ECONOMIC RESEARCH AND STRATEGY

LAURENTIAN BANK SECURITIES

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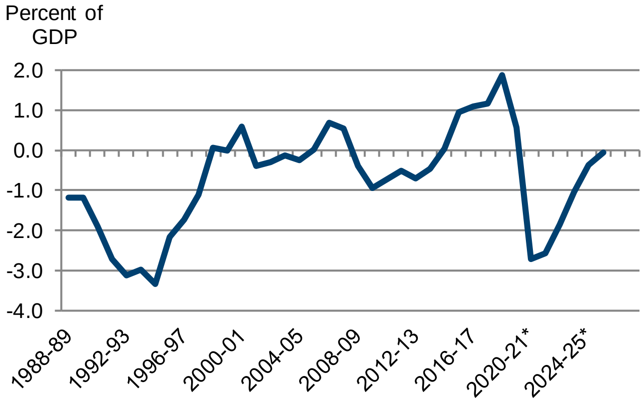
Quebec 2021 Budget – Short Term Support, Lengthy Deficit Reduction Path

The main takeaway of the 2021 Quebec Budget is simple: the severe and immediate drag of the pandemic on the Province's own-source revenue and additional support provided to improve health and economic outcomes will ultimately lead to a profound and lengthy impact on public finances.

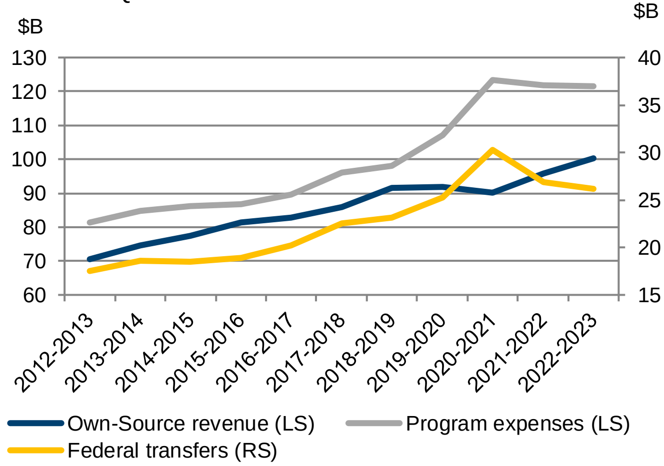
From the start, the province reiterates its $15.0B deficit estimate in FY 2020-21, or $13.0B before transfers to the Generations Fund (2.7% of GDP, chart 1). The short-term fiscal priority remains spending as necessary to support people and the recovery in the making: infrastructure spending, training, and measures to strengthen the health care sector amount to $15B by FY 2025-26. Total expenditures of $126B are projected in FY 2021-22 (chart 2), bringing the expenditures-to-GDP ratio to a record high of 27%, 3 percentage points higher than the historical average.

Chart 1: Quebec Budgetary Balance



Note: *Before* transfers to the Generations Fund.
Source: Quebec Government, GoC Fiscal Reference Tables, LBS Econ. Res. and Strategy.

Chart 2: Quebec Fiscal Framework



Meanwhile, own-source revenue is projected to increase by 6.3% in FY 2021-22 as real GDP returns to its pre-pandemic level toward the end of 2021. However, the uneven and slow labour market recovery implies that full employment won't be achieved before the middle of 2022. Since it will take more time than expected to build a solid labour market foundation, the Quebec government decided to suspend for two years its *Balanced Budget Act* mandating zero-deficit within five years. In other words, the budget proposes a lengthy 7-year path to a balanced budget in FY 2027-28, after transfers to the Generations Fund. At first, the cyclical component of the deficit will shrink in tandem with the economic recovery during the next two years, from $12.3B in FY 2021-22 to $8.5B in FY 2022-23.

Quebec Reiterates Call for Increase Federal Health Transfers

The Quebec government acknowledges the existence of a structural shortfall growing over time after the pandemic. In fact, this shortfall to offset grows from $1.3B in FY 2023-24 to $6.5B in FY 2027-28. The previous Liberals government used a similar approach following the 2008-09 Financial Crisis: Budget 2010 included an incomplete deficit reduction plan requiring more than $2.5B "unidentified measures". These measures eventually took the form of a 2ppts sales tax increase.

The future adjustment required could play out differently as the CAQ government committed itself not to increase the tax burden.[1] Also, bringing down the pace of total spending significantly below revenue growth, as the previous Liberals government privileged between 2014 and 2017, is not an approach the current government is willing to take. Like other provinces, Quebec renews its demand for the federal government to assume 35% of total health care costs through stronger transfers, up from 22% today. The federal government's announcement to transfer an additional one-time sum $7B to provinces and municipalities in FY 2021-22 falls short of the provinces' request for a long-term commitment. Nonetheless, Quebec will receive $0.9B in additional health care transfers from this new federal legislation, an amount not included in today's budget.

