Beyond the ABC of Quebec Public Accounting – Part II

Following the publication of our report *Beyond the ABC of Quebec Public Accounting*, interesting client feedback provides the opportunity to clarify additional concepts related to the Quebec financial framework. In this follow-up report, we give an overview of the Generations Fund and address why the Quebec government still borrows despite having accumulated budgetary surpluses. For completeness, Annex 1 presents an infographic of revenues and expenditures within the fiscal framework.

The Generations Fund was established to reduce debt

The Generations Fund was established in 2006 as part of the *Act to reduce the debt and establish the Generations Fund*. Back then, even though the government was running a budgetary surplus, Quebec's debt-to-GDP ratio was the second highest in Canada, only behind Newfoundland and Labrador, but far ahead of Nova Scotia which occupied the third place.[1] The government at the time set up the following goals: (1) to reduce Quebec's gross debt-to-GDP to 45% of GDP in FY 2025-26 from 49.7% in FY 2006-07 and (2) to reduce Quebec's debt representing the accumulated deficits-to-GDP from 33.5% in FY 2006-07 to 17% in FY 2025-26.[2]

Beside fiscal discipline, the main mechanism by which to achieve these financial objectives is the Generations Fund. Revenue streams that could go towards program expenditures are diverted into the Fund every year. The Caisse de Dépôt et Placement du Québec (CDPQ) is the Fund's manager. Barring any legislative changes, the government is not authorized to use these funds for other purposes than debt reduction. The rationale behind investing in the Fund rather than paying down the debt directly is that the return on the investments should exceed the province's marginal cost of borrowing. Therefore, net debt (gross debt minus financial assets) and the accumulated deficit (net debt minus non-financial assets) would be declining faster by investing in the Fund. Since inception twelve years ago, that strategy worked successfully, with 2008 being the only year when returns were significantly negative (-22.4%). From 2007 to 2018, the average annual return on investment was 5.5% versus an average annual cost of borrowing (10-year Quebec bond yield) of 3.4%.

Quebec's electricity powers the Fund

In FY 2019-20, 42% of dedicated revenues are expected to come from royalties, including Hydro-Québec (28%), private hydro producers (4%) and mining activities (10%, Chart 1). Revenues from electricity rate hikes are also included (11%) as well as an additional contribution from Hydro-Québec since FY 2017-18 (8%). Also, as the Fund grew, the share of total revenues that investment income represents increased. From 8% in FY 2007-08, investment income now accounts for nearly 20% of the annual inflow to the Generations Fund. While it allows the Fund to grow faster when returns are positive since they are re-invested, it also increases market risk should the return on investment turns unexpectedly negative. That is partly why the Quebec government removed $10B from the Fund between FY 2018-19 and 2019-20. Hence, the book value of the Fund, after increasing from $0.6B in its first year to

[1] As measured by net debt-to-GDP.
[2] Mainly due to the large accumulated surpluses over the past four years, those objectives are on track to be achieved ahead of schedule: in FY 2019-20 for the gross debt and in FY 2023-24 for the accumulated deficits.

$12.8B in FY 2017-18, dropped to $8.3B in FY 2018-19 (Chart 2). During a Conference held earlier this Fall, Finance Minister Éric Girard mentioned that he had no intention of making additional withdrawals in the future.

Chart 1: Dedicated Revenues to the Generations Fund (FY 2019-20: $2.7B)

