

# CONVERTING QUEBEC'S STRENGTHS INTO PROSPERITY

## *Executive Summary*

Few economies in North America have undergone the degree of post-War change as Quebec, beginning with the Quiet Revolution in the 1960s. The reforms have borne fruit over the past half century. Quebec enjoys a high quality of life, its culture and language have flourished and the income gap in the province between Francophones and Anglophones has all but been eliminated. What's more, Quebec has built up an enviable list of assets – a highly-diversified economy and high quality of life to name a few – that will stand the province in good stead in the future.

Yet there have been growing calls within Quebec for residents and businesses to embrace change once again. In spite of its numerous strengths, the province's standard of living – as measured by GDP per capita – continues to languish behind that of the rest of Canada (ROC). But the greater concern lies on the horizon. Although the forces of demographics and globalization will be felt in all corners of the world, Quebec's economy is poised to experience particularly pronounced impacts, which could further constrain living standards well into the future. This last point raises a number of questions:

### **Why does Quebec experience a prosperity gap?**

Recently, the Ontario Institute for Competitiveness and Prosperity carried out an in-depth analysis of the issue. The Institute measured Quebec's prosperity gap with the ROC at \$6,300 for every man, woman and child in the province. As importantly, the gap was decomposed into two main components: output per hour worked, which is commonly referred to by economists as "productivity", and total hours worked per person.

### **"Productivity" accounts for 38% of prosperity gap**

"Productivity" is a concept that is often misinterpreted. For many, an unproductive society can be perceived as one where its residents are not working hard enough. This belief is not only simplistic but incorrect. Instead, "productivity" is driven by the interaction of a number of complex structural barriers that are usually erected at the societal, rather than individual, level. For example, the In-

stitute looks at a number of measurable elements of "productivity" in its study, including the mix of industries, education attainment, the degree of urbanization and how much investment in machinery and infrastructure take place in an economy.

Interestingly, while there tends to be considerable attention placed on Quebec's "productivity" gap with the ROC, the Institute determined that output per hour worked explains only 38% of the difference in prosperity, of which three-quarters is attributable to industry mix, education attainment and capital investment.

### **What are the trade-offs in working less?**

At the same time, 62% of the prosperity gap is explained by reduced hours worked. In contrast to "productivity", this concept is more straight-forward. In many instances, work schedules are determined by individual choice.

We emphasize that there is nothing wrong with a jurisdiction making a choice to work fewer hours, especially in light of the fact that increased leisure is an important contributor to well-being. At the same time, however, it cannot then expect to have the same standard of living or quality of public services as others that record greater number of hours worked – that is, unless the fewer hours spent on the job is counter-balanced by a higher level of "productivity". And notwithstanding the fact that all Canadian jurisdictions confront the "productivity" challenge to varying degrees, Quebec records both lower hours and output per hour than in the ROC. As we have highlighted, the latter development largely reflects societal factors in the province.

### **More than \$8,000 per household if gap closed**

We acknowledge that the usual measure of prosperity or standard of living – GDP per capita – is an imperfect measure of well-being, which focuses on activities that have a dollar value attached to them, ignores the trade-off between leisure and work and doesn't take into account the impact of economic growth on the environment. Despite

its imperfections, there is a compelling argument that increased prosperity increases society's ability to preserve and protect its quality of life. In addition to generating higher government revenues that could be used to strengthen public services, closing the prosperity gap with the ROC would provide a boost to the average household after-tax income in Quebec of at least \$8,000 per year, which could be used to fund housing costs, tuition fees and other essential goods and services.

It is not Quebec's current prosperity performance that is found worrisome to those leading the call for change. Rather, it is the potential risks to the standard of living from an aging population, rising health costs and heightened emerging competition in manufacturing that are found to be greatest cause for concern.

### **Required policy mix not ground-breaking**

The necessary mix of policies required to adequately head off these risks is far from ground-breaking. Quebec can parlay its comparative strengths into prosperity by taking such actions as investing further in education, strengthening its system of infrastructure, opening up opportunities for trade and by knocking down barriers to working and investing. We discuss these areas in detail on pages 14-24. Certainly, comfort can be taken in the fact that many of these policies – at least in broad strokes – are supported by the majority of Quebecers. And the provincial and federal governments have responded in kind by implementing measures in recent budgets that chip away at them.

Still, we share the view of those advocating change that the scope and pace of reforms remain too slow to achieve meaningful results. In order for this to occur, there needs to be a fundamental change in perspective. **For one**, a greater sense of urgency is required. But while clarion calls for a new direction are being dampened by the fact that the economy is not currently in crisis, an objective of this study is to raise awareness that the potential storm clouds are not a long way off. In fact, based on status-quo projections, Quebec's labour force will begin to shrink in only 6 years.

**Second**, it will be critical for residents to recognize that governments will only be in a position to address the province's vulnerabilities – and, at the same time, live within their means – by better targeting assistance to those individuals most in need. Here, we are not just putting into question the traditional practice of providing large subsi-

dies to the business sector and to all Quebecers for electricity rates and tuition fees, but advocating a major shift in approach towards “user pay” in funding government infrastructure and other services.

Subsidies, in particular, generate benefits for households and businesses, but come at a heavy cost to the treasury – both directly and in terms of the opportunity cost of not allocating the funds to alternative areas. Electricity subsidies come at a particularly high price of more than \$5 billion per year, excluding the opportunity cost. There is also a fairness argument, as non-users of power end up paying a good chunk of the bill generated by heavy users. Support to low-income earners could be provided through redistribution mechanisms.

### **Action will pay off handsomely**

More widespread use of such a “user pay” strategy in Quebec would pay off handsomely through a system better grounded in efficiency, accountability and fairness. In addition, it could be a major weapon in the arsenal in achieving the all-important goals of sustainable development and a cleaner environment. While many in the province will undoubtedly balk at the idea of paying more for government services up front, we would hope that one of the ultimate objectives will be to reward taxpayers over time by cutting the income-tax burden, which remains one of the key barriers to working, saving and investing in Quebec.

### **Bottom Line**

Quebec is blessed with significant strengths. Making some tough choices today will help to leverage these strengths, head off the risks looming on the horizon and help to achieve a higher standard of living for the benefit of residents. Above all, a wealthier Quebec will assist in protecting its distinct way of life. Although citizens and government will need to spearhead the drive for change, the business community must also step up to the plate.

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# TD Economics

## Special Report

April 10, 2007

### CONVERTING QUEBEC'S STRENGTHS INTO PROSPERITY

Quebecers are no strangers to change. The Quiet Revolution in the early 1960s rang in an era of new institutions, attitudes and an increasing role for the State. Happily, many of the Revolution's objectives have been achieved over the past half century. Quebec enjoys a high quality of life, its culture and language have flourished and the income gap in the province between Francophones and Anglophones has been all but eliminated. What's more, Quebec has built up an enviable list of assets – a highly-diversified economy, a number of flourishing high-tech industries and a world leader in the export of hydroelectric power to name a few – that will stand the province in good stead in the future.

Yet, there have been growing calls within Quebec for residents and businesses to embrace change once again. In spite of its strengths and significant potential, the province continues to register a standard of living that falls well short of that posted in the rest of Canada (ROC). But the greater concern lies on the horizon. Although the forces of demographics and globalization will be felt in all corners of the world, Quebec is poised to experience particularly pronounced impacts, which in turn could further weigh on liv-

#### HIGHLIGHTS

- **Quebec enjoys enormous assets and potential, but continues to suffer from a prosperity gap with the rest of Canada (ROC)**
- **Demographic and globalization forces could greatly weigh on prosperity in the near future**
- **Efforts must be doubled to strengthen infrastructure, education, the tax and business climate and conditions in municipalities ...**
- **... while better targeting scarce public resources to helping those most in need**
- **Eliminating prosperity gap with ROC would raise average disposable household income in Quebec by at least \$8,000.**

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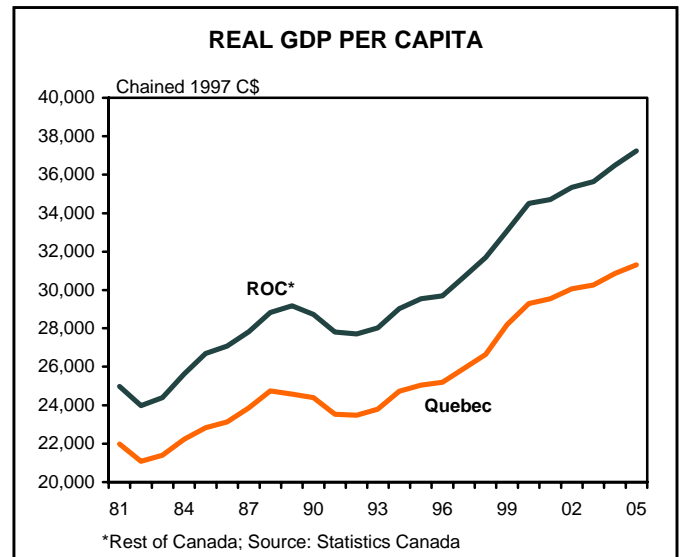
ing standards in the future. And a weaker economy would reduce the province's flexibility to preserve and protect what matters most to residents – the health system, the education system and their way of life.

The necessary mix of policies required to adequately head off these risks is far from ground-breaking. Quebec can parlay its comparative strengths into prosperity by doubling its efforts to strengthen such areas as education and infrastructure and to knock down barriers to working and investing. Certainly, comfort can be taken in the fact that many of these policies – at least in broad strokes – are supported by the majority of Quebecers. And the provincial and federal governments have responded in kind by implementing measures in recent budgets that chip away at them.

Still, we share the view of those advocating change that the scope and pace of reforms remain too slow to achieve meaningful results. In order for this to occur, there needs to be a fundamental change in perspective. For one, a greater sense of urgency is required. But while clarion calls for a new direction are being dampened by the fact that the economy is not currently in crisis, an objective of this study is to raise awareness that the potential storm clouds are not a long way off. Indeed, based on status-quo projections, Quebec’s labour force will begin to shrink in only 6 years.

Second, it will be critical for residents to recognize that governments will only be in a position to address the province’s vulnerabilities – and, at the same time, live within their means – by better targeting assistance to those individuals most in need. Here, we’re not just putting into question the traditional practice of providing large subsidies to all Quebecers for electricity rates and tuition fees and to businesses. Rather, we’re advocating a more sweeping shift in approach towards “user pay” in funding government infrastructure and other services, while assisting low-income earners through redistribution mechanisms.

More widespread use of such a strategy in Quebec would pay off handsomely through a system better grounded in efficiency, accountability and fairness. In addition, it could be a major weapon in the arsenal for achieving the all-important goals of sustainable development and a cleaner environment. While many in the province will undoubtedly balk at the idea of paying more directly for government services, we would hope that one of the ultimate objectives will be to lower the province’s high income-tax bur-



den, which remains one of the key barriers to working, saving and investing in Quebec.

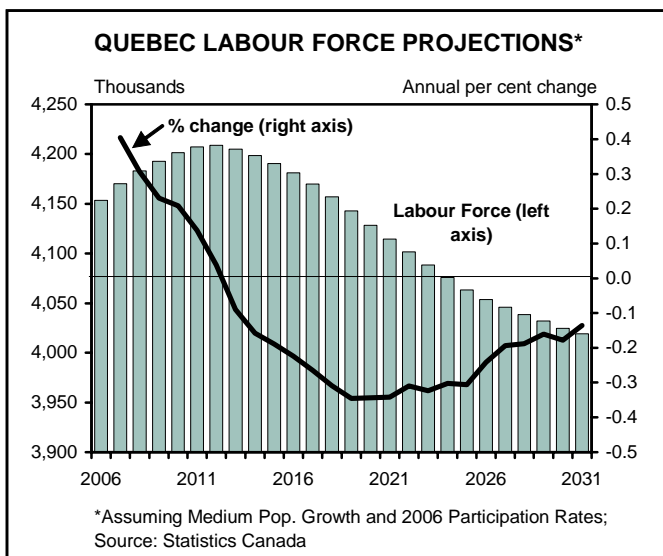
**Quiet Revolution a turning point**

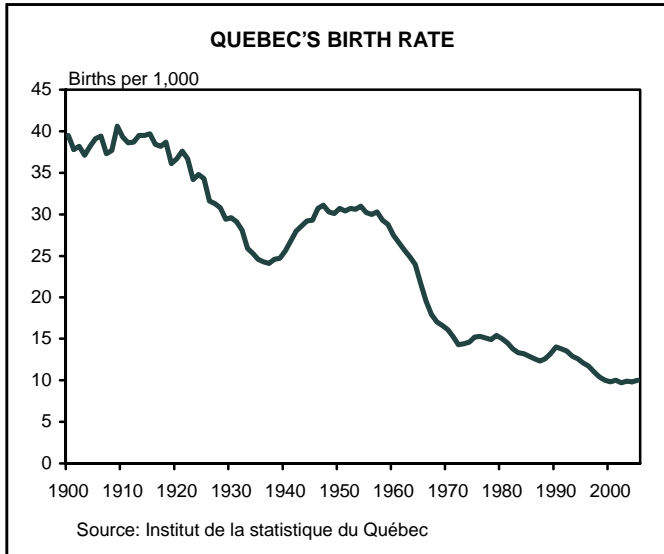
Before turning our attention to the future, it is useful to take a few steps backward in history in order to provide some context. Indeed, few economies in North America have undergone the degree of post-War transformation as Quebec, beginning with the Quiet Revolution in the 1960s.

