Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

The 2018 Quebec Budget

Quebec Finance Minister Carlos Leitao tabled the last provincial budget before the general elections to be held next October.

As it was announced on March 14th, the outright debt reduction of the Province using the Generations Fund is undeniably the single most important measure in this budget. The average annual return on investment on the Generations Fund was about 9.0% over the past six years while the cost of new borrowings averaged about 2.8%. As such a positive carry is not guaranteed in the future, the government made the prudent decision to slow down the growth of the Fund over the next five years. Current valuation of bonds and equities are high and there are growing signs that the global economy might be in the late stage of the current cycle. Furthermore, higher interest rates are increasing the cost of borrowing for the Province of Quebec which is holding a gross debt surpassing $200B. Thus, using part of the $13B Generations Fund to pay down debt is justifiable. Regardless, the value of the Fund will continue growing over time through both assumed future contributions and returns on the Fund’s assets.

The $2B annual withdrawal from the Fund over the next five years will obviously reduce the re-financing of maturing bonds ($14.6B in FY 2018-19 instead of previously forecast the $16.6B). The budget documents do not specifically mention what maturing borrowings won’t be re-issued. In FY 2018-19, the financing requirements are projected to be $13.4B, compared to $17.9B in FY 2017-18 (which included $7B in pre-financing activity).

It also appears to be prudent to reduce the debt by $10B over five years rather than by $10B right away. Indeed, the profitable investment income generated from the Fund over the cost of the debt of the Province is still a very reasonable assumption according to the government and this positive carry is essential to lower the Province’s debt-to-GDP ratio over time. In spite of the $2B annual contributions to the debt reduction effort, the Generations Fund is still assumed to be growing over the next five years. This obviously implicitly assumes there won’t be a major downturn in financial markets in the near future. The government proposes to maintain deposits to the Fund in the coming years above the $2B annual debt contribution from the Fund ($2.5B in FY 2018-19, $2.7B in FY 2019-20, etc.). Accordingly, the Fund is assumed to continue increasing over time, albeit slower than projected in last year’s budget.

Altogether, the objective is to manage risks by maintaining the Generations Fund within a reasonable size while facilitating the debt-to-GDP reduction to its long-term target of 45% in FY 2022-23 which budget documents claim will occur three years earlier than previously projected. It has to be noted however that the gradual reduction in the net unfunded public pension liabilities (from $24.6B in FY 2016-17 to $7.5B in FY 2022-23) which is assumed in the budget is a major contributor to the reduction of the debt-to-GDP ratio. If economic conditions were to worsen, such assumptions would be optimistic. At the same time, fiscal revenues, estimated contributions to the Generations Fund and the returns of the Fund over 5 years would probably fall and render the objective of reaching a 45% debt-to-GDP much more difficult. A reduction in infrastructure spending, tighter fiscal spending and the use of the stabilisation reserve would then be warranted to keep the ratio under 50%.

Major lift in spending, tax relief for small businesses, first-time buyer tax credit

With real GDP posting its strongest growth in nearly two decades in 2017 (3.0%), economic activity exceeded expectations. Thus, a third consecutive and large $1.7B surplus was registered in FY 2017-18 after the $2.2B contribution to the Generations Fund. Also, the debt-to-GDP ratio declined for the third consecutive year in FY 2017-18 to reach 49.6%. This ratio is below the 50% mark for the first time since the global financial crisis.

About half of the $1.7 surplus registered in FY 2017-18 is used to finance new initiatives proposed in this year's budget (as discussed below); reducing the effective 2017-18 surplus to $850M. Furthermore, given the massive 5.9% increase in program spending projected in FY 2018-19 and targeted tax cuts to small businesses, a $1.6B withdrawal from the stabilization reserve is necessary in FY 2018-19 to dedicate money to the Generation Funds and maintain a balanced budget.

Given the strength of the economy, the budget includes several generous spending measures while maintaining a balanced budget. First, the tax burden of small and medium-sized businesses (SMB) will fall by $2.2B over the next five years. About half of this tax relief will come from a payroll tax reduction (the employer's contribution to the health services fund will be reduced and the threshold to qualify for the reduced rate will be gradually increased). Also, the SMB income tax rate in the service and construction sector will gradually fall from 8% to 4% over the next five years; the tax rate for SMB companies in the primary and manufacturing sectors is already 4%. Overall, this new $2.2B tax relief will help companies to offset some of the costs related to the previously announced increase in QPP employer contributions.

Regarding the housing sector, there are two new measures worth mentioning. First, the government introduces, starting this year, a non-refundable tax credit for first-time home buyers. The maximum value of the non-refundable tax credit is $750 (for a total of $1376 with the similar federal tax credit) which is equivalent to the recent increase in the annual cost of carrying an average mortgage caused by higher short-term interest rates which have increased by almost 1% recently. Second, the RénoVert tax credit is extended by one year to March 2019.

Finally, the budget does not include a foreign-buying tax similar to the one applicable in Toronto and Vancouver since the presence of foreigners on the Quebec's real estate market is marginal. Non-Canadian buyers represented 1% of total residential transactions in 2017, up from 0.5% in 2013 and 0.8% in 2006.

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