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Market View – A closer look at the City of Toronto's 2020 budget

By Warren Lovely

It's officially *Budget Season in Canada*, which is kind of like *Hockey Night in Canada* ® for public policy wonks, public sector bond traders/investors and credit rating agencies. While there's long been a tendency to concentrate attention on the fiscal blueprints of Canada's federal and provincial governments, budget developments at our local level of government can be compelling in their own right. Consider the City of Toronto's 2020 tax supported operating and capital budgets, which secured passage by council last week. (Note: Rate-supported operating and capital budgets were approved back in December 2019.)

- For 2020, Toronto's operating budget amounts to $13.5 billion, with 86% tax supported. Operating spending is essentially steady in real, per capita terms: $4,344 forecast for 2020 vs $4,349 estimated for 2019. Looked at another way, Toronto spends more on operations in a given year than each of the four Atlantic Canada provinces. And the City's operating budget isn't all that far removed from total annual outlays in "medium-sized" provinces like Manitoba and Saskatchewan;
- As required by provincial legislation, the City's budget is balanced. Yes, there are a couple of asterisks here, including a provision for $77 million in federal refugee funding that has yet to be finalized. (That's the amount the City is spending on 2,500 refugee beds beyond the baseline level.) There's also a reserve draw of ~$500 million in 2020, designed to "smooth out expenses" and funded from prior-year contributions;
- Property taxes are a foundational element of any municipal government budget, with related tax increases tending to be closely scrutinized. This year, Toronto will fund 38% of its tax supported operating budget from property taxes. The average Toronto home owner will see a 4.24% increase in their property tax bill vs 2019. Based on an average assessed value of $703K, we're talking about a $128 increase in the representative tax bill to $3,141 (Chart 1). The residential property tax increase breaks down as follows:
    - 2% or $61 (on average) in a normal/regular residential tax rate increase, based on the trailing rate of inflation in the Toronto CMA, which helps fund operating costs and city services;
    - 1.5% or $45 tied to the previously approved City Building Fund, which is a multi-year levy dedicated to funding transit (e.g., subways, streetcars, stations and related infrastructure) and housing. Additional 1.5% annual increases are scheduled each year through 2025, which would bring the cumulative City Building Fund levy to 10.5% at that time;
    - 0.74% or $22 (net) in a policy related tax rate increase, inclusive of CVA (i.e., property value) adjustments and primarily reflecting the ongoing re-alignment/re-balancing of the City's tax burden. By way of background, the City set out (back in 2005) to bring commercial and industrial tax ratios down to 2.5-times the residential rate in order to improve competitiveness. This policy has necessitated relatively smaller tax rate increases on non-residential properties. For example, 2020's regular commercial tax rate increase is set at one half of the residential rate increase (or 1%), while the industrial rate increase is one third of the residential increase (or 0.66%). Revised projections suggest the desired ratio of 2.5-times for commercial and industrial properties will be achieved in 2023 (three years later than the original target) (Chart 2). Separately, multi-residential property taxes have once again been frozen for 2020, pursuant to a provincial directive that dates from 2017;
- Based on the 4.24% combined residential property tax rate increase, it's fair to say homeowners are being asked to support Toronto's ongoing growth/development. Without minimizing the increase for the average resident, comparisons of property tax rates across Ontario municipalities generally place Toronto towards the more competitive end of the spectrum, implying room for planned increases (Chart 3);
- In terms of other revenue sources, >20% is due to come from federal-provincial sources (inclusive of the refugee funding the City aims to get from Ottawa). Toronto is also somewhat unique in terms of its use of a land transfer tax (LTT), which funds ~7% of tax supported outlays in 2020 (Chart 4). This land transfer tax revenue—linked to special tax authorities enshrined in provincial legislation—is the budget's most immediate connection to shifting housing market conditions, and can generate a degree of revenue volatility. Nonetheless, based on an observed reacceleration in Toronto's resale market, continued strong household formation/housing demand (partly a byproduct of immigration), low mortgage rates and the announced easing of macroprudential rules, there could well be revenue *upside* here;
- Whereas the average province spends the majority of its budget on health and education, 73% of Toronto's tax bill is dedicated to public safety, mobility and city building efforts. For 2020, $76 million of new operating investments are focused on safety/security (including the Mayor's youth violence reduction strategy), poverty reduction efforts, transit and climate change initiatives. Separately, note that the City has prepared a contingency plan in the event its workers go on strike;
- In addition to the operating budget, council also approved a $27.9 billion 10-year tax supported capital plan, with related outlays focused primarily on transit/transportation, environment and housing. There's a clear focus on addressing a state-of-good-repair backlog, with Toronto moving to accelerate some planned capital projects;

