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The path to a balanced budget

By Marc Pinsonneault and Krishen Rangasamy

Highlights

- The first budget of Doug Ford's Progressive Conservative Party set Ontario on a path towards achieving a balanced budget. True, the timeline for balancing the books is five years from now, or after the scheduled next provincial elections of 2022. But given the massive size of inherited red ink – recall the $15.0 billion shortfall identified last September in the *Report of the Independent Financial Commission of Inquiry* –, Finance Minister Victor Fedeli's plan to return Canada's largest province to fiscal discipline should be welcome by investors.
- At $11.7 billion (or 1.4% of GDP), the budget deficit for the outgoing year (2018-19) is lower than the $14.5 billion estimated in last November's *Fall Economic Statement (FES)*. The $2.8 billion improvement from the inherited shortfall was due to better-than-expected revenues, particularly from corporate and sales taxes.
- Much in line with Finance Minister Fedeli's earlier pledge for a "thoughtful" return to balanced budget, there is an attempt to progressively chip away at red ink instead of going for a giant eraser which would have adversely affected an Ontario economy already reeling from headwinds coming from both home and abroad. The budget deficit is projected to narrow to $10.3 billion in 2019-20 (or 1.2% of GDP) thanks to almost zero growth in program expenses. The Ontario government expects the deficit to fall further in the following three years: $6.8 billion in 2020-21 (0.7% of GDP), $5.6 billion in 2021-22 (0.6% of GDP), $3.5 billion in 2022-23 (0.4% of GDP) –, before finally achieving a balanced budget in 2023-24 (technically it's a small surplus of $300 million). As such, the cumulated deficit over the next four years is expected to be $26.2 billion.
- How realistic are those projections? Assumptions underpinning the Ontario government's budget are arguably prudent. Indeed, the budget assumes average real GDP growth of 1.7% over the coming five years, 0.1 percentage point below the private sector average. Additional prudence comes in the form of an annual $1 billion "reserve" in case of unforeseen adverse changes in the province's revenue and expense forecasts, which increases to $1.3 billion in 2022-23 and $1.6 billion in 2023-24.
- A major announcement in the budget is the Childcare Access and Relief from Expenses Tax Credit (CARE). As promised during Doug Ford's election campaign, this will provide subsidized child care in the form of a refundable tax credit to about 300,000 families, and is estimated to cost $390 million/year. Looking at capital investment, the province is committing $11.2 billion of the estimated $28.5 billion (the federal government and the city of Toronto is expected to pitch in for the rest) for four rapid transit projects in the Greater Toronto Area. Those add to measures already outlined in the FES. For instance, the Ontario Job Creation Incentive (amounting to $2.5 billion over three years) is meant to allow firms to immediately write off equipment, the program working in parallel with the Federal government's *Accelerated Investment Incentive*. And as described in the FES, low income workers will receive a tax credit (LIFT), the program costing roughly half a billion dollars a year.
- Ontario's net debt burden, which ended 2018-19 at 40.2% of GDP, is projected to increase to 40.7% in 2019-20 and remain at that level the following year, before falling to 40.6% in 2021-22 and below 40% in subsequent years. The interest bite is expected to rise from 8.3% of revenue in 2018-19 to 8.6% this fiscal year, before reaching 8.9% of revenue by 2023-24. That would be the highest since 2013-14.
- Of the $39.6 billion borrowed by the province in 2018-19, $30.6 billion (or 77%) was sourced domestically. Long term borrowing requirements are pegged at $36 billion for 2019-20, with between 70-80% of that expected to be sourced from Canada. The province is projecting $32.8 billion of long-term borrowing in 2020-21. All in all, completed and planned bond issuance from 2018-19 to 2020-21 totals $108.4 billion, which is down from the $109.7 billion projected by the previous government for the same three-year period in last year's budget. The change in government has not altered the province's commitment to continue issuing Green Bonds, with a next issue planned for 2019-20. However, because of low sales, the Province has discontinued issuance of Ontario Savings Bonds.

