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Provincial Budget Briefs

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QUÉBEC BUDGET 2020

Continued strength in the economy is helping Québec beat its previous budget targets again, allowing the government to raise spending on key initiatives. The $4.5bn surplus now expected for 2019/20 (before deposits to the Generations Fund) is more than $2bn better than Budget 2019's projections, aided by better tax receipts and lower interest payments on debt, and comes despite a $603mn write-off related to the province's share of the CSeries jetliner program. The surplus is expected to narrow in the coming fiscal year, with spending growth of 5.1% reflecting increased spending announced today and at the time of the Fall Update. Québec drew down a total of $10bn from the Generations Fund to permanently reduce debt in the fiscal years 2018/19 and 2019/20. Because of these prudent actions, it will achieve its gross debt-to-GDP target of 45% in the current fiscal year — six years ahead of plan. Québec's financing plan shows that it will drop to $13.9bn in 2020/21 from $19.2bn in the current year, before stepping up again to $27.1bn in 2021/22. However, in the current year, it borrowed $7.4bn more than what was projected in Budget 2019, arising mainly from a decision to pre-borrow for the upcoming fiscal year. The 2020/21 funding plan does not allocate an amount for pre-funding, but pre-funding has averaged around $6-7bn annually over the past 5 years.

Table 1

$Billions	2018/19 Actual	2019/20 19 Budget	2019/20 20 Budget	2019/20 Change	2020/21 20 Budget	2021/22 20 Budget	2022/23 20 Budget	2023/24 20 Budget	2024/25 20 Budget
Consolidated Revenue	**114.7**	**115.6**	**117.9**	**2.3**	**121.3**	**125.2**	**128.6**	**132.2**	**135.9**
Own-Source	91.6	90.7	92.8	2.1	95.6	98.9	102.1	105.6	109.1
% change		*0.6*	*1.3*	*0.7*	*3.0*	*3.4*	*3.3*	*3.5*	*3.3*
Federal Transfers	23.1	24.9	25.1	0.2	25.7	26.3	26.5	26.6	26.8
Consolidated Expenditure	**106.5**	**113.0**	**112.8**	**-0.2**	**118.6**	**122.2**	**125.5**	**128.8**	**132.1**
Expenditure	97.7	104.0	105.0	0.9	110.3	113.6	116.8	120.4	123.7
% change		*5.0*	*7.4*	*2.4*	*5.1*	*3.0*	*2.8*	*3.0*	*2.7*
Public Debt Interest	8.7	9.0	7.8	-1.2	8.3	8.6	8.7	8.4	8.5
Contingency Reserve		0.1		-0.1					
Estimated Losses on the Cseries Inv.			-0.6						
Shortfall to be offset						0.125	0.250	0.250	0.250
Budget Balance (Public Accounts Basis)	**8.280**	**2.504**	**4.533**	**2.029**	**2.729**	**3.030**	**3.353**	**3.676**	**3.995**
Generations Fund Deposit	-3.477	-2.504	-2.633	-0.129	-2.729	-3.030	-3.353	-3.676	-3.995
Use of the Stabilization Reserve									
Budget Balance per *Balanced Budget Act*	**4.803**	**0.000**	**1.900**	**1.900**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**

Québec Economy to Slow After Hot 2019

Unlike most other parts of the country, the Québec economy witnessed an acceleration in growth in 2019, with a 2.8% increase in real GDP now estimated for last year. That's a full percentage point above the pace that was anticipated at the time of last year's budget. Growth is anticipated to cool from here, with a 2.0% growth rate penciled in for 2020 and 1.5% for 2021. The strong labour market will underpin a solid rise in consumer spending, but government spending and residential investment growth are expected to slow.

