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Subnational Government Outlook 2025: Canadian LRG Revenues Will Play Catchup To Meet Higher Operating Costs And Stabilize Debt Growth

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This report does not constitute a rating action.

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Key Takeaways

- Higher spending on wages and the reduction of the federal government's new immigration targets for nonpermanent residents will lead to smaller operating surpluses for Canadian provinces, with capital investment and refinancing of maturing debt underpinning borrowing in the next two years.
- In the medium term, provincial utilities' higher operating and capital spending, coupled with varying water levels affecting revenue performance, could increase provincial borrowing beyond our forecast.
- S&P Global Ratings expects total provincial and municipal debt will rise by about 6.5% in fiscal 2025 and by 4% annually in the following two years, reaching C$1.3 trillion by the end of fiscal 2027.
- Debt issuance will remain bond-based, dominated by fixed rate provincial bonds issued in the domestic market.

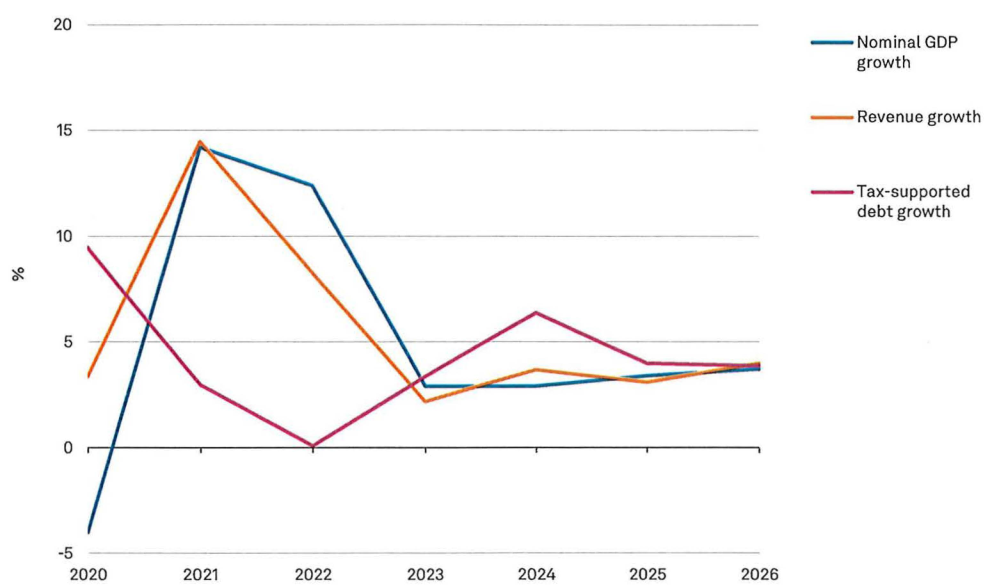
S&P Global Economics' baseline assumption for the next two years forecasts that Canada's real GDP will increase by 1.2% in 2024 and 1.7% in 2025 (see "Economic Outlook Canada Q1 2025: Immigration Policies Hamper Growth Expectations," published Nov. 26, 2024, on RatingsDirect). A key risk for Canada's economy stems from increased uncertainty surrounding trade relations with the U.S. and the potential renegotiation of the U.S.-Mexico-Canada Agreement in 2026. Our base case is that the established economic relationship and interconnection among the three countries remains robust, as they have worked through disputes in the past. We expect growth for most provinces (those without significant exposure to commodity prices) will converge toward the national level.

The Debt Burden Will Stabilize Through Fiscal 2027, Despite Higher Borrowing

S&P Global Ratings expects that total debt will rise through fiscal 2027, although at a slower pace than in recent years, as Canadian local and regional governments' (LRGs) revenues begin to outpace operating expenditure growth and the structural gap created in the past two years due to higher operating costs related to wages and the cost of goods (for provinces, in particular) begins to narrow. Canadian LRGs also plan to continue sizable investments in capital such as health care (at the provincial level) and municipal transportation and water and wastewater infrastructure. We still expect debt burdens will moderate back to historical levels, falling below nominal GDP since 2021 (chart 1). This is particularly true for Canadian provinces, which are among the largest bond issuers globally. We project that total LRG debt will represent about 40% of Canada's GDP in 2025, which is significantly higher than that of other federal nations, such as Australia or Germany.

