Canadian Municipalities Exercise Available Flexibility To Preserve Budgetary Strength Amid Rising Costs

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Key Takeaways

- Canadian municipal governments are accommodating rising costs by employing revenue levers, primarily property taxes, and adjusting capital plans.
- The institutional framework in Canada remains stable and supportive, despite reforms that could affect municipalities' ability to match revenues with expenditures.
- Proactive management responses and long-term planning that support fiscal sustainability are key to maintaining creditworthiness.

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Although escalating costs will continue to squeeze Canadian municipalities' budgets, we expect financial results will remain largely stable and consistent with our current base-case forecasts. The strength of the institutional framework and management response to higher operating and capital costs are key to maintaining credit stability.

We expect municipal governments will maintain above-inflation property tax increases into 2024 and use flexibility in their capital plans to manage higher costs. Despite the tax increases, in a weakening economy, tax affordability will remain top of mind for municipal governments and could constrain taxing flexibility. Although expanding tax bases, spurred by recent record population growth, support revenue increases, they also create more pressure to build housing stock and related infrastructure. Notably, the impact of recent legislative changes in the Province of Ontario around development charges (DCs) and regional government reviews is, in our view, manageable in the near term but remains an evolving story.

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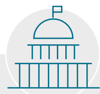
Canadian municipalities: What we're watching

Increasing costs

High inflation has been pressuring operating and capital costs and will require a management response to maintain balanced budgets.

Population growth

Higher projected population will bolster the assessment base and boost tax revenue, but will also increase demand for public services and municipal infrastructure to support housing growth.



Legislative reforms

Although material legislative changes are relatively rare and typically have good visibility, they could meaningfully affect governments' ability to match revenues with expenditures and fiscal flexibility in the long term.

Event risk

Cyber breaches, management turnover, and weather events can constrain budgetary flexibility.

At 14, Canada has the largest number of municipalities rated 'AAA' by S&P Global Ratings outside of the U.S. (see chart 1). Canadian municipal ratings have been stable in the past 12 months, concentrated in the 'AA' category. Of the 34 Canadian municipalities we rate, 26 are in Ontario. The outlooks on two municipalities are positive; the outlooks on the remainder are stable. Despite increased stress on municipal budgets, we expect Canadian municipalities will maintain healthy liquidity positions compared with those of global peers, with reserves built up over time for dedicated use. In our view, an extremely predictable and supportive institutional framework will also bolster creditworthiness. In addition, while we expect debt will increase in the next two years, it will remain relatively low compared with that of global peers, which we consider a credit strength.

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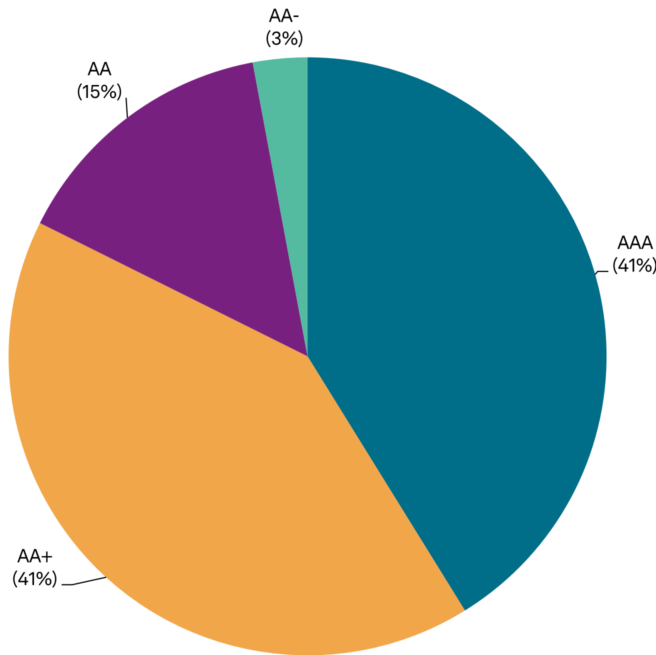
Chart 1

Canadian municipal ratings distribution



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Municipalities Are Navigating Faster Growth In Spending Due To Higher-For-Longer Inflation

