

Economics

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Provincial finances: Friends turning into foes

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We are in for a year of higher deficits and increased borrowing for most provincial governments. While provincial revenues benefitted from the higher inflation environment of prior years, public sector workers are now demanding catch-up pay which increases expenditures. At the same time, the rapid population growth that helped expand economic activity and fill open job vacancies coming out of the pandemic is now putting pressure on provincial infrastructure, bringing higher capital spending needs. In short, factors that were previously friendly for provincial finances are turning into foes.

While net debt held by provincial governments is no higher than it was before the pandemic as a percentage of GDP (Chart 1 left), it is trending upwards thanks to deficit projections and capital spending requirements. At the same time, the aggregate provincial deficit is projected to be the largest since 2013 as a percentage of GDP, outside of the pandemic years of 2020 and 2021 (Chart 1, right). With increases in nominal program spending and capital investment expected to be almost identical in 2024/25 as they were in 2023/24, even as inflationary pressures are fading, in real terms provincial

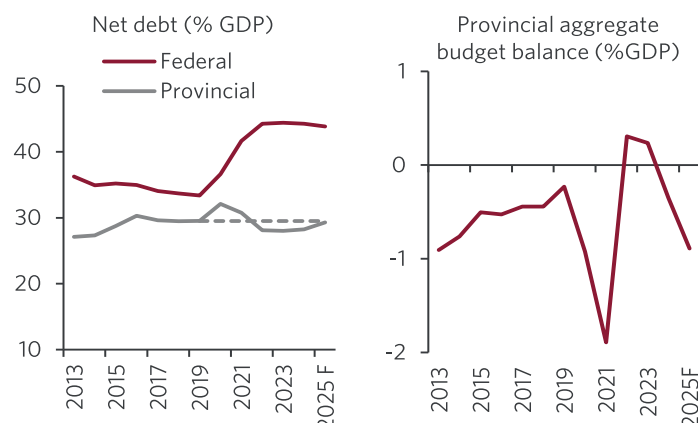
governments will provide modestly more stimulus to the economy this year than they did last year (Chart 2).

New spending pressures

In prior years, increases in spending by provincial governments were driven largely by one-off transfers to households under the banner of “helping with the cost of living”. With inflation now easing, the size and scale of provincial transfers to households has also decreased. However, provinces are now facing a new source of spending pressure, as government workers whose wages have not kept pace with inflation in recent years demand larger pay increases.

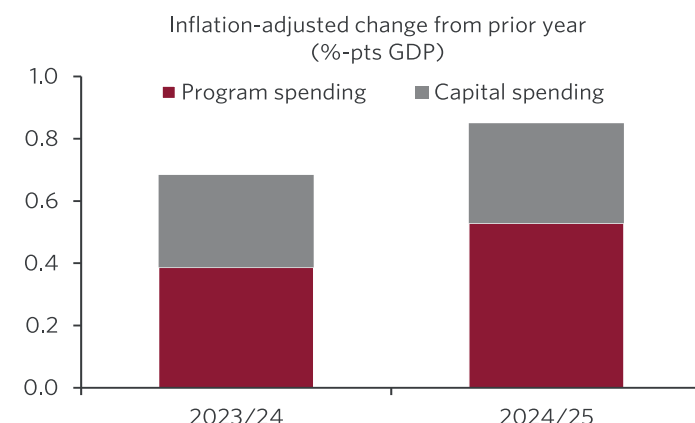
The latest available data for 2023 clearly show the degree to which government wages have fallen short of inflationary pressure and wage growth of private sector workers since 2019. Few provinces had seen public sector wage growth exceed inflation during that time period, with others seeing inflation-adjusted declines in wages of up to 5%. Relative to growth in private sector wages, government workers in Quebec and

Chart 1: Debt-to-GDP trending up to pre-pandemic level (L), in part due to higher expected deficits (R)



