QUEBEC BUDGET 2018

March 28, 2018

Checking all the boxes

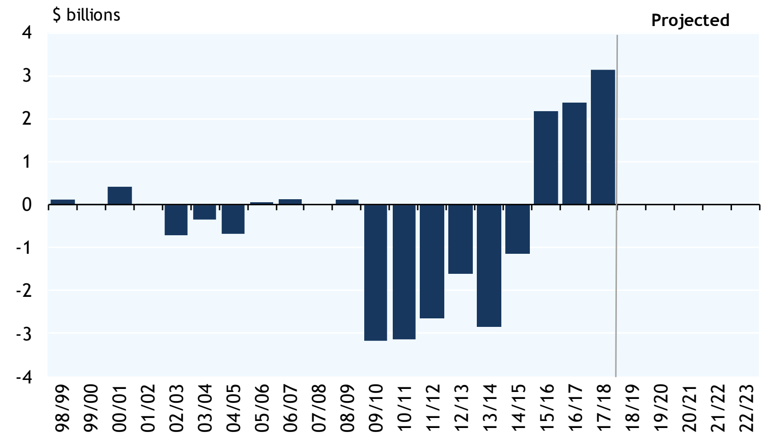
Overview

In its last budget before Quebecers go to the polls in October, the Quebec government has laid out a raft of new initiatives while staying true to the fiscal discipline that has been their hallmark. In this they are getting an assist from a strong economy which propelled a 4.2% increase in total revenues and led to an expected surplus of $850 million in 2017-18 (after a $2.3 billion deposit into the Generations Fund). From surplus the budget will make its way to balance as the government introduces $16 billion of new spending and tax reduction over the next 5 years and economic growth moderates. Nevertheless, the government intends to continue to make large deposits into the Generations Fund through 2023.

Revenues

Quebec's economy was firing on all cylinders in 2017: consumers boosted their spending, business and government investment increased and housing construction surged. The growing tax base added to a 12% increase in Federal Transfers leading to a 4.2% increase in overall revenues in 2017-18. Looking ahead, revenues are expected to grow by an average of 2.8% through 2020 led by a substantial rise in personal income taxes. Like previous budgets and updates from this government, Budget 2018 hands some of that revenue back. The largest such measure is a $2.2 billion tax cut over 5 years for small and medium sized businesses consisting of a reduced payroll tax and lower rates on construction and service-sector firms. The cut aims to ease the burden laid on businesses by previous or forthcoming government measures including a rising minimum wage, enhanced QPP contributions and the expanded parental insurance program. The Budget also provides for the collection of QST on ecommerce – commonly known as the Netflix tax – which deprives the government of an estimated of $270 million per year. Revenue sharing from cannabis sales, assistance to families with school-aged children, and a tax credit for first-time home buyers are also among a raft of modest tax measures.

Quebec budget balance



Source: Ministère des Finances du Québec, RBC Economics Research

Expenditures

As the government eases the tax burden it is also raising spending significantly. Budget 2018 contains $16 billion over 5 years in new initiatives across a host of files. The government has pledged $1.6 billion over five years for new education initiatives contributing to a 5% increase in overall education spending in 2018-19. Despite a diminished trajectory for the Canada Health Transfer, Budget 2018 lays out $5.4 billion in new health spending. Most of this new spending is weighted toward the later years of the fiscal plan, but health spending is expected to rise by 4.3% per year through 2020. The budget also includes new money for cultural initiatives ($0.5 billion), economic and regional development ($1.3 billion), and smaller initiatives for Aboriginal communities, affordable housing, and to promote gender equality.

Paying down the debt

Under the *Balanced Budget Act*, Quebec must stash its recorded surpluses in a stabilization reserve – a fund to help smooth the prov-

Gerard Walsh | Economist | 416-974-6525 | gerard.walsh@rbc.com

ince's year to year fiscal balance. As Quebec's budget surplus ballooned starting in 2015-16, the stabilization reserve grew rapidly to $4.6 billion in early 2017. After making another deposit this year, the government intends to draw down the reserve to cover "deficits" in 2018-19 and 2019-20. The scare quotes are apt because the province's projected deficits are net of multi-billion dollar deposits into the Generations Fund. Yet even as the government makes these large deposits, it plans to withdraw $2 billion per year from the Fund to pay down the province's debt. The flow of cash is circuitous, but the result is a drawdown of the stabilization reserve (halving its size to $2.9 billion by 2020), the steady growth of the Generations Fund (to $17.8 billion by 2023), and a reduction in the province's gross debt burden as a share of the economy.

