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FISCAL PULSE

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Provinces Taking a Cautiously Optimistic Stand

PROVINCIAL BUDGET 2023 ROUNDUP

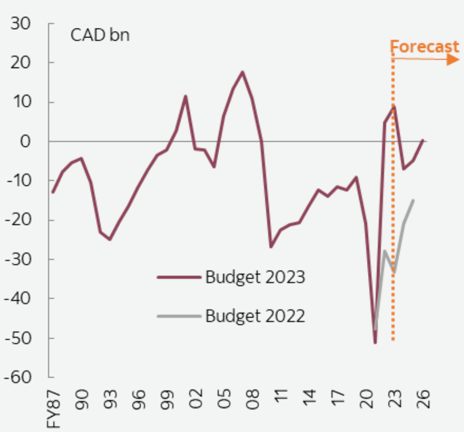
- **Banking on last year's windfalls, provinces experienced varying degrees of improvements in their bottom-lines, projecting a second consecutive year in collective surplus in FY23, followed by a small $6.9 bn deficit for FY24.**
- **With some newfound headroom, all provinces ramped up near-term spending, with a significant focus on healthcare. Fiscal stimulus winds down significantly.**
- **The provinces have generally taken a reasonable approach in their economic forecasting and budget planning, but many appeared somewhat complacent regarding potential downside risks of a more severe downturn.**
- **Provinces demonstrated prudence by setting aside about $12 bn as contingencies and provisions in FY24, followed by another $7.2 bn in FY25 and $8.2 bn in FY26, providing a sizeable buffer for a loss in revenues and additional spending needs associated with a plausible recession this year.**
- **Provinces' borrowing requirements are expected to total $94 bn in FY24, up from $80 bn completed in FY23.**
- **Despite being pulled back by over 30%, the elevated levels of fiscal stimulus announced by the provinces still have a material impact on inflation and hinders the Bank of Canada's ability to control it.**
- **Faced with increasing economic uncertainty, most provinces demonstrated relative spending discipline and prudent fiscal planning. Spending pressures associated with elevated inflation and record-high population growth have started to materialize, reflected in the provinces' lifted spending profiles. We expect continued upward pressure on spending, particularly in the healthcare sector where the gap remains evident. Potential wage increases could also lead to meaningful surges in expenditures—the on-going public sector strike for instance, could serve as a precedent for other wage negotiations this year and next.**

SECTION I. OVERVIEW

One prevalent theme in this year's budget season is that unexpected inflation initially benefits budget planning but the positive effect diminishes quickly. Nominal GDP increases with inflation, while most government revenues are linked to nominal output, which combined leads to lower fiscal deficits and public debt as a ratio to output.

Chart 1

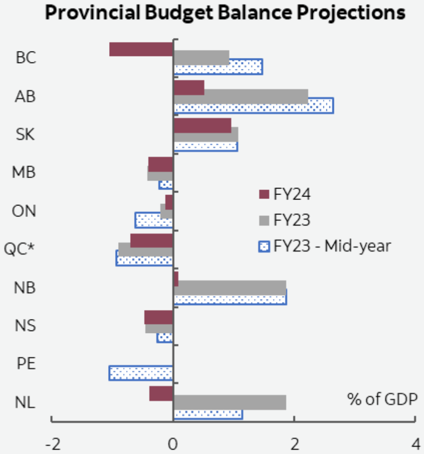
Provincial Aggregate* Budget Balance



* Excluding PEI due to missing Budget 2023.
Sources: Scotiabank Economics, Budget Documents.

Chart 2

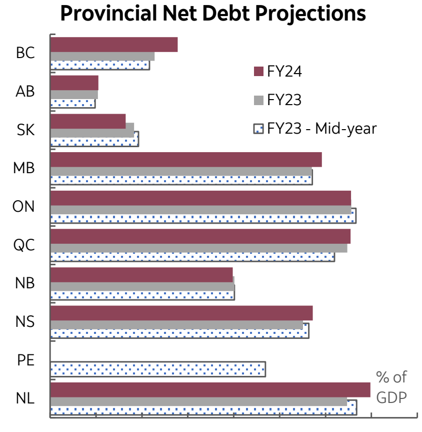
Provincial Budget Balance Projections



* Before Stabilization Reserve transfers and accounting changes. Sources: Scotiabank Economics, Statistics Canada, Budget Documents.

