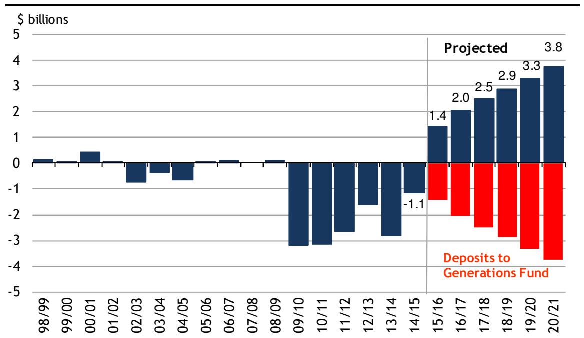
QUEBEC BUDGET 2016

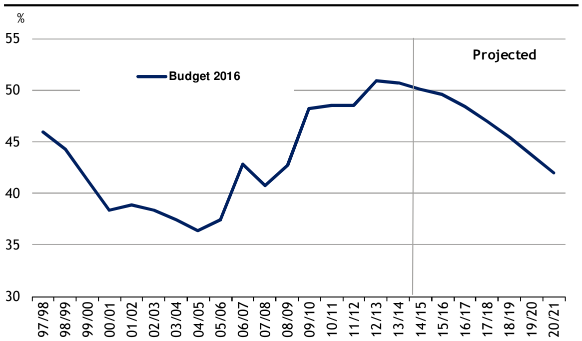
March 17, 2016

Quebec budget balance



Source: Ministère des Finances du Québec, RBC Economics Research

Net Debt as % of GDP



Source: Ministère des Finances du Québec, RBC Economics Research

Economic growth assumptions

	2014	2015	2016	2017	2018	2019
Real GDP growth (%)						
Budget 2016	1.5	1.1	1.5	1.6	1.5	1.5
RBC	1.5	1.0	1.4	1.8	-	-
Nominal GDP growth (%)						
Budget 2016	2.5	2.0	3.2	3.3	3.3	3.2
RBC	2.5	2.0	3.0	3.6	-	-

Source: Ministère des Finances du Québec, RBC Economics Research

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Basking in budgetary balance

The 2016 fiscal plan presented by the Quebec government saw Finance Minister Leitao take advantage of the opportunity to loosen the province's fiscal belt following years of tightening aimed to get the province back on firm fiscal footing. He tabled the province's second consecutive balanced budget and maintained the balanced budget projections through the fiscal plan (showing zero balances through to FY2020/21, in line with the Balanced Budget Act). Revenues are projected to exceed spending through the five-year plan resulting in budget surpluses; however, the excess funds, amounting to $1.4 billion in FY2015/16 and a cumulative $15.9 billion through to FY2020/21, will be deposited to the Generations Fund for debt reduction. A handful of 'goodies' were found in the plan, although the key takeaway from the documents was the notable shift in tone from those presented in recent years. Having largely tackled its structural budget challenges, the focus is now on creating conditions to foster economic growth in the medium-term and addressing the looming task of substantially reducing the weight of the provincial debt over the longer-term.

Returned to budget balance in 2015/16

Minister Leitao offered an optimistic assessment of Quebec's fiscal situation with the balanced budget for FY2015/16—the first since FY2008/09—and again in FY2016/17 marking a sharp contrast to the situation that the province found itself in only two short years ago. At that time, budget shortfalls were expected if the deteriorating fiscal situation was not addressed. The return to budget balance in FY2015/16 attests to the province's efforts in restraining program spending growth and provides a solid foundation for the province to maintain a balance budget profile through the forecast horizon.

Spending the fiscal dividend in 2016/17

The return to budget balance in FY2015/16 provides a solid foundation for a further improvement in the province's fiscal situation in FY2016/17; although significant challenges remain. In the near-term, headwinds emanating from weaker-than-expected economic growth are projected to keep revenue growth restrained; however, the measures taken in recent years and ongoing expenditure restraint still provide scope for the government to tap into its fiscal dividend.

The positive effects for the Quebec economy emanating from the depreciation in the Canadian currency and low crude oil prices have been slow to materialize, contributing to a weaker economic backdrop than had been anticipated at the time of the November 2015 Update. As these effects become more pronounced, the government anticipates that real GDP growth will strengthen modestly from 1.1% in 2015 to 1.5% and 1.6% in 2016 and 2017, respectively. Nominal GDP growth is forecasted to accelerate from 2.0% in 2015 to 3.2% in 2016 and 3.3% in 2017 which is broadly in line with our forecast. Despite this improving economic backdrop, own-source revenue growth is poised to slow in FY2016/17, rising by 2.6% to $82.4 billion (on a consolidated basis), down from an estimated 3.8% increase in FY2015/16. This reflects, in part, the expedited elimination of the health services tax (to be phased out in 2018, a year earlier than initially planned). Revenue-enhancing initiatives are limited in Budget 2016; although economic tailwinds are projected to be sufficient to lift total revenues by 3.2% in FY2016/17 and by 2.6%, on average, through the final four years of the plan. This compares to the 3.8% average annual increase in revenues seen over the past five years.

With deficit elimination in previous budgets driven predominantly by expenditure restraint, the return to a balanced budget position provided some room for the government to shift focus to "carefully targeted" program spending. Education expenditure was a notable beneficiary of the anticipated spending boost. A 3.0% increase in education spending is contributing to total program spending rising by 2.4% to $89.7 billion in FY2016/17 (on a consolidated basis).

