

BUDGET

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QUÉBEC BUDGET SPEECH OF APRIL 21, 2005

- Tax measures
- Economic Viewpoint

INFORMATION BULLETIN



Desjardins
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Office of the Vice-president, Tax Service
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TAX MEASURES

Québec Budget 2005



Office of the Vice-president, Tax Service
www.desjardins.com

April 21, 2005

Minister of Finance Michel Audet tabled his 2005-2006 budget this afternoon. The main focus of the budget is a cut in tax on capital for corporations offset by an important tax increase for corporations that cannot qualify as SMEs.

This budget does not provide any significant tax cuts to individuals. However, this year again, tax assistance for the handicapped is enhanced. The provincial budget is the one with the smallest amount of tax measures in a number of years.

Highlights

Measures affecting Desjardins - Entreprises	Measures affecting individuals	Measures affecting Businesses
<ul style="list-style-type: none"> • Increase of the basic corporate tax rate • New deduction for small corporations • Reduction in the rate of tax on capital for financial institutions • Easing of the requirements for investment by tax-advantaged funds • International financial centres (IFC) • Tax depreciation of works of art by a Canadian artist • Entertainment expenses with a limited deduction • Deposit insurance coverage limit 	<ul style="list-style-type: none"> • Implementation of a new parental insurance plan • New \$500 deduction for workers • Improvement of the tax assistance for handicapped persons • Changes to the tax assistance for a minor child with an impairment • Increase of the tax credit for natural caregivers • Amount for postsecondary studies granted for a handicapped child • Liste of eligible medical expenses • Improvement of the refundable tax credit for medical expenses • Tax treatment on the proceeds of the sale of a servitude • Introduction of a new stock savings plan 	<ul style="list-style-type: none"> • Changes of the tax on capital for corporations • Re-introduction of the refundable tax credit for major employment-generating projects • Adjustements regarding certain certain credits • Increase of the R&D tax credits • Adjustment of the refundable tax credit for design

MEASURES AFFECTING DESJARDINS - ENTREPRISES

Increase of the basic corporate tax rate

Corporations are currently subject to the payment of Québec tax on their taxable income. A 16.25% rate is applied on passive income while a 8.9% rate is applied on active income.

The applicable tax rate for active income will be increased gradually, from 2006 to 2009, as follows:

Current	2006	2007	2008	2009
8.9	9.9	9.9	11.4	11.9

This three-percentage-point increase of the basic rate represents in fact an increase of 34% of tax relative to the active income.

These increases will come into effect on January 1 of each year. For corporations whose financial year does not coincide with the calendar year, the applicable rate will be a weighted rate based on the number of days of the financial year in each of the calendar years.

New deduction for small corporations

To counter the impact of this increase in the basic rate for small corporations, the budget proposes to reintroduce a "deduction for small corporations." This deduction will apply only on the first \$400,000 of active income and the ceiling must be shared among associated corporations.

The rate of the tax deduction will be gradually increased in relation to the increase of the basic rate applicable to active income. As a result, by January 1, 2006, the applicable net rate for eligible income for this deduction will be 8.5%.

The rates in effect are as follows:

	Current	2006	2007	2008	2009
Basic rate	8.9	9.9	9.9	11.4	11.9
Small-business deduction	(0)	(1.4)	(1.4)	(2.9)	(3.4)
Net rate	<u>8.9</u>	<u>8.5</u>	<u>8.5</u>	<u>8.5</u>	<u>8.5</u>

In addition, the \$400,000 ceiling will not be available to a corporation with a paid-up capital over \$15M for purposes of the tax on capital for the previous year. This ceiling will also be gradually be lost for corporations with a paid-up capital between \$10M and \$15M.

For financial institutions, including credit unions, the paid-up capital for purposes of the gradual deduction of the small-business deduction will be equal to double the paid-up capital otherwise determined. Accordingly, the credit unions with a paid-up capital over \$7.5M will not be able to benefit from the small-business deduction.

Reduction in the rate of tax on capital for financial institutions

Financial institutions currently pay tax on capital at a rate of 1.20% of the paid-up capital.

