ECONOMIC VIEWPOINT

A Budget Season for the Books

Four Strong Winds Blew Through the 2023 Fiscal Plans in Canada's Provinces

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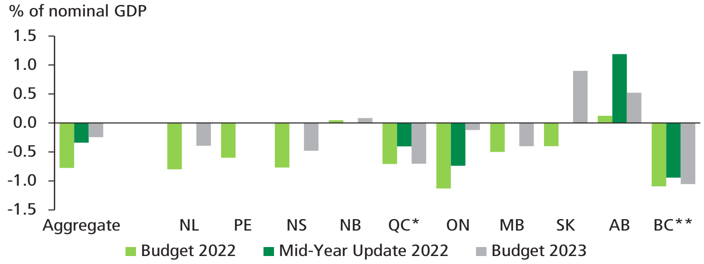
- In this note, we discuss four takeaways from an unusual 2023 budget season and what to expect if a recession begins later this year.
- Despite downward revisions to economic forecasts, revenues again got a starting point boost, improving some balance projections for fiscal year 2023–24 (FY2024) (graph 1). But we see plenty of potential downside risk this fiscal year.
- Policymakers generally scaled back on measures to combat the high cost of living, which somewhat lowers the risk of exacerbating inflation.
- Spending plans increased across Canada, concentrated in healthcare but reflecting many other priorities as well.
- Provincial rankings uncharacteristically changed on a number of fiscal fronts, but markets clearly interpreted Ontario as the winner of budget season 2023. Heading into a period of economic and financial market uncertainty, Canada's largest province holds several advantages despite its economic risks.

GRAPH 1
Balances Are Better than Last Year, Though Some Worsened versus Mid-Year

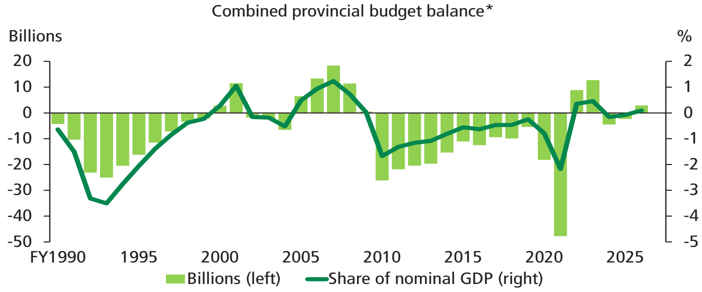


* Before deposits into the Generations Fund and use of the Stabilization Reserve
** Q1 FY2023 forecast
Sources: Provincial budget documents and Desjardins Economic Studies

Introduction

Budget season is always closely watched in Canada, but this year's edition was particularly eventful—and not just because six provincial plans were published in a single week. Amid financial market turmoil, looming elections, revenue windfalls and more signs of slowdown, Canada's subnational governments once again revised their fiscal outlooks higher and borrowing plans lower. What a turnaround! Two years ago, pandemic-era budgets projected huge, persistent deficits and blowouts in public debt. Now, the provinces collectively project a second consecutive surplus in FY2023 (graph 2) and one of the lowest combined debt burdens in a decade.

GRAPH 2
Canada's Provinces Expect to Run a Second Consecutive Surplus



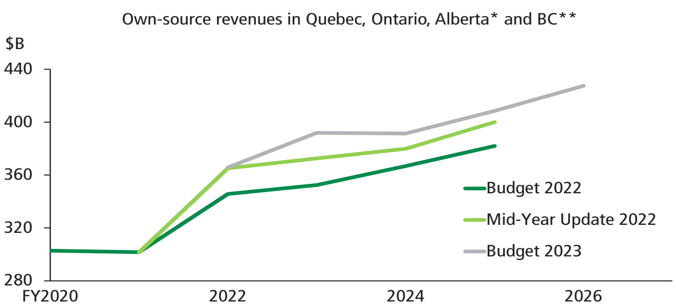
* FY2023, FY2024 and FY2025 do not include Prince Edward Island, Quebec balance is before deposits into the Generations Fund.
Sources: Finance Canada, provincial budget documents and Desjardins Economic Studies

In this note, we discuss four takeaways for investors from an unusual budget season and what to expect for government finances if a recession begins later this year.

1. Another Revenue Windfall Boosts Financial Prospects, but We See Plenty of Downside Risk

Despite downward revisions to economic forecasts, provincial governments once again projected stronger revenues, prompting expectations of improved balances and debt levels. The better revenue trajectory largely reflected huge starting point boosts. Multiple governments underestimated FY2023 receipts, and windfalls carried through into later years. Ontario was the most obvious example, forecasting some $13B more in own-source receipts than in November 2022. But the trend was present across Canada, especially in the largest provinces (graph 3).

GRAPH 3
Revenue Windfalls Again Persist



* Excluding non-renewable resource receipts
** Used Q1 FY2023 update forecasts for mid-year
Sources: Ontario Ministry of Finance and Desjardins Economic Studies

Still, we see four potential areas of downside risk to revenues.

