Economic Viewpoint

February 20, 2007

Desjardins
Economic Studies
www.desjardins.com/economics

Québec Budget

Analysis on the 2007 Québec Budget

A budget focused on the government's record and not on new initiatives

François Dupuis
Vice-President and Chief Economist

Benoit P. Durocher
Economist

Francis Généreux
Economist

Phone: 514 281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Highlights

As Minister of Finance Michel Audet is leaving political life in the near future, this, his last budget, is remarkably modest, given the election context that should probably get under way tomorrow in Quebec. It involves measures that are relatively timid with a mere $422.8M in 2007-2008. In the budget documents, the government was looking to showcase its record rather than future projects that it could put in place if it won a second term.

Even so, the Minister of Finance did manage to stay within his financial framework by capping expenses despite the pressures that are usually made in a pre-election context. Yet, the total debt of the Quebec government keeps going up even if new amounts will be allocated to the Generations Fund created last year. The main points in the Budget Speech include:

- The budgetary expenditures of the Quebec government will reach $60,823M as of March 31, 2008, including debt service, i.e. 20.6% of GDP.
- The increase in program spending anticipated for the next fiscal year stands at $2,075M (+ 4.0%). Nearly two third of this increase is allocated to health and social services and over one quarter to education. The expenditures of other departments are limited to a 1% increase.
- Several fiscal measures concerning individuals are put in place, among which: the taxable income threshold is increased starting January 2008; the retirement income is split, as in the case of the federal government; and the amount of tax credit for retirement income is increased by $500, i.e. from $1,000 to $1,500.
- For businesses and regions, fiscal measures totalling $212M in 2007-2008 and $314M in 2008-2009 are set out to support the economic development or boost investments.

Summary of budgetary transactions

In millions of $	2004-2005	2005-2006	2006-2007f	2007-2008f	2008-2009f
Own-source Revenue	44,381	45,744	48,533	48,021	49,209
- Ann. var. in %	5.9	3.1	6.1	-1.1	2.5
Federal Transfers	9,229	9,969	10,956	12,241	11,848
- Ann. var. in %	-1.5	8.0	9.9	11.7	-3.2
Total Budgetary Revenues	**53,610**	**55,713**	**59,489**	**60,262**	**61,057**
- Ann. var. in %	**4.5**	**3.9**	**6.8**	**1.3**	**1.3**
Operational Expenditures	-47,656	-49,230	-51,519	-53,594	-55,178
- Ann. var. in %	5.1	3.3	4.6	4.0	3.0
Public Debt Charges	-6,853	-6,875	-6,990	-7,229	7,170
- Ann. var. in %	3.0	0.3	1.7	3.4	-0.8
Total Budgetary Exp.	**-54,509**	**56,105**	**-58,509**	**-60,823**	**-62,348**
- Ann. var. in %	**4.8**	**2.9**	**4.3**	**4.0**	**2.5**
Appropriation Reserve	--	--	-500	500	--
Generations Fund	--	--	-500	--	--
Difference to be absorbed	--	--	--	--	995
Net Results of Consolidated Organizations	235	429	37	61	296
Budget Balance	**-664**	**37**	**17**	**0**	**0**
Non Budgetary Surplus	246	-246	-1,882	-1,062	-546
Net Results of the Generations Fund			575	446	726
Net Financial Requirements	-418	-209	-1,290	-616	180
Total Debt (excluding loan prepayments)	116,596	118,302	122,427	125,406	127,562
Total Debt over GDP (%)	44.3	43.2	43.1	42.3	41.6
Total Debt Service on Budgetary Revenues (%)	13.1	12.6	12.2	12.4	12.3

f: forecasts; --: not available

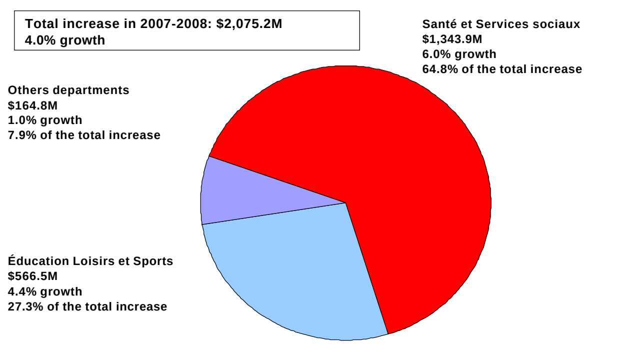
Source: Ministère des Finances du Québec

- The fiscal balance has been maintained in 2006-2007, with a slight surplus of $17M. Strong growth in federal transfers and the sale of Hydro-Québec assets helped maintain this balance and the government was able to set aside two $500M amounts, one for the Generations Fund and the other to fund the settlement of pay equity.

