BUDGET ANALYSIS

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017
#1 BEST OVERALL FORECASTER - CANADA

Quebec: Budget 2018

The Government Puts Its Fiscal Leeway to Good Use

HIGHLIGHTS

- Better economic conditions and faster federal transfer growth accelerate the rise in budgetary revenue.
- The Government of Quebec is using this fiscal room to significantly increase its spending.
- The 2018 budget contains many new measures, totalling close to $16B over the next five fiscal years.
- This, nonetheless, fits into the financial framework, with budgets balancing for all fiscal years between now and 2022–2023.
- The Government of Quebec is changing course in managing the province's debt, as $2B annually will be withdrawn from the Generations Fund to pay down debt over the next five years.

TABLE 1
Summary of transactions

IN $M (EXCEPT IF INDICATED)	ACTUAL 2016–2017	PROJECTIONS 2017–2018	2018–2019	2019–2020	2020–2021	2021–2022	2022–2023
Own-source revenue	82,728	84,527	85,923	88,595	91,544	94,616	97,745
Variation (%)	*1.8*	*2.2*	*1.7*	*3.1*	*3.3*	*3.4*	*3.3*
Federal transfers	20,179	22,669	23,674	24,764	25,296	25,621	26,001
Variation (%)	*6.8*	*12.3*	*4.4*	*4.6*	*2.1*	*1.3*	*1.5*
Total budget revenues	102,907	107,196	109,597	113,359	116,840	120,237	123,746
Variation (%)	*2.8*	*4.2*	*2.2*	*3.4*	*3.1*	*2.9*	*2.9*
Program spending	-89,018	-94,817	-99,313	-102,066	-104,696	-107,294	-110,480
Variation (%)	*2.9*	*6.5*	*4.7*	*2.8*	*2.6*	*2.5*	*3.0*
Debt service	-9,527	-9,237	-9,380	-9,422	-9,532	-9,578	-9,664
Variation (%)	*-4.8*	*-3.0*	*1.5*	*0.4*	*1.2*	*0.5*	*0.9*
Contingency reserves	---	---	---	-100	-100	-100	-100
Balance	4,362	3,142	904	1,771	2,512	3,265	3,502
Generations Fund	-2,001	-2,292	-2,491	-2,707	-2,991	-3,265	-3,502
Balance in the meaning of the Act	2,361	850	-1,587	-936	-479	0	0
Use of the stabilization reserve	-2,361	-850	1,587	936	479	0	0
Balance in the meaning of the Act after reserve	0	0	0	0	0	0	0
Gross debt	203,490	204,533	209,418	211,120	214,151	215,076	216,876
Variation (%)	*0.1*	*0.5*	*2.4*	*0.8*	*1.4*	*0.4*	*0.8*
In % of GDP	*51.5*	*49.6*	*49.1*	*47.9*	*47.1*	*45.9*	*45.0*
Debt representing combined deficits	117,401	115,109	112,618	109,911	106,920	103,655	100,153
Variation (%)	*-2.3*	*-2.0*	*-2.2*	*-2.4*	*-2.7*	*-3.1*	*-3.4*
In % of GDP	*29.7*	*27.9*	*26.4*	*24.9*	*23.5*	*22.1*	*20.8*

Source: Ministère des Finances du Québec

François Dupuis, Vice-President and Chief Economist • Hélène Bégin, Senior Economist • Benoit P. Durocher, Senior Economist
Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

Revenue and Expenditure Growth Is Accelerating

The 2018 budget confirms the Government of Quebec's sound financial position. According to the projections of the Ministère des Finances, the budget year ending on next March 31st will close with an $850M surplus. This will be in addition to the $2.191B and $2.361B surpluses for 2015–2016 and 2016–2017 respectively, and will be allocated to the stabilization reserve totalling $5.402B at March 31st, 2018.

