Already fragile, the public finances explode under pressure from revenues

The government has five years to get the situation back under control

Following federal Finance Minister Jim Flaherty’s news of a cumulative deficit of almost $64B over the next two fiscal years, our eyes automatically turned to the Québec government. We all know that Monique Jérôme-Forget, Minister of Finance and the Minister responsible for Infrastructure, has $2.3B in her “purse,” which has been saved up over the last few years to cope with a recession. Despite forecast economic growth of 0.8% for 2008 and 0.6% for 2009, presented in the Update on Québec’s Economic and Financial Situation in November 2008, the government already had a $1.2B shortfall for fiscal 2008-2009. As Québec’s economy seems to be getting 2009 off to a fairly negative start, there is no longer any doubt that the reserve will be almost completely used up this fiscal year to close the growing gap. In the absence of further leeway, deficits will be recorded for at least the next two fiscal years, which could make some people shudder. To pick up a well-known image, one used by the Minister herself, there’s a hole in the purse!

THE RECESSION IS SURPRISINGLY STRONG

At this point, almost all of the indicators for the last quarter of 2008 are out. Overall, the statistics show much grimmer results than expected, worldwide. Worse yet, the economic data are regularly in record-setting territory. For example, in the United States, housing starts have reached their lowest point since this statistic was first published in 1959. In Canada, last December’s 8.0% drop in manufacturing sales is the biggest drop since the indicator was instituted in 1992. In January, Canada also recorded the largest monthly loss of jobs (in both numbers and percentage) since this statistical series began in 1976. The list goes on, but these few examples are enough to show how severe this crisis is.

Clearly, Québec will be unable to avoid this heavy trend. The economic situation has also deteriorated quickly in Québec in the last few months. Our outlook for Québec’s 2009 real GDP has gone from +0.8% last fall, when the Update on Québec’s Economic and Financial Situation was released on November 4, to -1.3% now. The indicators confirm that what looked like a simple slowdown in Canada last fall will turn out to be a major downturn in economic activity, potentially as painful as the ones of the early 80s and 90s. As a result, more jobs will be lost than initially forecast, and the jobless rate will go higher (graph 1), exceeding 9% and perhaps even brushing 10%. It will take more draconian action from the government to rein in the recession’s length and magnitude. Sizeable budget deficits will be unavoidable for 2009-2010 and 2010-2011, and they could persist even after that.

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When the Minister of Finance presented additional, immediate measures to support the economy and employment in her January 14, 2009 Economic statement, the hot water already seemed imminent. First, the measures that were announced were, overall, somewhat disappointing. In our opinion, January’s Economic statement primarily contained facilitating measures whose impacts on the economy are sometimes difficult to measure, rather than the aggressive economic recovery measures that a stimulus plan generally contains. However, waiting until it had the new Government of Canada budget in hand in order to coordinate the efforts of both tiers of governments was a strategic move. Now that the Québec government has this information, it can establish its recovery strategy. The other component missing from the statement was an update on the financial balances, with the economic situation crumbling at lightning speed.

AN UNNERVING RETURN TO DEFICITS!
according to our estimates, the government would be able to balance the budget for fiscal 2008-2009 by using at least $2B of the $2.3B reserve it currently has on hand. To do this estimate, we projected the data in Finances Québec’s last monthly report on financial transactions, which covers April to November of 2008. This information is highly volatile from month to month but, over a longer period, the risk of error is lower. That said, there is still a risk.

Based on the above assumptions, a reserve of $300M would remain that could be applied to fiscal 2009-2010. Given how quickly economic conditions have deteriorated, fiscal 2009-2010 would result in a deficit of more than $3B, mainly triggered by a substantial decline in budgetary revenues. Clearly, a lot of uncertainty also surrounds this assessment because it is hard to estimate how program spending and the results of consolidated entities will evolve. This still shows the major impact that the economy’s deterioration is having on public finances. The deficit factors in an $820M payment to the Generations Fund and use of the remaining reserve. However, the amount does not take into consideration the implementation of further economic stimulus measures.