- The government of Quebec also expects to keep balancing its budget during the next two fiscal years. However a $995M “difference to be absorbed” remains for 2008-2009.

- The Minister of Finance did not incorporate any budget assumption aimed at settling the fiscal deficit with the federal government.

Health-related expenses take the largest share of the growth in expenses in 2007-2008



Sources: Ministère des Finances and Desjardins, Economic Studies

- Lastly, the government estimates that its total debt will reach $122.4B as of March 31, 2007, increasing by $4.1B in comparison with 2006. According to the budget, it will keep increasing by 4.2%, reaching $127.6B by the end of fiscal 2008-2009.

Optimistic Short-term Economic Forecasts

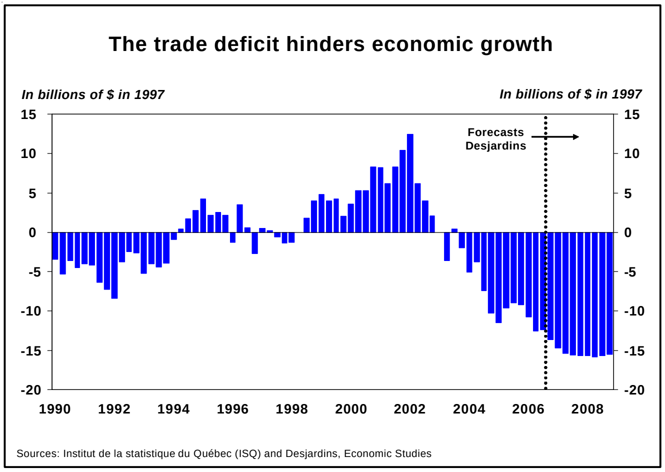
The ministère des Finances is again counting on relatively solid growth by the Quebec economy to be able to reach a fiscal balance over the next budget years. In working out his budget, Minister Audet relied on a real GDP that will grow by 1.8% in 2007 and 2.5% in 2008. These key assumptions underestimate, especially for the current year, the difficulties that the Quebec economy is facing.

Yet, there remain many pitfalls for Quebec businesses. The loony is still very high, as are the costs associated with higher energy prices, and not including the difficulties in facing stiffer international competition. In addition, the US economy that is so important for our exporters keeps growing at a modest pace, in the words of the president of the Federal Reserve, and many risks keep pointing to deteriorating conditions south of the border. In this context, we feel that the anticipated 2.9% growth of real Quebec exports in 2007 seems much too optimistic. More likely, the external sector (including the anticipated increase in imports) will keep contributing negatively and importantly on the progress of real GDP in 2007 and to a lesser extent

Economic and Financial Forecasts

	2006		2007		2008	
	Estimates and Realized		Forecasts		Forecasts	
Annual Average	Budget	Desjardins Group	Budget	Desjardins Group	Budget	Desjardins Group
Real Gross Domestic Product (in %)[1]	1,7	1,6	1,8	1,1	2,5	2,3
Nominal Gross Domestic Product (in %)[1]	3,9	3,7	4,3	2,8	3,5	4,4
GDP Deflator (in %)[1]	2,2	2,1	2,5	1,7	1,0	2,0
Real Consumption (in %)[1]	3,1	3,1	3,2	2,8	2,4	2,9
International Exports (in %)[1]	0,9	1,0	2,9	-0,4	5,2	2,0
Employment (in %)[1,2]	1,3		1,1	0,8	1,1	1,3
Unemployment Rate (in %)[2]	8,0		8,0	8,2	7,9	7,7
3-month Treasury Bond (in %)[2]	4,01		4,00	3,90	4,00	4,06
10-year Bond (in %)[2]	4,21		4,50	4,15	4,90	4,85
Canadian Dollar (US¢)[2]	88,20		86,10	85,30	86,20	91,60
WTI Oil (US$)[2]	66,10		62,13	59,00	59,86	72,00

