25 March 2021

Ontario Budget 2021 – Near Term Fiscal Prudence and a Long Path for Deficit Reduction

The vaccination campaign has been accelerating in Ontario and around the world, leading financial markets to expect a better economic outlook lately. However, Ontario Chief Medical Officer Dr. David Williams declared on Monday that the province entered the third wave of the pandemic. Without surprise, the 2021 Ontario Budget presented today by Minister of Finance Peter Bethlenfalvy remains focused on COVID-19, particularly on measures to improve short-term health and economic outcomes. As we exposed on our report, the 2021 Ontario budget includes plenty of fiscal prudence in the near term and a long term path exposing the positive and challenging turnaround in public finances over time.

Doubling Down on COVID-19 Support for Health, the Economy and Municipalities

Building on last November's 2020 Budget, the 2021 budget adds funding in response to COVID-19 now totalling $40B over four years. This large direct support includes: 1-health care measures of $16B include $2.3B for contact tracing and testing, $1.4B for PPE and $1.0B for the ongoing vaccination campaign; 2-$23B in support for households and businesses, such as more generous small business grants ($3.4B) and child care benefits ($1.8B); 3-the Ontario government will transfer an additional $1.0B to municipalities in FY 2021-22, building on the $4.0B Provincial-Federal 2020 *Safe Restart Agreement*. Given the financial strain observed at the municipal level, the federal government could match this extra contribution in the April 19th budget.

Short-Term Deficit Reduction Led by the Economic Recovery

The province continues to estimate a record high $38.5B deficit for FY 2020-21 (unchanged from the November Budget 2020 and the February Third Quarter Update). Both layers of prudence, the $13.3B extraordinary contingencies and the $4.0B standard contingencies, have been allocated.

As the recovery unfolds, the deficit will shrink to $32.1B (3.6% of GDP) in FY 2021-22 and $18.7B (1.9% of GDP) in FY 2023-24 (see chart 1). Following the sizeable 4.8% nominal GDP contraction in 2020, the Ontario government proposes three scenarios due to COVID uncertainty. The base case scenario assumes a 6.2% nominal GDP rebound in 2021 and growth of 6.4% in 2022, consistent our January exercise. Since then, the outlook generally improved because of the acceleration in U.S. economic momentum and encouraging signs of resilience domestically. The CPI inflation forecast of 1.7% also appears on the low side and could turn out to be slightly above 2% in our view. Thus, nominal GDP growth in 2021 and 2022 could turn out to be stronger. However, the short-term economic impact tied to the third wave remains to be seen and could lead to renewed lockdown measures unless vaccination tapers off hospitalizations. Overall, the economic rebound will boost the tax base in FY 2021-22. Still, the government anticipates taxation revenue to come back to pre-COVID level a year later, in part due to the slower job market recovery.

As of note, the vibrant housing market seems to be a small upside risk to the Ontario's short-term revenue outlook through the land transfer tax, currently expected to bring in $3.9B in revenues during FY 2021-22 (each 1 ppt increase in resale transactions or average prices boosts the land transfer tax take by $39M). The Ontario government expects a moderation in home price appreciation and resale activity. Unless the federal government imposes new measures to cool down the recent surge in activity, Ontario housing prices are likely to soar at a double-digit pace in 2021 in our view, above the 7.5% growth forecast assumed.

Besides the pandemic directly affecting own-source revenues, federal transfers are subject to change for two reasons. First, the federal budget will unusually come out after the release of Provincial budgets. Second, the long term outlook proposed in this budget showing large deficits for years to come mean Ottawa could have a bigger role to play to improve the fiscal sustainability of all Provinces, including Ontario. In this budget, federal transfers are projected to decline from a record high of $34B in FY 2020-21 to $27B in FY 2021-22, close to the $25B annual amount collected before the pandemic. Assuming an average annual growth rate in federal transfers of 3.5% over the medium-term, the federal share expressed as a percentage of the Province's total health care costs continue to fall further. For reference purposes, if the federal government was contributing to 35% of Ontario's health care costs, instead of the current 22% share, the province would get close to an additional $10B in health care transfers this year alone.

Due to COVID Uncertainty, Fiscal Prudence Stays

The budget includes several layers of prudence to absorb potential downside risks, with COVID-19 still on top of the list. The province incorporates nearly $10B in contingencies in FY 2021-22 ($6.7B in pandemic-related contingencies, $2.1B in standard contingency funds and the $1B reserve), representing a significant buffer relative to the projected $32B deficit. Fiscal buffers of about $5B are set aside in FY 2022-23. Any remaining balance in the contingency funds would go toward reducing the debt.

Balanced Budget in FY 2029-30 under Base Case Scenario

The FY 2023-24 deficit of $18.7B representing 1.9% of NGDP gives investors a good idea of the structural shortfall post-pandemic, about twice the size of the deficit registered in FY 2019-20 prior to the pandemic. Under the hypothesis that the economy expands at its potential rate, federal transfers' mechanisms stay the same and that no other major policy actions alter spending or revenues, Ontario projects to balance its budget in FY 2029-30. Of course, many things will change along the way. This being said, the base case scenario indicates that the Province could register combined deficits of about $182B since the pandemic started, relative to about $116B in combined deficits in the business cycle following the 2008-09 financial crisis. Under alternative optimistic (pessimistic) economic scenarios, a balanced budget would be achieved two years earlier (later).