In 1960, the Liberals – under Jean Lesage – were elected on a platform of sweeping change that would begin to modernize Quebec and transform the province into a more socially-liberal welfare state. As the government increased its involvement in the province’s economic sphere in the decade ahead, a number of new public institutions were spawned, including Hydro-Québec, SIDBEC, SOQUEM, Société générale de financement (SGF) and Régie des Rentes du Québec (Quebec Pension Plan). In addition, the education system was rebuilt along secular lines, the province’s Civil Code was modified to recognize the legal equality of spouses, and a New Labour Code emerged giving employees the right to strike.

These reforms coincided with renewed prosperity in Quebec, effectively bringing an end to the long period of economic stagnation recorded between the 1920s and the 1950s. At the same time, the 1960s would mark a period of societal change that was consistent with the objectives of the Quiet Revolution:

- Francophones’ position in the workplace improved and the income gap between English and French speaking workers narrowed sharply.





- Education rates in the province climbed, while many women opted to forego having children in order to participate in the labour force. Indeed, the average birth rate in the province went from among the highest to the lowest in the developed world.
- A trend towards urbanization and industrialization, particularly benefiting the Greater Montreal Area, which strengthened its position as an economic and business hub for Quebec and Canada.

### Expo 67 the high water mark

Real economic growth in the 1960s reached a sizzling 5% per year, or 3.5% in per-capita terms. Certainly, Quebec was not alone in recording strong growth over the period, as other provinces also benefited from low domestic interest rates, rising international immigration and capital spending. But while the decade proved to be a golden period for Canada as a whole, Quebec's prosperity was particularly impressive in light of the major structural and societal changes underway. The hosting of Expo 67 in Montreal turned up the spotlight even higher, as it enabled the city and the province as a whole to showcase its strength, beauty and overall 'joie de vivre'.

In many respects, the late 1960s would mark the apex of the Quebec economy, as a number of developments would eventually take shape in the 1970s that would begin to nibble away at Quebec's economic standing. These political and societal challenges have been well-documented. Suffice to say that while other provincial economies also experienced a significant slowdown in economic growth in

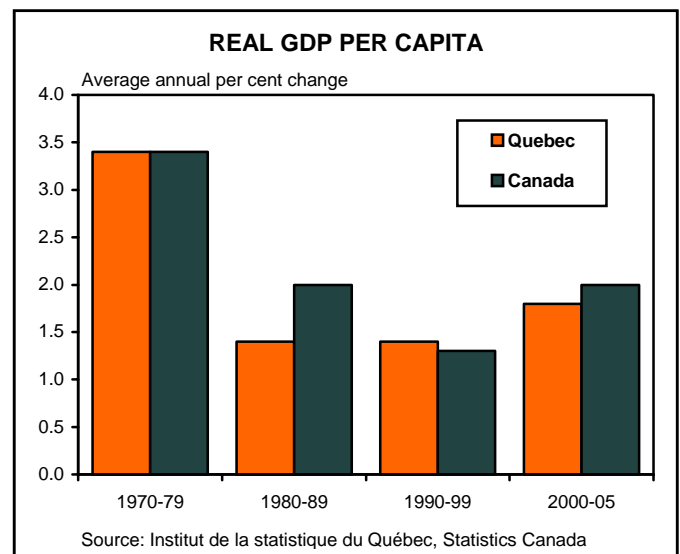
the 1980s, the slackening that took place in "la Belle Province" was even more pronounced. By the 1980s, gains in real GDP per capita in Quebec had been cut in half to about 1.5% per annum. Most telling, the gap between the province and the ROC in unemployment rates rose to as much as 4 percentage points.

### Economic model fine-tuned in the 1990s

The first half of the 1990s were marked by a national recession in 1990-92 and the second referendum on sovereignty in 1995. Above all, Quebec jumped on the bandwagon of Canadian jurisdictions waging war on their deficits. In some respects, the mid-1990s marked the first meaningful "fine-tuning" of the province's model of economic development since the Quiet Revolution.

Concerns about the sustainability of Quebec's fiscal course began to build in the 1980s. Government spending continued to advance at a rapid clip, outstripping growth in the economy. And even though tax rates were raised in the process, additional revenues would be more than offset by increases in program spending and debt charges, resulting in persistent budget deficits. In the early 1990s, the annual shortfall had swelled to almost \$6 billion (3.4% of GDP) and the province's debt-to-GDP ratio reached almost 50% – one of the highest among the provinces.

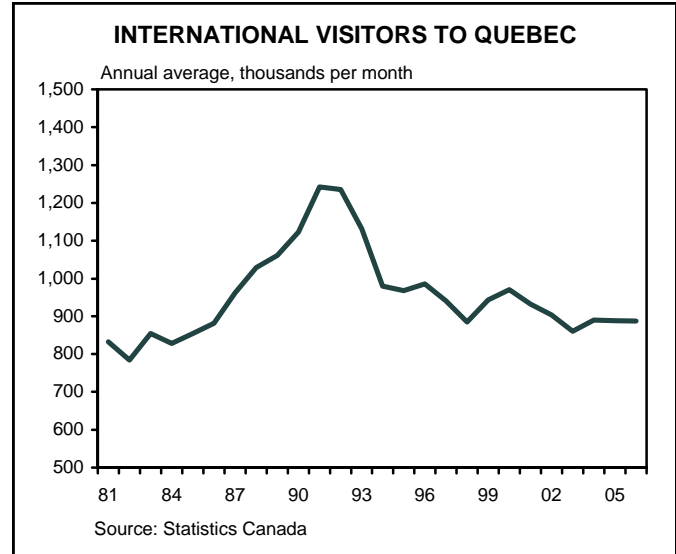
After successfully convincing Quebecers about the need to rein in the deficit, the provincial government restrained growth in program spending during the mid-to-late 1990s. Similar to other provinces, Quebec's job was complicated by the fact that the federal government had implemented cuts to cash transfer payments as part of its own deficit-



reduction plans. Still, the Quebec government managed to stay the course in deficit elimination, as the budget moved to balance by fiscal 1998-99, helped in part by two important developments:

- *Free trade* – the mid-to-late 1990s period witnessed unprecedented growth in Quebec exports, particularly in its manufacturing sector, following the signing of the Canada-U.S. Free Trade Agreement (FTA) in 1989 and the North American Free Trade Agreement (NAFTA) in 1994. The sharp drop in the Canadian dollar during the 1990s provided further fuel to the fire. Quebec’s proximity to the large U.S. market (the province is within one day’s drive of a market of 100 million households that account for US\$1 trillion in disposable income) and its strong transportation system paid off in spades.
- *High tech* – While free trade spurred growth in many of Quebec’s traditional strongholds of forestry and metals, Quebec was a main beneficiary of the rapid expansion in demand for high tech goods and services in the second half of the 1990s. The province’s aerospace, information technology and biotech industries recorded spectacular output increases.

As a result, by the end of the 1990s, the GDP share of manufacturing activity in Quebec had increased to a sizeable 23% – half of which was exported to the United States – while that of the information and communication technology (ICT) industries had soared from almost zero in the early 1990s to 7%. Meanwhile, international exports surpassed inter-provincial exports as a contributor to GDP. In 1981, Quebec sent \$1.50 of goods and services to other

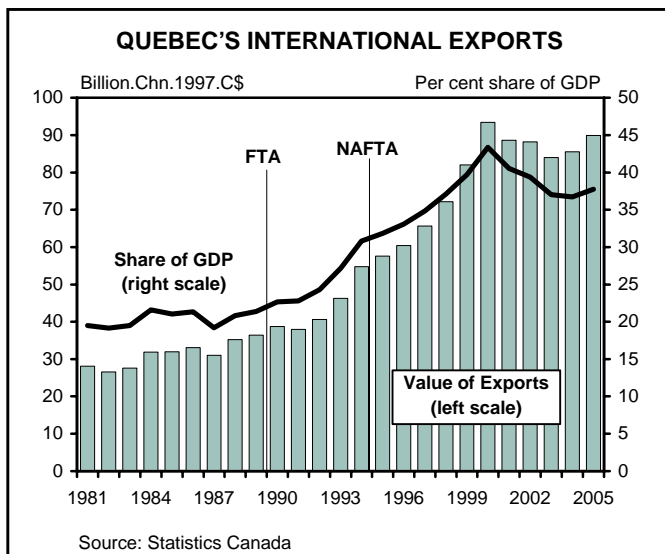


provinces for each \$1 sent to other countries. By 2005, the ratio was reversed: \$1.75 was exported internationally for each \$1 sent to other provinces. As a comparison, the international/inter-provincial export ratio for the rest of Canada rose from 1:1 in 1981 to 2.1:1 in 2005.

**Quebec displays resilience in the 2000s**

The changeover to the new millennium has come with its own batch of major challenges – including the high-tech bust, the September 2001 terrorist attacks, a super-spike in crude oil prices and a 40% rebound in the value of the Canadian dollar. These developments have had a particularly negative impact on the province’s high-flying manufacturing sector. In fact, since 2002, manufacturing output in Quebec has been scaled back by 5% and employment has declined by 10% or 68,000 jobs – larger relative declines than those suffered in other Canadian markets, including Ontario. Among the hardest manufacturing industries have been clothing and textiles, pulp and paper and machinery. Tourism activity in Quebec has also felt significant pain from the rising currency, as evidenced by the dramatic drop in the number of U.S. visitors to its lowest level since 1986.

Yet despite these difficult circumstances, the Quebec economy has displayed impressive resilience, as a number of domestically-oriented industries have stepped up to take up the slack. The metals and mining industries have flourished, supported by rising commodity prices. Booming housing activity has supported growth in construction and related services. Wholesale and retail trade and financial services have also been areas of strong growth since 2000.



And, while many pockets of high tech suffered during the slump in the early part of the decade, this area has come back in full force since 2002, spurred by healthy business investment spending across the continent.

The government sector has provided another source of stability to the economy in recent years. Supported partly by a rebound in federal transfer payments, the Quebec government has continued to keep its fiscal house in order,

re-invested in priority programs and delivered modest tax reductions. Particular excitement has surrounded the province's goal to invest some \$25 billion in hydro-electricity development by 2015 – along with \$6 billion for wind development – which would only strengthen its position as an export powerhouse in “clean” energy exports.<sup>1</sup>

Perhaps most encouraging has been the news related to two areas of particular vulnerability for Quebec – popula-

### Some Good News for Quebec in 2006 Census

2006 Census population figures released a few weeks ago revealed that since the last head-count in 2001, Québec's population grew by 4.3%, to 7.5 million. This is the second fastest 5-year growth rate recorded since the end of the baby boom, and considerably higher than the 1.4% rate posted in the 1996-2001 period.

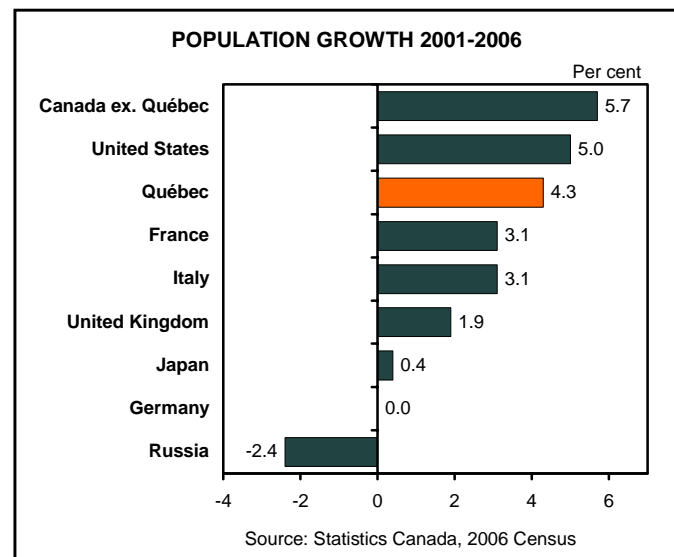
Quebec was far from alone among the provinces in recording stronger population growth. In fact, with population growth accelerating in all jurisdictions except PEI, Saskatchewan and Newfoundland & Labrador, Canada posted an overall gain of 5.4%. Hence the good news for Quebec is tempered somewhat by the fact that its share of the Canadian population still declined – from 24.1% in 2001 to 23.9% in 2006. This downward trend has been continuous since 1966, when Québec's share of the total population was 28.9%. At the same time, compared to G8 countries, Quebec finished third in terms of growth.

#### Immigration vs. natural increase

Although the specific breakdown into immigration and natural increase won't be released for several months, Statistic Canada noted that the upswing in population gains in Quebec was due to increased international immigration, paralleling that of Canada as a whole. Moreover, the overall count was supported by a much smaller net loss in inter-provincial migration. While the province's birth rate has been accelerating over the past few years, it occurred too late in the Census period to have a meaningful effect on the 2001-06 growth rate.