Inherited red ink

The first budget of Doug Ford's Progressive Conservative Party set Ontario on a path towards achieving a balanced budget. True, the timeline for balancing the books is five years from now, or after the scheduled next provincial elections of 2022. But given the massive size of the inherited red ink – recall the $15.0 billion shortfall identified last September in the *Report of the Independent Financial Commission of Inquiry* –, Finance Minister Victor Fedeli's plan to return Canada's largest province to fiscal discipline will be welcome by investors.

Interim results for 2018-19 came in quite a bit better than foreseen in the Fall Economic Statement (FES), with a deficit now estimated at $11.7 billion (1.4% of GDP), a $2.8 billion reduction from the $14.5 billion estimated at the time of the FES. Some might say it is a $3.3 billion reduction from the $15 billion deficit estimated by the Independent Financial Commission of Inquiry. Regardless of the starting point, a $1 billion improvement was obtained by not making use of the reserve during the fiscal year. If one compares with the FES, the rest of the improvement stemmed from revenues coming in $2.5 billion higher than projected in the FES, partly offset by a $0.7 billion increase in expenses.

The improvement in revenue came entirely from taxation revenue Corporation taxes were $1.4 billion higher due to stronger business operating profits and higher amounts from processing 2017 tax returns. Sales tax brought an extra $1.2 billion largely due to higher levels of household spending. Federal transfers for infrastructure were $0.9 billion less than expected, and a $0.5 billion shortfall came from revenues from Ontario Power Generation Inc./Hydro One Ltd. The revenue shortfall from these two items was roughly offset by an increase in other non-tax revenue (mostly recoveries from prior-year expenditures related to an arbitration settlement award regarding physician services and increased revenues from international students' tuition for colleges).

These extra revenues were more than sufficient to accommodate larger program expenses mostly in Health and in Postsecondary Education and Training sectors. For the latter, the government plans to curb cost increases by redesigning the Ontario Student Assistance Program (OSAP) for the start of the 2019-20 school year.

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There are no new taxes in the budget. For fiscal year 2019-20, a $1.4 deficit reduction to $10.3 billion is estimated. This latter figure incorporates a $1 billion reserve, meaning that if this reserve is left untouched, the deficit could in fact be reduced to $9.3 billion (1.1% of GDP).

Revenue is assumed to increase $3.4 billion in 2019-20 (+2.3%). Almost half of this increase is assumed to come from personal income tax (+$1.6 billion or +4.6%) even if the CARE tax credit (see new measures discussed later) is assumed to be fully implemented that year.

At a level of $150.1 billion, program expenses are projected to be almost flat this fiscal year. Expenses are slated to increase in Health (+2.1%) and in Education (+2.4%), but decline in the four other main groups of programs (Postsecondary Education and Training, Children's and Social Services, Justice and other programs). Interest on debt is projected to increase $0.8 billion. So total expenses growth is assumed at $0.9 billion or 0.5% this fiscal year.

Starting this year and up to 2023-24, total revenue is assumed to increase at an annual average rate of 3% while total expenses are projected to grow 1.3%. The government engaged in a multi-year planning process which found efficiencies that are projected to generate savings and cost avoidance of about 8 cents (on average) for every dollar spent over the next five years. At the end of this period, the budget is expected to be balanced (technically it's a small surplus of $300 million in 2023-24).

Economic Assumptions and Prudence

According to the Private-Sector Survey average, real GDP is assumed to grow 1.8% in 2019 and 1.7% in 2020, 1.6% in 2021 and at an average rate of 2.0% in the three following years. For fiscal planning, prudent assumptions have been used, with the Ontario Ministry of Finance's real GDP growth projections set below the average of the private sector. More prudence was applied to 2019 because private-sector forecasters are expected to lower their growth outlook as a result of weaker-than-expected national growth at the end of 2018 – recall that private sector analysts provided their forecasts before the disastrous 2018Q4 GDP results became available. Additional prudence comes in the form of an annual $1 billion "reserve" in case of unforeseen adverse changes in the province's revenue and expense forecasts, which increases to $1.3 billion in 2022-23 and $1.6 billion in 2023-24. Contingency funds, set at $1.1 billion in 2019-20, are also maintained to help mitigate risk to expenses.

