

ECONOMIC VIEWPOINT

Québec Budget 2006

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Comments on the Québec Budget 2006

Everything on Health, Education and the Establishment of a Debt Repayment Fund



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Highlights

The second budget of Minister of Finance Michel Audet is evidence of the difficult financial situation facing the Québec government. Yet, a balanced budget was maintained. In addition, additional revenues from royalties or water rights will be transferred to a new Generations Fund designed to tackle the issue of the Québec public debt. New funds are also allocated to more pressing health and education needs to the detriment of other items of expenditure. The total debt of the government keeps increasing and servicing it will drain some \$7.9B during the next fiscal year.

- The government is establishing a Generations Fund funded by royalties imposed on hydro-electricity producers, including Hydro-Québec. This fund will be managed by the Caisse de dépôt et placement du Québec and will be earmarked exclusively for repaying the debt. Including the investment income, the fund will receive \$74M in 2006-2007, \$390M the following year and \$668M in 2008-2009.
- Apart from the amounts allocated to the Generations Fund, the 2006-2007 and 2007-2008 fiscal years should be balanced.
- According to the budget projections, the growth of budget revenues should accelerate by approximately 4.4% during fiscal 2006-2007 while operating expenditures will increase annually by 4.2% over the same period.
- The education expenditures will increase by 5.4% in 2006-2007 and the health and social services expenditures will rise by 6.3%. Other budget items will go down by 0.2% during the next fiscal year.
- The surplus earmarked for the Generations Fund will mean a slight decrease in the accumulated operating deficits, i.e. a decrease of \$74M in 2006-2007 and \$390M in 2007-2008. However, the total debt will keep growing by approximately 2.2% on average per year and reach \$123.4B in 2007-2008. Given the economic growth anticipated by the ministère des Finances, the total debt-to-GDP ratio will go down from 42.7% in 2005-2006 to 41.1% in 2007-2008. The government is aiming for a 25%-of-GDP ratio in 2025.
- Even if this is far from earlier government promises, personal income tax will be cut by \$362M in 2006-2007, in particular by doubling the tax deduction for workers. The tax credit for home support for elderly persons is also increased.

Summary of Budgetary Transactions

In millions of \$	2003-2004	2004-2005	2005-2006 ^f	2006-2007 ^f	2007-2008 ^f
Own-source Revenues	44,410	46,946	48,148	49,790	51,442
- Ann. Var. in %	3.8	5.7	2.6	3.4	3.3
Federal Transfers	10,120	9,939	11,027	11,999	12,041
- Ann. Var. in %	7.0	-1.8	10.9	8.8	0.4
Total Budgetary Revenues	54,530	56,885	59,175	61,789	63,483
- Ann. Var. in %	4.4	4.3	4.0	4.4	2.7
Operation Expenses	-47,647	-50,100	-51,651	-53,828	-55,052
- Ann. Var. in %	4.0	5.1	3.1	4.2	2.3
Public Debt Charges	-7,241	-7,449	-7,524	-7,887	-8,041
- Ann. Var. in %	1.5	2.9	1.0	4.8	2.0
Total Budgetary Expenses	-54,888	-57,549	-59,175	-61,715	-63,093
- Ann. Var. in %	3.7	4.8	2.8	4.3	2.2
Generations Fund	-	-	-	-74	-390
Budgetary Balance	-358	-664	0	0	0
Non Budgetary Surplus	-1,108	246	-636	-569	-185
Net Financial Needs	-1,466	-418	-636	-495	205
Debt Servicing to Budgetary Revenues (%)	13.3	13.1	12.7	12.8	12.7
Total Debt (excluant emprunts par anticipations)	114,725	116,596	118,159	121,123	123,372
Program Spending-to-GDP Ratio (%)	45.5	44.0	42.7	42.0	41.4