#### The regional decomposition

Another development in Quebec that mirrored other



regions of Canada was the increasing share of the population gains in the suburbs of large metropolitan areas. The Montreal Census Metropolitan Area (5.3%) grew at a faster rate than the province as a whole, pushing up its share with the province's population to 48% and retaining its position as the second largest CMA in Canada. Yet at 2.3%, the City of Montreal expanded at less than half of the pace. The corollary is that outlying regions in the Greater Montreal Area posted average gains of about 8%, especially north of Montreal along Highway 15.

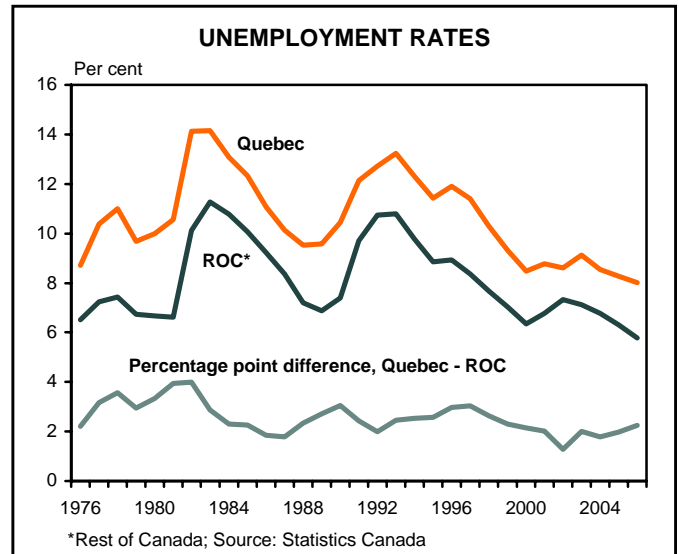
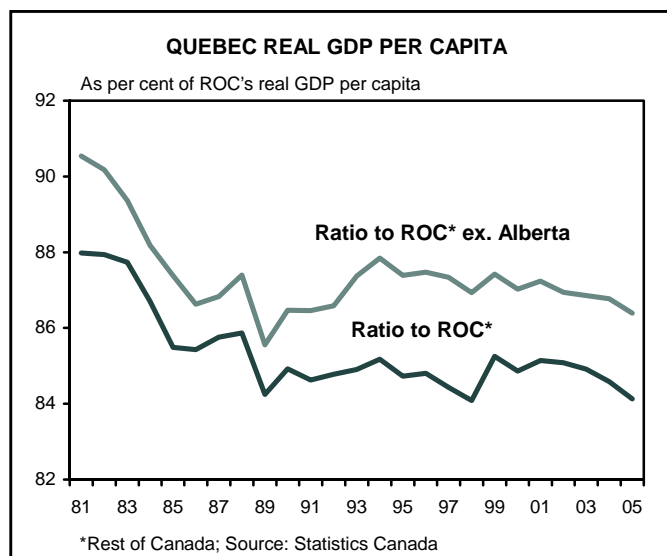
Of Quebec's largest urban regions, Gatineau (+8.5%) and Sherbrooke (6.3%) recorded the strongest population gains. Meanwhile, Quebec City CMA grew by 4.3%. Among mid-sized urban centres, Saint-Jean-sur-Richelieu (9.9%), Joliette (9.8%) and Granby (8.8%) finished in the top 20 of fastest growing markets in Canada with populations of at least 10,000 but not considered CMAs.

tion growth and unemployment. On the demographic front, the release of the 2006 Census confirmed that population gains have accelerated since the 1996-2001 period, fuelled largely by an improvement in net migration (see text box on page 6 for highlights). And in Quebec's job market, the unemployment rate recently fell through 8% – its lowest level in 30+ years. By January 2007, the gap in jobless rates between Quebec and the ROC had shrunk to 2 percentage points, half of that recorded in the early 1980s. The province has also managed to record a likewise improvement in its employment-to-population ratio relative to the ROC.

### Economic convergence still elusive

Putting it all together, the Quebec economy as a whole appeared to have dodged the roadblocks that have been erected in recent years not just in good condition, but in its best shape in decades. Still, a closer look provides less cause for celebration. For one, despite the pickup in population growth in Quebec over the past five years, the province's share of the Canadian total has continued to slip. And while the relative improvement in Quebec's job market is a particularly welcome development, the truth of the matter is that the Quebec-ROC gap in unemployment rates has virtually stalled since 2000. Above all, the broadest measure of economic prosperity, GDP per capita, shows that convergence between Quebec and the ROC remains elusive:

- After suffering a long gradual erosion in the 1980s and early 1990s, real GDP per capita in Quebec has stabilized at 84% of the ROC level (\$31,300 versus \$37,200

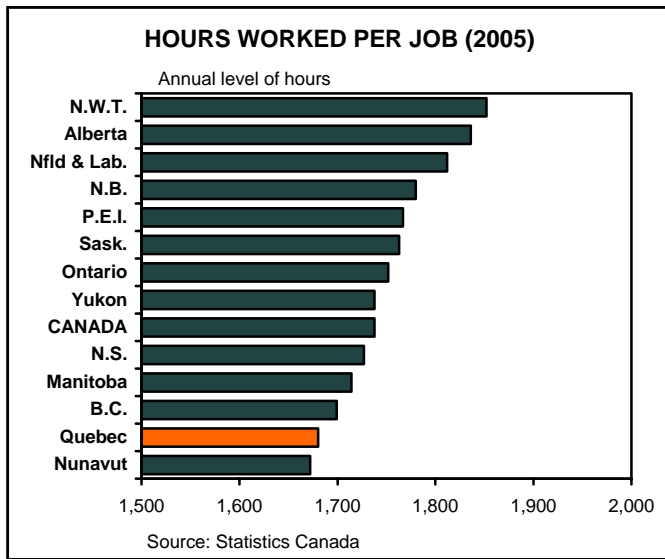


in 2005).

- Although real GDP is typically used for measuring economic performance, nominal GDP – which isn't adjusted for price changes – is also of importance because producer prices filter down into higher incomes. In nominal terms, per-capita GDP in Quebec shrank from 87% of the ROC level in the early 1990s to 81% in 2005. (2005 levels were \$36,000 and \$44,400, respectively).
- Comparisons to the ROC are distorted in part by Alberta, which has a considerably higher income level than other provinces. Real and nominal GDP per capita in Quebec has remained relatively stable at 87-88% of the ROC (ex-Alberta) level over the past few decades.
- Like most of its Canadian counterparts, Quebec has been losing ground on its U.S. counterpart. In 2005, the ratio of per-capita income in Quebec to the U.S. average stood at 73%, down from 80% in the early 1990s.

### What's behind Quebec's prosperity gap?

What factors are holding back the Quebec's economy? There have been various attempts made over the years to pin-point the drivers of the relative underperformance. Recently, the Ontario Institute for Competitiveness and Prosperity carried out an in-depth analysis on this issue, which we highlight in the text box on pages 8-10. In short, the Institute has decomposed the total prosperity gap into two components. The first one is *output per hour worked*, which is commonly referred to by economists as "produc-



tivity”. The second component is total *hours worked per person*.

“Productivity” is a concept that is often misinterpreted. For many, a society that is unproductive is perceived to be one where residents are not working hard enough. This interpretation is not only simplistic but incorrect. Instead, “productivity” is driven by the interaction of a number of complex structural barriers that are usually erected at the societal, rather than individual, level. For example, the Institute looks at a number of measurable elements in its study, including the mix of industries, education attainment, the degree of urbanization and how much investment in machinery and infrastructure take place in an economy.

Interestingly, while there tends to be considerable attention placed on Quebec’s “productivity” gap with the ROC, the Institute finds output per hour worked explains only 38% of the difference in prosperity, of which three-quarters is attributable to industry mix, education attainment and capital investment.

### Lower hours worked more than 60% of prosperity gap

At the same time, 62% of the prosperity gap is explained by reduced hours worked. In contrast to “productivity”, this concept is more straight-forward. In many instances, work schedules are dictated by individual choices. Keep in mind that there are exceptions to the rule, however. According to data from Statistics Canada’s Labour Force Survey, about one quarter of Quebecers (26%) working part-time indicated that they would take on full-time employment if they could find a job. Thus, in some cases,

hours worked are constrained by the lack of job market opportunities.

### Nothing wrong with a society working less

We emphasize that there is nothing wrong with a particular jurisdiction or society making a choice to work fewer hours, especially in light of the fact that increased leisure time is an important contributor to well-being. However, it cannot then expect to have the same level of prosperity (as measured by GDP or income per capita) or same quality of public services as other jurisdictions that record a greater number of hours worked – that is, unless the fewer hours spent on the job is counterbalanced by a higher level of “productivity”. Indeed, there is a good case to be made that a more rested, less stressed work force will be a more productive one. Unfortunately, Quebec records both lower hours and productivity compared to the ROC.

### Why does income per capita matter?

This last point raises the question of why a society should even target a higher GDP or income per capita in the first place. There is no doubt that GDP per capita is an imperfect measure of well-being that focuses on activities that have a dollar value attached to them and does not take into account the trade-off between work and leisure. Nor does this concept take into account the impact of economic growth on the environment. Besides, while Quebec records relatively low GDP per capita on the North American landscape, the province stacks up reasonably well in international comparisons, ranking in the middle of the pack among OECD countries. Even more importantly, broader measures of well-being that take into account the environment, crime and other social characteristics show Quebec in a favourable light.

#### Factors that Drive “Productivity”

- Macroeconomic climate
- Infrastructure
- Education and research
- Integration of immigrants
- Taxation
- Regulatory burden
- Private-sector behavior

### Decomposing Quebec's Prosperity Gap

The Ontario Institute for Competitiveness and Prosperity was established in 2001 as a research arm of the Ontario Task Force on Competitiveness, Productivity and Economic Progress, which was appointed by the Ontario Government to measure and monitor Ontario's economic progress. The Institute measured Quebec's prosperity gap with the ROC – as measured by real GDP per capita – at \$6,300 per person. Moreover, it has developed a methodology to decompose the gap into a number of measurable elements:

**Profile:** Out of the people in a jurisdiction, what percentage are of working age and therefore can contribute to the creation of products and services that add economic value and prosperity?

**Utilization:** for all those of working age, what percentage is actually working to add to economic value and prosperity? Here, the element focuses on the labour-market participation rate – which is the proportion of those of working age who are available for work – and employment rate, or the portion of those participating in the job market that are employed.

**Intensity:** for those that are employed, how many hours do they spend on the job in a year?

**Productivity:** For each hour worked, how much economic output is created by a jurisdiction's workers? A range of factors is considered, including, cluster/sector

mix of the economy, urbanization, education, capital investment and other "residual factors".

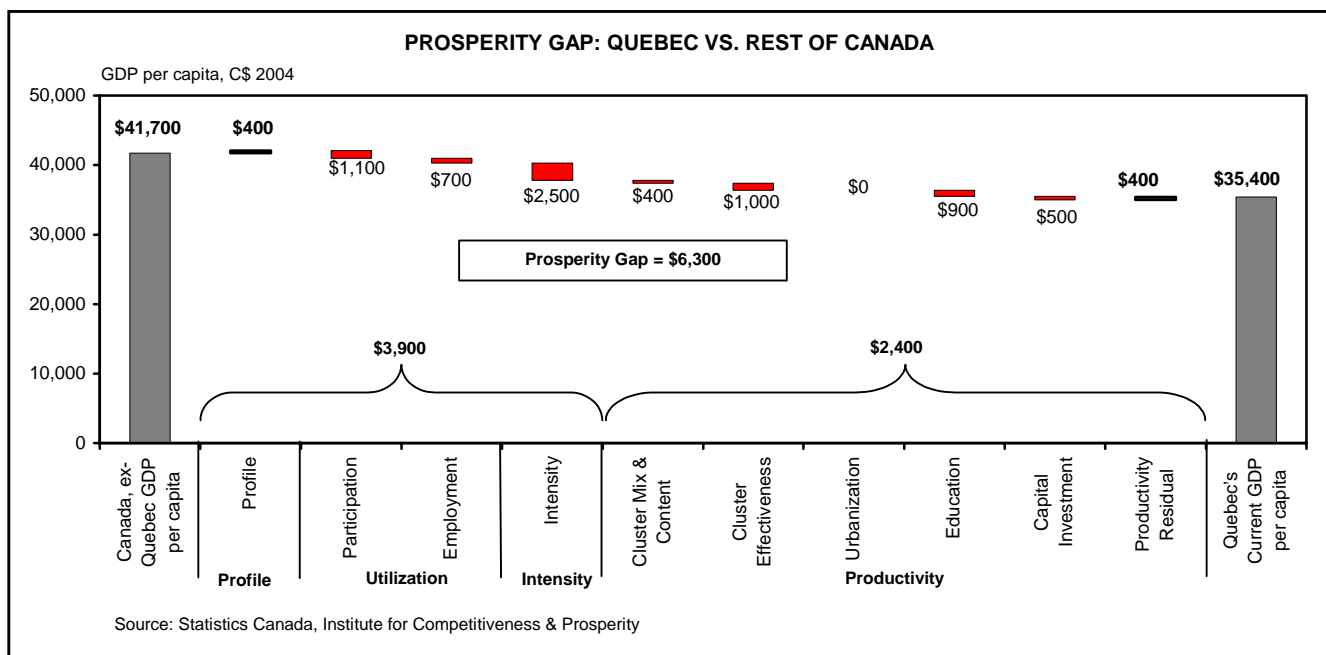
Another way to look at the first three factors – profile, utilization and intensity – is "labour effort" or total hours worked per capita. The last one, productivity, refers to how effective labour is in translating their efforts into goods and services of value to others around the world.

