NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Ontario
2017 Fiscal Update
Economics and Strategy

November 14, 2017

Staying in balance, providing relief for small businesses

Highlights

- Consistent with April's budget, Ontario remains on track to eliminate its deficit in 2017-18. A strong economy has bolstered the revenue outlook, offsetting negative prior-year adjustments and lower land transfer tax revenue following the introduction of provincial housing reforms, while still leaving room for targeted investments.
- A reserve of $0.5 billion and additional operating/capital contingencies of ~$0.4 billion provide residual, non-trivial insurance against the 2017-18 target. So there's a pretty good chance Ontario will have its first surplus in ten years when the dust finally settles on the 2017-18 fiscal year.
- The updated medium-term outlook sees balanced budgets for both 2018-19 and 2019-20. That's based on average annual revenue growth of 2.7% for the coming two fiscal years, against 2.4% average annual growth in program spending. In terms of direct fiscal insulation, there are future year reserves of $0.5 billion and $0.8 billion respectively, with the province continuing the tradition of setting its planning assumptions for real GDP growth a bit below the private-sector consensus.
- Ontario's 2017-18 net debt-to-GDP ratio is now projected at 37.3%, a couple ticks lower than the original budget plan and receding from the 39.3% peak level set in 2014-15. Additional near-term progress is expected, with an interim target of 35% debt-to-GDP by 2023-24 and a longer-term goal of getting back to the pre-crisis 27% level by 2029-30.
- The interest bite is quite manageable at <8½% of total provincial revenue. Barely 10% of outstanding debt is subject to rate reset, well below the policy limit, while virtually all FX exposure has been hedged. There are ample liquid reserves to draw upon in the event of a serious market disruption and/or to meet increasingly large single-day maturities. Moreover, Ontario has considerable untapped room on its short-term borrowing facilities.
- As for term borrowing, 2017-18's official requirement has eased $0.6 billion to $25.8 billion. Having thus far raised $24.2 billion, Ontario is within hailing distance of the 100% funded mark. Elevated geopolitical risks provide incentive to pre-fund, so look for Ontario to ultimately get a sizeable jump start on next year's $32.2 billion gross borrowing program before 2018-19 even kicks off.
- For 2017-18, the target share of borrowing completed internationally has been increased from 25% to approximately one-third. Domestically, term extension has remained the name of the game, although there's room to move down the curve should investor demand for duration fade.
- The fourth installment in Ontario's Green Bond program will be completed before the end of the 2017-18 fiscal year.
- Ontario is lowering its small business tax rate from 4.5% to 3.5% effective January 1, 2018—which coincides with a planned jump in the provincial minimum wage (from $11.6/hour to $14/hour). Additional measures seek to promote youth hiring and encourage apprenticeship completion. The government outlined expanded procurement opportunities for small businesses and continues to focus on enhancing the flexibility/efficiency of the regulatory environment. All told, the province's plan provides $500 million of relief over three years for small businesses.
- Ontario aims to be a welcoming destination for a burgeoning global FinTech industry. Meantime, in light of US trade worries, the province has launched a new trade strategy that seeks to cultivate overseas export markets. There's been plenty of action of other files, either in or since the 2017 budget, including significant investments in children/youth pharmacare, expanded tuition grants, support for seniors, additional child care spaces, public transit relief, etc.
- Ontario's 42nd general election is currently scheduled for June 7, 2018.

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Getting to & staying in balance

Give an assist to today's sturdy economic expansion, but Ontario's mid-year update shows a government intent on staying in balance. It's an administration focused on "fairness" and increasingly mindful of relative competitiveness and external risks, of which there a few.

Consistent with a keynote address delivered a week ago, Finance Minister Sousa's fall update shows Ontario well positioned to balance the budget in 2017-18. That follows a better-than-expected 2016-17 tally—where the deficit narrowed to less than $1 billion—and would mark the successful conclusion of an eight year deficit reduction strategy.

Growth, job creation, housing market activity and consumer spending have been pleasant surprises in 2017. This year's pace of real GDP growth is now pegged at 2.8%, half a percentage point stronger than at budget time, while the nominal growth outlook has been lifted by an even greater margin (by 1%-pt to 5.3%).

