April 27, 2017

Balanced budget: Mission accomplished! Now what?

Highlights

- Ontario projects a $1.5 billion deficit for 2016-17, equivalent to a scant 0.2% of GDP. That's largely consistent with February's Q3 update, controlling for the release of residual reserves/contingencies. The revised budget balance marks an improvement vs the prior fiscal year, the original 2016 budget plan or a fall update. It runs to eight the number of consecutive years in which Ontario has bettered its official deficit target, a nice track record of beating the budget.
- Making good on a long-standing commitment, Ontario is moving back into the black this fiscal year (2017-18) and aims to stay there through 2019-20. Extra revenue, interest relief, alongside a smaller reserve, make room for a notable increase in government spending.
- The province's land transfer tax (LTT) is coming under the microscope. Powered by a red-hot housing market, LTT revenue shot $570 million or 27% higher last fiscal year. A further 17% gain is anticipated this fiscal year, which would put LTT revenue at more than $3.1 billion or 2.2% of total provincial revenue. Official sensitivities suggest that each 1% decrease in either resales or existing home prices would erase $26 million in revenue.
- The budget is based on sub-consensus growth. For 2017-18, operating and capital contingencies total $615 million. Additional reserves are built directly into the fiscal plan, set at $600 million for each of 2017-18 and 2018-19, rising to $900 million in the final year of the fiscal plan. All else equal, reserves protect against a roughly 1%-pt miss in GDP growth. For reference, current year revenue amounts to just under $142 billion or 17% of GDP.
- The budget was light on new tax measures, but a number of spending commitments were outlined, including for health care, education, seniors and a variety of household pocketbook items. Electricity price relief and a housing reform package were outlined pre-budget. Total program spending is due for 3.2% average annual growth through 2019-20. We could see further investments made as the government gradually positions for a June 2018 election.
- Ontario ended 2016-17 with roughly $302 billion of net debt, equivalent to 37.8% of GDP—below more recent estimates or the original plan. Notwithstanding balanced budgets, the level of net debt will continue to grow due to new capital investments. The net debt-to-GDP ratio is seen falling for a third straight year to 37.5% in 2017-18. Ontario aims to ease the debt-to-GDP ratio down to 35% by 2023-24. That's a do-able target, assuming a continuation of balanced budgets and steady, moderate economic growth in-line with Ontario's potential. The budget also puts a timeline on the earlier pledge to get debt-to-GDP back to its pre-recession level of 27%. The goal: 2029-30. Demonstrated progress on working down the debt burden should be viewed as an important prerequisite for a credit rating upgrade, and while an immediate rating uplift can't be taken for granted, Ontario is moving in the right direction. The interest bite looks to remain quite manageable.
- Ontario raised $27 billion from debt capital markets in 2016-17—the lightest annual lift since the crisis. Just under 75% was sourced domestically, although the province remained active internationally (including in USD and AUD). Green bonds once again featured prominently. Last year's program included more than $3 billion in pre-funding.
- The province puts this year's long-term borrowing requirement at $26.4 billion. At least 75% is to be done in the C$ market, but issuance in US dollars and Euros deemed likely. There remains a strong commitment to annual green bond issuance. The budget envisions no net change in short-term borrowing. A decision to increase cash/near-cash balances adds $6 billion to this year's term debt requirement. That extra cash is being built up in advance of larger single-day bond maturities that will be coming due in the future and will also help bolster Ontario's overall liquidity levels—something that rating agencies tend to look favorably upon.
- Looking further out, Ontario bond issuance is expected to pick up to $32.2 billion in 2018-19 and $37.8 billion in 2019-20. While capital spending will remain a key driver of net funding needs, the increase in term funding captures larger refinancing requirements, with the pace of net bond issuance looking quite manageable for a highly liquid credit that has enjoyed strong investor subscription (at home and abroad) and where the credit rating outlook is stable to perhaps improving.

