Much like elsewhere around the world, the budget situation of Québec’s government has deteriorated significantly over the past few months. The 2008–2009 recession not only reduced the inflow of government revenues drawn from income and other taxes paid by individuals and businesses, it also boosted spending in the form of transfers to individuals and measures to revive the economy. After reaching equilibrium between 2005–2006 and 2007–2008, the budgetary balance of the Québec government proceeded to deteriorate sharply. According to the most recent forecasts issued by the Ministère des Finances, the 2009–2010 and 2010–2011 fiscal years will generate projected deficits of around $4.7B (graph 1).

**A DEBT THAT KEEPS GROWING**

It is obvious that these deficits have a direct impact on the scope of the Québec government’s debt. Other factors have also contributed to expanding the debt in recent years. In particular, those increases are the results of the economic stimulus plan that Québec adopted (as did many other governments) and of the public infrastructure renewal program that has been underway for a few years now.

There are several concepts that enable us to measure the size of the Québec government’s debt. The gross debt is the broadest measurement of the province’s debt; it includes the market debt and the net liabilities of government employee pension plans and future benefits. Although this practice is somewhat questionable, the Ministère des Finances also subtracts the funds that lie in the Generations Fund. As for the net debt, it is equivalent to the gross debt minus the value of financial assets. Finally, the debt representing...
accumulated deficits arises, as its name implies, directly from budget balances. It is derived from the net debt less the value of non-financial assets, such as capital investments. It is generally acknowledged that the net debt usually provides a better indication of the real size of a government’s debt. For example, Alberta has substantial financial assets in its Heritage Fund. Therefore, even though it has significant market debt, the size of its financial assets is such that its net debt becomes negative, which translates into a net asset for the province, changing the picture of its debt considerably. That said, our analysis will focus mainly on gross debt for the simple reason that it lends itself more easily to comparisons with other Canadian governments as well as those around the world. According to the most recent estimates from the Ministère des Finances, the Québec government’s gross debt will reach $161.6B as at March 31, 2010, representing 53.5% of the province’s GDP.

According to the Québec Auditor General, this snapshot of the Québec government’s debt underestimates the size of the public debt. If we also take into account debt that is self-financed by state-owned businesses and the debt supported by municipal sectors and universities, Québec’s debt would have stretched to $218.6B as at March 31, 2009, or 72.3% of the province’s GDP. Regardless of the definition used, the scope of Québec’s public debt seems extremely high and is raising serious concerns.

As shown in graph 2, the level of gross debt in Québec has continued to grow these past few years, a situation that contrasts sharply with the federal government which had, until very recently, managed to stabilize its debt level. Some people are nevertheless thrilled that the size of Québec’s economy grew at a faster pace than its debt these past few years. And so the gross-debt-to-GDP ratio went from a peak of 51.5% as at March 31, 1999 to 49.8% as at March 31, 2008. The budget deficits forecast for the next few years will see an about-face, with the debt’s relative size slated to increase. The gross-debt-to-GDP ratio could therefore shoot up to 55.2% by the end of the 2010–2011 fiscal year. One question remains, however: Is this level of debt excessive? To answer this question, we have to compare Québec’s debt load with that of other governments.

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Graph 3 compiles the gross debt of all Canadian provinces and their debt-to-nominal GDP ratio. Newfoundland and Labrador was traditionally the most debt-laden province in the country. In the past few years however, the windfalls generated by crude oil and natural gas operations have greatly improved this province’s financial position. Consequently, as at March 31, 2009, Québec was the country’s most indebted province with the highest gross-debt-to-GDP ratio in Canada.

Another worthwhile exercise is to compare Québec’s debt with that in different countries, but in doing so, we should use the same definition of debt. The Organisation for Economic Co-operation and Development (OECD) uses a specific methodology to analyze the public debt of industrialized countries. This organization defines public debt as a government’s total liabilities minus its commitments to pension funds. Québec’s Ministère des Finances recently published a study in which Québec’s debt was calculated based on this definition, thereby enabling the Québec government to compare the scope of its debt to that in

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3 Mainly Hydro-Québec.
4 It should be noted that similar comparisons on the net-debt-to-GDP ratio point pretty much to the same conclusions.
industrialized countries. This meant taking the gross debt, adding certain liabilities like accounts payable and municipal debt and then subtracting net liabilities that are tied to pension funds. Québec’s share of the Canadian government’s debt also has to be added, based on the demographic weighting of Québec’s population.

