ECONOMIC RESEARCH AND STRATEGY

LAURENTIAN BANK SECURITIES

November 1, 2021

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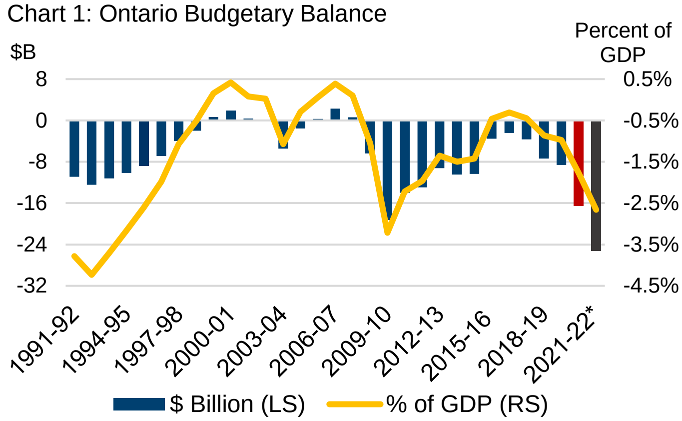
Ontario Fall Economic Statement (Preview): Upcoming improvements to the fiscal framework

The Ontario government will present its mid-year fiscal update on November 4th. In anticipation of this release, we present key elements of the province's economic and fiscal outlook that matter to market participants. Similar to other provinces (British Columbia, Nova Scotia), we expect significant improvement to Ontario's fiscal outlook. Stronger-than-expected level of economic activity in 2021, positive taxation spillover from federal government financial support programs and higher prices feeding through GDP deflator boost provincial revenue in FY 2021-22. On the expenditure side, current COVID-19 contingency funds should be sufficient to cover this year's needs related to the pandemic. Although higher interest on debt should be expected, Ontario should be able to eliminate its deficit more quickly than forecasted in the 2021 budget published last spring.

FY 2020-21 revenue windfall to improve this year's results

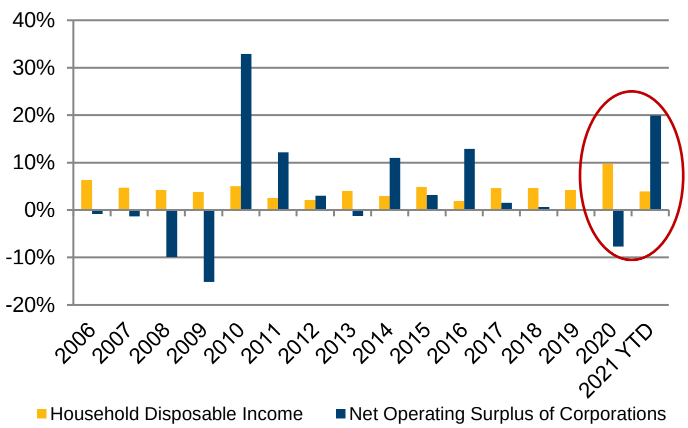
The public accounts published On September 24th revealed that Ontario registered a $16.4B deficit in FY 2020-21, less than half the $38.5B Budget 2020 forecast. At 1.8% of GDP, last year's deficit represents a smaller share of the economy than the shortfall registered in FY 2009-10 after the Great Financial Crisis (chart 1). Considering that real GDP declined 5.2% in 2020 versus 3.1% in 2009, this testifies to how crucial federal support was during the peak of the pandemic. Indeed, the net operating surplus of corporations only declined 8% last year and is up 20% year-to-date, compared to a combined 24% decline in 2008 and 2009 (chart 2). This contributed to the major 56% upward revision to corporate income taxes in FY 2020-21, from $11.4B in Budget 2021 to $17.8B in the public accounts. Additionally, despite a spike in the unemployment rate, Ontarians' disposable income rose by 10% last year, driving up personal income taxes to $40.3B, 7% higher than in FY 2019-20 and 12% above Budget 2021.

