The Economy and Public Finances of Québec

Assessment and Policy Directions

October 1999

Québec

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Introduction

Since it was first elected, the current government committed itself to restoring order to Québec's public finances and to creating a climate conducive to economic growth and job creation.

Remarkable progress has been made to date:

- the economy is growing;
- the unemployment rate has dropped from 13.2% in 1993 to below 10%;
- the government has eliminated its budget deficit a year earlier than expected.

In spite of this progress, major challenges remain in terms of both the economy and public finances:

- too many people are still out of work in Québec;
- the public debt is very large;
- the tax burden is much too heavy and hampers economic development.

Accordingly, existing efforts must be continued. In this regard, the government has adopted ambitious objectives to improve Québec's fiscal and economic competitiveness.

The March 1999 Budget Speech included the announcement of a personal income tax reduction of $1.3 billion by 2002-2003, bringing the total reduction since January 1998 to 15%.

Despite this sizeable reduction, large tax burden differentials will remain between Québec and the other provinces as well as the United States. Consequently, taxes will have to be reduced further over the coming years, while ensuring adequate funding for public services.

Québec now finds itself at a turning point. Crucial choices must be made to secure lasting economic and social development as we move into the next millennium.

Given this context, this paper:

- reviews the progress made in terms of the economy and public finances and describes the challenges ahead;
- gives a brief description of the budgetary outlook for fiscal year 1999-2000;
- sets out the fiscal and budgetary policy directions for the coming years.

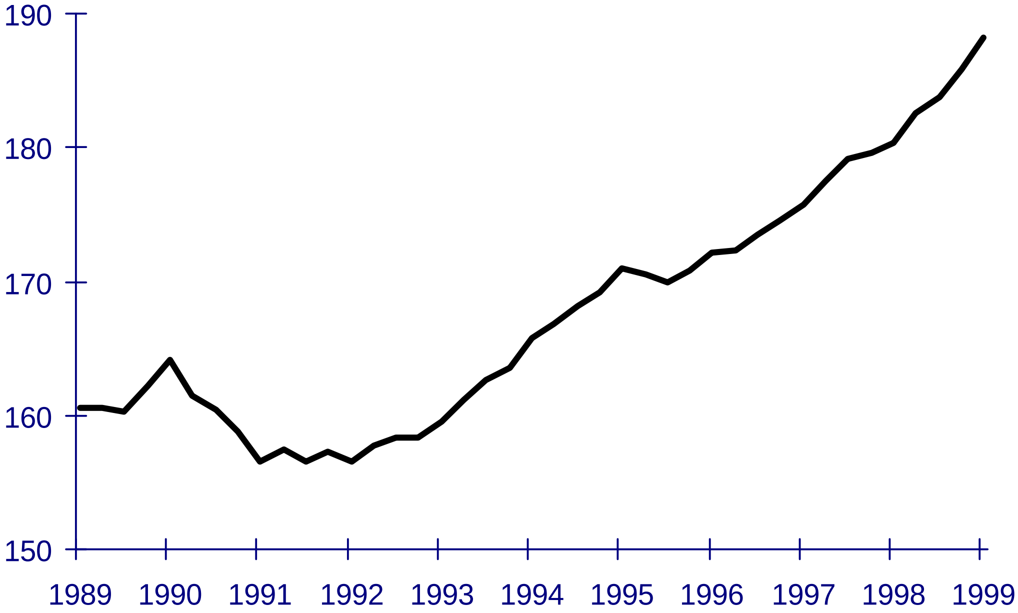
1 Progress made

EIGHT YEARS OF ECONOMIC GROWTH

- Significant progress has been made at the economic level in recent years:
  - Québec's economy has been growing for eight years;
  - while growth was slow between 1989 and 1994, real gross domestic product (GDP) rose by 9.3% between 1994 and 1998.
- In 1999, economic growth continues at a vigorous rate:
  - real gross domestic product is up 3.7% in the first half of 1999 compared to the same period in 1998.

Québec's gross domestic product

(in billions of 1992 dollars)



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

SIGNIFICANT DROP IN THE UNEMPLOYMENT RATE

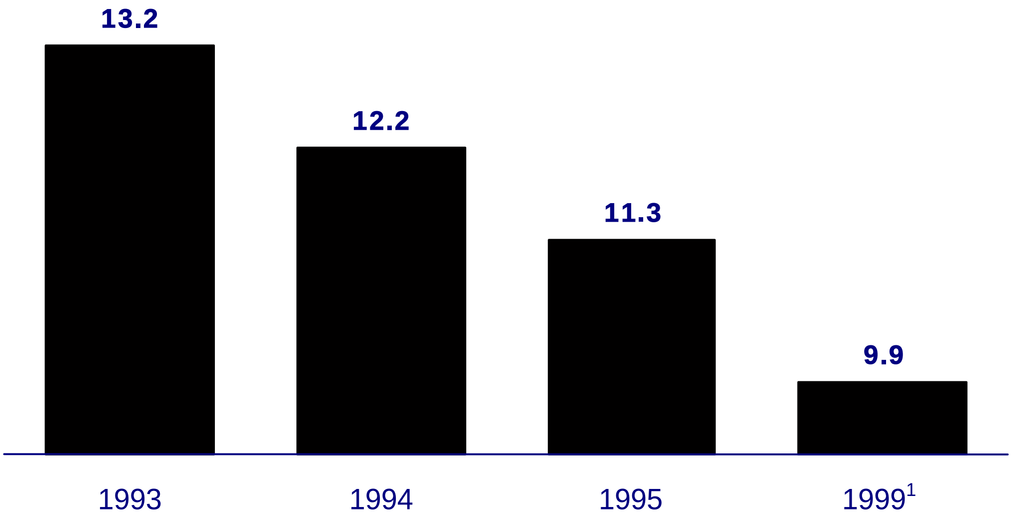
- The improving economic situation in recent years has had an impact on the labour market and job creation.

- Québec has made significant progress in this regard:
  - the unemployment rate, which stood at 13.2% in 1993, averaged 9.9% during the first eight months of 1999;
  - this is a drop of more than three percentage points.

- While the unemployment rate is still too high, the improvement in the economy has had positive effects on Quebecers as a whole, offering better job prospects and by the same token reducing the number of persons affected by the scourge of unemployment.

