Laurentian Bank Securities

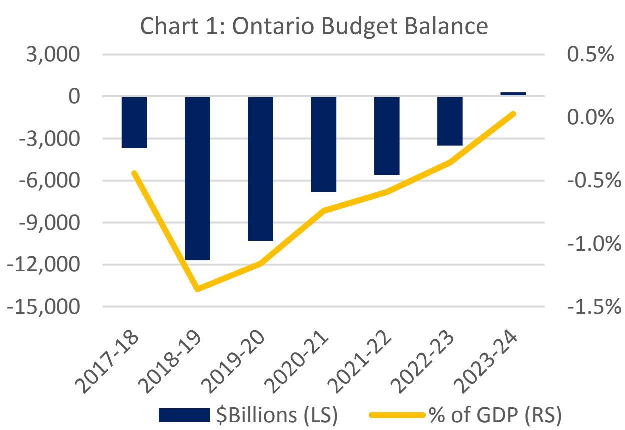
ECONOMIC RESEARCH AND STRATEGY

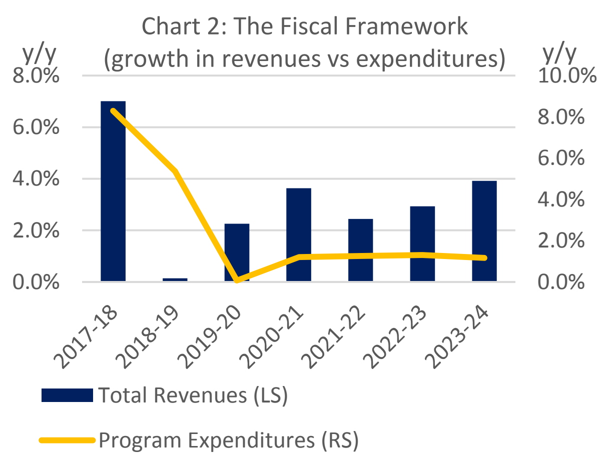
The 2019 Ontario Budget - Turning the Boat Around

The 2019 Ontario Budget addresses the daunting fiscal challenge inherited by the PC government when it took power in June 2018. Last Fall, the deficit for FY 2018-19 in Budget 2018 was revised up from $6.7B to $15.0B after the findings of the Independent Commission of Inquiry into Ontario's finances.

5 years to balance the budget

The government proposes to return to a balanced budget in five years, which we believe is a reasonable timeline. The deficit for FY 2018-19 was revised down by $3.3B to $11.7B (1.4% of GDP), principally reflecting higher fiscal revenues. The shortfall is projected to gradually decline from $10.3B (1.2% of GDP) in FY 2019-20 to $3.5B (0.4% of GDP) in FY 2022-23. Then, a small $300M surplus is planned in FY 2023-24 (chart 1). To achieve this objective, the government will rely on slower spending growth and moderate economic growth. This budget does not include any increases in tax rates.





Source: Ontario Government, LBS Econ. Res. and Strategy.

The economy is in good shape despite a slowdown in household spending growth

The economic momentum should be supportive to reduce the deficit over time. The unemployment rate stands at a multi-year low (5.7% in February 2019). The government nonetheless expects slower economic growth ahead, with real GDP growth forecasts of 1.4% and 1.6% in 2019 and 2020, respectively; broadly in line with our estimates. Of note, consumer spending growth is projected to moderate considerably in 2019 due to the past increase in interest rates. Also, residential investment is expected to drop for the second year in a row due to a cooling in homebuilding activity. Once the adjustment to higher interest rates is completed, the Ontario government forecasts real GDP growth to accelerate a notch without surpassing the 2% mark.

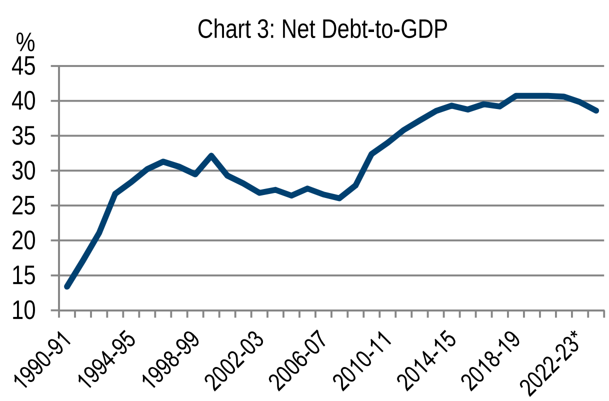
This relatively modest pace of economic growth will translate to a slower revenue intake relative to previous years. Between FY 2019-20 and FY 2023-24, total revenues are expected to grow by 3.0% on average every year (chart 2). This is lower than the 3.6% annual average pace registered between FY 2011-12 and FY 2018-19. The projected growth in fiscal revenues is also lower than the average nominal GDP growth forecast of 3.6%, which opens the way to upside surprises. A major tax measure is the *accelerated investment incentive,* allowing businesses to write off manufacturing M&E, processing M&E, technological and clean energy investment much earlier than before. This measure will cost $1.1B in FY 2019-20. The government also intends to further cut red tape in several industries to foster investment.

Keeping expenditures in check

Program expenditures will remain flat in FY 2019-20 to $150.1B. Most ministries will see a reduction in funding for FY 2019-20, with the exception of the education (+2.6%), health (+2.2%) and infrastructure (+16%) sectors. A very modest 1.2% annual increase in program expenditures is projected on average for the following four years (the average since FY 2011-12 was 3.1%). The government is also introducing its promised refundable childcare tax credit, effective for the 2019 tax year. This measure will cost $390M annually. Of note, the government is not planning to make deep cuts in the Ontario Public Sector (OPS). Since the PC government took office, public sector employment has been reduced by 3.5% through voluntary attrition. To ensure further savings, the government will implement other voluntary exit initiatives.

A new legislation to establish a credible debt reduction strategy

Ontario's net debt has more than doubled over the last decade to $343B in FY 2018-19. To restore trust in Ontario's public finances, the PC government is proposing a new framework that is expected to be passed into law: the *Fiscal Sustainability, Transparency and Accountability Act (FSTAA)*. By FY 2022-23, the government's commitment is to bring the net debt-to-GDP ratio below the 40.8% identified by the *Commission of Inquiry* in FY 2018-19. After reaching 39.2% in FY 2017-18 and 40.2% in FY 2018-19, the net debt-to-GDP ratio is projected to peak at 40.7% in FY 2019-20 before diminishing to 38.6% in FY 2023-24 (chart 3). Enacting the FSTAA will repeal the previous *Investing in Ontario Act* of 2008 where the government was allowed to spend better-than-expected fiscal results. Our understanding is that any surplus will now go towards debt reduction.



Source: Government of Canada Fiscal Reference Tables, Ontario Government and LBS Econ. Res. and Strategy.

Lower total borrowing requirements, more green bonds coming up

Total long-term borrowing needs for FY 2018-19 were revised up to $39.6B (from the $33.2B Fall Update estimate), mostly through an increase in cash and cash equivalents (likely for pre-financing purposes). Some of these cash amounts will be used to reduce long-term borrowings by $5B in FY 2019-20 and by $3B in FY 2020-21. Overall, long-term financing needs will decrease to $36.0B, $32.8B and $31.5B in FY 2019-20, 2020-21 and 2021-22. The largest component of long-term financing will be debt redemption and refinancing, averaging $26B per year. Finally, after issuing its fifth Green Bond for $0.950B last January, the government intends to issue its next Green Bond during FY 2019-20.

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