Local And Regional Governments Outlook - Midyear 2024

Persistent Spending Needs Are Leading To Growth In Debt Burdens

S&P Global Ratings

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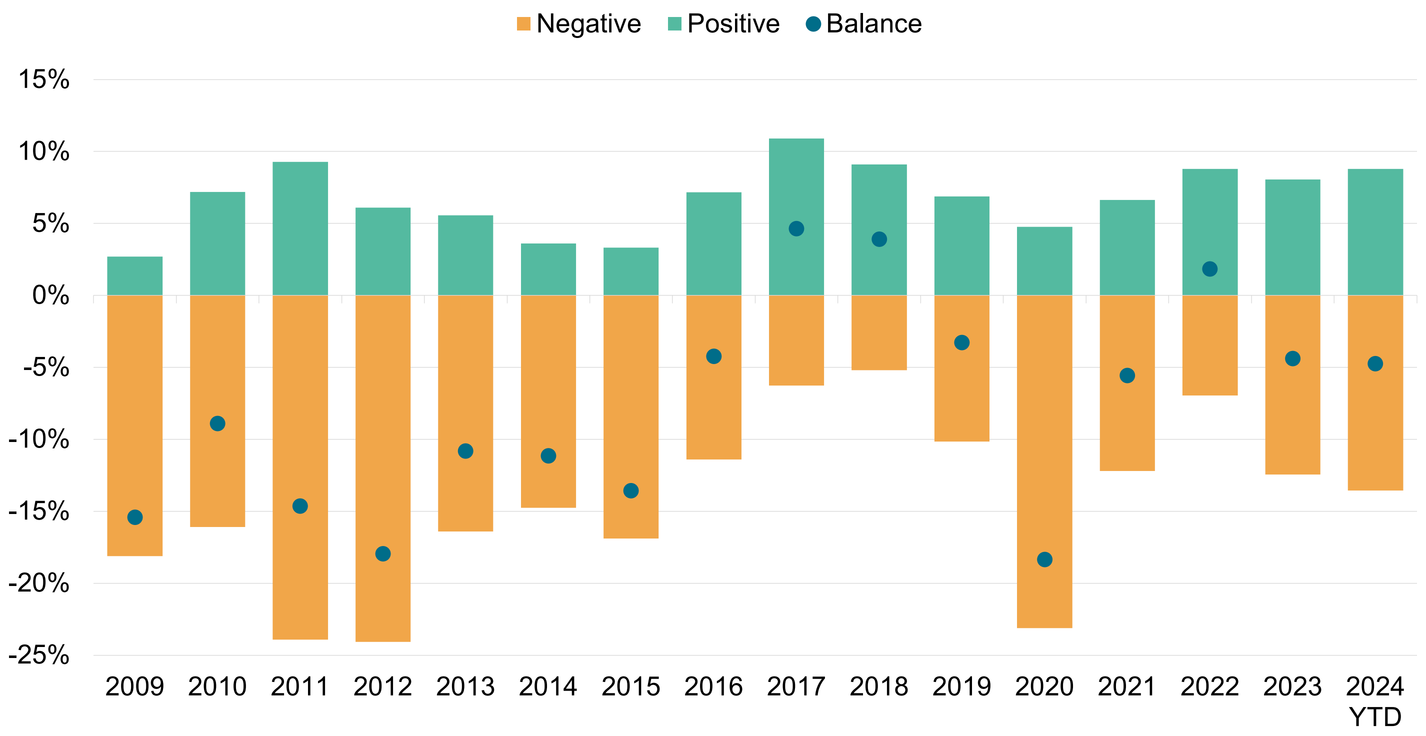
This report does not constitute a rating action

Key Takeaways

- Credit quality for local and regional governments (LRGs) outside the U.S. remains largely stable. A negative rating outlook bias persists and suggests ratings volatility over the next few years.
- Public-sector spending could accelerate, with different implications for budgets:
  - In countries where national restrictions on regional deficits and debt levels are either loose or don’t exist, budgetary performance remains weak, leading to relatively fast debt accumulation--for example in Australia, Belgium, and Canada.
  - In some European countries where regional governments must comply with national restrictions, spending pressure is transferred to lower tiers of government and public-sector enterprises. This deters economic recovery and will prevent material improvement in financial indicators when economic growth resumes.
- We anticipate our rated universe of LRGs will keep accumulating debt, directly and via public enterprises.
- We estimate average tax-supported debt will grow over the next two years and exceed a still moderate 110% of consolidated operating revenues by 2025, compared with 96% in 2019.
- Rising debt levels and higher interest rates will increase interest spending as a share of LRGs’ total revenues-to reach 3% on average in 2025.

Negative Outlook Bias Suggests Ratings Volatility

LRG outlook balance (% of total ratings)

