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FINANCIAL MARKETS
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ONTARIO
Fiscal update
Economics and Strategy

November 14, 2016

# Keeping an eye on the fiscal prize

Riding a hot economy (by North American standards at least), Ontario remains on track to achieve its core fiscal objectives. Revenue is coming in stronger-than-planned and interest costs are providing relief vs budget. And by dipping a bit into its reserves, Ontario has been able to provide notable electricity price relief and offset extra pension expenses, all without jeopardizing budget targets. So the 2016-17 deficit remains at $4.3 billion, equivalent to just 0.55% of GDP. Factor in residual reserves/contingencies and it's likely that Ontario will beat its official budget target for an eighth straight year when all is said and done. Meanwhile, the government is keeping its eyes focused squarely on the real fiscal prize: ending nine years of red ink by bringing the province back to balance in 2017-18 and keeping it there in 2018-19. Housing affordability is top of mind, as evidenced by fiscally neutral changes to land transfer taxes that benefit first-time buyers but raise the levy on the extreme high-end of the market. A new Financial Services Regulatory Authority is on its way. The net debt-to-GDP ratio is peaking in 2016-17 at 40.3%, with gradual declines commencing next year. This year's long-term borrowing requirement has edged lower to $23.8 billion, well below the amount of borrowing completed each year since 2009-10. At this point, $16.1 billion (or 68%) of the 2016-17 requirement has been completed. Remaining funding (up to March 31) could include a third C$ green bond. Medium-term funding requirements (i.e., for 2017-18 and 2018-19) are unchanged vs budget. While hardly a low-debt jurisdiction, Ontario's interest bite has, if anything, edged lower in recent years. Moreover, a concerted effort to lock in more of its debt for longer provides protection should the recent back-up in bond yields gather even more steam.

## An economic sweet spot, although risks/uncertainties linger

It might not be the most broadly-based expansion on record, but it's hard to take issue with the overall pace of Ontario's real growth of late. Canada's most populous province looks to churn out 2.5% real GDP growth in 2016, an impressive tally by any yardstick. Growth is (a) faster than that anticipated in February's budget (2.2%); (b) no less than 2½% for a third straight year; (c) well above what we consider to be Ontario's potential growth rate (aka the non-inflationary speed limit); (d) markedly better than a lacklustre national average (barely 1%); and (e) clearly superior to the 2016 US expansion (closer to 1½%). Indeed, relative to the challenges faced by the global economy, Ontario has more recently been sitting in something of an economic sweet spot.

What of the outlook for future years? Today's mid-year update sees a healthy growth backdrop extending into 2017 and beyond, albeit with growth rates stepping down a bit. The province anticipates 2.2% real GDP growth next year, moderating to an average 2% in the subsequent two years. For each year over the 2016-2019 forecast horizon, planning assumptions for real GDP growth have been set 0.1%-pt below the private sector average.

In general, Ontario's economy is drawing support from a cheaper currency, low oil prices and solid US demand. Large-scale infrastructure investments should also positively influence growth. The employment record has been solid, as witnessed by steady progress on the unemployment rate. Give an assist to housing, whether via robust residential construction or related consumer spending. There's a flip side to a sizzling housing market of course, and the province notes that "deteriorating affordability and high mortgage debt loads could contribute to a downturn in the housing market." Cue government action on housing affordability, which we'll examine in due course.

While there have been export gains in key international markets, it bears watching how President-elect Trump opts to proceed on tax policy—given protectionist sentiment raised on the campaign trail. Likewise, any prospective misalignment of Canada-US environment policies could have ramifications for Ontario's relative competitiveness. For its part, Ontario is doing its utmost to cultivate overseas export markets and attract investment, including a steady string of business missions (Japan and South Korea are next up) and the new Ontario Investment Office.

