Scotiabank

GLOBAL ECONOMICS

FISCAL PULSE

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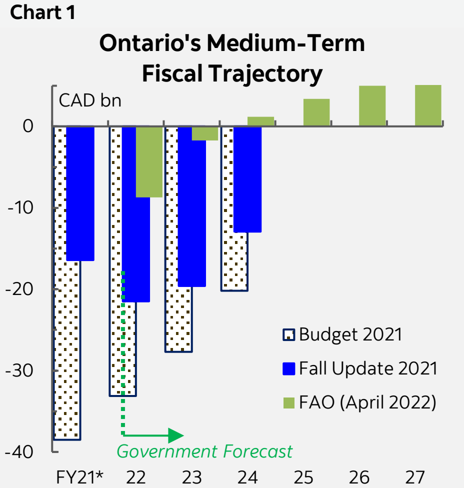
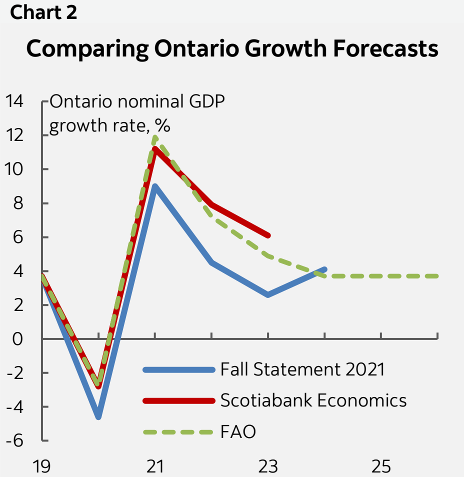
Chart 1



* Fall Update figure is final result.
Sources: Scotiabank Economics, Ontario Finance.

Chart 2



Sources: Scotiabank Economics, FAO, Ontario Finance.

Ontario: 2022–23 Budget Primer

SUMMARY

- **With Ontario's Progressive Conservative government set to table a budget on Thursday—likely just before launching the election campaign—we anticipate further improvements in the fiscal trajectory.**
- **Deficit and debt projections have been revised lower multiple times since the province's 2021 plan that projected record fiscal shortfalls and a return to balance only by the end of this decade.**
- **By our tally, a significantly improved revenue outlook and moderate spending increases would put Ontario on track to improve its bottom-line by more than $13 bn in FY23 versus the fall update, and attain surplus by FY24.**
- **Yet, we can reasonably expect continued conservative fiscal practices and more spending in a pre-election fiscal plan that absorb some of this newfound headroom.**

SUCCESSIVE FINANCIAL IMPROVEMENTS

With a highly uncertain outlook in the midst of the COVID-19 pandemic, Ontario's Budget 2021 pencilled in a series of deep deficits through FY24. Conservative forecasting and contingencies set up baseline budget balance projections of -$33.1 bn (-3.7% of nominal GDP) in FY22, -$27.7 bn (-2.9%) in FY23, and -$20.2 bn (-2%) in FY24. Excluding COVID-19 spending—which was set to wind down completely by FY24—program spending was expected to grow by 5.4% in FY22 and by 2.1% in FY23, before slowing down to growth of less than 1% in FY24.

The province then projected a $27 bn FY22–24 improvement versus Budget 2021 in the Fall Economic Statement (FES); the fiscal outlook has since continued to strengthen. In February 2022, the province's third-quarter finance update slashed the FY22 deficit forecast from -$21.5 bn (-2.3% of nominal GDP) to -$12.1 bn (-1.4%). More recently, the Financial Accountability Office of Ontario (FAO) highlighted a tight path back to balance by FY24 in their latest forecast, which assumed no increases to spending relative to the FES. The FAO report expected the province's strong nominal GDP growth—it assumed 7.2% gains in 2022 and a further 4.9% rise in 2023—would shrink deficits to -$8.7 bn (-0.9% of nominal GDP) in FY22, before reaching a surplus of +$1.2 bn (+0.1%) in FY24 (chart 1).

