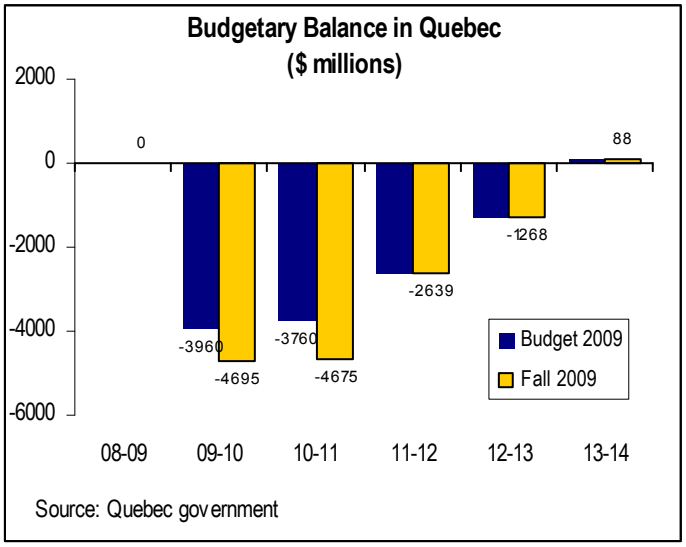
LAURENTIAN BANK SECURITIES

LBS Economics Daily

November 2, 2009

Quebec's Fiscal Update: Time for Consumers to Pay the Bills

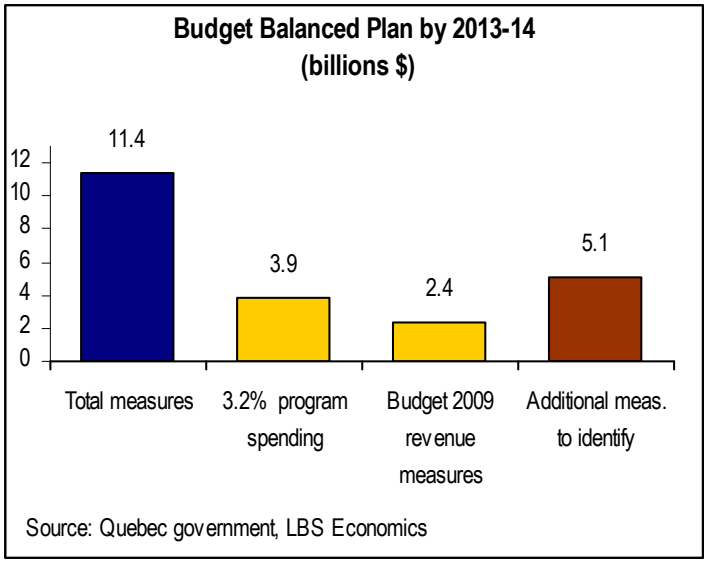
In recent weeks several Canadian provinces released fiscal mid-year updates, most recently Quebec. The province's Finance Minister Raymond Bachand revised the province's projected deficit during 2009-10 to $4.7 billion, up from $3.9 billion (see chart). The projected deficit for 2010-11 is also $4.7 billion. In all, Quebec sees $13.3 billion in cumulative deficits during in four years, $1.7 billion more than forecast in the 2009 budget.



The goal was to avoid what happened to Ontario. Both DBRS and Standard & Poor's downgraded Ontario's credit rating after the McGuinty government unveiled gargantuan deficits without having a concrete plan to redress the situation. To avoid this situation, Quebec kept intact its target date for balancing the books: FY 2013-14. That said, Quebec's plans are not as transparent as those of British Columbia, where the Campbell government is taking concrete actions to avoid having to write books in red ink in 2013-14. Quebec has committed to balancing the budget, but has given no indication regarding how it would do this.

$11.4 billion needed to reach the zero deficit mark

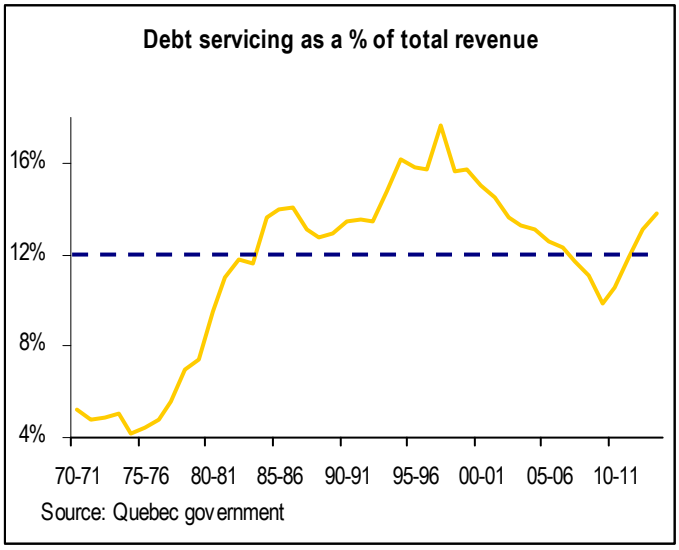
It should be noted right off that Quebec's deficit is structural in nature. Economic growth alone won't be enough to bring its budget into balance (though the government's projections appear reasonable). As a result, the government projects a further $5.1 billion in "*additional measures to be identified*". The word additional is important, because in reality $11.4 billion in new revenue- and expense- related measures over four years are needed to bring the books into balance by 2013-14 (see chart).



