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Understanding Toronto's shifting fiscal landscape

By Warren Lovely

Canada's largest city, Toronto (BBG Ticker: TRNT), is in the midst of the annual budget process. A detailed staff recommendation kicked things off back on January 10th. Mayor Olivia Chow's first full budget proposal followed on February 1st. City Council will next have its say via a special session on February 14th.

As befits a large, growing and diverse city, there are lot of moving parts to Toronto's annual budget. Fair to say the 2024 iteration has captured much interest, largely due to the frank assessment of the city's finances and the size of the property tax increase needed to address underlying pressures.

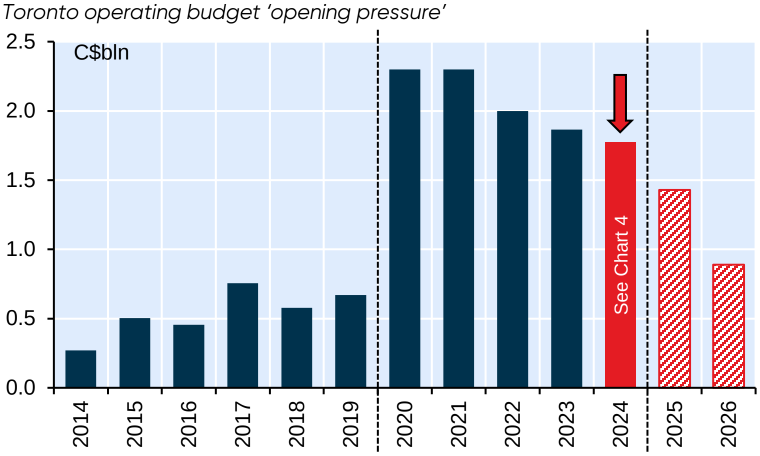
The following, which we present in **free-flowing Q&A format**, aims to highlight some of the major issues/questions we've been fielding on Toronto's evolving fiscal landscape.

Q: What's this hole I've been hearing about in Toronto's budget?

A: As per the January 10th staff presentation—which launched the annual budget process—Toronto saw itself facing a nearly $1.8 billion 'opening pressure' for calendar 2024. In essence, that's the underlying hole in the City's operating budget that must be closed, one way or another due to balanced budget legislation.

This is hardly the first time Toronto has flagged an 'opening pressure'. Indeed, the City has been dealing with material operating budget pressures since COVID hit, having relied on a number of remedial actions (including some stop-gap or temporary measures/supports) in years gone by.

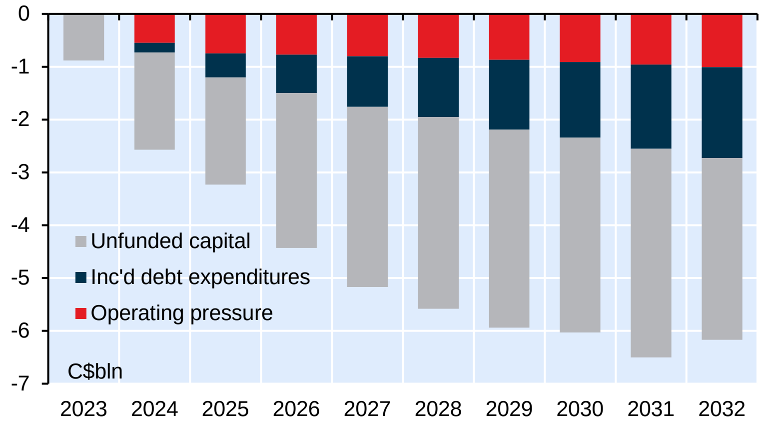
Chart 1: COVID's lasting impact… large 'opening pressures'
Toronto operating budget 'opening pressure'



Source: NBF, Toronto | Note: 2024 as per budget launch; 2025-26 pressures are indicative; figures before balancing actions, incl. city-led initiatives & inter-government support(s)

To us, prior-year budgets and the City's comprehensive investor relations material have attempted to make plain the challenges facing Toronto. To wit, the City adopted a Long-Term Financial Plan last year which was meant to ease budget pressures over the following decade. Meantime, there have been repeated calls for fair(er) treatment and incremental support from other levels of government, which in some respects have borne fruit. More on that later. Yet, as the 2024 budget process makes clear, there's still a need for aggressive balancing action in the here and now. A big part of that reflects lingering pandemic impacts, which have more recently been exacerbated by inflation and growth-related pressures.

