April 11, 2017

Manitoba starts multi-year fiscal recovery journey

Highlights

- As per the previously released Q3 update, the 2016-17 deficit is estimated at $872 million (1.3% of GDP). That's $39 million better than the original budget plan. The deficit for the coming fiscal year, 2017-18, is budgeted at $840 million (1.2% of GDP), a level deemed unsustainable. The medium-term fiscal plan puts the 2018-19 deficit at $698 million, followed by a $549 million shortfall in 2019-20. For each of the coming three fiscal years, the budget balance incorporates a $115 million in-year adjustment/lapse, which could take the form of extra revenue and/or reduced spending.
- In general, the province sees revenue growing at a ~3% average annual clip over the coming three years, while spending growth is held closer to 2% per year (on average). As it did in 2016-17, the government seeks to dispense with fiscal slippage by hitting or exceeded the fiscal targets set down in today's fiscal plan.
- A formal date for deficit elimination has not been set, although the budget reiterated the government's intention to return to balance over two political terms (i.e., by 2024). New legislation before the provincial legislature would require annual progress on the deficit. A portion of minister salaries are to be withheld each year of deficit, to be returned if progress on the shortfall is achieved. Once the deficit is eliminated, the *Act* would shift the government's focus to debt reduction. The new law would likewise require the government to hold a referendum prior to implementing a major tax increase.
- There were no new taxes or tax increases, although some "boutique" tax credits are being eliminated. Most notable on that front is a tuition fee income tax rebate, which will be fully phased out by 2018. Overall, new tax measures raise $77 million in 2017-18. At the same time, the budget committed to a number of ongoing tax relief measures, including indexation of personal income tax brackets and the extension of certain tax credits aimed at spurring business activity.
- Federal transfers account for over 25% of total revenue, but Manitoba views the current federal health care funding proposal as inadequate. At this point, Manitoba is the sole holdout on health care, with all other provinces having struck bilateral funding deals with Ottawa.
- While the budget included base funding increases for health and education, along with additional assistance for refugees, public sector wage restraint is meant to play an important role in controlling overall spending growth.
- Debt continues to accumulate. Net debt is set to rise $1.66 billion in 2017-18, reaching $24.77 billion or 35.7% of GDP. The budget does not contain longer-term debt projections. The province's debt burden has grown quickly in recent years, contributing to downward pressure on the province's credit rating. Reining in the debt burden will therefore be key in any effort to ultimately restore credit ratings. While the interest bite is still quite manageable, debt servicing costs are likewise growing rapidly, easily outstripping increase in program spending.
- The gross borrowing requirement for 2017-18 is set at $6.7 billion, with half of that tied to Manitoba Hydro (the provincial utility focused on major hydro generation/transmission projects). In gross and net terms, Manitoba's borrowing program is relatively large by provincial standards, but the province has succeeded in diversifying its sources of funding. Expect that strategy to continue. And $1.1 billion of this year's requirement has already been met, leaving $5.6 billion to go.
- Domestically, a focus on benchmark tenors seeks to bolster liquidity in the name, while international markets could be used to divert a non-trivial share of supply away from the C$ market. Last year, international issuance accounted for roughly one third of the province's total borrowings, and Manitoba will continue to look for opportunities in foreign currencies to the extent market conditions are favourable and pricing is competitive vis-à-vis domestic indications.
- There's something of an improvement in the economic outlook. Real GDP growth is set to pick up, from 1.4% in 2016 to an even 2% in both 2017 and 2018. Nominal growth is slated for a 3.6% advance this year, followed by a 3.8% gain the year after. Although economic momentum has been building, a number of uncertainties litter the outlook (including BREXIT adjustments and prospective tax changes south of the border). As is often noted, the diversity of the Manitoba economy typically means less volatility in economic growth relative to many provincial peers.