Possible upside risks in the near-term but third pandemic wave coming

Several other aspects of the 7-year financial framework merit our attention. First, many public sector employees have been without a wage contract for about a year as their previous 5-year agreement ended in March 2020. The teachers' union recently voted in favor of a general strike. The government offers a 6.2% enhancement over three years.

Second, we see an upside risk to the economy in 2021 assuming no severe negative pandemic developments. Following a 5.2% real GDP contraction of 2020, very conservative growth forecasts of 4.2% in 2021 and 4.0% in 2022 are part of the base case scenario underpinning the revenue outlook. In our view, real GDP growth could surpass 5% in 2021, bringing close to $0.8B additional revenue based on the Province's own sensitivity measure. The number of COVID-related hospitalizations continues to fall as the sprint race between the virus variants and vaccination campaign continues. Today's spike in new COVID-19 cases is a worrying development but the number of hospitalisations still fall. To account for the possibility of a 3rd wave of infections, renewed lockdowns and downside economic risks, a $1.5B provision in each of the next two years is included in the financial framework.

Transfers to the Generations Fund Intact

The Quebec government elected to leave intact future transfers to the Generations Fund despite the pandemic shock. This decision will continue to strengthen the market's positive perception regarding the Province's financial situation. Dedicated revenues to the fund amount to $3.1B in FY 2021-22. They will grow to $4.2B in FY 2025-26, above the $3.9B shortfall to be resorbed in that specific year. In other words, the province continues its debt reduction effort despite the lengthy deficit reduction process. The fund's book value of $11.9B today is projected to more than double to reach $30.3B in FY 2025-26 based on an expected annual return of 4.8%, thereby reducing the gross debt by the same amount.

Gross Debt above Pre-Pandemic Targets, Net Debt Remains Manageable

[1] We learn in this budget that the 0.48% compensation tax for financial institutions that was supposed to be abolished in 2024 will finally be maintained, which has to be interpreted as old tax staying rather than a new tax.

Before the pandemic, Quebec was largely on track to meet its legacy objectives of reducing its gross debt-to-GDP ratio below 45% and accumulated deficits-to-GDP ratio below 17% in FY 2025-26. The province won't be able to meet its objectives because COVID-19. The province forecasts gross debt-to-GDP and accumulated deficits-to-GDP at 47.9% and 24.6% in FY 2025-26. As a consequence, the government will review the *Act to reduce the debt and establish the Generations funds* over the coming months. The province could either 1) revise up the FY 2025-26 targets or 2) set longer-term, achievable, debt reduction objectives post-pandemic, a more likely scenario in our view.

By adopting the Auditor General's recent recommendation to modify the accounting treatment of transfers to municipalities and universities, Quebec inputs a $12.4B upward revision to net debt in FY 2019-20. The net debt-to-GDP at the end of this fiscal year is now estimated at 39.9%, a moderate increase relative to the 37.3% estimate of the 2020 Fall Update. Over the horizon, Quebec's net debt-to-GDP ratio remains manageable, lower than in FY 2013-14 prior to the previous fiscal consolidation cycle. Shrinking deficits, stronger nominal GDP and expectations of a significant improvement of the current $14B net liability for public sector retirement plans will bring down the ratio to 43.3% in FY 2025-26.

Elevated Borrowing Requirements and Low Debt Servicing-Revenue Ratio

Annual debt service payments will increase from $7.7B in FY 2020-21 to slightly above $9B over time. Fluctuating between 6.4% and 7.1% over the forecast horizon, the province's debt charges-to revenue ratio is expected to stay low by historical standards. This key fiscal anchor, more often utilized today given the ultra-accommodative global monetary policy stance, allows the government to incur large deficits without threatening the delivery of essential services. Of course, investors should monitor the effect of the ongoing repricing in global bond yields on Quebec's public debt charges going forward. More specifically, for a full percentage point upside surprise in market rates, Quebec's debt servicing costs would increase by $540M in FY 2021-22, or $1.9B over five years. We see a moderate upside risk to the government's projections in 2021 and 2022, namely a 1.5% and 1.7% annual average for 10-year Government of Canada bond yields.

Quebec completed a record $38.4B borrowing program in FY 2020-21, including $4.3B in pre-financing for FY 2021-22. The estimated program for FY 2021-22, at $28.5B, is somewhat lower than the $35.3B Fall Update forecast due in part to the sizeable downward revision to repayments of borrowing. Between FY 2023-24 to FY 2025-26, the program remains around $30B annually as the province resorbs its deficit while assuming higher repayments of borrowings and hefty public infrastructure investment.

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