QUEBEC BUDGET 2012

March 20, 2012

Robert Hogue
Senior Economist
(416) 974-6192
robert.hogue@rbc.com

Staying the course

Quebec Finance Minister Raymond Bachand headed into today's budget with a fairly detailed plan that was laid out in large part in his 2010 'seminal' budget and subsequently fine tuned in last year's budget and intervening budget updates. The last piece of the puzzle to balance the provincial budget by the prescribed date of 2013/14, of course, was found last September when his government and the federal government announced an agreement to harmonize Quebec's PST with the federal GST, which produced a one-time $2.2 billion compensation transfer (in two instalments in 2013 and 2014) from Ottawa to Quebec. Up to that point, Minister Bachand had identified 90% of the measures to close the estimated $12.3 billion gap that would have been created by 2013/14 if earlier trends in revenues and expenditures were left unaltered. Armed with 100% of the measures to close the gap in hand, it was now time for Minister Bachand and his government to demonstrate that it can deliver on its plan.

And, for the most part, deliver he did. To start, the deficit for the fiscal year ending this March 31 is now estimated to be $500 million (or 13%) lower than forecast earlier at $3.3 billion. Secondly, despite weak expected economic growth in the next two years in the province, the Quebec government still projects to lower its deficit to $1.5 billion in 2012/13 and eliminate it by 2013/14. This will be achieved by maintaining strict control over expenditures. Growth in consolidated expenditures excluding debt service will ease from 3.5% in 2011/12 to 2.0% in 2012/13 before edging slightly higher to 2.2% in 2013/14. Restraint will be evident in program spending where growth will be limited to 2.0% and 1.8% in the next two years, respectively. Given the uncertain economic context, maintaining spending discipline will be key to achieving a balanced budget.

We are also heartened by the prudence embedded in the budget projections. The Quebec government forecasts real GDP growth of 1.5% in 2012 and 1.9% in 2013, which is almost identical to RBC's forecasts of 1.6% and 1.9%, respectively. The government also increased its contingency reserves in both 2012/13 (to $300 million) and 2013/14(to $200 million). Such conservative assumptions and prudence factors will provide some cushion against unexpected developments.

A mild disappointment in today's budget was slight upward revisions to the provincial debt (the highest among the provinces); however, these revisions mainly resulted from accounting changes. While the new debt estimates do not meaningfully alter the debt picture for the province – improvements in the debt-to-GDP ratio are still on the way shortly – they are not making it any easier for the Quebec government to hit its long-term debt reduction targets.

Budget highlights

Overall, today's budget was a stay-the-course exercise, with most new measures having little impact on the bottom line. Except for the lower than expected deficit in 2011/12 (which resulted mainly from lower debt service and higher federal transfers), the budget balance projections remain unchanged throughout the rest of the plan. New measures or changes to existing measures on both sides of the ledger will work to offset each other entirely.

On the revenue side, the biggest change relative to last year's budget was the sales tax harmonization compensation transfer from the federal government that will add $733 million to revenues in 2012/13 and almost $1.5 billion in 2013/14. Additionally, spending on servicing the debt has been revised lower in all years. However, weak expected economic growth led to downward revisions to own-source revenue projections (-$360 million in 2012/13 and -$334 million in 2013/14).

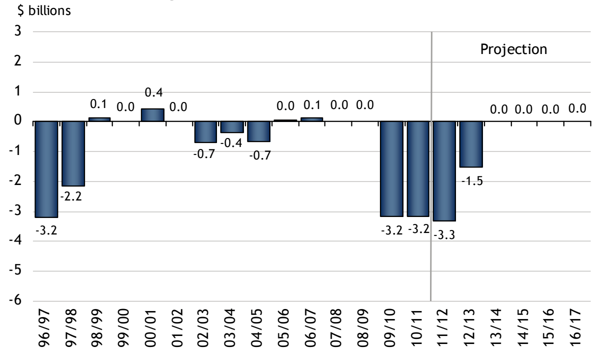
Growth in total revenues is forecast to increase from 4.6% in 2011/12 to 5.9% in 2012/13 and 4.5% in 2013/14. Most of this increase will reflect higher own-source revenues, although federal transfer are forecasted to rebound in 2012/13.

On the expenditure side, the government has set aside a $142 million reserve for public sector wage adjustments and spending on education has been revised higher by $100 million relative to projections in the 2011 budget.

