Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

The 2017 Ontario Budget: Balanced Budgets Ahead, Affordable Spending Initiatives Proposed

Without surprise, the 2017 Ontario budget confirms the end of 9 consecutive years of deficits. Finance Minister Charles Sousa proposes a balanced budget for FY 2017-18, fulfilling the pledge made by former Finance Minister Dwight Duncan in 2011.

Before discussing the "status quo" fiscal outlook proposed in this budget, let us review the better-than-expected fiscal performance of FY 2016-17. The books were almost balanced this year. The deficit for FY 2016-17 is now projected to be $1.5B, a very significant $2.8B improvement relative to last year's budget forecast, mostly because total fiscal revenues were $2.6B higher-than-expected. The very good performance of the economy notably led to higher corporate and personal income tax receipts as well as greater sales tax revenues. The surge in residential transactions and abnormal appreciation in home prices also generated a higher-than-expected $0.6B from the Land Transfer Tax. The Liquor and Lottery corporations also registered better results than anticipated. Lower-than-expected interest payments on the debt of the Province (-$0.5B) and the non-utilization of the reserve (-$1B) also contributed to shrink the deficit in FY 2016-17. Lastly, program spending came in $1.4B above last year's budget forecast, partly attributable to the hydro rate cuts for residential consumers and additional funding for health care and education.

The Province's borrowing needs have declined in line with the gradual return to a balanced budget. Annual borrowing requirements used to be slightly above the $30B mark a few years ago. The $27B borrowed on financial markets during FY 2016-17, which included $3.2B in pre-financing for FY 2017-18, was the smallest annual borrowing program since the global recession of 2008-09.

Given today's relatively low funding needs, the Province will take advantage of the situation by proactively building cash reserves. These cash reserves will minimize the impact (on interest costs notably) of the larger-than-usual bond maturities coming up in the medium-term; especially in the first quarter of FY 2019-20 (April-May-June 2019 period). These projected large single-day cash outflows are in part due to the Province's appropriate decision of creating large, liquid 10-year benchmarks in the aftermath of the global financial crisis. To date this year, $0.6B of the $26.4B borrowing program has been completed; $6.0B within this program will be raised to build-up cash reserves. The combination of larger debt maturities and higher financing required for infrastructure investments will also lead to a manageable increase in borrowing requirements in FY 2018-19 ($32.2B) and FY 2019-20 ($37.8B).

The good news is that the Province won't need to borrow further to finance deficits. This budget proposes balanced budgets in FY 2017-18, FY 2018-19 and FY 2019-20. The average annual growth in total revenues is projected at 3.9% during the next three years; this obviously is on the basis that no major economic incident will occur. Ontario's economy is expected to be a leader in terms of economic growth again this year; the Ministry of Finance is projecting real GDP growth of 2.3% in 2017.

Granted, the U.S. current positive economic momentum is undeniably constructive for Ontario's economy in the short-run. However, considerable uncertainty regarding U.S. protectionism and tax policies is clouding the Province's medium-term outlook as a 1pp change in U.S. real GDP growth leads historically to about a 0.4pp change in Ontario's real GDP growth. It is also difficult, at this stage, to assess the net impact on Ontario's competitiveness of enacting a major tax reform in the U.S. and renegotiating the NAFTA agreement; both intentions of the White House to be delivered by year end. Moreover, President Trump's recent aim at Canada's supply management system for dairy products is a new source of concern for the Province as Ontario is the second largest dairy producer in the country, just behind Quebec.

Regarding the domestic factors influencing the economic outlook, it will be important to monitor how housing market conditions evolve after the 16-point plan announced last week to improve affordability. We are of the view that the new non-resident speculation 15% tax on home purchases and the expansion of rent controls will be effective in partially curbing speculative activity and reducing the exorbitant pace of growth in home prices in the Greater Golden Horseshoe. The Province of BC's recent experience with targeted housing policies also suggests that domestic buyers in Ontario may wait a few months on the sidelines to assess the impact of the newly adopted measures before entering the homeownership market. All in all, our fundamental view has not changed: the robust annual household formation in the province underpinned by job creation and immigration will maintain housing market activity at a healthy level. The Ontario Ministry of Finance forecasts the annualized level of housing starts to remain near 70K, residential resale transactions to increase by about 3% annually and home prices to rise by approximately 5.2% on average during the 2018-20 period. A severe deterioration in housing market conditions and a massive decline in taxation revenues for the Province is, in our view, a very low-probability scenario.

Overall, the 3.9% annual average growth projected for fiscal revenues facilitates the Ontario government's intention to increase expenditures at a healthy pace. For instance, the budget's extended list of spending initiatives include the following: a $6B boost in health care funding over the next three years, free prescription drug coverage for children, free tuition for 200K students in postsecondary education, a new public transit tax credit for seniors and $200M for 24K new subsidized child-care spaces. Altogether, total spending is expected to advance at an average annual pace of 3.3% during the next three years. Most of this increase will occur in FY 2017-18 (+4.7% relative to FY 2016-17), setting the tone ahead of the June 2018 general elections.

With this budget, the government wants to improve the everyday life of Ontarians and ease the financial burden on families. Seen differently, the Ontario government does not intend to generate cyclical surpluses even though economic growth is above potential and above the national average. Without surpluses and the creation of a debt reduction fund like Quebec (the Generations fund was established a decade ago) and BC (the Prosperity fund was created two years ago), the Province of Ontario's debt-to-GDP ratio will not declined very rapidly in the coming years; this is after the ratio rose rapidly from a cyclical trough of 26% in FY 2007-08 to 37.8% in FY 2016-17. Still, the government is setting a credible interim target of mildly reducing the ratio to 35% by FY 2023-24. This target is based on the expectation that Ontario's GDP will grow faster than its debt (due in part to the positive impact of infrastructure investments on economic activity). While this interim target is not as aggressive as the debt reduction plan announced three years ago by the Quebec government, it seems to be a firmer commitment than the federal government's objective of stabilizing its debt-to-GDP ratio within five years. Also, reaching the target would appear to be a good step toward the previously announced longer term objective of bringing back the debt-to-GDP ratio to its pre-recession level of 27% by FY 2029-30. This means, however, that most of the efforts to reduce the debt-to-GDP ratio will likely be made in 5 to 10 years from now.

Budget 2017 set the tone for the 2018 elections

In summary, after nine years of deficits, the 2017 Ontario budget proposes a balanced budget for the next three years and the beginning of a reversal for its debt-to-GDP ratio. These are constructive developments but nothing really unexpected for market participants. Thus, although several new affordable spending initiatives were announced ahead of the 2018 election campaign, we do not see this budget as a game changer for bond investors.

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