2021 Budget Season Preview

A Tough Balancing Act

Omar Abdelrahman, Economist | 416-734-2873

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Highlights

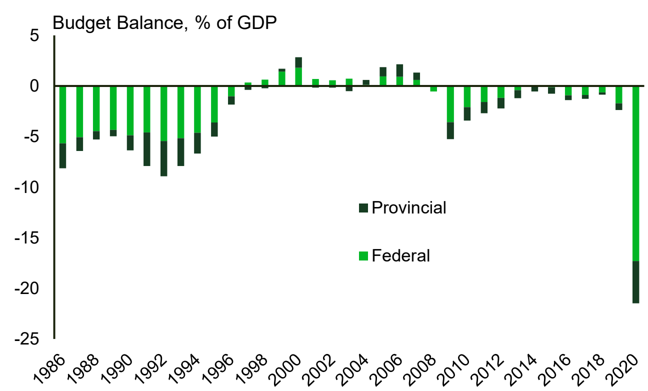
- Canada's fiscal response to COVID-19 has gone a long way in mitigating what could have been a significantly worse economic shock. This came with a massive price tag. Based on government estimates, the combined federal-provincial deficit now stands at $473 billion (roughly 21% of GDP) in FY 2020-21. The aggregate debt burden across both levels of government increased to around 87% of GDP.
- Provincial deficit estimates for the 2020-21 fiscal year have been either left unchanged or revised downwards modestly since early pandemic forecasts were issued. Both stronger-than-expected economic recoveries and higher federal transfer payments have led to upside surprises in revenues. This impact was at least partially offset by higher expenditures.
- The opposite is true for the federal shortfall, where the FY 2020-21 deficit target has been steadily ratcheted higher this year as pandemic supports have been extended. Although details were scant, the Fall Economic Statement also pointed to additional stimulus in the range of $70-$100 billion over the next three years.
- Attention is now turning to the FY 2021-22 budget season, where early guidance from governments points to a drop in the aggregate federal-provincial deficit to around $190 billion (8% of GDP). However, this estimate may be marked up up given the recent extensions to emergency support programs. With debt burdens elevated, credit rating agencies will keenly be awaiting information around governments' medium-term exit strategies.

The counter-cyclical role of fiscal policy has been on full display during the pandemic. Canada's response has been among the largest across the major advanced economies. These fiscal supports - alongside responses from the Bank of Canada, the Office of the Superintendent of Financial Institutions (OSFI) and the Canada Mortgage and Housing Corporation (CMHC) – helped Canada's economy avoid a much worse fate.

This policy medicine came with a hefty price tag. As it stands, the combined federal-provincial shortfall is on track to reach a record $473 billion (21% of GDP) for the 2020-21 fiscal year. The bulk of the heavy lifting ($382 billion, 17.3% of GDP) in terms of pandemic supports has been shouldered by the federal government, but provinces have also played a role (Chart 1). Accordingly, the aggregate federal-provincial debt-to-GDP ratio is also set to spike by some 27 percentage points, to about 87% (Chart 2).

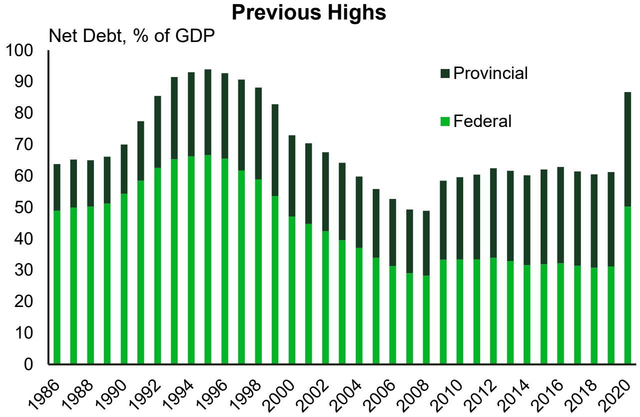
With the new budget season soon to ramp up, governments will be faced with a tough balancing act. Alberta kicked off the release schedule late last week (see report), with other governments expect-

Chart 1: Deficits Balloon, Federal Government Shoulders the Bulk of the Spending



Source: Federal Government, Provincial Governments, Statistics Canada, TD Economics.

