ECONOMIC VIEWPOINT

Don't Judge the Provinces' Books by Their Covers

Five Themes from the 2024 Provincial Budget Season, and Why Things Aren't as Bad as They Seem

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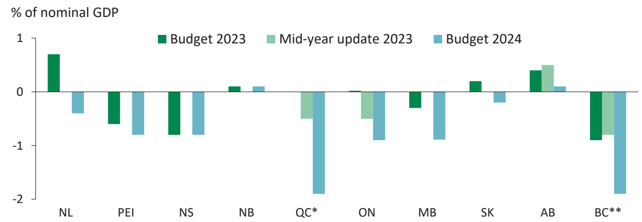
Highlights

- Many taxpayers and investors are feeling less optimistic about the future now that budget season 2024 has come to a close, as budget balances deteriorated nearly across the board (graph 1).
- However, no province is expecting to run a record shortfall as a share of GDP in the coming fiscal year. Moreover, while the provinces' combined net debt-to-GDP ratio is set to rise in the year ahead, projections for this metric are lower than they were for most of the decade before the pandemic.
- Spending increases drove the bulk of deficit deterioration, but that doesn't mean governments are being irresponsible. If we only look at headline spending numbers, we'll miss important fiscal planning nuances. We also need to consider population growth and aging.

Graph 1
Nearly Every Province's Bottom Line Has Deteriorated
FY2025 budget balance forecasts



* After deposits into the Generations Fund ** Used Q1 in place of mid-year update, as Q1 provided the last available forecast for FY2025
Provincial budget documents and Desjardins Economic Studies

- We continued to see meaningful changes to the tax base in budget season 2024, and these remain a risk going forward. That said, contingency funds are still sizeable and offer upside potential for the bottom line.
- Alberta and New Brunswick projected particularly impressive fiscal metrics, while markets gave Ontario's plan a warmer welcome than we might have expected following increases to its deficit forecasts.
- The short-run economic outlook, the effects of potentially higher-for-longer interest rates, and the consequences of population aging remain question marks going forward.

Introduction

Many taxpayers and investors are feeling less optimistic about the future now that budget season 2024 has come to a close. Nearly every province forecasted weaker-than-previously-anticipated fiscal balances, ballooning debt loads, higher spending, and a softer outlook for government revenues amid still-uncertain economic conditions.

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.
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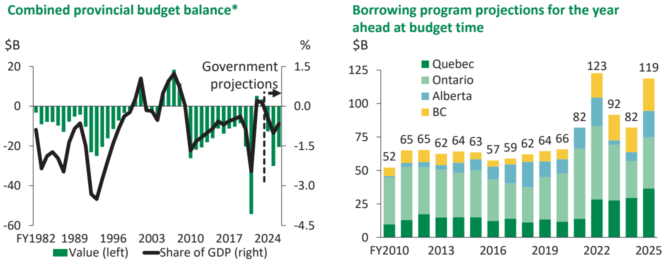
In this report, we discuss the five key themes from the fiscal year 2024–25 (FY2025) provincial budget season and what they mean for investors, policymakers and taxpayers going forward. There's no denying that many provincial governments are now grappling with more challenging fiscal outlooks. But we would argue that things aren't as bad as they seem. In fact, we still see some upside potential for provincial bottom lines.

1. Deficits Have Grown, but So Have the Economy and the Population

A great deal of media coverage has focused on the "record" deficits projected for this year. In particular, Quebec and BC are both expecting to run historic shortfalls this year. And indeed, the projected FY2025 deficit for all 10 provinces combined is more than $30 billion, which would be the largest ever recorded outside the pandemic. Ditto for borrowing requirements across the four largest provinces (graph 2). All this comes after combined provincial budget balance surpluses and lower financing forecasts in FY2022 and FY2023.

Graph 2
Deficits and Borrowing Plans Spike



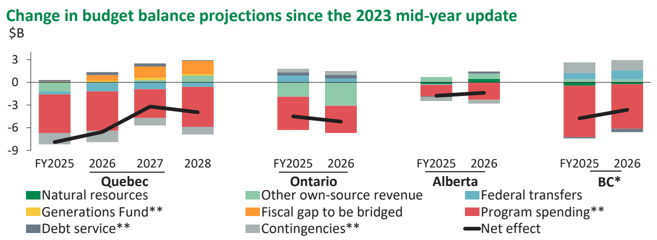
* Quebec balance is after deposits into the Generations Fund
Statistics Canada, Finance Canada, provincial budget documents and Desjardins Economic Studies

But focusing on nominal budget balances and borrowing projections gives an incomplete picture of any government's finances. Provincial economies and populations have grown over time, and (naturally) so too has the public sector. No province is expecting to run a record shortfall as a share of GDP in the coming fiscal year. Relative to output, the combined deficit—while rising—bears more similarities to the period of slow growth experienced in the early 2010s than to the 1980s, 1990s, or 2008–09 recessions. Moreover, while the provinces' combined net debt-to-GDP ratio is set to rise to just shy of 31% in the year ahead, it's lower than it was for most of the decade before the pandemic. And the upcoming year's borrowing numbers reflect strategic issuance practices as well as deficit-driven funding requirements (Alberta's program is a case in point).