Even though Québec has been doing a little better than the other provinces thus far, especially Ontario, the Québec government will have to get busy and put together a multifaceted recovery plan, in addition to the existing Infrastructure Plan. The key is to have a wide spectrum or array of measures to be sure of hitting the target—minimizing the recession—and to maximize all chances for the economy’s future recovery. Clearly, we have to accept the idea that the government is going to have a deficit. A government’s goal is not to avoid deficits at all costs, but to act on the economy in a countercyclical manner. During prosperous times, surpluses have to be generated so as to pay off some of the debt; during contractions, it is essential to stimulate the economy, which will inevitably result in a deficit and increased debt. However, respecting the Balanced Budget Act is critical.

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The Balanced Budget Act is also fairly explicit as to the government’s duty to balance its budget over a period of one to five years. Firstly, if a deficit of less than $1B under the terms of the Act is recorded during a fiscal year, the government must achieve a surplus that is equivalent to that overrun during the next fiscal year. For overruns of less than $1B that last more than one year and overruns that are greater than $1B in a single year, the government must fully offset them over at most five years. The government must then present a financial plan that will offset these overruns over the five-year period.

This law is fairly restrictive when major crisis periods occur, such as the one we are going through right now. The Act does not differentiate between the portion of the deficit that is created by the poor economic environment which takes a big bite out of the government’s revenues and increases its social welfare costs, and the portion created by the amounts invested in a recovery plan. Under these circumstances, we can understand why government has some reticence about injecting a lot of money into an economic stimulus plan in the short term, even though the need to do so is very palpable. In fact, the more the government increases its expenditures to turn the economy around, the more likely it is to increase its deficit. As such, it is giving itself some sizeable constraints, as it will have to figure out how to pay these amounts back in the next few years. However, we must remember that this law was created to prevent periods of chronic deficits from recurring. It has solid underpinnings and is perfectly justifiable. We must put aside the idea of amending it.

Moreover, the investments the government makes, such as its infrastructure investments, allow some of this problem to be skirted. In fact, the fiscal balances only reflect the amortization of the investment, not the total amount of the investment or of the costs. This is therefore an excellent time for the government to invest further or move capital spending projects up! By investing $5B in new money in the economy, using an amortization rate of just 5%, the government would be able to balance the budget for fiscal 2008-2009 by using at least $250M through current spending. However, the gross debt would feel the impact.

ACT FAST TO AVOID THE WORST
We have been saying so for some time, as well as emphasizing it to the federal government before it tabled its last budget, to remind it that new measures and actions must be put in place quickly and effectively, which must, as much as possible, have substantial multiplier effects. Moreover, to avoid generating structural deficits, the amounts injected must not
be recurring. Measures must be coordinated with other administrative tiers. For example, the federal and Québec governments now both have renovation tax credit programs, although the eligibility criteria differ. Harmonizing the two programs would multiply their potential impacts. Finally, the spending must, to the extent possible, have the maximum structuring impact on Québec’s economy.

The current global environment is very difficult. The recession is hitting all industrialized countries. Because it is very open to trade, Québec is feeling the effects of the global recession and, in the end, has very little power or control over the situation. Québec does not enjoy all the generally recognized levers or economic tools, such as monetary policy, nor does it have control over some social programs, such as employment insurance. Québec is also dependent on transfers from Ottawa and equalization payments. It must therefore take action using the tools at its disposal.

Among the measures that should be taken to meet the above criteria, we suggest income stimulus for the less well-off—those who have a greater propensity to spend. For example, distributing consumption coupons or stamps to be used at a Québec business, increasing the Quebec Sales Tax (QST) refund or raising the property tax credit all seem like more effective measures for stimulating consumer spending.