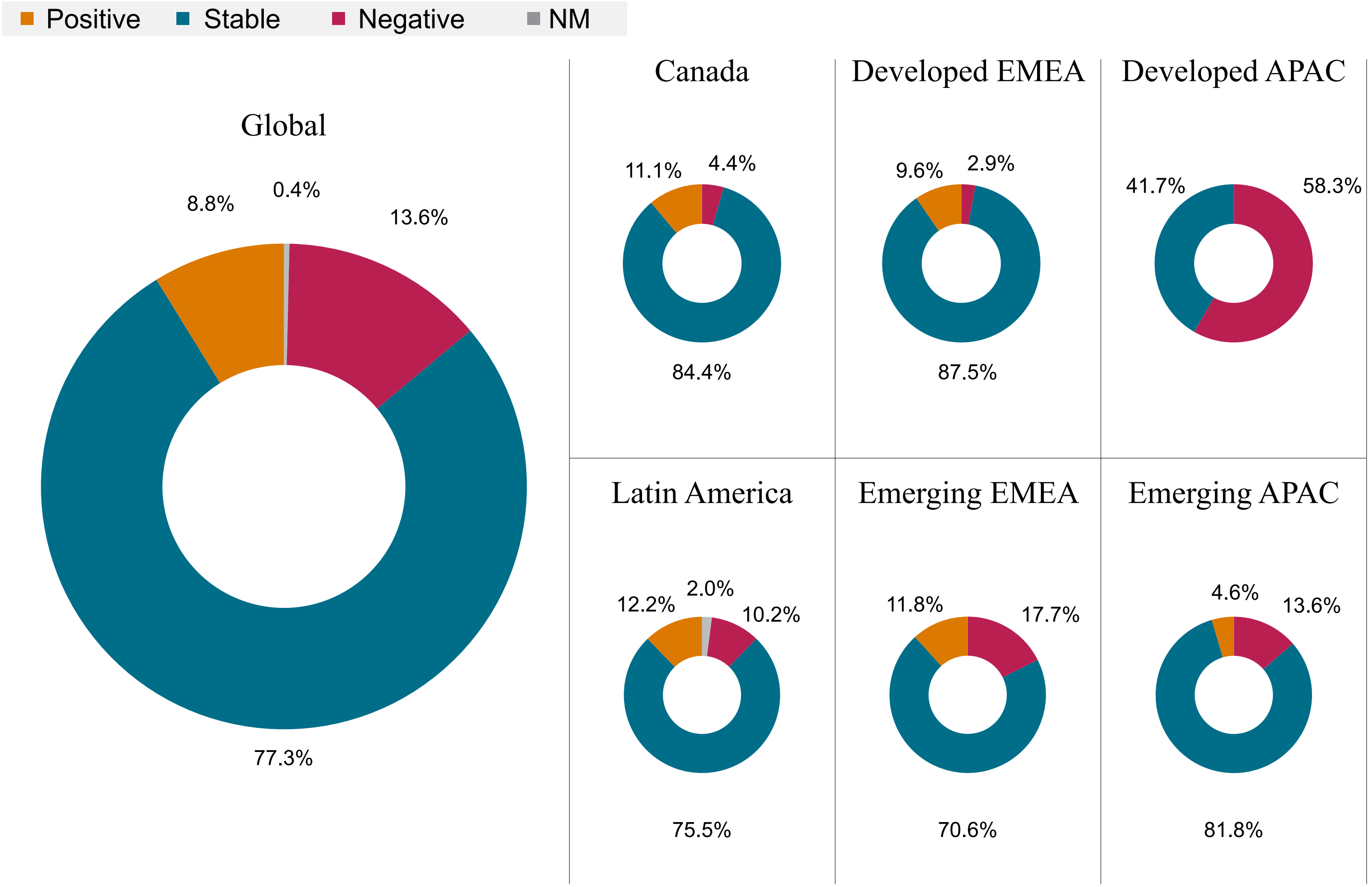


- Despite rising spending pressure, we expect the credit quality of most LRGs to remain largely stable over the next two to three years.
- The outlook bias remains negative, similar to year-end 2023.
- The share of ratings with stable outlooks is the lowest since 2012 (except for during the pandemic in 2020), suggesting increasing ratings volatility.

Data for all rated LRGs, including confidential ratings. LRG--Local and regional government. Source: S&P Global Ratings.

Rating Volatility Could Be Highest In Asia-Pacific And Emerging EMEA

Outlook balance per region

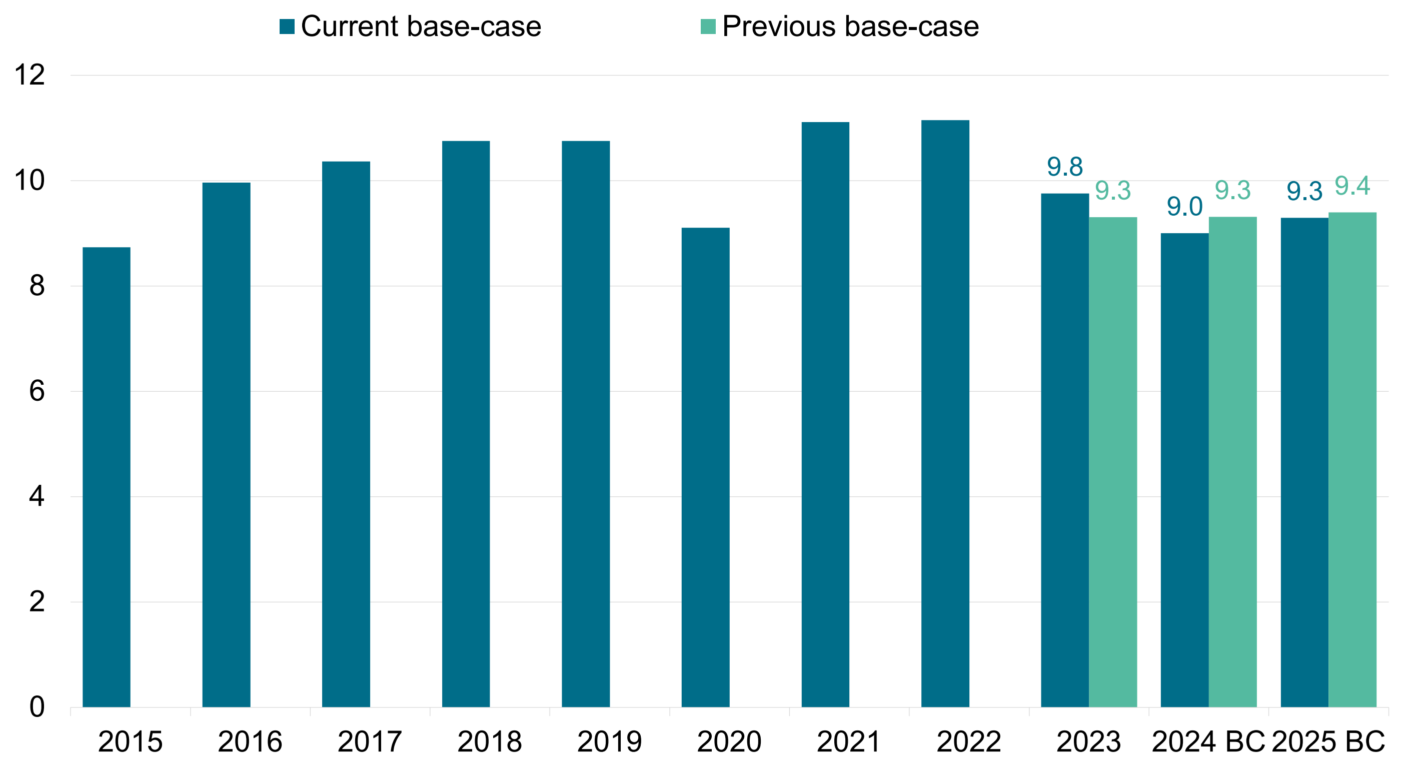


Data for all rated LRGs, including confidential ratings. APAC--Asia-Pacific. EMEA--Europe, Middle East, Africa. NM--Not meaningful. Source: S&P Global Ratings.