Inflation has remained elevated for longer than we assumed since the Bank of Canada initiated monetary tightening in March 2022; however, budgetary results of the rated Canadian municipal governments are generally stable (see chart 2). Higher approved tax increases and the flexibility to manage increasing costs will mitigate some of the adverse impact on budgetary performance. According to our latest economic outlook for Canada, we expect core inflation will average 3.9% this year and 2.6% in 2024, as price pressures subside because of dwindling demand (see "Economic Outlook Canada Q1 2024: Growth Is Set To Continue Slowing," published Nov. 27, 2023, on RatingsDirect).

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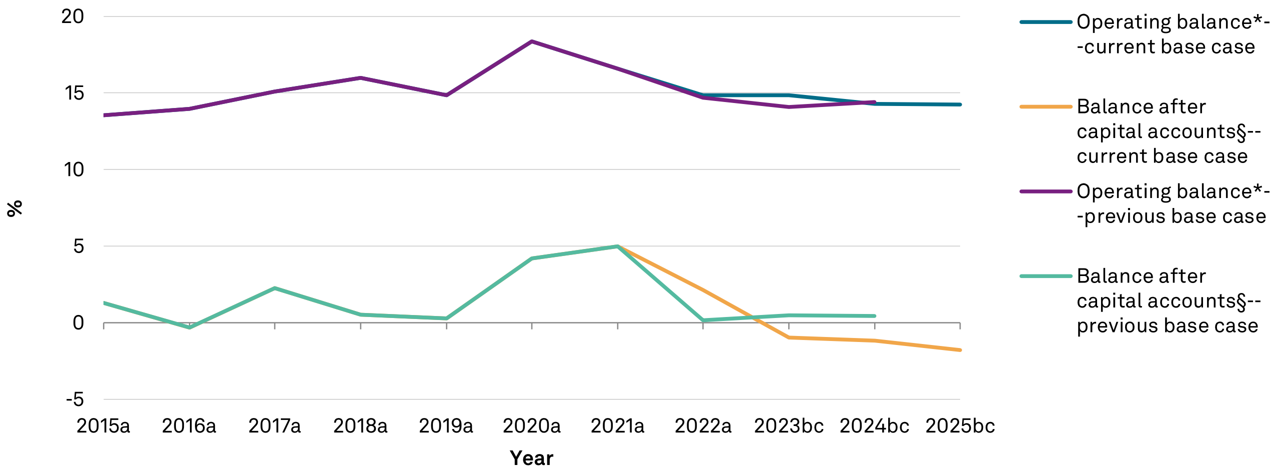
Chart 2

Budgetary performance expectations, 2023 versus 2022



*Percentage of adjusted operating revenue. §Percentage of total revenue. a--Actual. bc--Base case. Using actuals whenever available. Data for all rated Canadian municipalities. Data might differ compared with previously published reports.

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Our forward-looking view of Canadian municipalities' budgetary performance incorporates the impact of increased wage settlements compared with our previous expectations, as well as higher fuel costs for transit operations. This is resulting in a faster pace of growth in operating spending, in large part stemming from higher wages because personnel costs typically represent more than 50% of municipal operating spending. In addition, in urban centers where relatively larger transit systems lack significant flexibility to cut services, the new reality of hybrid work is negatively affecting transit revenues compared with related operating spending. Municipalities, in turn, are left to manage the shortfall.

With respect to capital spending, our expectations are two-fold. Municipal governments are facing higher-than-expected construction costs as well as a general increase in infrastructure needs, for both maintenance and growth. According to Statistics Canada, using the data of 11 census metropolitan areas in Canada, the price index for non-residential construction increased by 30% since the start of 2020. In Ontario, the increase was 40%. The annual increases in previous years averaged 3%-4%. For residential construction, the index increased by 57% during this time (see chart 3).