The idea of a consumption coupon deserves special attention. First, it meets the previously mentioned criteria regarding the effectiveness of the measures to implement. It has also been shown that such measures have substantial multiplier effects, which are even greater than those of infrastructure investments. Today’s technology provides many options for making this kind of measure operational. Distributing smart cards or electronic cards that would have to be used within a limited time at a business located in Québec, for example, would also have the advantage of avoiding a flight to savings.

Clearly, direct government spending in the economy must also be privileged. Think of infrastructure spending or investments in technology to improve government services, in the environment, in public transit, etc. Tax cuts, for their part, do not meet the criterion of non-recurrence and the extra money could be channelled into savings, unless it is specifically channelled toward lower income households. However, for the effects to be felt at a macro level, we should realize that the measures must have a powerful impact on the economy, which means substantial sums. And what we must not do during a recession period is cut government spending to combat deficits.

TO WHAT POINT SHOULD WE STIMULATE THE ECONOMY?

A frequent question involves how much the government must spend to make the economy turn around. There is no magic answer to this question. However, if the forecasts refer to a real GDP decline of 1.0% to 1.5%, we can conclude that it will take a similar increase to get growth back to neutral. With the deflator at about 0.5% forecast for 2009, we are near the International Monetary Fund (IMF) estimate that at least 2.0% of the nominal GDP will have to be invested to get the economy back on track. Taking 2% of nominal GDP as a yardstick gives us a figure of about $6B for 2009.

However, we must take into consideration that the federal government will also be injecting sizeable amounts into the economy ($18B in 2009-2010, without leverage effects). If we assume that Québec’s economy were to get about 25% of that amount, this would represent about $4.5B. The Québec government must therefore make up the difference, i.e. the additional $1.5B to be injected directly into the economy in 2009, an amount that will be added to the deficit generated by the poor economic environment. A similar amount could be needed in 2010 as well, given that we will only start to see the recovery at the end of 2009 and it could be fairly slow.

The Québec government’s deficit could therefore close in on $5B for 2009-2010 if a $1.5B economic stimulus plan were tabled, equalling about 1.7% of nominal GDP. This would take us to the deficit levels reached in the early 90s. The record deficit was $5.8B in fiscal 1994-1995, fifteen years ago. However, this deficit was then 3.4% of nominal GDP, twice what it is today. Of course, if the government privileges investment to kick start the economy, rather than direct spending, the deficit will not automatically be affected, given the different accounting treatment given the two measures.

One thing is certain: taking no action will, in our opinion, be a more costly long-term solution than the increase in gross debt created by the deficits—the deficit generated by the economic situation (+$3B) and the deficit generated by the recovery plan (+$1.5B) expected for 2009-2010, as well as the deficits of subsequent years. Québec’s economy is currently operating below capacity or below its growth potential, which is around 2.0%. Quick, effective government intervention would have the benefit of taking the economy back toward potential more rapidly.

With no intervention, it will take the economy longer to recover from the recession (graph 2). The consequences are clear: unemployment will remain higher for a longer period, with major social impacts. It will then be much more difficult
to get the budget back into balance. Moreover, if most industrialized nations, including the United States, the United Kingdom, Canada and several European countries (graph 3), have seen the exigency of instituting economic stimulus, we wonder how Québec can do otherwise without this having serious consequences for Québec’s economy over the short and medium range.

<table>
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<tr>
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<th>Value (US$B)</th>
<th>In % of GDP</th>
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<tr>
<td>United States</td>
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<td>Australia</td>
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</tr>
<tr>
<td>Total</td>
<td>1,900.5</td>
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* Calculated based on a rolling regression.
Sources: United Nations and Desjardins, Economic Studies

PRICING IS NOT THE ANSWER TO DEFICITS!
Talk of more rational pricing for the services the government provides did not just start yesterday. On October 30, 2007, moreover, the Minister of Finance created the Task Force on Fees for Public Services to “examine the issues and advise the government on the formulation of a new policy on rate setting.” The task force published its report on April 10, 2008; the report was quickly put aside as rate setting was not one of the government’s priorities at that time.