At 94.0%, Québec’s debt-to-GDP ratio (calculated by that method) is the fifth highest of the OECD member countries, just behind Iceland at 96.3%, Greece at 102.6%, Italy at 114.4% and Japan at 172.1% (table 1). This result is less than stellar for Québec, especially when we consider that the province will soon have to cope with a significantly aging population, and that both Greece and Iceland are currently obliged to make tough choices to improve their financial footing. The situation in Italy is also being closely watched by money lenders. With regard to Japan, its debt burden suggests that it is indeed possible to manage such indebtedness. However, it bears noting that managing Japan’s debt has been facilitated up to now by the high Japanese savings rate, weak demand for credit and a strong local bias, i.e. residents prefer to hold their own government’s debt rather than debt from foreign governments. This means that Japan’s government is far less dependent on foreign funds to finance its debt which protects the country from random shifts in international financial markets (graph 4). In fact, Japan’s debt is further inflated by liabilities tied to its past policy on exchange rates that consisted of accumulating foreign currency assets to prevent the yen from appreciating. This makes it clear that the Québec government’s financial position cannot easily be compared to the situation in Japan.

These international comparisons have their limits, however. Ideally, we would have to make the same assessments for all the regional governments in other industrialized countries across the board. While this exercise could change Québec’s relative position to some degree, the conclusion would no doubt be the same, i.e. that Québec’s debt is among the highest within the industrialized countries. In short, not only is Québec’s debt the highest in Canada, it is also one of the highest in the world, all things considered. Given the looming demographic shock and the constantly growing needs of healthcare and education, we can only worry about the size of Québec’s public debt, especially the fact that this debt keeps growing every day.

### CONSEQUENCES OF HIGH DEBT

The main concerns raised by Québec’s debt stem from the fact that an excessively high level of debt is not without consequences. One thing is clear: higher debt levels need higher interest payments to service the debt. As such, the cost of servicing this debt should reach a total of $6.2B for the 2009–2010 fiscal year, or almost 10% of all budget...
revenues. This represents a major opportunity cost when you consider the additional public services that $6.2B (or a portion thereof) could provide for Québécois. For example, this amount is equal to the total amount of government spending in 14 out of 22 government departments. Based on the growing debt and the anticipated increase in interest rates, the cost of servicing the debt could rise by 58.7% by 2013-2014, to $9.8B.

Higher debt also implies greater sensitivity to interest rate fluctuations. An increase of one percentage point in interest rates has a major impact on state spending when debt levels are higher. Moreover, the situation can quickly get worse if the deficit gets substantially bigger due to an interest rate hike, exacerbating the debt. This leads us into the vicious circle of debt.

Credit ratings for governments set by credit rating agencies also influence the cost of Québec’s debt and its management. Québec’s debt currently enjoys an A+ rating set by Standard & Poor’s and an Aa2 rating from Moody’s. While these ratings reflect a good credit history, they are not as strong as the ratings given to the federal government and to most other Canadian provinces (graph 5). Keep in mind that these agencies judge governments mainly on their capacity to manage their debt levels. Generally speaking, the higher a government’s debt, the lower its credit rating will be and the greater is the risk premium required on its debt. Thus, the lower ratings given to Québec are the main reason for the higher interest rates that apply to the province’s debt. When dealing with recurring deficits, it is better for governments to adopt a credible recovery plan to reassure the credit agencies and holders of debt securities and thereby avoid having their credit rating lowered. Keep in mind that the credit rating agencies currently assign a stable bias to nearly all the provinces (including Québec), which hints that credit ratings should remain fairly stable in the short term.

Another aspect of high indebtedness is the unfair burden it places on future generations. How do we justify saddling future generations with debt to pay for expenses enjoyed by previous generations? This issue is particularly true when it comes to debt that stems from an accumulation of budget deficits, what we usually associate with “grocery spending.” Yet according to the government, the portion of Québec’s debt representing accumulated deficits is likely to reach $102.4B as at March 31, 2010, an amount that corresponds to more than 60% of the overall gross debt.

Lastly, as mentioned earlier, the high level of Québec’s debt is especially worrisome when viewed through the prism of an aging population. According to the most recent demographic projections, the working-age population in Québec could start to decline as of 2014. At the same time, the baby boomers will boost the number of senior citizens. By 2026, the dependency ratio will be 90 demographic dependents for every 100 individuals of working age, a marked increase compared to the ratio of 58 to 100 seen in 2006. Public finances will feel the effect of a double impact: growth from tax revenues could slow down due to the drop in the number of workers and health spending will rise due to the growing number of elderly people. In such conditions, it will be increasingly difficult for the Québec government to find some financial leeway to stabilize its debt (or to start repaying it, eventually). In fact, a study has shown that the aging population issue could generate a structural deficit of approximately $92B by 2051 if no action is taken. Québec is clearly not the only region that will grapple with this issue, but we must admit that the aging of the population will be more keenly felt here in Québec, and the repercussions will be more serious as a result.

