

US States & Canadian Provinces: Apples & Oranges

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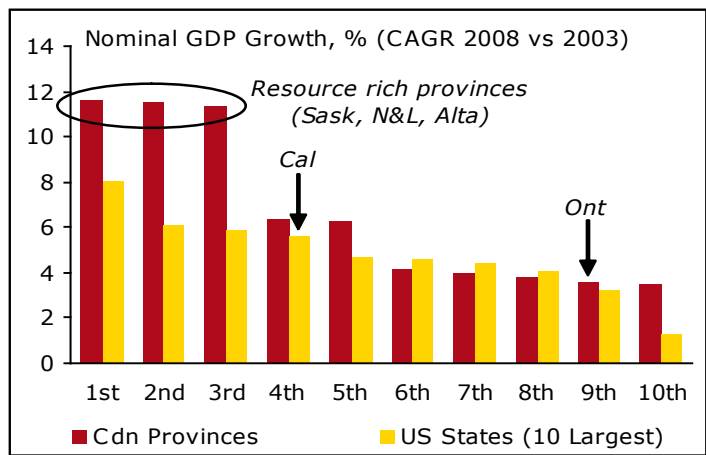
It's tempting to draw comparisons between Canadian provinces and US states—Ontario vs. California is a favoured pairing—but this is akin to comparing apples to oranges. Canadian provinces look debt laden relative to US states, but provincial interest burdens remain manageable, support from the federal government is more meaningful, and access to capital markets is exceptional. And fundamentally, fiscal prospects are brighter in Canada, putting ratings less at risk. Collateral damage from a weaker US is surely a concern, but there is greater flexibility in provincial capitals than in US states, and credit spreads will continue to reflect this reality.

Deviation in Economic Fundamentals

Economic disparities have not been as pronounced in the US as they have been in Canada, where leverage to vast natural resource wealth has meant stronger but more volatile provincial growth (Chart 1).

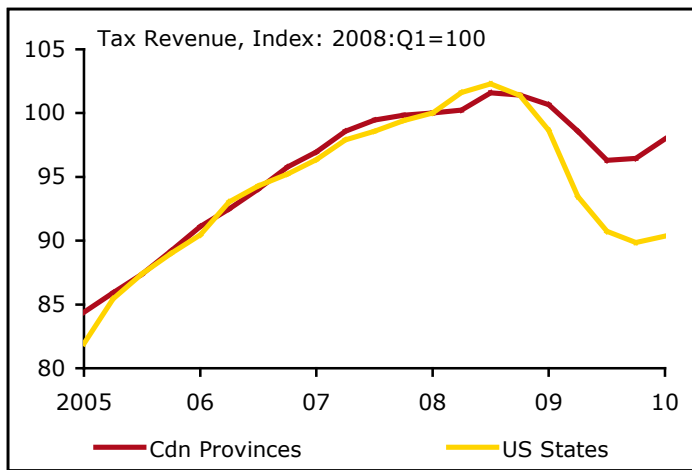
We see a brighter economic outlook north of the border, particularly for nominal GDP, which serves as a proxy for government revenue growth. Outperformance in the labour market remains striking—a big reason why government taxes suffered less damage and are recovering more quickly (Chart 2). While a number of states will be forced to acknowledge a more sober economic reality, a number of provinces, including Ontario, could upgrade their current-year economic outlook in fall updates.