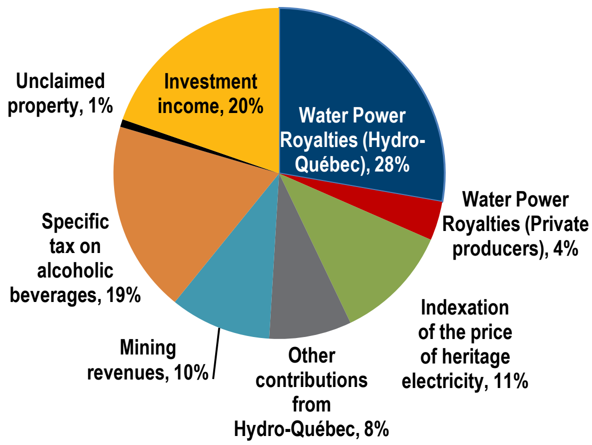
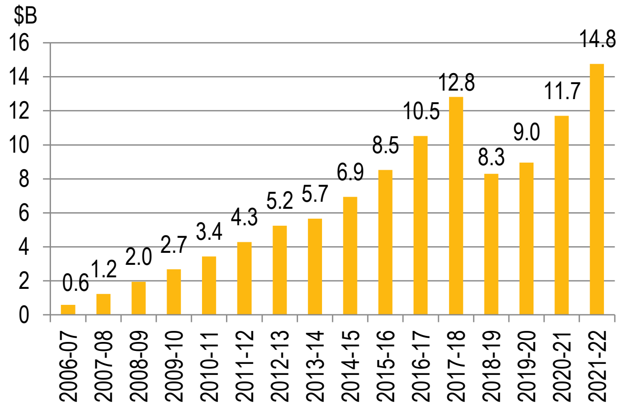


Chart 2: Book value of the Generations Fund



Note: In FY 2018-19 and 2019-20, the government withdrew $8B and $2B from the Fund, respectively, to pay back the debt. On December 31 2018, the market value of the Fund was $11.3B.
Source: Government of Quebec and LBS Econ. Res. and Strategy.

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You have to borrow even with a surplus

One question would be how come the Quebec government can still run a substantial borrowing program despite having preserved a budget balance and accumulated surpluses for the last five years. The reason is that provincial governments borrow for much more than an operational deficit. Table 1 shows Quebec's total borrowing program from 2019-20 to 2023-24, as included in the 2019 budget.[3] Financing raised through the program is allocated to three funds: the General Fund, the Financing Fund, and Financement-Québec.

The General Fund includes:

- **Net financial requirements** are estimated in Budget 2019 at $1.8B. These are the sum of the surplus and important non-budgetary transactions such as capital expenditures, investments, loans and advances and income from retirement plans;
- **Repayment of borrowings** make up the bulk of financing in the general fund and consist of rolling over debt maturing over the fiscal year;
- The use of **pre-financing** and the **Generations Fund** as well as **cash positions** all decrease financial requirements for the General Fund.

The Financing Fund and Financement-Québec account for 96% of total requirements in FY 2019-20. The strategy behind these funds is to pool the financing needs of large organisations that are within the government's reporting entity but not the government itself. These include health and social services, school boards, CEGEPs and the Université du Québec Network. By doing so, those institutions can lower their cost of borrowing in financial markets. Altogether, borrowing under these line items represents $11.3B in FY 2019-20.

[3] That information is not presented into the Fall Update.

Table 1: Quebec Financing Program ($M)	2019-20	2020-21	2021-22	2022-23	2023-24
General Fund					
Net financial requirements	1,826	2,750	3,087	3,325	3,369
Repayments of borrowings	4,823	3,848	9,293	8,326	5,928
Use of the Generations Fund to repay borrowings	-2,000				
Change in cash position	-4,167				
General Fund	482	6,598	12,380	11,651	9,297
Financing Fund	9,400	9,000	9,000	9,300	11,000
Financement-Québec	1,900	1,800	2,700	2,000	1,700
Total	11,782	17,398	24,080	22,951	21,997
Includes: Repayment of borrowings	11,066	11,528	14,231	13,277	12,820

Note: A negative entry indicates a source of financing and a positive entry, a financial requirement. The total financing program for FY 2019-20 was revised up to $12,489M in the Fall Update.

Source: Table I.27 of Quebec Budget 2019.

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Annex 1 – Revenues and expenditures within Quebec's Fiscal Framework for FY 2019-20