Chart 2: Earlier Long-Term Financial Plan flagged pressures
Nature of Toronto's financial pressure as per Long-Term Financial Plan



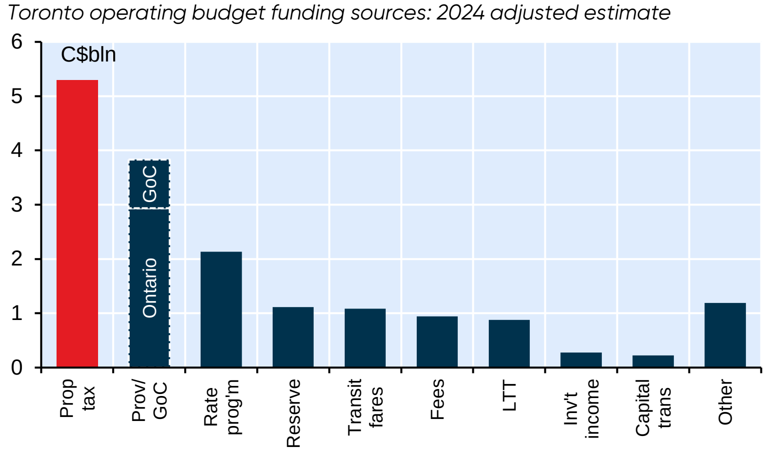
Source: NBF, Toronto | Note: Total pressure of C$46.5bln over 10 years

Q: What options are available to address this financial pressure?

A: As noted, Toronto's budget is complex, with a vast array of expenditures to be set and certain revenue levers available to pull. As a simple gauge of operational complexity, look no further than the 400-plus pages that comprise Mayor Olivia Chow's February 1st budget proposal. Boiling things down, Toronto's operating budget is roughly $17 billion, which is more than what each of the Atlantic Canada provinces spend in a given fiscal year. That covers a host of vital social programs, including affordable housing/shelters, in addition to transit/transportation, police/fire/paramedic services, public health, child care, parks/recreation, libraries, and various other city services and public administration.

Extensive consultations held in the lead-up to the budget highlighted broad support for many of these core services, implicitly limiting the Mayor's ability to cut her way to an operating balance. That really left revenue tools as an obvious route to balance.

Chart 3: Property taxes an essential revenue stream
Toronto operating budget funding sources: 2024 adjusted estimate



Source: NBF, Toronto | Note: Staff budget adjusted for lower proposed tax increase; excludes federal refugee support announced after budget proposed

Of note, Toronto has access to a few extra/special revenue tools that smaller Ontario municipalities don't possess. The City's land transfer tax and vacant home tax are obvious examples, although these are not necessarily the most stable or established revenue streams with which to attack structural pressures. The Mayor has pressed for even greater revenue flexibility, including perhaps through the adoption of a Municipal Sales Tax. Note that the creation of such a tool would be dependent on the province and would theoretically take time to iron out and implement. So even in Toronto, when it comes to municipal budgeting, property taxes are (for now) quite central. Indeed, there continues to be a heavy reliance on property taxes here and in other municipal jurisdictions, property tax receipts consistently comprising over 30% of Toronto's total operating revenue.

Finally, a little perspective is needed when it comes to just how much a given property tax hike really brings in. Toronto estimates that a single percentage point increase in property taxes generates just over $40 million/year. Given the spending pressure that has been telegraphed, one might argue a meaningful tax hike has really been in the cards for some time. Well, that time is now.

Q: The property tax hike is how big then?

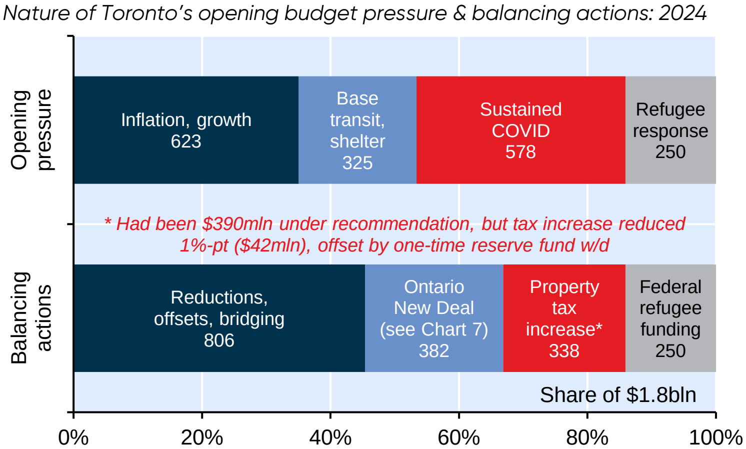
A: With little support/appetite for radical spending cuts, the preliminary staff budget (from January) floated a 9.0% residential property tax hike. Adding on the 1.5% City Building levy—dedicated to supporting investment in transit and housing—the prospective tax hike pushed into double-digit territory (i.e., 10.5%).