Chart 1

Debt burdens will start to decrease in 2026 as the pace of revenue growth increases relative to debt accumulation



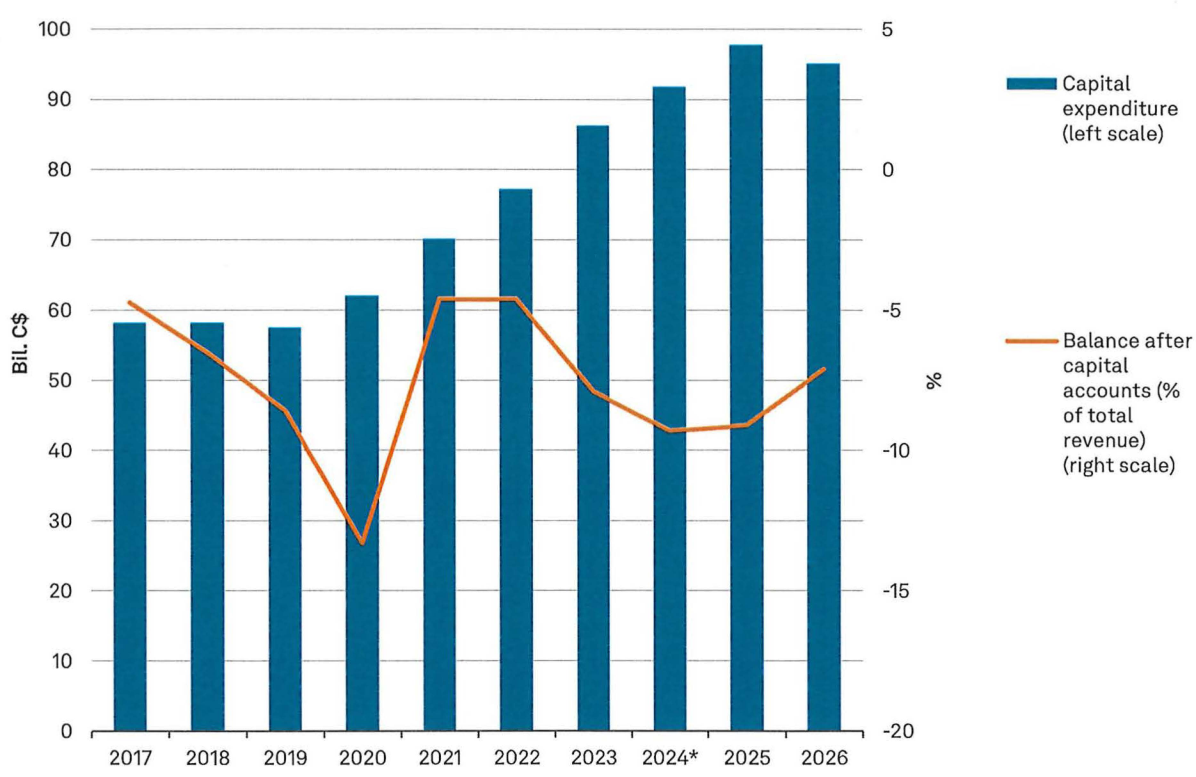
Source: S&P Global Ratings.

As of calendar year-end 2024, almost all Canadian provinces had provided their midyear updates to budgets they released last spring. The updates incorporated the effect of inflation, recent monetary and federal policy decisions, and expected near term economic difficulties through a slight downward revision to real GDP growth forecasts. Fiscal results outperformed expectations after a relatively modest rise in consolidated provincial operating revenues relative to year-to-date increases in operating expenses, led to upward revisions in current-year estimates for operating and after-capital balances. As a result, based on midyear fiscal 2025 provincial updates, we expect gross borrowings for Canadian LRGs in fiscal 2025 will total approximately C$140 billion, about C$1 billion less than expected when provincial budgets were released in spring 2024.