- Asia-Pacific shows a higher-than average proportion of negative outlooks on LRGs--for example, New Zealand--because of high investment needs.
- The bias for LRGs in Canada and European developed markets is more positive.
- LRGs in Switzerland continue to show strong financial results due to the resilience of the local economy.
- Some Spanish LRGs benefit from a solid recovery and access to EU funds to finance capital spending.
- In Latin America, outlooks are tilted to the upside in Mexico, whereas they are negative in Brazil and Argentina.

Operating Surpluses Are Under Pressure As Inflation Pushes Up Spending

Average operating balance (% of adjusted operating revenues)

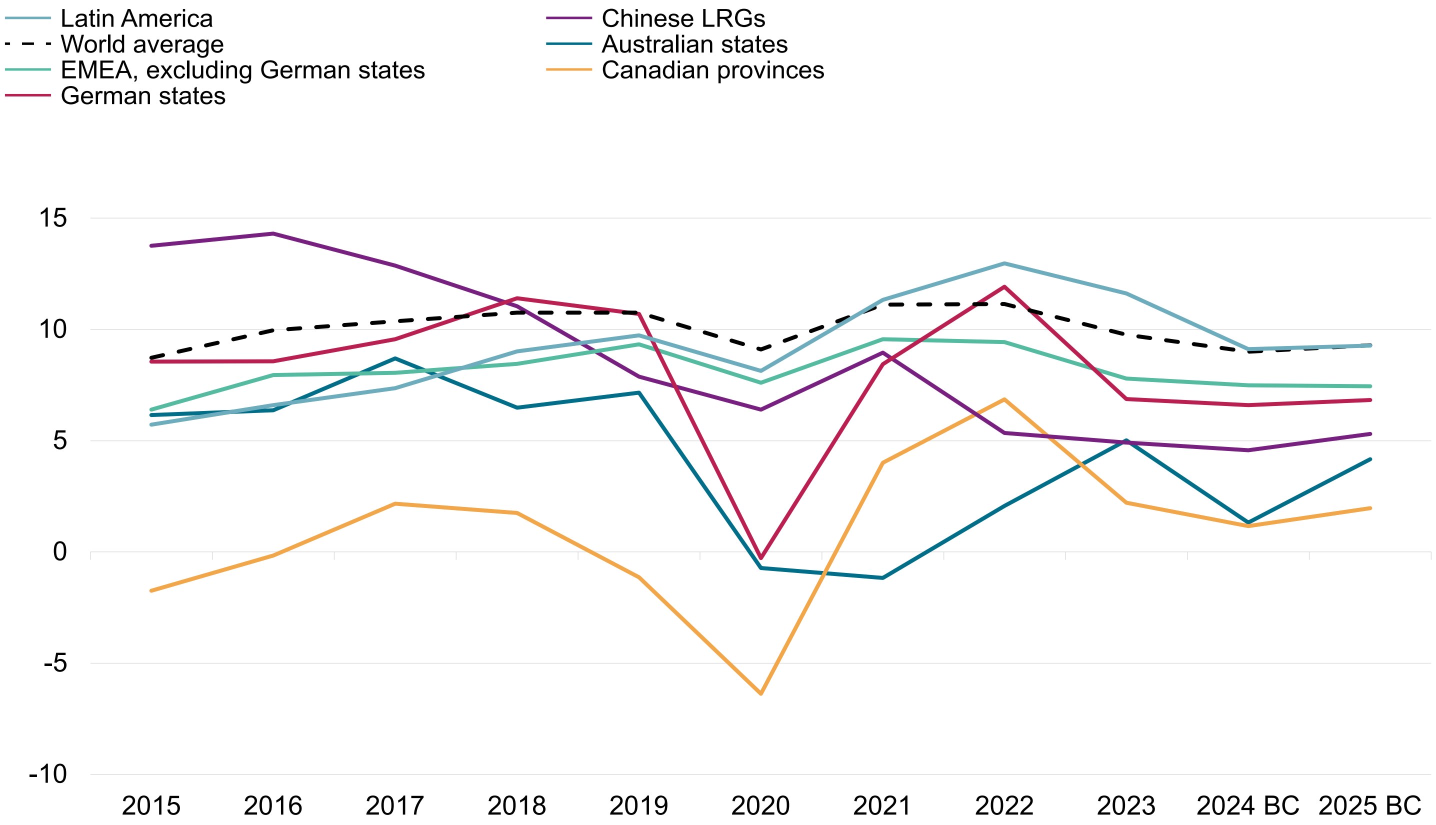


Using actuals whenever available. Data for all rated LRGs, including confidential ratings. Please note that data might differ compared to previously published reports, due to constant data analysis and change of entities included. BC--Base case. Source: S&P Global Ratings.

- We anticipate growing constraints on LRGs‘ budgets because of high inflation, higher interest rates, and demographic challenges.
- Amid lower transfers from central governments and slower growth in tax revenues, spending needs should result in the one of the weakest operating budgetary performances in a decade.
- Our projections on operating surpluses are somewhat weaker than our previous base case. This is stems from the lagged effects of inflation on spending, as well as higher interest rates over a longer period.

Many LRGs Are Unlikely To Reach Pre-Pandemic Surpluses

Average operating balance (% of adjusted operating revenues)