Table 2	**Key Assumptions**			
Y/Y % Chg	**2019**	**2020**	**2021**	**2022-24**
Economic Assumptions				
Real GDP	2.8	2.0	1.5	1.4
Private Sector Average		*1.8*	*1.5*	*1.4*
Nominal GDP	4.7	4.1	3.4	3.2
Private Sector Average		*3.7*	*3.4*	*3.3*
Employment (K)	77.7	37.2	25.8	18.9
Jobless Rate (%)	5.1	5.0	4.9	4.8
Household Consumption	3.2	3.5	3.5	3.0
Housing Starts (K)	48.0	47.6	45.2	42.2
Household Income	5.9	4.6	3.6	3.2
Corporate Net Operating Surplus	4.0	3.6	3.5	3.5
CPI	2.1	2.2	2.2	2.0
Financial Assumptions				
3-month T-Bills (%)	1.7	1.7	1.9	
10-year GoC Bonds (%)	1.6	1.7	2.0	
Exchange Rate (US¢/C$)	75.6	76.8	77.8	

Note: 2022-24 is three-year average

The 2020 forecast is marginally above the private sector consensus, and includes a slight acceleration in export growth which could be at risk from the slower global growth environment stemming from the coronavirus. The global growth projections in today's budget show a slight acceleration versus 2019, as they would have been set before consensus forecasts started to be cut.

Larger 2019/20 Surplus, Allowing Additional Spending Growth Ahead

Québec's strong economy is helping the province achieve another better-than-expected surplus in the outgoing 2019/20 fiscal year. Own-source revenue growth is tracking more than $2bn above the projections laid out in Budget 2019, with almost half of that coming from personal income taxes. Lower-than-anticipated debt service costs, to the tune of $1.2bn versus last year's projections, have also played a role in the improved budgetary balance. The smaller debt service cost was largely due to lower-than-expected interest rates, but also a higher-than-anticipated return on the Retirement Plans Sinking Fund (RPSF). The greater revenue and lower debt service costs are more than offsetting higher spending (+0.9bn versus Budget 2019) and a $603mn write-off taken to offset the lower value of the provincial government's stake in the CSeries jetliner project.

Before accounting for the deposit to the Generations Fund, the budget balance in 2019/20 is now expected to be $4.5bn, which is a more than $2bn improvement versus last year's budget.

On top of already announced measures in the Fall Update, Budget 2020 proposes additional spending of $15.5bn over seven years, with $1.7bn in the upcoming 2020/21 fiscal year. That spending will be targeted on previous initiatives including environmental policies. Nothing specific has been set aside to help the economy weather the impact from the coronavirus, but the budget document states that the government is "ready to cope" given its strong economic and fiscal starting points. In sum, expenditures (excluding debt service costs) are expected to rise by 5.1% in the coming fiscal year, before averaging just under 3% a year thereafter.

Own-source revenue is expected to rise by $2.8bn, or 3%, in 2020/21. That reflects some previously announced tax changes, including the standardization of school tax rates and capital investment depreciation. The budget states that, excluding those measures, own-source revenue would be expected to rise by 3.8% in 2020/21 – a growth rate more in-line with the projected pace of nominal GDP. The budget surplus is expected to come in at $2.7bn in the upcoming fiscal year, before deposits to the Generations Fund.

The longer-term forecasts see budget surpluses rising again, thanks to slower spending growth. Forecasts for the years 2021/22 through to 2024/25 include small shortfalls to be offset at a later date (of $125mn to $250mn). If these aren't able to be fully offset, the Budget states that the Stabilization Reserve could be used to provide the offset.

Within the meaning of the province's Balanced Budget Act, a budgetary balance that is greater than zero is automatically allocated to the Stabilization Reserve. This reserve can be used in the event of an overrun to keep the budget balanced. The balance of the Stabilization Reserve is estimated to be $13.9bn at March 31, 2020, growing with an allocation of $1.9bn in 2019/20.

Healthy Surpluses Plus Robust 'Generations Fund' Accelerates Attainment of Debt Targets

Québec has delivered its sixth balanced budget and has been on an accelerated track to reduce debt, thereby enhancing its fiscal sustainability. Windfall surpluses over the past few years combined with prudent multi-year measures to build funds for debt reduction (i.e. Generations Fund) have created the perfect circumstances when "preparation meets opportunity". Québec drew down a total of $10bn from the Generations Fund to permanently reduce debt in the fiscal years 2018/19 and 2019/20. Because of these prudent actions, it will have achieved its gross debt-to-GDP target of 45% in the current fiscal year — six years ahead of plan. This ratio peaked at 54.1% at March 31, 2014 and is expected to be $43.0% at March 31, 2020. Moreover, a bi-target debt metric of accumulated deficits (without the addition of the Stabilization Reserve) representing no more than 17% of GDP is expected to be reached by 2022/23 — three years ahead of schedule and faster than last year's projection of 2023/24.