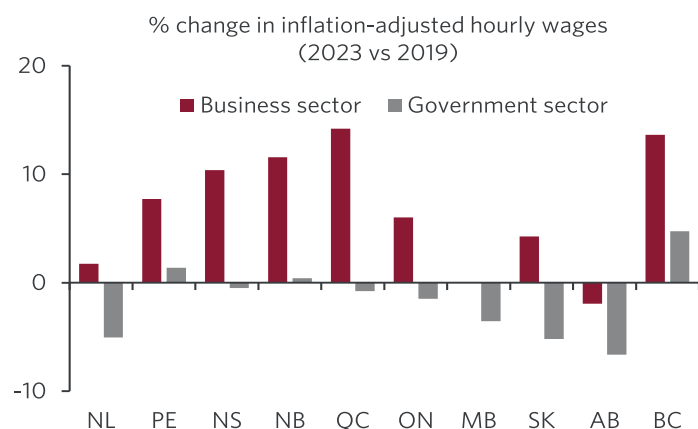
Source: Provincial Budgets, CIBC

Chart 2: Fiscal stimulus from provinces expected to increase slightly this year



Source: Provincial Budgets, CIBC

Chart 3: Public sector wages trailed private sector and inflation from 2019 to 2023



Source: Statistics Canada, CIBC

Atlantic Canada had seen the greatest degree of underperformance in their hourly earnings (Chart 3).

Against that backdrop, the strike action seen in Quebec towards the end of last year, resulting in the eventual agreement of a significant wage boost incorporated within Budget 2024, came as little surprise. A number of other provinces have also already seen spending increases due to wage settlements with workers, or have booked provisions for these. However, as more settlements expire and are renegotiated, this issue has the potential to be a continued source of spending pressure even beyond the current year.

Provincial borrowing is also being elevated by the pressure to build infrastructure to catch up to recent surges in population. While capital plans are accounted separately from current spending in provincial budgets, increased expenditure here still adds to debt levels and borrowing requirements.

The latest data from Statistics Canada highlights the scale of the issue facing some provinces. In inflation-adjusted terms, the

per capita stock of schools, hospitals etc. in New Brunswick, Ontario, Manitoba and Alberta are all lower than they were ten years ago (Chart 4). With this data representing the end-2022 level, and with most provinces having seen even stronger population growth since then, other areas of the country are also now in need of additional infrastructure.

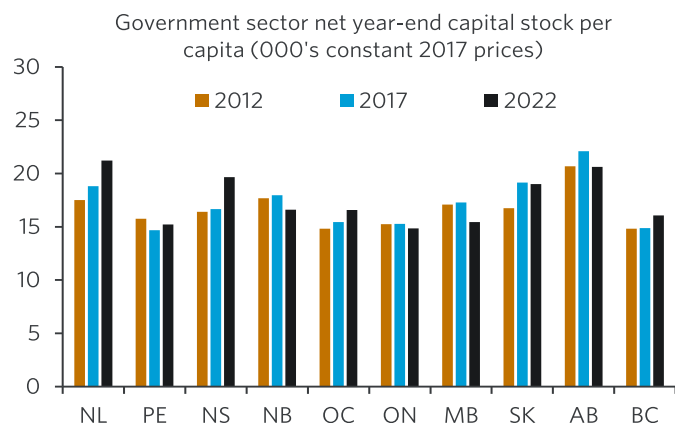
Because of this, increased capital spending by provinces contributed almost as much to national GDP growth as program spending last year, and is expected to do so again in the current fiscal year (see chart 2 again).

Risk factors

In any budget year, deficit projections rely on forecasts for economic growth which should correlate with revenues. During and after the pandemic there has been more volatility in these growth projections, making fiscal planning more challenging. The current year is no exception, although this time around the Canadian economy appears to be outperforming growth expectations that were made earlier in the year. Having stood at a mere 0.5% at the start of budget season in late February, the Bloomberg consensus for real GDP growth in 2024 now stands at just over 1%.