Chart 3

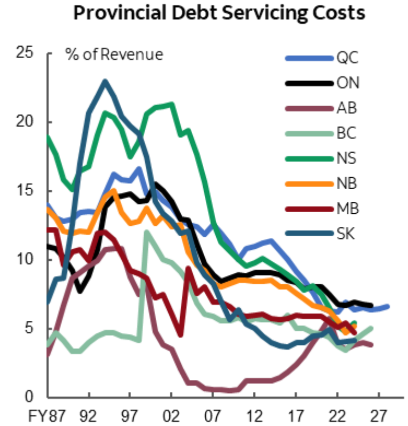
Provincial Net Debt Projections



Sources: Scotiabank Economics, Statistics Canada, Budget Documents.

Chart 4

Provincial Debt Servicing Costs



Sources: Scotiabank Economics, Statistics Canada, Budget Documents.

However, as inflation becomes persistent and better anticipated, it no longer contributes to fiscal improvement and might negatively affect public finances through multiple channels, which will be the case this year. The central bank's effort to restore price stability hampers growth prospects and hence brings down revenue growth. Spending pressures associated with persistently high inflation cannot be overlooked, particularly public wage growth, which has a direct and costly impact. Policy measures supporting the rising costs of living also erode provinces' fiscal position of provinces.

As anticipated, provincial governments continued to revise their fiscal outlooks upwards, collectively projecting a second consecutive year in surplus in FY23, followed by a small $6.9 bn deficit in FY24 (-0.2% of GDP, chart 1). That is a material improvement from projections a year ago. All provinces saw improvements in their public finances relative to prior plans as higher prior-year tax collections provide a temporary boost to their revenues, but the positive impact is projected to dissipate rapidly. Alberta, Saskatchewan, and New Brunswick are on track to maintain surpluses in FY24. Ontario also slashed its deficit forecast and now expects a balanced budget next year (chart 2).

The combined net debt burden is expected to significantly reduce in FY23 and run at around 29% of GDP in the coming years—down from the almost 35% of GDP debt burden at the peak of COVID-19 spending. Despite the overall improvement in the debt burden and the combined stabilization of net debt as a share of output, some jurisdictions still face high and increasing levels of indebtedness (chart 3). Ontario is on track to run the largest debt burden across provinces in FY23, but sees it stabilize over the next three years. Newfoundland and Labrador is expected to carry the largest debt burden next year with a notable projected increase in net debt. In the medium-term, Nova Scotia's debt share is projected to rise rapidly and surpass Quebec and Ontario next year. On the other hand, New Brunswick has made significant efforts to reduce its debt burden.

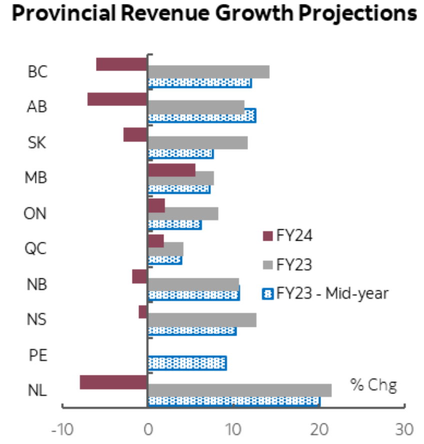
Although debt burdens are projected to rise in some provinces in an environment of tight financial conditions, the adjustment of interest expenses should be gradual due to long-dated debt structures with average maturities well above 10 years (chart 4).

SECTION II. REVENUE AND DOWNSIDE RISKS

As widely anticipated, most provinces expect revenue to stall or contract slightly in FY24, but they are building on strong base effects from last year's windfalls (chart 5). Hence, despite downward revisions in economic forecasts of various magnitudes, this year's revenues are still expected to be much stronger versus previous plans (chart 6), which improves budget balances and unlocks additional spending. Provinces that saw large windfalls in FY23 anticipate them to continue into the coming years. Alberta, BC, and Saskatchewan raised their respective FY24 revenue projections by over 10%, and even with the implementation of income tax cuts, Quebec still expects FY24 revenue to be 4% higher than in the last budget and in line with projected in its mid-year update.