Chart 1
Regional Economies See Varied Growth



Source: CIBC, StatCan, US BEA

Chart 2
Provincial Revenue: Smaller Hit, Quicker Recovery



Source: CIBC, StatCan, US Census Bureau

Budget Requirements Differ Materially

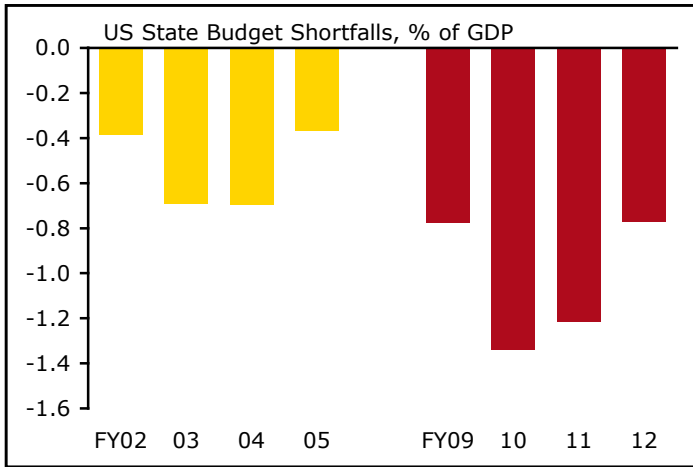
But economic performance goes only so far in explaining fiscal differences between provinces and states. Material differences in fiscal make-up are an important reason why the two are not considered peers by credit rating agencies.

All US states, save Vermont, are prevented from planning for operating deficits, with fiscal handcuffs generally embedded in state constitutions or other legislation. Budget requirements focus on the state general fund, which captures discretionary spending of own-source revenue. Capital spending is not subject to the same stipulations. Shortfalls cannot typically be rolled into future years, requiring budget amendments to remedy gaps that arise. States have a solid track record in this regard.

Balanced budget requirements are generally much less rigorous in Canada. Fiscal restrictions haven't been around as long, really only coming to the fore during the country's bounty of surpluses in the past decade. Legislation proved much less stringent, and was promptly rewritten or repealed during times of fiscal duress. As in the US, there is no ban against borrowing for capital spending.

Chart 3

States Forced to Close Large Budget Shortfalls



Source: CIBC, CBPP

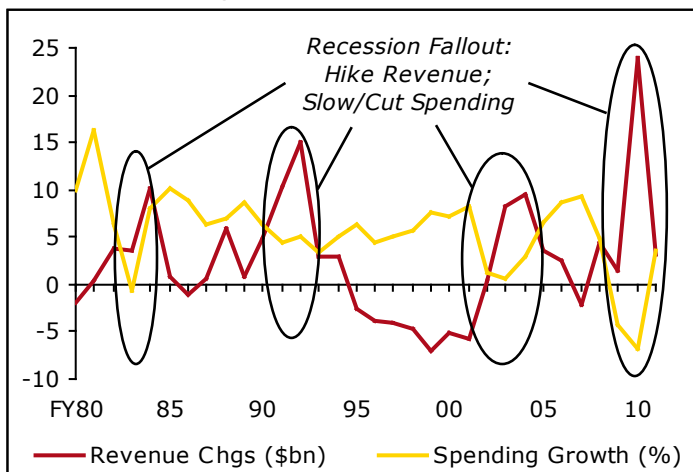
States Close Gaps, Provinces Support Economy

Unencumbered by binding legal restraints, Canadian provinces have used deficits as a fiscal shock absorber. Hamstrung by fiscal requirements, states were forced to close a budget shortfall of nearly \$200 bn in fiscal 2010. That's equivalent to roughly 30% of state spending or 1.3% of GDP—much more severe than in the wake of the early 2000s downturn (Chart 3). A further \$120 billion gap has so far been addressed for fiscal 2011, but could grow further as growth decelerates.

After two years of cutbacks, only modest spending growth is planned for fiscal 2011 (Chart 4). Following \$25 bn of tax and fee increases in fiscal 2010, more modest revenue measures are planned for 2011. But here again, a softer economy could add more intense pressure. Year-end balances have also been depleted, which outside

Chart 4

State Spending Cut, Taxes Hiked



Source: CIBC, NASBO

of Texas and Alaska, now average just 2% of annual expenditures—less than half of the buffer states generally strive to maintain.

While states have succeeded in closing large fiscal shortfalls—with an important assist from federal stimulus money—fiscal actions are exerting a drag on a fragile US economy. The Fed has argued that the overall fiscal impact should prove modest, but fiscal tightening risks growing more pronounced as the broader American economy decelerates.

