Reference Document

Prebudget Consultations

Outlook for Québec's Economy, Public Finances and Debt

January 2006

Québec

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Introduction

— Since 2003, the government has devoted its actions towards managing Québec's public finances rigorously and responsibly.

— Despite a difficult budgetary context, the government has been making every effort since 2003 to fulfil its commitments towards Quebeckers.

  – Since 2003, the health sector has benefited from new investments totalling $3 billion. Its budget for 2005-2006 stands at close to $21 billion. A reorganization of the health system has also helped to improve services for the population.

  – An additional $1 billion has been invested in education to ensure that youths are better prepared to meet the challenges of the future.

  – Several family support measures have been implemented. The child assistance program, the development of the childcare system and the new parental insurance plan illustrate just some of the actions intended to help parents balance work and family responsibilities. The total financial support for Québec families comes to $4.5 billion, for an amount of assistance per family three times higher than in Ontario.

  – A major business tax reform is now underway to stimulate investment and the creation of wealth.

— The debt is an important preoccupation of the government. It is at a very high level and three-quarters of it has been incurred to finance current expenditures. Maintaining budgetary equilibrium is the first step towards controlling the debt.

— Budget 2006-2007 will provide an opportunity to continue making progress in the management of public finances.

— The government must now look further ahead and make judicious choices to ensure a strong future for the generations to come. The Forum des générations held in the fall of 2004 gave participants the opportunity to discuss the challenges awaiting Québec in the years ahead, in particular the demographic challenge.

- The government and Québec society as a whole must reflect on the actions to be taken to ensure the development of Québec and the sustainability of its public services.

- The prebudget consultations provide an opportunity to discuss the issues surrounding public finance and to re-assess the priorities.

- This year, the prebudget consultations will focus on one main theme: the debt.

Prebudget Consultations Paper

- This paper is intended as a springboard for holding discussions and sharing ideas during the prebudget consultations.

- The first part presents the economy of Québec, its outlook and its structural challenges.

- The second part gives an overall portrait of the government's financial situation.

- The third part describes the evolution of the debt and the related issues, and presents a series of questions that go to the heart of the consultations.

- Also available is a supplementary document presenting a comprehensive portrait of the efforts, primarily fiscal in nature, that the government has made since 2003 to support individuals, enterprises and public infrastructures.

The Québec Economy: Evolution and Outlook

The Québec economy

— Québec's economy is doing well. Consumption and enterprise investments are increasing. The unemployment rate is holding steady at one of the lowest levels in Québec's history.

— However, Québec is facing numerous structural challenges:

- Lower productivity than that of its trading partners.
- Faster ageing of its population.
- A manufacturing sector facing stronger and stronger international competition.

— These challenges must be successfully met in order to continue improving the standard of living of Quebeckers, to ensure the sustainability of Québec's industrial base and to promote economic growth in all regions of the province. The measures that will be announced as part of the next budget should help to achieve these objectives in combination with the government's economic development strategy released last October.

Sustained economic growth

— In 2005, Québec's economy fully weathered the pressure caused by the increase in energy prices and the higher than forecasted increase in the value of the Canadian dollar.

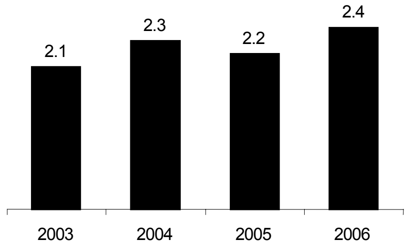
— Economic growth has thus come very close to what had been forecasted in Budget 2005-2006:

  – The Ministère des Finances had estimated an economic growth of 2.4% in 2005 and 2.6% in 2006.

  – Revised statistics show that the economic growth will stand at 2.2% in 2005 and at 2.4% in 2006.

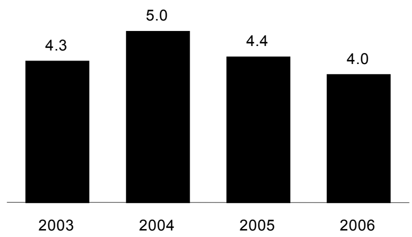
  – These forecasts are similar to the forecasts made in the private sector.

ECONOMIC GROWTH IN QUÉBEC
(annual variation of real GDP, in percentages)



Sources: Statistics Canada and Ministère des Finances du Québec.