Meantime, inflation hasn't exactly boiled over in 2016, which means growth in nominal GDP—the better proxy for own-source revenue—looks to be held to 3.4% growth this year. That's shy of the 4% pace anticipated at budget time. Still, take a peek at last week's provincial economic accounts and you won't find another province enjoying stronger nominal GDP growth in the prior two years. And nominal growth is slated to move back above 4% starting in 2017.

## More revenue, less interest…

What does this fairly robust economic performance mean for the budget? For starters, there's a lot more revenue than the province previously anticipated. That message resonated in the 2015-16 public accounts (where the deficit came in nicely below plan for the seventh straight year) and also echoed loudly today.

The revenue outlook for 2016-17 has been bolstered $2.1 billion (+1.6%) vs budget, with above-plan revenue as much as $3 billion/year by the time you get to 2018-19. Much of that can be traced to taxation sources, including support from personal and corporate income taxes, buoyant land transfer tax revenue (a very direct link to housing) and Ontario's larger anticipated share of harmonized sales tax revenue. The revenue picture has also benefited from enhanced tax compliance. The province's asset optimization revenue targets, including partial sale of Hydro One, are deemed "on track". Meantime, the first permit auction under a new cap-and-trade carbon regime is slated for March 2017. Equalization transfers will be lower in future years, but the overall profile for federal transfers is little changed vs budget. (Transfers account for just a bit more than 18% of total revenue this year.) While there continued to be an appeal for greater fiscal balance between the federal and provincial levels of government, the tone applied to federal-provincial relations has softened, thanks to progress on CPP reform and significant new federal infrastructure investments.

Elsewhere, debt charges are once again coming in below plan, saving the province anywhere from $0.4 billion to $0.8 billion a year through 2018-19. This one-two punch of extra revenue and lower debt charges largely offsets additional pension expenses that the province has prudently moved to incorporate.

## … but pension disagreement adds costs

For the uninitiated, this pension adjustment reflects a difference of opinion between the Auditor General and the province regarding the treatment of assets for certain jointly sponsored pension plans. An advisory panel has been struck to examine the issue and make recommendations. In the interim, however, Ontario has adopting the AG's opinion, adding $1.5 billion to last year's deficit and $10.7 billion to the corresponding level of provincial net debt. The pension hit (i.e., incremental pension expenses) grows to $2.2 billion in 2016-17 and could add as much as $3.7 billion to total expenditures by the time 2018-19 rolls around. Stay tuned then, as the pension accounting treatment risks exerting growing influence on the province's fiscal performance.

## What's the fiscal bottom line? No change

When it comes to the budget balance, additional revenue, lower interest charges and a partial drawdown of reserves fully offset pension adjustments and some targeted program spending initiatives (focused on health care and education). That leaves the official budget balance profile unchanged vs budget. More specifically, Ontario is projecting a $4.3 billion deficit this fiscal year, equivalent to 0.55% of GDP. As noted, this year's reserve has been partially drawn done, going from $1 billion in the budget to $0.4 billion today. Nonetheless, add in remaining contingencies and there's at least $1 billion of fiscal padding built into the current year's plan, a seemingly healthy cushion given how far we are into the fiscal year.

Importantly, Ontario clearly reiterated its intention to balance the budget in 2017-18. The province expects to remain in balance in 2018-19 as well. Again, there's less of a reserve set aside for future years compared to February's budget, suggesting somewhat less room to better official targets or absorb unanticipated economic weakness/unforeseen spending pressures. As currently laid out, getting to balance and staying there will require average annual revenue growth of 4.5% over the coming two years against average annual program spending growth of 2.5% for the same two-year period. As Finance Minister Sousa acknowledged: "it's not going to be easy." But the government's commitment to slay the deficit appears as strong today as it has ever been.

## Electricity price relief and housing affordability in focus

Recall that the government announced electricity price relief prior to the fall statement, highlighted by a rebate equivalent to the province's 8%-pt portion of the HST for residential consumers and small business starting January 2017. Among a host of additional actions, the government is suspending large renewable procurement, with anticipated savings of $3.8 billion relative to the prior long-term price forecast. Going forward, a debt retirement charge for commercial/industrial users is set to come off nine months earlier than previously promised (in April 2018). And then there's the recent Ontario-Québec power deal, which will see Ontario import 2 terawatt hours/year of clean power from its neighbour, saving $70 million over seven years.