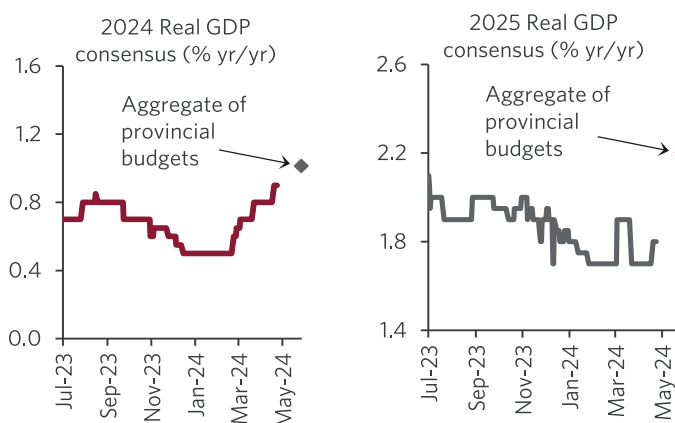
However, the Canadian economy may have to grow stronger still for this to be an upside risk for provincial revenues. While national growth appears to be beating previously low private-sector projections so far in 2024, it isn't yet outperforming the aggregate forecast from provincial governments (Chart 5 left). Provinces such as Alberta, PEI and Newfoundland & Labrador were already projecting stronger growth this year than the private sector average collated for the budget process. Moreover, these stronger growth projections are not just concentrated on the current calendar year, as the aggregate projection from provincial governments is also materially stronger for 2025 than the national Bloomberg consensus and our own forecast (Chart 5, right).

Chart 4: Infrastructure wasn't keeping pace with population growth in many provinces, even prior to latest population surge



Source: Statistics Canada, CIBC

Chart 5: Provincial budgets already based on stronger GDP growth for 2024 (L) and 2025 (R) compared with the consensus



Source: Bloomberg, Provincial Budgets, CIBC

Of course, for a number of provinces, commodity prices can be more important in accurately predicting revenues than real GDP growth. We have seen over the past couple of years that commodity price increases can play a large positive role in provincial finances. At the same time, they can also result in underperformance, as we saw with Saskatchewan and potash prices last year.

While oil prices have slipped recently, they are still averaging higher so far this fiscal year than provinces were anticipating. WTI prices have averaged \$82, which is \$8 above Alberta’s budget assumption. With fiscal sensitivities suggesting a \$630mn gain for every \$1 above, if oil stays at these levels, simple arithmetic shows an additional \$5bn windfall.

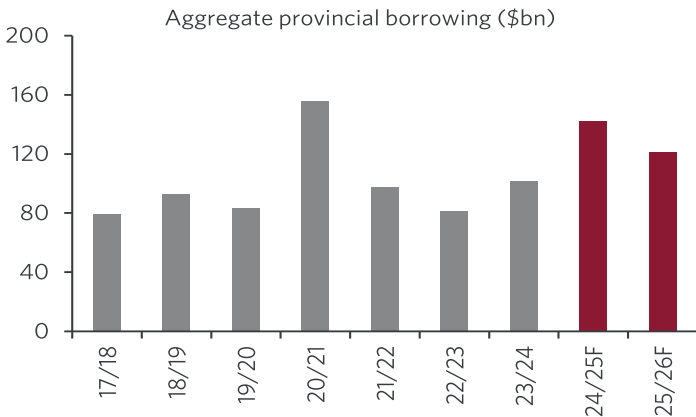
On the flip side, natural disasters such as flooding, forest fires and/or droughts pose potential downside risks to provincial finances. While provinces do set money aside for such events, the number and scale of weather events appears to be increasing. For example, the forest fires that ravaged the country last year ended up costing Alberta double the contingency that had been set aside for disaster spending. Alberta is allocating \$2.0bn in contingency for disaster relief this year, which is higher than the amount previously set aside but lower than actual \$2.9bn of spending last year. At the same time, Saskatchewan’s 2023/24 expenditure numbers were increased by \$1.1bn due to additional spending related to higher crop insurance claims following last year’s drought.

A jump in borrowing

Looming bond maturities were another key theme from this budget season, as the shorter-dated issuance that occurred early in the pandemic needs to be refinanced. With rates higher now relative to the pandemic lows, provinces will have to refinance at higher coupons.