QUÉBEC'S GROSS DOMESTIC PRODUCT
(annual variation of nominal GDP, in percentages)



Sources: Statistics Canada and Ministère des Finances du Québec.

— This ability of Québec's economy to hold its own in a difficult international context is largely due to the maintenance of a high level of consumer confidence; consumers increased their spending in 2005 more rapidly than had been forecasted.

— It has been estimated that the annual GDP growth, after reaching 5.0% in 2004, will gradually decrease to 4.4% in 2005 and to 4.0% in 2006.

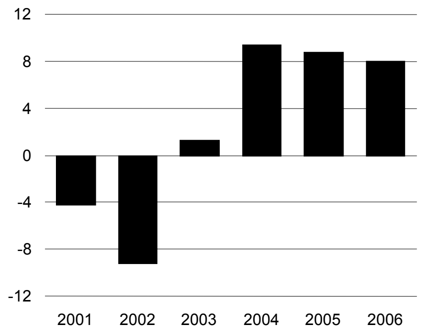
Recovery of exports well underway

— The recovery of exports that began in 2004 will continue, due in particular to a high demand from the United States for Québec investment goods, including machinery, office equipment and telecommunications equipment:

  – However, the strong increase in the value of the Canadian dollar will continue to encourage the purchase of foreign goods.

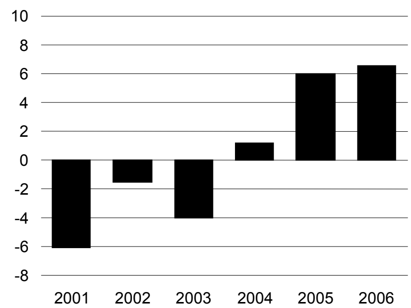
  – Therefore, it is not until 2006 that the external sector will continue to contribute to the economic growth, whereas growth in international exports will be maintained and growth in imports will slow down in keeping with the moderation of interior demand.

INVESTMENTS BY QUÉBEC ENTERPRISES IN THE U.S.
(annual variation in percentages)



Sources: Global Insight and Ministère des Finances du Québec.

INTERNATIONAL EXPORT OF QUÉBEC MERCHANDISE
(annual variation in percentages)

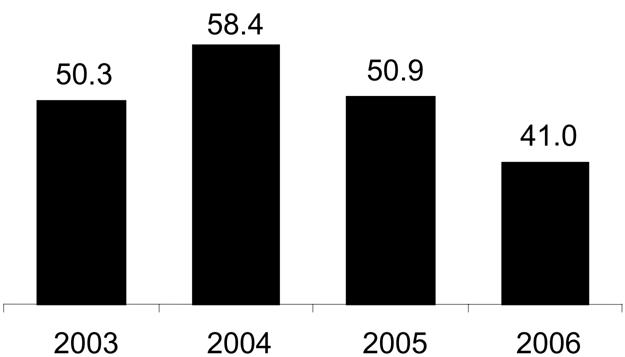


Sources: Institut de la statistique du Québec and Ministère des Finances du Québec.

Strong internal demand

- Households have not hesitated to reduce their savings in order to finance their purchasing. They have benefited in particular from:
  - The favourable impact of the tax reductions implemented by the Québec government over a three-year period ($2.2 billion including indexation).
  - The drop in the price of numerous imported goods such as automobiles, furniture, electronic products and clothing.
  - Favourable credit conditions due to low interest rates.
- However, household spending will slow down over the next few years. This will be seen particularly in a slowdown of housing starts:
  - In 2004, there were 58,500 housing unit starts, for the best performance in the past 17 years; in 2005, that number decreased to 51,600.

HOUSING STARTS IN QUÉBEC
(in thousands)



Sources: Canada Mortgage and Housing Corporation and Ministère des Finances du Québec.

— The number of housing starts should drop even more in 2006 due to a more moderate rate in household formation, higher interest rates and pricier homes:

  – Still, 41,000 housing units should be built in 2006; this level is well above the average 24,500 units built each year in the late 1990s.

— In addition, enterprises are continuing to increase their investments. This context is being fostered by:

  – Good profitability.

  – A high Canadian dollar, with two-thirds of machinery and equipment being imported.

  – Very high use of production capacities in several sectors such as mining, rubber and plastic, machinery, and computer and electronic products.

  – Furthermore, the implementation of a 5% capital tax credit for all new investments in machinery and equipment has helped to support investment in 2005.

— Thus, investments by enterprises should increase by nearly 6% in both 2005 and 2006.

