Historic Downturn, Historic Budget Pressures

ASSESSING THE PROVINCES' FINANCES DURING AND AFTER COVID-19

- **Depressed economic outlooks and new spending measures to mitigate the economic fallout from COVID-19 will throw all of Canada's provinces into deficit in fiscal year 2020–21 (FY21)** (chart 1).
- **Only Saskatchewan and Nova Scotia are likely to avoid record deficits in FY21; those Provinces plus Newfoundland and Labrador should be the only ones not to carry all-time high net debt burdens.**
- **We estimate that the Provinces' FY21 borrowing requirements will shift at least $64 bn higher than previously budgeted.**
- **Further fiscal supports anticipated in the coming months and lingering economic impacts should add to the Provinces' budget deficits, debt loads, and financing needs.**
- **Deficit spending is significant but necessary in the current crisis, and markets are generally tolerating the new cost pressures, supported by intervention by the Bank of Canada.**

PROVINCES OUTLINE ADDITIONAL FISCAL SUPPORT

Provincial policy supports to mitigate COVID-19's economic fallout now total about $62 bn and account for 3.1% of 2019 Canadian nominal GDP (chart 2). Quebec and Alberta continue to offer the most financial assistance.

Jurisdictions further along with respect to curve flattening and lockdown lightening have unveiled new infrastructure spending plans to bolster their recoveries from the COVID-19 downturn. Saskatchewan announced a $2 bn increase to its capital plan over the next two years—nearly 70% of which will fund large infrastructure projects. We include the full $2 bn in our chart 2 tally; that moves Saskatchewan to fourth position from 10th place as of our last note. Manitoba also made public a $500 mn top-up to existing capital expenditure plans. We still suspect that other provinces will boost infrastructure spending as containment measures ease.

RECORD DEFICITS, DEBT LEVELS ACROSS MOST OF THE COUNTRY

We incorporate our own real and nominal GDP projections, tallies of costed measures announced to date, and fiscal sensitivities published by the Provinces in our estimates of FY21 deficits and debt levels. Our outlook still incorporates record employment and output declines for all provinces in 2020. Newfoundland and Labrador was the only province yet to provide an FY21 net debt projection; as such, we added its last FY21 deficit forecast to its latest FY20 net debt level.

The distinction between fiscal and non-budgetary measures is important for provincial budget balances and debt levels. Tax cuts, transfers, and new spending—more prevalent in response to the Global Financial Crisis (GFC)—have

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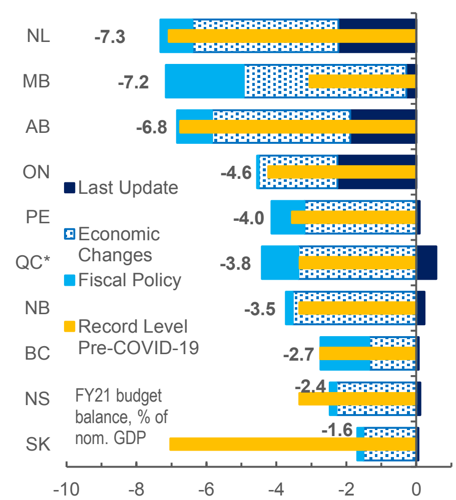
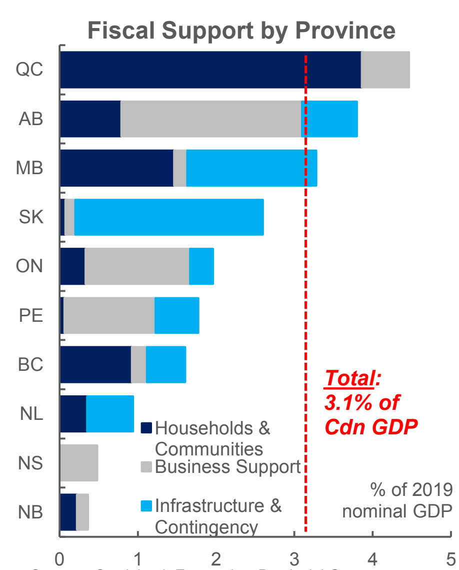
Chart 1



* Pre-*Generations Fund* Deposits. Sources: Scotiabank Economics, Provincial Governments.

Chart 2



Sources: Scotiabank Economics, Provincial Governments.

a direct, persistent impact on balances and debt loads. On the other hand, tax and fee deferrals and loan support intended to boost liquidity, which thus far account for the bulk of 2020 supports—have only a temporary fiscal cost as the government is eventually repaid (borrowing requirements shift higher in the interim). We follow the split outlined in the IMF's April 2020 *Fiscal Monitor* when considering provincial tax and spending plans.