For one thing, some economic forecasts are more optimistic than ours. That includes Quebec in 2023, while Ontario's planned faster-than-anticipated return to balance rests on very strong economic growth after this year. Those two provinces' own downside scenarios could cut their combined bottom lines by more than $22B between FY2024 and FY2026 and delay balance to beyond the forecast horizon.

Another potential area of downside risk is commodity prices. Crude values gained ground after news of planned OPEC production cuts broke over the weekend, but have also been significantly weighed down by recent financial market volatility. We noted in our preview and coverage of Alberta's budget that historic revenue sensitivity to crude prices means that WTI would only have to fall to US$75/barrel in FY2024 to eliminate the planned surplus; it's recently traded as low as US$64/barrel. Saskatchewan and Newfoundland and Labrador are also exposed in this respect, though far less so. Of course, to the extent that crude prices outperform government forecasts, there is upside for government balances and bond spreads.

The third key area centres around national-level adjustments to provincial tax bases as federal pandemic programs ease. Many provinces reported boosts to their revenues from upward revisions late last year.

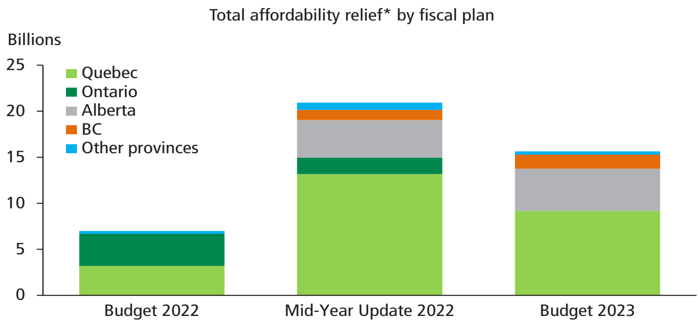
Finally, the timing of major projects—both public and private—presents risk to economic growth and the size of borrowing programs. Most provinces have already postponed some of their infrastructure spending plans closer to FY2024 and FY2025 as a result of labour and input product shortages, and further delays on this front could well persist. That is also possible for major mining and oil and gas projects expected to support the expansion in BC, Newfoundland and Labrador, and Saskatchewan.

2. Affordability Relief Is Winding Down (and That's a Good Thing)

In Spending Serenity Now Can Help Prevent Deficit Insanity Later, we argued that further stimulus risked weakening public finances and exacerbating inflation. Provinces generally avoided this in budget season 2023. Provincial affordability measures are now expected to total just under $12B (0.4% of nominal GDP) in FY2023, then ease to $5.7B (0.2%) in FY2024 and between $3.5B and $4B (0.1%) in FY2025 and FY2026.

Quebec continues to lead the provinces in terms of affordability relief, accounting for over half of the nearly $44B in new measures announced beginning in last year's budget season (graph 4). Its new initiatives this year were dominated by the signature tax cut for the two lowest income brackets. In the same vein, Manitoba implemented an increase to its Basic Personal Amount. Both measures should provide some assistance to low-income households most impacted by inflation. Alberta also increased affordability assistance meaningfully in its budget. Its two largest items include inflation indexation of personal income tax rates and reductions in provincial fuel taxes. Both are broad-based but should offer some assistance to lower-income households. Ontario's blueprint largely held off on new affordability relief.

GRAPH 4
The Provinces Scaled Back Affordability Relief, but Quebec Not So Much



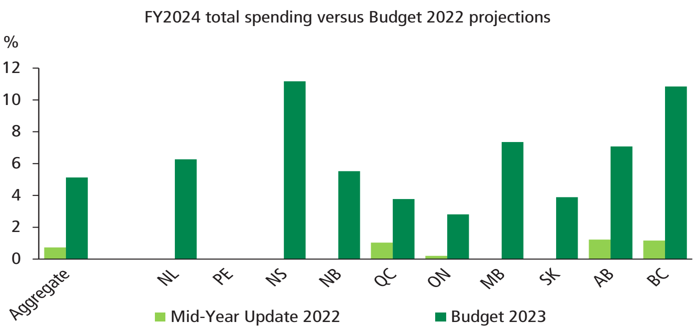
* Includes current and future fiscal year estimates
Sources: Provincial budget documents and Desjardins Economic Studies

3. But All Governments Are Spending More

With more revenues filling government coffers came the natural impulse to increase expenditures. All provinces raised their expenditure profiles throughout the forecast horizon, with boosts in FY2024 (graph 5) reflecting a variety of factors.

Higher-than-previously-forecast healthcare spending was a consistent theme. Every province is grappling with capacity constraints and labour shortages in the sector, the depths of which were laid bare during the pandemic. New expenditures were certainly enabled by the federal–provincial healthcare accord signed in February, and some provinces also cited bespoke bilateral deals with Ottawa as a source of new funds. More details on these agreements will become available in the coming months. However, financial support under these agreements paled in comparison to the overall rise in health spending.