[1] Average annual growth.
[2] Figures realized for 2006.
Sources: Ministère des Finances du Québec and Desjardins, Economic Studies



in 2008. In fact, we feel that the adjustment of the Quebec economy, and especially the manufacturing sector that lost 25,600 jobs in 2006, is particularly sluggish and that there could be more bad news. Yet, the Minister of Finance sees somewhat of an upturn in sectors such as office supplies, chemicals and industrial machinery.

However, it is true that Quebec domestic demand continues to be healthy. Undoubtedly, the amounts allocated retroactively to the settlement of pay equity ($1.9B) that will begin to be distributed this year and the adjustments to wage increases should help maintain a healthy pace for consumer spending and, hopefully, household savings. Unfortunately, an interruption in the progress of the labour market will limit these gains. A lower level of activity in housing construction also needs to be considered. The Minister of Finance is also counting on a marked increase of nominal GDP, reflecting rapid growth in prices measured by the GDP deflator, all of which favours comparisons of budgetary data with regard to the nominal GDP.

However, it needs to be underlined that our expectations concerning the 2007 interest rates, especially as regards the 10-year rates, will be lower than those of the government. So, the cost associated with debt servicing could be a little lower in this year than what the minister is anticipating.

The economic and financial forecasts appear to be more conservative and realistic for fiscal 2008-2009. The expectations of the ministère des Finances are then very close to our own, at least in general. For 2008, our forecasts concerning the external sector remain even less positive, but the indicators tied to domestic demand show significant signs of improvement for the economy.

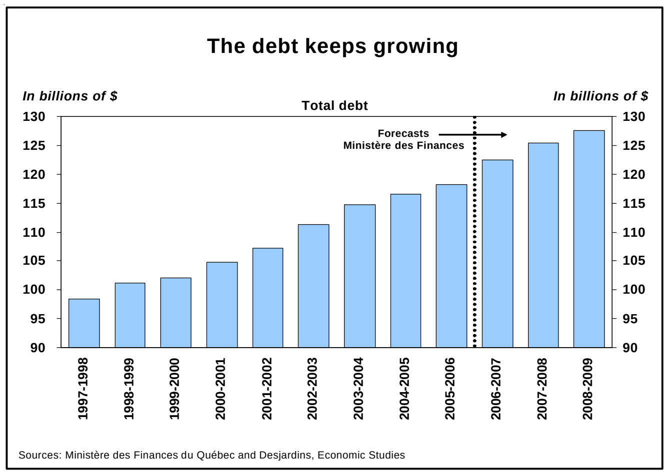
The Debt Keeps Growing…

The government of Quebec demonstrated some determination last year in facing the issue of the province's public debt by creating the Generations Fund. Bear in mind that the province of Quebec is one of provincial governments with the highest debt in North America. The weight of the total debt, which currently stands at 43.1% of nominal GDP, is a heavy burden for Quebec taxpayers. In addition, it hinders the financial leeway of the government as the payment of interests monopolizes $7.2B, i.e. a little over 12% of budgetary revenues. Admittedly, this ratio is lower than the 17.7% peak reached in 1997-1998, but it remains high in comparison with other governments.

The payment of Quebec's debt is all the more important given that baby-boomers who are gradually reaching retirement age will hold up and even eventually decrease the size of the working-age labour force, which will inevitably be felt in tax inflows. The ageing population will cause health expenses to increase while the replacement and modernization of public infrastructures will require important outlays. In this context, we can only support any initiative, such as the Generations Fund, whose objective is to cut down Quebec's public debt.