This performance is due in large part to significant budgetary revenue growth. Own source revenue benefitted from good economic conditions with high revenues stemming from income and consumption taxes. That said, revenues from federal transfers also increased considerably in 2016–2017 and 2017–2018. These increases are essentially due to higher-than-expected implementation of municipal projects funded by the Société de financement des infrastructures locales du Québec, higher revenues from the federal Disaster Financial Assistance Arrangements program in connection with the spring flooding in 2017, and a boost in health transfers. However, a return to normal is expected for the coming fiscal years, with slower growth in federal transfers. Budgetary revenue as a whole should, nonetheless, see average annual growth of 2.9% between 2018–2019 and 2022–2023.

In terms of program spending, the Government of Quebec is hitting the throttle. After average annual growth of 1.8% between the 2014–2015 and 2016–2017 fiscal years, the increase in program spending should accelerate to 6.5% in 2017–2018 and 4.7% in 2018–2019. Weaker growth is expected thereafter, with an average annual increase of 2.7% for the 2019–2020 to 2022–2023 fiscal years.

Ultimately, budgetary revenue will generally be higher than budgetary expenditures in the coming fiscal years. From 2017–2018 to 2022–2023, the provincial government's total operating surplus will be close to $15B. However, this amount comes from revenue that is actually allocated to the Generations Fund. Once the payments to the Generations Fund have been recorded, the government's balance within the meaning of the Act should not only drop back down to zero, but could even post a slight shortfall as of 2018–2019. That shortfall will be offset by monies available from the stabilization reserve. The budgetary balance within the meaning of the Act after the reserve has been used will, therefore, remain at zero for the entire forecast period of the Ministère des Finances.

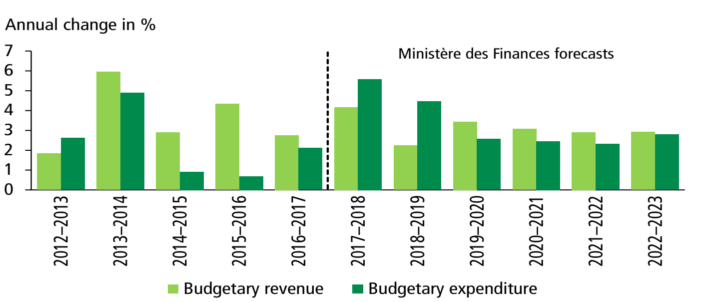
The sums deducted from the stabilization reserve should reach $3.0B by 2020–2021. The reserve balance could, therefore, drop from $5.4B at March 31st, 2018, to $2.4B at March 31st, 2021. The Government of Quebec plans to keep $2.4B in the stabilization reserve in subsequent fiscal years. Together with the $100M contingency reserve as of 2019–2020, the stabilization reserve will provide the Ministère des Finances with ammunition for dealing with any unpleasant surprises, such as an unexpected slowdown in economic growth, without compromising its goal of maintaining a balanced budget.

A Change of Course for the Generations Fund

As announced in recent days, the 2018 budget confirms a change in the strategy the Government of Quebec is following with regard to the Generations Fund. As of 2018–2019, and for the next four years, the Ministère des Finances plans to withdraw $2B annually from the Generations Fund to repay loans maturing on the financial markets. The *Act to reduce the debt and establish the Generations Fund* already provides for the option of taking any sum out of the Generations Fund to pay down debt. However, the Government of Quebec will continue to deposit dedicated revenue into the Generations Fund every year such that the Fund's book value will continue to increase in future fiscal years. It could, therefore, go from from $12.8B at March 31st, 2018, to $17.8B at March 31st, 2023.