Starting in 2006, this rate will be gradually decreased reaching 0.58% in 2009. This reduction will be implemented as follows:

Current	2006	2007	2008	2009
1.20	1.05	0.98	0.72	0.58

For financial institutions whose financial year does not coincide with the calendar year, the applicable rate will be a weighted rate based on the number of days of the financial year in each of the calendar years.

Easing of the requirements for investment by tax-advantaged funds

In Québec, there are three main tax-advantaged funds: Capital régional et coopératif Desjardins (CRCD), Fonds de solidarité des travailleurs du Québec (FTQ) and Fondation (CSN). These funds are subject to specific requirements for investment. In this budget, the rules have been eased.

For the purposes of the 60% requirement imposed on CRCD, an eligible entity includes a company or partnership that actively carries on a business, the majority of whose employees reside in Québec and whose assets are less than \$50M or whose net equity does not exceed \$20M. The budget increases the amounts respectively to \$100M and \$50M.

Amendments were recently brought to prevent the 60% requirement from limiting the corporation's participation in major projects with a structuring effect on the Québec economy. Lastly, clarifications were brought with respect to CRCD investments in local venture funds for purposes of the 60% requirement.

For the FTQ and CSN funds, similar measures to ease their investment requirements have also been introduced.

International financial centres (IFC)

To support the city of Montréal as an international finance centre, the government is renewing its commitment to maintain, until at least 2008, the tax benefits granted to IFC operators.

In addition, the government, in concert with the stakeholders concerned, will study over the coming months the relevance of focusing the efforts of the IFC program on the growth role of financial risk management and will review, where applicable, the mission of IFC Montréal, the organization in charge of its promotion.

Tax depreciation of works of art by a Canadian artist

The budget raises from 20% to 33 1/3% the depreciation rate of works of art by a Canadian artist acquired after April 21, 2005.

Entertainment expenses with a limited deduction

Entertainment expenses incurred in the course of carrying on a business are subject to a 50% deduction limit. Some of these expenses have been exempted from the application of this limit. The present budget adds to the activities not subject to the limit different types of performing arts and museum exhibits.

Deposit insurance coverage limit

Quebec government increases from \$60 000 to \$100 000 the maximum insured deposit in Quebec regulated financial institutions. This measure will take effect on the same date as the increase announced by the federal government in its recent budget.

MEASURES AFFECTING INDIVIDUALS

Implementation of a new parental insurance plan

On March 1, 2005, the Québec and federal governments reached an agreement on the implementation of the Québec parental insurance plan on January 1, 2006.

Without disclosing the details of the plan, the budget indicates that the premiums paid by the employer under the *Act respecting parental insurance* will be deductible for the employer and the self-employed worker, while the premium paid by the employee will be included in the worker's personal credits.

In addition, the premiums paid for under this Act will be taxable and subject to source deductions.

New \$500 deduction for workers

Starting in 2006, individuals will be able to deduct an amount equal to 6% of their salaries and eligible businesses for the year, up to \$500. A \$500 deduction represents savings between \$80 and \$120 depending on the taxable income of the individual.

Improvement of the tax assistance for handicapped persons

When the federal budget was tabled on February 23, 2005, measures were introduced to help persons with a mental or physical impairment.

Québec's tax legislation will be amended to incorporate some of the measures announced, including the measure aimed at lengthening the list of products and services recognized for the purposes of the impairment support deduction, as well as the measures concerning the tax credit for severe and prolonged mental or physical impairment

For the 2006 taxation year, the amount used to calculate the tax credit respecting a severe and prolonged mental or physical impairment will be raised from \$2,200 to \$2,250, thereby increasing the maximum tax credit from \$440 to \$450. Afterwards, this amount will be indexed annually.

Changes to the tax assistance for a minor child with an impairment

Since January 1, 2005, the child assistance tax credit was replaced by a supplement for handicapped children, equivalent of the old family allowance. The amount allocated for a child is currently increased when the child has an impairment. The current assistance is \$1,452 annually per handicapped child under 18 years of age.

In their tax return, parents can also claim a tax credit respecting a dependent child with an impairment, which could reach \$440 in 2005.