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"Responsible recovery" underway

Almost a year ago, Manitoba's Progressive Conservative Party secured a majority mandate in a provincial election. A placeholder budget in May 2016 set out the fiscal challenge to be overcome and took some initial steps towards repair. This year's budget continues the course correction, laying out a sustainable medium term plan for fiscal consolidation that eschews deep spending cuts and/or broad based tax hikes. Whether in health care or education, the government aims to wear the mantle of "most improved" province. By avoiding the "stark decisions" some other provinces have taken, returning to balance will take time. Still, there's been some initial progress, alongside new legislation requiring annual reductions in the deficit and a reiterated pledge to balance the books within two political terms (i.e., by 2024). Growth in net debt has been rapid of late, but there's a smaller increase in the debt burden flagged for 2017-18. Borrowing to fund capital investments (most notably at Manitoba Hydro) means a still-sizeable $6.7 bond requirement for the year ahead, of which a bit more than $1 billion has already been completed.

Putting an end to fiscal slippage

Manitoba aims to put an earlier era of fiscal misses behind it. Indeed, as per a third quarter update (released in the lead up to the budget), the province estimates 2016-17's deficit at $872 million (1.3% of GDP). That marks a $39 million improvement over the original plan. The smaller-than-planned deficit was driven by extra income taxes and additional fees/other revenue, which more than offset above-plan debt servicing costs. For the first time in a nearly a decade and a half, expenditure budget targets were seen being met.

Recall that early in its mandate, the government took some initial steps towards fiscal repair, including cabinet reductions, a reduced senior management headcount and a voluntary pay freeze for MLAs. Meantime, the government undertook extensive reviews, sought expert opinion and consulted widely, all with a view to getting a handle on inherited fiscal pressure points and establishing an optimal/balanced path with which to move forward. A number of challenges/deficiencies were identified, be it regional health authority deficits, large commitments for rural road development, a depleted fiscal stabilization fund, lengthy commitments on leases and wage settlements (which reduced flexibility), etc. In general, the prior administration was seen as having a "chronic spending problem", rather than facing legitimate revenue pressures.

The path forward

While the road ahead is deemed challenging, Budget 2017 sets out a multi-year plan, calling for steady and sustainable reductions in the deficit. For the current 2017-18 fiscal year, Manitoba projects a summary deficit of $840 million (1.2% of GDP). The core government shortfall is $779 million—a level still deemed "not sustainable". The budget sees the deficit getting down to $698 million in 2018-19 and to $549 million by 2019-20. In general, revenue is assumed to grow at a ~3% average annual pace over the coming three years, consistent with an economy likely to spit out steady gains in nominal GDP. Meanwhile, expenditure controls aim to place summary spending on a tamer trajectory, averaging 2.4%/year over that same three-year period. (The average annual increase in core government outlays is closer to 2%.) For each of the coming three fiscal years, the fiscal plan incorporates a $115 million in-year adjustment/lapse, which "could be an increase in revenue and/or decrease in expenditures".

While longer-term figures are not spelled out, the government reaffirmed its pledge to have the books balanced by roughly 2024. As with the prior fiscal year, the expectation is that future-year targets are fully met if not exceeded.

Legislation to force deficit reduction

New legislative requirements aim to ensure steady fiscal progress. Specifically, *The Fiscal Responsibility and Taxpayer Protection Act*, which received its first reading about a month ago, sets a new "base line" off which annual progress on the deficit must be made. The starting point is 2017-18's adjusted or "base line" deficit of $924 million. In case you're wondering, you get to that figure by excluding Manitoba Hydro net income and by controlling for transfers into/out of the Fiscal Stabilization Account (FSA). On that score, note that the province aims to rebuild its stabilization fund. The budget commits $10 million to the FSA this fiscal year, leaving the balance at $125 million (about 1% of core government revenue). Larger, $50 million deposits are planned for each of the two subsequent years, better insulating core government operations from unforeseen pressures down the road.

In addition to the requirement that the deficit must be less than the year before, the new *Act* sets out that once eliminated, a deficit cannot be again incurred. The legislation likewise stipulates that once back in balance, objectives must be set down for reducing government debt. There's some leeway here, in the event of natural disasters, acts of war or for unanticipated revenue losses linked to decisions taken by other governments.