Conversely, municipal finances were relatively stable in the past year. In the next 12-18 months, we expect that, generally, local governments will raise property taxes to offset the impact of high inflation on wages and the cost of goods. We also expect that municipalities will face higher capital spending on maintenance and new investment to support the needs of an expanding population (chart 2). If affordability constraints start to limit municipalities' practical revenue-raising flexibility as costs rise, we could also see a moderate draw on financial resources or the use of debt without a commensurate rise in taxes or fees.

Chart 2

Canadian LRGs capital expenditures and fiscal balances, 2017-2026

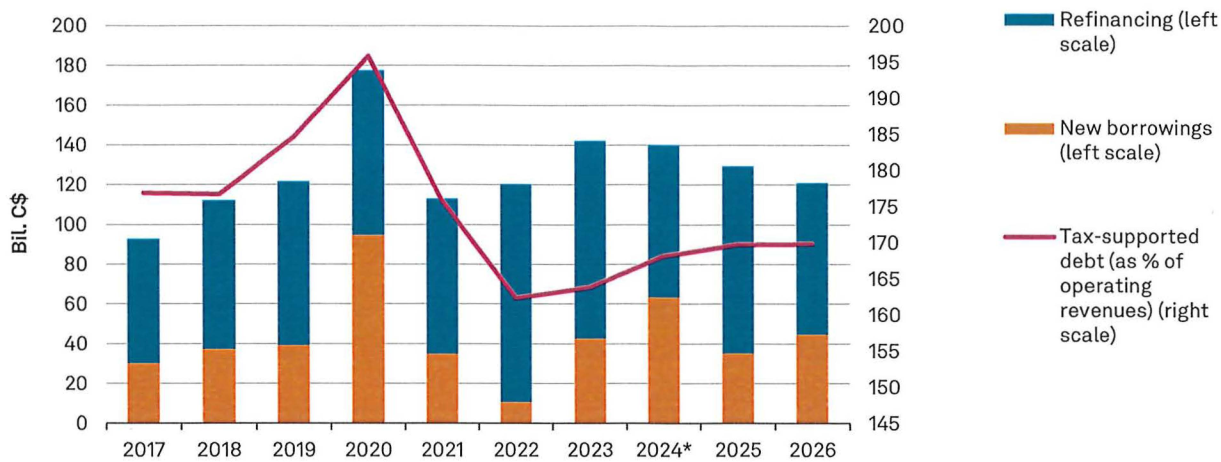


*2024=fiscal 2025. Source: S&P Global Ratings.

We expect total net new borrowings of about C$60.5 billion in fiscal 2025 compared with C$43 billion in fiscal 2024. In the next two fiscal years, we project that total provincial and municipal debt will rise by about 4% annually, to reach C$1.3 trillion by the end of fiscal 2027. Revenues will continue to increase moderately at a slightly slower rate in fiscal 2026 (3%) before settling at the same pace of growth in tax-supported debt in fiscal 2027. As a result, we project that relative to operating revenues, tax-supported debt will remain stable in the next two years (chart 3).

Chart 3

Canadian LRGs borrowing & debt relative to revenue, 2017-2026



*2024=fiscal 2025. Source: S&P Global Ratings.

Debt Composition Will Be Unchanged, And Structural Factors Will Underpin Borrowing Needs