f : forecast -- : not available

Source: Ministère des Finances du Québec

The debt keeps mounting despite a balanced budget

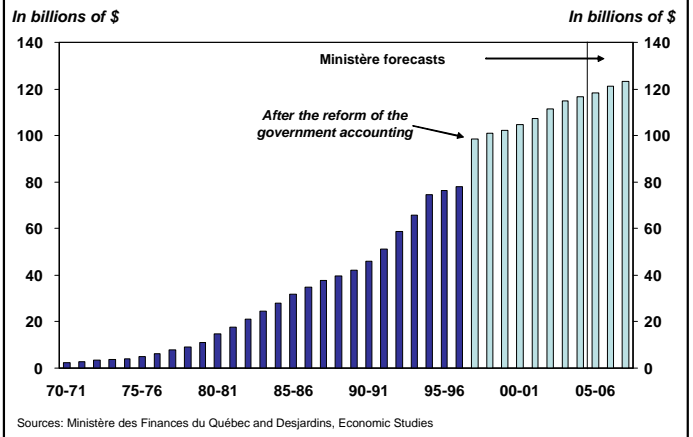
As the minister of Finance admits himself, developing the 2006-2007 budget was particularly tough. On the one hand, the needs are painfully obvious in many areas, in particular in health and education. On the other hand, the financial leeway of the Charest government is rather limited. So, the budgeting of minister Audet shows a 4.4% increase in revenues and a 4.3% increase in spending by the Québec government and its consolidated organizations. This rise is similar to what is anticipated for the Québec economy.

The ministère des Finances is again anticipating a balanced budget for fiscal 2006-2007. This wish seems difficult to realize, as shown by the three successive deficits recorded between 2002-2003 and 2004-2005. At this time, the government is still expecting to balance its expenditures and revenues for fiscal 2005-2006, but the release of the final results next fall could have some surprises in store for us.

Despite a balanced budget, the Québec government's debt should keep climbing in 2006-2007. As a result, the total debt could cross a threshold estimated at \$118.2B in 2005-2006, \$121.1B in 2006-2007 and \$123.4B in 2007-2008. This increase can be explained by an increase in capital investments among others. Bear in mind that they are funded through the government's financial assets (such as cash for instance) or an increase in the debt. However, only the annual depreciation is recorded in the current budget year.

The government is expecting to tackle the repayment of the debt by creating a Generations Fund. This fund, whose details are presented in the box on next page, will steadily accumulate financial assets that should bring down the size of Québec's net debt over time. The ministère des Finances expects that this fund will reach \$74M in 2006-2007 and \$464M in 2007-2008. According to the government's projections, this fund could even accumulate close to \$30B by 2025-2026.

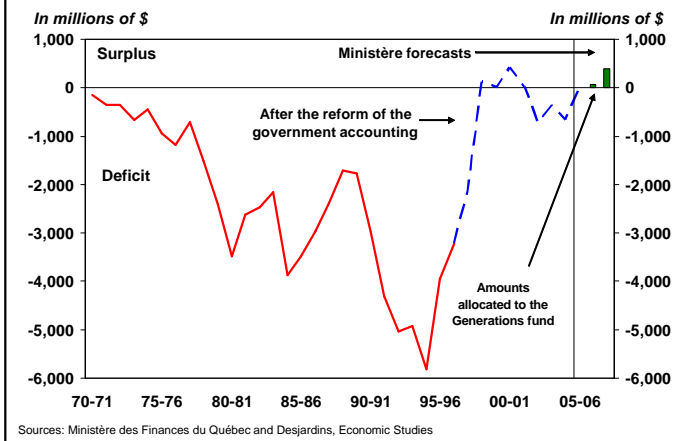
Changes in the Total Debt of the Québec government



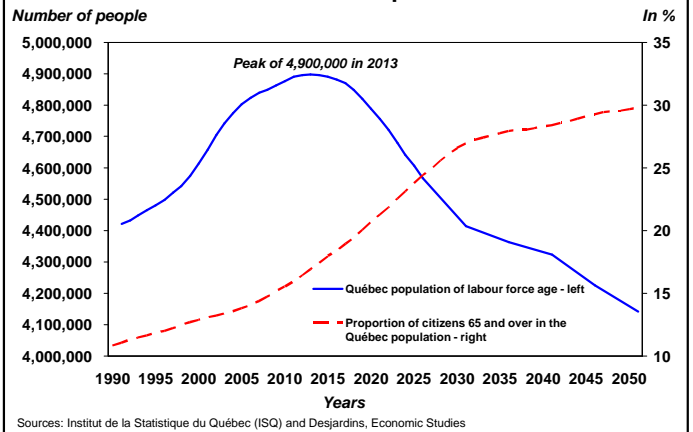
The establishment of the Generations Fund is very similar to our proposal of a gradual reduction of Québec's public debt as we indicated in a recent study of Québec's fiscal situation¹. Québec' debt is one of the highest among Canadian provinces and industrialized countries, so much so that if no corrective action is taken in the mid term, the competitiveness of the province on the world stage could be jeopardized. This problem is a crucial one in a context where Québec will have to overcome a major change in its demographics. Indeed, the share of people 65 and over in the Québec population will increase significantly over the next few decades while the number of people of labour force age will level off in 2013 and gradually decline afterwards. In addition, other factors will exacerbate the situation of Québec's public debt.