#### Profile a Quebec advantage ... for now

Paradoxically, with all the chatter about Quebec's aging population, this demographic component – the percentage of the population that is of working age (15-64 years) – is currently one of the province's competitive advantages, translating into a positive gap against the ROC of \$400 per person. However, this high ratio has much to do with the low fertility rates in the 1960s and 1970s and the dearth of 15 year olds entering Quebec's work force. With a larger share of Quebecers poised to turn 65 years of age over the next half decade, this advantage is projected to swing into a disadvantage by 2010.

#### Utilization a disadvantage

While labour utilization tends to represent a disadvantage of \$1,800 per capita, there is some good news on this front. As noted on page XX, both Quebec's labour-force participation rate and employment rate have increased relative to those of the rest of Canada in recent



### Decomposing Quebec's Prosperity Gap (continued)

years. Some of these gains can be chalked up to a rising participation rate among women, which recently surpassed the rest of Canada average. Other demographic factors may also be at work. For one, in recent years, Quebec's average participation and employment rates have been lifted in part by the declining share of younger individuals (i.e., less than 25 years) in Quebec's job market, since youths tend to record weaker attachment to the labour force. Moreover, international migrants have been accounting for a rising share of Canada's job market, but often record lower rates of participation and employment. Although migration trends have improved lately, Quebec still attracts a smaller share of international migrants per capita than Ontario and British Columbia.

#### Intensity the largest disadvantage

Intensity – or average hours worked per employee – represents the single biggest drag on Quebec's prosperity vis-à-vis the ROC, amounting to \$2,500. Furthermore, this gap has widened significantly since 1999.

#### So-called "productivity" just under 40% of gap

With labour-effort factors accounting for a total of \$3,900, the remaining 38% of the gap (or \$2,400) is owing to "productivity", or output per hour worked. The fact that this share is less than half may come as a surprise to some given the usual attention paid to Quebec's challenges on the "productivity" front. Even more

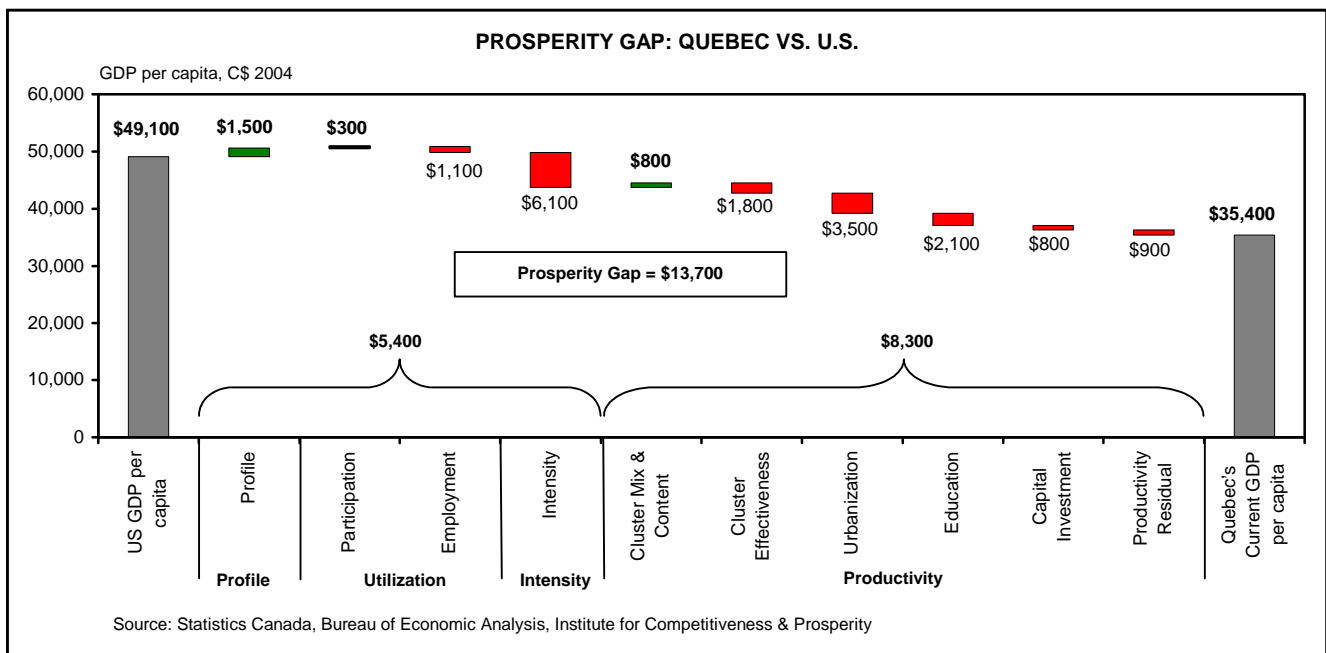
surprising may be the sources behind the gap. The Institute defines "productivity" to include six main components:

Cluster mix and content (-\$400): certain sectors, such as those that have a trade orientation, tend to be more innovative and record higher levels of productivity. Cluster mix looks at the share of employment in traded industries, while cluster content assesses the makeup within each traded cluster. On this count, Quebec posts a slight disadvantage.

Cluster effectiveness (-\$1000): this area focuses on how well Quebec's clusters of traded industries compete by comparing productivity differences (as proxied by wages) with other jurisdictions. Within these industries, wages and productivity were found to be 18% lower on average compared to the rest of Canada, which translates into reduced GDP per capita of \$1,000.

This result may raise some eyebrows, since many would associate weaker "effectiveness" as the key driver behind lower "productivity". Yet as we show above, this category only explains 40% of the "productivity gap" and only 15% of the overall prosperity gap.

Urbanization (\$0): this component measures the proportion of the population that lives in urban areas, which typically increases a jurisdiction's productivity due to the interaction of people and industries. Quebec has roughly the same urbanization level as the ROC.



### Decomposing Quebec's Prosperity Gap (*continued*)

Education (-\$900): the educational attainment of a population has a positive relationship with productivity levels. Overall, the proportion of persons 25-64 years in Quebec with a post-secondary diploma or degree is in line with the ROC. However, only 18% of Quebecers have a graduate or post-graduate degree from university compared with 23% in the ROC. Part of this gap is explained by the high share of Quebecers that complete CEGEP, which is captured under the "diploma" category but considered to be a more robust and professionally-oriented system on the whole than traditional community colleges in the ROC. Meanwhile, 24% hold less than a high school level in Quebec, compared to 21% in the ROC. Compared to other jurisdictions, Quebec spends more on education as a share of GDP, but less on a per-capita basis.

Capital investment (-\$500): this area represents the degree to which physical capital supports productivity. As a percentage of real GDP, Quebec businesses spent less on machinery and equipment than in the ROC (8.5% versus 12.8% in 2005). Governments in Quebec also tend to allocate a smaller share of each revenue dollar

to investment in areas like education as opposed to consumption in areas like health care and social services.

Other factors (+\$400): this is the residual that is unexplained by the factors considered above and related to productivity on the basis of like-to-like cluster mix and strength, urbanization, education and capital intensity.

#### **Quebec suffers a larger prosperity gap with the U.S.**

The chart above shows how Quebec stacks up against the United States in a similar calculation. In this case, it is the opposite: 60% of Quebec's shortfall in real per-capita GDP is chalked up to "productivity" while 40% is owing to lower labour effort. Compared to the analysis with the ROC, Quebec enjoys a similar comparative advantage in "profile" against the U.S. and its relative standing in labour market participation moves from a slight negative to a small positive. Lastly, although Quebec faces deeper-than-average challenges, it is far from alone among Canadian jurisdictions in experiencing a "productivity" gap with the United States. For example, the Institute estimated that about 85% of Ontario's prosperity gap with its American peers reflects lower output per hour worked.

These assertions have validity. However, there is a compelling argument that rising prosperity is a critical contributor to preserving and protecting quality of life through better health and education. Rising incomes generate revenues for governments to strengthen social services. The same can be said for households and businesses. In fact, if Quebec was able to close its prosperity gap with the ROC, an average household in the province would benefit from an increase in annual personal disposable income of more than \$8,000 per year that could be used to fund housing costs, tuition fees and other goods and services. Indeed, a relatively high poverty rate is one area where Quebec's lower income per capita has manifested itself.

At the same time, it is not Quebec's current prosperity performance that is found worrisome to groups that have been leading the call for change. Nor is the province's medium-term outlook setting off many alarm bells. Indeed, we share a consensus view that economic growth should expand at a moderate rate of about 2.5% per year in the 2007-08 period, which is not far off the province's usual cruising speed and just below the national average rate.

Rather, it is the potential threats to the province's standard of living looming on the longer-term horizon that are found to be the greater cause for concern. We now turn our attention to the long-term challenges facing the province.

#### **Labour force could start to fall by 2013**

Some of the greater threats to prosperity come on the demographic front. In comparison to the rest of Canada and the United States, Quebec has a significantly higher share of older individuals (those 50+ years) and a smaller share of youths (under 15 years). This structure yields a median age in the province (40.4 years) that is more than 2 years higher than the ROC and 5 years above that in the United States. What's more, with Quebecers also tending to retire earlier than other Canadians, the impact on the labour force participation of the aging baby-boom cohort will be greatly magnified over the next 10-20 years.

We present a status-quo forecast of labour force growth for Quebec and Canada using Statistics Canada's most recent "medium-growth" population projections (based on the 2001 Census) and assuming labour-force participation

rates by age group are unchanged at last year's historically-high levels. Strikingly, under this scenario, the size of Quebec's labour pool begins to decline in 2013 and heads steadily lower thereafter. In contrast, Canada's labour force manages to record slight growth over the next decade.

News of a spike in Quebec's average fertility rate over the past few years – and a faster rate of immigration – has provided some cause for optimism that population trends may have turned the corner. Still, the jury remains out on whether this improvement is an aberration or the start of a new trend. In any event, a trend pickup in the fertility rate would not influence the labour supply until 2025 and beyond.

### Health care pressures to rise

The concerns about the impact of the demographic shift on the standard of living extends beyond the labour force to the potential pressure that a greying population could place on the province's resources through costs for pensions and health care. In Quebec, the ratio of workers (20-64 years) to retirees (65+ years) – the so-called dependency ratio – is estimated to decline from 4.7 persons to 2.1 persons by 2030.<sup>2</sup> For the ROC, the ratio is expected to fall from 4.9 to 2.5 over the same period.

In response to this risk, actions were taken in the late 1990s and early 2000s to put the Quebec Pension Plan on a more sustainable footing, including a doubling of pension plan premium rate. However, the spotlight has remained on the potential squeeze that will emerge from rising public health care costs. According to a study by the CD Howe, provincial health spending on individuals aged 65 and over

MEDIAN AGE OF POPULATION		
	2001	2006
<b>CANADA</b>	<b>37.2</b>	<b>38.8</b>
Newfoundland and Labrador	38.1	41.3
Prince Edward Island	37.6	39.8
Nova Scotia	38.5	41.0
New Brunswick	38.2	40.8
<b>QUEBEC</b>	<b>38.5</b>	<b>40.4</b>
Ontario	36.7	38.2
Manitoba	36.4	37.3
Saskatchewan	36.4	37.7
Alberta	34.7	35.5
British Columbia	37.9	39.8
Yukon	35.8	38.0
Northwest Territories	29.9	30.9
Nunavut	22.5	23.2

Source: Statistics Canada

is some 5.4 times greater per person than on individuals under 65 years. By undertaking a similar "status-quo" forecast that applies current spending rates by age cohort, the CD Howe report estimated that health spending in Quebec would rise from 31% of government own-source revenue in 2000 to 41% in 2020.<sup>3</sup> Under its base case, provincial health spending would absorb 8.5% of Quebec's GDP by 2020, up from 6.5% in 2000.

### The competitive threat from Asia

Undoubtedly, a large share of Quebec's current prosperity is owing to its powerhouse manufacturing sector. This area not only remains Quebec's number one economic driver in terms of size, but is among the most productive. In fact, only the hydroelectricity, financial services, information and culture and wholesale trade industries recorded higher output per hour worked than manufacturing in 2005. Looking ahead, the biggest threat facing Quebec's export-oriented manufacturing sector is unlikely to come from the currency. The value of the Canadian dollar is trading closer to its purchasing power parity of about 83 U.S. cents. Furthermore, there's little reason for the currency to move sharply higher or lower on a sustained basis. Rather, the greatest risk facing Quebec's manufacturing industries is the competitive threat from low-cost Asia, notably China.

