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Quick Hit — City of Toronto budget strikes good balance

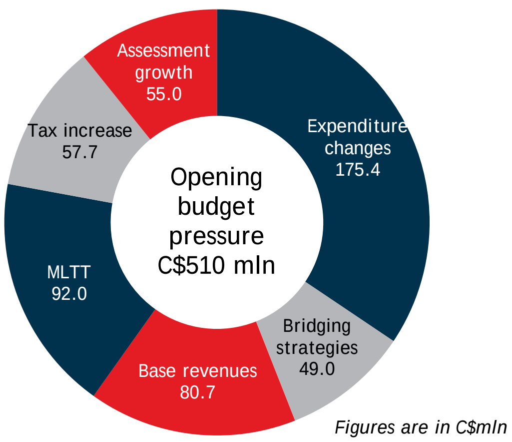
Canadian budget commentary typically focuses on the federal and provincial levels of government, but municipal finances shouldn't be overlooked. Take the City of Toronto, for instance, where Council voted Monday evening to approve the 2018 budget. At $11.089 billion, Toronto's budget is larger than each of the four Atlantic provinces (and budget documentation is at least as thorough). Mayor John Tory termed the balance between new spending commitments and a modest property tax hike as "just right". Whether you endorse this sanguine assessment or not, one thing is certain: as it is every year, the operating budget is balanced. It's required by law after all, something that bondholders should never lose sight of. Some budget highlights for you:

- Toronto's $11.089 billion in gross expenditures represents an increase of 3.6% vs 2017 levels. Many programs were limited to a base spending target of just 0.5% growth, but pressures emerged in certain areas (e.g., increased shelter demands). Roughly 80% of Toronto's budget is directed to five key program areas (policing, transit, fire, parks & rec, community housing) and debt service.
- Balance was achieved after addressing an "opening budget pressure" of $510 million (Chart 1). Savings/efficiencies were identified on the spending side and there were some one-time bridging strategies (deferrals, draws on reserves). On the revenue side, uploading services to the province, a hotel/lodging tax and user fee inflation helped, but the heavy lifting was done by a property tax increase, assessment growth and the City's land transfer tax. More on this in a moment. The budget committee still has work to do in the years ahead; before accounting for new/enhanced services, there's a net budget pressure of $301 million for 2019 and $216 million for 2020.
- The City gets 62% of its revenue from non-property tax sources. Ontario's contribution may account for the biggest chunk here, at 20%, but investment income (including a Toronto Hydro dividend) and the municipal land transfer tax (MLTT) are key drivers at the margin. The MLTT is really a special case; while Ontario has its own land transfer tax, no other municipality in Ontario has been granted the authority to tax real estate transactions. At $818 million, Toronto's MLTT revenue has shot 14% higher vs the prior year's budget. The City doesn't hide its increased dependence on the MLTT, acknowledging that it "has played a critical role in the City Council's ability to maintain below or at inflation-level property tax rate increases." Relying on the MLTT in the face of an "uncertain housing market" is a potential risk. But if, like us, you see Toronto housing supported by a robust labour market and demand for housing, the City's reliance on the MLTT is less risky than meets the eye.
- For 2018, there's an inflationary residential property tax increase of 2.1%. Additionally, there's a special levy, approved last year, of 0.5% per year (growing to 2.5% by 2021) for the City Building Fund, dedicated to funding transit and social housing. Add in changes in assessed value, etc. and the average Torontonian will see their property tax bill increase $82—a manageable increase for a City with exceptional job creation and income growth where the average homeowner has enjoyed a positive wealth effect. Having held the line on property tax increases in recent years, there's room to make up any potential slack in MLTT should it arise.
- The 10-year capital plan is pegged at ~$26 billion. Debt re-alignment and additional gas tax revenue means no incremental debt issuance vis-a-vis earlier estimates. One third of 2018's capital plan is set to be debt financed (Chart 2), held down by a variety of non-debt capital financing strategies. The budget authorizes $900 million in debenture debt, unchanged from 2017. (Last year's issuance was distributed across the 10-, 20- and 30-year sectors, tapping into healthy investor demand at home and abroad.) Debt service will account for 13.5% of property taxes in 2018. A City policy requires this ratio to be no more than 15% over a ten year period. The current plan sees debt servicing pushing right up against this limit, prompting an acknowledgement that Toronto may need to "consider the debt service ratio limit as part of its debt policy to ensure continued support for capital investment needs…" So no change for now, but fair to say capital pressures are building, both to address a state of good repair backlog and to get in front of the infrastructure needs a vibrant, growing, world-class city requires.

The punch line: Toronto, like many large, growing cities, faces underlying budget pressures. But the City must and has approved a balanced operating budget. A reliance on the MLTT creates a risk if housing activity sours, but we remain constructive on the housing market outlook and see scope to offset prospective MLTT weakness via property tax rate increases. Capital spending pressures are evident, but at $900 million, the City's bond program for 2018 is imminently manageable. We tend to view municipal debentures as some of the safest debt in Canada, with safeguards aplenty and a growing stable of investors bolstering liquidity of late.

Chart 1: Closing Toronto's budget pressures

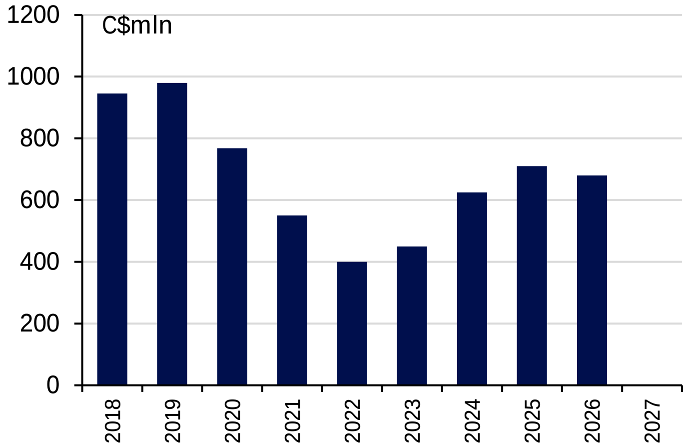
Strategies to close 2018's "opening budget pressure"



Source: NBF, City of Toronto

Chart 2: Toronto's debt financing outlook

Projected debt issuance to cover capital plan: 2018-2027



Source: NBF, City of Toronto

Fixed Income Trading Desk Strategy

Public Sector Strategy
Warren Lovely
+1 416-869-8598 | Warren.Lovely@nbc.ca

Catherine Maltais
+1 514-879-8598 | Catherine.Maltais@nbc.ca

Taylor Schleich
+1 416-869-6480 | Taylor.Schleich@nbc.ca

Corporate Credit
Connor Sedgewick
+1 514-879-3182 | Connor.Sedgewick@nbc.ca

Pete Metzger
+1 416-869-8607 | Pete.Metzger@nbc.ca

Relative Value Models
Drew Lloyd
+44 (0)20-7488-9379 | Drew.Lloyd@nbc.ca

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