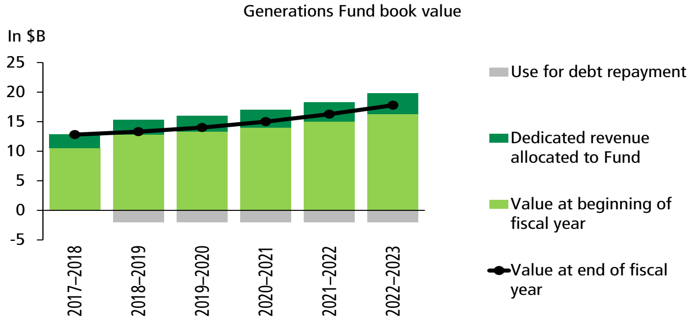
This new approach is a good way of reducing the provincial government's exposure to financial market uncertainty. It bears recalling that the idea behind the creation of the Generations Fund was to give the Government of Quebec leverage through a rate of return that was higher than the

GRAPH 1
Expenditure and revenue growth are expected to converge



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

GRAPH 2
The value of the Generations Fund will continue to rise despite withdrawals of $2B annually



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

TABLE 2
Economic outlook

VARIATION IN % (EXCEPT IF INDICATED)	2017	2018f	2019f
Real GDP[1]			
Ministère des Finances forecasts	3.0	2.1	1.7
Desjardins forecasts	3.1	2.2	1.9
Nominal GDP			
Ministère des Finances forecasts	4.4	3.5	3.3
Desjardins forecasts	5.3	4.5	4.3
GDP deflator[1]			
Ministère des Finances forecasts	1.4	1.4	1.6
Desjardins forecasts	2.1	2.3	2.5
Housing starts (annual rate in thousands of units)			
Ministère des Finances forecasts	46.5	40.3	33.8
Desjardins forecasts	46.5	46.0	43.0
Consumer prices			
Ministère des Finances forecasts	1.0	1.8	1.8
Desjardins forecasts	1.0	1.6	1.5
Job creation (annual average in thousands)			
Ministère des Finances forecasts	90.2	60.6	30.1
Desjardins forecasts	90.2	60.0	35.0
Unemployment rate (annual average in %)			
Ministère des Finances forecasts	6.1	5.4	5.3
Desjardins forecasts	6.1	5.2	4.8
Treasury bills—3-month (annual average in %)			
Ministère des Finances forecasts	0.7	1.4	2.1
Desjardins forecasts	0.7	1.4	2.1
Federal bonds—10-year (annual average in %)			
Ministère des Finances forecasts	1.8	2.5	2.9
Desjardins forecasts	1.8	2.5	2.9
Exchange rate (annual average in US$)			
Ministère des Finances forecasts	0.77	0.81	0.84
Desjardins forecasts	0.77	0.79	0.80

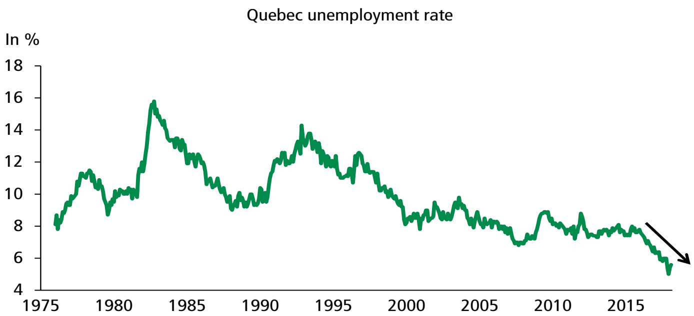
f: forecasts; [1] Due to rounding, the sum of the real GDP and GDP deflator does not correspond exactly to nominal GDP.
Sources: Ministère des Finances du Québec and Desjardins, Economic Studies

average interest rate of its loans. While this was the case most of the time, recent years saw major upheavals; during the financial crisis in 2008, the Fund's rate of return was -22.4%. Without an annual withdrawal, the sums accumulated in the Generations Funds in the years to come would have been very high. Under these circumstances, it is prudent for the provincial government to gradually repay its debt using monies available from the Fund. This will also result in savings with respect to the charges on the debt, which could total close to $1B by 2022–2023. Gross debt will, nonetheless, continue to rise in the coming years. On the one hand, the Generations Fund is already excluded from this measure. On the other hand, the government's financing needs arising notably from infrastructure financing will cause gross debt to balloon. Its ratio to GDP could, however, continue to decrease over the next few years from 51.5% at March 31st, 2017, to 45.0% at March 31st, 2023.