Ontario – 2017 Budget

NATIONAL BANK OF CANADA FINANCIAL MARKETS

What a long strange trip it's been

Ontario last balanced its budget a decade ago. Really, it might be fair to say that budget surpluses have been the exception more than the rule for the better part of a couple generations in Ontario. But making good on a long-standing commitment, the province is moving back into the black this fiscal year (2017-18) and aims to stay there. Indeed, the symbolism in the style and format of the main budget documents is plain as day: gone is the long-standing *red* cover, replaced with a new bold beautiful *black*!

Now, the road to fiscal recovery hasn't always been easy for Canada's most populous province. Recall that Ontario was laid low by the Great Recession, with key sectors like finance and manufacturing particularly hard hit. A relatively larger deficit (>3% of GDP at its peak in 2009-10) and a deliberate choice to forgo painful cuts meant a longer recovery timeline vis-à-vis some other provinces. Even with the government's helping hand, growth and job creation in some years of the recovery left something to be desired. Fiscal progress thus required tilting the program spending curve lower and, in select cases, enacting revenue measures in order to bring in some extra dough. A tougher line on public sector compensation at times sparked push back from unions. Debt accumulated, which in turn triggered earlier credit rating downgrades. Meantime, certain public sector assets were sold off (in whole or in part) as a means of partially funding an ambitious capital spending agenda. There was even a spat with the provincial Auditor General over pension accounting thrown in for good measure.

Ebbs and flows in the economy may have forced some course corrections over the years, but throughout, prudent budgeting allowed Ontario to better official targets. Look no further than the latest estimates for 2016-17 for evidence of better-than-expected fiscal results. Of course, some of the more recent fiscal traction can be traced to buoyant (in fact above-potential) economic growth.

With apologies to Jerry Garcia and the Grateful Dead, what a long strange trip it's been. But Ontario has kept on truckin', never wavering in its core fiscal commitment to erase the deficit by fiscal 2017-18. So here we sit in spring 2017, with a balanced budget in Ontario and a stable to perhaps improving rating profile for Canada's benchmark provincial credit.

Having strained for so many years toward this balanced budget objective and having arrived at this important fiscal destination, ask yourself: what now? In the event a host of pre-budget announcements escaped your attention, the government is shifting its attention to hydro price relief, housing affordability and expanded daycare, to name a few priorities. The government has rolled out a basic income pilot project and is moving to provide assorted other supports to targeted groups (like caregivers and students) or the vulnerable/disadvantaged (seniors for instance). Budget 2017 makes a notable investment in health care. We'll likely see further investments made as the government gradually positions for a June 2018 election.

You could forgive the temptation to pull a George W. Bush and hang a "Mission Accomplished" banner across the front of Queen's Park, but it's no time to get complacent or to get too loose with the purse strings. As strong as today's economy may be, growth isn't necessarily being generated in the most sustainable manner. Housing prices, the very lifeblood of today's economic expansion, have rocketed higher, fanning bubble fears. The geopolitical backdrop remains highly uncertain, while prospective US policy changes (most notably on tax and trade) present a clear and present danger to Ontario's export prospects and overall competitiveness. To be fair, earlier tax reforms have significantly lowered Ontario's business tax burden (notably the marginal effective tax rate on new investment). Still, we haven't exactly observed a swell of new business investment. Governments in Canada (federally and provincially) may well need to bolster competitiveness should a new US administration succeed in driving corporate tax rates decisively lower south of the border. Stay tuned… or rather watch Mr. Trump's Twitter feed for regular updates.

Finally, while net borrowing needs have stepped lower and the interest bite is eminently manageable, it's increasingly time to think about reining in a record debt burden, if only to generate the flexibility to respond to the next dip in the economy or to absorb the likely health care pressures tied to the gradual aging of the population. So we were glad to see more explicit medium- and longer-term debt-to-GDP reduction targets. After all, it's a lighter debt burden that's the pathway to a nearer-term credit rating improvement and longer-term fiscal sustainability. Let's end the editorial there and move on to the gory details of Ontario's 2017 budget…

Beating the budget again in 2016-17

Ontario now estimates a $1.5 billion deficit for 2016-17, equivalent to a scant 0.2% of GDP. That's largely consistent with February's Q3 update, controlling for the release of residual reserves/contingencies now that the fiscal year is over. Importantly, the revised budget balance marks an improvement vs the prior fiscal year, the original 2016 budget plan or a fall update. And it runs to eight the number of consecutive years in which Ontario has bettered its official deficit target. That's a nice track record of beating the budget.

