## The 2018 Ontario Budget: The Proposed Return to Manageable Deficits

Ontario Finance Minister Charles Sousa tabled the Province 2018 budget today. Our expectation is that the Liberal government will try to pass its budget into law before the end of the parliament session. The concrete materialization of the measures proposed in this budget will ultimately depend on the outcome of the elections to be held on June 7th.

The Liberal government proposes to ramp up spending, notably pledging free preschool child care, proposing a new drug and dental plan for families without workplace benefits and expanding the public prescription drug coverage to seniors. If implemented, these and many others measures aiming at improving the quality of life of Ontarians will boost total expenditures by a cumulative $20B, or 13%, over three years. Total revenues are forecasted to increase at a slower pace of $14B, or 9%, over these three years.

Thus, the return to a balanced budget, a small $0.6B surplus in FY 2017-18, was short-lived. The budget projects annual deficits averaging $6.6B between FY 2018-19 and FY 2020-21. The long-term outlook forecasts a slow return to a balanced budget in FY 2024-25, a target unlikely to be reached if an unexpected economic downturn occurred at some point before 2025.

Earlier this month, the Fitch credit agency warned that the return in deficit territory could add negative pressure on Ontario's long-term rating. In our view, there are multiple numbers in this budget suggesting that the Province is not at risk of an imminent credit downgrade. First, the projected deficits represent 0.7% of GDP or less. As such, the current manageable 37% debt-to-GDP ratio will increase very softly to 39% by FY 2020-21, exactly where it stood in FY 2014-15. Hitting a 39% debt-to-GDP would still be far from critical territory although it is elevated by Ontario's historical standards. Second, we learned in Quebec's budget released yesterday that the debt-to-GDP ratio barely fell below 50% for the first time in a decade, to 49.6%, after a couple of years of tight fiscal management. From this perspective, it would be somewhat inadequate to put too much weight on S&P's often-cited critic that Ontario has the highest debt level among subnational governments in North America ($301B in FY 2017-18; projected at $325B in FY 2018-19). Third, the Ontario government has the available taxation capacity to narrow or eliminate the deficit if necessary. Indeed, the fiscal revenue per capita ratio in Ontario is the lowest among Canadian Provinces. Thus, one may argue that the government runs a deficit even though the economy is at full-employment because the tax burden of individuals and companies is low. If the deficit was primarily driven by a spending problem, the Province's program spending-to-GDP ratio, estimated at a 10-year low of 16.6% in FY 2017-18, would be a lot higher.

Under the Liberal government's proposed outlook, borrowing requirements are poised to gradually increase over time due to three factors: deficits, higher-than-usual maturing bonds and additional funding needs to finance investment in capital assets. More precisely, borrowing requirements are projected at $31.7B in FY 2018-19, $36.7B in FY 2019-20 and $41.3B in FY 2020-21 (compared to $33.9B in FY 2017-18, which included a sizeable $11.5B in pre-financing activity). The Province is expected to continue to access the Green Bond market, following its fourth Green bond offering of last January.

Finally, there are very few tax changes in this budget. The government proposes to eliminate the surtax on high-income earners and replace it by new brackets. On the business side, the enhancements of tax credits for R&D and innovation are timid policy responses relative to the recent tax breaks proposed by the U.S. White House. It appears the Ontario government prefers to see the near term developments relative to NAFTA before adjusting the tax environment for businesses.

In summary, the Liberal government proposes the creation of new programs and expansion of existing public services, all financed by a gentle increase in the debt burden rather than by an increase in taxes. The next step for investors is to look at the soon-to-be released platforms from the NDP and PC provincial parties.

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