- Given the dedicated City Building Fund, monies arriving via established inter-governmental partnerships and other funding sources, new debt finances only a portion of Toronto's capital plan. Specifically, the City's debt requirement for the next three years is approximately $2.5 billion. Toronto aims to borrow up to $1 billion in 2020, with established authorities set out in *By-law No. 254-2019*. Planned debt issuance works out to around $340 for each Torontonian (population ~2.9 million) or less than one sixth of Ontario's per capital requirement for 2019-20. None of the City's outstanding bonds—combined par amount of $7.15 billion—mature in calendar 2020 (Chart 5), although as a reminder, the sinking fund nature of Toronto debentures neutralizes refi risk for the issuer;
- Overall, the pace of debt issuance from Canada's largest city should be largely in-line with what we observed in calendar 2019. Recall that Toronto completed $950 million of bond issuance last year, securing more than two-thirds of that amount in the final four months of the year when overall market conditions were deemed quite favourable;
- Consistent with the City's practice of providing regular, liquid bullet benchmarks in key tenors, Toronto established and re-opened a 10-year bond in 2019 for a combined total of $400 million and steered $350 million into a new 30-year issue. Additionally, Toronto remained at the forefront of municipal green bond movement, printing $200 million of a new 20-year labeled green bond into strong investor demand in September (its second green financing). The City's first Green Bond Newsletter landed in August 2019. Look for green bonds to remain a strategic focus for Toronto in 2020, consistent with an overall goal of reducing GHG emissions by 65% by 2030 (and 80% by 2050). Notwithstanding coronavirus-related volatility, we'd expect the City to maintain an established practice of accessing domestic debt capital markets in the spring;
- The debt service ratio is slated to remain below 15% each year of the 10-year capital plan, with the overall trajectory of this closely watched leverage measure improving relative to last year's budget (Chart 6);
- For context, Toronto 10-year bonds are currently seen in the area of GoC +80 bps (or Ontario +15 bps), with long Toronto spreads indicatively +104 bps to the Canada curve (or Ontario +27 bps) (Chart 7). In the context of ~1.2% 10-year Canada yields and ~1.3% yield for 30-year Canadas, relatively low-beta Canadian municipal bonds offer investors significant yield enhancement;
- Currently, the City's long-term credit ratings are as follows: S&P: AA, Stable | Moody's: Aa1, Stable | DBRS: AA, Stable

Bottom line: Toronto, as required by law, has passed a balanced budget for 2020. There are service demands as befits a rapidly growing city, with some federal refugee support still to be firmed up and somewhat unique leverage to housing (via a land transfer tax). Homeowners are being asked to swallow an overall 4.24% property tax increase. But there appears to be room to implement this tax increase without unduly pressuring the citizenry, which have enjoyed one of the hottest labour markets in the country and are once more seeing property values tick up. This approved property tax increase includes a special/dedicated levy for transit and housing, which allows the City to accelerate strategic capital investment and address a state-of-good-repair backlog without requiring relatively more debt (all else equal). At the end of the day, debt issuance should be little changed in 2020 vs 2019, at roughly $1 billion. Borrowing authorities up to that amount are already in place. As was the case last year, investors can expect the bond program to focus on developing liquid fixed-rate bullet benchmarks in the 10-, 20- and 30-year tenors, inclusive of what will likely be Toronto's third green bond offering. The debt service ratio remains near 15%, and if anything, the outlook for this metric has improved vs last year's projections, with the various and sundry bondholder safeguards that define Canada's highly rated muni market remaining in place.