Unfortunately, we must acknowledge that the direction given currently to the Generations Fund is clearly inadequate in settling the issue of the debt once and for all. The figures speak for themselves: the government deposited $575M in the Fund in 2006-2007 while the government's other financial requirements (budgetary balance, investments and loans, fixed assts, other factors) reached $4.7B for the same period. In the end, the total debt of the Quebec government grew by $4.1B in 2006-2007 despite the amounts allocated to the Generations Fund. In other words, the ministère des Finances should have deposited a little more than eight times more in the Fund just to strop the growth of the total debt. We are still way far for cutting down the debt.

According to the government's forecasts, everything leads us to believe that this situation will not improve in the coming years and that the anticipated deposits in the Generations Fund will only represent a small part of the increase in the total debt. The government's initiative may be commendable, it is however obvious that the current efforts are clearly inadequate to reduce the government's debt. Of course, as long as the fiscal imbalance between the federal government and the provinces is not settled, we feel that it will be difficult for the government to do more while staying within its budgetary framework. Bear in mind that we proposed last year another alternative to ease the payment of the debt, i.e. a controlled and



gradual increase in electricity rates to bring them more in line with the average North American rates.

However, it must be noted that despite a debt that keeps growing, the ratio of the total debt over nominal GDP decreased in the last few years. This decrease can be explained by more rapid growth, in current dollars, of the size of the economy than that of the debt. By the way, the government's forecasts indicate that the debt-over-GDP ratio should keep going down over the next few years and reach 25% on March 31, 2026, comparatively with 43.1% at present.

Yet, we feel that this target, which is in line with the current average of the other provinces, seems too high. On the one hand, the other provinces could also bring down their debt over the next few years so that we may not be able to significantly improve our position in relation to the rest of Canada. On the other hand, some aggravating factors (such as population ageing) should encourage the ministère des Finances to give itself some leeway for the future and as a result, aim for an even lower ratio.

Even so, the decrease of the debt-over-GDP ratio paved the way to an improvement of Quebec's credit rating. In fact, Moody's and DBRS both upgraded the province's rating one notch in June 2006. Moody's even proceeded with a second improvement in November, but this last one does not reflect a progress in Quebec's financial situation, rather a methodology change in the calculation method. So, most provinces also benefited from an upgrade in their rating in November and Quebec's relative position in comparison with other provinces has remained practically unchanged. Such news is encouraging, but there is still much improvement to be made as Quebec still has one of the lowest ratings among Canadian provinces.

Prudent-minded, the Minister Announces Few New Measures

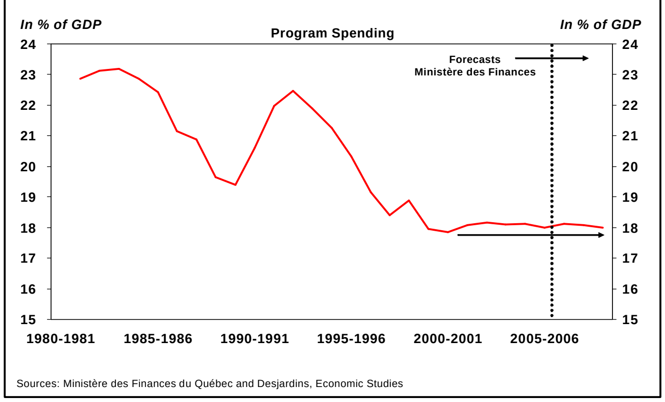
Given a financial context that is still difficult, the budget tabled today by Minister Audet has few new things to offer. The amounts allocated to new measures will only total $1.3B over two years, including only $422.8M for the fiscal year beginning on April 1, 2007. However, this timidity has obvious qualities for the financial health of the government. The financial balance is maintained (over