Starting in 2006, this tax credit respecting a dependent child with an impairment will be replaced by an amount of \$450 to be added to the supplement for handicapped children, as long as the child is under 18.

Increase of the tax credit for natural caregivers

The current legislation provides already for a tax credit that is granted to an individual who houses an eligible parent for a minimum period of one year. Starting in 2006, this credit will include a universal basic amount of \$550, plus a supplement of \$450 that will be reduced on the basis of the eligible relative's income. This supplement will be fully granted up to \$20,000 of income and will be lost when the income of the eligible parent reaches \$22,800.

These parameters will be indexed starting in 2007.

A close relative must be of full age and includes the ascendants and descendants of the individual or his or her spouse, in addition to the nephews, nieces, brothers, sisters, uncles, aunts etc. To be eligible, a close relative must be affected by a severe and prolonged physical or mental impairment, except if the individual is 70 or older and that this individual is the father, mother, grand-parent or other ascendant of the caregiver or his or her spouse, or the uncle, aunt, great uncle or great aunt of the caregiver or his or her spouse.

In general, the minimum housing period will be 365 consecutive days, 183 of which in the year. For handicapped persons under 70, the required housing period is 90 days as long as other relatives care for this individual during the year.

Amount for postsecondary studies granted for a handicapped child

An amount of \$1,780 per term completed is currently granted to the parent of a child who is studying full time in a recognized educational institution.

The current legislation will be amended to provide that a child with a major functional deficiency will be considered to be studying on a full-time basis if he or she is registered in a recognized educational program and receives at least 20 hours of instruction per month.

List of eligible medical expenses

The budget proposes to eliminate from the list of medical expenses giving entitlement to a tax credit for expenses paid for a service provided for purely cosmetic purposes. As well, for an expense incurred after April 21, 2005, the amount allocated to the taxpayer with respect to glass frames will be limited to \$200.

In addition, services provided by some practitioners, such as homeopaths, naturopaths and osteopaths, were in fact eligible as medical expenses even if the fiscal legislation did not recognize them. This budget amends the legislation to take into account this administrative policy.

Improvement of the refundable tax credit for medical expenses

A refundable tax credit for medical expenses is available for low-income workers. The maximum credit increases from \$543 to \$750 starting in 2005. Afterwards, this amount will be indexed.

Tax treatment on the proceeds of the sale of a servitude

The establishment of a real servitude currently gives entitlement to proceeds of disposition. The gain resulting from this disposition is taxable at 50% even if this property is a farm property or a principal residence that could give rise to a capital gains exemption.

Accordingly, in order that the gain resulting from the disposition of a real servitude affecting an immovable may also give rise to a capital gains exemption for a farm or a principal residence, where the immovable concerned satisfies the criteria, a legislative amendment will be introduced.

Introduction of a new stock savings plan

The government of Québec is introducing a new stock savings plan (SSP) called "SME Growth Stock Plan." This new plan replaces the current SSP and includes the following changes:

- it will end on December 31, 2009;
- the plan will be limited to common shares;
- a single deduction rate will be applicable i.e. 100%;
- the minimum holding period will be increased from 2 to 3 years;
- the issuing corporations must meet the following criteria:
 - a Canadian corporation;
 - assets under \$100M;
 - senior management in Québec;
 - over 50% of wages paid by a establishment located in Québec;
 - carried on a business with 5 employees at least over the last 12 months;
 - no more than 50% of the value of the property consisting of investments.

MEASURES AFFECTING BUSINESSES

Changes of the tax on capital for corporations

Corporations currently pay a rate on tax on capital of 0.6% of their paid-up capital. Starting in 2006, this rate will be gradually reduced to 0.29% in 2009. The reduction will be carried out as follows:

Current	2006	2007	2008	2009
0.60	0.525	0.49	0.36	0.29

If a corporation's taxation year does not coincide with the calendar year, the rate applicable for such taxation year will be a weighted rate reflecting the number of days of the taxation year included in each of the two calendar years.