Chart 1: Breaking down the property tax increase

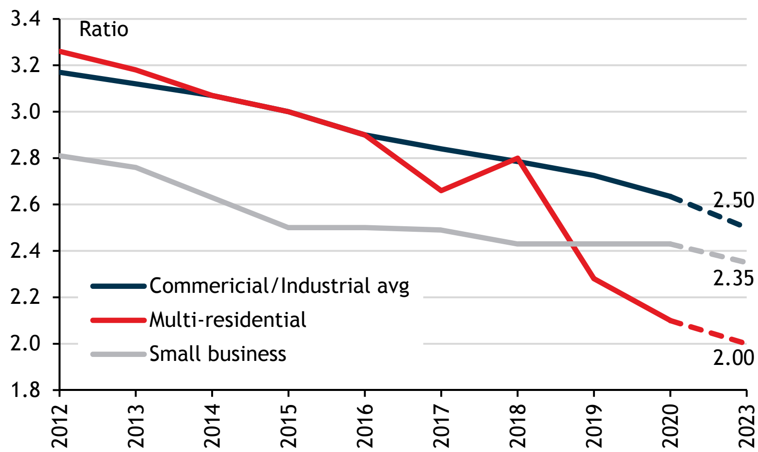
City of Toronto 2020 residential property tax increase (average home)

	Average residential*	
	$	%
2019 property tax	3,014	-
Budget increase	61	2.00
City Building Fund	45	1.50
CVA impact	-16	-0.52
Policy impact	23	0.78
Other adjustments	14	0.48
Total increase	128	4.24
2020 property tax	3,141	-

Source: NBF, City of Toronto | Note: Based on average CVA of $703,232; numbers may not add due to rounding

Chart 2: Ongoing re-alignment of tax burden

City of Toronto property tax ratios (relative to residential rate)



Source: NBF, City of Toronto | Note: 2020 is projection; 2023 is target

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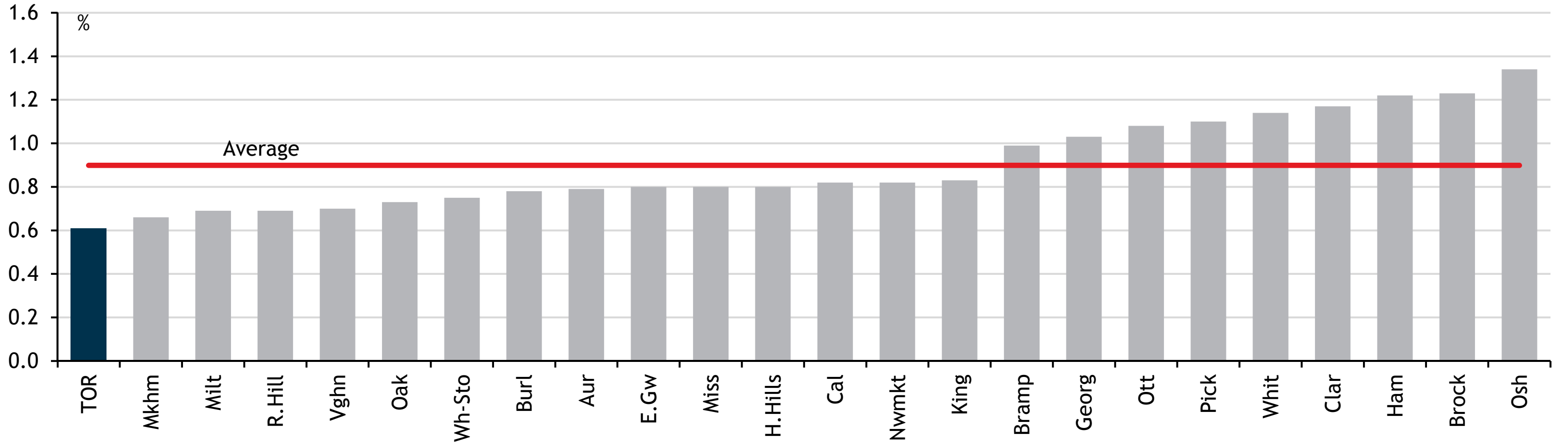
Chart 3: Relatively competitive tax rates in Toronto

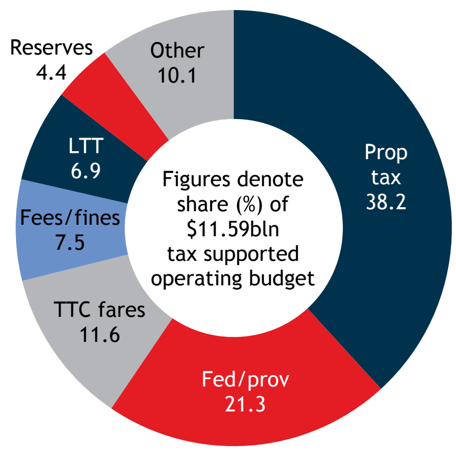
2019 residential property tax rates: GTHA municipalities & Ottawa