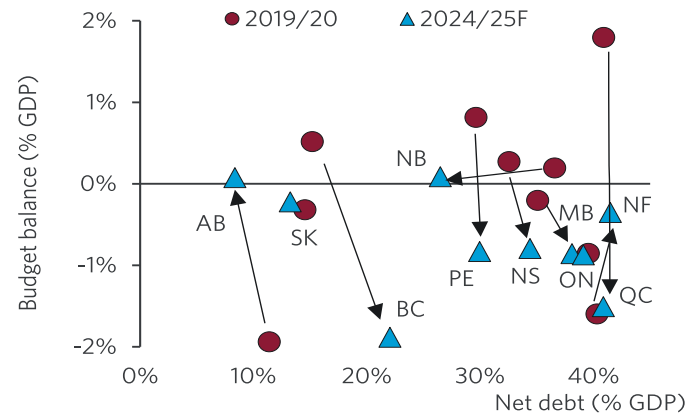
Combining the larger aggregate deficit, increased capital spending and maturities, projected borrowing is expected to be around \$140bn this fiscal year. That is an increase of 40% from

Chart 6: Aggregate provincial issuance to increase



Source: Provincial Budgets, CIBC Capital Markets

Chart 7: Not all provinces have seen a fiscal deterioration



Source: Provincial Budgets, CIBC

the outgoing year, without accounting for any large scale pre-funding that may take place. If we see any further fiscal deterioration, we could possibly approach the pandemic highs of just under \$160bn in provincial supply (Chart 6). Meanwhile, due to continued deficit forecasts and higher maturities, next year’s borrowing programs are projected to remain at elevated levels.

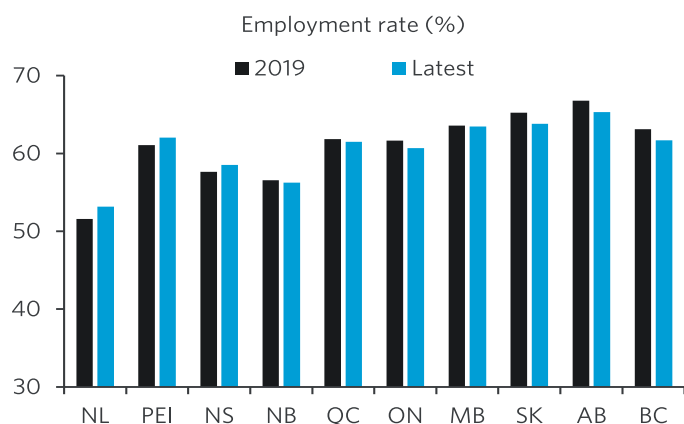
The 40% of additional supply would pressure domestic spreads if it were all completed in Canadian markets, which leads us to believe that this upcoming year will experience a higher proportion of international issuance than normal. Indeed, we have already seen 14 non-domestic bonds issued since mid-March, totaling C\$25.4bn. That represents approximately half of all completed provincial issuance so far in this new fiscal year.

A more level playing field

Even though the aggregate story is one of larger deficits and higher borrowing, it should be noted that this is not necessarily the case across the whole country. Indeed, relative to where provincial finances stood before the pandemic, there has been a levelling of the playing field (Chart 7). Higher oil prices mean that commodity-rich provinces are no longer running the large deficits they were in 2019, while some Atlantic provinces have made big improvements in either deficits (Newfoundland & Labrador) or debt levels (New Brunswick).

There has also been a levelling of the playing field economically as well, with immigration-fueled population growth helping to stem the impact of an ageing population on employment rates in Atlantic Canada (Chart 8). While that population growth has also brought increased spending requirements, and so hasn’t translated into fiscal improvement in all of those provinces yet, there is a stronger base for future provincial revenues.

Chart 8: Employment rates have generally risen in Atlantic Canada, fallen elsewhere



Source: Statistics Canada, CIBC

Friends turning into foes

Most provincial finances fared much better than initially expected during and after the pandemic, as transfers from the Federal government and higher inflation bolstered revenues, while population increases supported economic growth. However, some of the factors that were previously friendly for provincial finances are now turning into foes. Wage negotiations and pay increases for public sector workers have already added to spending and will likely continue to do so, while catching up with the infrastructure needs of a growing population is also likely to be a multi-year affair. As a result, this year's higher borrowing by provincial governments is unlikely to be a one-off, with elevated funding needs likely to persist into the 2025/26 fiscal year as well.

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