Chart 2: Aggregate Debt Burden Approaching Previous Highs



Source: Federal Government, Provincial Governments, Statistics Canada, TD Economics.

ed to follow in March and April. A uniform shift towards lower deficits is expected in the upcoming year as economic recoveries gain traction and revenues increase. At the same time, however, further targeted supports to households and businesses are likely due to ongoing uncertainty around economic restrictions and health/vaccination outcomes. This is expected to slow the anticipated pace of fiscal improvement. Similar to Alberta, a number of governments are likely to raise next year's deficit target. On the flip side, some provinces also tend to hold sizeable contingencies and yet-to-be-allocated funds, which could help offset the higher expenses associated with COVID-19. We also suspect that governments will follow Alberta's lead by basing their budget planning on cautious economic assumptions, leaving scope to better near-term budget targets.

Eyes will also will be on the federal government's upcoming spring budget. As a result of additional outlays and impacts from the second round of restrictions, the federal deficit may approach the upper end of the government's fall scenario estimates ($400 billion or 18% of GDP) for the 2020-21 fiscal year. For the upcoming year, the government predicted a sizeable drop to $121.2 billion (5.2% of GDP). That said, the Fall Economic Statement also announced around $70-$100 billion in new stimulus over the next three years that has yet to be built into its budget estimates, and has since also announced further extensions in a number of its pandemic support programs (for instance, rent and income supports). While this suggests that next year's deficit may be revised substantially upwards, a stronger than-expected outturn for the economy in Q4 of 2020 and early 2021 may provide some offset.

Suffice to say, the 2021 round of budgets will be closely watched by credit rating agencies and market participants who will be looking for some indications of how governments plan to exit from this period of swollen deficits and inflated borrowing.

A Look Back at a Historic Year for Public Finances

For all levels of governments, estimates provided early in the pandemic for FY 2020-21 were based on particularly gloomy economic projections. As such, even with spending plans coming in higher than expected, provincial deficits are tracking close to the initial estimates, or in some cases, below. A speedier than expected economic recovery has supported bottom lines across the board. This was complemented by higher federal transfers (for instance, through the Safe Restart Agreement). Combined, the provinces are on track to record a $92 billion deficit in the 2020-21 fiscal year, amounting to 4.2% of GDP, which is a stark deterioration from the $15 billion in red ink in FY 2019-20.

The largest driver of last year's fiscal slippage has been a roughly 14% average increase in provincial program expenses (including contingencies) on the back of COVID-19 response packages. However, this includes sizeable contingencies and forecast allowances, which may potentially be used to reduce deficit tallies. In contrast, debt servicing costs are set to edge up only slightly (+1.3%) from the prior year, with the impact of higher debt-loads offset by historically low interest rates. Meanwhile, the estimated decline in total provincial revenues has been comparatively modest (-2.5%). The limited hit was partly due to increased federal transfers.

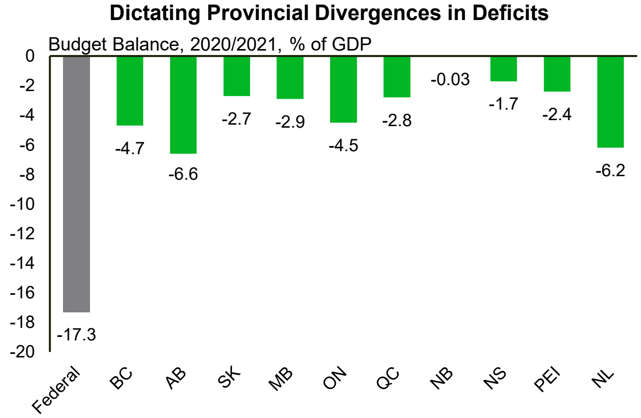
Underneath the aggregate provincial number lies significant provincial variation (Chart 3). This divergence was dictated by the severity of outbreaks and stringency of restrictions in each region. At one end of the spectrum, the Maritime region (New Brunswick, Nova Scotia, Prince Edward Island) has seen a comparatively modest hit to its finances. For all three provinces in the region, shortfalls (ranging from a negligible 0.03% to 2.4% of GDP) are expected to remain below those seen in the region as recently as 2017, and are also the lowest in the country. The Maritimes faced the mildest outbreaks in Canada (and more broadly, North America) during both infection waves. Restrictions on activity were more modest snd short-lived, and job losses and business closures were less pronounced. This lessened the need for additional stimulus and provided a backstop to revenues. Consistent with the scale of the hit, the Maritime provinces' net debt to GDP ratios are all expected to remain below previous peaks (Chart 4).