Table 3	**Financing Plan**			
$Billions	**2019/20E**	**2020/21F**	**2021/22F**	**2022/23F**
Net Financial Requirements	3.1	9.8	10.4	10.2
Maturities and Calls[2]	16.7	10.4	16.7	14.4
Use of Gen Fund to Repay Debt	-2.0	-	-	-
Withdrawal from Sick Leave Fund	-0.1	-	-	-
Use of Pre-Financing	-5.9	-6.3	-	-
Change in Cash Position	-0.7	-	-	-
Deposit to Pensions Sinking Fund[1]	1.5		-	-
Transactions Under Credit Policy[2]	0.4			
Pre-Financing	6.3			
Total	**19.2**	**13.9**	**27.1**	**24.7**

1. Special contributions to increase prudential liquidity (deposits in the RPSF are optional)
2. Payments to/(from) counterparties to reduce exposure

Québec's financing plan shows that it will drop in 2020/21 to $13.9bn from $19.2bn in the current year, before stepping up again to $27.1bn in 21/22. Thereafter, it is expected to average around $27bn per year through the end of the forecast period in 2024/25. However, in the current year, it borrowed $7.4bn more than what was projected in Budget 2019, arising mainly from a decision to pre-borrow for the upcoming fiscal year. The upcoming year's funding plan does not allocate an amount for pre-funding, but pre-funding has averaged around $6-7bn annually over the past 5 years.

We expect the province to tap the domestic market for around 80% of its borrowings. The percentage of borrowings in foreign markets has averaged 21% over the past 10 years. In the outgoing year, however, Québec carried out 36% of its borrowings in foreign markets, tapping the USD, Euro, Sterling, Aussie, Swedish and New Zealand markets.

As almost half of Québec's projected borrowing requirements are for refinancing, the pace of debt accumulation, essentially only for capital investment purposes, is expected to be modest relative to the pace of GDP growth.

The Generations Fund's assets are invested in units of a fund managed by La Caisse de dépôt et placement du Québec — the provincial pension fund. The acceleration of withdrawals for debt reduction in 2018/19 and 2019/20 were intended to reduce the investment risks that could potentially interfere with the province's over-arching objective of reducing its debt burden. The Generations Fund was created in 2006 for the express purpose of reducing public debt in order to protect future generations. The Fund accumulates assets through inflows from dedicated revenue sources (i.e. water power royalties from Hydro-Québec, mining revenues, consumption taxes on alcoholic beverages, and other). The drawdowns in 2018/19 and 2019/20 were the first time withdrawals were made since the Fund's establishment in 2006. The projected book value of the Generations Fund at March 31, 2020 is $8.9bn and is expected to grow to $25.7bn by March 31, 2025.

Québec's 10-year capital spending program, referred to as the 2020-2030 Québec Infrastructure Plan (QIP), calls for $130.5bn in cumulative investments. This has been increased by $15.1bn from the previous year's plan. Investments will be carried out by giving priority to public safety, replacement of outdated infrastructure and economic development. A portion of the QIP is supporting major public transit projects across the province like the Reseau express métropolitain (REM) in the Greater Montréal Area. QIP 2020: "Under the 2020-2030 QIP, the major share of investments, or 61%, will go to replacing and maintaining assets. The share devoted to the construction of new infrastructure is 39%."