The Province's planning assumptions for nominal GDP growth are as follows: 3.4% in 2019 and 2020, 3.2% in 2021, 3.6% in 2022 and 3.9% in both 2023 and 2024. Should nominal growth end up being 1% lower, sensitivities suggest annual revenues would be $705 million lower than planned.

New measures

A major announcement in the budget is the Childcare Access and Relief from Expenses Tax Credit (CARE). As promised during Doug Ford's election campaign, this will provide subsidized child care in the form of a refundable tax credit to about 300,000 families, and is estimated to cost $390 million/year.

Among other measures, low income seniors will enjoy a new dental care program beginning in the summer of 2019. That will cost $90 million annually when fully implemented. Helping to offset cost cutting in the OSAP, the Province is providing a 10% reduction in tuition for domestic students.

Queen's Park committed to a $384 million investment in hospitals and an additional $267 million is home and community care in order to improve front-line care delivery and reduce wait lists for long-term care. Funds will be allocated to create 15,000 new long term care beds and upgrade 15,000 existing long term care beds. There will be $3.8 billion invested over 10 years for mental health, addictions and housing support.

Looking at capital investment, the province is committing $11.2 billion of the estimated $28.5 billion (the federal government and the city of Toronto is expected to pitch in for the rest) for four rapid transit projects in the Greater Toronto Area.

Those add to measures already outlined in the FES. For instance, the Ontario Job Creation Incentive (amounting to $2.5 billion over three years) is meant to allow firms to immediately write off equipment, the program working in parallel with the Federal government's *Accelerated Investment Incentive*. And as described in the FES, low income workers will receive a tax credit (LIFT), the program costing roughly half a billion dollars a year.

Debt Management Strategy

The Province borrowed $39.6 billion in 2018-19, of which $30.6 billion (or 77%) was sourced domestically. The latter largely took the form of Canadian dollar syndicated bonds ($26 billion), but also C$ floating rate notes ($2.7 billion), Canadian dollar bond auction ($0.7 billion), Ontario Savings Bonds ($0.3 billion) and Green bonds ($0.95 billion). The domestic funding share ended up being higher than the guidance of 70% given in the FES. Issuance of bonds in U.S. dollar, euros and Australian dollars were indeed limited to just $9 billion.

Long term borrowing requirements are pegged at $36 billion for 2019-20, with between 70-80% of that expected to be sourced from Canada. The Province is projecting $32.8 billion of long-term borrowing in 2020-21.

All in all, completed and planned bond issuance from 2018-19 to 2020-21 totals $108.4 billion. That's down from $109.7 billion for the same three-year period projected by the previous government in last year's budget. The change in government has not altered the province's commitment to continue issuing Green Bonds, with a next issue planned for 2019-20. However, because of low sales, the Province has discontinued issuance of Ontario Savings Bonds.

The net debt to GDP ratio is projected to rise from 40.2% in 2018-19 to 40.7% in 2019-20 and the subsequent year, before dropping to 40.6% in 2021-22 and below 40% in subsequent years. The Province is committed to bringing down that ratio "to a sustainable level" via a new debt burden reduction strategy. The plan to return the budget to balance by 2023-24 goes in that direction. Much in line with its debt burden reduction strategy, the Province expects to use "a growing portion of borrowing" to refinance maturing debt instead of financing new debt. The proposed Fiscal Sustainability, Transparency and Accountability Act (FSTAA) would require government to report its debt reduction strategy in every budget going forward.

The interest bite is expected to rise from 8.3% of revenue in 2018-19 to 8.6% this fiscal year, before reaching 8.9% of revenue by 2023-24. That would be the highest since 2013-14. Even then, that still looks manageable in our view.

The weighted average term of 2018-19 borrowing climbed to 12.9 years, topping the average of the overall debt portfolio for the ninth year in a row. So much so that the weighted-average term to maturity of long-term provincial debt issued is now 10.6 years, compared to 9.7 years back in 2009-10. This extension of the debt portfolio translates to a lower sensitivity to interest rate shocks. Indeed, a 1%-pt increase in all interest rates would now cost the Province approximately $350 million — back in Budget 2010, when the provincial debt burden was much lower, a 1%-pt change in interest rates was thought to have a $480 million annual fiscal impact.