2. Spending Will Increase, but That Doesn't Necessarily Mean Governments Have Been Irresponsible

Higher-than-expected spending is the main reason why projected budget balances and debt burdens deteriorated this spring (graph 3). This has led some observers to claim that governments are being reckless with taxpayer money. In addition, we've been arguing for some time that our current period of high inflation poses a risk to provincial spending, since swiftly rising prices could put upward pressure on public sector wages.

Graph 3
Spending Increases Explain Most of the Projected Fiscal Deterioration

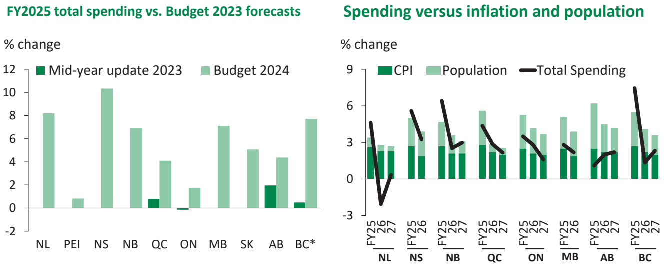


* Used Q1 in place of mid-year update , as Q1 provided the last available forecast for FY2025
** A positive impact indicates an improvement in budget balance and vice versa
Provincial budget documents and Desjardins Economic Studies

As in the case of budget balances, we'll miss some important nuances if we only look at the size of program spending overages. For one thing, public sector compensation costs drove much of the increase, and it's not like governments can simply refuse to raise their workers' wages when it's required by law. From a fiscal management perspective, then, the question should be whether the provinces adequately prepared for this risk ahead of time. We would argue that some of them did, thereby preventing their bottom lines from deteriorating even further. In particular, Ontario beefed up its Contingency Fund last fall. This helped absorb the cost of public sector wage hikes and kept it from having to increase spending as much as some other provinces. Similarly, after explicitly budgeting for further compensation increases, BC's fiscal plan noted that "Budget 2024 reallocates $7.4 billion from contingencies to permanent base funding to reflect known compensation costs for the delivery of public services."

The common refrain from many commentators these days—that governments should restrain all spending—also doesn't take population growth into account. Even though Canada is in the midst of a multi-decade demographic boom, most provinces are planning to keep total spending from growing as fast as the population plus inflation (graph 4 on page 3). In aggregate, that suggests the quality of public services could deteriorate in the years ahead. And that's not even considering the potential impacts of aging populations, which will put even more upward pressure on health care expenditures and system capacity.

Graph 4
Planned Spending Increased, but Remains Restrained



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Provincial budget documents and Desjardins Economic Studies

Granted, there are plenty of reasons to be cautious about spending at the current juncture. Three years after the pandemic and more than two years since central banks started ratcheting up borrowing costs, the economic outlook is still uncertain. Keeping some powder dry makes sense in this environment. There's still a risk of re-stimulating inflation, even though significant progress has been made on bringing price pressures to heel. And Ottawa's announcement that it will reduce the national temporary resident population—which came after this decision could be incorporated into provincial budget projections—clouds the demographic outlook for the next few years. But knee-jerk reactions to headline program spending numbers miss the bigger economic and policy picture.

A similar argument applies to planned infrastructure outlays, which were increased to record or near-record highs in nearly every province. These expenditures will add to debt levels and borrowing requirements, while generating additional economic activity that could send inflation soaring again. But we have a greater need for this kind of investment—particularly in the health and education sectors—given our growing, aging population. And more efficient transportation infrastructure has the potential to increase the economy's productive capacity over time, improving fiscal metrics and reducing inflationary risks along with it.

3. Tax Reassessments Remain a Question Mark for Revenues

We're less optimistic about the revenue side of the ledger for two reasons.

First, Desjardins Economic Studies is staying on the pessimistic end of the range of consensus forecasts. That's primarily because we think the Canadian economy has yet to feel the full impacts of the aggressive interest rate hiking campaign that began two years ago. The federal government's recently announced restrictions on temporary residents have only [reinforced this view](). [Our provincial forecasts]() largely tell the same story and as such, our latest projections are more bearish than most government estimates. To the extent that our gloomier outlook comes to pass, there is downside risk to government revenues.