Most Provinces provide fiscal sensitivity figures in their budget documents, which we employ in our calculations. BC's 2020 budget, for instance, associated every 1 percentage point change in nominal GDP with $150–250 mn in total revenues (we use $200 mn—the range midpoint). Alberta links every 1 USD/bbl in the WTI price with a net balance change of $350 mn. While those sensitivities can vary depending on the source of economic gains or losses, government figures nevertheless provide a sense of the magnitude of the fiscal hit from weaker output gains and commodity pricing. Where sensitivity figures were not available, we rescaled Ontario's latest estimates and applied them to the province in question.

On the basis of this approach, we estimate that only Saskatchewan and Nova Scotia will avoid record deficits (as a share of nominal GDP) this fiscal year. For BC and Alberta, the shortfalls forecast for FY21 are the largest since at least FY87—the first year for which data are available—but are within 0.1 ppts of the previous highs. Nova Scotia should miss its previous deficit record of 3.3% of GDP set in FY2000, which followed a period of soft economic growth and significant accounting changes. Although Alberta and Saskatchewan are set to witness some of their worst-ever economic conditions this year, their deficits compare somewhat favourably to those that followed two deep recessions in the 1980s. See table 2 on p.4 for updated FY21 budget balances and debt level forecasts.

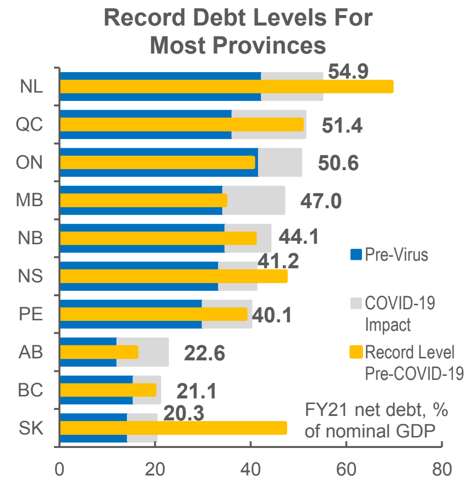
Provincial debt levels are projected to balloon as well. Similar to the Provinces listed above, Newfoundland and Labrador's 55% net debt-to-GDP ratio (chart 3) is expected to fall short of the whopping 69.5% attained in FY99. However, future debt loads will depend on the accounting treatment of obligations related to the Muskrat Falls hydroelectricity project. More details of the government's electricity rate mitigation plans had been expected in this year`s budget.

Of note with respect these calculations is the shift in interest rates over the last two decades. Most of the previous debt and deficit records occurred in the 1980s and 1990s, when borrowing costs exceeded 10% and the servicing of debt eroded a larger share of provincial spending room. With rates now near zero, the deficit spending estimated for FY21 is far more oriented towards operating balances, and arguably even more significant than implied by headline ratios.

FINANCING NEEDS ALSO SHIFT HIGHER

Greater financing needs are the obvious implication of higher deficits and debt loads. In this note, we consider only the borrowing requirements associated with wider deficits, adding the fiscal impacts associated with weaker economic conditions and fiscal measures announced to date to the pre-COVID-19 requirements. This approach assumes no changes to existing pre-financing plans or to debt maturities/redemptions. It also implies no use of sinking funds (e.g. Quebec's *Generations Fund*) or contingencies (e.g. Manitoba's *Fiscal Stabilization Fund*, BC's contingency account) to redress new debt or borrowings.

Chart 3



Sources: Scotiabank Economics, Provincial Governments.

Table 1

Provincial Borrowing Requirements

$ millions

	Latest Proj.	New Req.'s
NL	--*	1,370
PEI	--*	270
Nova Scotia	1,522	1,030
New Brunswick	--*	1,280
Quebec	13,908	18,180
Ontario	39,500	14,980
Manitoba	5,650	4,590
Saskatchewan	--*	1,220
Alberta	15,791	13,450
BC	6,899	7,480
Total	**83,270**	**63,850**

* Not available. Sources: Scotiabank Economics, Budget Documents.

We estimate that COVID-19-induced economic deterioration and spending plans could add roughly $64 bn to provincial borrowing requirements in FY21. In several cases, that results in a doubling of pre-virus requirement projections. The largest increases over the latest fiscal plans are expected to come in Quebec ($18 bn), Ontario ($15 bn), and Alberta ($13 bn) (table 1, p.2). With the exception of PEI, all provinces would require at least $1 bn in additional borrowing in FY21.

