Intelligence MEMOS

From: Matthew McLeish

To: Economy Observers

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Re: **Provincial Governments are Walking a Tightrope of Fiscal Short-termism – It's Time to Get Serious**

Economic concerns have dominated Canadian politics in recent years, with inflation and post-pandemic recovery taking centre stage. The cost of living tops most polls – 71 percent in one survey last summer – as an issue. And now, a tariff war threatens to deepen Canada's economic woes, pitching provincial economies into recession, compounding their existing fiscal challenges. New National Bank modelling suggests that a tariff-induced downturn will drop GDP by 2 percent in 2025 and expand provincial deficits by up to 1 percent of GDP.

Provincial and territorial governments are operating on fiscally fragile ground. Many already face rising deficits and debt-servicing costs, threatening essential public services if left unchecked.

Aging populations, rising wages, lingering pandemic expenses, and mounting infrastructure demands are all stretching budgets. BC's $95 billion 2025 budget reflects these pressures, further compounded by the threat of tariffs. Healthcare spending alone accounts for $35 billion, while $4 billion has been allocated annually to contingency funds to mitigate tariff-related risks through the 2027-2028 fiscal year – an increase from last year's $3.89 billion and other contingency reserves introduced since the pandemic to address unexpected costs. With a record $10.9 billion deficit projected for 2025, interest payments on taxpayer-supported debt are expected to rise from 4.9 cents per dollar of revenue to 6.9 cents by 2027-2028.

For both families and provinces, the consequences are stark. Provincial deficits are expected to total $43 billion this fiscal year, adding an additional debt burden of $1,050 per capita. While the Parliamentary Budget Officer (PBO) deemed fiscal policy sustainable in some provinces (Ontario, Alberta, and Quebec), it says others (Newfoundland and Labrador, Manitoba, and British Columbia) face unsustainable trajectories. Rising healthcare costs due to aging populations, reduced federal transfers relative to provincial economies, and increased reliance on debt are central to the PBO's concerns.

Even Alberta is vulnerable. A $4.4 billion drop in oil and gas revenue, a $1.2 billion income tax cut, and tariff uncertainty have driven the province into a projected deficit of $5.2 billion this fiscal year – an $11-billion swing from the previous budget. A worst-case tariff scenario could add another $3.5 billion in costs, while the average price of West Texas Intermediate oil is expected to fall to US$68 per barrel this year, down from last year's US$74 projection. BMO's 2024 outlook on provincial finances aptly captures the broader challenge: provinces must navigate a slowing economy, rising public sector wages, and growing infrastructure needs.

In the face of these challenges, both chronic and new, many provinces continue to embrace fiscal short-termism instead of offering sustainable long-term solutions. Rather than making tough decisions, governments seem too often infatuated with superficial gambits. Manitoba and Ontario introduced gas tax holidays, while Ontario also eliminated vehicle registration fees and issued a $200 "Ontario Taxpayer Rebate" ahead of the 2025 provincial election. These moves have pressured other provinces, including Saskatchewan and British Columbia, to follow suit. While politically convenient, such policies carry a high cost – lost revenue that will burden future taxpayers and deepen structural fiscal imbalances.

How can governments finance rising debt costs in the future? Almost surely through higher taxes or service cuts – the only questions are who will pay and when.

Provinces must chart a more responsible course, beginning with a reassessment of their spending priorities. Safeguarding provinces against economic threats like Donald Trump's tariffs requires maintaining strong reserves to maximize the flexibility needed for stability.

Another critical step is diversifying resource-dependent economies to reduce volatility. Fiscal planning is much harder in provinces like Alberta and Newfoundland and Labrador, where changes in the dollar or the price of oil drastically affect budgets. Improved risk analysis and long-term planning are essential to withstand price shocks, shifting national climate policy, and demographic trends.

Transparent fiscal planning and accountability are equally crucial. The C.D. Howe Institute's annual report card on fiscal accountability highlights several areas where provinces can improve financial reporting, budget forecasting, and public transparency. Committing to medium-term budget targets, publishing timely financial statements, and improving fiscal projections can go a long way in rebuilding public trust and ensuring sustainable finances.

Persistent fiscal short-termism drives up public debt and undermines social services at a time when an escalating trade war threatens to stall economic growth, disrupt markets, and destabilize the global economy. Provincial leaders must strike a balance between addressing immediate pressures and ensuring long-term fiscal sustainability. By committing to disciplined budgeting and thoughtful reforms, they can protect essential public services, strengthen public finances, and secure Canada's economic future in an increasingly uncertain environment.

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(This Memo is based on an assignment completed as part of the Munk School's public finance economics course, taught by C.D. Howe Institute Senior Fellow, Brian Lewis. The Institute is pleased to support and recognize the work of the next generation of Canadian public policy thinkers.)