Revenue ran $2.6 billion (or fully 2%) above budget last fiscal year, including an extra $1.3 billion of corporate income tax revenue, over $700 million in additional PIT/health premium receipts, a further $700 million in sales tax revenue and above-plan proceeds from the province's land transfer tax (the most direct, but by no means sole fiscal link to a rocking housing market). The revenue picture would have been even brighter save for a re-profiling of anticipated cap-and-trade

auction proceeds (now moved into 2017-18). Federal transfers are also a touch lower than anticipated at budget time. On balance, you can view this as a broadly based and non-trivial positive base effect heading into 2017-18.

Program spending was lifted almost $1.4 billion (or 1.1%) above plan in 2016-17, capturing (among other things) electricity price relief starting in January and commitments to social/affordable housing, alongside more recent investments in health care, higher school enrollments and extra disability supports. Meanwhile, debt servicing costs came in $0.5 billion below plan, consuming a modest 8.5 cents of the revenue dollar. Lower-than-planned debt servicing costs have been a consistent theme for Ontario, having provided a cumulative $24 billion of relief relative to the long-term fiscal recovery plan set down in 2010.

Balanced in 2017-18 and thereafter

Rather than looking back, a budget's really about focusing forward. On the surface, Ontario's medium-term budget balance is little changed compared to prior guidance. That is to say, the province sees itself in balance in 2017-18 and staying there through at least 2019-20.

But there are some not-so-subtle differences in how you get to and stay in balance in this budget vs last year's version. Owing to the strength of the economy, the picture has brightened nicely across a number of core revenue streams; starting in 2017-18, baseline revenue is at least $3 billion/year stronger than prior thinking. As noted, interest charges are also coming in well below what was previously telegraphed. Extra revenue, interest relief, alongside a smaller reserve, make room for a notable increase in government spending. Indeed, program spending has been boosted by more like $5 billion/year (on average) compared to the prior plan.

Getting a little more specific, revenue is set to advance at an average annual rate of 3.9% in the coming three years—which you could view as consistent with underlying economic projections. (Nominal GDP is slated to grow 4.3% this year, with average growth of just over 4% through decade's end. Real GDP growth is projected at 2.3% in 2017.) Again, when it comes to the revenue picture, dispersion is the name of the game, with broad-based and consistent growth slated for most core revenue line items. Personal income tax revenue is being buoyed by solid growth in employee compensation, while sales tax revenue keys off a sturdy outlook for consumer spending. A reasonably healthy profit outlook informs projected gains in corporate income tax.

Ontario expects to generate just over 18% of its revenue from the federal government in 2017-18. The detailed breakdown shows equalization stepping down—due to the province's superior economic performance of late—but infrastructure funding growing smartly.

Fiscal 2017-18 is now the first year of carbon allowance proceeds, which have been set at $1.8 billion. Meanwhile, "sales and rentals" are projected to bring in $3 billion. The budget reiterated the government's plan to reduce its stake in Hydro One to no less than 40% over time. (Ontario's current ownership share is ~70%, following two separate offerings of ~15% each in November 2015 and April 2016.)

Understandably, the province's land transfer tax (LTT) is coming under the microscope. Powered by a red-hot housing market, LTT revenue shot $570 million or 27% higher last fiscal year. A further 17% gain is anticipated this fiscal year, which would put LTT revenue at more than $3.1 billion or 2.2% of total provincial revenue. Official sensitivities suggest that each 1% decrease in either resales or existing home prices erases $26 million in revenue. Any prospective correction in Ontario housing prices would hit this revenue channel first, although when you consider the outsized share of provincial growth generated from housing, the revenue impacts for a given housing price trajectory go well beyond the LTT.