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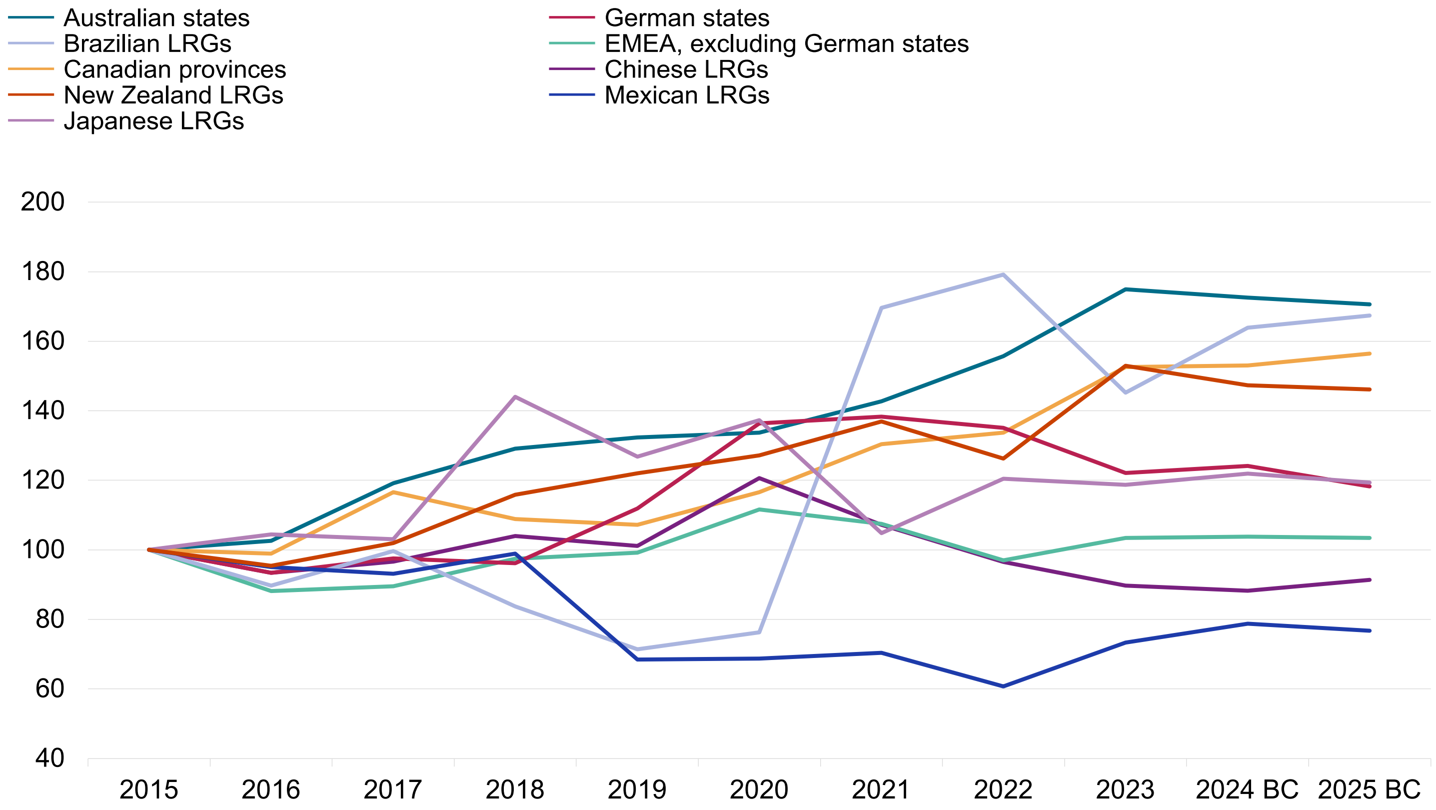
- Weakening operating performance will be broad-based across our rated universe.
- We anticipate Australian states, Canadian provinces, and Chinese LRGs will remain relatively weaker. Compared with global peers, their operating balances will average less than 5% of operating revenues.
- However, municipalities in Canada show stronger operating surpluses.
- In Latin America, we also expect some moderation in operating surpluses. However, they remain higher than global peers given more limited financing options.

Diverging Paths Of Public Investments

Total capital expenditure (indexed 2015=100)

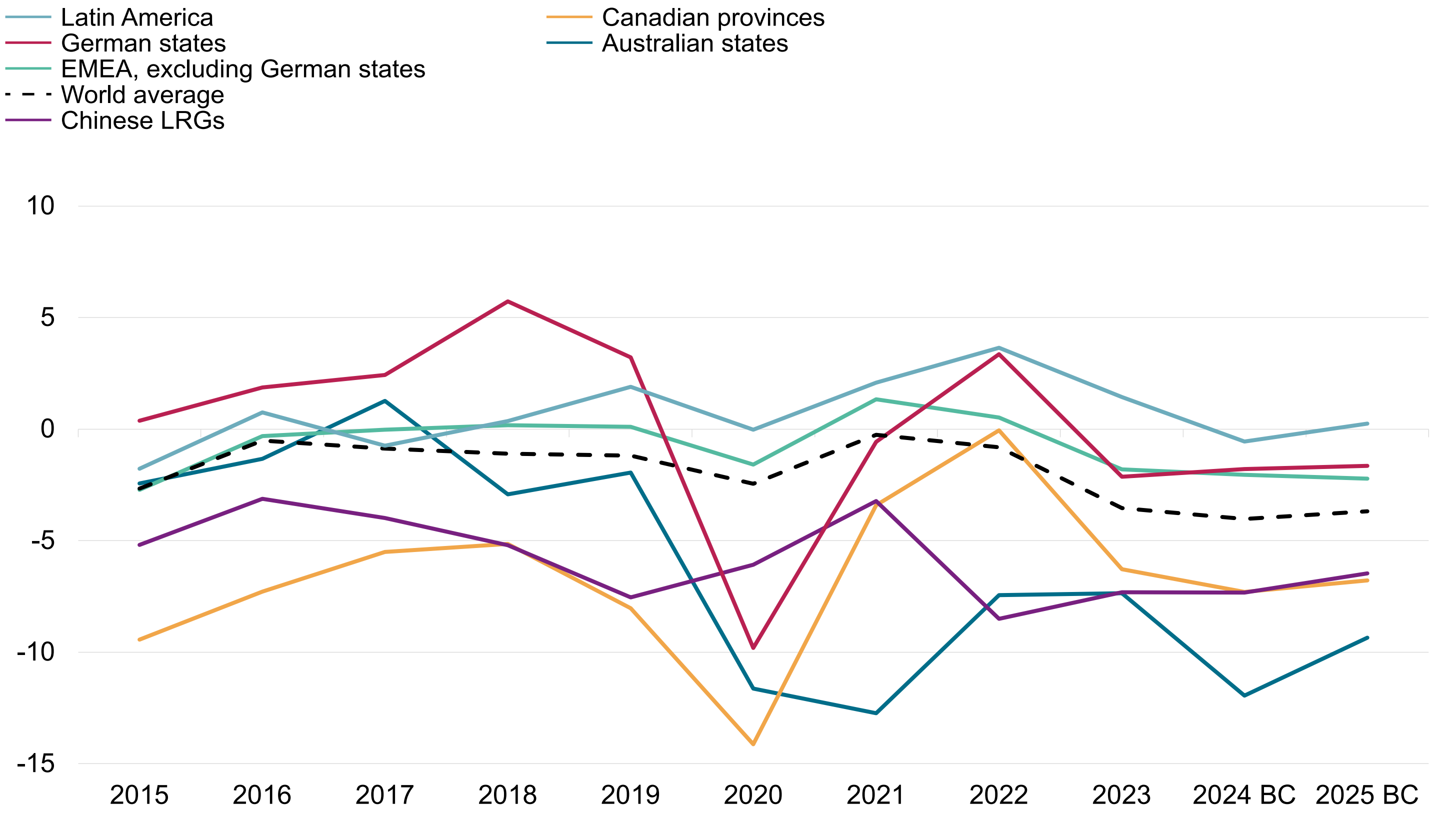


Data in LC at constant prices, except for EMEA, which uses USD at constant prices. Using actuals whenever available. Data for all rated LRGs, including confidential ratings. Please note that data might differ compared to previously published reports, due to constant data analysis and change of entities included. Source: S&P Global Ratings.

