March 28, 2017

QUEBEC TO REMAIN IN SURPLUS MODE, AIMING TO CHIP AWAY AT DEBT BURDEN

Highlights

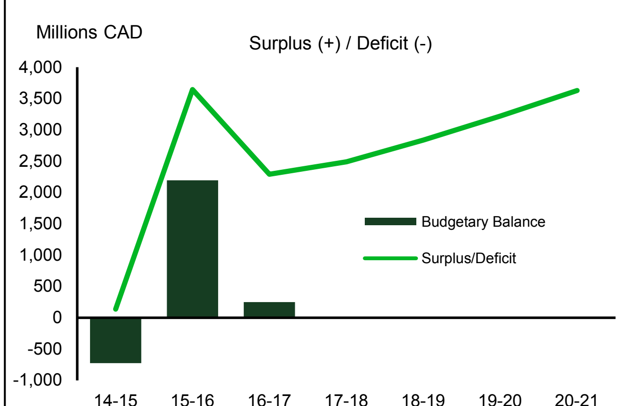
- Past efforts to control spending, a stronger economic backdrop and increased federal government transfers have given the Quebec government some additional wiggle room to loosen its purse strings further. Overall, the government has allocated almost $4.5 billion per year to new spending and tax-reduction initiatives, while still being able to meet its debt and budget balance targets.
- The Government of Quebec is forecasting a budget surplus of $2.5 billion in FY2017-18, with the surplus expected to rise to $3.6 billion by FY2020-21. The plan includes some tax-relief measures alongside infrastructure spending, with the remainder directed to the Generations Fund designed to pay down debt.
- Consistent with a higher surplus, medium-term borrowing requirements have come down somewhat relative to expectations laid out in Budget 2016, with the gross debt-to-GDP ratio forecasted to hit 52% in FY2017-18, decline below 50% by FY2019-20 and projected to reach the legislated target of 45% by FY2025-26.

Quebec is now reaping some of the benefits of its past deficit-elimination efforts. Last year's budgetary surplus came in at an estimated $2.3 billion, bettering expectations laid out in the Fall Update by about $300 million. The Budget Plan expands on previous plans for additional spending and tax reduction, while committing to still sizeable budget surpluses between $2.5 and $3 billion over the next several years. The sizeable public debt burden remains a challenge but the projected black ink, together with prospects for robust economic growth, should allow the Province to make further headway on its obligations. By fiscal year 2019-20, the gross debt-to-GDP ratio is projected to decline to 49.7%, more than 5 percentage points below its peak in FY2014-15.

Improving economy to help revenues

The government is looking forward to an improved economic outlook to help fund some of the new initiatives tabled in today's budget. The economy has picked up pace recently with nominal GDP growth on track to accelerate to an average annual pace of 3.3% per year over the budget horizon – a conservative estimate relative to our own forecast. The knock-on-effects of stronger economic growth, alongside a three year extension of the compensation tax for financial institu-

CHART 1: BALANCE* RETURNS FOR THE PROVINCE OF QUÉBEC



* Within the meaning of *Budget Balanced Act* after stabilization reserve.
Source: Fiscal Outlook Tables, Québec 2017 Budget.

Michael Dolega, Director & Senior Economist, 416-983-0500
Diana Petramala, Economist, 416-982-6420
Katherine Judge, Economic Analyst, 416-307-9484

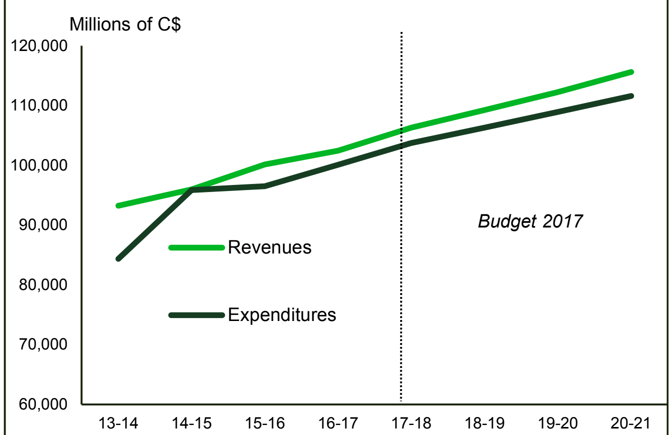
tions, should enable the province to generate more revenue from personal and corporate income taxes, now projected to be $550 million higher on average per year. Lower than previously anticipated interest rates should also allow the government to lower its debt payments by more than $500 million per year on average over the course of the coming years. The remainder of the revenue boost comes from higher federal transfers, which are anticipated to be $1.5 billion higher over the budget plan.