Québec's unemployment rate

(as a percentage)



1 Average from January to August.

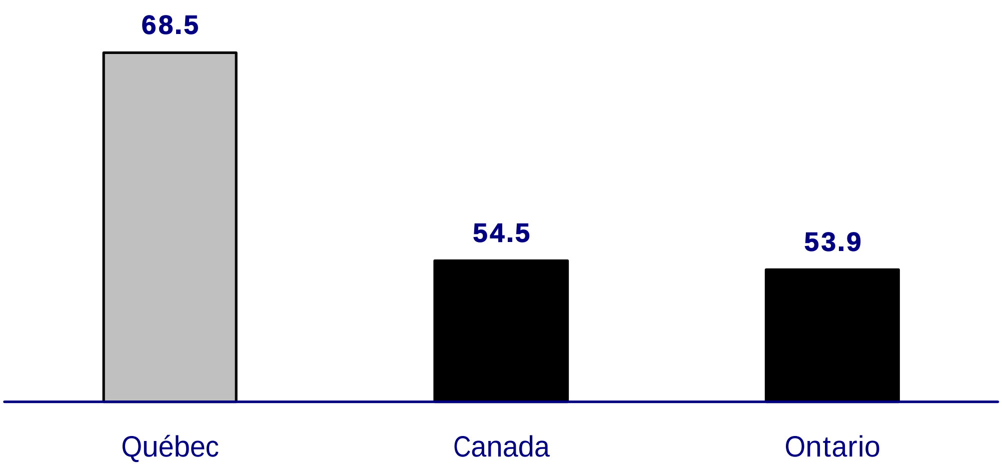
Source: Statistics Canada.

NON-RESIDENTIAL INVESTMENT: STRONG GROWTH IN QUÉBEC

- According to Statistics Canada's survey of investment intentions, private sector non-residential investment should grow by 11.7% in 1999:
  - this result is well ahead of the expected performance in Canada (7.7%) and Ontario (6.8%).
- Québec has made major progress in this regard in recent years. While private sector non-residential investment totalled $11.2 billion in 1994, it now amounts to $18.8 billion.
- This is an increase of 68.5% in Québec since 1994, more than in Canada (54.5%) and Ontario (53.9%).

Growth in private non-residential investment since 1994

(as a percentage)



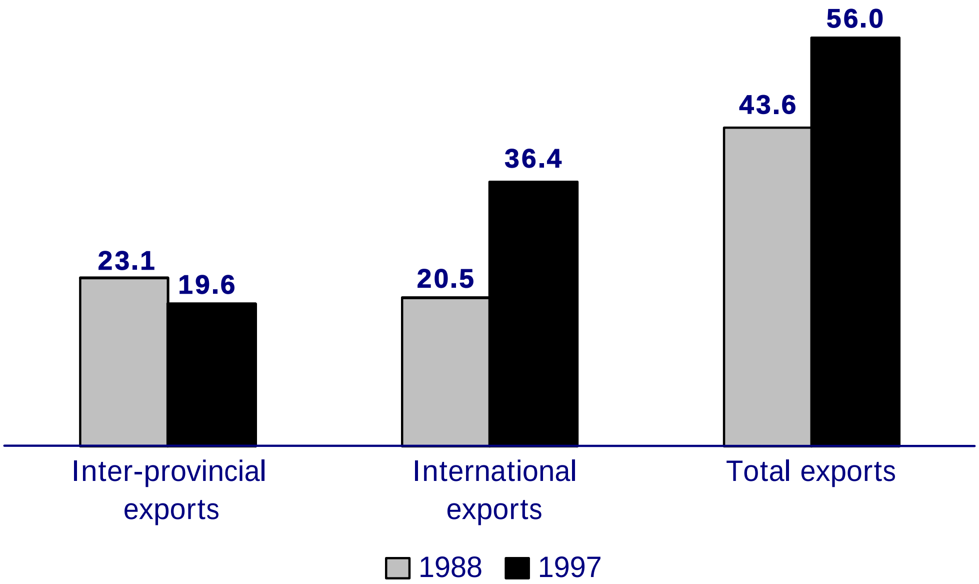
Source: Statistics Canada.

FREE TRADE HAS FAVOURED NORTH/SOUTH TRADE

- In 1997, Québec's total exports accounted for 56% of gross domestic product compared with 43.6% in 1988, just before free trade with the United States came into force.
- This increase is attributable exclusively to trade with countries other than Canada:
  - almost two-thirds of Québec's exports are now shipped outside Canada, compared with less than 50% in 1988;
  - the United States is now our major trading partner, ahead of the rest of Canada: more than 80% of all our exports of merchandise outside Canada are shipped there.

Québec's international and interprovincial exports

(as a percentage of GDP)



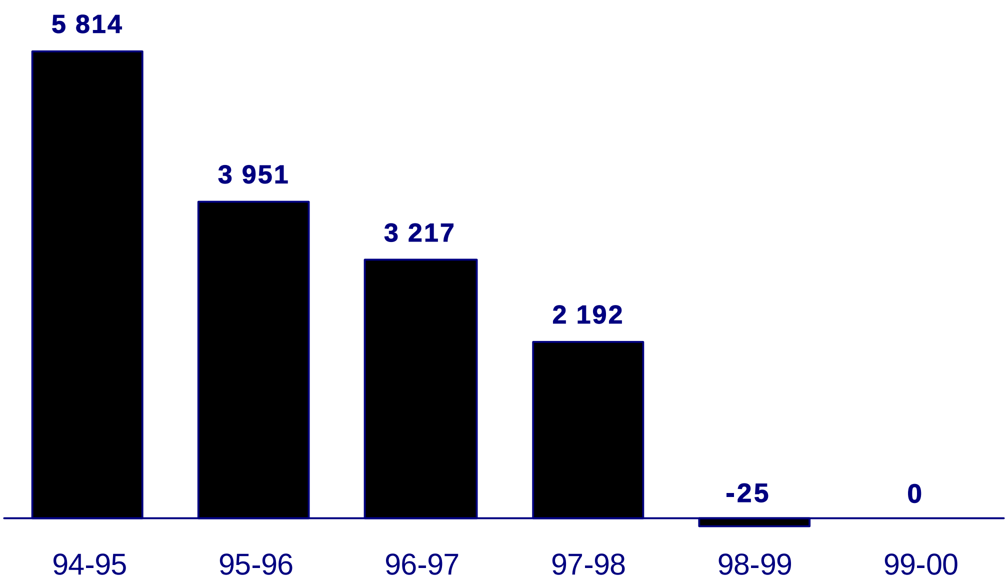
Source: Statistics Canada.