Good performance of the labour market

- Lastly, after having created a net total of 60,800 new jobs in 2004, enterprises slowed down their hiring rates slightly in order to maintain growth in profits and to take advantage of previous investments. This led to the creation of 35,700 jobs in 2005. It is being estimated that close to 49,000 jobs will be created in 2006:
  - In this context, the unemployment rate will hold near the level of 8.5% reached in 2004, i.e. 8.2% in 2005 and 8.4% in 2006. These rates are among the lowest posted in the past 30 years.
  - In addition, the employment rate will remain near the peak of 60.3% reached in 2004.

QUÉBEC'S ECONOMIC OUTLOOK

	2004	2005	2006
Real GDP (%)	2.3	2.2	2.4
Nominal GDP (%)	5.0	4.4	4.0
Jobs created (in thousands)	60.8	35.7	48.9
Unemployment rate (%)	8.5	8.2	8.4
Barrel price of petroleum (US$)	41.5	56.5	62.8
Canadian dollar (¢ US)	76.8	82.5	84.6

Structural challenges for the Québec economy

— In many regards, Québec's economic performance is to be envied. However, a number of challenges putting the future prosperity of Quebeckers at risk must be met. These challenges can be summarized as follows:

  – Québec is lagging behind in productivity growth.

  – The Québec population is ageing.

  – It is necessary to maintain the competitiveness of Québec's manufacturing sector and to ensure that the province retains its place in international trade.

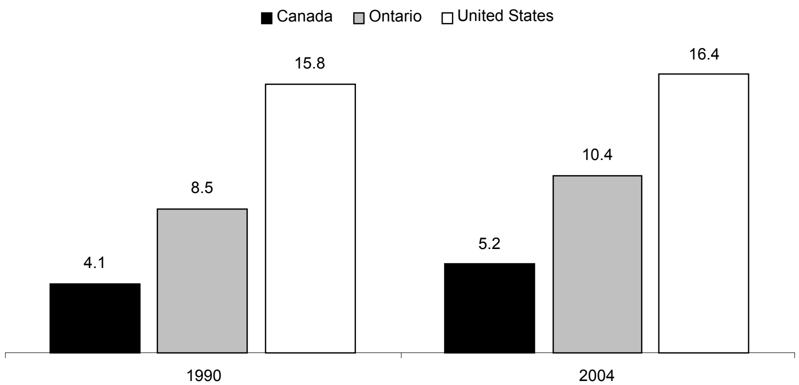
The productivity challenge

— Even though Québec's economy is well positioned on the international stage, it continues to be less productive than the economies of its neighbours and immediate competitors, namely Ontario, the rest of Canada and the United States:

  – This means that each hour worked in Québec produces less wealth than each hour worked elsewhere.

— Rather than diminishing, this productivity gap, which is measured in real GDP per hour worked, has widened over the past 15 years.

QUÉBEC'S PRODUCTIVITY GAP WITH ONTARIO, CANADA AND THE UNITED STATES
(gap in percentages, 1997 dollars and PPP in 2000)



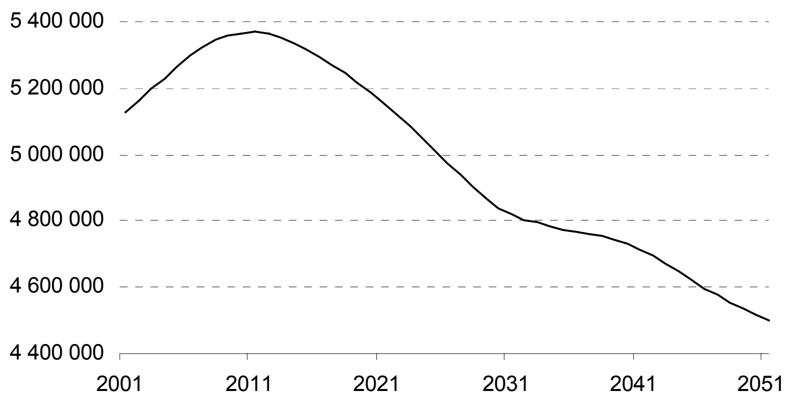
Sources: Statistics Canada, Bureau of Economic Analysis, Bureau of Labour Statistics, OECD.

