

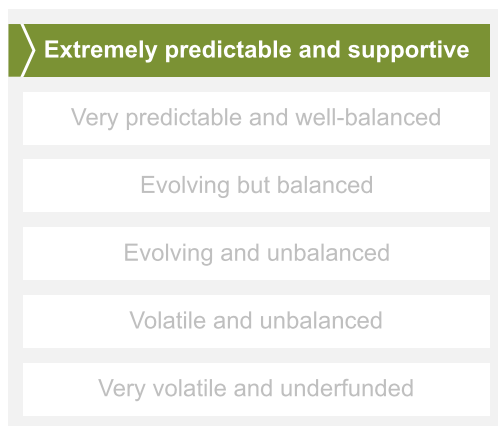
Institutional Framework Assessment:

Canadian Municipalities

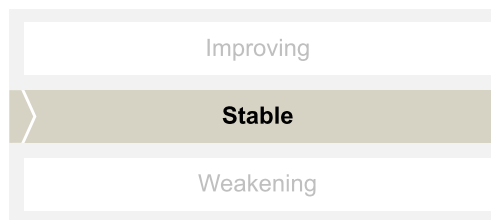
June 1, 2022

This report does not constitute a rating action.

Institutional Framework Assessment:



Trend:



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Major Factors

Strengths	Weaknesses
<ul style="list-style-type: none"> - Prudent fiscal policy framework - Track record of extraordinary support - Infrequent reforms 	<ul style="list-style-type: none"> - Limited ability to withstand changes

Recent Developments

With support from senior levels of government during the pandemic, Canadian municipalities maintained stable and strong financial results

Institutional Framework Assessment: Canadian Municipalities

Developments since S&P Global Ratings' last review of the institutional framework for Canadian municipalities have been positive overall, most notably those associated with the COVID-19 pandemic. Canadian municipalities' finances fared much better than we initially expected in 2020 and into 2021 as the pandemic unfolded. Between timely and prudent management and extraordinary financial support from upper levels of government, municipal sector operating balances increased in 2020, on average, compared with pre-pandemic levels. In addition, although 2021 fiscal results are not yet available, we expect they will be largely in line with 2020 due to continued federal and provincial government support.

Generally, the federal government does not provide operating funding for municipalities. However, a multiphase federal-provincial government grant announced in 2020 to help restart regional economies largely erased any outstanding municipal budget shortfalls. In addition, the federal government allocated the vast majority of its support directly to individuals and businesses in the form of income support for individuals and wage subsidies for business. This level of support in response to an extraordinary event, while not a formal policy response, also reinforces our view of the strength in the Canadian institutional framework.

We do not expect major municipal reforms will be implemented in the medium term. Key municipal responsibilities have not eased and municipal fiscal policy frameworks have not changed as a result of the pandemic. Despite expected modest weakening in financial results as support wanes in the next two years, especially for municipalities with transit systems that will face a slower recovery in ridership revenues, we don't believe weaker results will significantly affect creditworthiness. In addition, historically healthy liquidity and relatively low debt burdens remain key credit strengths for Canadian municipalities in general.

Predictability: Significant Reforms Are Rare

Frequency and extent of reforms

The Canadian municipal institutional framework is very predictable, in our opinion. Under the Canadian Constitution, the provinces are responsible for municipal governance and oversight. Most provinces have a principal statute that establishes the revenue-raising powers and service and expenditure responsibilities of all municipalities within their jurisdiction. However, some provinces use a group of statutes, each covering different aspects of municipal governance and oversight. These statutes establish the role of the mayor and council, municipal organization, municipal powers, financial administration, debt and investment policies, and taxation and collection, among other responsibilities. Some of Canada's largest municipalities, like Vancouver, Toronto, Edmonton, and Calgary, have separate city charters via provincial statutes. These charters recognize the different requirements that larger cities have and provide them with tools to adapt municipal laws to better fit their needs.

In our opinion, the provinces' municipal acts are largely similar, especially the provisions that govern municipal financial administration and debt and investment practices. Most provinces have made minor amendments to their municipal systems in the past 30 years, and significant modifications are rare. The levels of fiscal sustainability in provincial frameworks are also similar: Municipalities across the country have largely the same degree of tax- and fee-setting autonomy and have very similar service responsibilities. The greatest variance between provincial frameworks might lie in ongoing system support because of differences in the levels of funding. Nevertheless, the 10 provincial institutional frameworks are generally far more alike than they are different.