On its own, this heady economic performance is a plus for provincial own-source revenue; call it a positive base effect. Indeed, at just north of $150 billion, current year revenue is up almost $10 billion (or a sizzling 6.7%) vs 2016-17. For the current year, the extra revenue spun off by a robust expansion compensates for negative prior-year adjustments to personal income tax revenue and a smaller land transfer take (as housing activity moderates) but still leaves room left over for targeted investments (see page 2). A residual "reserve" of $0.5 billion and additional operating/capital contingencies of ~$0.4 billion provide non-trivial insurance for 2017-18, particularly given the advanced stage of the fiscal year. In other words, there's a pretty good chance Ontario will have its first surplus in ten years when the dust finally settles on the 2017-18 fiscal year.

Consistent with the 2017 budget, the updated medium-term outlook sees balanced budgets for both 2018-19 and 2019-20. That's based on average annual revenue growth of 2.7% for the coming two fiscal years, against 2.4% average annual growth in program spending. In terms of direct fiscal insulation, there are future year reserves of $0.5 billion and $0.8 billion respectively, with the province continuing the tradition of setting its planning assumptions for real GDP growth a bit below the private-sector consensus (a sensible/prudent approach).

[Note: For those comparing the latest revenue/expenditure profile with that previously outlined in the budget, be aware of an accounting adjustment/reclassification related to hospitals, school boards and colleges. Equal amounts of revenue and spending (~$8½ billion/year) have been incorporated into the fiscal outlook to "increase transparency in financial reporting". Importantly, the reclassification has no impact on the budget balance, net debt or the accumulated deficit. This is not to be confused with accounting issues raised by the provincial Auditor General related to public sector pensions and energy price relief.]

Lighter debt burden

A balanced budget and healthy nominal GDP growth represent a nice one-two punch when it comes to the provincial debt burden. Ontario's 2017-18 net debt-to-GDP ratio is now projected at 37.3%, a couple ticks lower than the original budget plan and receding from the 39.3% peak level set in 2014-15. Additional near-term progress is expected, with an interim target of 35% debt-to-GDP by 2023-24 and a longer-term goal of getting back to the pre-crisis 27% level by 2029-30.

The province's interest bite is slated to remain quite manageable at <8½% of total provincial revenue. Having skewed so much of its financing to longer tenors, Ontario has given itself flexibility to deal with a rising interest rate environment (should an anticipated back-up in underlying GoC yields ultimate come to fruition). Barely 10% of outstanding debt is subject to rate reset, well below the policy limit, while virtually all FX exposure has been hedged. There are ample liquid reserves to draw upon in the event of a serious market disruption and/or to meet increasingly large single-day maturities. Moreover, Ontario has considerable untapped room on its short-term borrowing facilities.

Pre-funding here we come

As for term borrowing, the current year's official requirement has eased $0.6 billion to $25.8 billion, reflecting the stronger-than-estimated prior-year budgetary balance. Having thus far raised $24.2 billion, Ontario is within hailing distance of the 100% funded mark—it should breach that threshold before the end of the current quarter. Elevated geopolitical risks provide incentive enough to pre-fund, so look for Ontario to follow Québec's lead, tipping into pre-borrowing mode in short order and ultimately getting a sizeable jump start on next year's $32.2 billion gross borrowing program before 2018-19 even kicks off.

In terms of funding strategy, Ontario has boosted its current fiscal year target for the share of borrowing completed internationally… from 25% at budget to approximately one-third. These foreign currency trades (primarily USD and EUR) account for 37% of fiscal year-to-date borrowing, and help to diversify the investor base, lower borrowing costs and/or keep important funding avenues open should market conditions deteriorate. Domestically, term extension has remained the name of the game, although there's room to move down the curve should investor demand for duration fade. Really though, we expect to Ontario to continue to benefit from strong demand for long-dated product, with ample December cash soon to be put to work and broader asset allocation shifts likely to support demand for high quality, liquid fixed-income paper.

Finally, the province remains a leader in Green Bonds. Ontario's last issue was in January 2017: an $800 million reopening of a Jan-2023 maturity, bringing the total outstanding amount to $1.55 billion. The fourth installment in Ontario's Green Bond program will be completed before the end of the 2017-18 fiscal year. Interested investors should refer to the Green Bond segment of the Ontario Financing Authority website: **Link**.