Main Growth Factors for the Government's Debt

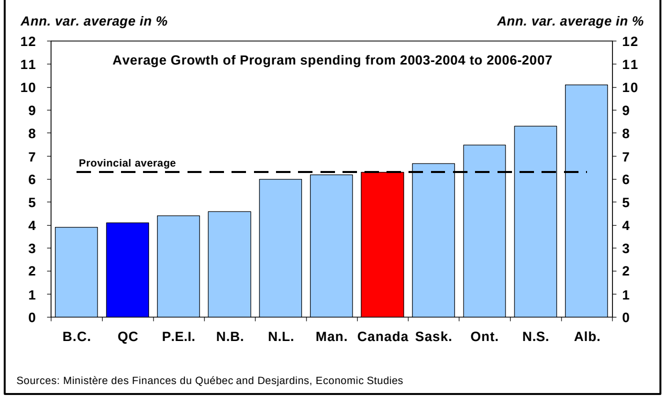
In millions of $	Debt at the Beginning of the Year	Budgetary Surplus (Deficit)	Investments, Loans and Advances	Net Fixed Assets	Other Factors	Generations Fund	Total Debt at the End of the Year	In % of GDP
1998-1999	98 385	-126	1 402	217	1 235		101 113	51,5
1999-2000	101 113	-7	2 006	359	-1 351		102 120	48,4
2000-2001	102 120	-427	1 632	473	1 050		104 848	46,6
2001-2002	104 848	-22	1 142	995	212		107 175	46,3
2002-2003	107 175	728	1 651	1 482	306		111 342	46,1
2003-2004	111 342	358	1 125	1 019	881		114 725	45,8
2004-2005	114 725	664	979	1 083	-855		116 596	44,3
2005-2006	116 596	-37	1 182	1 166	-605		118 302	43,2
2006-2007[f]	118 302	-17	1 672	1 342	1 703	-575	122 427	43,1
2007-2008[f]	122 427	-	1 692	1 954	-221	-446	125 406	42,3
2008-2009[f]	125 406	-	1 841	1 404	-363	-726	127 562	41,6

Sources: Ministère des Finances du Québec and Desjardins, Economic Studies **f: forecasts**

Since the beginning of the decade, program spending is growing as fast as the economy



Growth in program spending is turning out to be lower than in most other provinces



and above the $995M difference to be absorbed in 2008-2009) and the increase in program spending turns out to be lower than the estimates of the ministère des Finances on the growth of nominal GDP. In fact, the weight of the program spending of the Quebec government remains around 18%, the average since fiscal 1999-2000. Thanks to this restraint, the Liberal government expects to repeat its performance with regard to the progress of program spending, which turned out to be the lowest among Canadian provinces since 2003-2004, except for British Columbia.

The most expensive measure for the Minister of Finance involves the increase in the taxable income threshold of the tax table for individuals starting on January 1, 2008. The shortfall for the government will reach $50M for 2007-2008 and $250M for 2008-2009. All the initiatives aimed at lightening the tax burden of individuals, including many measures on retirement income, will cost $166.8M in 2007-2008 and $539.3M in 2008-2009.

Many measures aimed at encouraging the development of regions are also announced. Among them, are the amounts for the Fonds de développement régional and the support for the development of niches of excellence. These measures total $138M for 2007-2008 and $143M for 2008-2009. Over five years, $825M will be allocated to these initiatives.

In this budget, Minister Audet is also looking to encourage private investments by businesses, namely in the manufacturing sector that is experiencing serious difficulties in the current economic context. The key investment support measure aims at getting rid of capital tax on new investments and eliminating the tax applicable on the facilities and current equipment for manufacturing businesses. For the coming fiscal years, the amounts will reach $74M in 2007-2008 and $171M in 2008-2009. Over five years, some $840M will be allocated to this tax easing for businesses. By 2012, the government expects to have cut capital tax by 92% for businesses in the manufacturing sector and by 57% for businesses involved in other sectors. According to Minister Audet, investment taxation will at that point be comparable to that of Alberta.

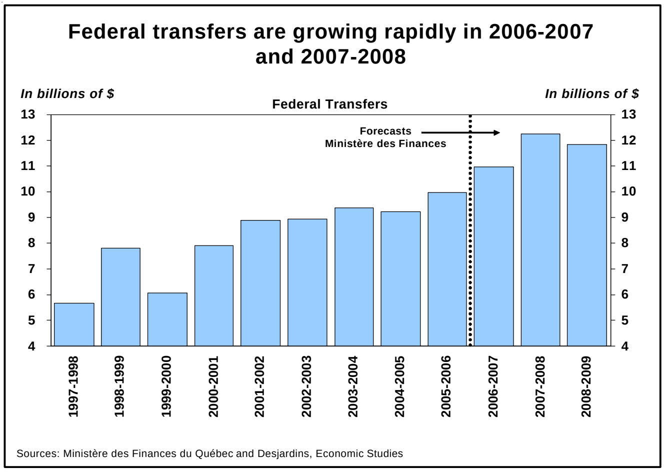
Other budgetary measures are intended to promote culture with a little under $40M allocated over two years. There are also amounts for public transit, namely for the funding of the Montreal metro. In contrast, the government will collect $20M over two years as it gradually cuts the tax holiday for resource regions.