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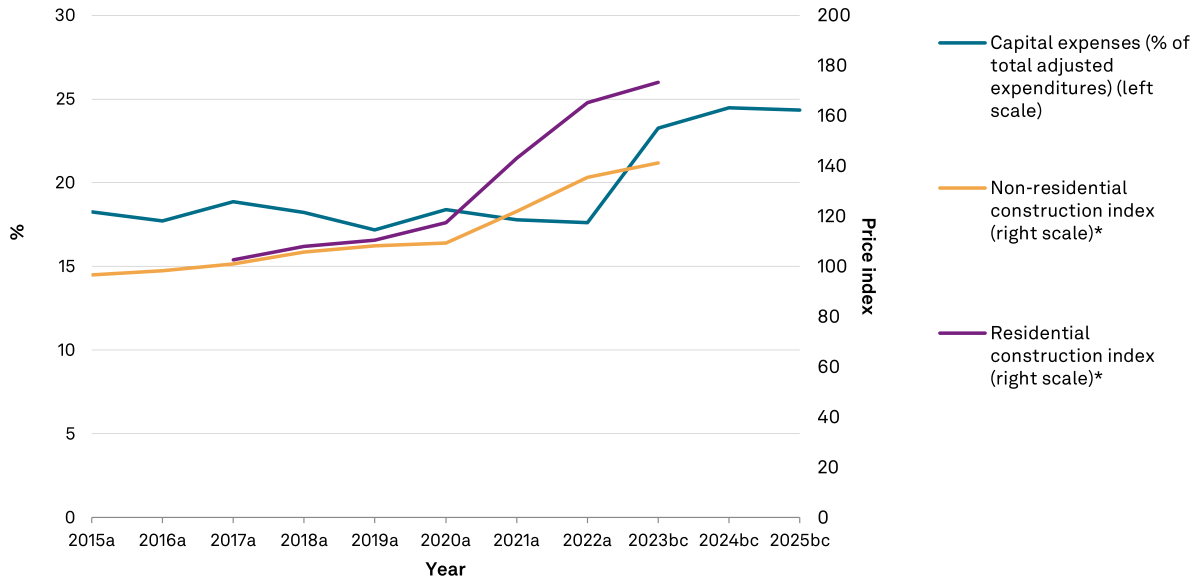
Chart 3

Capital spending expectations relative to price index



*2023 as of third quarter. a--Actual. bc--Base case. Using actuals whenever available. Data for all rated Canadian municipalities. Data might differ compared with previously published reports.

Sources--Statistics Canada, S&P Global Ratings.

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National immigration targets and the projected higher population growth across Canada will contribute to cost pressures as well. We assume that the municipalities' most likely response in the next two years will be to manage largely within the existing funding envelope and use available flexibility to adjust and defer projects, where possible. We also expect municipalities will take advantage of funding from senior levels of government. Both the provincial and federal governments have funding programs available to municipalities, focused on community and public transit infrastructure, supporting clean-growth economies, and climate-disaster mitigation. There is also funding targeted at increasing the housing supply, such as the agreement-based federal C$4 billion Housing Accelerator Fund; and the Province of Ontario's C$1.2 billion Building Faster Fund, an incentive program targeted at municipalities based on progress against housing start goals.

Management Actions Are Offsetting Cost Pressures

Despite the higher costs municipalities face, our current base-case operating balances remain largely unchanged and balances after capital accounts are only modestly weaker compared with our 2022 base-case forecasts. The strength of the institutional framework for Canadian municipalities, particularly with respect to revenue and expenditure management, supports these results. Although there are some limitations to adjusting operating costs, especially given the mandated nature of service provision, many municipal governments have responded to budgetary

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stress by increasing 2023 taxes above inflation growth, where typically, we observe annual tax increases at or below inflation levels. We expect elevated tax increases will continue in 2024 to support municipal needs. However, we do not expect increases of this magnitude will persist long term, given both affordability and tax competitiveness considerations. Nevertheless, we expect that population growth will bolster assessment-base strength and property tax revenues, which typically make up more than 50% of adjusted operating revenues.