In addition, a non refundable tax credit will be introduced to promote investments in new manufacturing and processing equipment. Accordingly, an amount equal to 5% of the eligible investment will help reduce the tax on capital payable in a taxation year. The non-refundable portion of such capital tax credit that exceeds the tax on capital otherwise payable for such taxation year may be carried over to subsequent taxation years.

From now on, the bonds issued by partnerships will be subject to the holding period rule of 120 days.

Re-introduction of the refundable tax credit for major employment-generating projects

In previous budgets, the government had cut the tax credits granted to corporations. This budget re-introduces the refundable tax credit for major employment-generating projects (minimum of 500 jobs created within 24 months) related to the technological sector.

This credit will be equal to 25% of the eligible salaries incurred as of January 1, 2005 and paid to eligible employees working in the course of carrying out eligible contracts. An eligible corporation may receive this tax credit regarding salaries incurred, in relation to such contract, until December 31, 2016, but the contract must have been concluded no later than January 1, 2008.

Investissement Québec will certify the eligibility of a project.

Adjustments regarding certain credits

This budget brings adjustments to three specific credits: the refundable tax credit for processing activities in resource regions, the refundable tax credit for Gaspésie and certain maritime regions of Québec and the refundable tax credit for the Vallée de l'aluminium.

Adjustments will be brought to the three tax credits so that the period during which the eligible corporations will be able to benefit from the tax assistance will now be established on the basis of a common deadline. In addition, the notion of certified business will be adjusted for the purposes of the three refundable tax credits and a clarification will be made to the terms and conditions for issuing eligibility certificates.

Increase of the R&D tax credits

A few tax credits exist in Québec to promote scientific research and experimental development (R&D). These credits apply to salary expenses for this activity, to contracts granted to university entities and projects related to pre-competitive research.

In this budget, the government raises the rate of the tax credit for R&D for businesses that meet the SME criterion. The credit rates will gradually be raised as follows:

Corporate assets (in \$M)	Current rates (in %)	New rates (in %)
25 or less	35	37.5
30	31.5	33.5
35	28	29.5
37.5	26.25	27.5
40	24.50	25.5
45	21	21.5
50	17.5	17.5

In addition, a clarification will be made to the legislation so that a person claiming the credit be quickly required to operate a business in Québec and have an establishment.

Adjustment of the refundable tax credit for design

In this budget, many measures are implemented to restructure the refundable tax credit for design in order to reflect the new reality of Québec's economy. Many measures will increase this credit.

ECONOMIC VIEWPOINT

Québec Budget 2005

April 21, 2005

Comments on the Québec Budget 2005

**A lacklustre budget that meets expectations and
is open to compromises**



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Highlights

The new Minister of Finance, Michel Audet, tabled his first budget today. Like previous Charest government budgets, this exercise underlines that the fiscal balance was maintained in 2004-2005 and points out that this performance will continue over the coming years. As the financial situation of the Québec government remains difficult, the new measures introduced by Minister Audet are modest. Although the fiscal balance is maintained and the financial ratios are improving, though slightly, this is definitely a lacklustre budget that only is noticeable for its willingness to compromise.

- The 2005-2006 fiscal year should result in a balanced budget. Yet a budget impasse of \$773M appears for the next fiscal year.
- The Québec government's revenues will be increasing by 3.3% in 2005-2006 while the operating expenditures will grow by 3.6%. The public debt charges will only expand by 1.8% over the same period.
- The total debt-to-GDP ratio will shrink from 43.7% in 2004-2005 to 42.7% in 2005-2006.
- Starting in 2006, Québec workers will benefit from a new 6% fiscal deduction on their income, up to \$500 per year.
- Corporate taxation will undergo a reform that will favour investments and productivity improvements. Among the other measures, there is a gradual decrease of the tax on capital. However, the taxation of large corporations will go up. The government also is introducing a SME Growth Stock Plan to stimulate and facilitate the financing of SMEs.
- The ministère des Finances du Québec will set aside \$240M over the next three years to support regional development and prosperity.
- Investment in public infrastructures will accelerate reaching \$4.9B in 2005-2006 compared with \$4.1B in 2004-2005.