The issue of fees for public services was put back on the table recently. Under the current circumstances, there is a risk that the government will be tempted to use rate setting to solve the problem with the public finances—namely a decline in revenues coupled with an increase in expenditures. This would be a serious error in the short term. Rates must follow their normal course as per the basic principles associated with the current pricing. The economic relationship between fees and services provided must be maintained—that is, between the costs of delivering services and the fees charged. Most of all, the public must not be given the impression that fees are being raised to solve the deficit problem. That is a very dangerous avenue.

Nor would it be good to freeze some rates to allow the public to get through the current economic difficulties. The government’s goal is to help those who are being hurt as a direct result of this crisis—people who lose their jobs, for example—not the entire population. Those who still have their jobs do not need a freeze on electricity prices, for instance.

On the other hand, this is not a good time to raise rates too much to fill the state’s coffers. This is not an opportune moment to raise tuition fees, daycare fees, or drivers’ licence and registration fees. Doing so would have the same impact as raising taxes at a time when the economy needs stimulus instead. If the government really wants to tackle the problem of rate setting for public services, it will have to do so once the economy has recovered from the crisis. Times of crisis are never the right time to make draconian changes to public services, such as cutting spending or raising rates.

DON’T TOUCH THE GENERATIONS FUND!
In June, 2006, the Québec government passed the Act to reduce the debt and establish the Generations Fund. The goal was to reduce the government’s debt load by creating this specific fund. To finance it, the government was relying on our biggest collective renewable resource: water. The Generations Fund’s revenue stream is primarily constituted by water-power royalties paid by Hydro-Québec and private producers, and some of the profits from foreign sales of Hydro-Québec’s surplus electricity. In addition to these sources, the Fund also gets all of the income from selling off unclaimed property administered by the Ministère du Revenu and from donations to pay off the debt; it may also benefit from a portion of the proceeds of government asset sales.

These revenues are directly earmarked for the Generations Fund. Using them for any other purpose would mean turning away from the goal of paying off the debt. Derived from our primary natural resource, these amounts must not be used as a tax. The fund was created to pay off the debt; the royalties created to supply the fund were created specifically for this goal, not as a provision for dealing with economic cycles. Opening the door to using these funds or revenues for purposes other than those for which they were originally earmarked is, in our opinion, a dangerous precedent.
QUÉBEC’S GOVERNMENT IS LITERALLY IN A “STRANGLEHOLD”

It’s only when really tough economic times come along that we become aware of the virtues of efficient, farsighted, responsible management. The same goes for the value of savings, as promoted by a fable involving a grasshopper and an ant. These very simple principles are just as applicable to a single household, a business, and a government.

For a variety of reasons, Québec’s public finances have always been fairly precarious. The biggest surplus prior to reserve ever recorded was achieved in fiscal 2006-2007. It reached $1.4B. Note, however, that this surplus was made possible thanks to increased profits by government corporations, including an extraordinary $944M gain from the sale of Hydro-Québec’s holdings in businesses that it owned. We could therefore ask ourselves whether Québec is living beyond its means. The extent of this recession is helping to highlight the fact that, after a long period of economic growth, the government was unable to gain enough manoeuvring room to get it through the current crisis.

The most worrisome fact in this situation is that demographics will soon start to have a marked negative impact on public finances. First, because the population is aging and health care will put greater and greater pressure on expenditures. Also, because the decline in the labour force will slow down the economy’s growth potential, having a negative effect on tax revenue growth. As a result, we will have to make a greater effort over the next few years to get the public finances back into line because we will be swimming upstream. In this contest, not doing enough to make the economy recover is riskier than overdoing it. It is not yet too late to start rethinking the government’s role and making the necessary choices soon. They will probably be painful choices, but they are inevitable.

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