Understandably, a tax hike recommendation of such magnitude garnered attention, including from municipal bond investors. Subsequent to January's initial presentation, and following additional stakeholder input sessions, the Mayor ultimately proposed a 8.0% residential property tax hike for 2024 (or 9.5% after tacking on the City Building Fund). The Mayor's plan would draw $42 million from the Tax Stabilization Reserve Fund as a means of offsetting the 1%-pt property tax reduction vs. the initial presentation (i.e., opting for an 8.0% increase as opposed to 9.0%).

The above-noted property tax hike relates to residential properties, with the Mayor's proposed increase for multi-residential properties set at 3.5% (also down 1%-pt from January's staff recommendation).

Chart 4: Addressing 2024's 'opening pressure'

Nature of Toronto's opening budget pressure & balancing actions: 2024



Source: NBF, Toronto | Note: As per budget documents; figures in chart are C$mln

Q: Why not simply run a deficit?

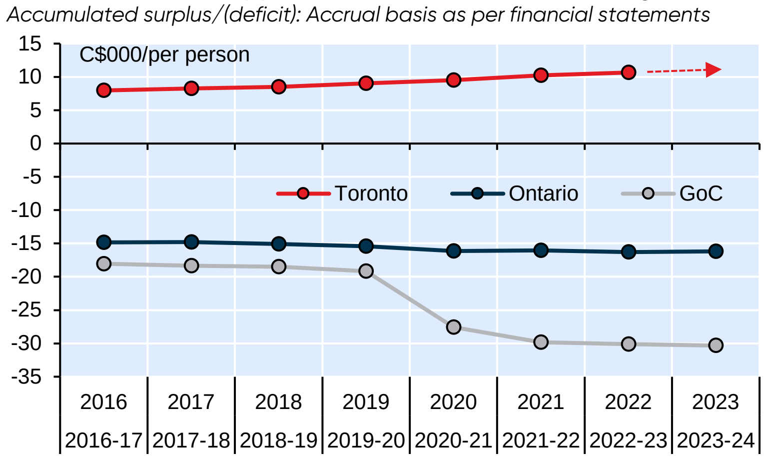
A: Well it's not that simple. When it comes to public sector budgeting, a city is not a province... nor a central government for that matter. As prescribed in provincial legislation, Toronto like all other Ontario municipalities, is obliged to present and pass a balanced operating budget. In contrast, and as we have repeatedly seen, provinces and the feds have full autonomy/authority to run operational deficits, which can involve issuing long-term debt to finance less-than-long-term program outlays and/or cyclical revenue pressures.

To us, Toronto's recent episode reinforces the point that a municipal government's annual budget must identify sufficient income to cover operational outlays, even if it means marginal pain for taxpayers. In certain cases, reserves built up in prior years can be drawn upon to address pressures. In other instances, relief may be afforded by other levels of government. But under no circumstances can Toronto (or any other municipal government) simply tap bond investors as a means as keeping the lights on, operationally speaking. It should follow that when a budgetary pressure of considerable magnitude arises—one that reserves and/or one-off inter-governmental transfers can't fully offset—an enlarged property tax bill can result.

Audited financial statements—which unlike Toronto's operating budget rely on accrual as opposed to cash accounting—further highlight the fiscal divergence between the more-constrained municipal sector and less-constrained provincial/federal jurisdictions. Despite noted operating pressures, Toronto consistently runs a surplus on an accrual basis, the City's accumulated surplus thus growing. Ontario and the feds both carry accumulated deficits, the latter's balance sheet showing COVID scars.

Chart 5: Different approaches at different levels of gov't

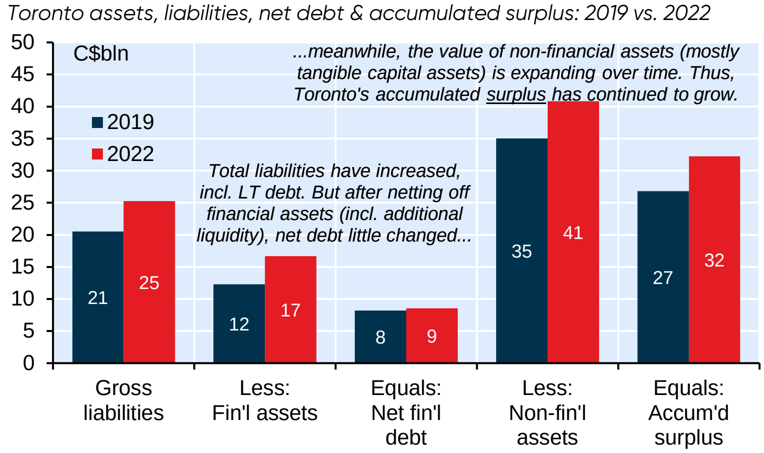
Accumulated surplus/(deficit): Accrual basis as per financial statements



Source: NBF, GoC, Ontario, Toronto | Note: Based on latest audited financial statements

Chart 6: Pre- & post-COVID look at Toronto's balance sheet

Toronto assets, liabilities, net debt & accumulated surplus: 2019 vs. 2022



Source: NBF, Toronto | Note: 2022 is latest available audited financial statements

As an aside, and as most of our readers certainly appreciate, municipalities can partially fund eligible capital projects via new debt. But even here, provincial legislation/regulation generally establishes strict limits on the incurrence and management of municipal debt. This is all part of a suite of bondholder safeguards and we wouldn't necessarily advocate for any serious relaxation of said controls/limits, even in the face of municipal budget pressures.

