Comments on the Québec Budget 2005

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

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.
A tax deduction for workers

Budget 2005-2006 proposes a few measures aimed at cutting the tax burden of Quebeckers 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 Quebec workers to offset some work-related expenses (transportation, clothing, etc.). The ministere 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 Quebec 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 Quebec corporations in 2006-2007.

The Quebec 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 ministere 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, Quebec’s situation remains extremely uncertain.

Quebec is by far the province with the highest debt load in Canada. In march 2004, the total debt of the Quebec 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.

<table>
<thead>
<tr>
<th>Province</th>
<th>2003</th>
<th>2005f</th>
<th>2006f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alberta</td>
<td>4,433</td>
<td>4,081</td>
<td>3,756</td>
</tr>
<tr>
<td>Ontario</td>
<td>5,627</td>
<td>3,758</td>
<td>3,420</td>
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<tr>
<td>British Columbia</td>
<td>3,538</td>
<td>3,046</td>
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<td>Saskatchewan</td>
<td>2,234</td>
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<td>Manitoba</td>
<td>937</td>
<td>577</td>
<td>414</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>689</td>
<td>435</td>
<td>86</td>
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<tr>
<td>Prince Edward Island</td>
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<td>41</td>
</tr>
<tr>
<td>Newfoundland</td>
<td>-677</td>
<td>-1,316</td>
<td>-1,663</td>
</tr>
<tr>
<td>Average differential</td>
<td>2,156</td>
<td>1,508</td>
<td>1,238</td>
</tr>
</tbody>
</table>

Source: Ministere des Finances du Quebec
f: forecasts
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.