- The greater financial autonomy of Australian states and Canadian provinces, and their sizable spending needs, will keep investments elevated at more than 50% higher than in 2015 in real terms.
- In Europe and Japan, we expect LRGs to stabilize and even reduce capital spending, except for in Italy and Spain where LRGs have access to EU funds.
- In many emerging markets, including China, Mexico, and Central and Eastern Europe, LRG investments are set to decline. This is due, respectively, to the property market crisis, limited management capacity, and the EU budget cycle.
- In Brazil, capex will continue to rise, but from very low pre-pandemic levels and remain small in terms of GDP. Initially, capex was financed by federal COVID relief, and now some LRGs have somewhat better access to lending.

Investments In Australia, Canada and China Drag On Performance

Average balance after capital accounts (% of adjusted total revenues)



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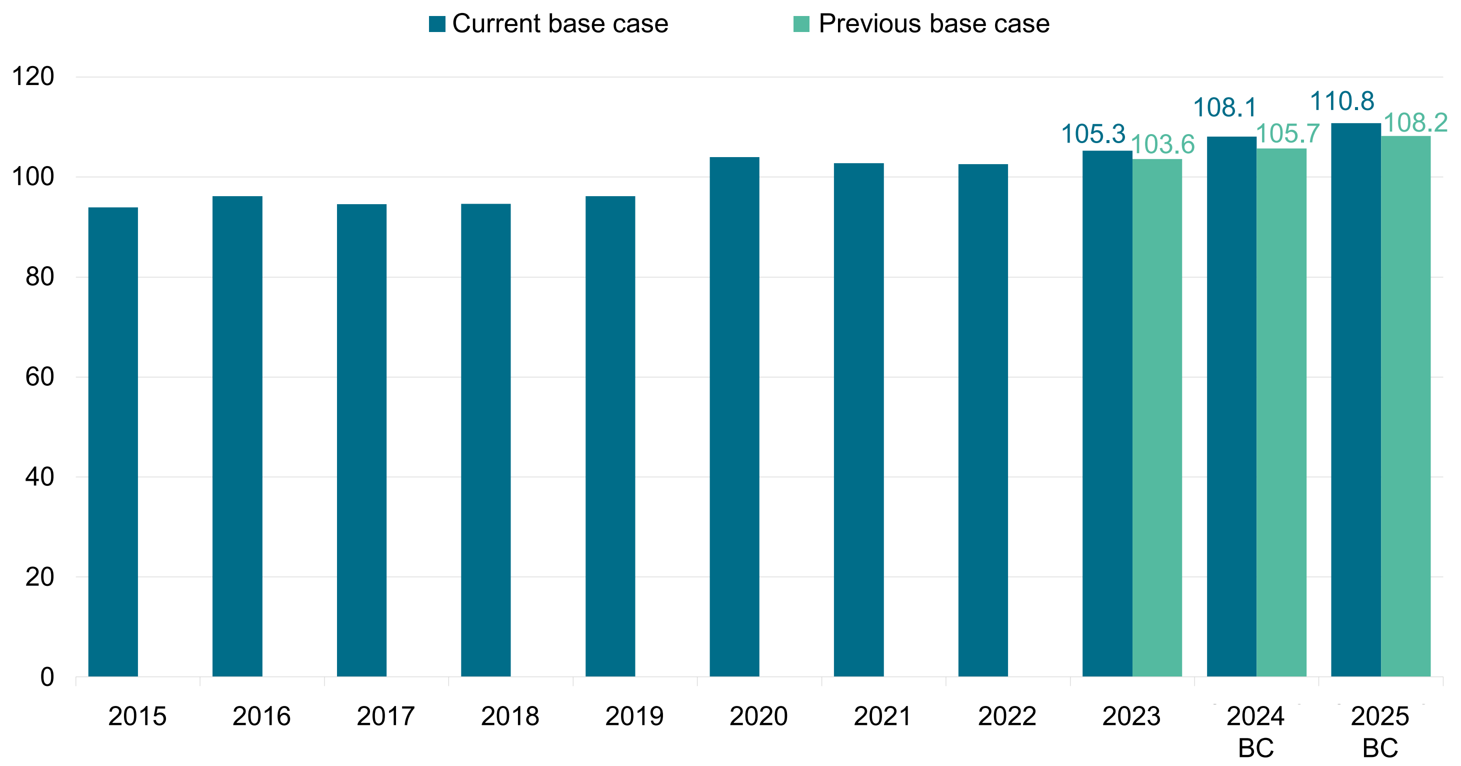
- With the projected weakening in operating performance and sizable investment spending, we anticipate some deterioration in total budget deficits.
- Limited regulation and high infrastructure investment needs will keep Australian states', Canadian provinces', and Chinese LRGs' deficits relatively high.
- In contrast, rated Latin America LRGs' balances should be broadly balanced. In Mexico, this reflects a short planning horizon for investment projects and reluctance to take on debt. In Argentina, recession and limited access to financing is forcing budgetary adjustments.
- In 2023 and 2024 the post-pandemic return to stricter national regulations on debt and deficits will lead to only minor deficits for LRGs in Europe.

Average Debt Burden Will Increase Faster Than We Previously Expected

Average tax-supported debt (% of consolidated operating revenues)