Even if the total debt will keep climbing over the next few years, the debt-to-GDP ratio, which provides an indication of the relative importance of the debt in relation to the size of the

Budgetary balance



Towards an Aging and a Decline of the Québec Population

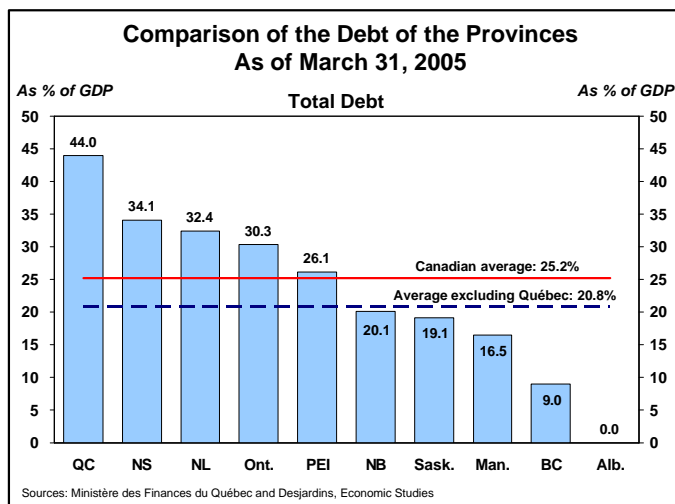


The Generations Fund

Minister Audet proposes to create via an act a fund designed to pay down the debt. The goal of the Generations Fund is to bring the total debt-to-GDP ratio to 25%, i.e. the current level of the Canadian average (including Québec). Starting on January 1, 2007, the government intends to gradually subject Hydro-Québec to the same water royalties that currently apply to private producers in order to put money into the fund. Hydro-Québec should absorb these additional costs through improved efficiencies and an increase in export revenues. In addition, part of the profits on the foreign sales of electricity coming from an anticipated increase in production capacities will also be paid to the Generations Fund. The government also proposes to pay royalties currently levied on private hydro-electricity producers to the fund starting on January 1, 2007. The fund could also be financed by a royalty on harnessed water and the sale of non strategic assets.

In practical terms, the Generations Fund will be managed by the Caisse de dépôt et placement du Québec. To maximize the lowering of the debt burden, the amounts allocated to the Generations Fund during the next few years will not be used to directly repay government loans. They will accumulate within the fund to yield profits. It should be noted that the average rate of return of the Caisse de dépôt et placement has been 9.4% since 1995, which is far greater than the average 6.9% cost of debt servicing. Thus, the Generations Fund will increase the financial assets of the Québec government. As a result, the government's net debt (i.e. the total debt less the net financial assets) should gradually go down over the coming years.

According to the projections of the Québec government, the balance in the Generations Fund will total close to \$30B in 2025-2026, 53% of which will come from investment revenues and 47% from water royalties. Amounts could even be added in the coming years from profits on electricity exports, royalties on harnessed water and the sale of non strategic assets.



PROJECTION OF THE AMOUNTS ACCUMULATED IN THE GENERATIONS FUND (in thousands of dollars)

	Water royalties		Hydro-Québec	Harnessed	Sale of	Investment	Balance as
	Hydro-Québec ⁽¹⁾	Private producers	electricity exports by	water	assets	revenues	of March 31
2006-2007	64	9	--	--	--	1	74
2007-2008	325	49	↑	↑	↑	16	464
2008-2009	535	80	↑	↑	↑	53	1,132
2009-2010	546	81	↑	↑	↑	102	1,861
2010-2011	564	83	↑	↑	↑	158	2,666
Impact to be determined							
2015-2016	645	91	↓	↓	↓	578	8,173
2020-2021	712	100	↓	↓	↓	1,212	16,764
2025-2026	787	110	↓	↓	↓	2,180	29,877

⁽¹⁾ : The anticipated growth up to 2011-2012 is mainly due to the increase currently anticipated in the production capacities of Hydro-Québec. Afterwards, the increase is due solely to the indexation of water royalties already provided for by the Watercourses Act.

economy, will decrease somewhat due to a growth of the economy that is more rapid than that of the debt. As a result, the total debt-to-GDP ratio, which stands at 42.7% in 2005-2006 according to preliminary data, could go down to 42.0% in 2006-2007 and 41.1% in 2007-2008. Bear in mind that this same ratio had reached a peak of 52.2% in 1997-1998.