Ahead of the budget, provincial energy crown corporation Hydro-Québec announced their 2019 results, reporting net income of $2.923bn, down 8.4% from 2018. However, excluding non-recurring items, namely the $277mn gain recognized in 2018 on the sale of an equity interest in subsidiary TM4 and a $46mn depreciation expense resulting from the write-off of certain costs related to the Northern Pass Transmission (NPT) project in 2019, net income was up $54mn year-over-year. In 2019, Hydro-Québec reported a new sales record in Québec which reflected baseload demand growth in all customer segments. The utility also continued to experience strong electricity export sales and signed a new agreement with Province of New Brunswick to start 2020.

Hydro-Québec also announced it will pay a dividend of $2.192bn to the Government of Québec — the seventh consecutive annual dividend in its history.

Debt Reduction Achieved Ahead of Schedule, But More Work Needed To Improve Fiscal Capacity

Credit Ratings: DBRS Morningstar AA (low), Fitch AA-, S&P AA-, Moody's Aa2 — All Stable outlooks

Québec's credit ratings are solidly placed within their current rating categories with no near-term changes anticipated. We believe today's budget is neutral for ratings, while debt investors will look favourably upon the unwavering course of continuous balanced budgets and achieving debt reduction ahead of plan. The province plans to keep the budget balanced from 2020/2021 to 2024/25 without using the Stabilization Reserve, which is another positive factor.

The province's strong fiscal performance and high, but improving debt burden over the past few years has won notice from the rating agencies. In June 2017, Standard & Poor's upgraded the province one notch to AA- citing "strong budget surpluses and declining debt burden."

In May 2019, DBRS Morningstar changed its rating outlook to positive. This action was followed by an upgrade to AA (low) stable in November. The upgrade occurred shortly after the release of the 2018/19 Public Accounts and 2019/20 Mid-Year Fiscal Update. DBRS Morningstar's upgrade announcement stated that these financial releases "once again reinforced Québec's commitment to a pro-growth agenda, sustainable public finances and meaningful debt reduction. DBRS Morningstar has confidence that the province will continue to report positive operating results, that debt ratios will continue to fall and that policy measures will be supportive of growth through the medium term."

The basis of Moody's Aa2 rating is Québec's Baseline Credit Assessment rating of aa3 — an assessment of intrinsic strength — combined with a one notch uplift that is based on a high likelihood of extraordinary support from the federal government under its Joint Default Analysis (JDA) Methodology. A 2019 Moody's report cites that "Despite modest improvement in recent years, Québec's debt burden remains above the median debt burden of its Aa2 Canadian peers. Continued high levels of debt issuance across the next four years to finance the province's ambitious capital plan will ensure that both the debt and interest burdens remain elevated." We don't foresee the province obtaining a Moody's upgrade in the near-term. The rating agency explicitly states that an upgrade would be predicated on Québec's debt burden sustaining a range of 150-155% of revenue and interest expense declining below 7%. Moody's projects that in 2021 these metrics will be at 166.4% and 7.2%, respectively.

We highlight that Hydro-Québec is considered self-supporting by the rating agencies; therefore, its debt is not imputed in overall taxpayer-supported debt of the province, even though it is explicitly guaranteed by the province.

Notwithstanding Québec's strong fiscal and economic performance, its fiscal capacity is considered weak on a relative basis, which is confirmed by Québec's status as a 'have not' province under the federal Equalization framework. Québec will collect 64.4% of the ~$20.6bn of Equalization in 2020/21. This is down from 66% of the ~$20bn of federal equalization payments in 2019/20, reflecting some relative fiscal capacity gains year-over-year.

Moody's 2019 report also expresses a similar view: "Québec currently has less fiscal flexibility than other provinces due to its relatively high tax burden, which limits its ability to raise taxes in the event of negative revenue shocks. However, continued measures to decrease the overall tax burden are incorporated in the forecast for continued balanced budgets over the medium-term. This plan will provide the province with improved fiscal flexibility, should the province need to rely on revenue measures in the future to offset fiscal pressures."

On a positive finish, according to the Parliamentary Budget Officer's (PBO) 2020 Fiscal Sustainability Report which is a review to assess whether policy changes are required to avoid unsustainable public debt accumulation over a 75-year planning horizon (after considering the economic and fiscal impacts of population ageing), Québec is listed among the few provinces in Canada as having sustainable fiscal policies.