At the other end of the spectrum, the pandemic has battered finances in Canada's oil-producing provinces. Alberta and Newfoundland & Labrador are estimating that revenues will plummet by more than 8% in FY 2020-21. As a result, both provinces have witnessed the largest deficits in Canada in the prior fiscal year - at more than 6% of GDP. With the oil shock hitting as early as February of last year, finances in FY 2019-2020 were also more disproportionately impacted relative to other provinces. Meanwhile, Saskatchewan's laudable progress in recent years towards balancing its books was interrupted by the pandemic. Still, at an estimated 2.7% of GDP, the deficit in the province this year is likely to be among the lowest in the country. A more diversified revenue stream and lesser exposure to COVID-19 restrictions have left Saskatchewan's coffers in better shape than in other oil producers. In terms of net debt-to-GDP ratios, Alberta and Newfoundland and Labrador are set to see the biggest spike (around +9 ppts and +14 ppts, respectively) among all provinces in FY 2020-21. Saskatchewan's more modest increase, meanwhile, still leaves it with the lowest debt burden among the provinces (19.6%).

The remaining provinces (Ontario, Quebec, B.C., Manitoba) lie somewhere in between. These provinces had among the largest spending responses to the pandemic. At 4.7% of GDP, B.C.'s projected deficit in the current year is trailing only Alberta's and Newfoundland and Labrador's. The B.C. government had initially allocated around $5 billion for its pandemic response. An additional $2 billion of income supports and benefits, first telegraphed in the NDP's election platform, were announced in the fall fiscal update. Nonetheless, B.C.'s net debt to GDP ratio is expected to remain among the lowest in the country. Ontario's longer-lasting restrictions relative to other provinces have also left it with a large budgetary gap. In its third quarter update, Ontario's expenses were adjusted upwards by a whopping $2 billion as the revenue projection was held steady. The higher expenses were funded by a drawdown in a reserve fund, leaving the deficit unchanged at 4.5% of GDP. The deficit is expected to lift Ontario's debt burden by a substantial 7.5 ppts this year, to 47%. Despite being the most impacted by the winter restrictions on activity, Quebec's allocation of a $4 billion contingency fund is expected to absorb much of the fiscal impact from the pandemic this year, as it widens its advantage on neighbouring Ontario in terms of debt burden. Elsewhere, Manitoba's government has highlighted that its pandemic spending was among the largest provincially. A disproportionate hit from the second wave may add further upward pressure on its deficit.

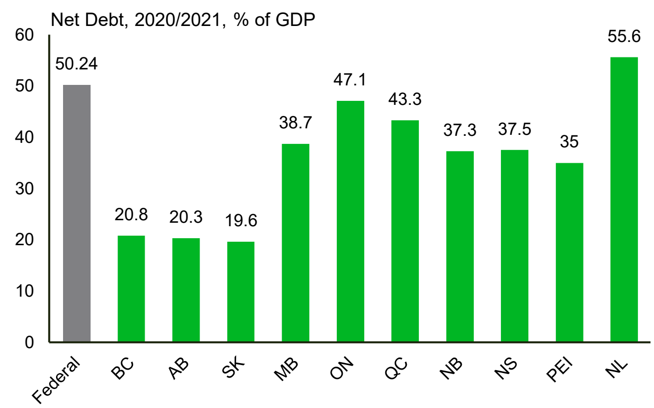
In contrast to the provinces, the federal government's deficit has been steadily revised upwards this year. The Fall Economic Statement pointed to a $382 billion deficit (see our report), up from a projected shortfall of $343 billion in July. What's more, the late November update highlighted a possible increase in the deficit to $400 billion, or 18% of GDP, under a scenario of increased restrictions. Extensions to rent and income support programs will likely only be partially offset by a better-than-expected economic performance in 2020 and early 2021. The much wider federal deficit relative to the provinces is not surprising. The hallmarks of Canada's fiscal response, including the Canada

Chart 3: Pandemic and Oil Shock Impacts Dictating Provincial Divergences in Deficits



Source: Government Budgets and Fiscal Updates, TD Economics.

Chart 4: Debt Burdens Rise Across the Board



Source: Government Budget and Fiscal Updates TD Economics.

Table 1: Budget Balance (% of GDP)						
Region	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Federal	-17.3	-5.2	-2.1	-1.7	-1.2	-0.9
BC	-4.7	-	-	-	-	-
AB	-6.6	-5.4	-3.1	-2.1	-	-
SK	-2.7	-1.7	-1	-0.4	0.1	-
MB	-2.9	-	-	-	-	-
ON	-4.5	-3.7	-2.9	-	-	-
QC	-2.8	-1.1	-0.8	-	-	-
NB	-0.03	-	-	-	-	-
NS	-1.7	-	-	-	-	-
PE	-2.4	-0.9	-0.5	-	-	-
NL	-6.2	-	-	-	-	-

*Government estimates for FY 2021-22 onwards are preliminary estimates from 2020 budgets and fiscal updates, except for Alberta, which has released medium-term targets in its 2021 budget.
Source: Federal and Provincial Governments, TD Economics.