A BALANCED BUDGET ONE YEAR EARLIER THAN EXPECTED

- Turning to public finances, the substantial efforts made to eliminate the deficit have produced results.
- The budget deficit was eliminated in 1998-1999, a year earlier than expected, whereas it stood at $5.8 billion in 1994-1995.
- The progress achieved even made it possible to invest substantial additional amounts in the health and education sectors in 1998-1999.

The Québec government's deficit

(in millions of dollars)



Source: Ministère des Finances du Québec.

2 Challenges ahead

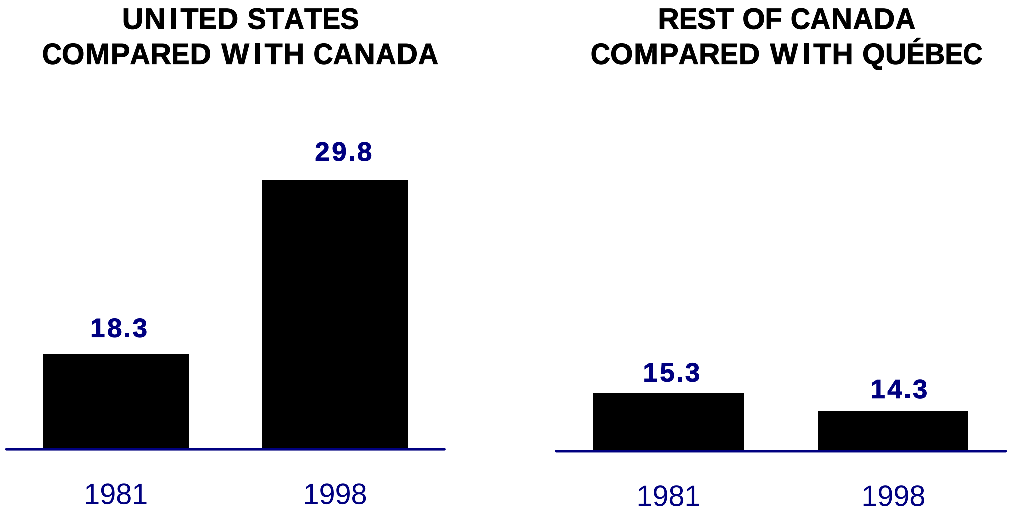
2.1 The economy

PER CAPITA REAL GDP BELOW THAT OF OUR PARTNERS

- Despite the progress made in recent years, in terms of both the economy and public finances, major challenges remain.
- Turning to the economy first, on the basis of per capita gross domestic product, Canadians and Quebecers are less wealthy than Americans. In fact:
  - Americans are 30% wealthier than Canadians;
  - while the rest of Canada is about 14% wealthier than Québec.
- Compared with Ontario, Québec's difference was 23% in 1998.
- In dollar terms, this means that in 1998:
  - Canada's gross domestic product excluding Québec amounted to about $28 500 per capita (constant 1992 dollars);
  - compared with less than $25 000 in Québec;
  - and about $36 000 in the United States (Canadian dollars).

Extra per capita GDP

(as a percentage)



Sources: Data Resources Inc., Statistics Canada, Institut de la statistique du Québec and ministère des Finances du Québec.

A HIGHER UNEMPLOYMENT RATE THAN THAT OF OUR PARTNERS

➨ The unemployment rate has fallen in recent years. However, it remains decidedly higher than in Canada and Ontario:

- 25% above the Canadian average;
- 48% higher than in Ontario.

➨ These differences are not new. They have been noted ever since unemployment data have been collected, i.e. since the late 1940s. While there has been little change compared with Canada, progress has been made compared with Ontario. During the 1940s and 1950s, the unemployment rate exceeded:

- the Canadian average by 26%;
- and was about 70% higher than the unemployment rate in Ontario.

➨ Accordingly, some progress has been made, but much work remains to be done.

Unemployment rate: Québec, Ontario and Canada

	1946-59	1960-79	1980-98	1999[1]
Average rate in %:				
Québec	4.8	7.4	11.5	9.9
Ontario	2.8	4.7	8.1	6.6
Canada	3.8	5.9	9.6	7.9
Ratio in %:				
Québec/Ontario	169	162	145	148
Québec/Canada	126	127	121	125

1 Average January to August

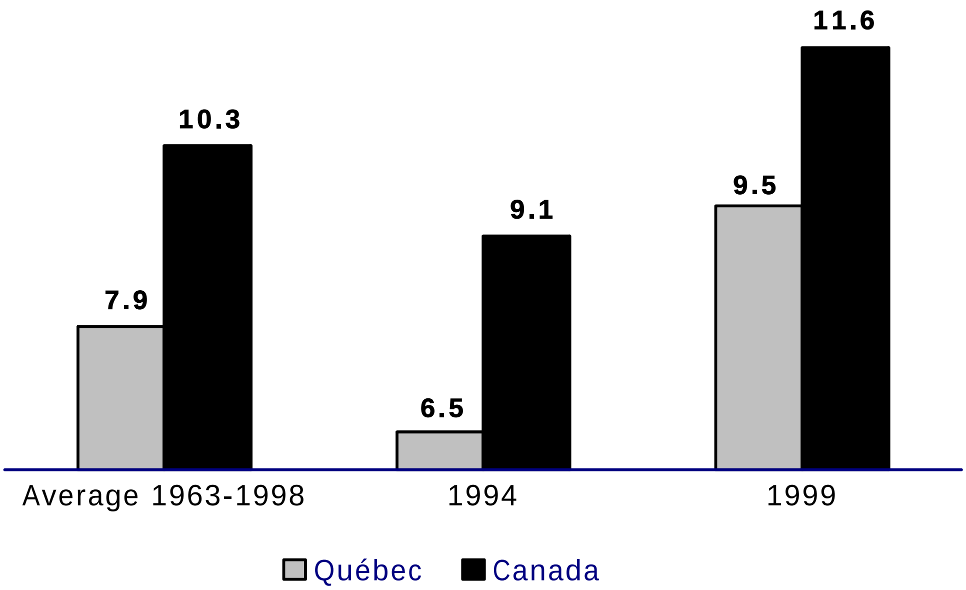
Source: Statistics Canada.

IN SPITE OF PROGRESS MADE, THERE IS STILL AN INVESTMENT GAP

- In recent years, Québec has made significant progress in terms of investment.
- Despite this improvement, Québec still suffers from under-investment.
- In 1999 private non-residential investment as a percentage of GDP amounts to 9.5% in Québec and 11.6% in Canada:
  - this is a difference of 2.1 percentage points of GDP;
  - this is less than the 2.6 percentage points in 1994;
  - it is even slightly below the average difference noted over many years (2.4 percentage points from 1963 to 1998).