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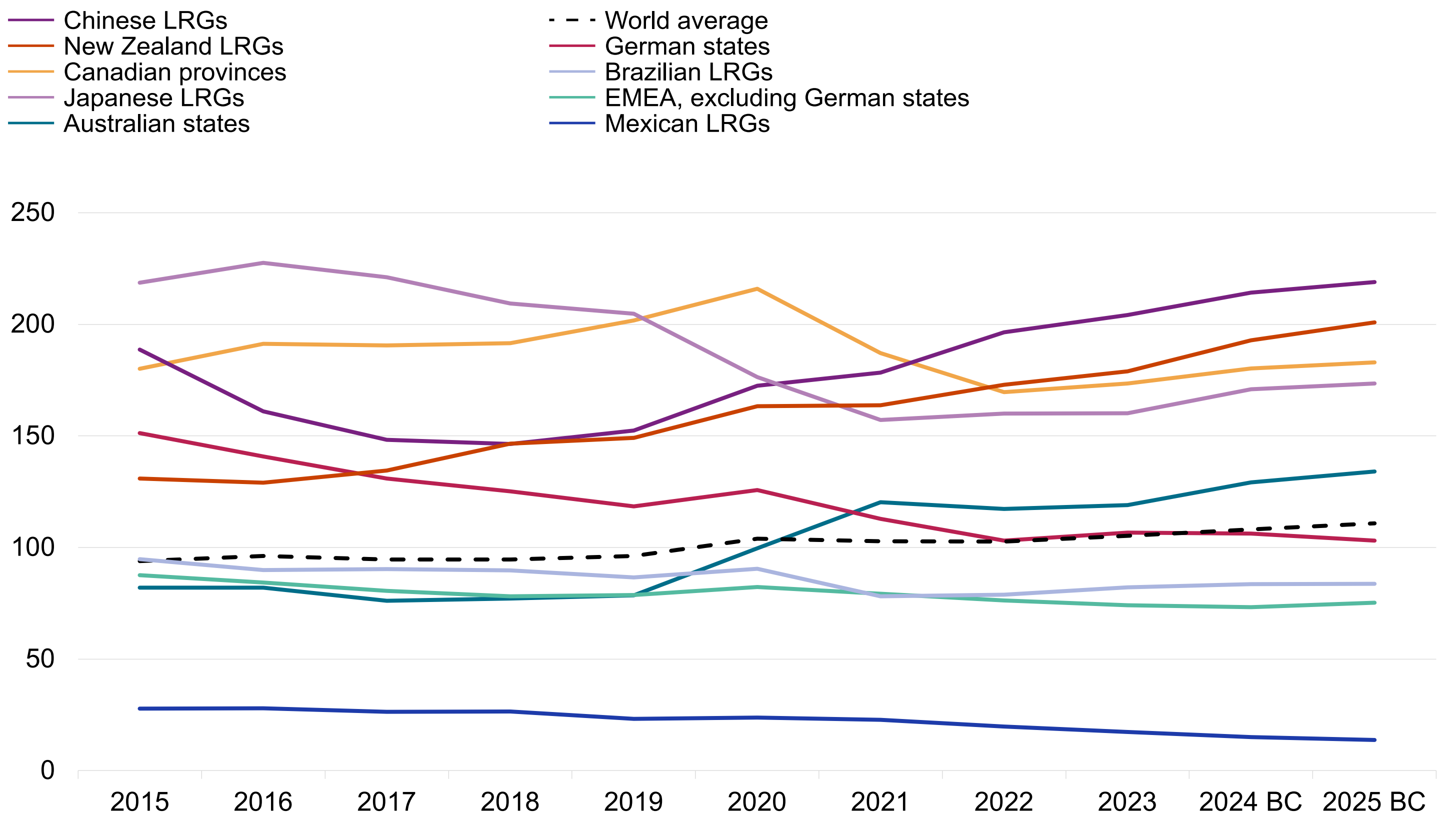
- As a consequence of a relatively sizable average deficit after capital accounts of 4% over 2024-2025, and subdued revenue growth, we anticipate debt burdens will increase over next two-to-three years.
- We expect tax-supported debt (TSD), including governments' direct debt and debt of closely related public enterprises, to steadily increase and exceed a still moderate 110% of consolidated operating revenues by 2025.
- This is higher than we expected in our previous forecast, albeit not substantially.

Fast Debt Growth For LRGs In Australia, China, And New Zealand

Tax-supported debt (% of consolidated operating revenues)

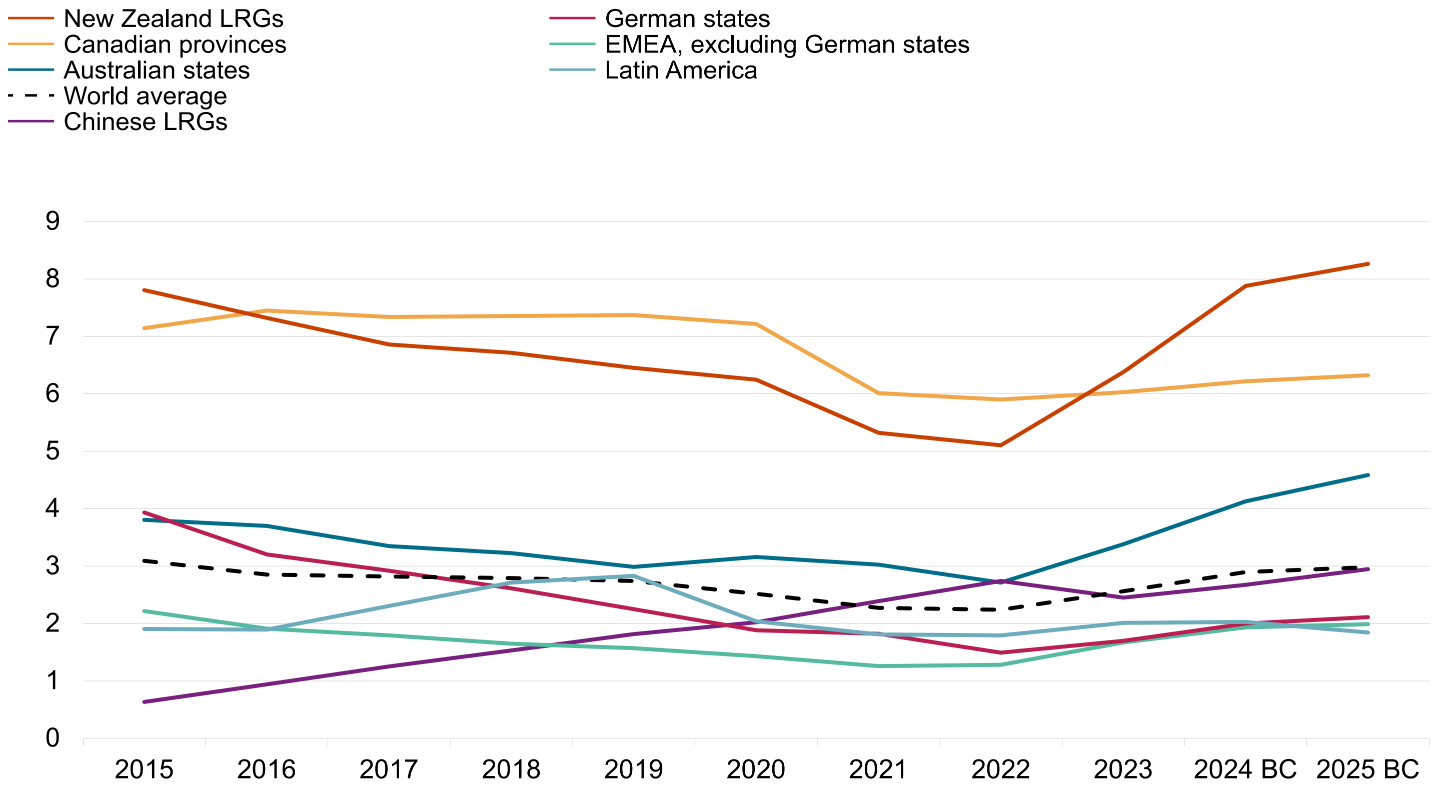


Ratio excludes onlending for Chinese LRGs. Using actuals whenever available. Data for all rated LRGs, including confidential ratings. Please note that data might differ compared to previously published reports, due to constant data analysis and change of entities included. BC--Base case. Source: S&P Global Ratings.