Emergency Response Benefit (CERB), the Canada Recovery Benefit (CRB), the Canada Emergency Wage Subsidy (CEWS), and a multitude of other big-ticket support measures, were all shouldered by the federal government. The extension of some of these measures during the second wave has added upward pressure on the deficit. The federal government's estimated debt to GDP (accumulated deficit) ratio has jumped 19 ppts to 50.2% in FY 2020-21 as a result.

A Look Ahead to an Eventful Budget Season

Turning to the upcoming year, deficits are expected to downshift across the board, but the pace at which they fall will vary considerably (see Table 1). All governments will be walking a difficult balance. Even as governments are likely to wean households and businesses off broad emergency supports, pressure to provide targeted assistance to those still struggling will constrain the extent of deficit improvement. Budgets are likely to assume a moderate increase in debt charges reflecting an upward move in bond yields off their pandemic lows. Governments from coast to coast will almost certainly assume a notable rebound in revenues, though it will be more pronounced in provinces hit the hardest by last year's downturn. Indeed, commodity-producing provinces may see some additional windfall from the faster-than-expected recovery in oil and other commodity prices. Any tax increases announced in the spring budgets are likely to be relatively modest and targeted, as governments avoid undertaking measures that may impede economic recoveries in the near term.

Table 1 compiles the latest estimates from governments. On aggregate, the provincial deficit is projected to drop from $90 billion to around $70 billion (3% of GDP). Despite the reduction in the deficit, most provinces are likely to target a modest increase in debt-to-GDP ratios (see Table 2). Continued deficits and higher capital spending plans are expected to contribute to overall provincial borrowing. In fact, recent data from Statistics Canada suggest that public sector capital spending may rise by 9.3% in 2021 (see note).

Alberta provided a first glimpse of what to expect from the provincial budget season, at least from the provinces facing larger deficit challenges. Its 2021 budget showcased a still-sizeable deficit of $18.2 billion (5.4% of GDP) for the year ahead, only a modest improvement from the past year's tally and some $2.7 billion higher than its guidance earlier in December. Total expenses in FY 2021-22 are anticipated to drop by 5.7%, driven predominantly by a tapering of its COVID-19 response. Meanwhile, revenues are forecast to increase by a moderate 3.3%. The silver lining is that conservative WTI forecasts will likely set the stage for upward revisions on the revenue side of the ledger. Alberta's 2021 budgetary assumption for WTI prices in 2021-22 (US$46) is far below the current market price (US$65), suggesting a potential for a meaningful revenue windfall in upcoming updates. Alberta's net debt is expected to continue climb-

Table 2: Net Debt (% of GDP)						
Region	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Federal	50.2	52.6	52.1	51.6	50.6	49.6
BC	20.8	-	-	-	-	-
AB	20.3	24.5	26.1	26.6	-	-
SK	19.6	21.1	21.7	21.6	20.7	-
MB	38.7	-	-	-	-	-
ON	47.9	48.5	49.6	-	-	-
QC	43.3	42.5	42.3	-	-	-
NB	37.9	-	-	-	-	-
NS	37.5	-	-	-	-	-
PE	35	34	33.4	-	-	-
NL	55.6	-	-	-	-	-

*Government estimates for FY 2021-22 onwards are preliminary estimates from 2020 budgets and fiscal updates, except for Alberta, which has released medium-term targets in its 2021 budget.
Source: Federal and Provincial Governments, TD Economics.

ing higher due to continued sizeable deficits and capital spending, with its net debt burden surpassing Saskatchewan and possibly B.C this year.

Four other provinces have provided preliminary medium-term targets (Ontario, Quebec, Saskatchewan, PEI) in their 2020 budgets or fiscal updates. As a share of GDP (see Table 1), deficits for these provinces are expected to range from 3.7% of GDP (Ontario) to 0.9% of GDP (PEI). B.C. hasn't included a preliminary medium-term estimate, but we can expect a relatively slow downshift in its deficit. The province's relatively low debt burden provides it with more flexibility in its 2021 fiscal plan. In fact, B.C. has been among the few provinces so far to signal plans to introduce new permanent spending, though others may follow given the current focus on growth. Elsewhere, the Maritime provinces could strive to bring deficits down within striking distance of balance in the year ahead - with New Brunswick already close to balanced territory prior to starting the new fiscal year. These three provinces were all in the black prior to the pandemic. For some provinces (Quebec, Ontario, B.C.), the sizeable contingencies and forecast allowances may result in downward revisions to deficits.