Private non-residential investment

(as a percentage of GDP)



Sources: Statistics Canada, Institut de la statistique du Québec and ministère des Finances du Québec.

2.2 Public finances

QUÉBEC INVESTS A GREAT DEAL IN PUBLIC SERVICES

➡ Turning to public finances, although the deficit has been eliminated, major challenges remain.

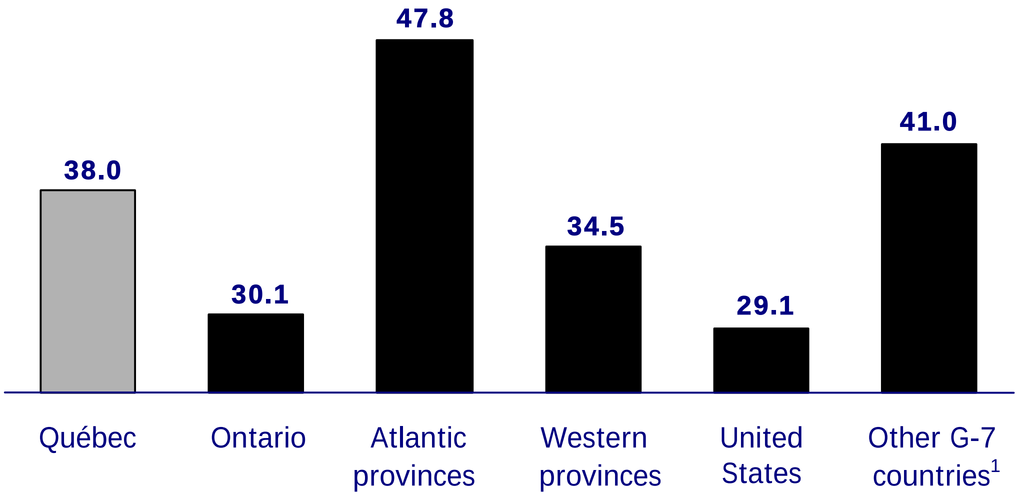
➡ In spite of lower per capita wealth, the level of services offered in Québec is comparable if not higher than elsewhere:

- public spending by all levels of government in Québec totals close to $10 000 per capita, more than in Ontario and than the average for Canada;
- the proportion of GDP allocated to public services is significantly higher in Québec (38.0%) than among our main trading partners;
- in the Atlantic provinces, program spending accounts for a high proportion of GDP (47.8%) because per capita GDP is lower, while federal government expenditures and federal transfers are high.

➡ To fund this level of spending without incurring deficits, Québec must tax heavily.

Program spending by all public administrations (1998-1999)

(as a percentage of GDP)



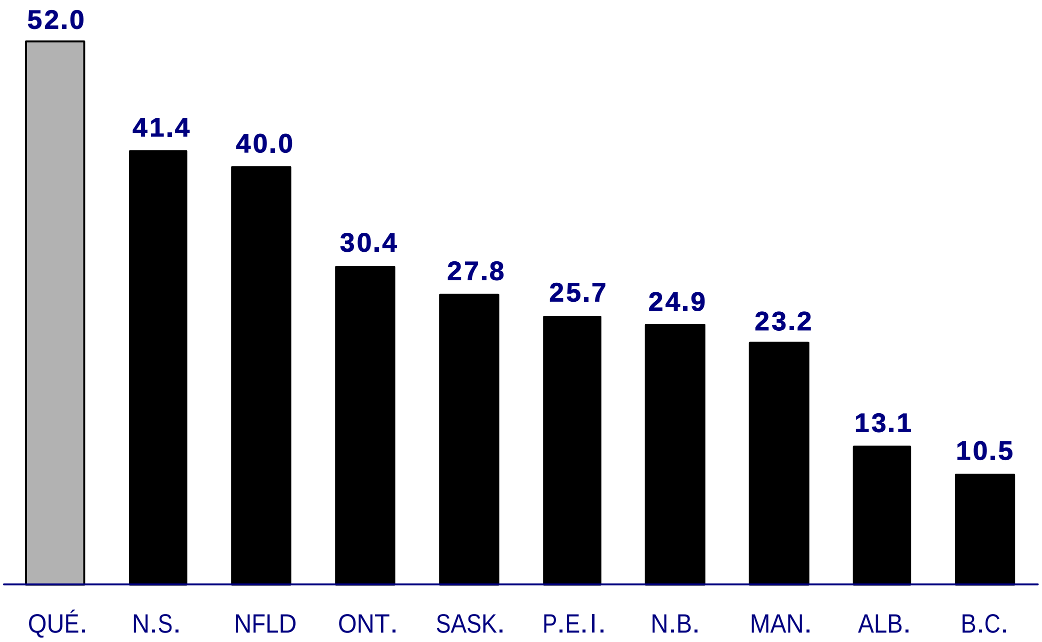
1 Germany, France, Italy, Japan and United Kingdom.
Sources: OECD, Statistics Canada and ministère des Finances du Québec.

QUÉBEC HAS A HIGH DEBT RATIO

- It is important to note that in the past, a large part of public services was funded through the use of debt.
- Consequently, even though the deficit has been eliminated recently, Québec's debt ratio is the highest in Canada.
- The total debt of the Québec government amounts to:
  - $98 billion, or 52% of GDP;
  - $13 300 per capita.
- In only thirty years, the debt as a proportion of GDP has risen by a factor of five (from 10.8% in 1970 to 52% in 1998).

Gross debt of Canadian provinces as at March 31, 1998

(as a percentage of GDP)



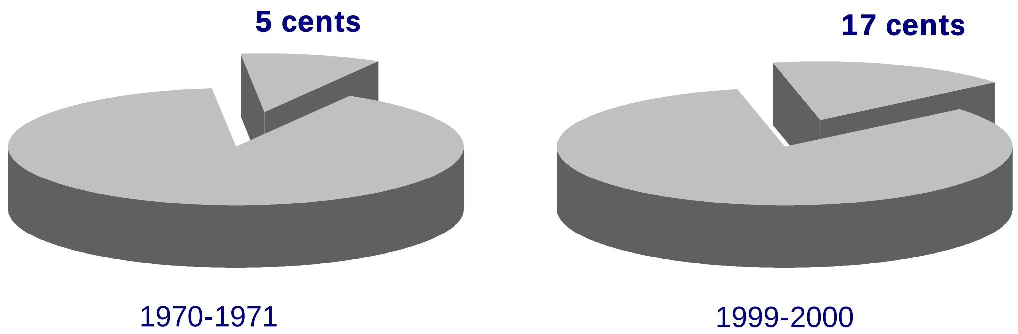
Source: Ministère des Finances du Québec.