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In our opinion, the predictability of the various municipal frameworks is still strong because significant reforms by provinces are rare, they are usually preceded by a period of extensive consultation with stakeholders, and interim changes are generally minor. For example, Prince Edward Island's Municipal Act came into effect in December 2017 and replaces a patchwork of legislation introduced in the 1980s. Notably, work to update these laws began in 2004.

Collectively, we consider the frameworks mature and stable, despite the rare instances of major reforms. Nevertheless, provincial-municipal relationships have proved to be more dynamic than federal-provincial relationships, owing largely to the municipal governments being established through provincial statute and not through the constitution.

A number of provinces have implemented major changes to their systems. Ontario undertook a major reform of its municipal taxation and transfer of responsibilities in 1998 and a review of its Municipal Act in 2008, resulting in only marginal changes after public consultation. Quebec unilaterally amalgamated municipalities in the largest urban centers and many smaller centers in 2002, abolishing more than 200 former municipalities. Major reforms with significant impacts on municipalities have involved involuntary amalgamation, property assessment, property taxation, provincial transfers, environmental standards, and uploading or downloading of responsibilities.

There are no provincial-municipal transfer programs under the constitution. Provinces have established some municipal grant programs in their own statutes, giving these programs' higher status than mere policy. In 2011, Saskatchewan dedicated one-fifth of its provincial sales tax (PST) revenues annually in grants to the municipal sector. However, a provincial legislature can readily amend or repeal its statutes. For example, in 2018, as a result of increasing fiscal pressures related to revenue exposure to commodity prices, Saskatchewan amended its municipal grant structure to 1% of PST. Although the change was meant to be temporary, the government has yet to create a new formula. Accordingly, we believe that provincial statutes are not as enduring as the constitution, which we view as highly stable and having a special status above that of provincial statutes.

Ability of municipalities to influence or oppose reform

As is the case in some other jurisdictions, Canadian municipalities are not directly represented in their respective provincial legislatures and do not have the power to veto unfavorable provincial decisions. They must rely instead on the force of public opinion to oppose unwanted changes.

Revenue And Expenditure Balance: Strong And Stable Budgetary Results Despite Some Constraints

Overall adequacy of revenues to cover expenditures needs

Canadian municipalities have sufficient revenue and expenditure autonomy to manage their budgets, in our view. Although system data are available, we have chosen to present the relevant metrics for the entities that we rate to incorporate adjustments to reported fiscal results. These entities represent approximately two-thirds of Canada's population and economic base and are a good proxy for the nation, in our view (see chart 1). The main municipal revenue sources are property taxes, water and sewer fees, investment income, provincial and federal transfers, licenses and permits, and (for some) net income (dividends) from government business entities (see chart 2). The chief expenditures are for protective services (policing, firefighting, and emergency medical response); environmental services (water, sewer, and solid waste);

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transportation services (roads and transit); social services; libraries; and parks and recreation. Personnel costs make up the largest component of operating spending (see chart 3). Municipal councils can set tax rates and water and sewer fees and authorize expenditures.

Provinces have the power to constrain their municipalities, which are the creatures of the provinces under the constitution and, accordingly, are subject to their oversight.

Provinces have sought to influence municipal property taxation levels before. For example, Ontario's property tax reform in 1998 established ranges of fairness that limit the ability of some municipalities to raise the tax rates of certain property classes relative to the base residential tax rate. As well, Alberta, Manitoba, and Saskatchewan have reduced their provincial education property tax, easing landowners' property tax burden. Nevertheless, these powers have not diminished the municipalities' financial performance or their long-term credit quality. More recently, some municipalities have incorporated capital levies into their budgeting process for property tax increases or increased utility rates as a funding source for capital to further mitigate debt issuance. Tax competitiveness and political factors, however, have been the most effective long-term constraints on municipalities' ability to increase their revenues beyond gains resulting from economic growth. We expect taxpayer affordability will be at the forefront of budget discussions in the next two years as local economies recover from the effects of the pandemic. Those municipalities with more established transit systems would be affected to a greater extent, since the recovery in ridership could lag for a few years as more people continue to work from home compared with pre-pandemic levels. However, transit is a key priority for all levels of government, and we expect provinces will continue to support affected municipalities.