By way of financial incentive, the legislation sees ministers forgo 20% of their salary each year a deficit is projected, with that salary returned to them as progress towards deficit reduction is made. The *Act* also restores a requirement that certain tax increases be put to the electorate in the form of a referendum. That applies to health/education taxes, income taxes and the sales tax.

Some colour on revenue/spending

As noted up front, Manitoba has opted against new taxes or tax increases. Saying that, the government axed certain "boutique" tax credits that had either proved ineffective or had limited take up. While bringing in some additional revenue, these changes seek to reduce the complexity and related compliance costs within the tax system. Of note, and as expected, a tuition fee income tax rebate is being phased out starting this year (with full elimination for the 2018 tax year). A related tuition income tax rebate advance is also being canceled.

All told, personal and business tax measures look to net the province $77 million in 2017-18 (accounting for 0.5% of current year revenue) and closer to $90 million/year once fully implemented. At the same time, a number of continuing tax measures provide relief for taxpayers or incentives for certain industries, including indexation of personal income tax brackets and the basic personal exemption, alongside the extension of tax credits for manufacturing investment and mineral exploration (among others). Reduced red tape and a less restrictive regulatory burden on businesses are clear priorities as well.

Federal transfers are slated to provide over $4.1 billion of revenue support, accounting for more than one quarter of Manitoba's total summary revenue. Nonetheless, the budget laments what has historically been a below-average growth rate in transfers for Manitoba, constraints on equalization growth, and the new, slower growth trajectory for health transfers to all provinces.

Health transfers, in particular, are a sticking point. A new CHT formula, unilaterally imposed by Ottawa, is estimated to cost the province $39 million in 2017-18. Note that Ottawa made a time-limited offer of additional health care funding, which *all other* provinces and the territories accepted (if somewhat begrudgingly). At this point, Manitoba is sole holdout, with the province continuing to label the federal health care funding offer "inadequate" and pressing its case for incremental federal support in complementary areas. Moreover, the budget warns that federal deficits and a growing federal debt could constrain the federal government's ability to support the provinces longer term. All the more reason to tackle the province's structural deficit.

When it comes to spending control, a number of initiatives have already kicked off. Notwithstanding initial progress, there's a clear focus on restraining wage growth, given that each 1%-pt increase in wage settlements costs the government an estimated $100 million/year. The budget includes funding increases for health and education, but likewise notes that outcomes need to improve given a relatively high per capita spend vs many of its provincial peers. (Health care accounts for just under 40% of total spending, while education's share is north of 25%.) As expected, the budget enhanced assistance for refugee resettlement.

Taming the debt burden

Net debt will continue to grow, up $1.66 billion to $24.77 billion by the end of 2017-18. The corresponding net debt-to-GDP ratio would rise, to 35.7%, albeit at a slower rate than in recent years. The net debt burden had been not much more than 20% of GDP pre-crisis, but in the past few years rose by >2%-pts a year. It was at 34.5% in fiscal 2016-17.

Rapid debt accumulation (and above-planned spending) has contributed to credit rating downgrades in Manitoba, a fact that's not lost on the government. As part of its way forward, the province is pledging greater fiscal discipline and seeks to stabilize the net debt-to-GDP ratio over time. As noted above, the province's new fiscal responsibility legislation will train the government's focus on debt reduction once the deficit has been slayed. Saying that, the budget does not give details of the debt profile beyond the current fiscal year.

Eventual progress on debt containment would also help alleviate pressure from a growing interest bill. To be clear, the province's debt burden is still quite affordable, as debt servicing costs consume little more than 6% of summary revenue. But these debt servicing are growing quickly—5.7% in the year ahead—and risk consuming a growing share of revenue down the road, money that could be better devoted to core government priorities. Here again, the benefit (whether in terms of credit ratings, borrowing costs or overall investor sentiment) of correcting the province's fiscal path is well understood. Consistent progress must now be demonstrated.