FEWER SERVICES FOR EACH TAX DOLLAR

- The substantial increase in debt over the last thirty years means that the Québec government must allocate an ever increasing proportion of its revenue to interest payment on the total debt:
  - this share has grown from 5 cents per dollar of revenue in 1970-1971 to 17 cents in 1999-2000.
- While the tax burden is greater than in 1970, taxpayers receive fewer services for each tax dollar paid to the government.

Québec government revenue allocated to interest on the total debt

(in cents per dollar)



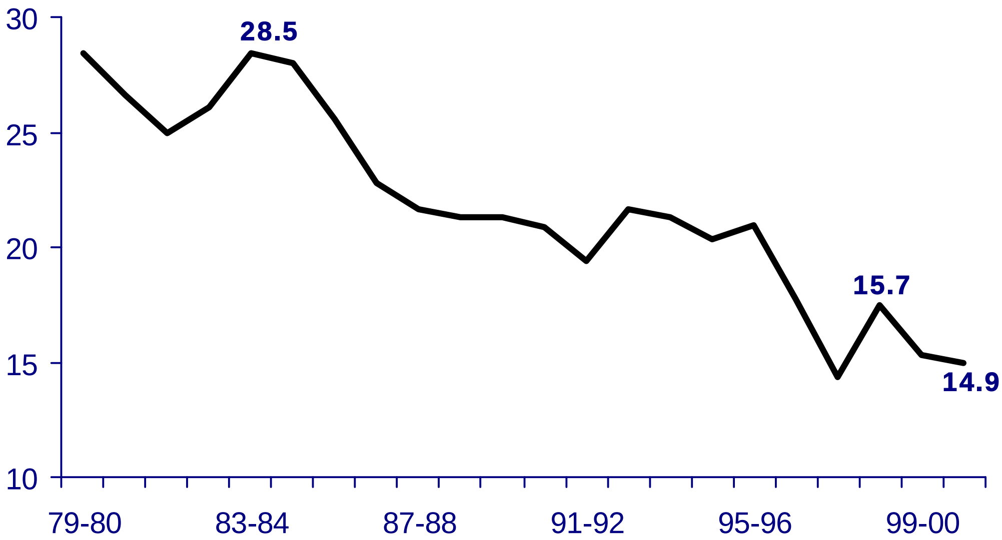
Source: Ministère des Finances du Québec.

THE FEDERAL GOVERNMENT CONTRIBUTES LESS AND LESS TO THE FINANCING OF PUBLIC SERVICES

- On the revenue side, the decrease in cash transfers paid by the federal government imposes a major financial constraint on the Québec government:
  - in 1983-1984, federal cash transfers accounted for 28.5% of the Québec government's revenue;
  - in 2000-2001, this proportion will only be 14.9%.
- The federal government contributes less and less to the financing of public services, in particular for health, education and income security.

Federal transfers paid to the Québec government

(as a percentage of budgetary revenue)



Source: Ministère des Finances du Québec.

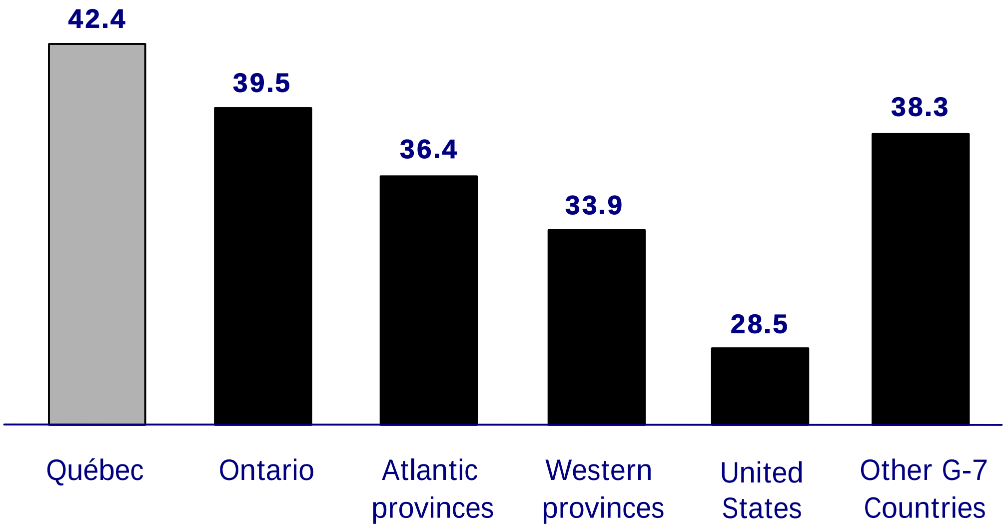
CONSEQUENCE: THE HEAVIEST TAX BURDEN IN NORTH AMERICA

- The direct consequence of lower per capita wealth, a high level of public services, a high debt ratio and declining federal transfers is a heavier tax burden.

- When all tax revenues collected by all levels of government are taken into account, Québec has the heaviest tax burden in North America:
  - taxation as a proportion of GDP is higher than anywhere else;
  - since 1980, in particular, taxes have absorbed almost two-thirds of the increase in per capita wealth;
  - this situation hampers economic growth, either because economic activity moves elsewhere, investment declines, there is less incentive to work or a greater inducement to tax evasion. The capacity to adequately fund public services is also affected.

Tax revenues of all public administrations (1996)

(as a percentage of GDP)



Sources: OECD and ministère des Finances du Québec.

THE TAX BURDEN DIFFERENTIAL IS PARTICULARLY LARGE FOR PERSONAL INCOME TAX

➡ The tax burden differential is particularly large for personal income tax:

- the average differential with the other provinces is $3.1 billion, and is $5.8 billion with Ontario.