- TSD as a percentage of operating revenues is growing relatively fast in APAC, specifically in Australia and New Zealand where governments are prioritizing infrastructure development to accommodate ballooning population growth.
- In China, TSD (excluding onlending) will continue to increase, albeit at slowing pace, because of consolidation of government-related company debt and support for property markets.
- In China and New Zealand, the ratio will exceed 200%, almost twice the world average.
- Debt burdens for German states will stabilize at about the global average, after a pronounced deleveraging since 2015. Fiscal rules appear to contain rising spending.
- Debt loads for Latin American LRGs will remain subdued as infrastructure gaps persist amid limited funding options.

Upward Trend In Interest Payments, Particularly In New Zealand And Australia

Average interest payments (% of adjusted operating revenues)

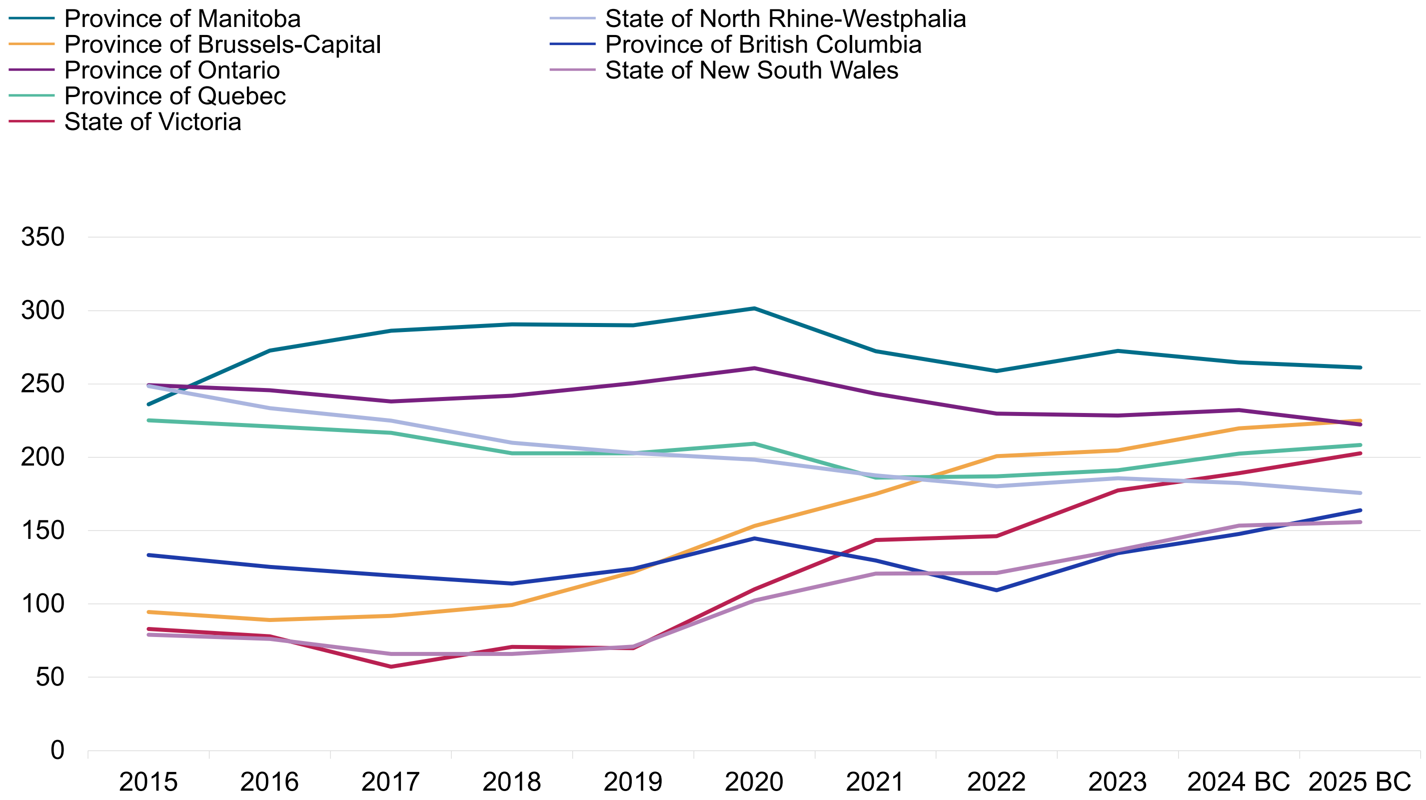


Ratio excludes onlending for Chinese LRGs. Using actuals whenever available. Data for all rated LRGs, including confidential ratings. Please note that data might differ compared to previously published reports, due to constant data analysis and change of entities included. BC--Base case. Source: S&P Global Ratings.

- LRG debt accumulation globally will result in rising interest spending, accounting for a relatively small 3% of operating revenues, compared with 2% in 2021.
- In New Zealand, debt costs have gone up swiftly amid higher nominal interest rates, a steeper yield curve, and short debt maturities for councils. We project interest spending will reach more than 8% of operating revenues.
- Interest spending will be stable in Canadian provinces given the fixed-rate and very long tenor of their debt. That said, still higher interest and debt burdens will limit space to materially improve budgetary peformance alongside rising needs for spending on healthcare and housing.