As a result of the fiscal room, the Government of Quebec has put forth several initiatives that continue to lower the tax burden on Quebeckers. The province has introduced over $2.1 billion dollars in tax relief for households and businesses, with some retroactive measures. Among the big-ticket items are:

- Eliminating the health service tax, including a retroactive refund for the amount collected during 2016 (over $700M)
- An increase in the basic tax credit, raising the threshold for the first income tax bracket by nearly 30% to $14,890 (over $400M)
- Extension of the renovation tax credit by another year (nearly $200M)
- Tax relief on the sale of a family business (nearly $300M)

Overall, revenues are expected to rise by 3.7% in FY2017-18 before moderating to a near-3% growth rate over the budget horizon, a pace below the growth in nominal GDP.

CHART 2: QUÉBEC EXPENDITURES AND REVENUES



Source: Québec 2017 Budget

TABLE 1: QUÉBEC ECONOMIC ASSUMPTIONS
(% change unless otherwise noted)

	2017 BUDGET		
Calendar Year	**2016**	**2017**	**2018**
Real GDP	1.7	1.7	1.6
Nominal GDP	3.0	3.3	3.3
Employment rate (%)	60.0	60.2	60.3
Unemployment rate (%)	7.1	6.6	6.4
Population (000s)	8,326	8,391	8,456
Housing starts (000s)	38.9	36.4	34.0
3-month T-bills (%)	0.5	0.5	0.8
10-year bonds (%)	1.3	2.0	2.4

Source: Québec Budget 2017.

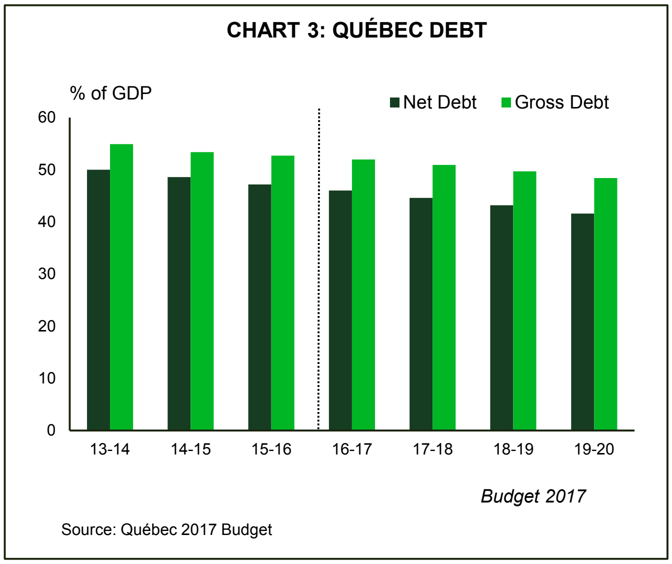
Quebec to give a little boost to spending

Following a substantial restraint in prior years, the Quebec government has continued to loosen its purse strings. Expenditures are expected to increase by 3.6% in FY2017-18 before moderating closer to the mid-2% range over the remainder of the budget plan. The big-ticket items remain education and health care. Education received will get $3.4 billion more in funding over the next five years, including programs across all levels of schooling. Following record amounts of investment in health care, the sector will get an additional $772 million in FY2017-18 and $1.8 billion in FY2018-19 – or roughly 4% more per year relative to last year's budget. The government also earmarked almost $600 million to supporting entrepreneurship and immigrant integration.

The government also expects to boost the capital expenditure plan, earmarking $255 million for affordable housing units, $1.3 billion for Montreal's electric train project, and another $800 million for various transportation projects.