- The slow growth in Québec's productivity is based primarily on two factors:
  - The Québec economy is investing a smaller portion of its resources in the machinery and equipment that will allow workers to be more productive:
    - This situation is prevailing despite the good investment growth in recent years.
  - Québec workers have, on average, less education and occupational training than do workers in Ontario and the United States. However, this observation does not hold for young Quebeckers, who are as well educated as other Canadians.
- It would also be beneficial to see an increase in the average size of Québec enterprises, which would allow them to innovate more easily through research and development or through the acquisition of new technologies.
- In this regard, the government's economic development strategy proposes several means for creating conditions favourable to productivity growth in the future, including:
  - The implementation of tax measures favourable to investment.
  - An increased support for research and development.
  - The provision of assistance for labour market education and training and support to improve the recruitment and integration of qualified immigrants into the labour market.

The demographic challenge

- The second challenge facing Québec's economy involves demographic issues.
- Québec's population is ageing faster than the populations of its main competitors:
  - Québec's birth rate is among the lowest in the world.
  - The working age population as a proportion of the total population has stabilized and will begin declining in a few years.
  - The migration balance does not help to compensate for these factors.
- Therefore, Québec's working age population could decrease by close to 1 million between 2011 and 2051.

WORKING AGE POPULATION (15-64)
(number of persons)



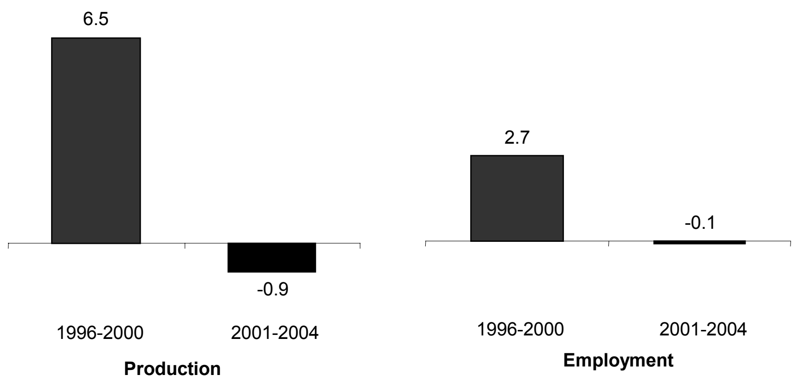
Source: Institut de la statistique du Québec.

- This demographic challenge could have several consequences for Québec's economy:
  - A slower increase in the standard of living due to a reduction of the working age population.
  - A weakened internal market.
  - Greater pressure on public finances due to increased health spending and the slower growth of government revenues.
- It is thus important to act now to remedy this situation.

The future of the manufacturing sector

- Overall, the second half of the 1990s was favourable to the growth of Québec's manufacturing sector:
  - The manufacturing sector's added value grew at an average annual rate of 6.5%, outstripping performance in the services sector.
  - Manufacturing productivity in Québec increased faster than in Ontario.
- Nevertheless, difficulties have begun accumulating for this sector since 2001:
  - Cyclical drop in demand from the United States.
  - Rapid increase in the value of the Canadian dollar.
  - Increasingly stronger competition from China and other emerging economies.
  - Trade disputes in some major sectors (e.g., softwood lumber).
  - The end of import quotas in the textiles and clothing sectors.
- Despite these difficulties, some industries have benefited from an increase in the international demand for Québec's raw materials and expertise, while others have been hit hard by international competition and higher production costs:
  - Thus, from 2001 to 2004, the added value in Québec's manufacturing sector decreased annually by an average of 0.9% while employment went down annually by 0.1%.
  - Some Québec enterprises located in regions where there is little economic diversification have closed, which has brought about important difficulties for the workers affected.

EVOLUTION OF THE MANUFACTURING SECTOR
(annual variation in percentages)



Source: Statistics Canada.

— The forestry industry is a good example of a driving industry for many resource regions in Québec, but it is facing important competition:

  – It accounts for 90,000 jobs directly related to forestry and wood manufacturing, or 12.5% of manufacturing jobs in Québec.

  – It has been hit hard by the softwood lumber trade dispute with the United States.

  – While diversified, this industry has difficulty making investments and maintaining a good profitability level.

— In a context that is becoming more and more competitive, the manufacturing sector must strive continually to improve its competitiveness. In this regard, the government's economic development strategy identifies objectives for guiding its actions, including:

  – Supporting the expansion of leading sectors for which Québec shows potential and competitive advantages.

  – Supporting the restructuring and reorientation of sectors in transition, in particular those related to forest products, towards more focused niches offering comparative advantages.