Medium term, the picture remains murky. On a status-quo basis, deficits would be expected to linger, as scarring effects in labour markets and business investment continue to weigh on revenues. As a result, budgets will still be closely watched for guidance around medium-term exit strategies. Given the uncertainty seen in the past year, only a few provinces have outlined plans to implement fiscal consolidation. Alberta's previous plans to rebalance its budget by 2022-23 were thrown off course. Instead, the government has offered explicit anchors to guide its post-pandemic budgetary path. These include maintaining a net debt to GDP ratio that is below 30%, efforts to lower per capita program spending down to levels seen in other provinces, and outlining a plan to balance once the pandemic is in the rear view mirror. With corporate taxes already slashed to 8% the past year, a path to surpluses will likely involve some challenging decisions on both sides of the ledger (new taxes or cuts in non-core spending). Still, none of these is expected until the economy fully recovers from the impacts of the pandemic. Saskatchewan is the only province that has already released a road map to balanced books (by 2023-2024). However, its Finance Minister has recently suggested that these initial plans may be delayed. Some provinces with pre-existing structural deficits, namely, Newfoundland and Labrador, and Ontario, will have a more challenging time outlining a road map to balanced budgets.

Turning to the federal government, the fall statement revealed a projected deficit of 5.2% of GDP next year (a sharp drop from 17.3%). The shortfall is projected to fall to 0.9% by 2026. This medium-term target would be consistent with the level of deficits seen in previous years, but it's still unclear how both sides of the ledger will evolve to achieve this target. The government has also added a potential $70-$100 billion in new stimulus over the next three

Federal and Provincial Credit Ratings				
Province	Moody's	S&P	DBRS	Fitch
Canada	Aaa	AAA	AAA	AA+
BC	Aaa	AAA	AA high	AAA
AB	Aa3	A+	AA low	AA-
SK	Aaa	AA	AA low	AA
MB	Aa2	A+	A high	-
ON	Aa3	AA+	AA low	AA-
QC	Aa2	AA-	AA low	AA-
NB	Aa2	A+	A high	-
NS	Aa2	AA-	A high	-
PEI	Aa2	A	A	-
NL	A1	A	A low	-

Source: Moody's, Standard & Poor's, DRBS, Fitch Group, Provincial Governments, TD Economics.

years contingent on labour market outcomes. On this note, some announcements have already been made on municipal transfers for transit infrastructure ($6 billion in immediate funds). Extensions to the rental and wage subsidy programs to June (reportedly at a cost of around $16 billion) were also announced. The government has already taken steps to signal its intent on reining in spending. For instance, the Prime Minister's mandate letter to the Finance Minister has cautioned against any new permanent spending.

Low Borrowing Rates are Supportive, but We Shouldn't get Too Carried Away

The last time Canada and the provinces saw similar levels of deficits and debt burdens was in the 1990s. At the time, borrowing rates were significantly higher, and as a result, debt charges added severe upward pressure on finances. This time around, historically low borrowing rates have kept debt charges in check. The Bank of Canada's accommodative stance has been supportive. This included leaving the overnight rate at its effective lower bound and conducting bond purchases programs (including its Provincial Bond Purchase Program). These measures helped suppress yields while providing a liquidity backstop at the onset of the pandemic. Given the global nature of the crisis and the similar experiences elsewhere, debt and currency markets have not signaled concern with Canadian and provincial fiscal trajectories yet. Spreads between Canadian and U.S. borrowing yields remain consistent with historical levels. In other news, non-resident investor appetite for Canadian fixed income was robust. For 2020, transactions of Canadian government (all levels) money market instruments and bonds reached $98 billion. Aside from some modest downgrades to some provinces (Alberta, Newfoundland & Labrador, and Saskatchewan) and a downgrade to Canada's rating by Fitch, Canada's federal and provincial ratings have held steady despite the pandemic (see Table 3).

However, this budget season will likely be watched closely by ratings agencies and debt markets. Signals of fiscal sustainability will be expected, including a road map towards consolidation and/or fiscal anchors. Governments will be facing the tough task of weighing these objectives while supporting a full recovery.

Bottom Line

Putting it all together, Canada's response to the pandemic has gone a long way in providing a backstop the historic downturn. This year's budgets will face the daunting task of outlining exit plans from historic deficits, without compromising the recovery process.