Q: Why the big tax increase now, when COVID first hit in 2020?

A: In some cases, Toronto relied on/benefited from special offsets to balance prior year budgets. The federal government's Safe Restart Agreement channeled needed support from Ottawa to the provinces and municipalities as the economy was gradually re-opened. There have been other one-off/non-recurring measures, including the use of reserves and expenditure cutbacks. Property taxes were increased in prior years too.

But now, and really for the first time, Toronto is fully incorporating the sustained pandemic impacts—what you might call the lasting COVID hangover, including transit farebox pressure—into the city's budget. That's a fundamentally different approach than simply hoping for special relief from other levels of government to arrive each year, not that the City doesn't have a case for broader fiscal reform.

Q: How much of a fix is this?

A: There's a different (and we'd argue more responsible) fiscal philosophy behind Toronto's 2024 budget. Call it a regime shift if you'd rather, and the sizeable property tax increase being proposed is a clear enough demarcation line.

As with any major overhaul, it's expected that some time will be needed to fully complete Toronto's fiscal transition. Supplementing and building on the Long-Term Financial Plan (LTFP) earlier adopted, the City is now talking about a three-year plan to secure greater budgetary sustainability.

Even with LTFP actions paying dividends and the sizeable property tax increase now proposed, there will likely still be operating pressures to offset when future-year budgets are launched. But forceful and permanent action taken today (i.e., in the 2024 budget) will mean less aggressive offsets down the road, all else being equal.

Q: But wait, didn't Toronto get a New Deal from Ontario?

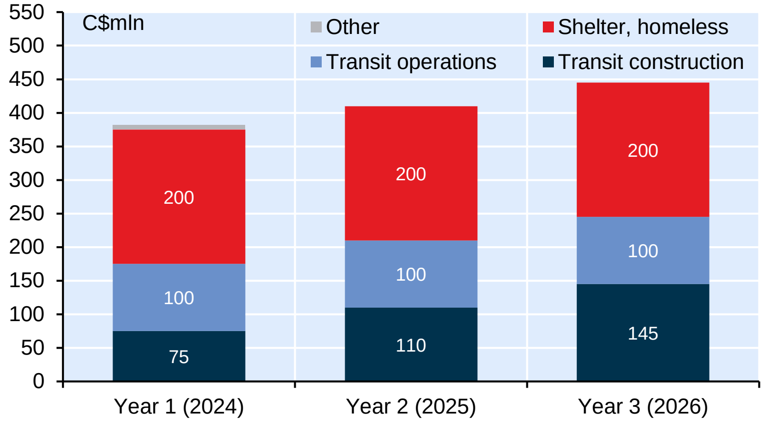
A: Yes, the Ontario-Toronto New Deal is a *big deal* for the City. No question, it clearly helps, both from an operating and capital budgeting perspective.

As per the agreement struck last year, Toronto will receive ~$1.2 billion in operating supports over three years, including $382 million in 2024. Think of it this way: In the absence of the New Deal, Toronto would have needed an even larger property tax hike (or some combination of tougher fiscal measures/restraint) to balance the operating budget.

Don't lose sight of the additional $3 billion in capital support that the New Deal outlined over 10 years. That provides Toronto important relief. With some critical yet aging infrastructure uploaded to the province, Toronto should be in a position to more aggressively tackle a hefty backlog of state-of-good-repair (SOGR) spending.

Chart 7: New Deal with province lends operating support…

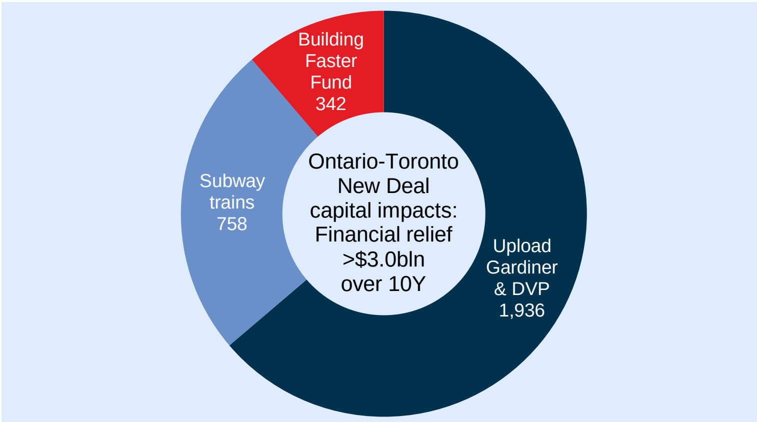
Toronto operating impacts (i.e., funding) of New Deal with Ontario