This begs the question: how much prudence is built into the fiscal plan? In keeping with past practice, the budget is based on sub-consensus growth; the real GDP outlook has been set one tick below the private sector average each and every year of the plan. Contingency funds are another long-standing feature of Ontario budgeting. For 2017-18, operating and capital contingencies total $615 million. And then there's the reserve, which is built directly into the fiscal plan in a very transparent manner. That reserve has been set at $600 million for each of 2017-18 and 2018-19, rising to $900 million in the final year of the fiscal plan. While always to be treated with a grain of salt, official sensitivities imply that the reserve funds would be sufficient to cover a roughly 1%-pt miss in GDP growth, all else equal. All told, there's some non-trivial prudence built into the fiscal plan, even if the total amount of insulation has been taken down relative to prior years in order to make way for new investments.

Taking action on many fronts

The budget may have been light on new tax measures—there was a public transit credit for seniors, more than offset by increased tobacco taxes—but a number of spending commitments were outlined. The total program spending envelope is due for 3.2% average annual growth through 2019-20. That's a step-up from the sub-2% average program spending growth registered over the past half-decade.

As we highlighted in the introductory paragraphs of this report, Ontario is moving forward on a number of fronts. Health is a key focus, including universal pharmacare for children/youth, reduced wait times, an ambitious hospital modernization programme and growing support for home/community care. Not to be overlooked, education spending is on the rise, in part due to expanded enrollment,

new child care investments, skills programming and enhancements to post-secondary institutions. This is by no means all, and we're deliberately keeping our focus high-level here. See the official budget documentation for more granularity.

Meanwhile, the government had previously outlined a package of reforms designed to lower hydro bills by an average of 25%. The province's Fair Housing Plan—a slate of new measures designed to slow the torrid rate of increase in housing prices and spur new investment—was likewise rolled out pre-budget. A key plank of the housing affordability strategy was a 15% non-resident speculation tax for the Golden Horseshoe region, but there were plenty of other actions, covering everything from approval for a vacancy tax in Toronto to expanded rent controls. We put out a separate piece on this last week, and those seeking greater information on housing reforms will find no shortage of analysis. Again, we'll need to monitor the impact of these measures on the province's housing market given the significant economic and fiscal leverage to housing in today's Ontario economy.

Debt profile tilted lower

As for the balance sheet, Ontario estimates that it ended 2016-17 with roughly $302 billion of net debt, equivalent to 37.8% of GDP—below more recent estimates or the original budget plan. Notwithstanding balanced budgets, the level of net debt will continue to grow due to new capital investments. Although the province expects to increase net debt by some $10 billion this year, the corresponding net debt-to-GDP ratio is seen falling for a third straight year in 2017-18 to 37.5%. (The peak debt-to-GDP ratio was 39.1% in 2014-15.)

Moreover, the budget provides a bit more guidance on medium- and longer-term debt reduction targets. Ontario aims to ease the debt-to-GDP ratio down to 35% by 2023-24. That's a do-able target, assuming a continuation of balanced budgets and steady, moderate economic growth in-line with Ontario's potential. The budget also puts a timeline on the earlier pledge to get debt-to-GDP back to its pre-recession level of 27%. The goal: 2029-30. That implies a more rapid average annual decline in the debt burden than what we've observed of late, incorporating the economic lift from unprecedented infrastructure investments and presumably a gradual/sustained improvement in the after-capital balance.

Demonstrated progress on working down the debt burden should be viewed as an important prerequisite for a credit rating upgrade, and while an immediate rating uplift can't be taken for granted, Ontario is moving in the right direction.

Deconstructing the borrowing program

Notwithstanding an expectation of rising interest rates, Ontario's interest bite looks to remain quite manageable. Credit the province for locking in much of its issuance longer-term, dulling the immediate fallout from higher borrowing rates and providing ample flexibility to move some bond issuance down the curve if necessary. (The weighted-average term of borrowing has hovered between 12½ to 14-plus years since fiscal 2010.)

