LAURENTIAN BANK SECURITIES

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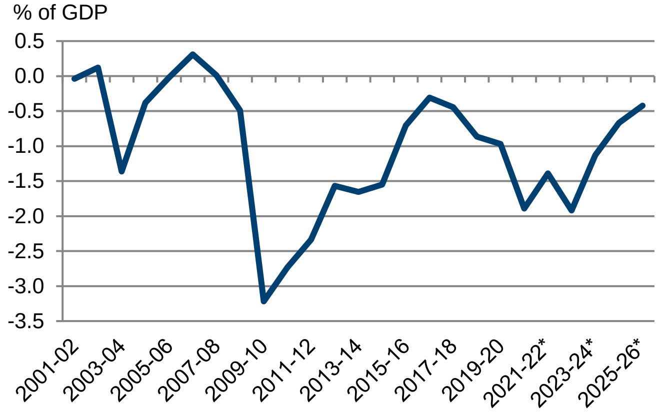
Ontario Budget 2022: Deficit spending to improve affordability and critical services

Minister of Finance Peter Bethlenfalvy delivered yesterday his second budget . Since the election campaign starts on May 4th, it is safe to assume that Budget 2022 includes most costed measures of the PC Party platform. This budget is unlikely to be adopted by the current Legislative Assembly due to its imminent dissolution for the election campaign. From a policy perspective, Budget 2022 centers on three axes: improving affordability for households facing elevated inflation, investing into health and long-term care capacity and developing critical industries. However, the spending and tax proposals leave aside fiscal consolidation and the importance to place debt-to-GDP on a downward trend.

Tax measures and new spending generate larger-than-expected near-term deficits

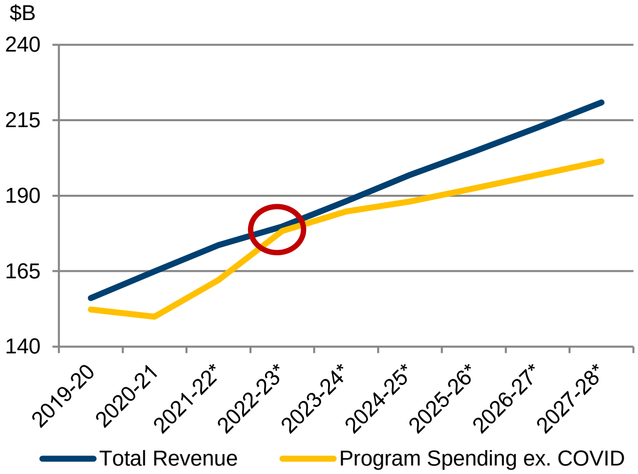
Overall, Budget 2022 reveals a $19.9B deficit for FY 2022-23, larger than the $13.5B interim estimate for FY 2021-22 and more than twice our $8.4B expectations., At 1.9%, the deficit estimate for FY 2022-23 represents the same share of GDP than in FY 2020-21 when the coronavirus first hit (chart 1). On the revenue side, the Ministry of Finance forecasts solid real GDP growth of 3.7% and 3.1% in 2022 and 2023, respectively, as the Ontario economy continues to recover from the COVID-19 pandemic. The forecast assumes no further COVID-19 related shutdowns and no major escalation in the conflict in Ukraine. The government forecasts 3.6% total revenue growth this fiscal year, reaching $180B. That represents a slowdown from last year's 5.3% jump and includes flagship tax measures to improve life affordability. Starting this July, the government temporarily cuts the gasoline and the fuel tax, a $645M measure. This aims to lower households' transportation costs, assuming that the gas rebate is effectively transmitted to households by gasoline retailers, something that hasn't always been the case, as reported in a recent IRPP commentary. The PC government also enhances the Low-Income Families Tax Credit (LIFT), through increased maximum benefits and extended fading out income range. From FY 2023-24 to FY 2027-28, the government projects annual revenue growth of 4.2%, in line with historical average (chart 2).

Chart 1: Ontario Medium-Term Budgetary Balance



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

Chart 2:Ontario Fiscal Framework Forecast



Source: Ontario Government.

Program expenditures excluding the $6.9B time-limited COVID-19 funding, tops $178B, a 10% jump from last year. Fiscal moderation comes back in FY 2023-24: annual program expenditures growth slows down to 2.5%, around half the historical average. Spending rises in all sectors, underpinned by additional health care funding for hospital beds and wage increases for health and personal care workers. Budget 2022 also incorporates the $6.8B three-year fiscal impact of the Canada-Wide childcare program as a co-funding deal was recently reached with the federal government. Other important outlays include a $2.8B 3-year investment to expand high-speed internet access across the province, as well as standard contingencies (see below).