Strong Economic Growth Increases Fiscal Room

The Government of Quebec had plenty of fiscal room in preparing its 2018 budget, as economic conditions had improved considerably over the past year. The labour market is doing well, and the unemployment rate continues to be near record lows. Given that exceptional job gains in 2017 will give way to a more moderate increase and, since interest rate hikes will continue, household spending is expected to rise at a slower pace as of this year. Our most recent forecasts, therefore, point to an increase in Québec's real GDP of 2.2% in 2018 and 1.9% in 2019, compared to 3.1% last year. These real GDP projections are similar to those of the provincial government. The Quebec economy may, however, benefit from a more favourable situation in the United States than the one forecast in the budget, which would lead to stronger economic growth.

GRAPH 3
Economic conditions have improved dramatically in Quebec



Sources: Statistics Canada and Desjardins, Economic Studies

However, nominal GDP forecasts differ considerably because the numbers released this morning by the Institut de la statistique du Québec for 2017 turned out to be much higher than expected. Nominal GDP growth reached 5.3% last year, about a percentage point more than anticipated. Our forecasts were, therefore, revised upward: nominal GDP should increase by about 4.5% this year and next, a faster pace than our previous predictions and those of the Ministère des Finances. This could result in additional fiscal room for public finances because a one percentage point change in nominal GDP raises own source revenue by $650M, according to the Government of Quebec. Given the uncertainty surrounding the trade talks with the United States, it pays to be cautious. Key downside risks hanging over the economic outlook for the province are NAFTA's (North American Free Trade Agreement) future and developments in trade between Quebec and the United States, as well as a deeper than expected cooling of Canada's housing market.

The Government of Quebec Opens the Taps

As evidenced by the strong growth in program spending, the 2018 budget has many new measures totalling close to $16B over the next five years. Public services, primarily education and health, will receive $8.0B in additional funding. Quebecers will receive an additional $2.7B in assistance, whereas Quebec's economic development will receive $5.4B. This means that many new measures are contained in the 600 page budget released today, and it is very difficult to provide a detailed overview in this analysis. Nonetheless, here are some key initiatives that caught our attention:

- The 2018 budget provides for more than $1.6B in additional investments by 2022–2023 for education and higher education, including:
  - $319M to enhance support for and the success and integration of students;
  - $355M for the Digital Action Plan in education and higher education;
  - $545M to modernize funding for higher education institutions.
- An additional investment of $5.4B in health and social services is announced between now and 2022–2023:
  - $4.3B for access to health care;
  - $541M for social services;
  - $499M for seniors.
- Nearly $2.2B in additional tax relief for SMBs is proposed over five years:
  - A $1.2B reduction in Health Services Fund (HSF) contributions;
  - A gradual reduction from 8% to 4% in the tax rate of SMBs in the services and construction sectors, representing tax relief of nearly $1B.
- With the initiatives proposed in the 2018 budget, Quebecers will enjoy a better standard of living thanks to additional tax assistance of over $800M over five years:
  - Nearly $300M will go toward families and support for parents thanks to more childcare assistance and new assistance for the purchase of a first home;
  - Over $100M will be allocated to improving support for informal caregivers and volunteer respite services, as well as independent living for seniors;
  - Nearly $230M will be allocated to encouraging labour force participation and improving the living standards of workers. The government is also enhancing the tax credit for experienced workers by lowering the age of eligibility to 61 and increasing the maximum amount of eligible work income on which the tax credit is calculated. The government is also enhancing the tax shield in order to cover a bigger increase in work income;
  - More than $170M will go toward eco-friendly renovation work through a 1-year extension of the Rénovert refundable tax credit.
- To better support families and communities, the Government of Quebec is providing nearly $2.3B in investments. More specifically, the announced measures aim to:
  - Further support families with children, in particular by fostering family-work-study balance;
  - Improve the quality of life for seniors;
  - Promote gender equality and counter domestic violence and sexual violence;
  - Modernize the justice system;
  - Facilitate access to affordable, quality housing with $431M in investments.