Source: NBF, City of Toronto, BMA Consulting Inc. (2019 Municipal Study) | Note: Includes education property taxes; tax rates reflect weighted median assessment of seven property types per MPAC Municipal Status Report (2019:Q1)

Chart 4: Funding Toronto's operating budget

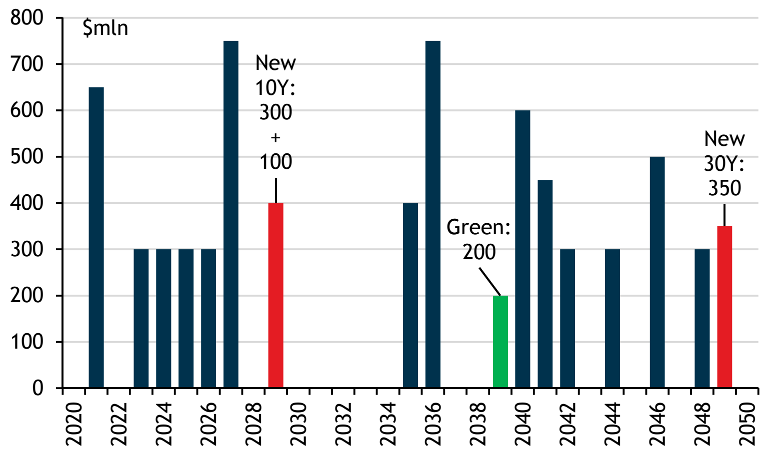
City of Toronto 2020 tax supported operating revenue sources (% of total)



Source: NBF, City of Toronto | Note: Federal contribution includes expected $77mln in support of refugee funding; excludes portion of budget that is rate-supported

Chart 5: A history of building liquid benchmarks

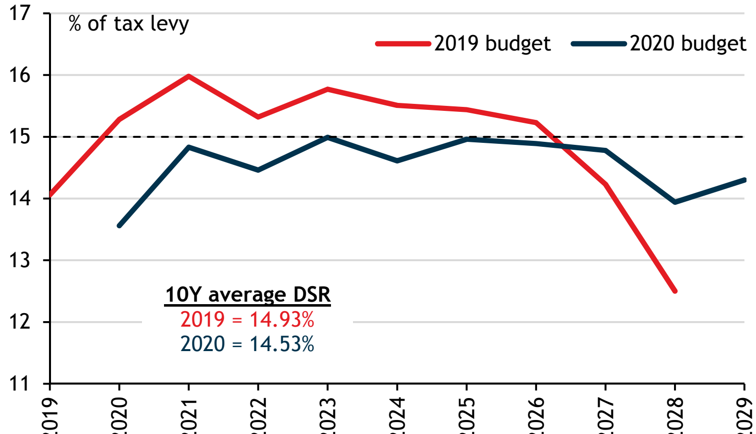
City of Toronto debt maturity profile, highlighting 2019 financings ($950mln)



Source: NBF, Bloomberg | Note: Red/green bars denote bonds issued in 2019

Chart 6: Lower trajectory for debt service ratio

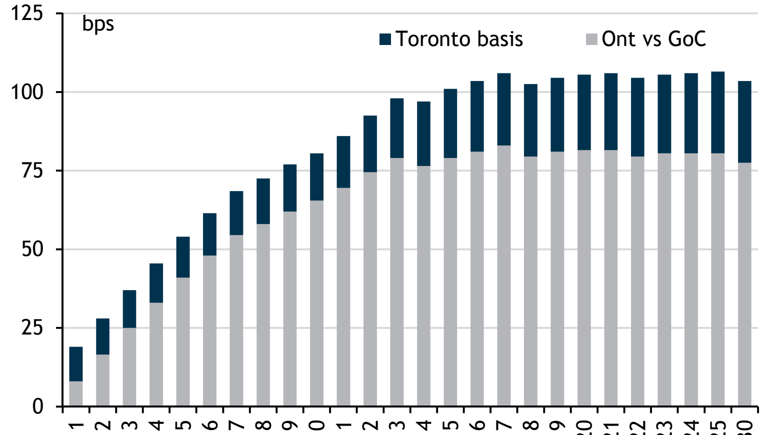
City of Toronto debt service ratio projections: 2020 budget vs prior year



Source: NBF, City of Toronto | Note: Based on 10-year Capital Plan

Chart 7: Toronto spread shapshot

City of Toronto indicative new issue spreads by tenor



Source: NBF | Note: Indicative levels as at 25-Feb

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