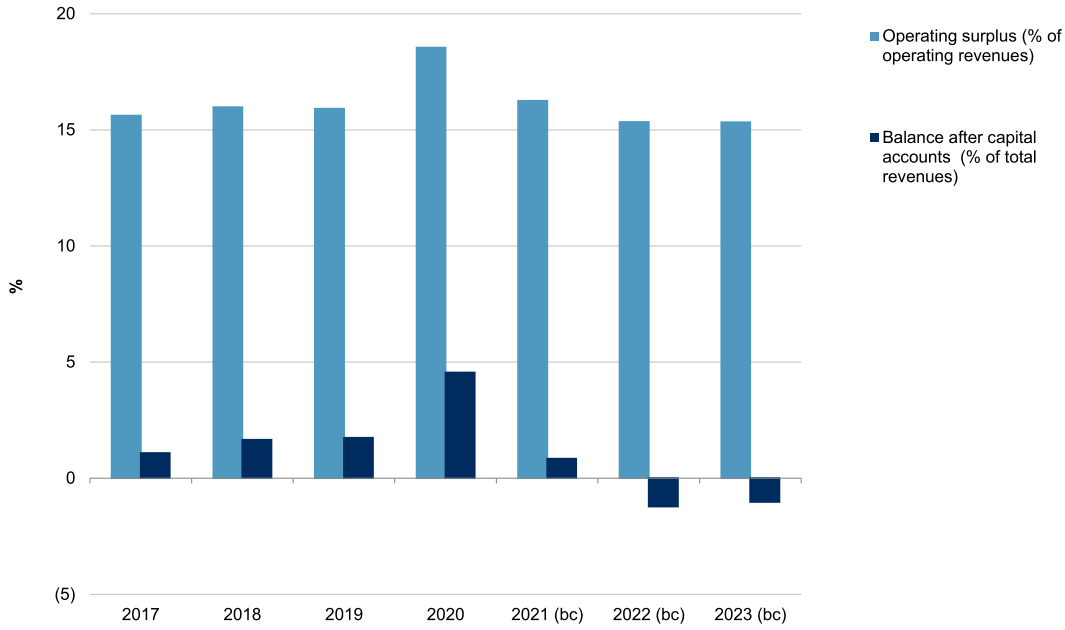
Ongoing fiscal support to municipalities from the provinces is generally strong, in our view, but varies between and within provincial jurisdictions. In addition, the federal government provides grants to the municipalities, such as sharing a portion of gasoline taxes, or sharing the cost of approved infrastructure projects equally between itself and respective provinces and municipalities. Ongoing fiscal support takes the form of conditional and unconditional grants. Conditional grants usually support a provincially mandated program or policy objective. Unconditional grants, which are not intended for any specific purpose, can act as a form of equalization in some jurisdictions. For most municipalities, conditional grants are normally larger than unconditional grants.

Provinces set and revise municipal service delivery standards in a number of areas, which constrains municipal spending autonomy. Examples of some of the most common municipal service standards include potable water and wastewater quality, protection levels (such as the number of police officers or firefighters per 1,000 inhabitants), building standards, and solid waste disposal. In addition, labor costs (salaries and benefits) represent the largest share of municipal operating expenditures. Multiyear collective agreements govern these costs, which tends to limit spending flexibility in the next one-three years. However, expenditure management was one of the avenues Canadian municipalities used to mitigate the revenue impact of the pandemic. These include temporary staff and service-level reductions, where feasible, and operating efficiencies.

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Chart 1

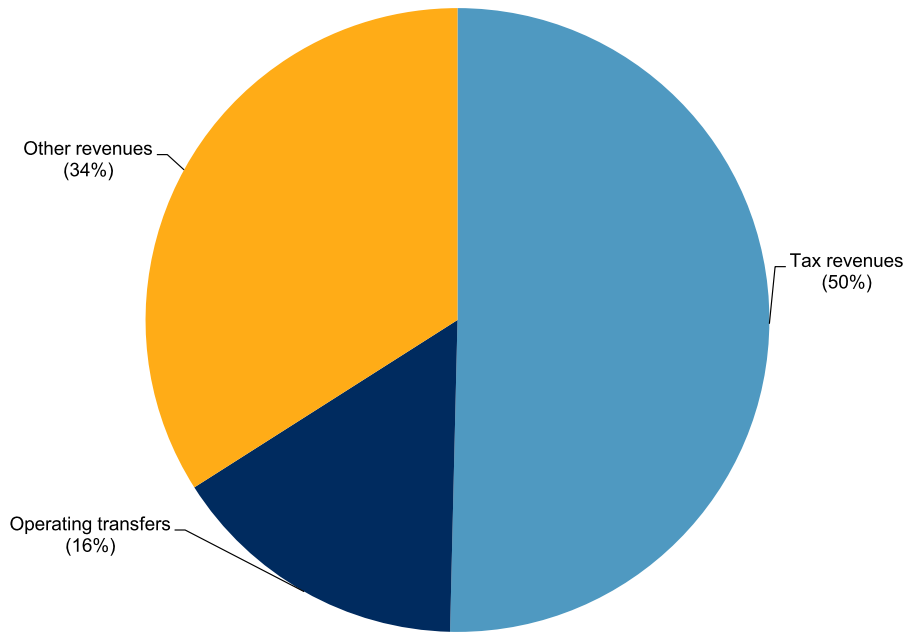
Canadian Municipalities Budgetary Performance