Restrained expenditure growth has not been abandoned in Budget 2016, however. Over the first two-years of the five-year plan, program spending is projected to rise by 2.4% annually (on a consolidated basis). This represents only a slight increase from the 2.3% average annual advance seen over the previous five years; a rate which is expected to materialize again over the final four years of the plan. Accounting for population growth and inflation, these spending increases amount to close to zero real growth. One motivation for focusing on continuing to restrain overall spending was to arm the government with the capacity to provide fiscal stimulus in the event that challenging economic conditions arise.

With revenues projected to exceed total expenditures through the projection period, the excess will be dedicated to the Generations Fund. These transfers are expected to amount to $2.0 billion in 2016/17 and $2.5 billion in 2017/18 following a $1.4 billion deposit anticipated in 2015/16. The government also maintained a degree of fiscal prudence in its projections with a $400 million contingency reserve allocated annually in 2016/17 through to 2019/20 with an additional $500 million set aside for 2020/21. A $300 million reserve was also added to the 2015/16 estimate, which may not be needed given that the province, over the first nine months of FY2015/16, is tracking a surplus of nearly $1.8 billion.

Tackling the debt burden

The government has made significant strides to improve its fiscal position; although with the highest levels of indebtedness of all of the provinces, sizeable challenges still lie ahead. Gross debt (defined as debt contracted on financial markets and the net liability for the retirement plans for employee future benefits of public and parapublic sector employees, minus the balance of the Generations Fund) is projected to be $208 billion by the end of 2016/17, which represents modest deterioration from the $204 billion anticipated as of March 31, 2016. As a share of GDP, gross debt is expected to inch down in 2016/17 to 54.7% from a peak of 55.1% in 2015/16 and gradually decline each year thereafter. Following a peak of 50.9% in 2012/13, net debt as a share of GDP has declined and is projected to come in at 48.4% in 2016/17. However, this still represents a high net debt-to-GDP ratio and compares to projections of 43.5% in Newfoundland and Labrador, 39.6% in Ontario and 39.9% in New Brunswick. Despite the relatively high indebtedness, the government affirmed its commitment to lowering the gross debt-to GDP ratio to a long-standing targets of 45% by 2025/2026.

New measures to set the foundation for medium-term growth

Importantly, tackling the debt challenge will not be an easy task. The province faces structural challenges emanating from a rapidly aging population that will weigh more heavily on health care expenditures over the medium-term. Budget 2016 aimed to address these longer-term challenges by providing $2.3 billion in funding over the five-year plan to foster economic development.

The $2.3 billion package of initiatives were focused on supporting economic growth by stimulating investment, innovation and employment. Of these funds, $0.85 billion will be allocated to accelerating innovation and investment in the province's manufacturing sector (including a tax cut for "innovative Quebec businesses", a lower electricity rate for manufacturing investment and natural resource processing, and the creation of a RenoVert refundable tax credit). An additional $0.6 billion will be targeted to supporting innovation in other "key sectors" (e.g. life sciences, forestry, agriculture and aerospace) while the remainder will be used to support small and medium-sized businesses, adopting a "cutting-edge digital strategy" and implementing strategies to increase labour market participation.

On the revenue side, the government accelerated the elimination of the health care contribution by one year at a total cost of $509 million over the five-year plan. Further initiatives targeted to tax relief for individuals over the 2016/17 to 2019/20 period amounted to $186 million. This included a 50% reduction in the contribution for a second child using childcare services and enhancements to the donation tax credit.

Financing program for FY2016/17

The government expects its financing program to total $47.8 billion over three years: $14.0 billion in 2016/17 (excluding $7.6 billion in pre-financing made during 2015/16), $16.0 billion in 2017/18 and $17.8 billion in 2018/19. In 2015/16, the government estimates its financing program at $15.5 billion, which includes the $7.6 billion pre-financing.

Challenges lie ahead, but progress has been made

The Quebec government saw Budget 2016 as a means of restating their fiscal policy directions while taking into account the current economic environment. Despite disappointing growth in 2015, the forecast assumes that the province will take better advantage of solid domestic spending in the U.S. and the weak Canadian dollar, sending export growth higher over the forecast. This will allow scope for the government to tackle the looming debt challenges after the difficult process of addressing its deficit difficulties. Encouragingly, the fiscal plan indicates a downward trajectory for its debt-to-GDP measures. This improvement relies upon a strengthening in economic growth through the forecast horizon and in our view, the economic assumptions underpinning the outlook are reasonable. Moreover, the government boosted its contingency reserve which provides additional room to manoeuvre should economic conditions unexpectedly deteriorate.

Quebec's consolidated fiscal plan

($ millions)	Actual	Forecast					
	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
General Fund - total budgetary revenues	71,541	73,924	76,542	78,929	80,695	82,708	85,146
Own-source revenue	54,712	56,888	58,338	60,036	61,803	63,484	65,107
Federal transfers	16,830	17,036	18,204	18,893	18,892	19,224	20,039
General Fund - total budgetary expenditures	73,492	74,479	76,556	78,439	80,211	82,188	84,348
Program spending	65,342	66,460	68,238	70,156	72,089	74,072	76,118
Interest on public debt	8,150	8,019	8,318	8,283	8,122	8,116	8,230
Net results of consolidated entities	807	2,286	2,442	2,414	2,798	3,191	3,456
Contingency reserve	-	300	400	400	400	400	500
Surplus/(Deficit)	(1,143)	1,431	2,028	2,504	2,882	3,311	3,754
Payments to the Generations Fund		(1,431)	(2,028)	(2,504)	(2,882)	(3,311)	(3,754)
Budgetary balance for the purposes of the Balanced Budget Act	(1,143)	-	-	-	-	-	-
		-	-	-	-	-	-

Source: Quebec Ministry of Finance, RBC Economics Research