Additional fiscal prudence and liquidity

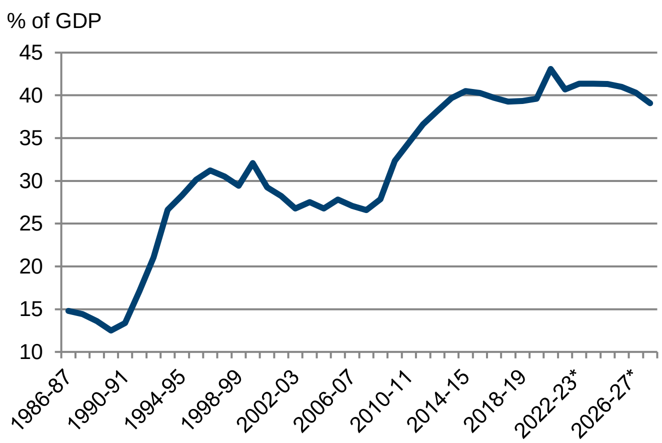
Among other risks, rising interest rates and the war in Ukraine could materially slow down the global economy and cause upside pressures to interest-on-debt and funding costs. Consequently, the government continues to incorporate several layers of prudence for unforeseen events, which investors will appreciate in the current economic and geopolitical context. For instance, to face uncertainty related to COVID-19, Budget 2022 includes $6.9B in time-limited funding, twice the amount projected in the Mid-Year Report. The government also maintains a large standard contingency funds of $4.6B in FY 2022-23 and a $1.0B fiscal reserve. Finally, from a capital market perspective, prudential liquidity reserves are expected to average $47.2B this year. As a comparison, they stood at $32.3B in FY 2019-20 prior to the COVID-19 pandemic.

Slow but steady path to balance and more capital investment

Last month, the Financial Accountability Office of Ontario wrote that the province could balance its budget as soon as next year, in FY 2023-24. Budget 2022 projects a return to balance in FY 2027-28, four years later than the FAO's projection but nonetheless two years before the Budget 2021 goals. Part of the large discrepancy between the two projections stems from the large spending proposed in Budget 2022 that we believe will make for the bulk of the PC Party electoral platform, which the FAO did not account for. The gap can also be explained by relatively more conservative revenue forecasts, including new tax measures described above.

Debt-to-GDP remains fairly constant over the horizon, projected to edge down from 40.7% in FY 2021-22 to 39.1% in FY 2027-28 (chart 3). That being said, aside from deficits, Ontario's massive $159B 10-year capital plan also fuels the provincial debt, with a sizeable $40B investment in new hospitals. Ontario's infrastructure spending will reach 2% of GDP over the forecast horizon versus 1.7% before the pandemic. As a comparison, Quebec plans to spend 3% of GDP on infrastructure. While we believe that investment in health, education, and transit investment remain important for long-run productivity and that they address acute needs, Canada's construction industry capacity utilization rate was already at 92% in 2021 (versus 83% for all industries). This poses the risk that provinces face capacity constraints and/or inflationary pressures when initiating new projects.

Chart 3: Ontario Net Debt



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

Elevated borrowings and constant debt term

The OFA will borrow $41.5B in FY 2022-23, broadly unchanged from the $41.1B program conducted in FY 2021-22 and including $10.3B in pre-funding conducted last year. The medium-term borrowing plan is set at $44.6B and $38.9B in FY 2023-24 and FY 2024-25, respectively. Over these three years, refinancing will make up for the largest part of the borrowing program, followed by capital investment and deficit financing. The target range for issuances in Canadian dollar bonds remains at 65-80%, versus 70% before the pandemic. This range provides the Ontario government some flexibility to meet its funding objectives if market conditions become more challenging. Of note, the OFA will continue to keep the average term-to-maturity of its debt constant at 10.9 years.

Developing industries for the future

Our last words go to the Ontario's industrial strategy previously announced but re-affirmed in the budget. China-US tensions, the Russian invasion of Ukraine and climate change imperatives shed lights on the importance of developing reliable supply-chains and suppliers for the production of key manufacturing inputs such as micro-processors, energy and critical minerals. The White-House already laid out its long-term strategy in a report published in 2021. Investors will therefore take note of Ontario's strategy to develop its critical minerals industry, including Nickel and Cobalt. In turn, these two minerals can serve as inputs into Ontario's strategy to regear its auto industry toward electric vehicles and batteries. Subject to review and further research and development, the energy and environmental potential of Small Modular Nuclear reactor is also interesting.

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