About 40% of China's GDP is directly tied to manufacturing – a proportion that has risen dramatically since China's ascension to the WTO in 2001. Initially, Chinese exports were geared to lower-value-added products – such as textiles, clothing and furniture – as producers benefitted

PER CAPITA PERSONAL DISPOSABLE INCOME (2005)	
<b>CANADA</b>	<b>\$24,382</b>
<b>ROC*</b>	<b>\$24,974</b>
British Columbia	\$23,732
Alberta	\$29,523
Saskatchewan	\$22,475
Manitoba	\$22,379
Ontario	\$25,231
<b>QUEBEC</b>	<b>\$22,454</b>
New Brunswick	\$21,491
Nova Scotia	\$22,023
Prince Edward Island	\$20,568
Newfoundland & Labrador	\$20,180
Northwest Territories	\$36,173
Nunavut	\$29,361
Yukon	\$34,414

\* Canada ex. Quebec; Source: Institut de la statistique du Québec

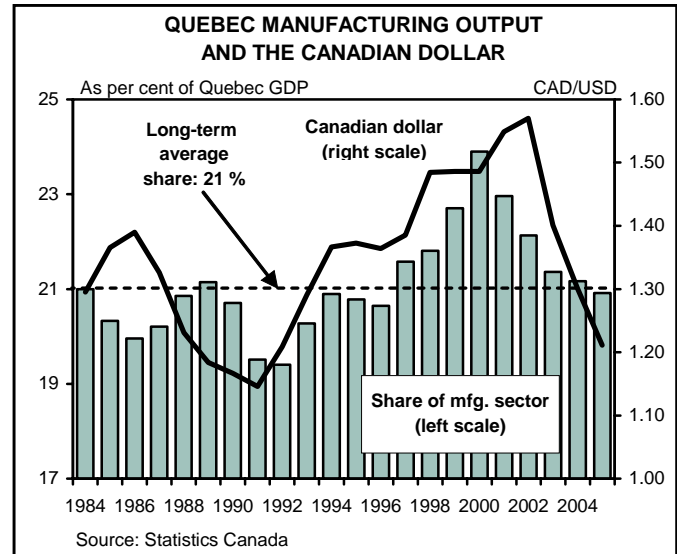
from economies of scale, cheap labour (average salaries ranged between US\$1,000-1,500 per worker in 2003), and lenient environmental standards.<sup>4</sup> More recently, the China's foreign strategy has emphasized advanced technologies and innovation, as it strives to climb the value-added curve.

The impact of Chinese competition is already being felt in Quebec. Quebec's trade balance in goods with foreign countries has been deteriorating, falling from a surplus of 3.7% of GDP in 2000 to a deficit of 2.9% in 2005. Roughly one-fifth of the deterioration in the goods trade balance has been against China. The impact of emerging economies competition on the province's textile industry has generated considerable attention. At its peak in the 2000, this sector contributed \$1.4 billion to real GDP and employed more than 20,000 workers. The comparable figures in 2005 were \$1 billion and 15,000, respectively. However, the competitive challenge is already broadening to other areas of capital-intensive, manufacturing, including newsprint and pharmaceuticals.

This is not to say that Quebec's higher-value-added manufacturing industries, as Chinese firms still face several barriers to market entry, including a perception of inferior goods, a lack of technical management competencies and limited R&D and innovation.<sup>5</sup> However, the risk is that China will successfully overcome these impediments in the years ahead.

### A new wave of U.S. competition

Quebec's manufacturers are not just facing enormous challenges directly from China, but indirectly through com-

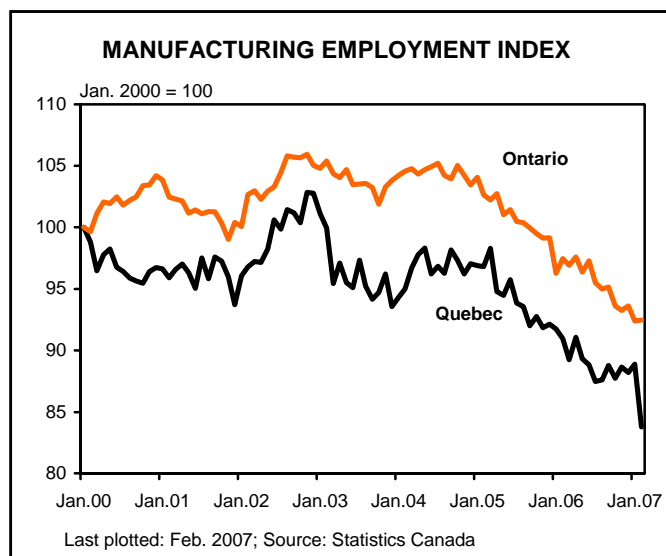


petitive pressures that are spilling over to wage structures in the United States – a development we often refer to as the “Delphi effect”. When the Delphi auto parts workers were part of General Motors, the base wage for workers was about US\$40 per hour. When GM spun off Delphi, wages were cut to US\$27 per hour. Currently, in order to emerge from bankruptcy protection, the company is pushing for concessions to knock the base wage rate to US\$16-17 per hour and to cut back benefits sharply in order to compete against foreign producers such as China. In some industries, there are also competitiveness challenges from foreign-based companies that aren't saddled with the pension and medical legacy costs, as well as workers in the U.S., particularly in the south, who are accepting lower wages and benefits. Over the long run, the well-paying manufacturing jobs can only be sustained with superior “productivity”.

### Re-thinking the vision

There are significant opportunities for Quebec to address these longer-term risks and, at the same time, parlay its numerous strengths into future prosperity. This will require action on a number of fronts, including doubling efforts to improve Quebec's macroeconomic climate, tax competitiveness, business environment, education, infrastructure and conditions in municipalities. And while citizens and government will need to spearhead the drive, the business community will be required to step up to the plate.

Just as Quebec launched ahead with a new vision in the 1960s, a number of jurisdictions have forged ahead with major structural change, yielding positive results. In



recent decades, countries such as Ireland, Sweden and Finland have implemented bold reforms that have substantially raised their growth potential and placed them on a more sustainable foundation. Recently, leaders in the European Union have been looking at solutions to their pressing challenges of weak potential growth and an aging population. Focus there has been steadily turning to the need to reduce over-reliance on the State and addressing improving the business environment.

### Squaring the circle

It is all too often the case that when a busy “to do” list is proposed the reader is left hanging about how all the goals will be achieved without pushing the public finances back into deficit. Certainly, some of the objectives can be addressed without a direct fiscal cost, such as paving the way for increased trade opportunities. For provincial governments, the fiscal imbalance had been an issue in recent years, but moves by the 2007 federal budget to provide increased provincial transfers suggests that little more will be done on that front over the medium term. In order to square the circle, two actions must be taken. First, a way must be found to bring rapid health-care cost increases under control. And, second, the government must meticulously scrutinize where and how it spends taxpayer dollars in order to ensure that programs and services pass the litmus test of providing value for money.

The second point will require a fundamental shift in attitude. The view that governments are in a position to provide large subsidies for electricity, tuition and day care needs to be replaced by one that better targeting assistance to those most in need. Subsidies generate benefits for house-

#### Quebec Economic Strengths

- High quality of life
- Relatively low business costs
- Excellent location
- Highly diversified economy
- Leader in hydroelectricity
- Leader in aerospace and biotechnology
- Large and talented workforce
- Leader in R&D and venture capital

REAL GDP BY INDUSTRY		
As per cent of total, 2005		
	Quebec	ROC*
<b>Goods-producing industries</b>		
Agriculture, forestry, fishing & hunting	2.0	2.5
Mining and oil and gas extraction	0.5	4.5
Manufacturing	20.5	15.4
Construction	5.7	6.1
Utilities	3.8	2.3
<b>Services-producing industries</b>		
Transportation & Warehousing	4.3	4.9
Information & Cultural Industries	4.4	4.0
Wholesale Trade	5.8	6.3
Retail Trade	6.3	5.7
Finance, Insurance & Real Estate	17.3	20.9
Professional, Scient. & Techn. Serv.	4.2	4.5
Public Administration	6.2	5.4
Educational Services	4.6	4.4
Health care and social assistance	6.2	5.6
Other Services	8.2	6.3

\* Rest of Canada; Source: Statistics Canada

holds and businesses, but come at a heavy cost to the treasury – both directly and in terms of the opportunity cost of not allocating the funds to alternative means. And in many cases, the costs outweigh the benefits. In particular, Hydro-Quebec has estimated that, excluding the opportunity cost, holding power prices in the province below their real market cost lowers government revenues by more than \$5 billion per year.<sup>6</sup> This strategy is inefficient and runs counter to the province’s goal to realizing the maximum benefits from its huge potential in hydro-electricity. There is also the fairness argument. The large subsidy embedded in the price of electricity means that non-users, or those that use less electricity, end up paying a good chunk of the bill for heavy users of power.

Certainly, with regards to tuition fees and day care, there are more grounds to justify a subsidy in view of the positive externalities that are derived. But the benefits of the policy must be balanced against the costs. Low tuition fees have deprived post secondary education (PSE) institutions of much-needed funding, which imposes a cost in terms of future prosperity. Individuals without university or college education foot a good part of the bill for those that attend PSE. Yet they tend to earn considerably less. Meanwhile, despite the low tuition policy, the province’s PSE participation rate is relatively low and has been declining relative to the ROC.<sup>7</sup> A preferred approach would be to address accessibility issues through targeted financial assistance.

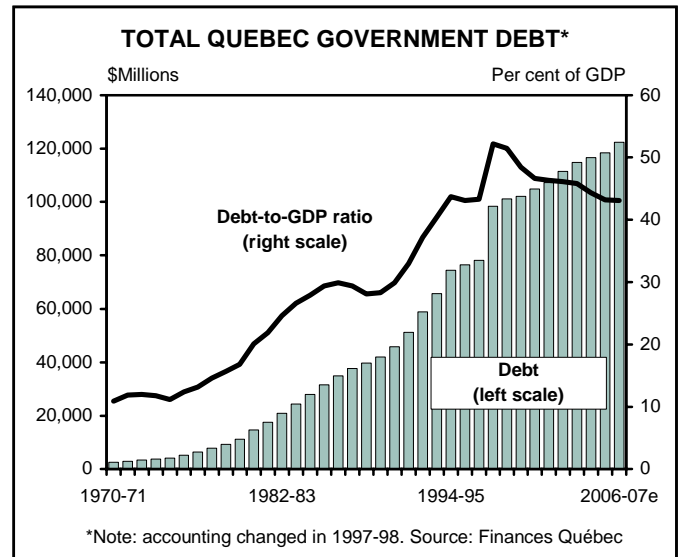
Even more broadly, a fundamental shift in approach

towards “user pay” in funding many government services, including infrastructure and water, should be embraced in Quebec and in other parts of Canada. Such a move, complemented by redistribution mechanisms to assist low-income earners, would pay off handsomely through a more, efficient, accountable and fair system. And, in the case of electricity, paying the full market price would be consistent with the province’s goals of encouraging energy conservation and sustainable development.

**Equalization no roadblock**

One concern that is raised is the disincentive embedded in the equalization system for the “have not” provinces to grow their economies. More specifically, the equalization formula has been underpinned by the notion that assistance should be pared back as a region’s fiscal capacity increases in order to reduce dependency. And while changes made to equalization in recent years have marked a departure away from these traditions, the reforms announced by the federal government in its 2007 budget shift the system back towards a more formula- and principles-based approach. The move to include all provinces, 50% of non-renewable resource revenue and reforms of certain bases such as property tax in the calculation will also provide Quebec with an estimated \$2.9 billion in additional equalization funding over three years. Adding on the announced increases to other federal transfer payments brings that total of new funding for Quebec to \$4.1 billion from fiscal 2005-06 to fiscal 2008-09.

Happily, the disincentive to generate wealth has not stopped Quebec from reducing its reliance on equalization



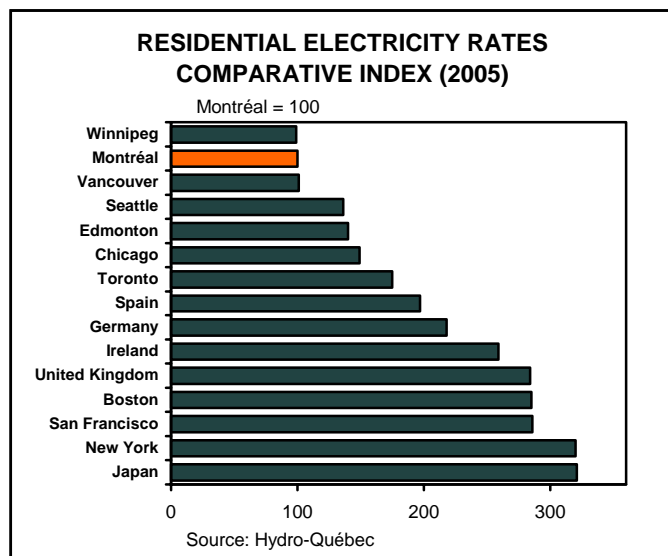
gradually over the past few decades, from 12% of total revenues in the 1970s to 9% in fiscal 2006-07. Hence, we see no reason why this should be a concern going forward. Keep in mind that as a share of GDP, equalization payments account for a relatively small 2%.