Source: NBF, Ontario, Toronto | Note: Refer to official terms for full details/conditions

Chart 8: … and ushers in welcome capital relief too

Toronto capital impacts (i.e., financial relief) of New Deal with Ontario



Source: NBF, Ontario, Toronto | Note: Refer to official terms for full details/conditions

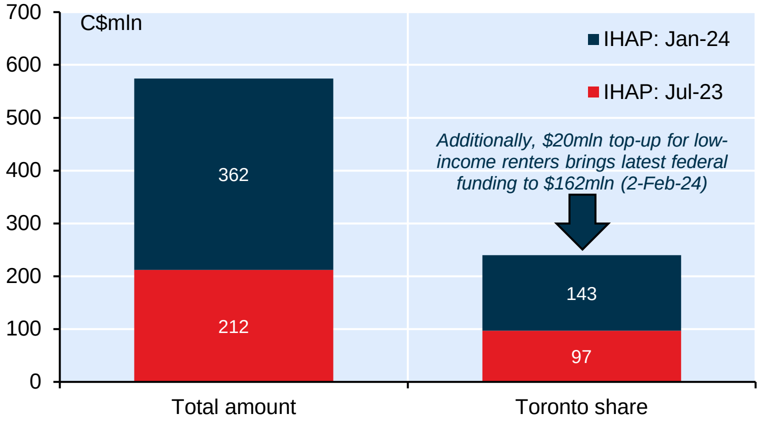
Q: And what about that refugee money from the feds?

A: Importantly, the City is also receiving incremental support from the feds to help address refugee-related costs. A fresh commitment outlined by Deputy PM Freeland will funnel $162 million to Toronto, much of it via the established Interim Housing Assistance Program (IHAP) which helps defray shelter-related costs for the burgeoning number of refugees coming to the City. The feds' latest announcement also included roughly $20 million in rent-support for low-income Torontonians.

While welcome, and surely needed, note that Toronto's budget had assumed the feds would come through with refugee-related funding. So again, the provision of this marginal federal funding simply forgoes what might have been an even larger property tax increase.

Note: As per budget-related documentation, an extra 6%-points might have been needed to cover the cost of sheltering refugees, a prospective increase the Mayor now (thankfully) confirms will not be necessary.

Chart 9: Feds provide needed refugee/asylum shelter relief
Toronto's share of GoC funding via Interim Housing Assistance Program (IHAP)



Source: NBF, Canada, Toronto | Note: Refer to official announcements for full details

Q: Just how unique is Toronto's situation?

A: As the largest city in Canada, Toronto certainly has unique attributes/characteristics. But to some extent, what Toronto is coping with is not entirely dissimilar to what other ultra-large urban centres face.

The largest cities tend to have extensive transit systems that ferry people to/from the core. And where ridership has not fully recovered, gaps in transit farebox revenue can lead to sustained budgetary pressure. The large cities also tend to be beacons for newcomers, including asylum seekers/refugees. As noted, that can add a disproportionate burden on the local administration. As major economic hubs, the large cities and surrounding areas are also coping with growth-related pressures. Simply put, as Canada's population swells, more public infrastructure is needed. It's the cities, regional governments and provinces that provide most of the public services demanded of Canada's rapidly growing population. And from the look of things, many local and regional jurisdictions are struggling to keep up with the burgeoning headcount. It's little wonder that Toronto has so consistently advocated a 'whole-of-government' solution when it comes to ensuring fiscal fairness as Canada's population booms. Makes sense.

Toronto is hardly the only city proposing a meaningful property tax hike to balance an operating budget. A quick and by-no-means-comprehensive scan shows that Vancouver property taxes will be up 7.5% in 2024, adding to a double-digit increase the year prior. Elsewhere, property taxes are rising by more than 7% in Calgary and Hamilton, by more than 6% in Edmonton and in excess of 5% in London. While seemingly more modest, Montreal's 4.9% average property tax hike still looks to be the biggest in over a dozen years. Winnipeg kept a promise to limit the property tax increase to 3.5% but is leaning into other fees/levies. Ottawa's mayor likewise followed through on an election promise to cap the property tax increase at 2.5% during the first two years of his administration. Budget pressures are nonetheless apparent in the nation's capital too.

Q: Can Torontonians afford the planned property tax increase?