Having already taken a series of actions on electricity costs, the province used its fall statement to address concerns over housing affordability—a hot button issue to be sure, particularly in Toronto and environs. Opting against a BC-style foreign buyers tax, Ontario instead chose to tweak its land transfer tax, providing relief for first-time buyers while increasing the levy on ultra-high end homes. Specifically, the maximum land transfer tax refund for first-time buyers will double to $4,000 effective January 2017. Once implemented, eligible buyers would pay no land transfer tax on the first $368,000 of their purchase price. This measure is expected to cost $105 million in 2017-18. Note that an equivalent amount of revenue is tied to a higher land transfer levy on homes sold for more than $2 million (it's going from 2% to 2.5%). Above $400,000, the land transfer levy on commercial, industrial and multiple-residential properties is also headed higher. Thus, land transfer tax changes provide relief for those trying to break into the housing market and place a steeper levy on premium home sales, all while being fiscally neutral. On their own, Ontario's moves to address housing affordability don't appear as drastic as in British Columbia. But don't lose sight of the fact that the federal government has recently implemented important changes to the mortgage market, and it may be prudent to assess the impact on residential housing activity/prices before moving more aggressively at the provincial level.

As promised, Ontario will introduce legislation setting out parameters for a Financial Services Regulatory Authority, which the province terms "a new independent and flexible regulator of financial services and pensions that would be more consumer-focused and improve protections for consumers, investors and pension plan beneficiaries." Separately, a final report on regulation of financial planning/advisory services is to be released in early 2017. Meanwhile, a working group has been struck to develop recommendations on syndicated mortgages, with further actions coming in spring 2017.

So-called "high impact" SMEs will benefit from a scale-up voucher program, worth $32 million over four years, funding everything from talent recruitment/development, market access to intellectual property.

## Debt burden peaking, borrowing needs a tad lower

As previously noted, the pension adjustment added to Ontario's net debt and means that the peak debt-to-GDP ratio is now a bit higher than envisioned in the budget. The high water mark is now estimated at 40.3%, set this year, with gradual declines in this important fiscal metric slated for 2017-18 and beyond… eventually getting it back to pre-recession levels. An alternative, narrower debt metric—the accumulated deficit-to-GDP ratio—topped out last fiscal year at 26.6%, a level comfortably below the prior peak. The growing gap between net debt and the accumulated deficit reflects the government's sizeable net investments in public infrastructure—a central plank of Ontario's economic plan.

Despite the heavier debt burden, the interest bite remains manageable, as interest charges consume barely 8½% of total revenue. True, bond yields have more recently headed higher, but a concerted effort to lock-in more of its debt for longer reduces Ontario's near-term exposure. As such, even after building in higher interest rates, the province's interest bite is not expected to be any higher in the coming two years than it is today.

That brings us to the borrowing program, and as with the budget balance, not much is changed vs prior guidance. Officially, the long-term funding requirement for 2016-17 (after accounting for pre-funding) edged a bit lower, from $24.4 billion to $23.8 billion. That's well shy of the actual amount of borrowing completed each and every year since the financial crisis really left its mark. From 2009-10 to 2015-16, long-term borrowing has averaged >$37 billion/year, falling just shy of $40 billion as recently as 2014-15. So the step down in gross funding needs is not immaterial. And again, we'd note that there's some residual padding built into the current year's budget target.

Against this $23.8 billion funding target, $16.1 billion has so far been raised. Thus, Ontario is 68% funded at the 62% mark of the fiscal year (which ends March 31). As expected, the domestic bond market has accounted for the bulk of the issuance digested thus far, leaving the C$ share of completed funding, at 77%, pretty much in line with prior guidance. Ontario has also succeeded in securing very long-term funding. Witness the 15.1 weighted average-term (in years) of completed funding.