Summary of Budgetary Transactions

In millions of \$	01-02	02-03	03-04	04-05f	05-06f	06-07f
Own-source Revenues	38,506	40,720	42,241	44,161	45,528	46,603
- Ann. Var. in %	-4.5	5.7	3.7	4.5	3.1	2.4
Federal Transfers	8,885	8,932	9,370	9,228	9,607	9,856
- Ann. Var. in %	12.5	0.5	4.9	-1.5	4.1	2.6
Total Budgetary Revenues	47,391	49,652	51,611	53,389	55,135	56,459
- Ann. Var. in %	-1.7	4.8	3.9	3.4	3.3	2.4
Operation Expenses	-41,863	-43,837	-45,302	-46,742	-48,407	-50,149
- Ann. Var. in %	4.3	4.7	3.3	3.2	3.6	3.6
Public Debt Charges	-6,687	-6,583	-6,655	-6,868	-6,995	-7,309
- Ann. Var. in %	-4.1	-1.6	1.1	3.2	1.8	4.5
Total Budgetary Expenses	-48,550	-50,420	-51,957	-53,610	-55,402	-57,458
- Ann. Var. in %	3.0	3.9	3.0	3.2	3.3	3.7
Net Figures of Consolidated Organizations	322	379	346	221	267	226
Exceptional losses of the SGF	-91	-339	-358	--	--	--
Shortfall to be absorbed	--	--	--	--	--	773
Budgetary Balance (including the SGF losses)	22	-728	-358	0	0	0
Non Budgetary Surplus	-637	-909	-1,108	-412	-434	-301
Net Financial Needs	-615	-1,637	-1,466	-412	-434	-301
Program Spending-to-GDP Ratio (%)	18.1	18.0	17.9	17.5	17.3	17.3
Debt Servicing to Budgetary Revenues (%)	14.5	13.7	13.3	13.2	13.1	--
Total Debt (\$M)	107,175	111,342	114,725	116,589	119,408	122,019
Total Debt-to-GDP Ratio (%)	46.4	45.7	45.2	43.7	42.7	42.2

f: forecasts --: not available Source: Ministère des Finances du Québec

Budget Analysis

Another balanced budget ... or so it seems

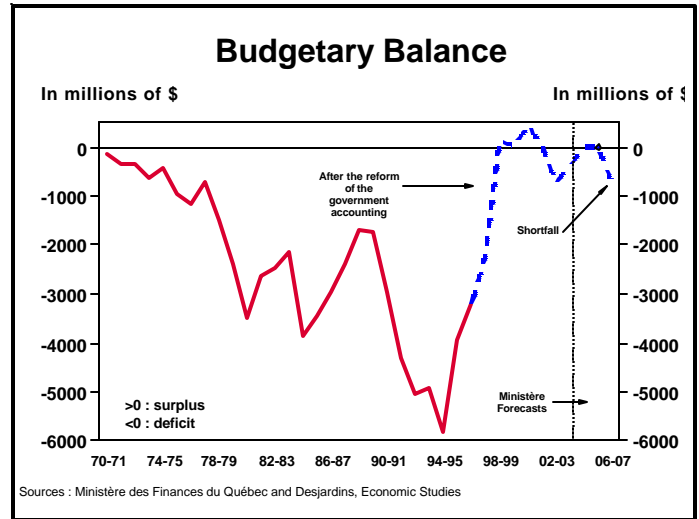
Minister Audet's first budget was not an easy job. Not only were expectations relatively high, particularly with respect to reducing the tax burden of individuals, but there was not much leeway. Bear in mind that the government and its employees are currently negotiating the renewal of the collective agreements and that pay equity adjustments are also being discussed, which risks increasing operating expenditures considerably during this current fiscal year.

The Charest government is staying the course and maintaining a balance between budget expenditures and revenues in 2005-2006, i.e. results that are identical to those of 2004-2005. Yet, reaching a balanced budget could be somewhat harder in 2006-2007 since the budget plan includes a shortfall of \$773M. This way of doing things is not new: last year's budget also had a \$1.6B shortfall to be absorbed in 2005-2006, a goal that seems to have been reached if the results that Minister Audet has just presented are accurate.