Debt Burdens Are Still Rising For Most Large Bond Issuers

Tax-supported debt (% of consolidated operating revenues)



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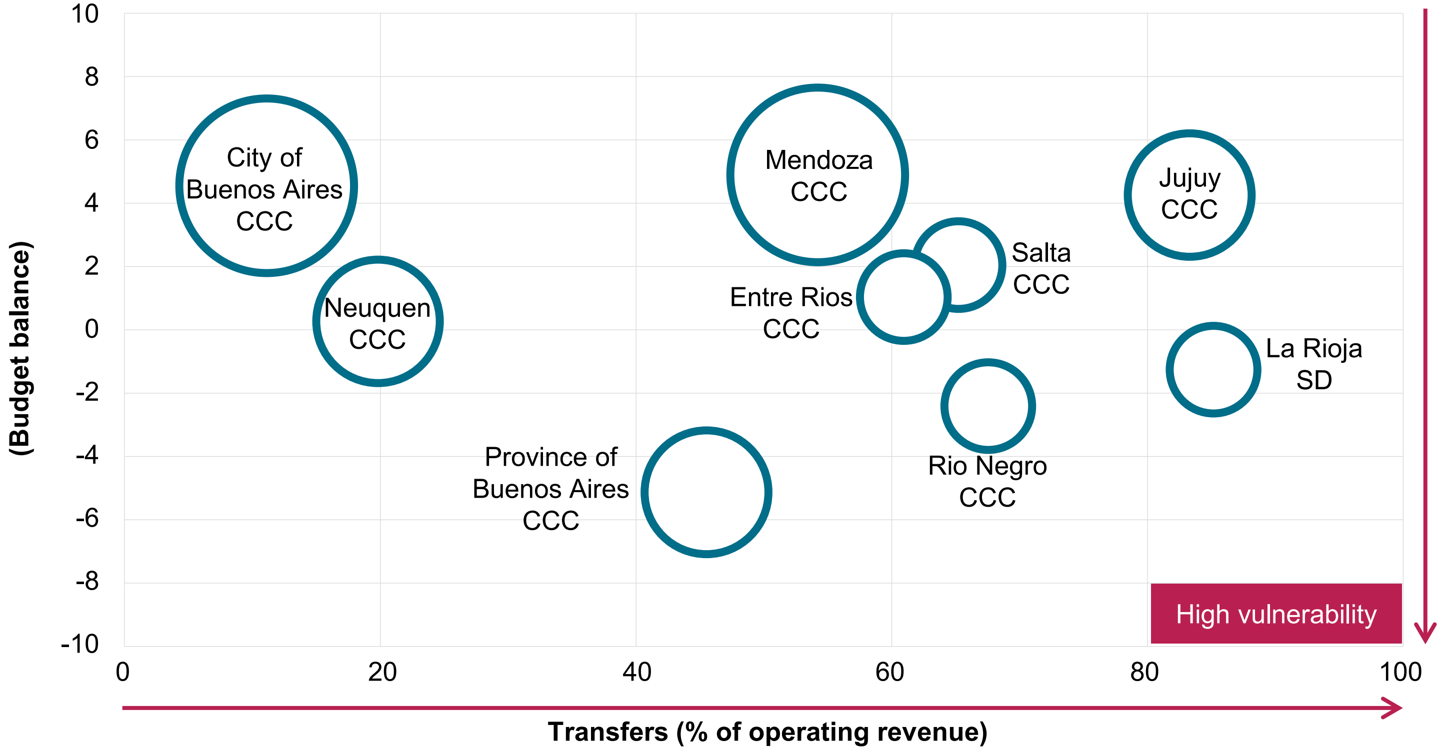
- A few regions in federal countries such as in Australia, Belgium, Canada, and Germany maintain a particularly high level of indebtedness with tax-supported debt above 150% of operating revenues.
- German states, like North Rhine-Westphalia, follow a balanced budget requirement, albeit with some loopholes in national regulation, and are reducing their debt burden.
- Some governments, which are not constrained by national budget rules, address rising demand for services with higher spending and rising debt burdens.
- We expect the region of Brussels, the Australian state of Victoria, and the Canadian province of British Columbia to accumulate debt faster than peers over the next two years.

Argentine Provinces Squeezed By Macro Imbalances And Fiscal Correction

Resilience depends on their starting position and reliance on transfers



- A steep economic contraction and cuts in discretionary transfers should weaken LRG finances in 2024.
- A 20% decline in real LRG revenue in the first quarter of 2024 also reflects the 2023 pre-election cut in personal income tax rates. Delays in reinstating higher tax rates have added more strain.
- However, we don't expect the broad-based LRG restructurings we saw in 2020. Each LRG's debt management, accumulated liquidity, and local market access will be key for resilience.
- Access to global markets in 2025-2026 could facilitate debt roll-overs, opening space for less stringent fiscal corrections and allowing much needed capex to resume.

Bubble size represents savings at the beginning of the year as a percent of foreign-currency bond payments for 2024. S&P Global Ratings estimate based on available information. The largest bubble (of three) corresponds to coverage above 2x. Budget balance: Average balance after capex (% of total revenues) 2021-2023. SD--Selective default. Sources: S&P Global Ratings based on central bank, provincial ministries of finance, and bond documentation.

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Related Research

- Your Three Minutes In LRGs: Persistent Spending Needs Are Seeing Growth In Debt Burdens, June 27, 2024
- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S. June 18, 2024
- Global LRGs Rating History List, June 17, 2024
- China Local Governments: The Slow Road To Stabilization, June 13, 2024
- U.K. Local Authorities Are Bending, But Adapting, June 6, 2024
- Mexico's New Administration Faces Old Challenges, June 3, 2024
- Your Three Minutes In Argentine Provinces: Debt Restructurings Will Likely Be Case By Case, April 30, 2024
- Your Three Minutes In Spanish Regional Finance: Higher Expenditure May Limit Deleveraging, April 24, 2024
- China LRGs: Recouping Revenue Is Key To Fiscal Sustainability, March 27, 2024
- Brazil's Fiscal Recovery Programs Support Local And Regional Governments' Finances Amid Budget Rigidities, March 14, 2024
- Paris' Lean Olympics Are Unlikely To Blow Any Budgets, March 11, 2024
- Subnational Debt 2024: Fiscal Policy Differences Influence Borrowing In Developed Markets, March 4, 2024
- Subnational Debt 2024: Focus on debt sustainability, Feb. 29, 2024
- Subnational Debt 2024: Canadian Local And Regional Governments Are Running Fast To Stay In Place, Feb. 29, 2024
- Subnational Debt 2024: Chinese Governments Reach Their Limits; Other Emerging Markets Taper Borrowing, Feb. 29, 2024
- Subnational Debt 2024: Infrastructure Spending Succumbs To Economic Slowdown, Feb. 29, 2024
- Global Ratings List: International Public Finance Entities January 2024, Jan. 18, 2024

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