Similarly, the ministère des Finances has agreed to publish a monthly report on the statement of changes in the financial situation of the government similar to the one by the federal government. Québec will therefore be the first Canadian province to publish this type of information on a monthly basis, which should improve the transparency of public accounts in Québec. This new way of doing things must be recognized as it will make it easier to follow the Québec government's budget situation.

The government's economic forecasts could be difficult to reach

In the process of developing this budget, the economic growth forecasts of the ministère des Finances were close to the average forecasts of the private sector. The forecasts for nominal growth in constant dollars are also similar to our own. However, when just growth in constant dollars is taken into account, we feel that these projections could be difficult to achieve. The anticipated slowdown of the US economy, the levelling off of the real estate market, the appreciation of the Canadian dollar, the hikes in energy prices and the monetary tightening on the part of the Bank of Canada could lead to lower real growth than that anticipated by the ministère. The budget documents presented by minister Audet count on 2.5% growth of real GDP this year and 2.4% in 2007, while our own forecasts anticipate an average growth of 2.0% over the next two years.

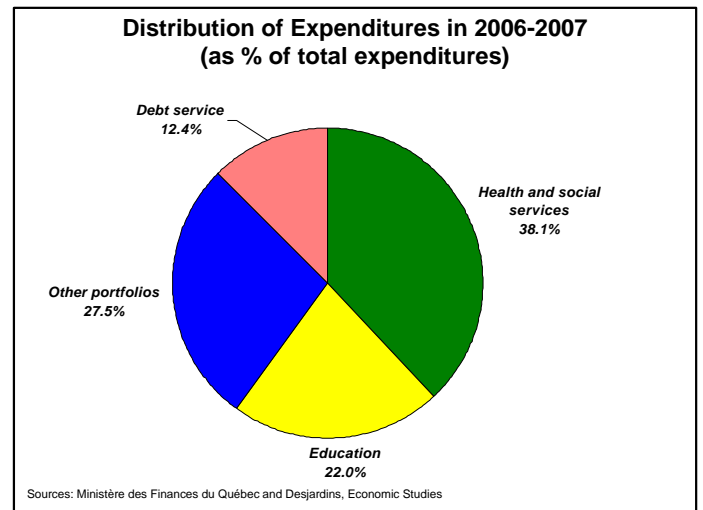
The government is also counting on a significant decline of the Canadian dollar in comparison to the current rate. If, as we anticipate, a new appreciation, although moderate, occurs, the competitiveness of many Québec businesses and, indirectly, the economic growth outlook put forward by the government could be jeopardized. As a result, the balanced budgets anticipated by the minister of Finance may well be difficult to reach. On the other hand, the slight decline in interest rates that we anticipate, especially in 2007, could offer a slight leeway for public debt servicing.

New modest but targeted measures

The scope of the new measures brought in this budget is rather small. Of course, the budget balancing is so precarious that it leaves very little leeway for the minister of Finance. In addition, the operating expenditures earmarked for health and education and the amounts allocated to debt servicing absorb most of the resources of the Québec government (over 90% of self-generated revenues). During the next fiscal year, the government focused its new expenditures on education (+660M) and health (+1,303M) with annual increases of 5.4% and 6.3% respectively. However, it should be mentioned that a great part of the new expenditures in these two items is attributed to the reserve built up for pay equity, wage adjustments and improvements to labour conditions, which leaves little for any real growth in services. The other program expenditure items are paying for these increases by taking cuts of 0.2%. In addition, the budget allocations of some ten departments are cut this year. More specifically, here are the main budget measures proposed in the budget:

	2005 and preliminary estimates		2006 forecasts		2007 forecasts	
	Budget	Mouvement Desjardins	Budget	Mouvement Desjardins	Budget	Mouvement Desjardins
Québec nominal GDP (%)	4.5	4.4	4.2	4.3	4.0	3.9
Québec real GDP (%)	2.2	2.1	2.5	2.2	2.4	1.8
Québec GDP deflator (%)	2.3	2.3	1.7	2.1	1.6	2.1
3-month Canadian Treasury bills (%)	2.70		3.70	3.90	4.00	3.60
10-year Canadian bonds (%)	4.10		4.40	4.30	5.10	4.00
Canadian Dollars (in US currency)	82.5		85.1	88.0	81.6	90.0