That enormous amount (close to 8% of nominal GDP) includes the $2.4 billion in revenue-generating measures announced during the 2009 budget, such as the indexation of fees and a 1% increase in the provincial sales tax starting in January 2011.

Also, the Charest government's plans to tighten its belt. The debt service is projected to increase rapidly in the medium-term (interest payments are expected to eat up 10 cents of every dollar of revenues in 2009-10; and 14 cents by 2013-14). With such upward pressures coming interest debt expenses, the Quebec government wants to cap annual program spending growth at 3.2% during the coming four years. That will be a big challenge since it averaged 4.6% during the past seven years. One major risk concerns coming salary negotiations with public sector employees (remuneration accounts for 55% of all program spending in 2009-10). The public sector is asking for wage increases of 11.25% over three years totalling $3.2 billion. The ambitious objective of capping the annual growth of program expenditures at 3.2% during the coming four years would trim a further $3.9 billion. The provincial government projects average annual nominal GDP growth at 3.3%. That means the goal is to maintain program expenditures to about 20% of nominal GDP.

November 2, 2009



Will the additional $5.1 billion in new measures come strictly from the revenue side?

The Quebec government has specified how $6.3 billion of its $11.4 billion projected budget shortfall will be bridged. However it has not said how the remaining $5.1 billion hole will be filled. It is a bit curious to see that the government knows when the measures are scheduled be implemented: $450 million in 2010-11, $2.1 billion in 2011-12, $1.6 billion in 2012-2013 and $957 million in 2013-2014.

The documents provided by the provincial government imply that individuals will be asked to contribute most (if not for all of the $5.1 billion). For example the government states that it foresees a "*balanced approach between means to be taken to limit the growth in spending and new measures to increase revenues*." However the additional measures to be identified form part of the "revenue efforts" column, much the same way as did measures announced in Budget 2009. The plan appears to fill the $11.4 billion gap by raising $7.5 billion in new revenues and by cutting expenses by $3.9 billion. In other words, the strategy appears to be a two-thirds/one third revenue/expense split. If Quebecers really wanted to bridge the fiscal shortfall using a 50-50 revenue and expense split, then each set of initiatives would be worth about $5.65 billion. In our view, 2010-2011 is the only fiscal year in which the even split could be maintained: the government plans to save $869 million by tightening expenses and to bring in $1.065 billion in new revenues.

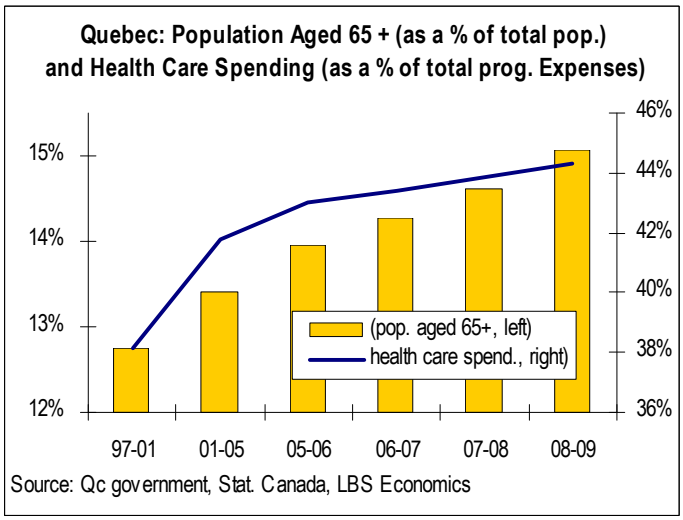
Although the government appears to be shying away from a balanced approach for the time being, we are in wholehearted agreement with the two other principals that will guide its efforts to find $5.1 billion: Limit the undesirable effects of tax increases on economic growth by targeting areas that would least hurt the economy, and making decisions that are equitable.