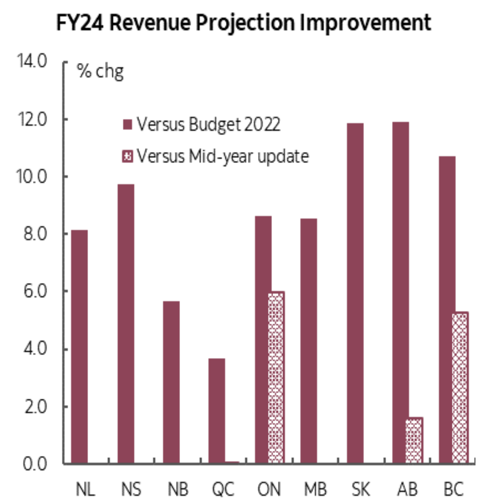
Provinces used reasonable economic assumptions, but most appeared sanguine regarding downside risks associated with mounting uncertainty in the near-term and the possibility of a more severe downturn. The sharp slowdown in real growth in 2023 is consistent across all provinces, albeit most are more optimistic than our forecasts (chart 7). Levels of prudence vary—Ontario is the most prudent, building its forecast on real growth assumptions of 0.2% and 1.3% for 2023 and 2024, respectively. However, its alternative scenario with a recession adds $3.7 bn and $6 bn more deficit to this year and next, delaying the path to balance to beyond FY26. Quebec's updated fiscal path is based on optimistic economic assumptions, but the planning included an alternative scenario with a recession

Chart 5



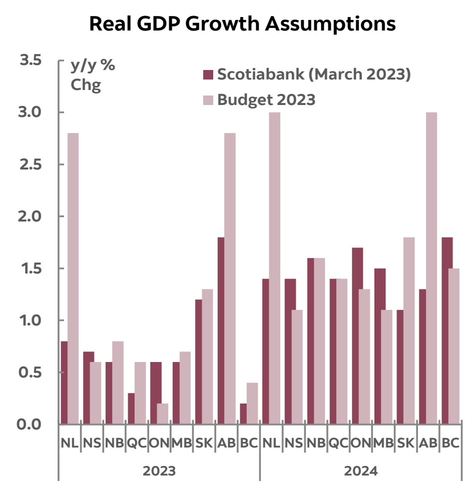
Sources: Scotiabank Economics, Statistics Canada, Budget Documents.

Chart 6



Sources: Scotiabank Economics, Budget Documents.

Chart 7



Sources: Scotiabank Economics, Budget Documents.

this year, which reduces its bottom line by $2.2 bn and $1.4 bn this year and next. A bumpier recover could bring further downside given the provinces' cautiously optimistic stand—most provinces expect real growth to pick up next year, ranging from 1.1–1.6%, with Alberta and Newfoundland and Labrador both projecting even higher of real growth of 3% in 2023. All provinces have taken the consensus view on inflation and anticipate it to average above 3.5% in 2023, before returning back to the Bank of Canada's target range in 2024.

Provinces expect above-trend population growth to remain a strong tailwind for growth in the coming years, after experiencing record growth in 2022 due to pandemic disruptions. Immigration is expected to continue expanding provinces' tax base at a pace that is well above trend, particularly in the Maritime provinces, which project growth close to 2% in 2023. Alberta, BC, and Ontario are expected to remain popular destinations for international migration, with projected population growth of 2.9%, 2.4% and 1.7%, respectively.

Commodity prices pose potential risks to the outlook. Despite the slight pick-up in crude values after the announcement of planned cuts by the OPEC+ alliance, they have been facing headwinds from a highly uncertain economic outlook that could dent fuel demand. Alberta and Saskatchewan expect WTI price to average around 79 USD/bbl in FY24, which is slightly below the current price, but they remain optimistic about the pricing strength over the planning horizon. The near-term wild swings in oil prices suggest that these assumptions are not as conservative as the ones in the last budget, and the high sensitivity to oil prices could lead to material downside risks (Alberta's budget links 1 USD/bbl with a net fiscal impact of $630 mn), though supply-side politics continue to represent a wildcard.

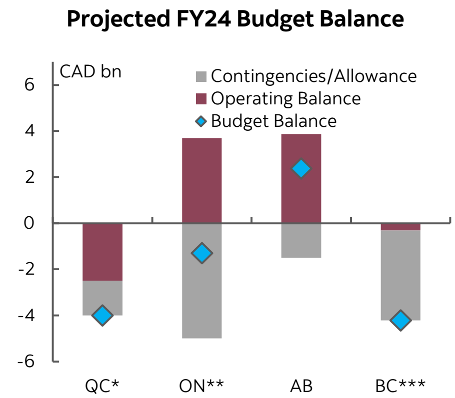
The four largest provinces incorporated significant levels of prudence through the use of contingency funds and forecast reserves (chart 8). Ontario included hefty contingencies of $5 bn in a standard forecast reserve along with some contingency funds under program spending—sufficient to absorb the downside risks in its recession scenario and would bring the province very close to a balanced book if some remain unused. Quebec and Alberta each included $1.5 bn forecast reserve for FY24, which is less than Ontario but still sizeable. BC has set aside $2.2 bn in contingency funds in anticipation of future public sector wage increases, in addition to $700 mn forecast allowance. Manitoba is the only other province that included contingencies, which amount to $200 mn.

