leave room to outperform market expectations.

The second is a contingency fund for unexpected expenses and capital outlays, which was topped up by $2.5B (accounting for the increase in program spending noted above). As such, net of a small drawdown, Ontario's fiscal plans now include $5.5B in unused contingencies.

The third is a standard forecast allowance, which is still substantial but was reduced. Recall that Budget 2023 earmarked $1B for FY2024, $2B for FY2025, and a hefty $4B for FY2026 (graph 5 on page 4). FES 2023 slightly reduced the amount set aside for next fiscal year to $1.5B but cut the FY2026 contingency in half to $2B. This helped offset the hit to the bottom line from the reduced revenue profile.

GRAPH 5
Ontario Keeps Large Fiscal Buffers in Place



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Sources: Ontario Ministry of Finance and Desjardins Economic Studies

Borrowing Program Increased

Ontario's borrowing requirements are now expected to total $34.7B in FY2024, $37.4B in FY2025, and $37.0B in FY2026, up a combined $19.5B versus Budget 2023 forecasts. The increases primarily reflect the larger projected deficits. This fiscal year's $34.7B is helped by $14.5B in pre-borrowing conducted in FY2023. Almost all of the borrowing completed this fiscal year has been in Canadian dollars, via 19 syndicated issues. The target range for domestic borrowing remains 75 to 90%. The weighted average borrowing term for outstanding debt in FY2024 is estimated at 17.2 years, a duration that should mitigate risks related to refinancing at higher rates. Going forward, the province will "monitor the market and adjust the debt term strategy in the future, if necessary, in response to further changes to interest rates and the yield curve."

Spreads Little Changed in Immediate Aftermath

Ontario bond spreads were little changed immediately after the release of the FES. Markets likely anticipated some increase in deficit targets following the disappointing FY2023 Public Accounts results, but a fuller sense of the market response will only become clear in the weeks ahead.

Going forward, we still expect Ontario bond spreads to be driven primarily by overall risk sentiment during the coming year. As we noted in our FES preview, the province's yields have increased relative to Canadian benchmarks in recent weeks, consistent with the volatility experienced by global financial markets. Still, Ontario's large, liquid and diversified borrowing program likely means it will avoid a significant widening of spreads in the event of widespread risk off sentiment.

TABLE 2
Updated Ontario Borrowing Program

	2023–24		2024–25		2025–26	
IN $B (UNLESS OTHERWISE INDICATED)	**Bud. 2023**	**FES* 2023**	**Bud. 2023**	**FES* 2023**	**Bud. 2023**	**FES* 2023**
Deficit/(Surplus)	1.3	5.6	(0.2)	5.3	(4.4)	(0.5)
Investment in Capital Assets	13.6	13.6	18.6	18.7	18.8	19.0
Non-Cash and Cash Timing Adjustments	(9.2)	(1.3)	(11.7)	(11.2)	(14.0)	(12.0)
Loans to Infrastructure Ontario	0.1	0.1	0.1	0.1	0.2	0.1
Other Net Loans/Investments	0.1	0.1	(1.0)	(1.0)	(0.2)	(0.2)
Debt Maturities/Redemptions	31.2	31.2	27.9	28.0	33.1	33.1
Total Funding Requirement	37.0	49.2	33.7	39.9	33.4	39.5
Decrease/(Increase) in Short-Term Borrowing	—	—	—	(2.5)	—	(2.5)
Increase/(Decrease) in Cash and Cash Equivalents	5.0	—	(5.0)	—	—	—
Pre-borrowing in 2021–22 for 2022–23	—	—	—	—	—	—
Pre-borrowing for 2023–24	(14.5)	(14.5)	—	—	—	—
Total Long-Term Borrowing	**27.5**	**34.7**	**28.7**	**37.4**	**33.4**	**37.0**

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Sources: Ontario Ministry of Finance and Desjardins Economic Studies