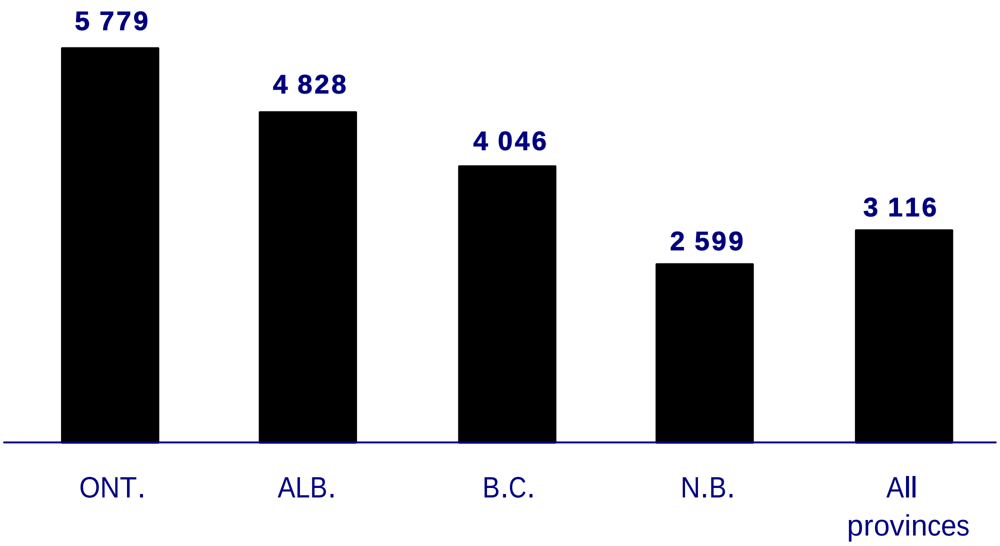
➡ The government's commitment to reduce personal income tax by $1.3 billion by 2002-2003 will only partially offset the existing differential with the rest of Canada since taxes will also be lowered in many other provinces.

➡ For instance, including the additional 20% reduction announced in Ontario, the difference with that province will remain essentially the same, in spite of the reduction of $1.3 billion in Québec:

- in fact, it will decline from $5.8 billion to $5.7 billion.

Extra personal income tax burden in Québec (1999)

(in millions of dollars)



Source: Ministère des Finances du Québec.

THE LEVEL OF CONSUMPTION TAXES IS COMPARABLE TO THE CANADIAN AVERAGE

- All other revenue sources are fully utilized.
- The level of Québec's consumption taxes is comparable to the Canadian average:
  - the rate of the Québec sales tax (QST) is of the same order as in the other provinces;
  - the rate of the specific tax on gasoline is higher;
  - the rate of the tobacco tax is lower than the average in the rest of Canada, but a large increase is not desirable because of smuggling problems.

Consumption tax rates (1999)

	Québec	Other provinces
Sales tax (as a percentage)	8.0[1]	7.0
Specific tax on regular gas (cents per liter)	15.2	12.8
Specific tax on cigarettes (cents per cigarette)	4.0	7.0

1 Effective rate of the QST of 7.5% applied to the federal GST of 7%.
Source: Ministère des Finances du Québec.

CORPORATE TAXATION: COMPETITIVE ON THE WHOLE, THOUGH PAYROLL TAXES ARE HIGH

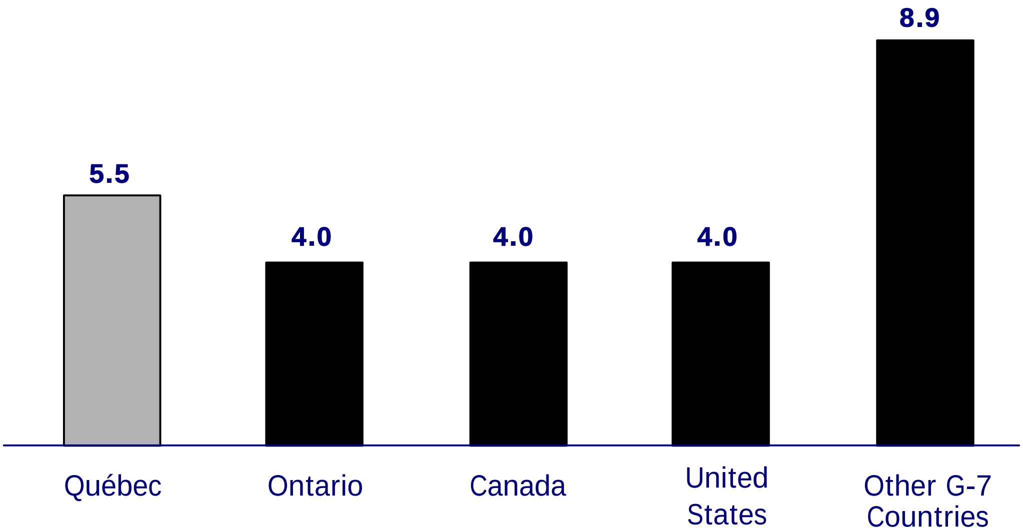
➡ Payroll taxes in Québec are high in a North American context:

- as a percentage of GDP, payroll taxes paid by employers are higher in Québec than in Canada and the United States;
- however, they are lower than in the other G-7 countries.

➡ It is important to maintain a tax system that is competitive with the United States and the rest of Canada, since they are Québec's main trading partners.

Payroll taxes (1996)

(as a percentage of GDP)



Sources: OECD and ministère des Finances du Québec.

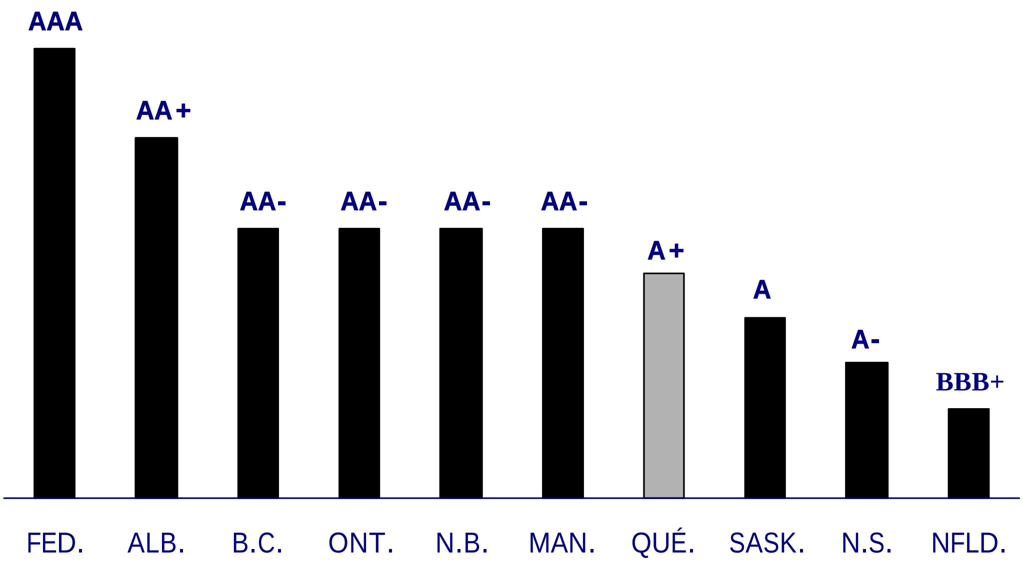
IN SPITE OF AN IMPROVED OUTLOOK, ONE OF THE LOWEST CREDIT RATINGS IN CANADA

- Lastly, even though the budget was balanced in 1998-1999, Québec remains vulnerable to shocks on financial markets.