  – Promoting the development of sectoral business networks that can work to reinforce links between sub-contractors, suppliers and major contract givers.

Québec's Financial Situation

- Since the last election, the government has worked determinedly to resolve the structural problems facing Québec's public finances.
  - The government has imposed rigorous budgetary discipline on itself to maintain fiscal balance.
  - It has also stayed on course in the work to meet the priorities of Quebeckers, particularly in health and education.
  - The tax burden on taxpayers, especially families with children, has been eased.

Revenues and spending in 2005-2006

— For 2005-2006, the government is forecasting revenue of $55.7 billion, with $45.5 billion coming from own-source revenues and $9.8 billion coming from federal transfers.

QUÉBEC GOVERNMENT REVENUES
(in millions of dollars)

	2005-2006	% of revenues
Own-source revenues		
Individual income tax	16 766	30.1
Sales tax (QST)	9 745	17.5
Fonds des services de santé	5 081	9.1
Corporate income tax	4 427	7.9
Fuel taxes	1 705	3.1
Hydro-Québec	2 125	3.8
Loto-Québec	1 536	2.8
Société des alcools du Québec	667	1.2
Other own-source revenues	3 469	6.2
Total own-source revenues	**45 521**	**81.7**
Federal transfers		
Equalization	4 798	8.6
Health transfers	3 114	5.6
Others	1 899	3.4
Total federal transfers	**9 811**	**17.6**
Net results of consolidated organizations	380	0.7
Total	**55 712**	**100.0**

— Total budgetary revenues are accounted for in the Consolidated Revenue Fund and will serve to finance the government's spending of $55.7 billion in 2005-2006.

QUÉBEC GOVERNMENT SPENDING
(in millions of dollars)

	2005-2006	% of program spending	% of total spending
Program spending			
Health and social services	20 862	42.8	—
Education, recreation and sport	12 202	25.0	—
Employment, social solidarity and families	5 646	11.6	—
Other program spending	10 055	20.6	—
Total program spending	**48 765**	**100.0**	**87.5**
Debt service	**6 947**	**—**	**12.5**
Total spending	**55 712**	**—**	**100.0**

Rigorous budgetary discipline in the past 3 years

— In keeping with the government's objectives, fiscal balance has been maintained since 2003.

  – The deficits posted in 2003-2004 and 2004-2005 are due to exceptional items, namely losses incurred by the SGF in 2003-2004 and inclusion of an accounting provision for estimated pay equity costs in 2004-2005 to cover the period of 2001 to 2005.

FINANCIAL PLAN OF THE QUÉBEC GOVERNMENT
(in millions of dollars)

	2003-2004	2004-2005	2005-2006
Budgetary transactions			
Revenues	51 611	53 610	55 332
Spending	-51 957	-53 836	-55 712
Net results of consolidated organizations	346	235	380
Consolidated budgetary balance before exceptional items	**0**	**9**	**0**
SGF exceptional losses	-358	—	—
Provision for pay equity	—	-673	—
Consolidated budgetary balance	**-358**	**-664**	**0**

— Furthermore, the government is complying with the requirements of the *Balanced Budget Act*, which stipulates that if the government achieves a surplus in a fiscal year following the adoption of this law in 1996-1997, it may incur deficits up to the amount of that surplus.

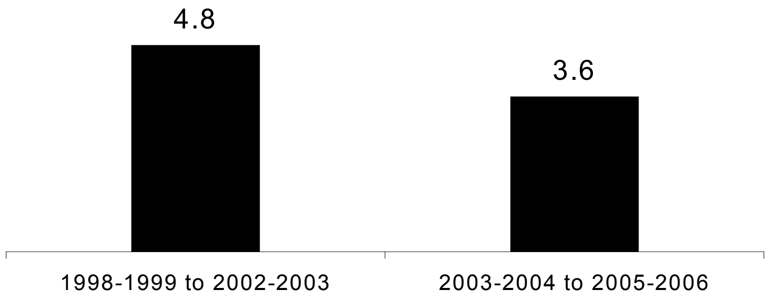
  – As of March 31, 2005, budgetary surpluses stood at $155 million.

— Fiscal balance is achieved primarily through tight control of spending.

Tight control of spending

— Since 2003, the average annual growth of program spending has been limited to 3.6%, in keeping with the government's capacity to pay for that spending.