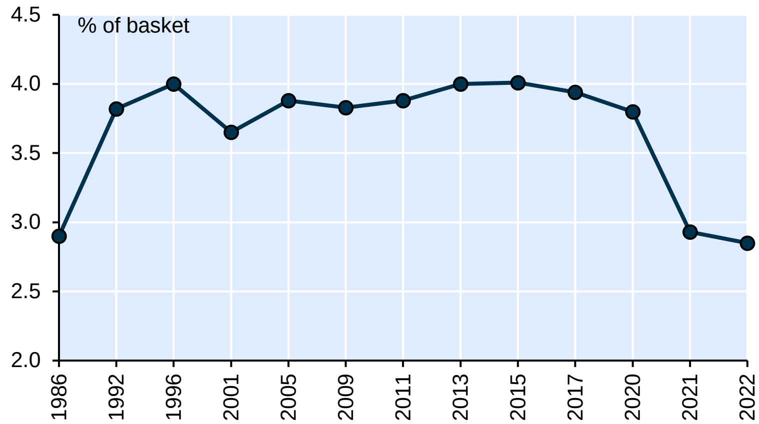
A: Based on thoughtful analysis by City Hall staffers and the budget proposal ultimately presented by the Mayor on February 1st, the presumption is clearly 'yes'. Yet this is an important question, particularly at a time when affordability and cost-of-living pressures appear acute. One can debate how best to characterize the proposed property tax increase, whether it should be labeled 'semi-modest' or 'historic'. Certainly, Toronto is not alone when it comes to needing property tax increases to operate a rapidly growing city.

Stop and ask what the 'representative' citizen of Toronto really wants from their local government. For the most part, consultation feedback suggests it's the continued provision of core public services. As we stated earlier, operating a large and growing city requires financial resources. Given existing fiscal frameworks that necessitates incremental property tax revenue, in Toronto and many other cities.

Divided by the roughly 1.2 million homes across the City, the proposed 8.0% residential property tax increase works out to about $285/year. That's not nothing, although as the Mayor's covering letter noted, it's about 80 cents/day—far less than the cost of a small cup of joe at your corner coffee shop.

Directly or indirectly, you can add property taxes to the list of items set to consume a bit more disposable income this year. Thankfully, this isn't necessarily the largest expenditure line item for the average household. Based on StatCan's latest official CPI weights, property taxes comprise 2.85% of the consumer basket in Ontario. That may be above the national average but is lower than at any time since the mid-1980s.

Chart 10: Property taxes a smaller CPI component over time
Weight of property taxes & other special charges in Ontario CPI basket



Source: NBF, StatCan | Note: As per CPI basket update from Jun-23

It seems Toronto and other Canadian municipalities had generally been holding the line on property taxes in years gone by. To some extent then, the large(r) increases seen in 2024 municipal budget proposals may represent a bit of catch up. Meanwhile, if you control for the often-substantial appreciation in the assessed value of real property, mill rates appear relatively contained/competitive.

Municipalities should never dismiss the role the property taxes can play in attracting or retaining skilled labour and dynamic businesses/industries. That's why it's important for Toronto to stabilize its finances for the long term. While seemingly aggressive, the proposed tax increase is meant to place Canada's largest city on a more sustainable footing going forward, more seriously addressing an ongoing COVID hangover. Importantly, support from other levels of government can ultimately limit the ask of property owners.

Q: What do the rating agencies have to say?

A: Of late, not a whole lot, but that's largely to be expected. Credit rating agencies are no doubt following the annual municipal budgeting process, in Toronto and elsewhere. But the budget is not yet passed. Moreover, it's not clear that the Mayor's plain fiscal talk and recent budgetary proposal warrants a fundamental re-think of the outlook, with ratings for Canada's municipal sector having generally proven resilient (impervious?) to the economic cycle.

When it comes to Toronto, credit rating agencies have variously emphasized the size and diversity of the local economy, the stable nature of core revenue streams alongside unique taxing powers, the manageable/affordable debt load and consistently strong liquidity profile, among other things. Repeated outsized property tax hikes and/or material utilization of reserves could influence thinking. But as it stands, that's not where Toronto is really guiding.

For its part, S&P's 'downside scenario' is predicated on an inability to take necessary steps to address budget shortfalls on a sustained basis. No one can say the City is failing to take decisive action, the multi-year approach outlined in Budget 2024 clearly aimed at bolstering longer-term sustainability.

In the background, rating agencies generally see Canada's municipalities benefiting from a strong institutional framework. Even if there's room for additional transfer support, Toronto's New Deal with Ontario and fresh federal commitments for refugees demonstrate the importance of the City to other levels of government.