Hydro continues to drive borrowing

When it comes to borrowing needs, the budget stakes out a $6.7 billion gross funding requirement for the 2017-18 fiscal year, which is little changed vs the prior fiscal year. Some $2.1 billion of that amount relates to refinancing, meaning $4.6 billion in net new requirements. As in years past, Manitoba Hydro accounts for a healthy share of the province's borrowing program. For the uninitiated, the province issues debt in its own name and on-lends proceeds to the utility, which has been making large-scale investments in new generation and transmission assets. For 2017-18, total Hydro requirements add up to ~$3.4 billion (including refinancing), which is roughly one half of the total provincial requirement.

Manitoba has traditionally pursued a diversified funding strategy, and that can be expected to continue in the year ahead. In the domestic market, the focus will continue to be on 5-, 10- and 30-year benchmark terms, with a view to supporting liquidity in the Manitoba name. That implies less reliance on domestic MTNs.

As always, the province will contemplate international issuance to the extent market conditions are favourable and pricing is competitive (relative to what it could source in the home market). Note that the province was active in a variety of currencies last fiscal year, sourcing one third of its total bond issuance internationally. Manitoba likewise has a larger share of its debt outstanding in foreign currencies than any other province. So while gross and net borrowing needs are relatively large for a province its size, we view Manitoba's requirements as manageable, given demonstrated access to domestic and international debt capital markets. It should also be noted that $1.1 billion of this year's program has been pre-funded/completed, leaving $5.6 billion to go over the remaining 11+ months of fiscal 2017-18.

Warren Lovely

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NATIONAL BANK OF CANADA FINANCIAL MARKETS

Manitoba

$000,000	Budget 2016/17	Forecast 2016/17	Budget 2017/18	Projection 2018/19	2019/20
SUMMARY BUDGET					
Revenue	**15,475**	**15,643**	**16,101**	**16584**	**17081**
Income taxes	3,868	3,950	4,194		
Other taxes	4,396	4,395	4,497		
Fees and other revenues	2,220	2,307	2,307		
Federal transfers	4,108	4,117	4,163		
Net income (loss), government business entreprises	674	644	705		
Sinking funds and other earnings	209	230	235		
Expenditure	**16,536**	**16,515**	**17,056**	**17397**	**17745**
Health	6,504	6,475	6,681		
Education	4,281	4,284	4,400		
Family services	2,037	2,037	2,159		
Community, economic and resource development	1,521	1,511	1,531		
Justice and other program expenses	1,282	1,270	1,294		
Debt servicing	911	938	991		
In-Year Adjustments/Lapse	**(150)**	**-**	**(115)**	**(115)**	**(115)**
Summary net income	**(911)**	**(872)**	**(840)**	**(698)**	**(549)**
Debt servicing as a % of revenues	5.9%	6.0%	6.2%		
Summary net income as a % of GDP	-1.3%	-1.3%	-1.2%	-1.0%	
CORE GOVERNMENT					
Revenue	12,578	12,663	13,016	13,406	13,808
Expenditure	13,538	13,463	13,820	14,096	14,378
Year-end Adjustments/Lapse	(70)	-	(35)	(35)	(35)
Transfer from Fiscal Stabilization Account	-	-	(10)	(50)	(50)
Core governemnt net income	**(890)**	**(800)**	**(779)**	**(705)**	**(585)**
SUMMARY NET DEBT					
Provincial Borrowings, guarantees & obligations	43,745	41,961	45,464		
Net pension liability	2,513	2,619	2,766		
Debt repayable by the Manitoba Hydro-Electric Board	(17,760)	(16,286)	(19,267)		
Other debt	805	840	874		
Less: Net financial assets	6,154	6,023	5,065		
=Summary net debt	**23,149**	**23,111**	**24,772**		
Summary net debt as a % of GDP	**33.8%**	**34.5%**	**35.7%**		
BORROWING REQUIREMENTS ($ million)					
Refinancing			2,094		
New cash requirements			5,206		
Less Repayments			571		
Total borrowing requitrements			**6,728**		

Source: Province of Manitoba, *Budget* and *Supplementary Financial Information.*

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