Aiming to cement recovery, Canadian provinces won't put program spending on a slower track until fiscal 2011/12. Public sector wages will be less severely impacted and job cuts will be largely achieved via attrition as opposed to layoffs. Still, the resulting deficits are generally quite manageable at 0.5% to 1.5% of GDP, but are higher in Ontario and New Brunswick. Budget plans generally foresee a return to balance in three to five years, with Ontario moving slower.

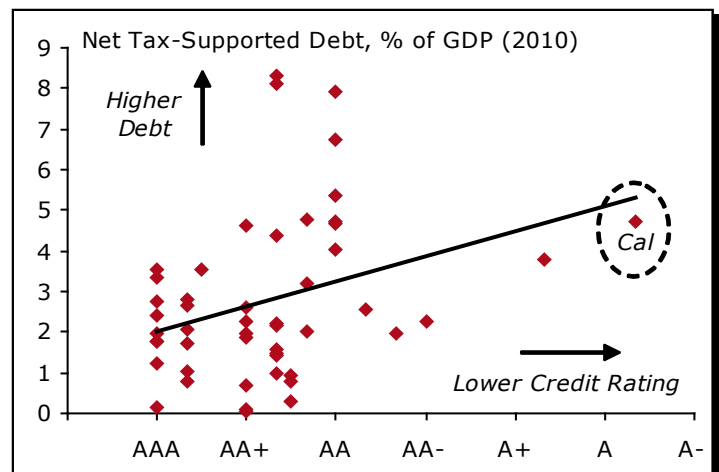
Debt & Rating Agency Comparisons

Decisive fiscal actions by state governments, while a negative for the economy, have prevented more damage to credit ratings. Despite some high profile downgrades, the weighted average credit rating for state general obligation (GO) debt is still solidly AA. Only Illinois and California are rated below AA-, with both seeing 5-year CDS levels of around 300 basis points.

State credit ratings draw support from a diverse and rich tax base and tight fiscal controls. Many states lack easy access to long-term funding, with the issuance of GO

Chart 5

Some Exceptions, But State Ratings High, Debt Level Low



Source: CIBC, S&P, Moody's, Fitch

debt often requiring legislative or full voter approval. As such, state net tax-supported debt currently averages less than 3% of GDP. Even at the high end of the spectrum, debt-to-GDP ratios are south of 10% (Chart 5). These figures do not include unfunded pension liabilities, which are typically larger than the same burdens in Canada.

With fewer budgetary restraints, provincial net debt now stands at some 25% of GDP (Chart 6), up 5%-pts in 2009/10 alone. Still, the long-term credit rating for Canada's provincial sector (a strong AA-) is not much lower than for US states. And in the case of Ontario vs. California, the former's credit rating is stronger despite a debt to GDP ratio that is some 30%-pts higher (Chart 7). This partially speaks to reduced flexibility that California possesses, where fiscal policy changes are more difficult to adopt. More importantly, Ottawa has safeguarded transfers to the provinces, which comprise roughly 25% of provincial revenue. And there's little chance the federal government would allow a provincial default. This implicit

guarantee is embedded in Moody's provincial ratings, which hover in a very narrow band from Aa2 to Aaa.