Growth in budgetary expenditures (including debt service) is forecasted to rise from 2.5% in 2011/12 to 3.0% in 2012/13 but then ease to 2.4% in 2013/14; however, much of the acceleration in 2012/13 reflects a sharp rise in debt service (up 10.5%). Program expenditures are forecasted to grow by 2.0% in both 2011/12 and 2012/13 and by 1.8% in 2013/14.

In terms of new measures, the Quebec government announced the creation of new investment funds (Ressources Québec, Fonds Valorisation Bois, Fonds de co-investissement COOP) and a Voluntary Retirement Savings Plan (VSRP) that will be offered to employees of companies with five or more employees that currently do not offer a pension plan (the VSRP will effectively work like an RRSP). The government also announced a program to help develop the tourism industry, a 10% payroll tax reduction in 2013 for workers aged 65 or more and a program (to start in 2016/17) to help seniors stay in their community.

Quebec budget balance



Source: Ministère des Finances du Québec, RBC Economics Research

Capital spending

As has become customary in recent years, the Quebec government's Infrastructures Plan incurred less spending than projected in the ending fiscal year and ramps up spending in the upcoming fiscal year. In today's budget, the Infrastructures Plan shows expenditures totalling $7.9 billion in 2011/12 (down from a projected $9.6 billion in Budget 2011), rising to $9.8 billion in 2012/13 (versus $9.1 billion expected earlier) – which would constitute an all-time high for the province. Capital expenditures are then projected to decline gradually to reach $8.0 billion by 2015/16 (still high by historical standards).

Generations Fund growing

The book value of the Generations Fund (Quebec's version of a sovereign wealth fund) is expected to be $4.3 billion at the end of the 2011/12 fiscal year (up from $3.4 billion at the end of 2010/11). With annual contributions to this fund growing from $848 million in 2011/12 to $2.5 billion by 2016/17, and reinvested income growing

$142 million to $717 million during this period, the book value of the Generations Fund is projected to rise to $12.6 billion by the end of 2016/17.

Accounting changes slightly increases debt load

The Quebec government continues to be firmly committed to reduce its debt representing accumulated deficits to 17% of GDP and gross debt to 45% of GDP by 2025/26. These objectives were made a little more difficult in this budget, however, as accounting changes affecting the treatment of the government's transfers to two entities (Société de financement des infrastructures locales and Société d'habitation du Québec) and the value of the government's investment in Hydro-Québec caused modest upward revisions to debt levels. Debt representing accumulated deficits is now estimated to edge upward from 35.0% of GDP at March 31, 2011, to 35.2% at March 31, 2012. It will then trend lower and reach 29.4% by March 31, 2016; however, it will track higher than projected earlier (the government forecast debt, representing accumulated deficits, to reach 28.5% by March, 2016, in last year's budget). Gross debt is now projected to rise from 55.0% at March 31, 2012 to a peak of 55.3% of GDP at March 31, 2013, and then progressively decline subsequently to reach 52.1% by the end of 2016/17.

Lower financing requirements in 2012/13

The Quebec government expects to require close to $15 billion in financing in 2012/13, a substantial decline from $20.1 billion in 2011/12, although the latter number included $4.4 billion in pre-financing. The budget documents indicated that financing requirements would have been $19.3 billion in 2012/13 without the previous year's pre-financing operations. The documents also indicate that the province's financing program should total $17.8 billion in 2013/14.

Quebec's fiscal plan

($ millions)	Actual	Preliminary	Forecast		Projections		
	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Total revenues	62,650	65,539	69,395	72,524	73,987	76,737	79,409
Total expenditures	67,150	68,836	70,879	72,578	74,532	76,930	79,382
Program spending	60,166	61,384	62,642	63,751	65,635	67,840	70,116
Interest on public debt	6,984	7,452	8,237	8,827	8,897	9,090	9,266
Net results of consolidated entities	2,110	1,145	1,195	1,295	1,245	1,348	1,602
Contingency reserve		300	300	200			
Measures to be identified					875	875	875
Surplus/(Deficit)	(2,390)	(2,452)	(589)	1,041	1,575	2,030	2,504
Payments to the Generations Fund	(760)	(848)	(911)	(1,041)	(1,575)	(2,030)	(2,504)
Budgetary balance for the purposes of the Balanced Budget Act	**(3,150)**	**(3,300)**	**(1,500)**	–	–	–	–

Source: Ministère des Finances du Québec, RBC Economics Research