Multiple Fiscal Anchors to Properly Guide the Debt Burden Reduction Strategy

In last year's budget, the government introduced a debt burden reduction strategy. This year, this strategy is reinforced with the addition of two anchors to follow over time: the net-debt-to-revenue and public debt charges-to-revenue (PDC) ratios.

One objective is to do not let the net-debt-to-GDP ratio exceed 50.5%. Slightly under 40% before the pandemic, this metric is poised to stay around 50% for a few years before gently declining over the long run. The net-debt-to-revenue will move from the current record high of 263% in FY 2020-21 to 301% in FY 2023-24. The PDC shows a better picture. At 8.2% in FY 2020-21, it will rise gently to remain below the 10-15% range observed in the 1990s (chart 2). This being said, investors will need to monitor the recent downward revaluation in global bond prices and its potential upside impact on the PDC in the years to come. The average cost of borrowing of the Province is forecast at 1.90% in FY 2021-22, 2.4% in FY 2022-23 and a decade-high of 3.20% in FY 2023-24, based on underlying 10YR GoC bond yield projections of 1.0%, 1.4%, 1.8% and 2.4% between 2021 and 2024 (versus 1.48% today). In terms of sensitivity, the government's own estimate impact of a 100 basis-point change in borrowing rates is $750M over the first full year.

Elevated Borrowing Requirements, Strong International Demand for Ontario Bonds

The budget notes the strong international appetite for Ontario's bonds in FY 2020-21, ultimately leading the share of domestic borrowing to fall below its usual 70-80% target range. This being said, the large borrowing needs of $59B nonetheless led to a record-high domestic issuance of $38.3B in FY 2020-21, compared to $20.7B on international markets. Considering the future elevated requirements and current market conditions, the domestic target range is adjusted downward to 65-80% and could be further modified if necessary. For FY 2021-22, borrowing requirements will remain elevated at $54.7B. On top of $33.1B required to finance the large deficit, the province also plans to borrow $11.8B for investment in capital assets and repay $25.0B in debt maturities. The Ontario Financing Authority will also increase short-term borrowings by $6.0B, which will reduce long-term needs by the same amount. Similar to FY 2021-22, borrowing requirements after FY 2021-22 do not fall as much as the deficit shrinks due to the large size of maturing bonds. Thus, financing needs are estimated at $59.1B and $55.2B in FY 2022-23 and FY 2023-24, respectively.

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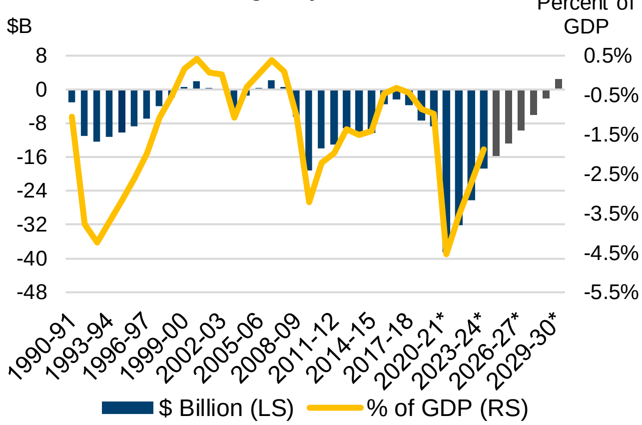
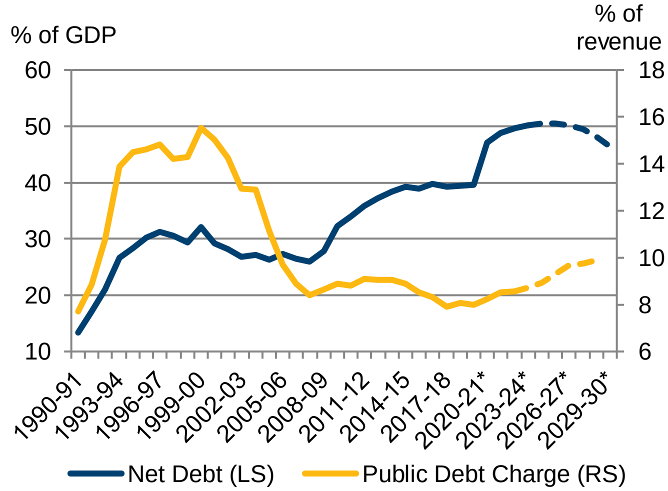
Chart 1: Ontario Budgetary Balance



Note: Medium-term fiscal plan: FY 2021-22 to FY 2023-24; Recovery Plan: FY 2024-25 to FY 2029-30.
Source: Ontario Government and LBS Economic Research and Strategy.

Chart 2: Ontario Fiscal Anchors



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