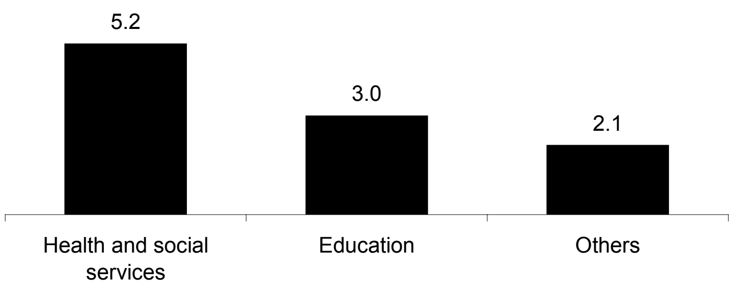
GROWTH OF PROGRAM SPENDING
(Average annual growth rate, in percentages)



— This control of spending has not prevented the government from following up on its commitment to give priority to health and education.

- From 2003-2004 to 2005-2006, health spending increased by an average of 5.2% per year and education spending increased by an average of 3.0% per year.

GROWTH IN PROGRAM SPENDING FROM 2003-2004 TO 2005-2006 – HEALTH AND SOCIAL SERVICES, EDUCATION, OTHERS
(Average annual growth rate, in percentages)



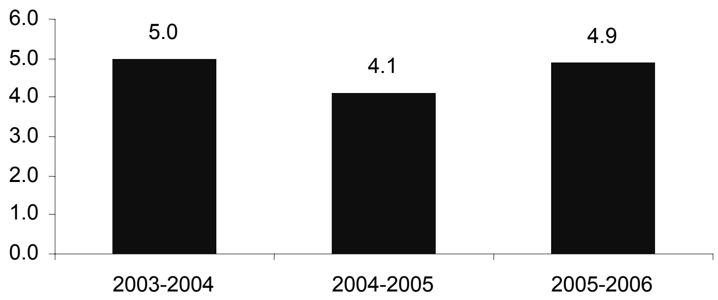
Fiscal balance maintained in 2005-2006 and improved accountability

- The objective of a zero deficit for fiscal year 2005-2006 is being maintained:
  - Continued good economic performance has led to higher than anticipated revenues.
  - This upward revision of revenues has allowed the government to counter certain pressures on spending, in particular with regard to pension plans (increase of $200 million) and the bad debt provision for the Ministère du Revenu (increase of $258 million).
- The government has announced that it will be releasing monthly financial reports beginning in 2006-2007 to increase transparency and to improve accountability.
  - Québec will thus be leading the way with regard to financial transparency in becoming the first Canadian province to make its financial situation public on a monthly basis.

Investments in infrastructures

— The government has made modernizing Québec's infrastructures a priority. Its contribution to investments in public infrastructures has almost doubled in five years, with $4.9 billion earmarked for 2005-2006.

GOVERNMENT CONTRIBUTION TO INVESTMENTS IN PUBLIC INFRASTRUCTURE
(in billions of dollars)



— The government has announced new investments in health and education over the next three years.

- The new health investments announced by the government come to $1.6 billion. This amount will serve in particular to improve long-term health care, emergency, radiation oncology and cardiology services.
- The announced investments for education come to $900 million the construction of new schools and the purchase of new equipment and materials.

— The level of investments allocated for highway infrastructure will increase gradually over the next several years and reach $1.4 billion in 2007-2008, nearly double the amount that was allocated annually between 1994 and 2002.

— The government has announced that it will be increasing its contribution to municipal infrastructures through the Société de financement des infrastructures locales du Québec (SOFIL).

- It is being anticipated that the funding allocated by the two levels of government will reach a level allowing the municipalities to make additional investments of nearly $1 billion in their infrastructure.

Québec's debt: Evolution and issues

— The Forum des générations, an initiative of the Premier held in the fall of 2004, underlined the demographic challenge that Québec will be facing within the next several years. Indeed, the declining population puts the focus directly on Québec's public debt.

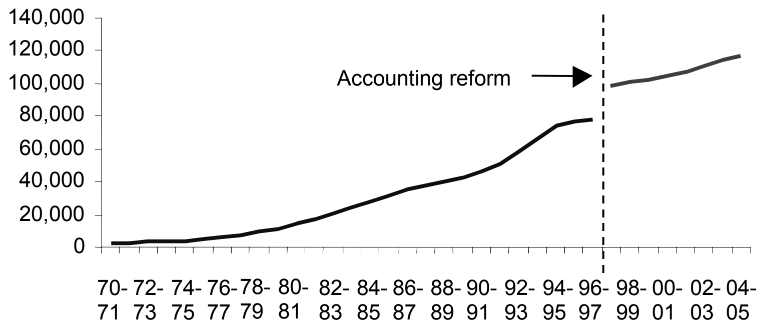
— In its previous budget, the government indicated its concern with the size of the public debt by announcing its desire to bring it to less than 40% of the GDP by the end of this decade.