Federal Transfers and Fiscal Imbalance

Even if the fiscal imbalance issue between the federal government and the provinces is not settled yet, the ministère des Finances still anticipates a significant increase in federal transfers. As a result, the federal transfers should increase by 9.9% in 2006-2007 zooming up to 11.7% in 2007-2008, due to the increased equalization income stemming from the announcement by the federal government last January 16. The ratio of federal transfers on all budgetary revenues should then reach 20.3% in 2007-2008, i.e. the highest level ever in over 10 years.

These transfers could increase even more in the near future as the federal government recently announced that it wanted to fully or partly settle the fiscal imbalance issue in its next budget. Even if we will have to wait for the tabling of Minster Flaherty's budget, planned for March 19, 2007, to know in detail the additional amounts that will be paid to Quebec, we can hope that the federal government will transfer part of its financial leeway to the provinces.

Even if these additional amounts are not included in today's budget, the Quebec government is visibly counting on an increase in federal transfers over the next few



years. For instance, a significant share of a possible increase in transfers could, according to Minister Audet's comments, be used to absorb the $995M shortfall identified for 2008-2009. In such a case, the surplus of new federal transfers could fund new initiatives in education or health. We would hope however that the Quebec government limit its new programs and that it allocate part of its new leeway, like the Federal government did, to establishing a contingency reserve and a controlled plan for a genuine repayment of the debt. This strategy has proven itself in Ottawa as the net debt of the federal government has gone down by $72B since 1996-1997 (i.e. from 72% to 38% of GDP ratio).

Impact on Financial Markets

The budget tabled today by the ministère des Finances will have very little immediate impact on financial markets. Not only does the likely election call on Wednesday mean that it is possible that this budget will never be voted upon, but the new proposed initiatives are all in all very modest. Admittedly, investors could be put at ease by the $1.7B deposited in the Generations Fund by 2008-2009, although we mentioned previously that these amounts are clearly inadequate to prevent an increase of the debt. As a result, the relative debt situation of Quebec in comparison with other provinces should not improve significantly and we foresee no great fluctuations in the spreads between the interest rates of debt instruments of the Quebec government and those of other provinces. However, we must underline once again that the lack of a genuine contingency reserve ensures that the government's financial framework remains vulnerable to the ups and downs of the economic, political and financial conditions.

Conclusion: a Non Electoral Budget

On the eve of an election call, it was feared that minister Audet's last budget would be filled with a host of announcements aimed at satisfying a wide range of electors. However, the new initiatives unveiled today are all in all relatively limited and, for the most part, they stay within the relatively shaky financial framework of the government of Quebec. The ministère des Finances simply did not have the means to embark on large-scale measures. Bear in mind that the 2006-2007 budget year would have ended on a deficit were it not for the sale of almost $1B of Hydro-Québec assets and that a shortfall of almost $1B remains for fiscal 2008-2009.

In addition, the pre-budget consultations of the last few weeks seemed to suggest that today's budget would focus on the different regions of Quebec. But the budgetary measures aimed at the regions are finally relatively limited, which could cause some disappointments. The new specific initiatives for the regions total a mere $138M for 2007-2008, which represents only 33% of all the new measures. Bear in mind that Quebec has 17 administrative regions and that, as a result, each of them will only receive on average around $8M in 2007-2008.

In closing, keep in mind that this budget may never be adopted by the Assemblée nationale. Depending on the result of the coming elections, a win by the Parti Québécois or the Action démocratique du Québec or even the election of a minority government could probably mean that an entire new budget would be tabled in the spring for the 2007-2008 budget year.