Note: for all the indicators, the data shows annual averages.
Sources: Ministère des Finances du Québec and Desjardins, Economic Studies



- The Québec government intends to help the forest sector that is currently going through a difficult situation with an injection of \$925M by 2009-2010. This assistance should help forest businesses invest, modernize and bring down operating costs. Indeed, \$500M come from new tax and budget measures and \$425M as loans. Similarly, the government is earmarking \$100M for some support measures for farmers by 2008-2009.
- The minister of Finance announced new measures to cut personal income tax. Far from the annual billion dollars promises made during the last election campaign, the tax cuts will reach \$362M in 2006-2007. The largest part of this amount is due to an increase from \$500 to \$1,000 of the deduction for workers. This measure will start on January 1, 2007 and will cost \$288M in 2007-2008. The government is also increasing the refundable tax credit for home support for elderly persons. Modest measures on work-family balance are also introduced.
- Some minor measures aimed at bringing down the tax burden of businesses are put forward. The tax rate of SMEs will be cut from 8.5% to 8.0%, a measure that will cost \$106M over three years. The government is also improving on-the-job training periods and is allocating \$75M to help research and development.
- The regions are not completely forgotten and the government will invest \$150M to support them, in particular to increase the funding of businesses through local investment funds (FLIs) and the regional economic intervention fund (FIER).

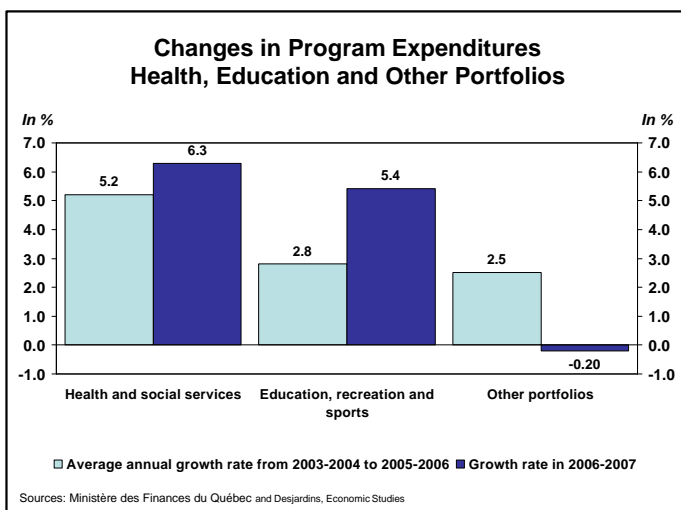
- Including the amounts and projects already announced (with the new commuter train in northeast Montreal and the renovation of the metro), the government will allocate \$1,500M to public transit. The scope of the tax measure covering the payment of the cost of transit passes by employers is however smaller than anticipated.
- The government will allocate \$158M to the construction and renovation of social housing.
- The government will invest \$200M over five years for the establishment of the Fonds culturel du patrimoine québécois [Québec heritage culture fund] and \$500M for the Fonds pour le développement du sport et de l'activité physique [sport and physical activity development fund]. Some of the amounts freed by the total payment of the Olympic debt (repaid by a share of the tax on tobacco) will help fund these measures.

Impact on Financial Markets

Like the previous budgets tabled by the Liberal Party government, the current exercise presented by minister Audet will have little impact, on the short term at least, on financial markets and credit rating agencies. Of course, the attention given to the problem of the Québec government's debt will be at the forefront. However, the holders of Québec government securities would have no doubt appreciated a more ambitious repayment project or at least, a more detailed one. Given that many other provinces are also looking to limit their debt, Québec risks again looking bad in comparison with its neighbours. With a debt level that should remain high and no real annual reserve for contingencies, the finances of the Québec government will remain exposed to the ups and downs of economic, political and financial circumstances. A setback in economic circumstances, an unexpected hike in interest rates or an unforeseen decrease in transfers from Ottawa would risk seriously jeopardizing the financial situation of the government. On the longer term, if the projections of the ministère des Finances are right and the debt decreases as planned, the markets and agencies could possibly reward the efforts of the government.

Towards an increase of electricity rates eventually?

In general, the 2006-2007 budget has little new major initiatives. Of course, today's budget plan proposes many measures, but the financial scope of these measures is rather limited. The Québec government did not really have much leeway. Accordingly, the total financial impact of these new measures (excluding the new capital expenditures) announced in the 2006-2007 budget totals no more than \$290M for the next fiscal year and \$560M for 2007-2008.