— The efforts made by the government to meet the requirements of the *Balanced Budget Act* and to maintain a zero deficit have unquestionably served as a first step towards putting Québec's public finances in order. A second step, now within sight, involves tackling the problem of Québec's debt load.

A heavy debt load

- As of March 31, 2005, the total debt of the Québec government stood at $116.6 billion.
  - There was practically no debt in the early 1970s.

TOTAL DEBT OF THE QUEBEC GOVERNMENT
(in billions of dollars)

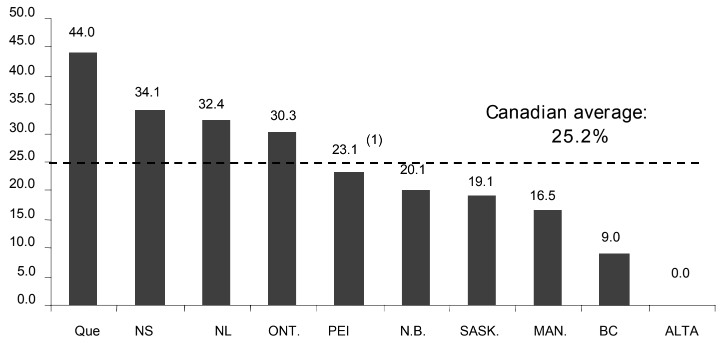


- The costs of financing this debt come to $7.6 billion[1] for 2005-2006, or 13.7 cents for each revenue dollar.
  - It is the government's third highest spending item after health and education.

- Following the achievement of a zero deficit, the debt load on Québec's economy has decreased. It stood at 52.2% of the GDP on March 31, 1998 and at 44.0% at March 31, 2005. However, this improvement remains insufficient.
  - This debt load is today among the highest in all Canadian provinces.
  - The burden of Québec's debt is nearly double the Canadian average, which is 25.2%.

[1] Financing costs include $6,947 million for servicing the government's debt, as indicated in the table on government spending in the previous section, and $679 million for servicing the debt of consolidated organizations.

COMPARISON OF PROVINCIAL DEBT LOADS
AS AT MARCH 31 2005
(as a percentage of the GDP)

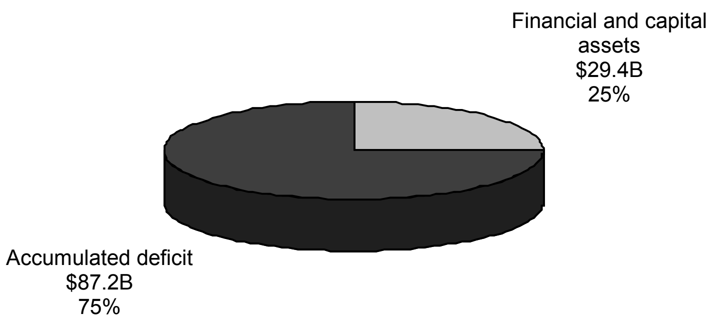


Sources: Most recent budgetary and public finance plans of the provinces.
(1) As at March 31, 2004.

A debt that serves primarily to pay for current spending

— Three-quarters of the debt, or \$87.2 billion, has accumulated from the deficits that Québec recorded year after year from the early 1970s to 1997-1998 to pay for current spending.

TOTAL DEBT LOAD AS AT MARCH 31, 2005: \$116.6B
(in billions of dollars)

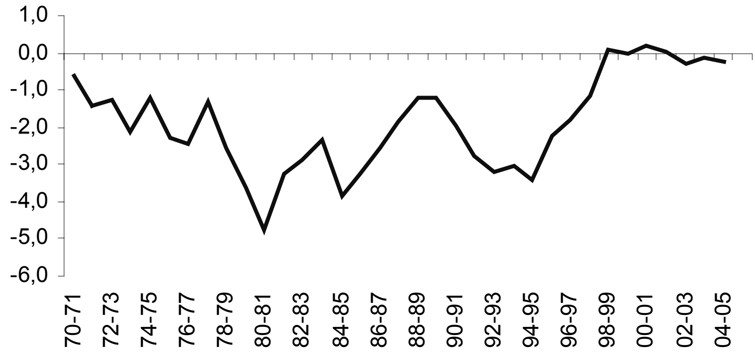


— In difficult economic times, it is normal for a government to incur budgetary deficits, which help to mitigate the harmful effects of an economic slowdown.