These principals lead us to conclude that households will soon face a mix consisting of: increase in fees for government services (to notably reflect their real cost of utilization); an additional rise in the provincial sales tax (consumers will have a hard time avoiding it in contrast to a personal income tax rate increase); and an increase in residential electricity rates (this sacred cow is a luxury that cannot last for long, specially with an increasing debt burden).

This Isn't It: The Debt Burden Will Need to Decline Thereafter

The Charest government projects four years of modest deficits, followed by a return to a balanced budget by the fifth year. Once the plan is achieved, the government must guard against resting on its laurels because the province's heavy debt burden will continue to haunt Quebecers. Former Quebec Finance Minister Michel Audet implemented the Generations Fund in 2006, in order to reduce the weight of the debt (as a share of the size of the economy) between now and 2026. The fact that transfers to this fund ($4.7 billion over five years) are maintained is good news.

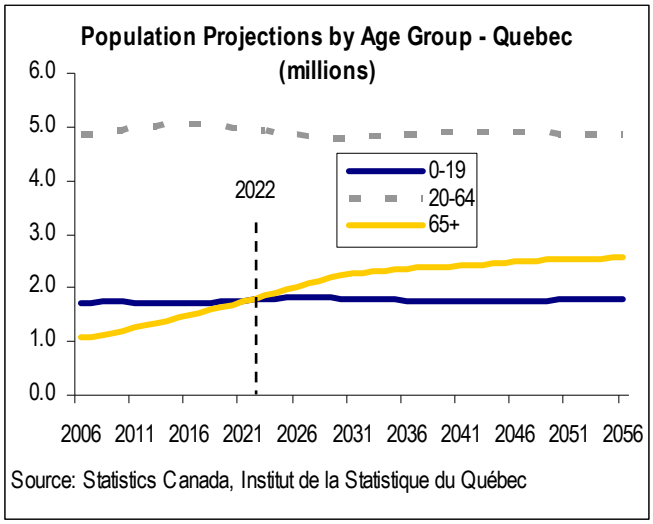
Reducing the debt-to-GDP ratio will not be an easy feat. For one, economic growth is expected to be slower over the medium term than it has been in the past. On that front, the Institut de la Statistique du Québec (ISQ) notably projects the working age population (those aged between 15 and 64) will begin to decline in 2013. In addition, the ageing of the population will spark astronomic pressures on health sector costs. According to the ISQ, by 2022, the number of persons aged 65 and over will exceed those who are under 20. The proportion of those aged 65 and over – which tracks very well the government's health care spending as a share of total program expenses – will double to 28% by 2056. This will pose significant challenges because according to the ISQ per capita government spending increases exponentially once a person turns 65.

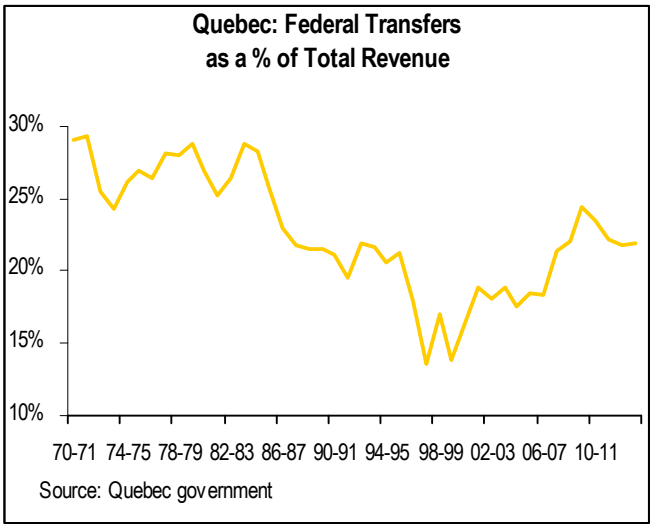


LAURENTIAN BANK SECURITIES

LBS Economics Daily

November 2, 2009





The time has come to pay the bill

Projected deficits in Quebec present no cause for alarm, and certainly are smaller than those expected in Queen's Park and Ottawa. That said, the evolution of Ontario's and the federal government's finances adds up to Quebec's list of fiscal challenges because close to 20% of the total revenue take stem from federal transfers. For example Ontario's declining fiscal capacity leads a reduction in transfer payments to have-not provinces receiving equalizations, notably Quebec. Quebecers thus won't be able to count as much on the federal government, and will have do more on their own to clean up and finance public services. In conclusion the main solution envisaged in the mid-year fiscal update appears to be an increase on the fiscal burden imposed on individuals through hikes in various government fees, residential electricity rates and the provincial sales tax.

Sébastien Lavoie, Assistant Chief Economist