Ontario succeeded in raising $27 billion from all markets in 2016-17—the lightest annual lift from debt capital markets since the crisis. Just under 75% was sourced domestically, although the province remained active internationally (including in USD and AUD). Green bonds once again featured prominently, with the province's third green bond offering of $800 million attracting good demand.

It's important to note that more than $3 billion of that was pre-funding, as Ontario once more opted to take advantage of favourable market conditions (attractive borrowing rates, sturdy investor demand for its name) to get a jump start on 2017-18.

So the province now puts this year's long-term borrowing requirement at $26.4 billion. (At this point, $0.6 billion has been completed.) The budget envisions no net change in short-term borrowing. Note that a decision to increase cash/near-cash balances adds $6 billion to this year's term debt requirement. That extra cash is being built up in advance of larger single-day bond maturities that will be coming due in the future and will also help bolster Ontario's overall liquidity levels—something that rating agencies tend to look favorably upon.

Overall then, gross bond issuance could be little changed compared to the prior fiscal year. At least 75% of this year's program looks to be funded in the C$ market, but issuance in US dollars and Euros is deemed likely. There's a strong commitment to continue the green bond program, issuing in this format on an annual basis. Looking further out, Ontario issuance is expected to pick up to $32.2 billion in 2018-19 and $37.8 billion in 2019-20. While capital spending will remain a key driver of net funding needs, one need appreciate that the increase in term funding captures larger refinancing requirements. We would see the pace of net bond issuance as quite manageable for a highly liquid credit that has enjoyed strong investor subscription (at home and abroad) and where the credit rating outlook is stable to perhaps improving.

Warren Lovely

Ontario – 2017 Budget

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Ontario

$ billions	Budget 2016/17	Interim 2016/17	Budget 2017/18	Outlook 2018/19	Outlook 2019/20
Revenue	**130.6**	**133.3**	**141.7**	**144.9**	**149.3**
Own-Source Revenue	91.8	95.1	100.1	105.4	110.3
Personal Income Tax	32.2	32.9	35.0	37.3	39.5
Retail Sales Tax	24.0	24.7	26.0	27.1	28.0
Corporations Tax	12.1	13.3	13.8	14.7	15.5
Education Property Tax	5.8	5.9	6.0	6.1	6.1
Ontario Health Premium	3.6	3.7	3.8	4.0	4.2
Other	14.1	14.6	15.6	16.3	17.1
Federal Transfers	24.6	24.4	25.7	25.4	24.9
Income from Government Business Enterprises	5.0	5.3	4.9	5.7	6.0
Other non-tax revenue	9.1	8.5	11.0	8.3	8.1
Expenses	**133.9**	**134.8**	**141.1**	**144.3**	**148.4**
Program Spending	122.1	123.5	129.5	132.3	135.8
Interest on Debt	11.8	11.3	11.6	12.0	12.6
Reserve	**1.0**	**-**	**0.6**	**0.6**	**0.9**
Surplus (Deficit)	**(4.3)**	**(1.5)**	**(0.0)**	**(0.0)**	**(0.0)**
Net Debt	**308.3**	**301.9**	**311.9**	**323.3**	**335.9**
As a % of GDP		37.8	37.5	37.3	37.2
Accumulated Deficit	**197.8**	**193.5**	**193.5**	**193.5**	**193.5**
As a % of GDP		24.2	23.2	22.3	21.4
Borrowing Requirement	**26.4**	**27.0**	**26.4**	**32.2**	**37.8**
(Surplus) Deficit	4.3	1.5	0.0	0.0	0.0
Maturities	21.5	20.9	17.5	21.8	27.4
Redemptions	0.1	0.1	0.1	0.1	0.1
Investment in Capital Assets	11.2	8.9	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)	-	
Other	(10.7)	(5.6)	(1.1)	(5.1)	(6.8)

Source: 2017 Ontario Budget

Ontario – 2017 Budget

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Economics and Strategy

Montreal Office
514-879-2529

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

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

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Matthieu Arseneau
Senior Economist
matthieu.arseneau@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Toronto Office
416-869-8598

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

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