— On the other hand, budgetary deficits posted during times of slow economic growth should be offset by budgetary surpluses that occur in times of economic growth.

  – This has not happened in Québec even though the economy has grown steadily since the early 1990s.

EVOLUTION OF THE BUDGETARY BALANCE
(as a percentage of the GDP)



- Furthermore, the portion of the debt that has served to fund financial or capital assets comes to $29.4 billion, or one-quarter of the total debt load.
  - This portion of the debt does not create intergenerational inequity because future generations will benefit from the financial and capital assets that are funded by the debt.
  - The debt increases by about $1.5 billion each year because the government borrows to finance its assets. This cost is charged as an expenditure and is depreciated over the useful life of these assets.
  - Québec must also borrow approximately $1 billion each year because it includes all Hydro-Québec profits (close to $2 billion per year) as revenues for accounting purposes, even though it annually receives a dividend corresponding to only about half of these profits.
  - In addition, the government borrows to provide capital funding for its crown corporations, in particular the SGF and the Innovatech companies.
    - Two years ago, the government revised the mandate of the crown corporations that were investing in risk capital (SGF and Innovatech companies) by having this capital funding replaced by self-funding.

Why reduce the debt load?

- It is acceptable for the government to incur debt for purposes of financing capital or financial assets. However, the debt that has served in the past to pay for current spending must be repaid.

- Repaying deficits that have accumulated in the past to pay for current spending makes it possible to:
  - Improve intergenerational equity.
  - Provide the government with room for manoeuvre in its budget in order to prevent the risk of deterioration in its financial situation following an economic slowdown or an interest rate hike.
  - Withstand ever-increasing pressures that demographic changes are exerting on public finances.

- The current low interest rates offer an excellent opportunity for reducing the debt load.
  - If interest rates increase to levels similar to what we saw in the 1990s, the debt service will increase annually by $1.1 billion.
  - If interest rates increase to levels similar to what we saw in the 1980s, the debt service will increase annually by $2.3 billion.

How are other governments in Canada reducing their debt loads?

— Several governments in Canada have taken measures to reduce their debt loads.

Federal government

— The federal government includes a contingency fund of $3 billion per year in its financial planning to protect itself from economic changes.

  – At the end of each fiscal year, the unused amounts in this fund are allocated towards paying back the public debt.

— Bill C-67, which was tabled in October 2005, stipulates that amounts in any budget surplus exceeding the $3 billion contingency fund are to be allocated as follows:

  – One-third for priority spending.

  – One-third to provide one-time tax credits to all taxpayers.

  – One-third for reducing the debt.

Nova Scotia

— In June 2003, the Nova Scotia government announced a plan for reducing its net debt:

  – Creation of a specific fund for eliminating the debt.

  – Enactment of a law for allocating exceptional revenues coming from the sale of assets to debt reduction.

— In 2005, the Nova Scotia government adopted a new debt reduction plan following its agreement with the federal government for special treatment in calculating equalization of the province's off-shore oil revenues:

  – According to this new legislation, amounts calculated under the agreement may be used for the sole purpose of repaying the government's debt load.

Alberta

— In 1995, the Alberta government adopted its *Balanced Budget and Debt Retirement Act*. This law, which came into effect in 1996-1997, required the government to balance its budget every year and to establish a plan for repaying the entire debt (excluding pension plan liabilities) no later than 2021-2022. The objective to repay the debt was achieved in 2000-2001.

Manitoba

— Since 1997-1998, the Manitoba government has, under its debt repayment plan, been transferring to its Debt Retirement Fund annual amounts devoted entirely to debt repayment ($75 million between 1997-1998 and 1999-2000, $96 million between 2001-2002 and 2004-2005, and $10 million in subsequent years).

Questions for discussion

— Should the government implement measures for reducing the debt load?

— There are various options that the government can consider for reducing the debt load.

Should the government:

- Create a contingency reserve with the unused balance going towards paying back the debt?
- Pass a law requiring a plan for paying back the debt?
- Create a debt repayment fund to which specific forms of revenue would be allocated?

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