Recurring capital deferral is a short-term solution, in our view, and without long-term planning and funding accommodations, it could ultimately lead to an unsustainable state of infrastructure and higher repair costs in the future. As a result, we expect the use of targeted infrastructure levies will remain as an important revenue lever for municipalities. In addition, we could see increasing reliance on debt in the medium term, beyond what we already incorporate into our projections. Despite the increase, we believe that Canadian municipalities will maintain relatively low debt burdens compared with those of international peers and debt levels will remain well within the provincially determined limits.

Effects Stemming From Legislative Changes In Ontario Can Be Absorbed In The Short Term

Recent legislative changes in Ontario could challenge municipalities' ability to match revenues with expenditures. However, we believe that municipal governments' generally prudent practices will persist and support fiscal sustainability in the future. The two most important acts from a creditworthiness perspective, are the More Homes Built Faster Act (Bill 23), passed in November 2022; and the Better Municipal Governance Act (Bill 39), passed in December 2022. Details of some components of both acts have yet to be finalized.

A prudent fiscal policy framework, track record of extraordinary support, and infrequent reforms support our extremely predictable and supportive institutional framework assessment for all Canadian municipalities. Enactment of these bills falls within our current expectations of predictability in the system. Our view remains that significant reforms are rare and, although municipalities do not have the power to veto unfavorable provincial decisions, we believe they have time to prepare for changes. As these reforms pertain to adequacy of revenues to cover expenditures, municipalities maintain sufficient autonomy to manage their budgets and must abide by comprehensive and prescriptive fiscal policy frameworks, including a balanced budget requirement, restrictions around debt use, and investment guidelines. More important, we expect the provincial and federal governments will continue to support the local governments.

From a financial perspective, we believe the impact of Bill 23, which affects the ability of municipalities to collect DCs to fund future growth, will be manageable in the short term. We believe that the time frame for municipalities to adjust future budgets and find alternative sources of funding to offset potential lost DC revenue is sufficient. Despite much uncertainty remaining about the impact of the legislation on a municipality's revenue-raising capacity and Ontario's role in supporting its municipalities because of these legislative changes, managements' swift response to manage potential significant deterioration in reserves or increase in debt-financing is an important consideration. To that end, the province is undertaking an audit of certain cities' DC reserves to better understand the impact.

Bill 39 expands mayoral powers and aims to reduce municipal responsibility duplication to realize joint provincial-municipal priorities with a focus on the construction of new homes. This includes a review of six regional governments by a legislative committee, with public hearings set to begin in January 2024. With respect to the impact of actions in response to the legislation on issuer ratings, it is uncertain and could vary in magnitude based on outcomes on governance,

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decision-making, and service delivery functions. We don't expect the outcome of each individual review to bear the same result and, for some, the creditworthiness outcome could be neutral. However, the potential impact on both revenue and spending could, in our view, influence a municipality's budgetary flexibility and add to its debt burden.

Prudent and capable management with a focus on long-term fiscal sustainability to address expanded service responsibilities is key in transitionary periods. Canadian municipalities generally benefit from a very strong financial management assessment, in our view. For these reasons, we affirmed our 'AAA' ratings with stable outlooks on the City of Mississauga and the City of Brampton in our most recent reviews. These two municipalities are part of the Regional Municipality of Peel, which is being dissolved. The dissolution is scheduled to be complete by January 2025, but remains an evolving story. We will incorporate new developments into our analysis and ratings of the affected municipalities as these become available.

Credit Profiles Will Accommodate A Challenging Operating Environment In The Next Two Years

There are several moving parts in the municipal government space that lead to both revenue and expense considerations. We expect management teams will have sufficient ability to manage these pressures within the current governance framework and maintain financial results consistent with our current expectations. However, proactive management response and long-term planning that support fiscal sustainability while addressing the needs of citizens are factors we will continue to monitor. The federal government's immigration targets, while favorable to revenue growth, will accelerate communities' service and infrastructure needs. Available liquid resources, accumulated over time and dedicated to specific uses, remain a key strength for most rated Canadian municipalities and we expect reliance on these could increase in the medium term. Similarly, although we are incorporating a moderate increase in the debt burden into our current projections, we will monitor any acceleration in the pace of borrowing beyond current expectations.