As a result, we feel that the most important initiative seems to be the establishment of a Generations Fund. This fund is definitely a step in the right direction. It is similar in part to our proposals concerning the challenge of public finances¹. However, we feel that the measures that were announced are inadequate.

On the one hand, the amounts allocated to this fund will be rather modest in the short term. The ministère des Finances plans to allocate a total of \$464M over the next two fiscal years while the net debt will increase by close to \$2B over the same period.

On the other hand, we feel that the government projections seem ambitious and we are sceptical about its ability to accumulate \$30B by 2025-2026 and reach its objectives of bringing down the debt-to-GDP ratio to 25%. Yet, this target is the current provincial average and this needs to be qualified. First, excluding Québec, which has one of the worst balance sheets in terms of public debt, the current average of other provinces is much lower, i.e. around 20%. Second, everything leads us to believe that the other provinces will improve their bottom line as regards the debt over the next few years so that average debt-to-GDP ratio of Canadian provinces should decrease by 2025.

Lastly, even if the government does not mention it, it would be unrealistic to believe that the establishment of royalties for Hydro-Québec, the payment of part of its profits from electricity exports and the improvement of increased efficiencies for the public producer will not have an impact on its profitability. In the end, the Régie de l'énergie could be forced to increase electricity rates to ensure the mid- and long-term profitability of Hydro-Québec and its constituent entities.

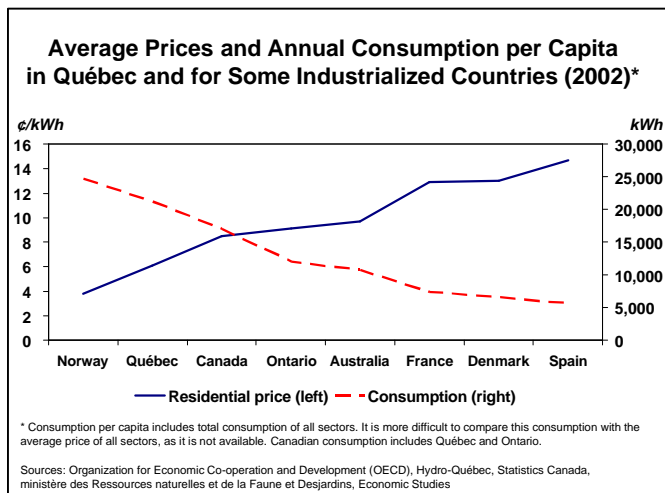
As we proposed it in our document on restoring Québec's fiscal situation, we feel that it would have been also appropriate

to increase electricity rates slightly in order to lighten the government's debt burden. This would provide the advantage of better monitoring the future progress of electricity rates and the amounts earmarked for the repayment of the debt while helping to alleviate the impact of the rate increases on low-income households.

The abundance and size of hydro-electric resources in Québec as well as the ecological aspects justify an increase in electricity rates. This operation is profitable in the very short term as it provides the amounts needed to pay down the debt. Québec is the second largest consumer of electricity per capita in the world! There is currently an overconsumption, if not waste, of hydro-electric resources. Applying low electricity rates (lower than those in effect outside Québec) leads to a revenue loss, indeed a shortfall for society. In addition, it is a socially regressive measure: it benefits to the more fortunate consumers, i.e. those who consume the most electricity. Pricing these public services adequately brings the reality of the costs at the forefront in the efficient use of resources.

Comparatively, according to the ministère des Finances, the Generations Fund project should help reach the current average of Canadian provinces in 19 years in terms of debt-to-GDP. Our estimates indicate that this objective could be reached more rapidly through supervised increases of electricity rates. For instance, a 5% increase per year would help reach the average price on the North American market in seven to eleven years and catch up with the current average debt per capita ratio of Canadian provinces in eleven years. A more ambitious situation, with 10% increases per year, would help catch up with Canadian debt standards in eight years.

In closing, it is unfortunate that the ministère des Finances du Québec did not establish, as the federal government and many provinces did, an annual reserve for contingencies. A reserve would not only help protect public finances against the ups and downs of economic circumstances, it would also guarantee reaching a balanced budget. Bear in mind that the government had constantly anticipated balanced budgets over the last few years, which did not prevent it from ending up with a deficit during 2002-2003, 2003-2004 and 2004-2005.



¹ See "Rectifying Québec's fiscal situation - A priority, critical challenge" published jointly by Mouvement Desjardins Economic Studies and the Centre interuniversitaire de recherche en analyse des organisations (CIRANO) available at www.desjardins.com/economy