Paradoxically, the Québec government's debt keeps growing despite the balance between the budget expenditures and revenues. As a result, the total debt should stand at \$119.5B in 2005-2006, an increase of \$2.8B over the previous year. The government's funding needs stem from chronic deficits of its non budgetary transactions (pension plans, investments, loans, advances and amortization of capital expenditures, etc.). The acceleration of infrastructure investments and the support for regional development could incidentally exacerbate this trend as the amount allocated to the amortization of capital expenditures will increase over the coming years. Yet, the increase of the indebtedness is growing at a slower pace than Québec's economy. As a result, the total debt-to-GDP ratio will drop to 42.7% in 2005-2006, i.e. a clear decline since the peak of 52.2% recorded during fiscal 1997-1998.

Conservative economic assumptions

As for the economic assumptions used to prepare the budget, we feel that the parameters estimated by the ministère des Finances are realistic, particularly for 2005. The budget projections are based on real GDP growth of 2.4% in 2005 and 2.6% in 2006. For the same periods, we anticipate respective growth of 2.1% and 2.9%. However, we feel that the GDP deflator, estimated by the ministère des Finances at 2.2% in 2005 and only 1.2% in 2006, is conservative. The high level of prices for raw materials and the anticipated evolution of consumer prices lead us to believe that it will grow by 2.7% in 2005 and 2.6% in 2006.



Economic and Financial Forecasts

	2004	2005		2006	
	Realized	Budget	Desjardins Group	Budget	Desjardins Group
Québec Nominal GDP (%)	5.3	4.6	4.8	3.8	5.5
Québec Real GDP (%)	1.9	2.4	2.1	2.6	2.9
Québec GDP Deflator (%)	3.4	2.2	2.7	1.2	2.6
3-month Canadian Treasury bills (%)	2.2	2.7	2.6	3.6	3.6
10-year Canadian bonds (%)	4.6	4.4	4.5	4.8	5.1
Canadian Dollars (in US currency)	76.8	81.0	82.0	77.3	84.0

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

So, while the ministère des Finances is expecting that nominal GDP will increase by 4.6% in 2005 and by only 3.8% in 2006, our own projections are counting on 4.8% and 5.5% growth respectively. The 2006 shortfall is particularly blatant and we feel that the ministère des Finances projections are relatively cautious. The modest growth of the nominal GDP in 2006 anticipated by the government of Québec could then in a way provide some leeway.

Limited measures reflecting the government's budget capacity

As the government had some difficulty in balancing the budget due to important pressures stemming from the increase in health care costs and the upcoming renewal of the collective agreements with the provincial civil servants, it is not surprising to see that the 2005-2006 budget offers few new initiatives. Of course, the budget plan has several dozen pages detailing a host of new measures, but in fact, the impact of the great majority of them seems limited.

Personal income tax: differential of the tax burden between Québec and the other provinces (by applying the other provinces tax structure to Québec)

In millions of \$	2003	2005f	2006f
Alberta	4,433	4,081	3,756
Ontario	5,627	3,758	3,420
British Columbia	3,538	3,046	3,057
Saskatchewan	2,234	1,799	1,461
Nes Brunswick	1,526	798	573
Manitoba	937	577	414
Nova Scotia	689	435	86
Prince Edward Island	1 099	390	41
Newfoundland	-677	-1,316	-1,663
Average differential	2,156	1,508	1,238

Source: Ministère des Finances du Québec
f: forecasts

A tax deduction for workers

Budget 2005-2006 proposes a few measures aimed at cutting the tax burden of Quebecers a little more. The ceilings of contributions to a registered retirement savings plan (RRSP) and a registered pension plan (RPP) will go up in the coming years. Bear in mind that these ceilings were initially slated to be indexed starting in 2007. The 2005-2006 budget significantly increases the ceilings of RRSP and RPP contributions until 2010. For instance, the ceiling for RRSP contributions will increase to \$19,000 in 2007, compared with \$18,000 in 2006 and reach \$22,000 in 2010. Minister Audet also proposes to increase tax assistance for persons with a severe and prolonged mental or physical impairment, to improve tax assistance to natural caregivers and to increase the refundable tax credit for medical expenses.