**A SERIOUS ISSUE WE CANNOT TRIVIALIZE**

Some stakeholders in the public arena have recently minimized the size of Québec’s debt. Achieving a consensus just to define the Québec government’s debt has proven difficult. What do we include or exclude in the calculation? We cannot lose sight of the fact that the need to compile this information is to make comparisons over time and with different governments. On its own, the level of Québec’s debt says little about the sheer size of the province’s indebtedness; we still have to be able to compare debt levels against other provinces and countries even. That is why this text describes measures that facilitate comparisons with other governments.

A debate on the concept of good and bad debt also captured our attention. The definition of good debt usually refers to debt incurred to finance capital spending. Conversely, bad

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debt stems from total budget deficits. According to the accounting standards applied by the Ministère des Finances, the capital investments made each year are not taken into account in the budgetary expenditures, they are accounted for directly as a debt instead. However, to reflect the wear and tear of infrastructures, the annual depreciation of capital assets is subtracted from the debt for each fiscal year and then added to budgetary expenditures. Some analysts consider that in most cases these accounting entries translate into an increase in the budget deficit, and by extension, an increase in bad debt. This is akin to transferring a portion of good debt to the bad debt, which darkens the picture of Québec’s indebtedness.

In our opinion, this argument does not hold up. The annual depreciation corresponds to a loss of capital asset value which, as a result, should be accounted for as resource utilization in the budgetary expenditures. If the outcome of this entry is a deficit, this implies that budgetary revenues were insufficient to pay for the use of these capital assets.

**DEBT STABILIZATION IS NEEDED**

Comparisons of Québec’s debt level are unequivocal: the province is one of the regions with the highest public debt in Canada and in other industrialized countries. And yet there are major risks to carrying such high debt. Further still, the province is more vulnerable to sudden fluctuations in financial markets, more vulnerable to money-lenders’ moods and more vulnerable to the evaluations set by the different rating agencies. In addition, the high level of interest charges monopolizes a large portion of budget revenues, reducing the Québec government’s financial leeway and generating an opportunity cost.

If we also take into account the greying of the population expected in coming years, the Québec government’s debt could become an even greater concern. Clearly, this situation must be remedied. The government’s first objective should be to restore fiscal balance in order to stabilize the debt’s growth. Initiatives should then be instituted to repay the debt and reduce the government’s debt burden, mainly by raising certain fees to a level more consistent with market prices and by increasing the amounts allocated to the Generations Fund. To get there, the Québec government has no choice but to set out an achievable action plan that is spread out over several years.

In particular, it would be advisable for this action plan to include a bold and well-defined target to set a course for reducing Québec’s debt. The *Balanced Budget Act* and *An Act to reduce the debt and establish the Generations Fund* are certainly a step in the right direction. Moreover, they specify a target of 38% to be reached by 2013 for the gross-debt-to-GDP ratio. However, the recent legislative changes that the Québec government adopted in order to support the economy during the recession have raised grave doubts as to whether these financial targets will be reached. The government is predicting that the gross-debt-to-GDP ratio will amount to 54.5% as at March 31, 2013, which is definitely above the target. Clearly, the government’s strategy for paying down the debt must be reviewed and strengthened. Furthermore, it would be preferable for the government to pass legislation specifying a firmer target, expressed as a ratio of net debt rather than of total debt. This would make it possible to properly account for financial assets (such as the Generations Fund) and would facilitate comparisons with the other provinces. For example, Québec could aim for a net-debt-to-GDP ratio closer to the current average of the other provinces, i.e. around 15% or 22% if we exclude Alberta, which possesses substantial financial assets. With its net-debt-to-GDP ratio currently standing at 42.6%, Québec obviously has a long way to go. The need for action is urgent.

The action plan should also include an overhaul of the state’s ways of doing things. Not only must the fee structure and taxes be re-examined, but spending must be controlled better. In these circumstances, the next budget tabled by the Charest government will be crucial in that measures that were previously announced to restore balance will likely be spelled out and improved upon. If no action is taken, that could not only hinder the return to a balanced budget, but eventually jeopardize our social programs. The recent experience of Greece shows the constraints and problems that can arise from certain changes when the international financial community becomes alarmed about a country’s debt.

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