- In spite of eight consecutive years of economic growth, Québec's credit rating has not improved and remains one of the lowest in Canada, mainly because:
  - of its debt load resulting from the accumulation of past deficits;
  - the onerous tax burden.

- However, the two major American rating agencies have recently acknowledged the improvement in Québec's public finances by favourably adjusting their outlook associated with Québec's rating.

Credit ratings assigned by Standard and Poor's[1]



1 Québec's relative position is the same considering the credit ratings assigned by Moody's.

3 Outlook for 1999-2000

BUDGET TO REMAIN BALANCED IN 1999-2000 AND 2000-2001

- The Québec government's budget plan in the March 1999 Budget Speech forecasts a balanced budget in 1999-2000 and 2000-2001.
- This plan reflects the expected growth in the government's revenue and expenditure, according to the fiscal and budgetary policies in effect, and forecast economic growth.

The Québec government's budget plan

(in millions of dollars)

	1999-2000	2000-2001
Own-source revenue	38 284	38 952
Federal transfers	6 908	6 839
Total revenue	**45 192**	**45 791**
Operating expenditure	– 37 593	– 38 162
Debt service	– 7 599	– 7 629
Total expenditure	**– 45 192**	**– 45 791**
Budget surplus	**0**	**0**

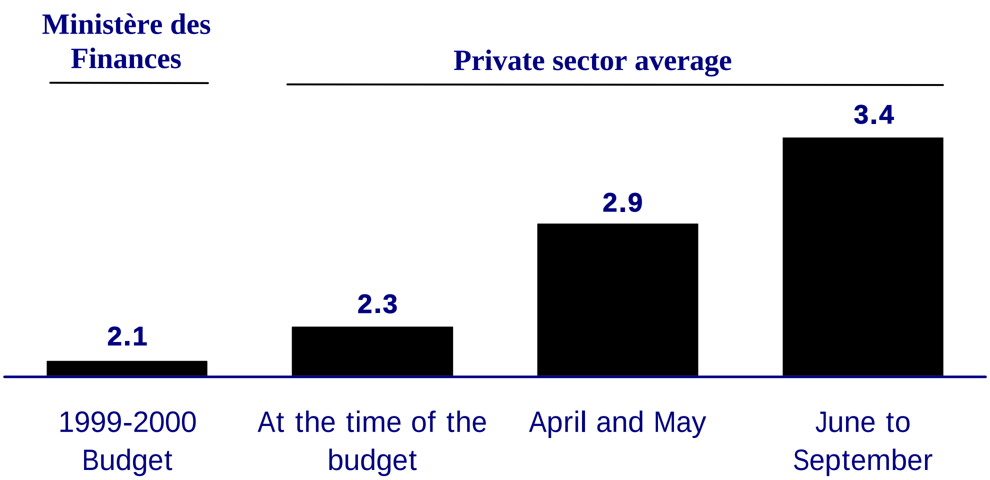
Source: Ministère des Finances du Québec.

SINCE THE BUDGET, THE PRIVATE SECTOR HAS ADJUSTED UPWARD ITS ECONOMIC GROWTH FORECASTS FOR 1999

- Since the Budget Speech, the outlook for economic growth has improved.
- At the time of the 1999-2000 Budget Speech, the private sector forecast an average real GDP growth of 2.3% in Québec. That was about 0.2 percentage points more than the forecast used for budget planning purposes.
- The experts have been surprised by the vigour of the results to date:
  - once again, U.S. economic growth has clearly exceeded forecasts;
  - in Québec, retail sales were up 5.8% during the first seven months of the year;
  - according to Statistics Canada's survey of investment intentions of last July, total non-residential investment should rise by 7.7% in Québec in 1999. This is much more than indicated by the February survey (0.9%).
- These data, among others, have prompted experts to adjust their growth forecasts for this year to 3.4%.

Forecasts of real GDP growth in Québec in 1999

(as a percentage)



Source: Ministère des Finances du Québec.

LITTLE ADDITIONAL LEEWAY FOR THE GOVERNMENT IN 1999-2000

- Even if economic growth in 1999 is stronger than forecast, that will have little impact on the government's revenue:
  - an extra 1 percentage point of economic growth would result in an increase of some $380 million in own-source revenue.
- However, Québec could lose half of this increase, i.e. $190 million, in lower federal transfer revenue.
- The net impact on the government's revenue would be an additional $190 million, which represents only 0.4% of total forecast budgetary revenue.
- However, at this time, the government does not have sufficient information to adjust its budget forecasts.

Net impact on the Québec government's revenue of a 1 percentage point change in GDP

(in millions of dollars)

Own-source revenue forecast for 1999-2000	38 284
Change of 1 percentage point in economic growth	X 0.01
Additional own-source revenue	**380**
Less: reduction in federal transfers	**– 190**
Net impact	**190**

4 Fiscal and budgetary policy directions for the coming years

PRIORITIES: LOWERING THE TAX BURDEN…

- Over the next few years, the government's priority should be to lower the tax burden, the chief obstacle facing Québec, while maintaining a balanced budget.

- A lower tax burden would make it possible to:

  - foster economic growth and job creation;

  - make Québec more economically competitive by reducing the unfavourable disparities with neighbouring jurisdictions;

  - give back to taxpayers a portion of the rewards of deficit elimination;

  - safeguard public services for the future through stronger economic growth.

- In the last Budget Speech, the government committed itself to lowering the tax burden by $1.3 billion by 2002-2003.

- However, this reduction will not be enough to significantly reduce the difference that currently exists with the other provinces regarding personal income tax.

... WHILE PRESERVING THE GAINS ACHIEVED IN TERMS OF PUBLIC SERVICES

➡ In order to lower the tax burden, it will be necessary for spending to rise at a rate that is compatible with Quebecers' ability to pay, especially since Québec already invests a great deal in public services compared with other jurisdictions.