However, the most significant initiative is the introduction of a new tax deduction for Québec workers to offset some work-related expenses (transportation, clothing, etc.). The ministère des Finances is introducing a 6% tax deduction of their income up to a maximum of \$500 per year, which will come into effect in January 2006. Overall, this measure is evaluated at \$300M per year, which represents 80% of the new amounts set aside to reduce the tax burden of individuals.

The government wants to bolster corporate investment

As far as businesses are concerned, budget 2005-2006 proposes many measures aimed at improving the efficiency of the tax system and the productivity of Québec businesses and supporting regional development. However, the financial impact of most of these measures is limited to just a few million

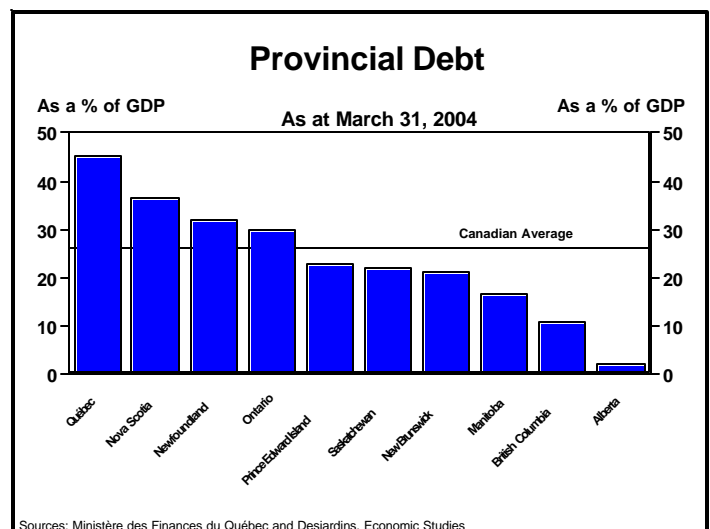
dollars. For instance, the minister of Finance announces measures to facilitate business financing, as well as research, development and exports. However, the most important measure concerns a reform of corporate taxation, including a 50% cut of tax on capital. So, the rate of tax on capital of non-financial corporations, which stands currently at 0.6%, will be cut to 0.525% in 2006 and will gradually decrease afterwards reaching 0.29% in 2009. The financial impact of this measure is evaluated at \$221M for fiscal 2006-2007. But, this cost will be offset in part by a \$174M tax increase for large Québec corporations in 2006-2007.

The Québec government is also introducing in the 2005-2006 budget a program for regional development and prosperity. The regions will benefit from a cumulative contribution of \$240M over the next three years, including \$57M in 2005-2006. The ministère des Finances will also significantly increase investments in public infrastructures, which will total \$4.9B in 2005-2006, compared with \$4.1B during the previous year.

Impact on capital markets

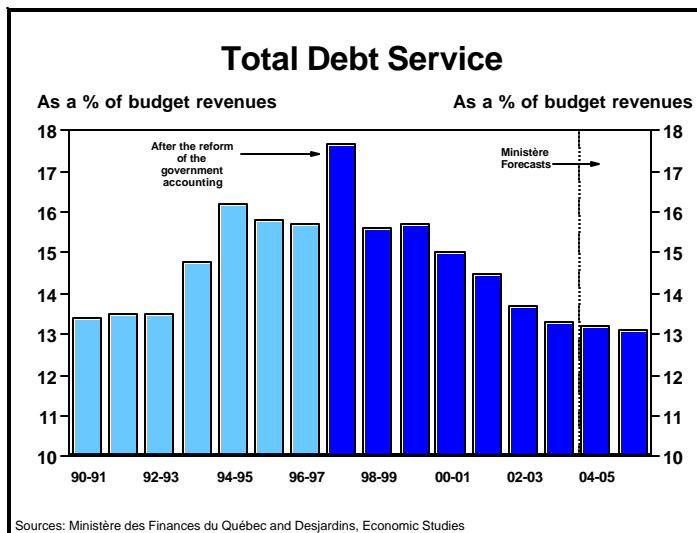
The first Audet budget should have no significant impact on the short term on capital markets and rating agencies. Although some positive elements can be emphasized, such as deciding to increase productive private investments in businesses and continuing to bring down the weight of the debt, Québec's situation remains extremely uncertain.

