

## Québec Budget 2008: Above all, keep it in balance

**With no room to manoeuvre, Québec should focus its attention on improving the effectiveness of the tax system and the efficiency of the economy**

The theme chosen for the Québec government's pre-budget 2008 consultations was the prosperity of the Québec economy. This was particularly appropriate in a situation where many businesses are struggling to cope with the impacts of a strong loonie, accelerated market globalization, a sharp increase in energy costs and, recently, sagging U.S. demand for goods and services. Since then, the federal budget has been tabled, and the federal Finance Minister emphasized prudence and discipline in his speech. Those words were quickly picked up by the Québec Finance Minister, Ms. Jérôme-Forget, to set the tone for her budget, scheduled for release next week. She will have to factor in an economic downturn which is likely to affect her revenues, and she would be roundly criticized if, at this point, she were to announce a deficit for the 2008-2009 fiscal year.

### HAVE WE BEEN TOO FOOLHARDY?

As far as the 2007-2008 budget is concerned, the Update on Québec's Economic and Financial Situation that was released last fall revealed tax revenues that were \$699M higher than those forecast in the budget presented in May 2007. That provided a nice cushion. However, government program spending also rose by \$302M for the same year, eroding nearly half of the manoeuvring room generated by the higher revenues. At the same time, an extra \$801M in forecast budget revenues had been added for the 2008-2009 fiscal year. Those extra revenues encouraged the government to increase its program spending forecasts by \$598M during the next year.

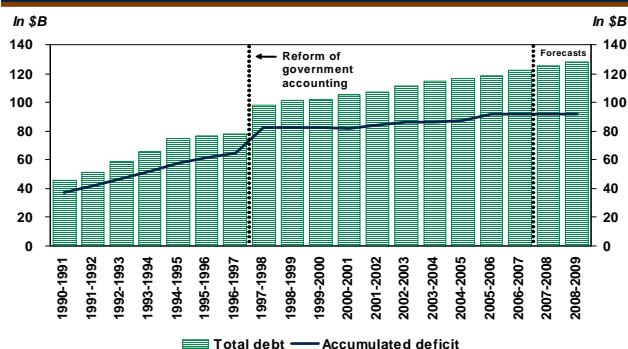
Given the current economic climate, the upward revision of spending seems to have been inappropriate. The uncertainty about the future of the economy should have led the government to be more cautious. Consequently, a

return to the original budget forecasts of the 2007 budget would be appropriate in a context where the economic growth of 2.2% forecast for 2008 in the Update presented last fall (and revised from the figure of 2.5% called for in the 2007 budget) is now 1.5%. The extent and the duration of the economic slowdown may have a significant downward effect on revenues and, consequently, on the budget balance. The risks of returning to a deficit position are not unlikely in the event that the downturn in the American economy lasts for some time.

### THE TOTAL DEBT REMAINS WORRISOME

The Québec government's total debt will reach \$127.8B<sup>1</sup> by the end of the 2008-2009 fiscal year, according to the latest forecasts of the ministère des Finances (graph 1). At that point, it will represent 41.7% of GDP. Despite a

Graph 1 – The debt continues its ascent



Sources: Ministère des Finances of Québec and Desjardins, Economic Studies

<sup>1</sup> The debt data are from the 2007-2008 budget, released in May 2007, before the accounting reform. These data will be revised with the next budget.

**François Dupuis**  
Vice-President and Chief Economist

**Yves St-Maurice**  
Director and Deputy Chief Economist

**Benoit P. Durocher**  
Senior Economist

514-281-2336 or 1 866 866-7000, ext. 2336  
E-mail: [desjardins.economics@desjardins.com](mailto:desjardins.economics@desjardins.com)

**NOTE TO READERS:** The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

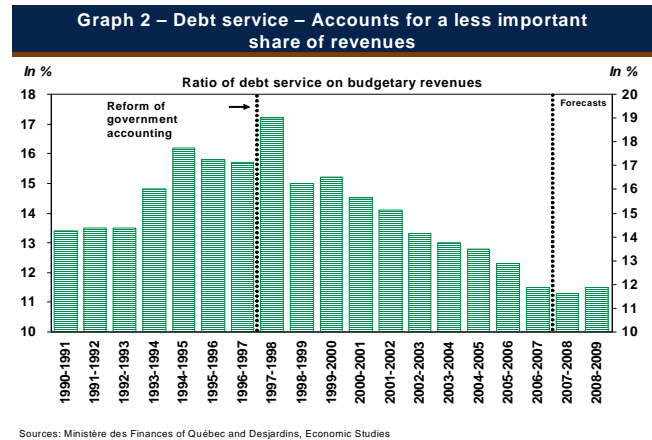
**IMPORTANT:** This document is based on public information, obtained from sources that are deemed to be reliable. Desjardins Group in no way guarantees that the information is complete or accurate. The document is provided solely for information purposes and does not constitute an offer or solicitation for purchase or sale. The document may under no circumstances be construed as a commitment by Desjardins Group, which takes no responsibility for the consequences of any decision made based on the information herein. The prices and rates shown are for information purposes only as they may change at any time based on market conditions. Past returns are no guarantee of future performance, and Desjardins Group does not hereby purport to provide any investment advice. The opinions and forecasts contained herein are, unless otherwise indicated, those of the document's authors and do not represent the official position of Desjardins Group. Copyright © 2008, Desjardins Group. All rights reserved.