➡ Accordingly, the government proposes to maintain per capita program spending constant, while allowing for inflation:

- this means that the overall amount of program spending will rise by 2% per year;
- this will make it possible to preserve what has been achieved in terms of public services.

➡ In addition, many expenditure sectors are under significant pressure.

➡ In particular, health spending is growing rapidly because of:

- the aging of the population;
- the rising cost of technology and new treatments;
- increases in the cost and consumption of insured prescription drugs.

➡ Consequently, the government must continue to rigorously manage spending to achieve its targets.

➡ Provided the budget remains balanced, the debt will gradually decline as a proportion of GDP as a result of economic growth.

EXPENDITURE MANAGEMENT THAT ALLOWS FOR THE FACT THAT THE ECONOMY IS NOT GROWING AS RAPIDLY AS IT USED TO

- The proposed approach to program spending reflects the fact that the economy and government revenue are not growing as rapidly as they used to.

- During the 1960s, average real economic growth in Québec exceeded 5% per year whereas, during the 1990s, it has averaged only 1.5%.

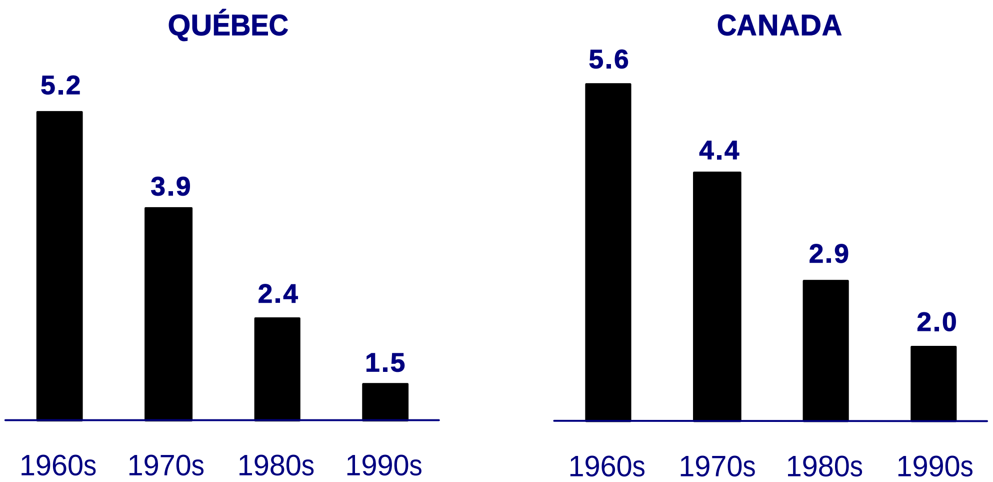
- This phenomenon is not unique to Québec; Canada's rate of economic growth has also declined over the last few decades: from an average of 5.6% per year in the 1960s to an average of 2.0% during the 1990s.

- Slower economic growth and lower inflation have a direct impact on the government's own-source revenue, which tends to rise at roughly the same rate as the economy when the tax structure is held constant.

- In addition, assuming federal transfers remain stable, overall, budgetary revenue will rise more slowly than nominal GDP.

Average growth in real gross domestic product

(as a percentage)



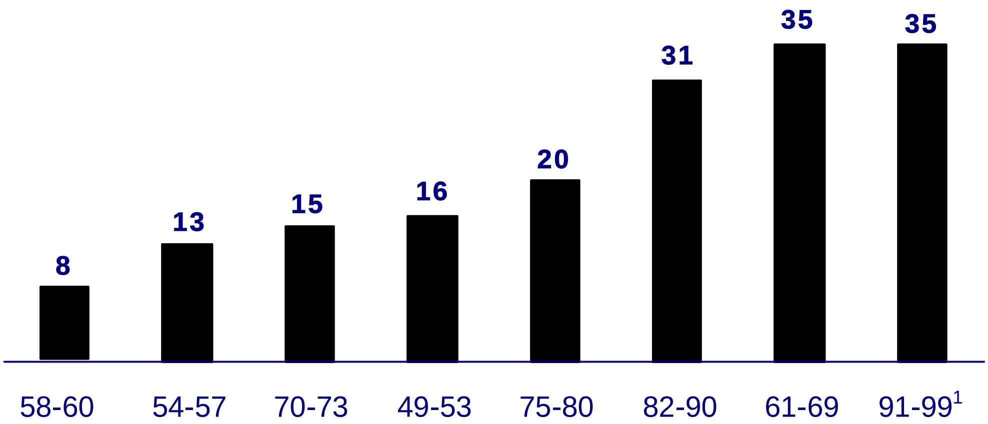
Sources: Institut de la statistique du Québec, Statistics Canada, Conference Board of Canada and ministère des Finances du Québec.

QUÉBEC'S ECONOMY IS NOT RECESSION-PROOF

- Lastly, the government must be in a position to deal with unforeseen situations without jeopardizing its fiscal and budgetary objectives.
- In this regard, the current economic growth cycle is one of the longest since the second world war.
- By the end of 1999, the United States will have experienced 35 consecutive quarters of economic growth:
  - making this, along with the one in the 1960s, the longest growth cycle in post-war history;
  - this growth cycle will not continue indefinitely.
- When the U.S. economy slips into recession, Québec's economy, which increasingly depends on markets to the south, will not be able to avoid following it.
- A recession could lead to a significant revenue shortfall.
- A recession means a decline in collective wealth. This leads to:
  - a drop in the government's revenue;
  - an increase in spending, including income security expenditures.

Length of growth cycles in the United States

(number of quarters)



1 Estimate at the end of 1999.

Source: Data Resources Inc.

Conclusion

Although the deficit has been eliminated, the government must continue with its sound management of public finances and its efforts to improve the competitiveness of Québec's economy.

Over the coming years, the government must give priority to lowering the tax burden while preserving the gains achieved in public services. A more competitive tax system will encourage sustained economic growth and job creation, which will help secure public services for the future.

In order to lower the tax burden, government spending will have to rise at a rate compatible with Quebecers' ability to pay. Accordingly, the government is proposing to stabilize per capita program spending. Allowing for inflation, this means annual growth in program spending of 2%. This rate of growth in spending will make it possible to preserve what has been gained in terms of public services.

In addition, in view of the pressure many expenditure sectors are experiencing, the government will have to continue with rigorous management to achieve its targets.

A tax burden scaled back to a reasonable level and growth in program spending sufficient to adequately fund public services are essential conditions that will enable Québec to meet the challenges it faces as it prepares to enter the next millennium.