Québec is by far the province with the highest debt load in Canada. In march 2004, the total debt of the Québec government stood at 45.3% of GDP. This debt represents \$15,220 per capita, i.e. \$5,178 more per capita than the Canadian average. The weight of this debt leads to higher interest payments, which considerably hampers the leeway needed to fund public services, particularly those related to health care and education.

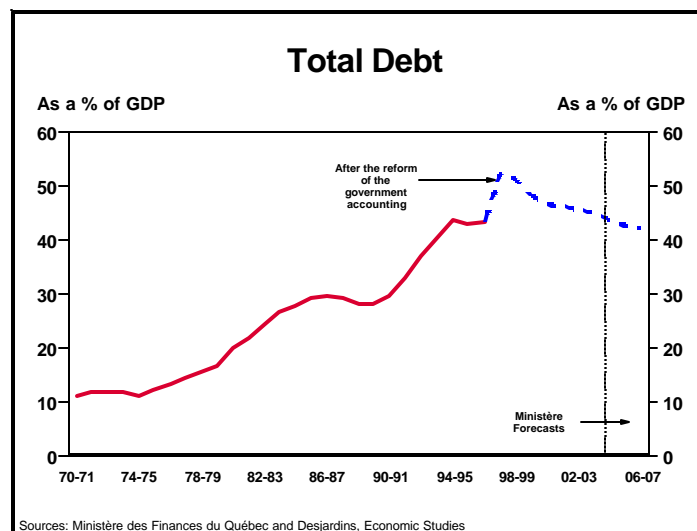


In addition, this situation makes Québec public finances vulnerable to unexpected negative shocks, such as a greater than anticipated increase in interest rates or a decrease in transfers from Ottawa.

For fiscal 2005-2006 and 2006-2007, the assumptions on the government's budget transactions are based on maintaining a balanced budget, despite a deadlock of \$773M next year. This technical deficit, or "shortfall to be absorbed" as the Charest government points out, is indicative of the great difficulty it has in balancing its budget. Incidentally, Québec is the only Canadian province that has not adopted contingency reserves in its fiscal framework. This is a significant failure.



In short, in the immediate future, the financial impact of the current budget is likely to be insignificant. However, if no major changes are made with respect to improving financial ratios and debt in the next budgets, Québec could be seriously penalized by the markets and rating agencies. The road to a first-rate balance sheet for Québec still seems a long and winding one.



Conclusion

A lacklustre yet sound budget that is open to compromises

The first budget of the new minister of Finance, Michel Audet, is a lacklustre budget, even modest given the magnitude of its content. Nevertheless, it is a rigorous budget that is open to compromises as the government enters a period of intense negotiation to renew the collective agreements with its employees.

So, the tax cuts are so limited that it is not exaggerated to presume that the government is backing down on its promise to cut taxes by \$1B per year during its mandate. It is evident that its budget situation is clearly too hazardous to allow such a move. The government rather chose to avoid endangering its financial situation by granting tax cuts against a return to deficits. The minister is then presenting a balanced budget in which the financial ratios of the government keep improving, particularly the debt-to-GDP ratio. However, for fiscal 2006-2007, the minister will have a shortfall of \$773M to be absorbed if he wants to maintain his zero-deficit objective. In addition, we feel that he should have given himself a "contingency reserve" like the federal government and several provinces, to protect himself against adverse economic conditions, such as an unanticipated recession.

Minister Audet is presenting many economic measures of limited scope, but that are likely to promote productive private investments and job creation. Among the measures, note the 50% cut in tax on capital, a harmful tax that were widely criticized by the business community. In addition, the government is reducing its 5% tax on capital on any new investment in machinery or equipment, which will favour investments and productivity growth at a time when businesses are dealing with a dollar that appreciated by close to 30% since the start of 2003.

In short, this is a modest yet consistent budget, but above all, it does not jeopardize the future financial situation of the government and provides some leeway to the government to get through its public-sector negotiations.