Chart 1: Ontario Budgetary Balance



Note: FY 2019-20, 2020-21 from Public Accounts, FY 2021-22 from LBS. GDP for 2020 and 2021 from LBS.
Source: Ontario Government and LBS Econ. Res. and Strategy.

Chart 2: Unprecedented federal support boosted household and corporate income



Source: Ontario Ministry of Finance.

Considering that several key financial support programs, including the Canada Recovery Benefit (CRB), the Canada Emergency Wage Subsidy (CEWS) and the Canada Emergency Rent Subsidy (CERS) remained in place for more than half of this fiscal year, the effect of federal emergency transfer on taxes collected should persist in FY 2021-22. Partly due to an elevated vaccination rate, the fourth wave of infections in Ontario has so far been kept in check. This has prevented another round of tightening in economic restrictions. Nonetheless, they remained elevated as of mid-October according the Bank of Canada stringency index (chart 3). The gradual lifting of all economic restrictions by the end of the fiscal year should accelerate economic growth and allow tax revenue to keep growing at a gentle pace. Furthermore, Ontario's plan to eliminate mandatory Canadian work experience required to work in their field should ease labour shortages and contribute to wage growth acceleration.

On the spending side, positive outcome relative to pandemic management makes it likely that current contingencies in the fiscal framework will be sufficient to cover this year's COVID-19 related expenses. Also, we do not anticipate spending cuts to accelerate a return to balance. The latest Throne Speech mentioned that the recovery would be "fueled by economic growth, not painful tax hikes or spending cuts". Considering that the General elections will be held on or before June 2, 2022, targeted spending measures and policies could also be introduced in the upcoming statement. Investors should also watch for an increase in Ontario's interest on debt as Canadian interest rates have risen extensively over the past few months. Given our latest forecasts for interest rates and Ontario's 2020-21 fiscal sensitivities, the 10-year Canadian bond yield could average 50bps more than the 1.0% forecast in Budget 2021. This would generate around $300M more in debt servicing costs this year.

Smaller deficit and funding requirements

Overall, we forecast a $25B deficit in FY 2021-22 (2.7% of GDP) as spending growth should outpace higher-than-projected revenues (chart 1). This represents a $7B improvement relative to the $32.4B First Quarter Finances projection. Consequently, we estimate the borrowing program at $46B, down from $53B in the First Quarter Update. Keeping all else equal, such an improvement puts Ontario 3 years ahead in its decade-long recovery plan to a balanced budget in FY 2029-30. Moreover, the general improvement to the revenue base reduces the structural deficit and alleviate needed cuts to spending growth in order to rein in the deficit.

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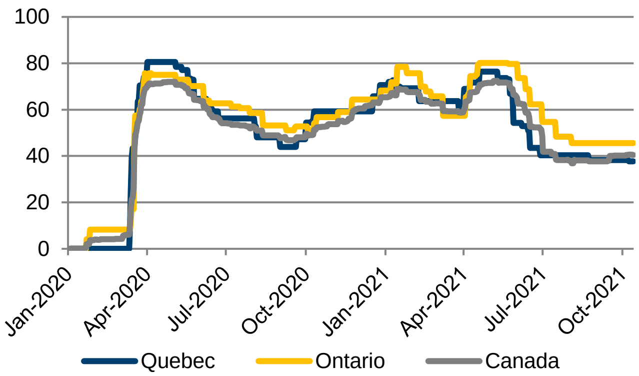
Chart 3: Economic restrictions have eased, but have room to fall further



Note: 100 represents strictest restrictions and 0 represents no restrictions (pre-pandemic). Last data point is October 13th.
Source: Bank of Canada Stringency Index.

Borrowing Program ($B, 2021-22)	First Quarter Update	LBS (Oct.)
Deficit	32.4	25.2
Total Funding Requirements	53.0	45.7