With Ontario's Progressive Conservative government expected to table a budget on Thursday, April 28, we expect to see further improvements to the previously published fiscal path, though new spending will likely reduce the bottom-line impact.

ECONOMY HAS MOMENTUM

Ontario will release its FY23 fiscal plan with considerable economic momentum. Q4-2021 growth exceeded 6% (q/q annualized)—in line with the national average—with advances across components that brought provincial output back to pre-pandemic levels. By March 2022, the province had also recouped job losses incurred during the pandemic's omicron wave, and employment, unemployment, and labour force participation rates were all near or better than pre-pandemic levels.

Though subject to the same growth-slowing forces as the rest of the country, we see a steady real expansion in the range of 4% for Ontario again this year. Car production—Ontario's primary export industry—plunged to an all-time low in 2021 (see our analysis **here**) but is set to advance by more than 20% this year per Wards Automotive. We also suspect that Ontario's acute housing supply shortfall will provide an offset to rate hike- and affordability-induced downward pressure on home prices.

That solid real growth backdrop—along with inflationary pressures pushing growth in nominal terms even higher—should underpin by extension stronger revenue forecasts than anticipated in FY23 as of the October 2021 Fall Economic Statement. Scotiabank's nominal GDP growth forecasts for Ontario for 2022 (7.9%) and 2023 (6.1%) are both over 3.4 ppts higher than the fall update and close to 1 ppt higher than even the buoyant FAO assumptions (chart 2, p.1). Budget 2021 linked every 1 ppt in nominal GDP growth with $1.1 bn in tax revenues. That rate would add over $3.7 bn in tax revenue on top of the fall update baseline for both FY23 and FY24 assuming that our economic projections come to fruition. However, this would likely be an upper-bound estimate considering Ontario's typical practice of including fiscal plan contingencies.

ECONOMIC GROWTH MEANS UPSIDE FOR PUBLIC FINANCES

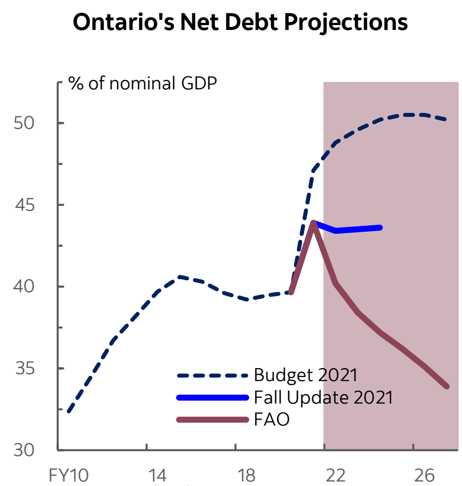
We estimate that without major additional policy measures, Ontario could improve its FY23 bottom-line by over $13 bn versus the fall update (table 1, p3)**.** For the current fiscal year, our calculation—which incorporates our updated nominal growth forecast, a series of assumptions about spending, and the impact of some announced policy measures—suggests that the deficit would narrow to roughly $6 bn this fiscal year, before reaching a small surplus in FY24. The assumptions are detailed below.

Tax relief measures aimed at helping with rising cost of living will partially offset the revenue gains stemming from stronger nominal growth. Like most of its peers, Ontario has announced measures to assist with rising cost of living. These include the elimination of licence-plate renewal fees and the Tax Relief at the Pumps Act; we estimate the fiscal impact of these measures to be in the order of $3 bn in FY23 and $1 bn per year thereafter.

Program spending is likely to increase in key areas to improve housing affordability and serve the province's aging population. We assume that health sector spending will grow at an average of 2.4% per year during FY23–24, in line with the average increase announced across other provinces in their FY23 budgets. The federal-provincial agreement for the child care program is expected to add an average of $2.6 bn per year in spending from FY23 to FY27, while boosting transfer revenues by the same amount. With details of other potential policy measures yet to be announced, these new spending programs could add an additional $3–4 bn per year in FY23 and FY24.