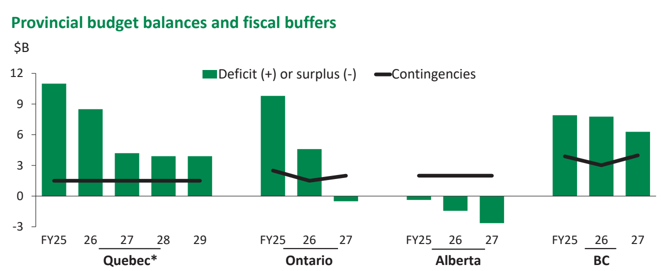
More importantly, we continued to see meaningful changes to the tax base in budget season 2024, and these remain a risk going forward. A downward revision to Saskatchewan's corporate taxes weakened that province's fiscal outlook, while Nova Scotia's revenue projections were revised upward once more. Ontario reported a mix of upward and downward tax assessments in its budget, after previously experiencing both huge windfalls that accelerated plans to return to surplus and downward adjustments that delayed those plans. While the size of tax revenue re-assessments has generally decreased as we've gotten further away from the pandemic's peak, we can't rule out additional upward or downward adjustments. In many cases, provinces don't receive full taxation information until nearly 12 months after the reference year.

4. There's Still Upside Risk to Budget Balance Projections

On a more positive note, though budget balance forecasts weakened this spring and some contingency allocations were drawn down, there's still upside risk to many provincial plans. Quebec set aside $1.5 billion for economic risks in every year of its updated blueprint, reversing the fall 2023 decision to cut its fiscal buffers. Ontario retained similar provisions of $1–2 billion per annum and allotted $1.4 billion to its Operating Contingency Fund for FY2025, while BC set aside $3–4 billion per year in funds from FY2025 through FY2027. Alberta increased its annual contingencies to $2 billion (graph 5). These amounts are available to cover unexpected shortfalls or improve the bottom line if they prove unnecessary.

Prudent commodity price projections also offer potential for better-than-expected budget projections this year and in the years to come. Alberta assumed a WTI price and WCS-WTI differential below the private-sector forecast average and well below Desjardins Economic Studies' projections. That's particularly wise at this stage given that oil and gas royalties are expected to make up an unusually large share of provincial revenues and the province's public finances are historically

Graph 5
Contingencies Remain Generous



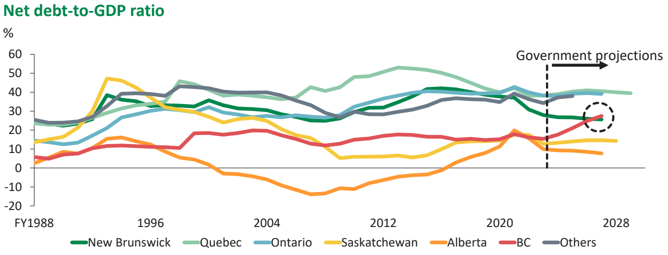
* Budget balance after deposits into the Generations Fund
Provincial budget documents and Desjardins Economic Studies

sensitive to crude values. Saskatchewan and Newfoundland and Labrador are less vulnerable in this respect (and therefore subject to less potential upside) but should still be given credit for conservative oil price projections. BC was similarly cautious with its natural gas price assumptions.

5. Alberta and New Brunswick Were Outperformers

We highlight two principal fiscal outperformers this year. One was Alberta. Although the province's surplus forecasts were reduced, it looks likely to stay firmly in the black for the next few years given the upside potential from conservative oil price projections and larger contingencies. We also like the focus on increasing deposits into the Heritage Fund over time to support intergenerational equity and fiscal sustainability, though we'll have to wait until later this year for implementation details. The other fiscal outperformer was New Brunswick, which also plans to stay in the black for the foreseeable future. Maybe more impressively, after multiple years of debt reduction and spending control, it's on track to rank third among the provinces in a few years with respect to the key net debt-to-GDP ratio (graph 6). That would be the first time it has ever ranked so high.

Graph 6
Debt Burden Rankings Change



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Markets gave Ontario's plan a warmer welcome than we might have expected following increases to the province's deficit forecasts. Timing helped: eight provincial governments released budgets before Ontario, so their balances were deteriorating while that of the largest province remained unchanged for several weeks. That contributed to those other regions' bond spreads widening versus the provincial benchmark since the start of budget season. Ontario's spreads also didn't move much following the release of its fiscal blueprint. That's in part because earlier this year the province conducted strategic pre-borrowing that's expected to help prevent it from significantly increasing its debt issuance despite a larger-than-anticipated deficit.

Final Thoughts

Headlines have—to some extent understandably—focused on the bigger deficits and higher debt burdens forecast in budget season 2024. But we hold a less pessimistic view of Canada's provinces' finances. Fiscal shortfalls, debt loads, and borrowing plans aren't anywhere near record levels when we consider the size of each province's economy and population. We could also make the argument that expenditure increases are a natural consequence of the fastest headcount gains in generations, and some provinces have effectively mitigated the effects of new spending pressures. Fiscal buffers remain significant.

Much is still uncertain, including short-run economic outlooks, the effects of potentially higher-for-longer interest rates, and the consequences of population aging. All of these factors are making things more challenging for Canada's provincial governments and should continue to do so going forward. But against that backdrop, this year's budgets could certainly have looked a lot worse.