SECTION III. SPENDING AND POLICY MEASURES

With these revenue windfalls, the provinces all ramped up near-term spending to varying degrees, with a significant focus on healthcare (chart 9). Overall, Ontario and Saskatchewan demonstrated most restraints in new spending, but their respective spending profile was nonetheless higher than outlined in last year's budget, with Ontario's increase mainly due to healthcare costs while Saskatchewan's largely attributable to agriculture spending. On the other hand, BC and Alberta have both chosen to spend most of their sizeable revenue windfalls but with different priorities. Over 70% of BC's new spending will go towards improving the healthcare system and housing affordability, while Alberta's pre-election budget contains plenty of affordability support initiatives. Compared to FY23, most provinces anticipate continued growth in total spending this year, except for Saskatchewan, which expects some declines as its affordability measures subside.

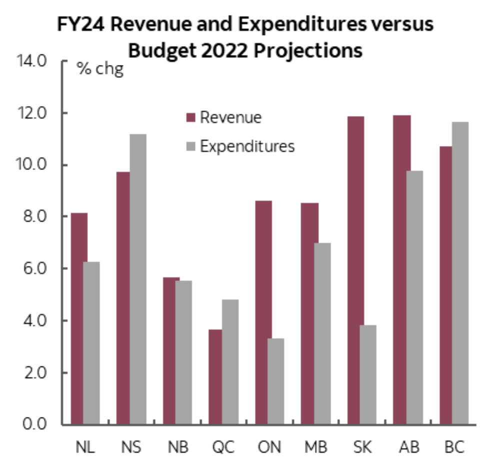
Provinces have made healthcare spending a top priority, employing varying strategies to address shared challenges related to hospital capacity, labour shortages, and backlogs. Ontario and BC allocated the highest percentage increases to healthcare spending among the larger provinces this year—at 8% and 13%—bringing per capita public healthcare

Chart 8



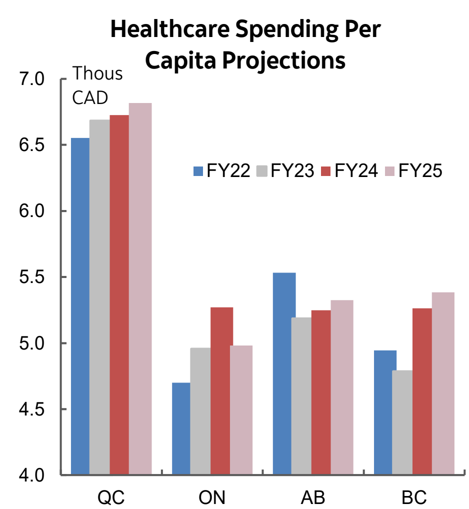
* Before Stablization Reserve withdrawals, after Generation Fund deposits. ** Includes Contingency Funds under other programs spending.
*** Includes pandemic recovery and wage mandate contingencies. Sources: Scotiabank Economics Budget Documents.

Chart 9



Sources: Scotiabank Economics, Budget Documents.

Chart 10



Sources: Scotiabank Economics, Budget Documents, Statistics Canada.

spending closer to their peers (chart 10). Nova Scotia also dedicated major investments to fix its healthcare system following recent ER incidents due to long wait time. Although new healthcare expenditures were supported by federal-provincial healthcare agreements, the increase in near-term health spending far exceeded federal financial support. In Ontario, incremental healthcare investments were over three times the size of additional federal funding. Quebec had a similar pattern but to a lesser extent, while Alberta and BC presented their budgets without incorporating these agreements. As substantial new federal healthcare supports are unlikely in the near-term beyond what was announced earlier this year, provincial governments may have to shoulder most of the spending pressure to address the healthcare gap revealed during the pandemic.