Select measures: Small business tax relief in the spotlight

Ontario is moving to provide tax relief and hiring incentives to small businesses, which have been a key source of job creation in recent years. Specifically, Ontario is lowering its small business tax rate from 4.5% to 3.5% effective January 1, 2018—which coincides with a planned jump in the provincial minimum wage (from $11.6/hour to $14/hour). Note that the federal government recently announced that it would move forward with a reduction in its own small business tax rate, from the current 10.5% to 10% effective 2018 and down to 9% starting in 2019. In little more than a year then, the combined federal-provincial small business tax rate in Ontario will be 12.5%, the lowest in the G7. Additional measures seek to promote youth hiring (e.g., eligible small businesses will be able to access hiring/retention incentives of a $1000 each) and encourage apprenticeship completion. The government outlined expanded procurement opportunities for small businesses and continues to focus on enhancing the flexibility/efficiency of the regulatory environment. All told, the province's plan provides $500 million of relief over three years for small businesses.

Ontario aims to be a welcoming destination for a burgeoning global FinTech industry. Cue a new Regulatory Super Sandbox (defined as a "regulatory mechanism designed to bring innovative financial products and services to market more quickly, while ensuring customer protection") and the Ontario FinTech Accelerator Office. Meantime, in light of US trade worries, the province has launched a new trade strategy that seeks to cultivate overseas export markets.

There's been plenty of action of other files, either in or since the 2017 budget, including significant investments in children/youth pharmacare, expanded tuition grants, support for seniors (e.g., 5000 new long-term care beds by 2022), additional child care spaces, public transit relief via regional fare integration, etc.

Housing, meanwhile, remains top of mind. Consistent with a Fair Housing Plan announced in the spring, Ontario is focused on stabilizing the housing market and encouraging new housing supply. At this point, Ontario sees its suite of policy actions as "having its intended effect".

Warren Lovely

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$ billions	Actual 2016/17	Budget 2017/18	Fall 2017/18	Outlook 2018/19	Outlook 2019/20
Revenue	**140.7**	**150.0**	**150.1**	**153.6**	**158.2**
Own-Source Revenue	94.3	100.1	99.9	105.1	**110.0**
Personal Income Tax	30.7	35.0	33.3	37.3	**39.5**
Sales Tax	24.8	26.0	26.3	27.1	**28.0**
Corporations Tax	14.9	13.8	15.4	14.7	**15.5**
Education Property Tax	5.9	6.0	6.0	6.1	**6.1**
Ontario Health Premium	3.6	3.8	3.7	4.0	**4.2**
Other	14.6	15.6	15.3	16.0	**16.8**
Federal Transfers	24.5	26.1	26.2	26.0	**25.4**
Income from Government Business Enterprises	5.6	4.9	5.1	5.9	**6.2**
Other non-tax revenue	16.3	19.0	19.0	16.5	**16.6**
Expenses	**141.7**	**149.4**	**149.6**	**153.1**	**157.4**
Program Spending	130.0	137.2	137.4	140.4	144.2
Interest on Debt	11.7	12.2	12.2	12.7	13.3
Reserve	**-**	**0.6**	**0.5**	**0.5**	**0.8**
Surplus (Deficit)	**(1.0)**	**-**	**-**	**-**	**-**
Net Debt	**301.6**	**311.9**	**311.7**	**323.0**	**335.6**
As a % of GDP	38.0	37.5	37.3	37.1	37.0
Accumulated Deficit	**193.5**	**193.5**	**193.5**	**193.5**	**193.5**
As a % of GDP	24.3	23.2	23.1	22.2	21.3
Borrowing Requirement	**27.0**	**26.4**	**25.8**	**32.3**	**38.7**
(Surplus) Deficit	1.0	-	-	-	-
Maturities	20.9	17.5	17.4	21.8	27.4
Redemptions	0.1	0.1	0.1	0.1	0.1
Investment in Capital Assets	8.9	13.1	13.1	15.4	17.1
Pre-borrowing from 2015-16	(2.0)	-	-	-	-
Pre-borrowing in 2016-17 for 2017-18	3.2	(3.2)	(3.8)	-	-
Other	(5.1)	(1.1)	(1.0)	(5.0)	(5.9)

Source: 2017 Ontario Economic and Fiscal Review

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Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Paul-André Pinsonnault
Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Matthieu Arseneau
Senior Economist
matthieu.arseneau@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
MD, Public Sector Research and Strategy
warren.lovely@nbc.ca