With officially $7.7 billion to go and assuming roughly one quarter of that amount could be destined for foreign markets, Ontario might theoretically raise the equivalent of up to $2 billion (CAD) from foreign currency trades before the fiscal year is out. The province has so far taken $3.55 billion out of the US dollar market and, indicatively at least, the USD-CAD funding arb appears reasonably attractive. As for stated priorities, the mid-year highlights the success of past green bond offerings and notes that a third C$ green bond is expected before 2016-17 draws to a close.

Further out, the mid-year left gross funding needs for 2017-18 and 2018-19 unchanged vs budget. At this point, next year's program is pegged at $23.3 billion, followed by $28.7 billion in 2018-19. For both years, Ontario aims to raise "at least 75%" in the domestic market.

Overall, gross funding needs may be a shadow of their former peak, but there's still some notable supply in multiple currencies expected from an Ontario credit where ratings are stable and secondary market liquidity remains exceptional.

***Warren Lovely***

# ONTARIO FISCAL UPDATE

***Ontario***

| $ billions | Actual 2015/16 | Budget 2016/17 | Update 2016/17 | Outlook 2017/18 | Outlook 2018/19 |
|---|---|---|---|---|---|
| **Revenue** | **128.4** | **130.6** | **132.7** | **140.1** | **144.9** |
| Own-Source Revenue | 91.8 | 91.8 | 93.8 | 98.1 | 103.0 |
| *Personal Income Tax* | 31.1 | 32.2 | 33.2 | | |
| *Retail Sales Tax* | 23.5 | 24.0 | 23.8 | | |
| *Corporations Tax* | 11.4 | 12.1 | 12.8 | | |
| *Education Property Tax* | 5.8 | 5.8 | 5.9 | | |
| *Ontario Health Premium* | 3.5 | 3.6 | 3.7 | | |
| *Other* | 16.5 | 14.1 | 14.4 | | |
| Federal Transfers | 22.9 | 24.6 | 24.5 | 25.7 | 26.5 |
| Income from Government Business Enterprises | 4.9 | 5.0 | 5.2 | 5.5 | 5.9 |
| Other revenue | 8.8 | 9.1 | 9.2 | 10.7 | 9.5 |
| **Expenses** | **133.4** | **133.9** | **136.6** | **139.4** | **144.1** |
| Program Spending | 122.4 | 122.1 | 125.3 | 127.7 | 131.7 |
| Interest on Debt | 11.0 | 11.8 | 11.4 | 11.7 | 12.4 |
| **Reserve** | **-** | **1.0** | **0.4** | **0.7** | **0.8** |
| **Surplus (Deficit)** | **(5.0)** | **(4.3)** | **(4.3)** | **0.0** | **0.0** |
| **Net Debt** | **305.2** | **308.3** | **317.9** | **327.0** | **336.1** |
| As a % of GDP | 40.0 | | 40.3 | 39.8 | 39.3 |
| **Accumulated Deficit** | **202.7** | **197.8** | **207.0** | **207.0** | **207.0** |
| As a % of GDP | 26.6 | | 26.2 | 25.2 | 24.2 |
| **Borrowing Requirement** | | **26.4** | **23.8** | **23.3** | **28.7** |
| (Surplus) Deficit | | 4.3 | 4.3 | 0.0 | 0.0 |
| Maturities | | 21.5 | 21.2 | 17.5 | 22.1 |
| Redemptions | | 0.1 | - | 0.1 | 0.1 |
| Investment in Capital Assets | | 11.2 | 11.7 | 12.4 | 14.2 |
| Pre-borrowing from 2015-16 | | - | (2.0) | - | - |
| Other | | (10.7) | (11.4) | (6.7) | (7.7) |

Source: 2016 Ontario Economic Outlook and Fiscal Review

# ONTARIO FISCAL UPDATE

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