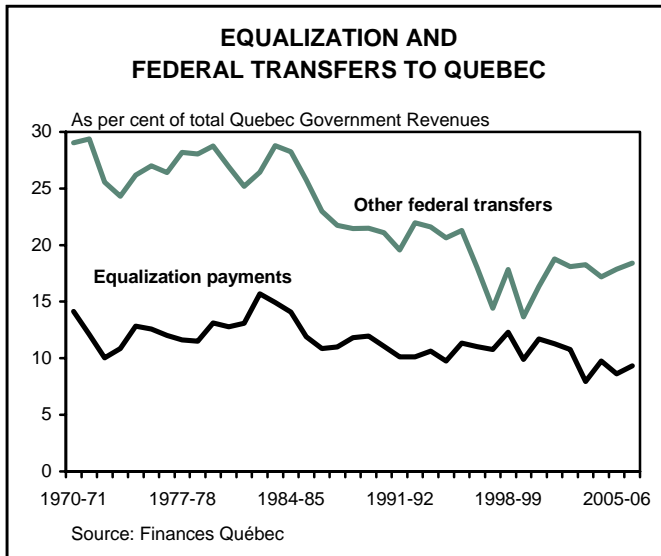
We now take a closer look at some of the key policy areas that will be critical to strengthening prosperity in Quebec.

**Strengthen the macroeconomic climate**

Few countries in the industrialized world have recorded such a dramatic improvement in their macroeconomic climate than Canada. The Canadian economy has registered steady growth in line with its potential rate over the past decade, the unemployment rate has fallen to its lowest level in a generation and interest rates have remained stable and below those in the United States. After years of keeping inflation low, the Bank of Canada recently renewed its 2% inflation target for another five years. And, on the fiscal front, Canada’s all-government budget balance has swung from deficit to surplus, pushing down the national debt-to-GDP ratio from 95% in fiscal 1995-96 to 56% in fiscal 2005-06. Looking ahead, the federal government has committed to reducing its debt-to-GDP ratio from its current level of 33% to 25% by fiscal 2012-13.

Quebec too has also managed to place its fiscal house on a stronger footing – recording balanced or near-balanced budgets in every year since fiscal 1998-99 – and joined the federal government in taking actions to improve the sustainability of the QPP/CPP. At the same time, there





is no denying that Quebec's debt-load remains one of its tallest challenges. Despite the improved budgetary position, the province's total debt has continued to rise by about \$4-5 billion annually, reflecting additional capital spending. A growing economy has managed to trim the province's debt-to-GDP ratio from its peak of 52% in fiscal 1997-98 to 43% in 2005-06. Nonetheless, the ratio remains one of the highest among the provinces. Currently, a sizeable 12 cents of each revenue dollar is allocated to servicing the debt.

In 2005, the government committed to lowering its debt-to-GDP ratio to 25% by 2025. This target could be achieved by holding the level of debt steady and recording annual average growth of 3% per year. However, if nominal growth were to slow to, say to 2.5% per year – which certainly can't be ruled out in view of the long-term downside risks at hand – the target would become considerably more ambitious. In that case, total debt would need to be reduced by \$9 billion from current levels (about \$500 billion on average each year). That estimate doesn't even take into account annual "status quo" capital borrowing requirements. In its 2006 budget, the government set up a Generations Fund as a vehicle to save a portion of water royalties for debt reduction. The fund has amassed about \$625 million thus far, which is a good first step but well short of what may be required.

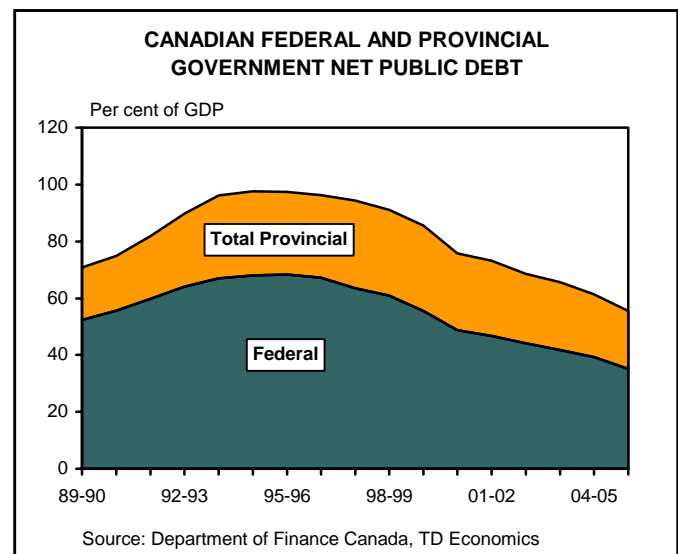
The government's 25% debt target is a worthy one. This would benefit coffers by freeing up interest costs that could be used for other purposes. Quebec's bond rating would probably improve in lockstep, generating lower bor-

rowing yields for the province. Canadian experience has shown that a virtuous cycle can be set in motion by reducing a debt burden significantly. In order to facilitate this process, the Quebec government should consider broadening its operating books to better match annual budget balances with changes in debt – a move that the Auditor General would support.

### Shift tax mix towards consumption

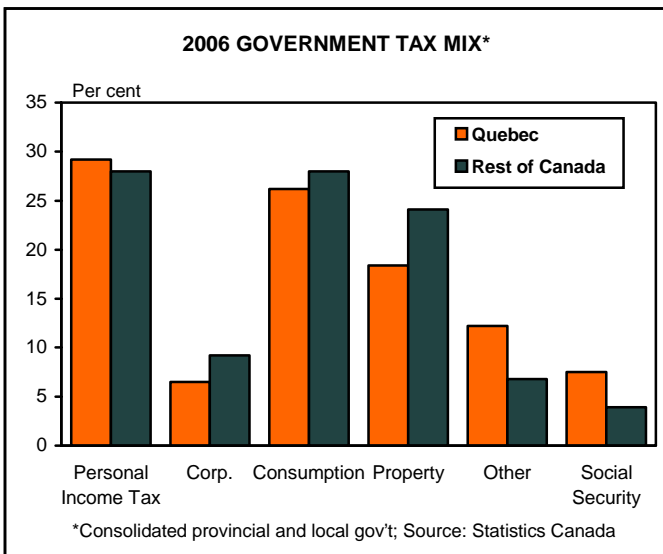
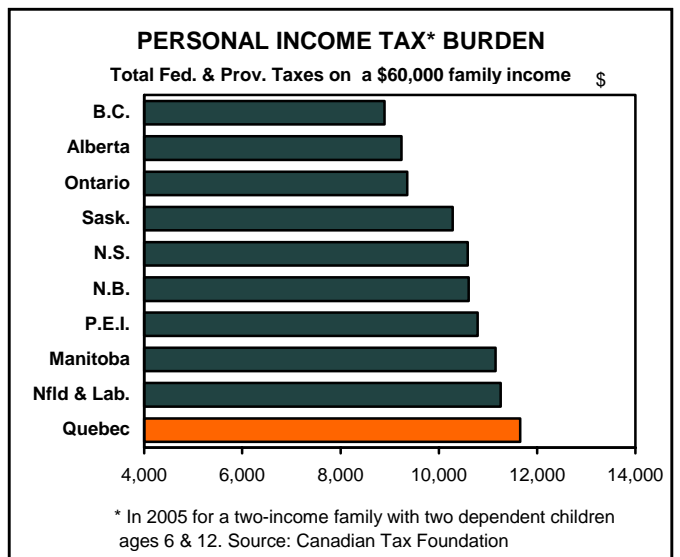
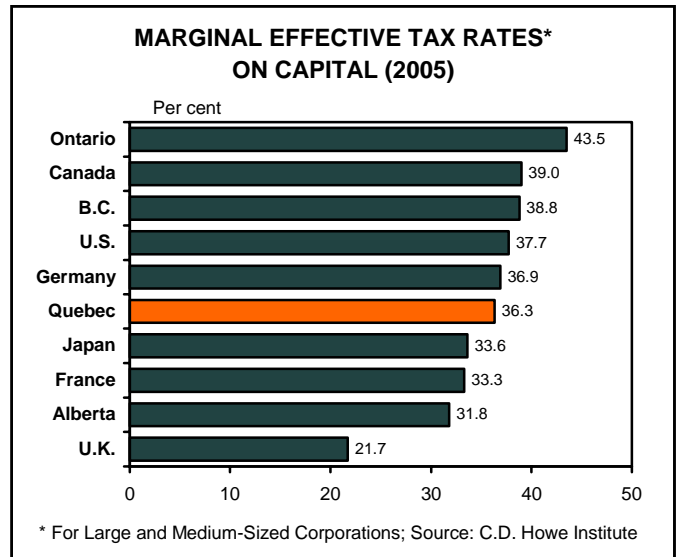
Quebec's tax structure leaves much to be desired. The overall tax burden is lofty. But, as importantly, it is highly inefficient. The provincial government raises a disproportionate share of revenues through taxes on income and capital, and a relatively small share through consumption. In fact, Quebec has among the highest personal income tax burdens in the world. And while the common view is that its largely a problem at the top and medium end of the income tax spectrum – where federal-provincial marginal personal income tax (PIT) rates rise to as high as 48% – marginal effective PIT rates rise to as high as 60-80% at family income of less than \$40,000 once the taxing back of social assistance benefits is factored into the equation.<sup>8</sup> The provincial government has got the ball rolling by delivering modest personal tax relief in recent budgets, including the reindexation of the tax system, but deeper cuts are urged. The election pledge of the Liberal party to earmark \$700 million to personal tax cuts has raised the odds that further PIT relief may be forthcoming. Still, this is not a slam dunk in view of the minority status of the government.

On the corporate side, Quebec compares much more



favourably. The marginal effective tax on capital investment for medium and large corporations – which includes income taxes, payroll taxes and capital cost allowances – in Quebec stood at 36.3% in 2005, about 7 percentage points lower than that of Ontario and below the 37.7% rate on average in the United States. Compared to its counterparts in other provinces that do not have harmonized sales tax systems in place, Quebec’s business sector enjoys a competitive advantage in that the tax burden on purchases of business inputs is lower. Still, it remains the case that many large companies in Quebec are not afforded full input tax credits under the QST.

A weak spot on the business front remains the province’s relatively high taxation on capital (the federal government has eliminated its capital tax). Research has shown that capital taxes are the single largest impediments to economic growth. On the bright side, the Quebec government has a plan in place to half the rate of capital tax on non-financial institutions to 0.3%, and financial institutions to 0.6%, by 2009. Furthermore, exemptions on capital tax are provided up to the first \$4 million of paid-up capital. However, that would still leave the capital tax burden at an uncompetitive level within North America, especially on financial institutions. Quebec’s financial sector has shown considerable promise as a wealth generator, boasting highly-productive domestic and international players. The Montreal Exchange is also experiencing rapid growth and is well-positioned to become a major strength in derivatives trading. Recently, it established a partnership with both NYMEX and the Chicago Climate Exchange, with the latter being the platform for the only emission trad-



ing program in the United States. But while the overall sector has grown at a respectable clip of almost 3% per year since 1997, it has lagged rates of expansion posted in Alberta (4.2%) and Ontario (4.1%).

Even if resources are not available over the next few years to lower the overall tax burden substantially, working to improve the efficiency of the system by tax shifting from taxes on income and capital to consumption would be wise policy. Accelerating and deepening the plan to cut the provincial capital tax should be a high priority.

**Improving the business environment**

In order to improve Quebec’s business environment, there needs to be a shift in focus away from inefficient business subsidies towards opening up new markets, re-

FINANCIAL SERVICES SECTOR OUTPUT IN REAL GDP		
Annual average per cent change		
	Quebec	Canada
1998	3.9	3.7
1999	6.0	2.9
2000	-0.6	3.5
2001	-1.7	5.0
2002	1.4	2.0
2003	3.5	3.0
2004	3.8	5.1
2005	5.4	4.7
2006	3.5	5.8
<b>Average 1998-2006</b>	<b>2.8</b>	<b>3.9</b>

\* Activities of banks and credit unions; excludes real estate and leasing  
Source: Statistics Canada

moving disincentives to work and scaling back regulation. One of the challenges with business subsidies is that they create a “free rider” problem, whereby firms receive assistance for actions they would have undertaken anyway. Savings could be diverted towards other areas which are likely to generate a bigger bang for the buck. Happily, there has been some good news on this front. The government has scaled back subsidies from \$1.01 billion in fiscal 2003-04 to \$984 million in fiscal 2004-05 and implemented a tri-annual review of looking at business aid programs.<sup>9</sup> We hope this process continues.