Unrestricted liquid reserves, which averaged roughly $20 billion over 2009-2017, has jumped in the last couple of years to reach $32.6 billion in 2018-19. The province's decision to build larger buffers reflect prior issuance of long bonds which are now maturing. Those larger reserves, together with unused capacity in the short-term program, will help the province manage single-day large cash outflows.

This fiscal year, i.e. 2019-20 and the next two, long term borrowing requirements are reduced by roughly $1 billion/year through net emission of short term borrowing. The Province says this will keep the proportion of short-term debt to total debt outstanding in the middle of the 6-8% range that has been maintained over the last decade.

Thanks to hedging, foreign exchange exposure is only 0.2% of debt issued, well below the policy limit of 3%. Net interest rate resetting exposure has also been well managed at 10.8%, which is significantly below the 35% policy limit.

NATIONAL BANK OF CANADA FINANCIAL MARKETS

Ontario

$ billions	FES 2018-19	Interim 2018-19	Budget 2019-20	Outlook 2020-21	2021-22	2022-23	2023-24
Revenue	**148.2**	**150.8**	**154.2**	**159.8**	**163.7**	**168.5**	**175.0**
Own-Source Revenue	100.9	103.6	106.1	109.8	111.9	115.2	120.2
Personal Income Tax	34.9	35.0	36.6	38.2	39.0	40.1	42.1
Sales Tax	26.7	27.9	28.1	28.9	29.9	31.0	32.2
Corporations Tax	13.8	15.2	15.2	15.7	16.3	16.9	17.9
Education Property Tax	6.1	6.0	6.1	6.2	6.2	6.2	6.2
Ontario Health Premium	3.9	3.8	4.0	4.2	4.4	4.6	4.8
Other	15.6	15.7	16.2	16.7	16.2	16.4	17.0
Federal Transfers	26.0	25.0	25.5	26.6	27.2	28.2	29.0
Income from Government Business Enterprises	5.2	4.9	5.8	6.2	6.9	7.0	7.2
Other non-tax revenue	16.1	17.4	16.8	17.2	17.6	18.1	18.6
Expenses	161.8	162.5	**163.4**	**165.6**	**168.2**	**170.7**	**173.2**
Program Spending	149.2	150.0	150.1	151.9	153.8	155.8	157.6
Interest on Debt	12.5	12.5	13.3	13.7	14.4	14.9	15.5
Reserve	**1.0**	**-**	**1.0**	**1.0**	**1.0**	**1.3**	**1.6**
Surplus (Deficit)	**(14.5)**	**(11.7)**	**(10.3)**	**(6.8)**	**(5.6)**	**(3.5)**	**0.3**
As a % of GDP		**-1.4%**	**-1.2%**	**-0.7%**	**-0.6%**	**-0.4%**	**0.0%**
Net Debt	**347.1**	**343.4**	**359.9**	**372.3**	**382.4**	**388.7**	**391.6**
As a % of GDP	40.5	40.2	40.7	40.7	40.6	39.8	38.6
Accumulated Deficit	**223.6**	**220.8**	**230.0**	**235.8**	**240.4**	**243.9**	**243.6**
As a % of GDP	26.1	25.8	26.0	25.8	25.5	25.0	24.0
Interest on debt as a % of revenue	**8.5%**	**8.3%**	**8.6%**	**8.6%**	**8.8%**	**8.8%**	**8.9%**

	FES 2018-19	Interim 2018-19	Budget 2019-20	2020-21	2021-22
Borrowing Requirement	**33.2**	**39.6**	**36.0**	**32.8**	**31.5**
(Surplus) Deficit	14.5	11.7	10.3	6.8	5.6
Maturities/Redemptions	21.9	21.9	27.5	26.4	24.1
Investment in Capital Assets	12.8	11.9	11.6	11.1	10.5
Pre-borrowing in 2017-18 for 2018-19	(12.4)	(12.4)	-	-	-
Other	(3.6)	6.5	(13.4)	(11.6)	(8.8)

Source: 2019 Ontario Budget

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