(5)
Source: S&P Global Ratings. bc--Base case.
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Chart 2

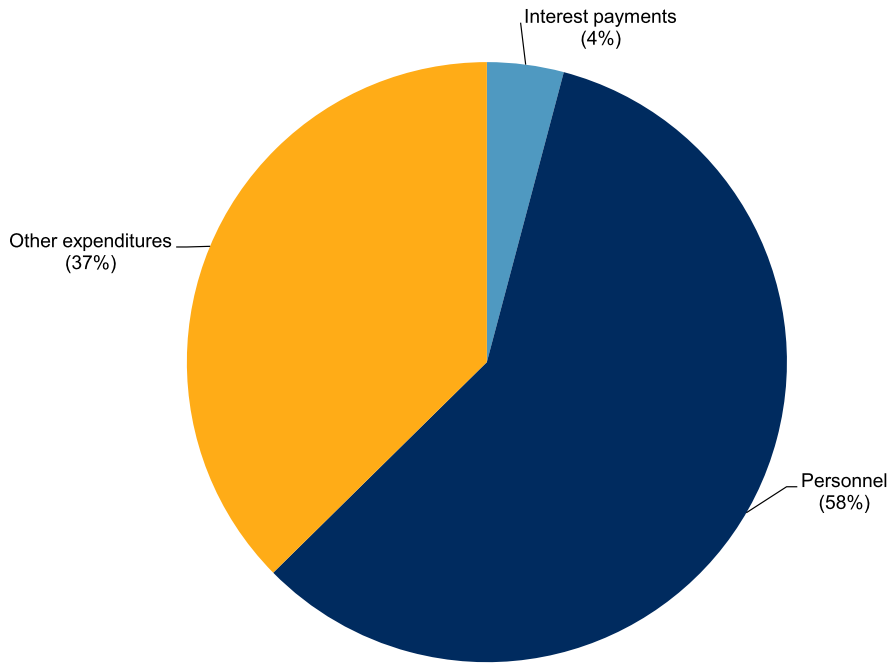
Canadian Municipalities Operating Revenue Breakdown (2020)



Source: S&P Global Ratings.
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Chart 3

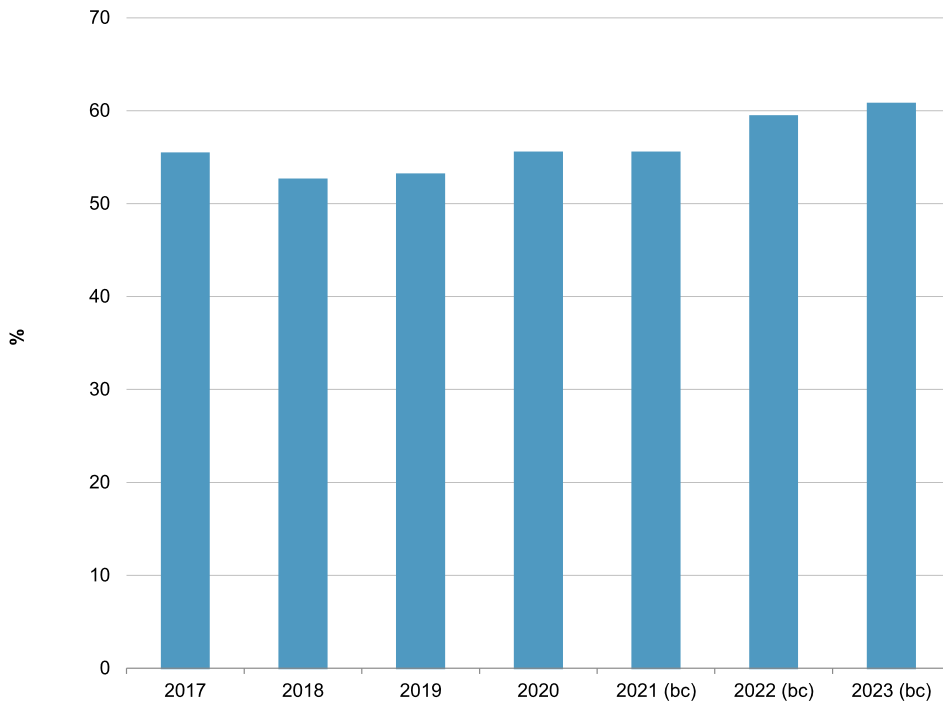
Canadian Municipalities Operating Expenditure Breakdown (2020)