- The 2018 budget provides for additional measures representing more than $1B in support tailored to different sectors of activity for their digital transformation, including:
  - $355M for implementation of the digital action plan in education and higher education;
  - $116M for initiatives in the cultural sector;
  - $194M to bring justice up to step with new technologies;
  - $241M to enhance tax measures to foster appropriation of digital technologies by businesses.
- The Ministère des Finances provides for investments of nearly $662M to:
  - Implement initiatives in support of the energy transition;
  - Protect ecosystems and ensure sustainable development of the territory;
  - Improve water management and mitigate risks related to flooding.
- Over the next few weeks, the government will present the 2018–2023 national workforce strategy. This strategy will be based, in particular, on $810M in additional investments provided in the 2018 budget.
- The government is also making public, through the Expenditure Management Strategy 2018–2019, a second program review cycle with a view to instilling a true program review and continuous improvement culture within Quebec's public administration. The second cycle will include new innovation and optimization projects for the purpose of improving the quality of services provided to the public, families and businesses.
- When the November 2017 update of the Quebec Economic Plan was tabled, the government announced its intention to reform the school tax system. The bill to reform the school tax system introduces major changes that would reduce the school property tax by more than $3.2B over five years for all owners, businesses and individuals. The proposed reform also provides for the establishment of a single regional school tax rate based on the lowest effective tax rate for each region, and a basic exemption on the first $25,000 of the value on the property assessment roll as of the 2018–2019 school year. The government has also committed to compensating the school boards for the reduction in their school tax revenues through an equivalent increase in the government subsidy paid to enable them to maintain their funding levels.
- To improve tax fairness, the Government of Quebec is introducing the following measures for 2018–2019:
  - Making the collection of the Quebec sales tax mandatory for suppliers outside Quebec, including through electronic transactions;
  - Eliminating certain loopholes, particularly with regard to international taxation;
  - Restricting income sprinkling arrangements;
  - Improving tax and corporate transparency via the Registraire des entreprises du Québec;
  - Rewarding certain tax informants;
  - Reviewing Revenu Québec's voluntary disclosure program;
  - Supporting clients and workers to more effectively combat unreported work in the employment agency sector;
  - Subjecting food trucks and trailers to mandatory billing via sales recording modules;
  - Enhancing the provision to increase any appropriation for initiatives concerning revenues.
- The improvement in Quebec's financial situation allows the government to raise investments under the 2018–2028 Quebec Infrastructure Plan (QIP) to a record level. Investments under the 2018–2028 QIP amount to $100.4B, an increase of $9.3B compared to the 2017–2027 QIP. The increase means that, from now until 2028, the government will be injecting over $10B a year, on average, into Quebec's infrastructure.

Better Funded Public Services, as Debt Gets Repaid

The acceleration in government spending presented in the 2018 budget is poles apart from the more modest growth of recent years. Some will see this as having to do with the upcoming election in the fall of 2018. That said, the Government of Quebec clearly had plenty of fiscal room, with better economic conditions translating into faster budgetary revenue growth. The Government of Quebec, therefore, chose to put this fiscal room to good use in order to meet important needs, particularly in health and education.

Despite higher spending, the government's financial framework is respected, while a balanced budget is projected for every fiscal year of the forecast period. In addition, the Government of Quebec opted to use the sums available in the Generations Fund, thereby initiating the repayment of public debt. In short, the 2018 budget has everything to please a vast majority of economic agents and financial markets.