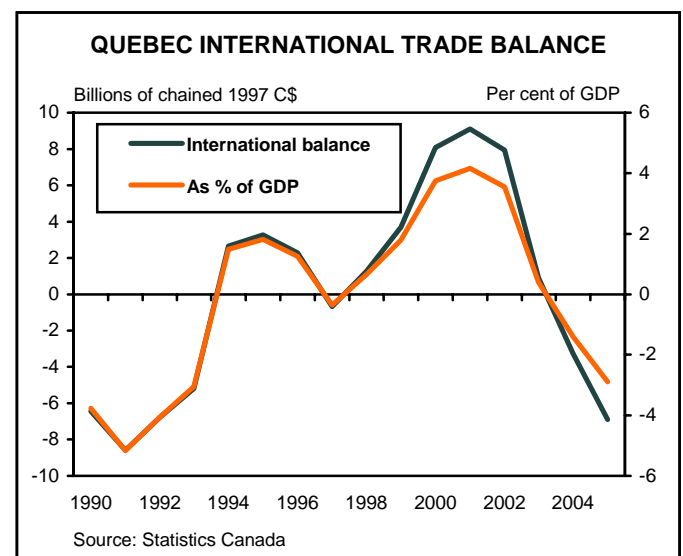
### Pursue free trade

On the trade front, Quebec is already a leader in North America, with total international exports amounting to 38% of GDP. At 50% of GDP, only Ontario is more reliant on international exports, partly reflecting trade in its export-oriented auto sector. However, despite its success post-NAFTA, Quebec can't rest on its laurels. For one, on the heels of the run-up in the Canadian dollar, the province's international export position has swung dramatically from a sizeable surplus of \$9 billion in 2001 to a deficit of \$7 billion in 2005. Without booming resource exports, the deterioration would have been even worse. Quebec has roughly the same reliance on interprovincial trade as other jurisdictions, at 18% of GDP. Once again, its position in domestic trade has also been slipping, moving from balance in 1997 to a deficit of about \$3.5 billion in 2005. Overall net trade activity, which was once a economic boon to Quebec, now represents a drag on the accounting of GDP. Keep in mind that part of the recent trends reflects rising imports of capital equipment which provide some offsetting benefits.

Quebec's potential to generate increased trade is substantial. Its location is second to none, positioned at the heart of the transportation corridor that connects Europe and the mid-west U.S. market. In addition, the widening of the Suez Canal – along with recent bottlenecks along the Pacific Corridor – have paved the way for increased trade from Asia. On the plus side, the federal government announced plans to invest in border infrastructure and pursue regulatory convergence with the United States. Federal investments made in infrastructure as part of its Atlantic Gateway Strategy will also lay the foundation for stronger trade activity along the St. Lawrence Seaway.

An area that will require increased attention is free trade. In fact, Canada hasn't signed a bilateral trade deal since 2001, when it joined forces with Costa Rica. In contrast, the U.S. has entered into 7 agreements with 12 countries around the world. This string may come to an end shortly, as Canada is poised to establish a bilateral agreement with a block of four European countries – Liechtenstein, Norway, Iceland and Switzerland. Still, trade with that region is small. The European Union would be a much more important milestone for Quebec and Canada, but that doesn't appear to be on the table anytime soon. On the flip side, Canada is now considering a potential free trade agreement with India.

In the shorter term, there are significantly greater opportunities at home. The last major inter-provincial trade agreement was the 1995 Internal Agreement on Trade and Tariffs (IATT). It was limited to a specific list of areas, did not have any satisfactory dispute resolution mecha-



nism and has been largely deemed a failure. Many barriers to labour and goods mobility have remained in place, constraining trade across the provinces.

Recently, there have been some hopeful signs that provinces are stepping up their efforts to knock down trade barriers. An agreement was reached across the provinces to recognize foreign credentials by 2009. But even more importantly, a sweeping trade deal that was signed last April between Alberta and British Columbia – labeled the Investment and Labour Mobility Agreement or TILMA – has caught the attention of provinces across the country. Unlike the AITT, TILMA covers all barriers on goods, trade and people unless specifically excluded and includes a strong enforcement mechanism. Interestingly, the deal between Alberta and B.C. will form an economic union accounting for 25% of GDP, surpassing Quebec as Canada’s second largest economic region. Other provinces, including Manitoba and Saskatchewan, have already expressed interest in joining TILMA. Quebec should also explore the possibilities, including the prospect of adopting something along the same lines with Ontario.

It is important that once governments generate the opportunities for trade, Quebec’s companies don’t waste any time taking advantage of them. In some cases, preparedness appears to be lacking – in a recent survey by Secur-Taktik, roughly 4 in 5 Quebec manufacturers said they have no idea how to profit from the Chinese market.<sup>10</sup> Often, though, it is more an issue with small and medium-sized enterprises, who lack the knowledge or confidence to engage in business outside of their borders. In many cases, the roadblocks are more perception than reality.

RELATIVE SIZE OF REGIONAL MARKETS		
	Population*	GDP**
<b>Alberta &amp; B.C. (TILMA Area)</b>	7,403	288,397
% of Canada	23.4	24.9
<b>Sask. &amp; Manitoba</b>	2,116	70,029
% of Canada	6.7	6.0
<b>Ontario</b>	12,160	483,962
% of Canada	38.5	41.8
<b>Quebec</b>	7,546	237,981
% of Canada	23.9	20.6
<b>Atlantic</b>	2,284	65,488
% of Canada	7.2	5.7

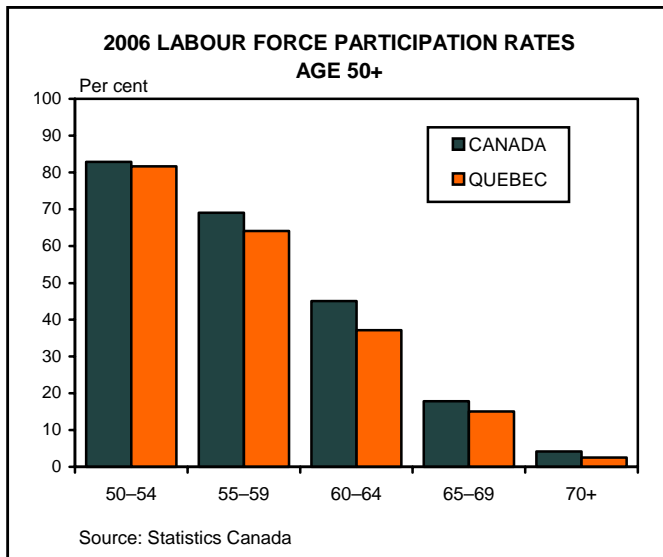
\*Thousands, 2006 Census; \*\*Real GDP (\$Millions 1997) for 2005  
Source: Statistics Canada

### Removing disincentives to work

A big theme thus far has been the risks to Quebec’s labour supply from an aging population. Hence, any efforts to increase labour-market participation will be of critical importance. There are three primary areas that need to be addressed:

- *Make work pay for low income workers* – we touched on the problem of high marginal PIT rates at the low end of the income spectrum. Quebec has been a leader in providing support to low-income earners through its working income supplement program. While raising the minimum wage is often discussed as a solution to assisting those in low income, it is hardly a panacea. Rather, an increase in the minimum wage without an offsetting increase in productivity leads to lower employment, so benefits are leaked. In our view, more value would come from a more holistic approach that builds on successes of its current program.
- *Encourage older workers to remain in the workforce* – the private sector should lead the way in establishing more flexible work arrangements (i.e., choice of part-time hours and/or daily start and finishing times) and in designing compensation, benefit and pension packages that are tailored to older workers. The need to encourage participation also raises the question of whether the age of entitlement under the CPP/QPP should be raised from 65 to 67 years and/or raising the actuarial penalty for receiving benefits early, mirroring moves in the United States.
- *Consider reforms to employment insurance (EI)* – In response to the notion that EI, while well-intended, acts as a disincentive to work, a number of commentators have suggested moving to re-establish the intensity





rule and introduce an employee or employer-based ‘experience rating’ system whereby premiums depend on past layoffs or unemployment experience. Less controversial is the view that EI premium rates should continue to head lower in order to better bring into line contributions with benefits.

### Reduce regulatory burden

Quebec’s regulatory burden has been measured to be the highest among the provinces. In its 2006 *Provincial Investment Climate* report, the Fraser Institute ranked Quebec last in terms of total cost of regulation, which it estimated at 4.5% of GDP compared to 2.6-4% rates in other provinces.<sup>11</sup> Quebec also rated last in terms of labour-market flexibility. The government has moved to scale back regulation in some areas in recent years – most recently, relaxing some of the Labour Code rules on subcontracting. Moreover, the federal government has committed to reducing its administrative burden by 20%. Still, the regulatory burden in the province, which threatens to increase even more as the province addresses its environmental challenges, remains a barrier to business investment. Certainly, any effort to enter into a trade agreement with another province would require the Quebec government to review those regulatory policies that are at odds with those in the other jurisdiction.

### Support PSE institutions by increasing tuition

Quebec is home to a strong education system, featuring robust CEGEP institutions and some of the top universities in North America. However, its solid standing in this

area is being put to the test by funding challenges. In fiscal 2004-05, funding per full-time equivalent student – including tuition, government support and gifts/donations – was slightly lower than in the ROC. While government has been doing the best it can to ramp up PSE support amid budgetary pressures – and the 2007 federal budget announcement of a \$300 million hike in funding for Quebec under the Canada Social Transfer will no doubt provide a helping hand going forward – the bigger culprit is a 13-year freeze in tuition fees. Last year, average tuition in Quebec was 60% below that of the rest of the country. By moving to raise tuition fees and focusing financial assistance on those in need, PSE institutions will be better-positioned to prosper and remain competitive. At the same time, Quebec should continue to build on its competitive strength in university research, where it ranks highest among the provinces.

The argument for keeping tuition fees very low would be furthered if the province’s enrolment rate had managed to climb higher than the average in Canada. Yet the opposite has occurred, as university participation in Quebec has not only remained relatively low but been on a declining trend in recent years. Furthermore, there is a good argument that those that benefit from a university education should bear a good part of the cost, especially in light of the fact that private returns to investing in PSE, after factoring in direct and indirect costs, amount to 14-19% for a bachelor’s degree.<sup>12</sup>

During the election campaign, the Liberal party put forward a plan to raise tuition fees to rise by \$100 per year over 5 years. Barring major changes in fees in other provinces, the average price tag for PSE under this plan would continue to run at half the ROC average. And while student groups voice concern about the impact of higher costs

MEDIAN RETIREMENT AGE (2002)	
<b>CANADA</b>	<b>60.6</b>
British Columbia	60.3
Alberta	63.4
Saskatchewan	65.1
Manitoba	61.2
Ontario	60.8
<b>QUEBEC</b>	<b>59.8</b>
New Brunswick	59.6
Nova Scotia	59.8
Prince Edward Island	59.4
Newfoundland & Labrador	59.6

Source: Statistics Canada

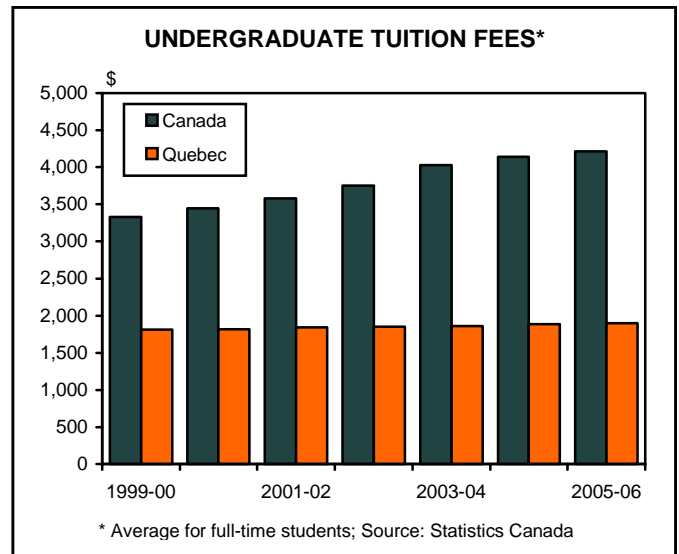
of education on students' financial position, the average debt-load in Quebec is significantly lower than that registered in other provinces.<sup>13</sup>

A lack of training expenditures by the private sector remains a vulnerability for Canada as a whole. Across the country, surveys have revealed that one-third of workers are not receiving the training they need, while less than 30% of adult workers participate in job-related training compared to 45% in the United States. Furthermore, it has been estimated that U.S. firms spend about 50% more on training than do Canadian firms.<sup>14</sup> In Quebec, the number in apprenticeship programs has been on a steep increase over the past half decade. However, completion rates have risen only modestly.

### Work to integrate immigrants

The focus on the immigration front tends to be on the absolute numbers of new migrants. However, a greater challenge appears to be on effectively integrating existing immigrants into the labour market. As is the case in other provinces, more and more immigrants – including those in the economic class – are falling into poverty and staying there longer than previous groups of immigrants. In some cases, language may be a barrier to successful entry into the labour market. But it is often the situation that licensing and credential recognition is the main issue. Moreover, private-sector participation in mentoring new Quebecers will go a long way in knocking down impediments to successful integration of immigrants into the job market.

Quebec has taken the lead within Canada in its efforts to retain foreign students once they graduate from post-secondary education. For example, a foreign student can



qualify for a three-year work visa regardless of whether he or she has found a job. Other provinces, such as New Brunswick and Nova Scotia, have been looking at Quebec's model with interest.