Source: S&P Global Ratings.
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Chart 4

Canadian Municipalities Total Debt As % Of Operating Revenue



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Fiscal Policy Framework

Canadian provinces impose extensive fiscal policy frameworks on their municipalities (see chart 4). All 10 provinces require that their municipalities prepare balanced budgets and independently audited financial statements. The provinces place restrictions on the use of derivatives (for genuine hedging purposes only, such as interest- or exchange-rate risks) and on the type of investments municipalities can make. Debt limits are established by statute or through regulation, and all municipalities must issue amortizing debt or establish sinking funds. All frameworks provide supervisory powers over municipalities to the provincial ministry or department responsible for municipalities.

Extraordinary Support

There are no formalized procedures for municipal bailouts. Nevertheless, there is a history of workouts of distressed municipalities by provincial governments. Provincial governments have the capability to provide extraordinary support through their grant-making powers and significant financial resources. There is a long history of extraordinary support from the provinces to their municipalities for natural disasters. More recently, during the pandemic, municipalities received

extraordinary support from the multiphase C\$19 billion federal-provincial Safe Restart Agreement funding, which included both operating and transit-related streams. This funding generally offset budget shortfalls municipalities experienced in 2020 and 2021 and, in many cases, led to improved budgetary outcomes compared with pre-pandemic results. The federal government has also provided a historic level of support throughout the pandemic (almost C\$200 billion in 2020 and 2021) directly to individuals and businesses. As a result, the collection of property taxes, a municipality's largest revenue source, generally remained stable, while grants mitigated the impact of a decline in user fees for transit, parking, and recreation. Another example of extraordinary support occurred in 2000 when the town of Tumbler Ridge, B.C. had difficulties following the closure of a coal mine that was a major employer and taxpayer. The province assumed the municipality's debt and dedicated funding for services. In addition, during the 2008-2009 recession, the provinces, in conjunction with the federal government, boosted their infrastructure grants to provide fiscal stimulus.

Transparency And Accountability

Transparency and institutionalization of budgetary process

There is no national standard for budgets, and the comprehensiveness, level of detail, and span (current year only versus multiyear) vary substantially, usually depending on the municipality's size and sophistication. Budgeting practices are very prudent, in our opinion, and are another reason for the strong credit quality of Canadian municipalities. Of note, municipal budgeting processes are evolving and improving as many municipalities have begun or are planning to undertake multiyear operating budgets and 10-year capital budgets. In addition, monitoring systems identify negative expenditure variances efficiently and capital budgets are evolving to better reflect annual cash outlays rather than total project procurement costs.

At the municipal level, the separation of roles and responsibilities between administration staff and politicians is what we consider high. As in other jurisdictions, staffs implement the policies set by politicians; their ability to block political decisions is limited.

Disclosure and accounting standards

Reporting standards are generally high, but there can be some exceptions (especially with respect to timeliness) among small and rural municipalities, in our view. Financial information is usually timely, accurate, and comprehensive. There are strong national accounting standards for all governments' financial statements based on Canadian public sector generally accepted accounting principles (full accrual) accounting. All municipalities must have their annual financial statements independently audited.

Municipal disclosure tends to be greater than that of the provinces, owing to the provinces' oversight of the sector. Statutes mandate some disclosure requirements, especially budgets and annual financial statements. Municipal budgets and financial statements are available to the public in a variety of ways. No standards exist for governance, controls, or financial planning, in our experience. Nevertheless, municipal practices, especially in larger cities, are usually quite advanced, in our view.

Control levels and reliability of information

We believe reporting standards are high: Annual financial information is timely, accurate, and comprehensive. The restatement of financial information tends to have only a minor impact on results. Expenditure control systems are timely, allowing municipal managers to implement spending measures within the current year.

Trend: Stable

Throughout the pandemic, effective, albeit temporary, support was provided to municipalities via the federal-provincial Safe Restart Agreement funding, in addition to direct federal support to individuals and businesses, which helped to limit tax arrears and stimulate the economy by bolstering consumption. We do not foresee any changes to the framework in the next two-three years that would cause us to revise our assessment.

Claudia Piron and Adam Paunic contributed research to this article.

Related Criteria

- Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019

Related Research

- Institutional Framework Assessments For Non-U.S. Local And Regional Governments, May 18, 2022

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