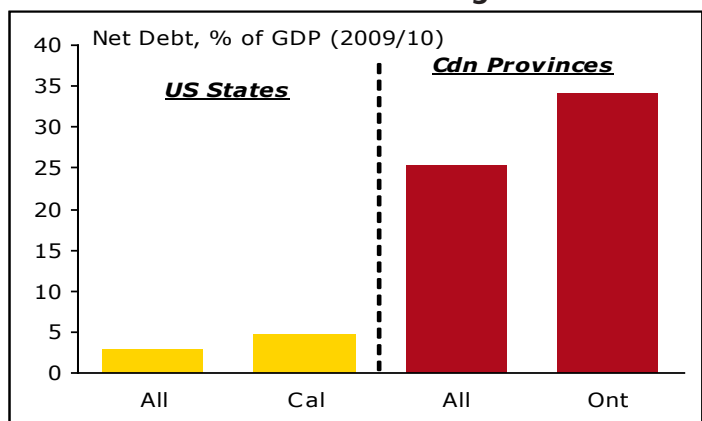
Future Pressures

Looking ahead, economic weakness, structural deficits, unfunded pension liabilities, declining federal support, depleted reserves and limited liquidity weigh on the outlook for US states. Rating agencies also take issue with budget planning assumptions, whereas provinces tend to apply greater prudence to their outlooks. Meanwhile, divisive state politics can wreak havoc on the budget process, delaying budget adoption and leaving state governments in financial limbo. Witness California's reliance on IOUs and unpaid leave for state employees. All provinces are currently governed by majority, allowing for timely adoption of budget measures. And you won't find furloughed workers in Canada, with that tactic not used since Ontario's 'Rae Days' in the 1990s.

Taming provincial health care costs could be tricky, and additional fiscal measures could be needed to balance the books. But past debt reduction efforts created fiscal flexibility for most provinces. In Ontario, the debt service burden looks to remain manageable, even if rates are higher than forecast or growth disappoints (Chart 8).

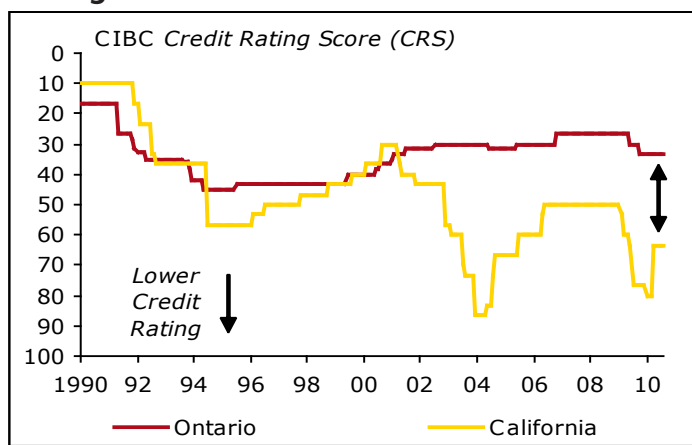
While CDS levels imply very real concern over the ability of some states to manage their liabilities, spreads on provincial debt reflect the relative safety of the asset class. Provinces are taking advantage of international demand to relieve pressure on the domestic market, where investors continue to favour the sector for its liquidity and incremental spread over Canadas in a low yield world. So look past catchy media headlines; a province is not a state, and Ontario is not California.

Chart 6
Provincial Debt Levels Much Higher



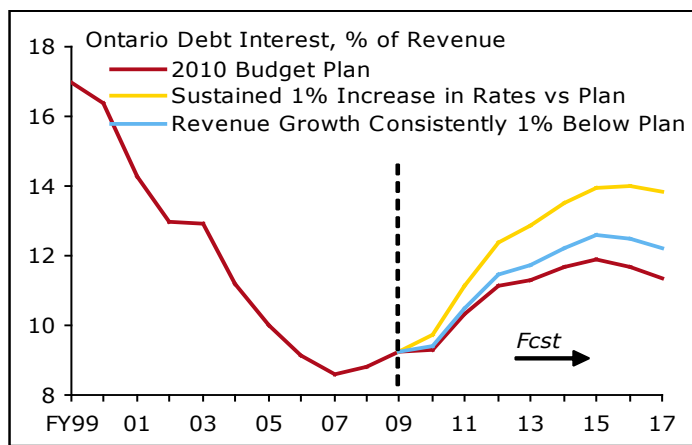
Source: CIBC, Provincial Public Accounts, Moody's

Chart 7
Despite Higher Debt, Ontario's Credit Rating Stronger Than California



Source: CIBC, S&P, Moody's, DBRS, Fitch

Chart 8
Provincial Debt Burdens Remain Affordable



Source: CIBC, Ontario Budget