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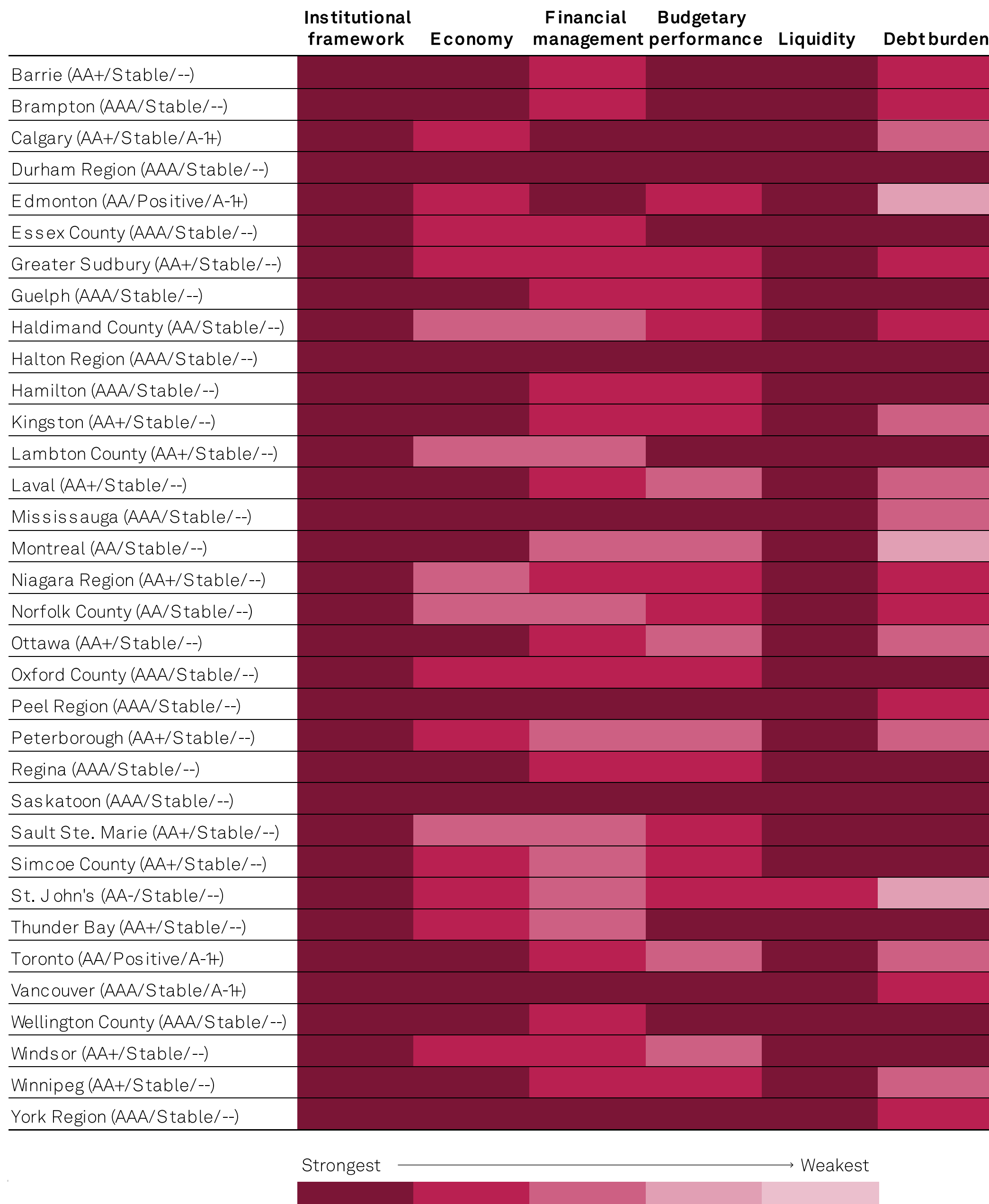
Chart 4

Canadian municipalities ratings and key assessment factors



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Related Research

- Local And Regional Government Risk Indicators: Canadian LRGs' Buoyant Fiscal Performance Will Persist Despite High Inflation And Near-Term Headwinds, Sept. 20, 2023

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