Debt remains elevated but is projected to decrease

All told, the Government of Quebec projects to run budgetary surpluses, with these set to widen from $2.3 billion in the fiscal year now ending to $2.5 billion in FY2017-18 and $3.6 billion by FY2020-21. The surpluses will be reinvested back into the Generations Fund designed to pay down the province's debt. While gross debt is expected to inch higher in absolute terms over the budget plan, it will fall as a share of GDP. Gross debt-to-GDP is expected to clock in at 52% of GDP in the upcoming fiscal year, and fall below 50% by the end of the decade, before gradually inching towards the provinces 45% target by fiscal year 2025-26. At the same time, net debt-to-GDP ratio is expected to go from 46% in 2017-18 to 41.6% by the end of the fiscal plan.



Bottom line

Budget Plan 2017 represents another step forward in addressing Quebec's challenges, which include infrastructure, tax competitiveness, and elevated debt levels. The budget is mildly stimulative in nature, which should help keep the provincial economic momentum going by boosting disposable income and supporting sentiment. At the same time, the government is aware of its high debt load and has laid out the groundwork to reduce it at a gradual pace. While risks remain plentiful, with potential for border-thickening and the softwood lumber dispute top of mind, the plan laid out by the government appears overall reasonable.

TABLE 2: QUÉBEC GOVERNMENT FISCAL POSITION
(Millions CAD unless otherwise noted)

	Actual	2017 Budget				
Fiscal Year	**15-16**	**16-17**	**17-18**	**18-19**	**19-20**	**20-21**
REVENUES	**100,146**	**102,466**	**106,308**	**109,225**	**112,243**	**115,608**
% change	4.3	2.3	3.7	2.7	2.8	3.0
Own-source	81,245	81,968	84,279	87,004	89,690	92,452
Federal transfers	18,901	20,498	22,029	22,221	22,553	23,156
EXPENDITURES	**96,502**	**100,074**	**103,720**	**106,291**	**108,927**	**111,581**
% change	0.7	3.7	3.6	2.5	2.5	2.4
Program expenditures	86,493	90,387	93,852	96,533	98,917	101,133
Debt charges	10,009	9,687	9,868	9,758	10,010	10,448
Total consolidated entities	**3,644**	**2,392**	**2,588**	**2,934**	**3,316**	**4,027**
Contingency Reserve	0	-100	-100	-100	-100	-400
SURPLUS (DEFICIT)	**3,644**	**2,292**	**2,488**	**2,834**	**3,216**	**3,627**
% of GDP	1.0	0.6	0.6	0.7	0.7	0.8
Generations Fund deposits	1,453	2,042	2,488	2,834	3,216	3,627
BUDGETARY BALANCE*	**2,191**	**250**	**0**	**0**	**0**	**0**
% of GDP	0.6	0.1	0.0	0.0	0.0	0.0
NET DEBT	**185,025**	**185,214**	**186,503**	**186,992**	**186,935**	**185,595**
% of GDP	48.6	47.2	46.0	44.6	43.2	41.6
GROSS DEBT	**203,347**	**206,953**	**210,824**	**213,261**	**214,966**	**215,711**
% of GDP	53.4	52.7	52.0	50.9	49.7	48.4
ACCUMULATED DEFICITS	**120,121**	**118,079**	**115,591**	**112,757**	**109,541**	**105,914**
% of GDP	31.5	30.1	28.5	26.9	25.3	23.7

* Budgetary balance within the meaning of the *Balanced Budget Act* after contributions towards the Generations Fund.
Sources: Québec Budget 2017.

TABLE 3: Value of the Generations Fund ($ Millions)		
	Book Value	Market Value
2006-2007	584	576
2007-2008	1,233	1,147
2008-2009	1,952	1,598
2009-2010	2,677	2,556
2010-2011	3,437	3,524
2011-2012	4,277	4,375
2012-2013	5,238	5,550
2013-2014	5,659	6,299
2014-2015	6,938	8,182
2015-2016	8,522	9,562
2016-2017	10,564	
2017-2018	13,052	
2018-2019	15,886	
2019-2020	19,102	
2020-2021	22,729	

Source: Québec Budgets 2017.