consolidated budget balance pursuant to balanced budget legislation which is very slightly positive in 2007-2008 and a growing, albeit still small, balance in the Generations Fund, the government's total debt is continuing to rise, mainly due to capital investments. Now, taking on debt in order to invest is not necessarily a sin in itself. On the contrary; the investment generates benefits over a long period (in theory), especially if they are productive. It is therefore logical to spread the cost out over a long period of time. However, one must use this tool carefully because an increase in public debt implies, among other things, an increase in the servicing of the debt which has a direct impact on financial results, and could be inequitable from an intergenerational point of view.

It would be foolish to believe that the major infrastructure investment plan, which calls for an average annual injection of \$5.9B over the next five years, will have no impact on the province's indebtedness. Due to the rule that only the depreciation of capital assets is accounted for in budget expenditures, the funding of investment projects necessarily generates an increase in the debt. Said increase is justifiable, however, as long as it is based on the creation of productive assets. In this situation, we should instead aim for a reduction of the debt excluding financial and physical (real estate) assets. That debt, which represents accumulated deficits, stands at \$91.7B<sup>1</sup>. This should be equivalent to 29.9% of GDP in 2008-2009, which is fairly similar to what is recorded in Canada. However, we believe it is of primary importance that Québec continue investing in these infrastructures. They have greatly suffered from inadequate funding for several decades now, and intensive catching up is necessary. In that sense, the government's current infrastructure program is a step in the right direction, and we encourage the ministère des Finances to continue along that road.

The ministère des Finances's figures show that the debt representing accumulated deficits has remained practically unchanged since 2005-2006. We would like to see it reduced, to the extent possible. However, according to the government's figures, servicing of the debt will represent approximately 11.3% of the province's budget revenues in 2007-2008 (graph 2). At the federal level, that same percentage is estimated at 13.5%. In a period of economic slowdown, one must be sure of keeping control

by maintaining a balanced budget if possible, or failing that, a slight deficit. However, keeping a balanced budget does not mean doing nothing!



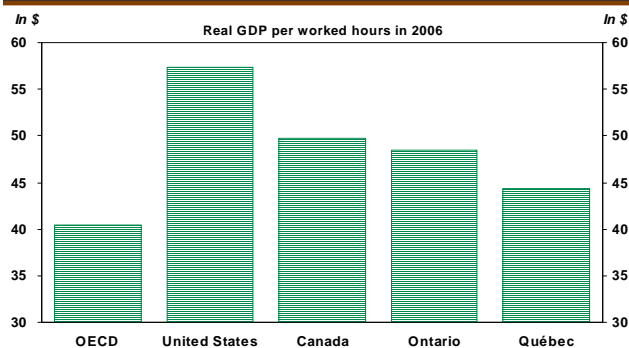
**WHAT TO DO WHEN THERE IS BARELY ANY ROOM TO MANOEUVRE?**

When a government is faced with limited financial room to manoeuvre, it should not throw up its hands and restrict itself to the status quo. It must find imaginative ways to improve the efficiency of the economy and create conditions that are conducive to enhancing the population's current and future prosperity. Québec's current woes extend beyond the manufacturing sector; in fact, many indicators tell us that Québec is losing ground compared to its adjacent neighbours as far as overall prosperity is concerned. For example, public infrastructures are suffering from several decades' worth of chronic under-funding, and businesses are not investing to the same degree as the majority of our trading partners. Moreover, these weaknesses will soon be exacerbated by the population decline that will materialize in the years and decades to come. In the end, it is Québécois' standard of living that is in the process of deteriorating. Therefore it is essential to act quickly to avoid a new widening of the prosperity gap separating Québec and its partners.

Individuals, businesses and governments all have a role to play to turn the situation around. To that end, we need to reduce the productivity gaps between Québec and its neighbours and trading partners (graph 3), and adopt a labour supply policy to lessen the impact of an aging population, among other things. We need more workers in the job market and they need to remain active in it for longer. It is also essential that they contribute towards improving their own productivity through higher levels of

<sup>1</sup> The debt data are from the 2007-2008 budget, released in May 2007, before the accounting reform. These data will be revised with the next budget.