The anticipated bottom-line improvement associated with the revenue and expenditure assumptions outlined above would help reduce the province's debt burden. We expect the province's net debt-to-GDP ratio to be on a lower trajectory than projected in the fall update (chart 3), with the caveat that additional infrastructure spending such as hospital development could slow down the debt-reduction effort.

Chart 3



Sources: Scotiabank Economics, Ontario Finance.

ADDITIONAL CONSIDERATIONS

Thus far, we have only incorporated new policy measures announced since the FES and made minor adjustments to base health care spending projections; given that this is a pre-election budget, there is clear potential for additional spending and tax initiatives. We have seen pressures in other provinces related to priorities such as health and long-term care and housing affordability drive increases in the magnitude of 5–12% in FY23 and FY24 versus the fall updates. It is reasonable to assume Ontario is facing similar spending pressures, which could further absorb anticipated revenue gains and delay the timeline to balance.

Recent commentary on inflation has largely concentrated on the impact to revenues, but we also see upside potential on the expenditure side if price pressures persist. Broadly speaking, government fiscal models anchor long-run projections for many spending categories to the rate of population growth plus the rate of inflation; accordingly, price appreciation puts pressure on nominal public sector spending levels and the province's per capita spending is already relatively low compared to most peers. The prospect of a wage response to cost of living also raises the possibility of a higher public sector wage bill. Scotiabank Economics' modelling **suggests** that all-industry Canadian total compensation per hour worked will accelerate to around 6% in 2023 following the opening of a wage gap with inflation and productivity this year. Such a rise would be well above historical norms, though actual wage increases will depend on the timing and outcomes of future negotiations.

In the near term, sovereign bond market movements continue to be driven by global developments exogenous to jurisdictional policy decisions. Elevated uncertainty—most recently related to the Russia-Ukraine conflict and now aggressive rate tightening cycles—has pushed up risk-sensitive spreads in a synchronized fashion including in provincial sovereign bond markets largely irrespective of fundamentals. These pressures are likely to persist, but expected improvements in Ontario's fiscal trajectory would put the province in good stead to weather volatility and—directionally at least—support a tightening of spreads over time.

Table 1: Budget Balance Projections Based on Announced Policy Measures and Updated Nominal Growth Assumptions

	3rd Quarter Finances	Scotiabank Economics			FAO		
	FY22	**FY22**	**FY23**	**FY24**	**FY22**	**FY23**	**FY24**
Total Program Expense	175.8	176.7	178.5	179.7	172.6	171.8	177.0
Temporary COVID-19 Funds		11.2	2.5	0.1	12.9	2.5	0.1
New Policy Measures			3.0	4.0			
Child Care			2.6	2.6			
Other			0.4	1.4			
Interest Expense	13.0	12.3	12.3	12.5	12.3	12.3	12.5
Total Revenue	176.7	175.5	184.4	196.2	176.2	182.4	190.7
Taxation Revenue	124.4	124.4	131.9	140.1	125.8	129.1	135.0
Federal Transfers	29.4	29.4	27.7	28.7	29.4	30.2	31.4
Child care program transfer			2.6	2.6			
One-time CHT transfer			0.8	0.0			
Income from Government Business Enterprises (GBE)	5.6	5.6	6.5	7.8	5.6	5.9	6.2
Eliminated licence-plate renewal fees, and refund any such fees paid since March, 2020		-1.2	-2.4	-1.2			
Tax Relief at the Pumps, effective July 1 until December 31, 2022			-0.6				
Permanently removing tolls on Highways 412 and 418			-0.01	-0.01			
Other Non-Tax Revenue	17.3	17.3	17.8	18.2	15.5	17.2	18.1
Balance	**-12.1**	**-13.5**	**-6.5**	**4.0**	**-8.7**	**-1.7**	**1.2**
Nominal GDP Growth (%)	11.9	11.2	7.9	6.1	11.9	7.2	4.9