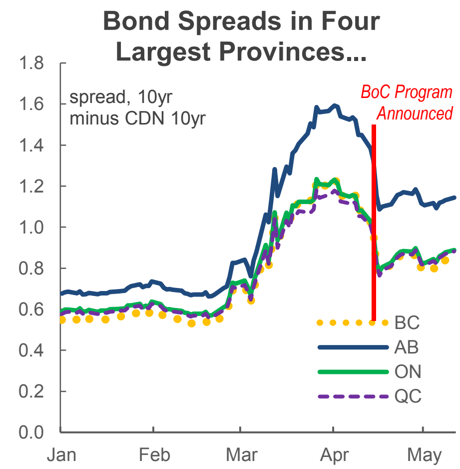
Infrastructure and other fiscal stimulus anticipated in the coming months could push provincial borrowing requirements even higher, though there will likely be opportunities to share costs with the federal government. We are also encouraged by the Bank of Canada's $50 bn provincial bond-buying program, which should help provide additional liquidity, especially for provinces constrained by weaker fiscal positions and borrowing costs.

FINAL THOUGHTS

Although we limit our analysis to FY21, the Provinces' fiscal histories make abundantly clear that COVID-19's financial pressures will also weigh on future fiscal years. The 2008–09 recession had ended by 2010 in Quebec and Ontario, but lingering impacts in some sectors and the need to gradually wean others off of stimulus measures kept the first province from returning to surplus until FY15; the latter is still carrying a deficit. Other jurisdictions that quickly returned to balance—such as Nova Scotia and Newfoundland and Labrador in the early 2000s—continued to carry elevated debt loads in ensuing years.

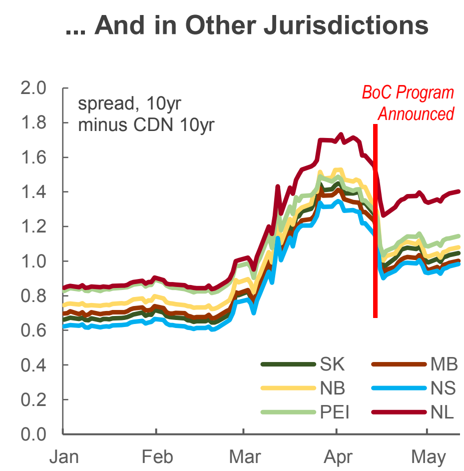
The COVID-19 downturn is in some ways fundamentally different than past recessions, but it is nonetheless likely to result in long-lasting economic and fiscal impacts. Our base case forecast assumes a return to growth at the national level in Q3-2020—a relatively short-lived contraction. However, we do not anticipate that real Canadian GDP will reach its pre-virus, Q4-2019 peak until early 2022—with a similar path for most provinces. That reflects our expectation that households will remain cautious with respect to spending even as lockdowns are unwound, which presents a challenging outlook for consumer-reliant sectors such as tourism and retail. With the oil and gas industries also facing unprecedented pressures, this highlights the potential for long-run economic effects and a likely need for further fiscal supports.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

As significant as financial pressures are, our view remains that fiscal support is necessary in the current environment. With assistance from the Bank of Canada, markets are thus far are tolerating—with some volatility—the increased burdens on provincial finances expected in the coming months, as suggested by compressions in provincial bond spreads since the onset of the crisis (charts 4 and 5). More support for the economic recovery will be needed in the near-term, but the expected shift to infrastructure outlays should make federal funding available and minimize fiscal costs. As we learned during and after the GFC, the key challenge beyond this year will be timing of the removal of stimulus with the rebound in economic activity. That will be crucial for credible consolidation plans in the aftermath of COVID-19, and to ensure fiscal sustainability over the longer-run.

Table 2

The Provinces' Updated Fiscal Positions

CAD millions unless otherwise stated

	NL	PE	NS	NB	QC*	ON	MB	SK	AB	BC
Budget Balances										
Pre-Virus Estimate	-776	7	55	92	2,729	-20,510	-220	49	-6,810	227
% of GDP	*-2.2*	*0.1*	*0.1*	*0.2*	*0.6*	*-2.3*	*-0.3*	*0.1*	*-1.9*	*0.1*
Current Projection	**-2,150**	**-260**	**-970**	**-1,190**	**-15,450**	**-35,490**	**-4,810**	**-1,170**	**-20,260**	**-7,250**
% of GDP	***-7.3***	***-4.0***	***-2.4***	***-3.5***	***-3.8***	***-4.6***	***-7.2***	***-1.6***	***-6.8***	***-2.7***
Net Debt										
Pre-Virus Estimate	14,726	2,280	15,716	13,681	172,625	379,175	26,450	12,359	43,600	49,202
% of GDP	*42.3*	*29.9*	*33.3*	*34.7*	*36.1*	*41.7*	*34.2*	*14.3*	*12.1*	*15.5*
Current Projection	**16,100**	**2,630**	**16,970**	**15,010**	**206,470**	**394,160**	**31,520**	**14,570**	**67,020**	**57,180**
% of GDP	***54.9***	***40.1***	***41.2***	***44.1***	***51.4***	***50.6***	***47.0***	***20.3***	***22.6***	***21.1***

* Balance before *Generations Fund* deposits. Sources: Scotiabank Economics, Budget Documents.