Graph 3 – The Quebec economy is less productive



Sources: Ministère des Finances of Québec and Desjardins, Economic Studies

education or ongoing training. Businesses must also promote higher productivity by training their workforce in the workplace and by making new, productive investments. Even entrepreneurs need to take care to upgrade their expertise to maximize their chances of succeeding against increasingly fierce international competition. The government must also create an environment that is conducive to the improvement of prosperity, be it by renewing public infrastructures, achieving greater efficiency in the administration of public funds, and a more effective taxation system that would rely more on consumption taxes and less on individual income tax.

### POLICIES TO IMPROVE WORKER PRODUCTIVITY

Productivity is one of the major levers that can help us improve, or at least retain, our current standard of living. This issue is particularly important given the gap that has been observed between Québec and its main trading partners. Since Québec's productivity is less than that of Ontario or of the United States, Québécois' standard of living could continue losing ground compared to their neighbours unless the situation is addressed quickly. Comparisons with some countries that belong to the OECD already show that Québec has dropped from 12th place in 1982, to 17th place in 2006, in this respect (table 1).

The two main factors that make it possible to increase an economy's productivity are manpower and capital. On the manpower side, a better education and on-job training generally produce significant gains in productivity. Accordingly, the government should not only provide an accessible, high-quality education, but must also encourage businesses to provide ongoing training to their workers. We must also encourage dialogue between successful business people and young entrepreneurs who are striving

**Table 1**  
Comparisons of the standards of living of certain OECD countries, Québec and Ontario

Country	Rank		Level in CAN\$
	1982	2006	
Switzerland	1	7	39 885
Luxembourg	2	1	75 860
Ontario	3	5	41 117
United States	4	3	45 247
Iceland	5	6	40 353
Norway	6	2	47 730
Canada	7	8	39 303
Sweden	8	9	38 523
Austria	9	11	37 708
Denmark	10	12	37 676
Québec	12	17	33 966
Netherlands	13	10	37 708
Finland	18	14	36 140
Ireland	24	4	42 499

Sources: Ministère des Finances of Québec, Statistics Canada and Organisation for Economic Co-operation and Development

to build prosperous companies. It is also essential that the government increase the rates of graduation from vocational, technical and university programs. Special attention must be paid to school drop-out rates, a scourge that particularly affects young boys. Finally, strong support for the retraining of laid-off workers so they may acquire new skills and find jobs in other sectors or businesses with strong potential for development would be extremely beneficial.

It is also undeniable that universities are currently suffering from acute under-funding which must inevitably be dealt with in order to preserve, for the long term, the quality of teaching and research which are essential to Québec's ability to innovate. The accessibility of education and adequate funding of the education network are not irreconcilable.

In addition, adapting the workforce to the structural changes in our economy requires government action to ensure that Québec workers can adequately meet businesses' new needs. The government should therefore assist employees in low value-added industries, which are condemned to face chronic problems due to globalization, to retrain and qualify to work in other sectors that are growing or that show greater potential. Such new qualifications may be acquired either within the education network, or through on-job training and internships.

As far as capital is concerned (the other factor that generates productivity gains), it can be used to modernize production capacities, to innovate and to engage in research and development. Comparisons with the other provinces show that Québec lags far behind in the area of capital investments. Greater attention therefore needs to be devoted to this aspect.

The reasons for this lag in Québec investments, especially in the private sector, are difficult to pinpoint exactly. We should mention, though, that the lack of private investment in Québec is probably due in part to a lack of incentives, relatively low private saving and an industrial structure consisting of more small and medium-sized companies which are less likely to embark on major projects. In addition, it is very possible that the omnipresence of the public sector captures too great a share of investment and capital, at the expense of the private sector. Lower rates of return have also been pointed at as causal factors.

To attract and promote private investment, we first need sufficient public infrastructures of good quality. Québec needs an efficient road and railway network as well as modern port and airport facilities. It strikes us as essential that, in collaboration with the federal government, Québec continue investing in these infrastructures, giving priority to those projects that provide the greatest economic benefit.

A variety of measures could also be adopted to promote private investment. From a tax viewpoint, the government should eliminate the tax on capital, which curbs investment, and replace it with investment incentives such as investment tax credits, for example. We suggest to the government that it not necessarily focus on existing companies, but rather on those projects that have the greatest potential for generating productivity gains. Neither should it waste resources attempting to save industries that are less competitive, or not competitive at all, and in decline, at the expense of promising industries that could accelerate their development.

Finally, the environment and sustainable development should continue to be among the government's concerns. In particular, improvements to urban and interurban public transit, especially in Greater Montréal, are not only an environmental issue but also affect economic efficiency, since they promote worker mobility.