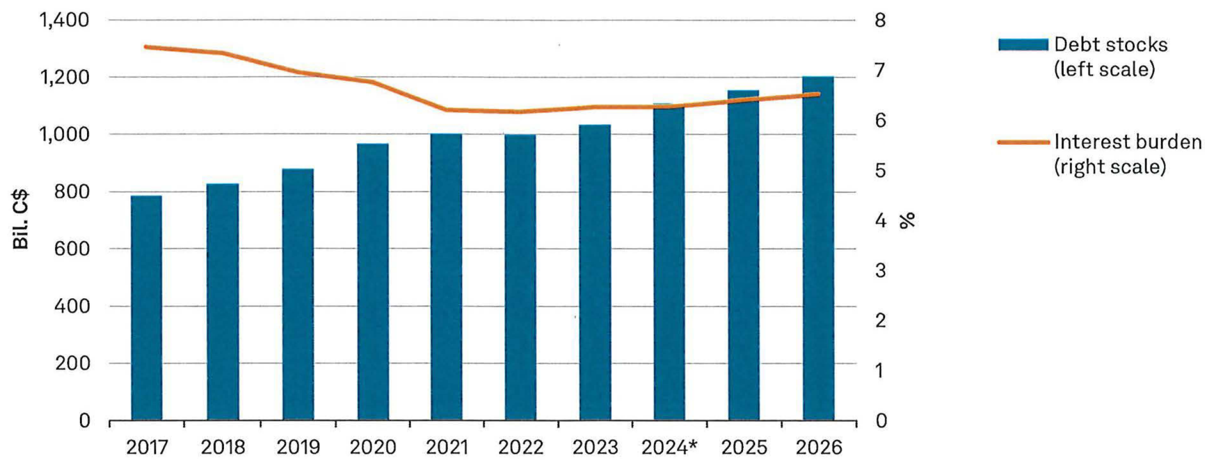
The overwhelming majority of Canadian LRG borrowing is through public bond markets, largely domestic, and mostly at fixed rates. Private-placement financing is typically only a small and infrequent component of total bond market financing and bank lending is minimal. We do not expect any meaningful change in the sources of funding in the next two years. Canadian municipalities borrow almost exclusively in Canadian dollars. Although most provincial borrowing is denominated in Canadian dollars, some provinces do borrow in international markets opportunistically and to bolster their access to external liquidity. In addition, even with debt levels climbing, we expect interest expense will rise only modestly and will remain relatively stable at about 5.5% of operating revenues, given that about 11% of provincial debt, on average, is exposed to variable interest rates, and about 10%-12% of provincial debt stock is refinanced annually.

At more than 90% of total LRG debt, provincial debt dominates. Canadian provinces are not bound to any fiscal framework by the federal government. In addition, provincial service-delivery responsibilities, such as health care and education, are significantly more onerous than those of municipalities and, as a result, total provincial debt is larger and has risen faster than that of the municipalities over time.

Multiple economic and fiscal shocks, such as the 2008 financial crisis and the fall in the price of oil in 2014-2015, have pushed up most provincial debt burdens over the long term. For some provincial governments with electric utilities, historically large investments in new generation capacity have further increased their debt burdens. More recently, since the pandemic, provinces have significantly increased spending on health care delivery and health care-related capital investment, contributing to the rise in debt burdens (chart 4).