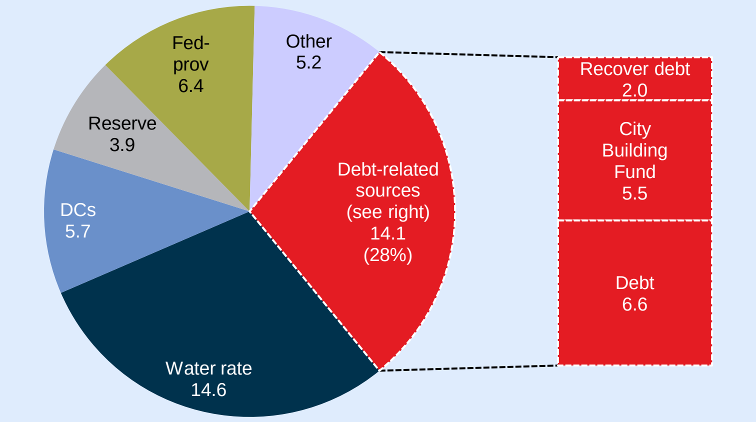
City of Toronto	S&P	Moody's	DBRS
Long-term rating	AA	Aa1	AA
Outlook	Positive	Stable	Stable
Last detailed report	*17-Oct-23*	*23-Oct-23*	*09-Nov-23*

Q: What's going on with Toronto's capital budget?

A: To be clear, much of the above discussion and well-covered property tax fireworks relate to Toronto's operating budget, which as noted, must be balanced. But for a such large and growing city, the capital budget is no side-show.

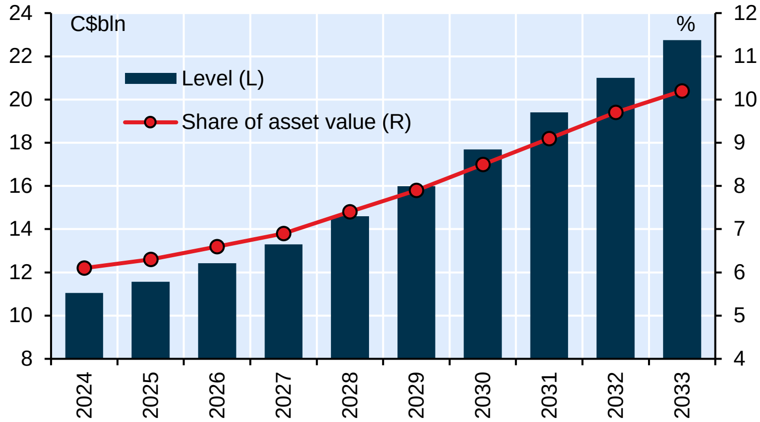
The City has outlined a 10-year capital plan worth almost $50 billion covering 2024 to 2033. Only a portion (13%) of that sizeable capital plan is meant to be financed via fresh, non-recoverable debt. The balance is to be either rate-supported or covered by some combination of development charges (DCs), reserves, dedicated funds (e.g., City Building Fund), current funding, other levels of government, etc. Note: On the subject of DCs, discussions with Ontario regarding potential Bill 23 impacts are ongoing.

Chart 11: How is Toronto's $50bln capital plan to be funded?
Funding sources for Toronto 10-year Capital Plan: 2024-33



Source: NBF, Toronto | Note: Figures in chart are C$bln, totaling C$49.8bln over 10 years

Chart 12: Tackling large SOGR backlog a noted priority
Toronto State of Good Repair (SOGR) backlog



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

As for the previously noted New Deal with Ontario, the upload of some critical infrastructure (notably the Don Valley Parkway and F.G. Gardiner Expressway) along with subway-related supports, should allow Toronto to advance on its SOGR backlog. This has been a priority for some time, with SOGR spending currently accounting for just over half of the 10-year total capital plan. As the City makes clear, even with planned action, it is expected the SOGR backlog could continue to grow, owing to cost escalations, updated assessments and the steady march of time (which brings more infrastructure to the end of its useful life).

Q: Just how much can we expect Toronto to borrow in 2024?

A: As the previous section tried to make clear, there are some important moving pieces in the capital plan and some items still to be sorted. But Toronto's near-term approach to debt capital markets doesn't look to be much changed.

The City is focused on maximizing non-debt financing streams. While debt is to be selectively taken on—exclusively for capital as opposed to operational purposes—relative leverage is limited by established debt service limits/caps. Specifically, Toronto's debt service costs cannot exceed 15% of property tax revenues. Background material provided as part of the budget process sees the debt service ratio hovering a bit below 14% through 2028, edging closer to the 15% threshold by the end of the current 10-year capital plan.