GRAPH 5
All Provinces Increased Spending Plans



Sources: Provincial budget documents and Desjardins Economic Studies

A more generalized concern was the requirement to meet the needs of rapidly growing populations. Both New Brunswick and Nova Scotia anticipate that their headcount gains will ease from the recent all-time high pace. But they still forecast very strong rates of growth relative to most of their history, with significant support from higher immigration and non-permanent resident intake. Newfoundland and Labrador also foresees some momentum in population growth, while the 2.9% increase expected for the coming year in Alberta would be the highest since 2006.

The longer-term fiscal and economic risks associated with climate change were also on display in this budget season. Following the flooding that significantly disrupted its economy in late 2021, BC remains focused on building infrastructure resilient to severe weather events. The costs associated with Hurricane Fiona impacted spending in Nova Scotia. And Saskatchewan, continuing to grapple with drought conditions, raised agricultural insurance payment forecasts for the third time in FY2023.

Given high levels of uncertainty about the economic and financial outlook, most provinces increased fiscal plan contingencies beyond typical levels. In contrast to the federal government's plan, this provides a margin for error in achieving longer-run fiscal targets. However, as we've noted multiple times in prior reports, large reserves can lead investors to assume fiscal outperformance, limiting potential bond yield movements in the event that provinces beat their targets.

4. Provincial Rankings Change on Several Fiscal Metrics, but Markets Saw Ontario as This Year's Winner

Perhaps the most unusual development in this year's budget season was the extent to which provincial rankings changed on a several fiscal indicators. This is not typically the case: in past financial update periods, one province's improvement in fiscal prospects tended to coincide with better conditions in others (and vice versa). This season, we saw some significant market moves.

Quebec will uncharacteristically run a larger borrowing program than Ontario in FY2024 and borrow roughly the same amount as Canada's largest province in FY2025. That mirrors significant improvements in Ontario's financial projections. But it also comes despite cuts to borrowing forecasts in La Belle Province that stem from reduced deposits into the Generations Fund.

There were also changes in net debt rankings. Despite a better-than-previously forecast financial trajectory, Ontario is expected to carry the largest debt burden of any province as a share of GDP in FY2023 for the first time in recorded history. If current projections hold, New Brunswick's debt-to-GDP ratio would come very close to BC's in FY2026. Meanwhile, Nova Scotia's debt share of provincial output is expected to approach that of Quebec by FY2027. Nova Scotia's ratio has not exceeded that of Quebec since before the Global Financial Crisis. Granted, larger, diversified economies with liquid borrowing programs will always enjoy advantages over other jurisdictions in bond markets. Still, those figures highlight differences in fiscal planning approaches and shifting risk profiles across Canada's provinces.

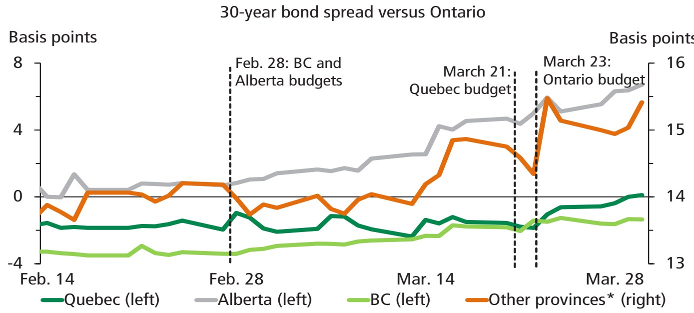
In spite of these developments, markets clearly interpreted Ontario as the winner of budget season 2023. In the immediate aftermath of its budget publication, long bond spreads for Canada's largest province tightened significantly versus all other jurisdictions. This included 30-year spreads closing flat to Quebec late last week (graph 6 on page 4) and briefly trading through those of BC. Ontario long bond spreads also tightened versus Canada after the federal budget was released.

Indeed, despite Ontario's still-high debt load and outsized economic vulnerability to the coming downturn, we think its fiscal prospects now look solid. While growth forecasts in later years are optimistic, significant contingencies provide a margin for error. And as we noted in our Budget 2023 preview, a large, liquid and diversified borrowing program should mitigate potential spread blowout in the event of widespread risk off moves, as we saw during the peak COVID-19 lockdown period.

Final Thoughts

Provincial budget season 2023 was truly one for the books—and not just because six provincial budgets were published in a single week. Canada's subnational governments continued to revise their financial trajectories higher. But in the shadow of a recession, longer-run risks—from supporting long-run growth to the challenge of delivering infrastructure and affordable housing to climate change—are coming into view.

GRAPH 6
Markets Crown Ontario the Winner of Budget Season 2023



* Simple average
Sources: Bloomberg and Desjardins Economic Studies