Chart 4

Canadian provinces debt outstanding and interest burden, 2017-2026

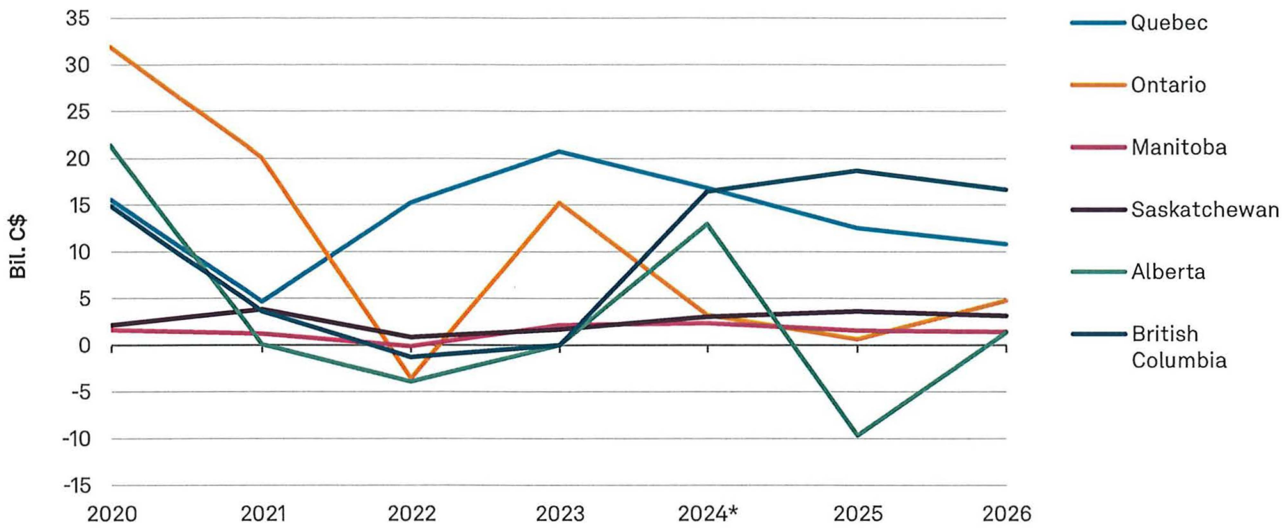


*2024=fiscal 2025. Source: S&P Global Ratings.

On a net basis, we project most provinces will borrow less than they did before the pandemic, with Ontario and Alberta showing the largest drops in new borrowing compared with fiscal 2021 levels. As a result, we expect Ontario's debt burden will remain stable or rise modestly. Considering a sizable amount of debt set to mature in fiscal 2026, in our opinion, Alberta's borrowings will rise in the next two years as the province issues debt to fund a temporary debt-retirement account to help manage refinancing risk in fiscal 2026. The growth in new debt for Quebec and British Columbia (B.C.) is the most pronounced of the provinces, accounting for almost all new borrowings in the next two fiscal years (chart 5).

Chart 5

Individual fiscal policies result in varying borrowing trends



*2024=fiscal 2025. Source: S&P Global Ratings.

Municipalities' Budgets Are On Steadier Ground

Municipal operating results are more insulated from economic shocks. Canadian municipalities continue to perform well and we expect budgetary performance and debt burdens will remain generally stable in the next two years. Capital needs remain a key pressure, both to address infrastructure backlogs as well as to accommodate the needs of an expanding population. To date, municipalities have been managing costs with revenue levers, including targeted infrastructure levies. With municipalities' robust accumulated reserves, we expect they will draw on their own resources to fund capital, particularly state-of-good-repair projects. We could see some new debt for growth-related infrastructure, but we expect debt burdens will remain manageable.

Provinces impose fiscal frameworks on municipalities through their respective municipal acts. Legislation requires that municipalities balance their operations and issue debt only for capital purposes, the bulk of which is allocated to infrastructure. In addition, debt issued by municipalities is typically amortizing. As a result, Canadian municipalities' debt burdens compared against operating revenues are generally materially lower than those of the provinces. Some fast-growing municipalities, however, have substantial capital-intensive local infrastructure responsibilities, such as water, sewer, and transit networks, that could require more debt funding. Only one municipality, Montreal, is among the top 10 most indebted Canadian LRGs.

We assess the institutional framework of Canadian provinces as very predictable and well balanced, which reflects some of these structural challenges while acknowledging the institutional strengths of the system. This is weaker than our view of the framework for municipalities, which we assess as extremely predictable and supportive due to their lower spending needs, higher taxing flexibility, and generally strong and predictable support from higher tiers of government (see "Institutional Framework Assessment: Canadian Provinces," April 2, 2024, and "Institutional Framework Assessment: Canadian Municipalities," April 2, 2024).

Despite the provinces' relatively high debt burdens, in our view, provincial ratings are supported by a solid institutional framework, healthy regional economies, solid financial management, and strong access to external liquidity. We expect that, compared with previous levels, while borrowing requirements of the provinces will increase in the next two years, the debt burden will remain relatively flat as the economy remains resilient and real GDP growth improves, budgetary performance strengthens, and financial management remains focused on fiscal sustainability. In the medium term, we will continue to monitor the evolution of capital investment programs at provincial electric utilities, as recent announcements would suggest higher borrowing requirements that will need to be either debt-financed provincially and on-lent to the utility or guaranteed by provinces. In the next two years, we expect the borrowing needs of three of the largest provinces, B.C., Ontario, and Quebec, will continue to dominate Canadian LRG borrowing.

Related Research

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- Subnational Government Outlook 2025: Anticipating A Year Of Change, Jan. 16, 2025
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