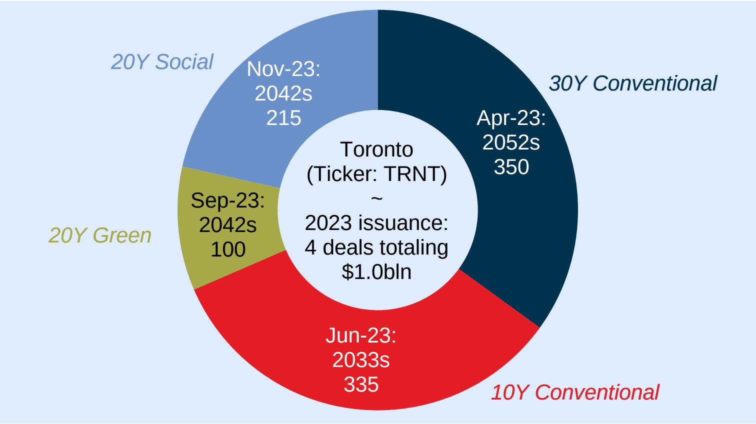
As endorsed by City Council, Toronto has an annual debt issuance cap of $2 billion that's been in place since 2022 and extends through 2026.

Last year, in calendar 2023, the City tapped debt capital markets for an even $1 billion via four trades (in April, June, September and November). As it currently stands, Toronto is planning to issue $1.2 billion in new long-term debt in 2024. That was the planned issuance figure before the operating budget exercise began and it's still the guidance being offered today.

Q: When and how should we expect Toronto to approach debt capital markets?

A: One could expect Toronto to once again be in the market four times in calendar 2024, cumulatively satisfying the above-noted $1.2 billion gross bond requirement.

Chart 13: Last year's bond program a partial guide for 2024
Composition of Toronto's bond issuance by timing/maturity/format: 2023



Source: NBF, Toronto, Bloomberg | Note: Figures in chart are C$mln (par value)

Following passage of the budget, it's expected that Toronto would gradually get in position to access debt capital markets, March or April looking like a reasonable timeframe for the City's first deal of the year (if traditional seasonal patterns hold sway). As always, we'd emphasize that Toronto's approach to debt capital markets will be calibrated to underlying financial conditions and investor sentiment.

Given established frameworks, we'd expect Toronto to utilize both conventional and labeled (Green and Social) formats. As to term, 10s, 20s and 30s would all seemingly fit the bill, the long(er) term focus for many municipal debt issuers consistent with the extended useful life of the capital assets bond proceeds are dedicated to.

Overall, you can expect Toronto to account for a non-trivial share (nearly 20%) of total municipal bond issuance this year, the City remaining at the more liquid end of the municipal spectrum. Incorporating Toronto's $1.2 billion requirement, NBF currently envisions some $5.3-6.4 billion in gross municipal bond issuance in 2024. That's a noted increase vs. the $3.8 billion of long-term supply cleared in calendar 2023. Based on an admittedly tiny year-to-date sample, municipal bond deals have thus far been well received by investors, the traditional spring issuance window representing an important test.

Q: I want to know more about Toronto's Green and Social Bond frameworks?

A: And why wouldn't you. After all, Toronto has been at the vanguard of the labeled financing movement in Canada's municipal sector. Toronto issued its first Green Bond back in 2018, while its inaugural Social Bond arrived in 2020.

Given the ongoing strategic importance of these financing programs, Toronto's Investor Relations site provides ready and comprehensive access to all relevant documentation, including detailed frameworks, annual newsletters, project selection details, use of proceeds, compliance reviews and second-party opinions/assurance. Check it out, with relevant hyperlinks included below.

Q: Finally, what are the next steps in this whole budget process?

A: Mayor Chow presented her proposed budget on February 1st. The next step is for Toronto to convene a special session of City Council. That happens on February 14th, festivities getting under way at 9:30ET.

While Councillors will have their say, it's important to note that provincial legislation has handed many of Ontario's big-city mayors fresh power, including as it relates to passage of the annual budget.

While Council can put forward amendments to the currently proposed budget, Mayor Chow—just like her counterparts in 25 other designated fast-growing jurisdictions in Ontario—has the power to veto such amendments. Council would then need to muster a two-thirds majority to override any prospective mayoral veto.

Let's see how the debate goes and what, if any, amendments Council would like to see. But with big-city mayoral powers in place, we don't see Toronto's final/approved budget deviating much from the February 1st proposal. We'll nonetheless tune in to related debate and will update as appropriate.

Select references/links

The following comprises some potentially useful resources/links relevant to Toronto's current financial situation:

- Toronto City Budget main page
- Toronto Investor Relations main page
  - Green Debenture Program
  - Social Debenture Program
- Toronto Staff Budget Proposal/Presentation (January 10, 2024)
- Toronto Mayor Chow's Operating and Capital Budget proposal (February 1, 2024)
- Toronto Council & Committee Meetings main page
- Toronto Annual Financial Report (year ended December 31, 2022)
- Toronto Financial Update and Outlook (March 20, 2023)
- Ontario-Toronto New Deal (November 26, 2023)
- Latest Federal support for Toronto (refugees/asylum claimants & low-income renters) (February 2, 2024)
- Strong Mayors, Building Homes Act Backgrounder (August 10, 2022)
- Ontario Municipal Councillors Guide on Annual Budget Process (updated July 7, 2023)

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