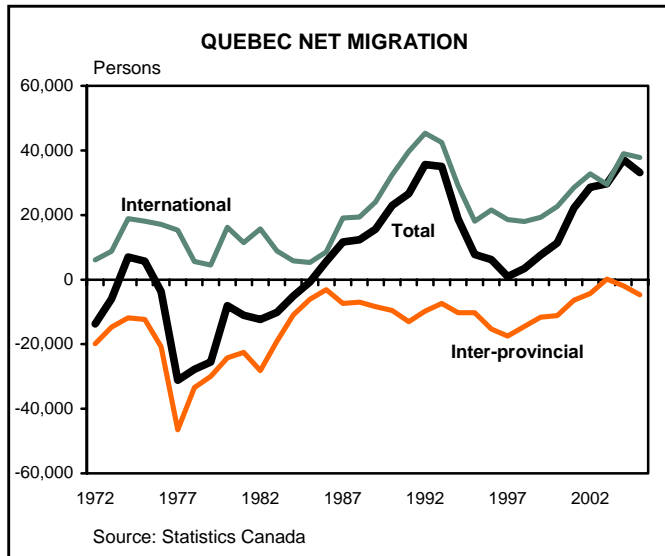
### Looking outside the box on infrastructure

We have already discussed the necessity of reducing Quebec's hefty government debt-burden. However, there is another liability that also needs to go on the chopping block – that being the province's large accumulated infrastructure deficit. The Conference Board of Canada has estimated that the deficit for sewers, aqueducts and road systems in Quebec stands at \$15-18 billion (7-8% of GDP).<sup>15</sup> And while measuring the size of the gap is a mug's game, there is a consensus that a sizeable gap exists. The infrastructure challenge in Quebec is complicated by its severe weather conditions.

In 2004, TD Economics published a comprehensive report on how to address Canada's overall infrastructure challenge. Since that time, there has been a flurry of developments, including a new wave of federal infrastructure funding for municipalities – notably for green projects – as well as substantial new support provided by the Quebec government. However, given the extent of the challenge, we argued that the solution will lie in more than just new money, but a more efficient approach. For one, governments would do well by better aligning the price of services with the true marginal cost, also factoring in the environment. The most conducive areas of user pay are those where consumption can be monitored and metred (elec-

UNIVERSITY ENROLMENT			
	1997-98	2004-05	% change
<b>CANADA</b>	<b>822,800</b>	<b>1,014,486</b>	<b>23.3</b>
<b>ROC*</b>	<b>590,700</b>	<b>751,089</b>	<b>27.2</b>
Newfoundland & Labrador	15,800	18,048	14.2
Prince Edward Island	2,900	3,972	37.0
Nova Scotia	37,100	43,533	17.3
New Brunswick	22,700	24,903	9.7
<b>Quebec</b>	<b>232,100</b>	<b>263,397</b>	<b>13.5</b>
Ontario	303,400	413,409	36.3
Manitoba	30,800	39,285	27.5
Saskatchewan	31,200	32,838	5.3
Alberta	71,400	88,077	23.4
British Columbia	75,300	87,024	15.6

\* Canada ex. Quebec; Source: Statistics Canada



tricity, waste water and garbage collection) and where there is no over-riding equity issues. But, in our view, greater application of road tolls represented the greatest opportunity to effectively fund the infrastructure gap.

Another area of promise in funding infrastructure is the public-private-partnership (P3). There remain the old “hang-ups” across the country about P3s, particularly concerns about private sector involvement in public infrastructure delivery and the higher private costs of financing. But international experience has shown that if done right, P3s can generate benefits that more than offset the costs and, at the same time, ease pressure on government resources. The good news is that P3s are gaining momentum in Quebec and the ROC. While B.C. has been a leader in Canada on this front, Quebec has established a specialized office for P3s (*L'Agence des partenariats public-privé du Québec*) and forged ahead with a number of projects, including a concert hall, health care facilities and Autoroutes 25 and 30. A survey carried out by the Canadian Council of P3s shows that Quebecers are more open to P3s than their Canadian counterparts.

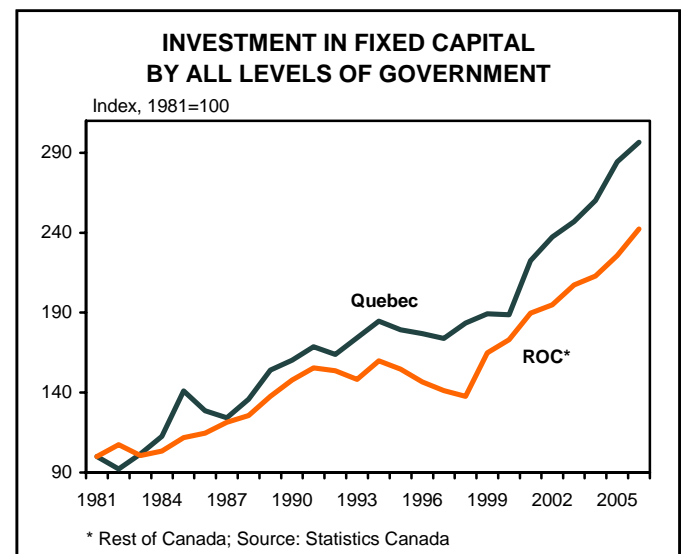
### Give cities adequate tools

The 2004 TD report on infrastructure highlighted the fact that without an increased array of funding tools for cities, the infrastructure gap will remain open and likely grow over time. This is because more than half of all infrastructure assets are under the direct purview of local governments. In Montreal alone, an investment of \$7.2 billion over 10 years will be required to rehabilitate its in-

frastructure, with about half of that reflecting road demands.<sup>16</sup> Yet three-quarters of revenues in Montreal (and other Canadian municipalities) are generated by a single source, the property tax, representing among the highest ratios in the OECD.<sup>17</sup> Although property taxes tend to be relatively stable, they also usually grow more slowly over time than capital needs.

Some of the onus is on local governments to make better use of the tools they already have at their disposal. In particular, proper land planning strategies that encourage intensification and reduce urban sprawl would lessen the cost of providing transit and other infrastructure. The establishment of the Metropolitan Community of Montreal (CMM) in 2000 marked a step forward in regional planning across the region. Municipal governments should more actively jump on the bandwagon of exploring alternative approaches to service delivery, including P3s. But while cities in Canada have not made use of debt to finance capital spending, this is not the case in Quebec, where debt burdens in Montreal and other major cities are relatively high. Still, DBRS has granted Montreal a respectable rating of Aa2, citing many of its offsetting credit strengths.

That said, the ongoing challenge in Quebec, as is the case in other provinces, is to provide cities with adequate fiscal and administrative tools so that they can address the many challenges on their doorstep. On the plus side, Quebec has been a leader in Canada in experimenting with some innovative new funding sources for municipal services. In particular, the Agence métropolitaine de transport (AMT), which is funded through a grant equal to 1.5 cents per litre of the provincial gasoline tax and a \$30 registra-



### Quebec's Challenges Mirrored in Montreal

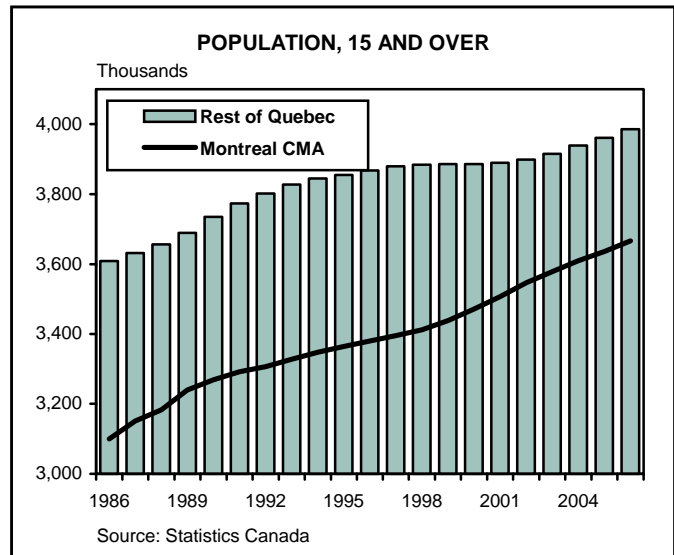
It should come as little surprise that Quebec's economic strengths, challenges and overall fortunes are increasingly mirrored within its largest urban regions -- the Greater Montreal Area. Montreal accounts for just under half of Quebec's population and GDP. With more than 3.6 million residents, it's the second largest metropolis in Canada and 15<sup>th</sup> largest urban conglomeration in the world (source OECD). When we speak of Quebec's many strengths -- a highly diversified economy as well as a major centre for manufacturing, tourism, financial services, transportation and high tech -- we're largely referring to Montreal. This is not to say that other areas of Quebec aren't major economic contributors. Quebec City, with a sizeable 715,000 residents, is the home to significant manufacturing and high-tech industries and is the hub for provincial government activities in the province. Quebec's abundant supplies of power, newsprint, lumber, metals and other resources are generated in smaller communities, particularly in the north. However, it is hard to refute the fact that Greater Montreal is still the primary engine of growth in Quebec. Consider this impressive list:

- 4<sup>th</sup> in North America in terms of quality of life (Mercer 2006)
- The destination of almost one-fifth of Canadian international immigrants
- The lowest business operating costs in North America
- As measured by jobs/capita, 2<sup>nd</sup> in the world for aerospace
- As measured by jobs/capita, 4<sup>th</sup> in North America

tion fee charged on registered vehicles, is often regarded by other provincial jurisdictions as a best practice. As we discuss in the text box above, there is a lot at stake in ensuring that the urban engines, and notably the Greater Montreal Area economy, flourish. Research carried out by the Conference Board of Canada has shown that rising activity in hub cities generates substantial benefits for surrounding municipalities and regions in the province.<sup>18</sup>

#### Be parsimonious in non-priority spending

The importance of increasing investments in the key



for high tech and 6<sup>th</sup> for pharmaceuticals

- 1<sup>st</sup> in Canada for research centres and academic research funding
- Home to Canada's largest container port and 3<sup>rd</sup> largest on the Atlantic Coast of North America

But just as Montreal is home to many of Quebec's key strengths, it reflects most of the province's greatest challenges. Household incomes, rates of poverty and university and levels of education attainment are significantly lower in Montreal than in other large international cities. What's more, while the city has enjoyed steady growth in recent years, it has continued to lose head offices since 1999. In a 2004 report, the OECD reported that Montreal ranked 44<sup>th</sup> in terms of real GDP per capita among a selection of 65 international cities.<sup>19</sup>

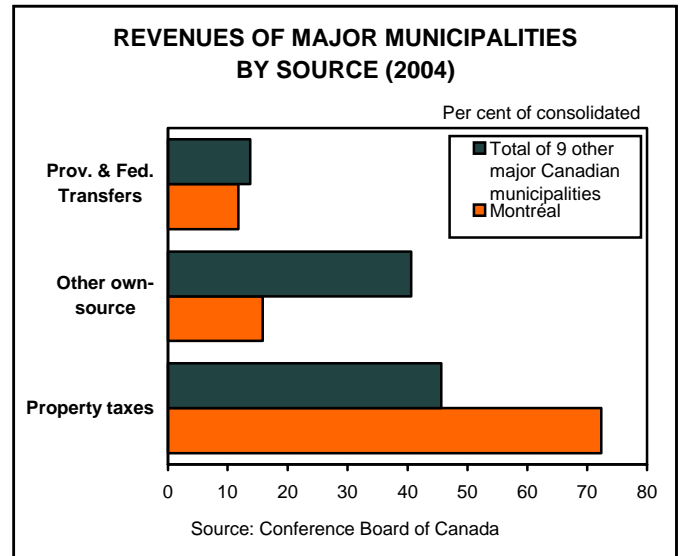
strategic areas and operating within a balanced-budget constraint means that governments in the province will be required to constrain spending in areas of lower priority. To some extent, Quebec has been moving down this path. Spending in non-health, non-education has increased at a moderate rate of 3-4% per year since fiscal 2003-04. The number of public-sector employees has also been reduced by about 4% since 2003, as part of a longer-term goal of a 20% reduction in 10 years. Meanwhile, the federal government has committed to keeping overall program expanding at a rate below nominal GDP.

The Quebec government might consider adopting a formal review process. The review should be ongoing. One lesson in history is learned from the first federal program review in 1994, which was driven by a process under the Privy Council Office with strong support from the Department of Finance and Treasury Board Secretariat. But while the program generated significant savings by meticulously going through each program, once these reductions were identified, the machinery was abandoned. In the 10 years that followed, program spending shot up by about 7% per year.

### The bottom line

An aging population, rising health costs and increased global competition within manufacturing are threatening to place significant pressure on Quebec's standard of living over the next few decades. We believe that Quebec is not only well-positioned to deal with these risks, but has the potential to come out on top. Few jurisdictions enjoy such an enviable list of assets, including a highly-diversified economy, an enormous wealth of natural resources, a talented labour force and high overall quality of life. The province can parlay these strengths into future prosperity by taking such actions as investing in education, strengthening its system of infrastructure and improving the business climate. The majority of Quebecers are supportive of many of these policies.

Still, in order to ensure that meaningful results are achieved over the longer haul, tough choices over will be required over the short run. Notably, it will be critical for residents to recognize that governments will only be in a



position to address the province's vulnerabilities – and at the same time, live within their means – by better targeting assistance to those individuals most in need. Although this will require a fundamental shift in attitude, the fact that Quebecers have rallied behind significant change in the past leaves us with considerable optimism.

Quebec's economic evolution has a history of extremes. The province's economy blazed the trail in Canada in the 1960s, then lagged behind in the 1970s and 1980s before turning in a modest comeback in the 1990s. If Quebec plays its cards right, it could re-emerge as a force to be reckoned with in the decades ahead.

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