## **EFFICIENCY OF THE MACHINERY OF GOVERNMENT**

Apart from these considerations relating to Québecers' productivity, there are other important issues concerning Québec's public finances. First of all, we need to promote better efficiency in the Québec economy in general and improve the effectiveness of the machinery of government. One of the first actions that might be taken would be to reduce the number of government agencies (bureaus, commissions, etc.) of which there are still far too many. The savings achieved would convey an image of a much more efficient government administration, besides having an impact on government expenditures. Such a step would show that the government was serious about reforming the machinery of government.

Better government efficiency also requires a long-term, comprehensive strategy for public finances. This implies tax and budget planning over several years, extending beyond the electoral timetable. For example, budget forecasts could be prepared over a two-year horizon, as is done now, but it would be useful to add in three-year forecasts, as the federal government does.

## **A MORE EFFICIENT ECONOMY**

The efficiency of Québec's economy would be greatly increased if greater space were allotted to market forces. With this in mind, we should stimulate competitive reflexes, in particular by removing political considerations from business decisions as much as possible. Private enterprise could play a much broader role in the delivery of public services through public-private partnerships. However, this would entail reviewing, in some cases, the concept of free public services, and the user-pay principle should be encouraged, provided that support is given to the most vulnerable or underprivileged clientele. Moreover, Québecers should pay a price that is more reflective of market realities for the public services they receive, be it tuition fees, electricity charges or any other service.

On the issue of adjustments to electricity rates, it would seem appropriate to repeat here our proposal to raise rates in order to finance the repayment of Québec's debt. In a study published jointly with the CIRANO centre in the winter of 2006, we showed that a controlled increase in electricity rates, combined with compensatory measures for the most destitute members of society, would generate considerable sums that could significantly reduce Québec's indebtedness. This would give the government much more leeway.

Finally, the Québec government should give greater thought to the role of the city of Montréal as the driver of the province's economy. Québec needs the centre of attraction that a strong metropolitan area provides. Montréal brings drive to the labour and investment market that generates significant fallout in the surrounding regions. The demographic and, most of all, economic weight of Québec's major cities gives them the status of inevitable leaders.

### **A MORE EFFICIENT TAX SYSTEM FOR A MORE PRODUCTIVE ECONOMY**

Again in the interest of efficiency, the Québec government should immediately raise its sales tax and redistribute the resulting revenue gains as income tax reductions. The elimination of the tax on capital and the reduction of personal income taxes, financed through an increase of the sales tax, would certainly improve the efficiency of Québec's tax system. In fact, a study by the federal Department of Finance<sup>2</sup> shows that the benefits of reducing taxes on capital are nearly ten times greater than those achieved from an equivalent reduction of the goods and services tax. The benefits of lower personal income taxes would also be approximately twice as great as those gained from a reduction in the GST. Moreover, we believe that, during an economic downturn, revenues derived from the provincial sales tax would be less negatively affected than those derived from personal income taxes. The impact of an economic slowdown on government tax revenues would therefore be alleviated.

### **CONCLUSION**

Even though Québec's prosperity has lost ground compared to its main neighbours in recent years, we are convinced that the situation can be reversed. This text proposes several measures, some of them quite bold, that could help strengthen Québec. Individuals, businesses and government all have a role to play to improve the province's prosperity and productivity. But the time to act is now, because the apprehended contraction in Québec's population and the new geo-economic conditions are such that the desired reversal in prosperity trends will be increasingly difficult to achieve.

The government has made several improvements lately that have been favourably received. The recent accounting

reform and the public infrastructures plan are two examples. We still have a long way to go because, despite large transfers from the federal government and an economic climate that has recently been very positive, the Québec government's room to manoeuvre remains tight. We need to think about the future now, and set up winning conditions to ensure Québec's future prosperity. The next budget should be the starting point of a comprehensive, long-term strategy to meet the next major challenges facing Québec, such as productivity.

We already know that Québec is in for several shocks in the next few decades: the demographic shock that will soon cause a labour shortage, climate change and aging infrastructures. We must immediately put long-term policies into place with the goal of increasing the supply or the capacity of economic production and achieve a better distribution of resources in order to better withstand the shocks that are coming. We must stop being constantly distracted by the adoption of counter-cyclic policies, and stop neglecting the fundamental aspects of those factors that determine the prosperity of our economy.<sup>2</sup>

**François Dupuis**

Vice-President and Chief Economist

**Yves St-Maurice**

Director and Deputy Chief Economist

**Benoit Durocher**

Senior Economist

<sup>2</sup> Maximilian BAYLOR and Louis BEAUSÉJOUR, "Taxation and Economic Efficiency: Results from Canadian CGE Model," Department of Finance, Canada, 2004.