Despite the fact that most provinces have lifted their spending profiles and anticipate further growth this year, they generally rolled back on fiscal stimulus during this budget season (chart 11). Total stimulus was reduced by over 30% in FY24 compared to the size in FY23, primarily due to the time-limited measures in last year's plan, such as the one-time cheques. Quebec remains the province with the highest amount of affordability measures with its income tax cut for the two lowest income brackets, while Manitoba has also implemented tax relief by increasing its Basic Personal Amount. Alberta's pre-election budget unsurprisingly announced broad-based affordability support highlighted by a PIT indexation measure and the continuation of fuel tax relief program. Despite the pullback, the impact of elevated levels of fiscal stimulus is still material—as noted by the Bank of Canada's April Monetary Policy Report, the $25 bn per year in fiscal measures announced by provincial and federal governments add pressure on inflation through increased household spending and consumer demand.

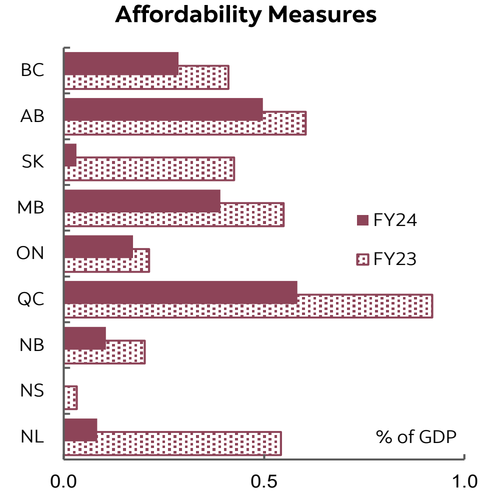
Provinces continue to commit to high levels of infrastructure investments, collectively boosting planned capital spending by around 16% in FY24, partly as a result of project delays from the year prior (chart 12). BC and Ontario are aiming to raise capital spending per capita notably in the next two years by over 30%. Nova Scotia announced the largest single-year capital funding program in the province's history, boosting per capital spending to levels above Ontario's. Public infrastructure spending is crucial in facilitating long-term economic growth and help strengthen essential services, yet keeping pace on the capital spending might become increasingly challenging with chronic labour shortages, particularly in the construction sector.

SECTION IV. BORROWINGS AND CREDIT RATINGS

Planned total borrowings are $14 bn higher in FY24 than in the year prior, and are expected to remain high through FY26 (table 1). Increased supply could put upward pressure on provincial spreads, particularly for provinces such as BC and Quebec that saw the largest increase in financing needs. However, due to abundant contingency and allowances built in the budget and the possibility of capital project delays, borrowing requirements will likely come in lower over the course of the year. As a reference, the actual borrowing amount completed in FY23 was more than $20 bn lower than the planned amount in the previous budget.

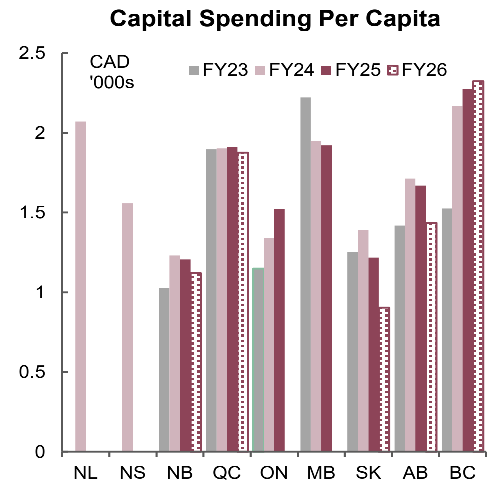
With recent financial market turmoil, renewed uncertainty, and widening risk spreads, there is little room for fiscal complacency. For instance, BC's credit rating was recently downgraded by S&P from 'AA+' to 'AA' and its outlook changed to negative as it embarked on substantial new spending that would see its debt levels increasing despite a relatively low starting position. While it was the only province holding the coveted AA+ status, it no doubt puts other provinces on alert for potential rating actions should fiscal positions not be calibrated to economic and financial conditions.

Chart 11



Sources: Scotiabank Economics, Statistics Canada, Budget Documents.

Chart 12



Sources: Scotiabank Economics, Budget documents, Statistics Canada.

Table 1: Long-Term Borrowing Requirements
$ billions

	FY23	FY24	FY25	FY26
NL	1.7	1.5	-	-
PE	-	-	-	-
NS	1.6	2.0	2.3	2.2
NB	1.7	1.8	-	-
QC	24.2	29.5	28.6	29.0
ON	32.1	27.5	28.7	33.4
MB	3.9	4.7	5.3	5.7
SK	2.7	1.7	-	-
AB	3.3	6.7	6.1	15.0
BC	8.7	18.9	20.4	19.3
Total	79.9	94.4	91.4	104.6

Sources: Scotiabank Economics, budget documents.