Economic growth assumptions

	2017	2018	2019	2020	2021	2022
Real GDP growth (%)						
Budget 2018	3.0	2.1	1.7	1.5	1.3	1.3
RBC	3.0	1.9	1.5	-	-	-
Nominal GDP growth (%)						
Budget 2018	4.4	3.5	3.3	3.2	3.0	3.0
RBC	4.5	3.9	3.2	-	-	-

Source: Ministère des Finances du Québec, RBC Economics Research

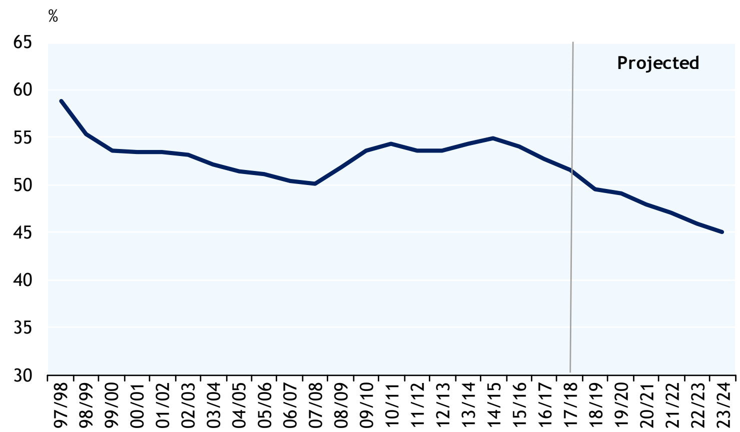
Capital Spending

Accompanying rising program expenditures is a boost to the infrastructure plan. Relative to last year, the province is adding $9.3 billion to its 10-year capital spending plan bringing it to $100.4 billion from 2018 to 2028. The impact will be felt in the out years as substantial increases relative to last year begin in earnest in 2021. Consistent with the budget's priorities, there is $16 billion for education and $19 billion for health infrastructure, but also a substantial increase in investment in sustainable mobility. The plan includes large blocks of money for the Réseau express métropolitain ($6.3 billion), an extension to the Montréal blue line ($3.9 billion), and Quebec City's strategic transportation network ($3.3 billion).

Debt and Borrowing

When Quebec created its Generations Fund it set a goal for the 2025-26 fiscal year that "gross debt must not exceed 45% of GDP." The province is on its way to achieving that objective by 2023, two years ahead of schedule. Financial markets have taken notice and generally praised the province's efforts, most recently in 2017 when Quebec's credit rating was raised by Standard and Poor's. Strong economic growth and budget surpluses are contributing, as is a plan to steadily lower the province's debt to GDP ratio. Because Quebec reports its gross debt net of its Generations Fund, the government's payments out of that Fund don't affect its gross debt-to-GDP ratio, but the government hopes to save $1.1 billion on its interest payments over 5 years by using its Generations Fund to avoid debt issuance. Quebec's gross debt levels are also helped by returns earned on the Generations Fund by the Caisse de Dépôt which have exceeded the rate on new borrowings by 2.1 percentage points on average since 2007.

Gross Debt as % of GDP



Source: Ministère des Finances du Québec, RBC Economics Research

Despite its large budget surpluses and earnings in the Generations Fund, Quebec's stock of gross debt will continue to grow in dollar terms because of increases in capital investments from $205 billion in 2017-18 to $217 billion in 2022-23. Partly as a result, the government's borrowing plans remain substantial with total financing requirements of $13.4 billion in 2018-19, $18.6 billion in 2019-20, and $18.1 billion in 2020-21.

Our Take

In the lead up to the budget, we got indications that Quebec would be loosening the purse strings and Budget 2018 delivered. As the government prepares to face the voters in October, it has allocated more money for education, health care, infrastructure and tax cuts. Yet, these efforts are not breaking the bank, the surplus (before deposits into the Generations Fund) is secure, and the province remains on track to reduce its debt burden. The economic assumptions underlying Budget 2018 are prudent and the government estimates that a 1 percentage point change in nominal GDP growth hits own-source revenues by $650 million giving it a large economic cushion. We applaud Quebec's maintenance of large surpluses given the size of its debt burden (second largest in Canada as a share of GDP) and the direct application of funds to reducing it. Directing surpluses into the Generations Fund rather than debt repayment allows the province to leverage le Caisse de Dépôt's investment returns, but in an era of rising interest rates it makes sense to apply some of those funds directly to the provincial debt.

Quebec's consolidated fiscal plan						
($ millions)	Forecast					
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
General Fund - total budgetary revenues	80,605	82,807	86,694	89,400	92,102	94,822
Own-source revenue	56,054	57,891	59,923	61,721	63,669	65,789
Government enterprises	4,302	3,872	3,955	4,186	4,336	4,484
Federal transfers	20,249	21,044	22,816	23,493	24,097	24,549
General Fund - total budgetary expenditures	79,811	84,029	86,705	89,181	91,552	94,055
Program spending	72,591	76,869	79,682	82,294	84,908	87,563
Interest on public debt	7,220	7,160	7,023	6,887	6,644	6,492
Net results of consolidated entities	2,348	2,126	1,882	2,393	2,815	2,835
Contingency reserve	-	-	100	100	100	100
Surplus/(Deficit)	3,142	904	1,771	2,512	3,265	3,502
Payments to the Generations Fund	(2,292)	(2,491)	(2,707)	(2,991)	(3,265)	(3,502)
Use of the stabilization reserve	-	1,587	936	479	-	-
Budgetary balance for the purposes of the Balanced Budget Act	**850**	**-**	**-**	**-**	**-**	**-**

Source: Quebec Ministry of Finance, RBC Economics Research