BUDGET ANALYSIS

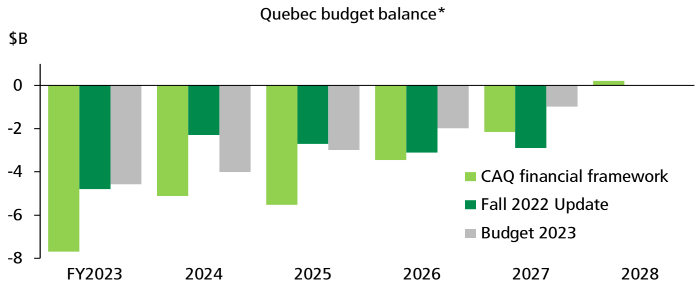
Quebec: Budget 2023

Tax Cuts Come with a Price Tag

HIGHLIGHTS

- Despite an improvement in its deficit for 2022–2023, Quebec is now expecting to run a larger-than-previously forecast deficit of $4B (0.7% of nominal GDP) in 2023–2024, and $2.3B (0.4%) in 2023–2024 after deposits in the Generations Fund (graph 1). Before deposits in the Generations Fund, the government expects to run a budget surplus in 2024–2025, two years later than indicated in December.
- Certain aspects of the Balanced Budget Act (BBA) will be amended. For now, the budget plan intends to reduce the deficit (after deposits in the Generations Fund) by $1B annually from 2023–2024 until 2027–2028. Going forward, the government wishes to modernize other features of the existing Act.
- As a percentage of GDP, Quebec's net debt is expected to increase to 38% in 2023–2024 and then gradually decrease to 35.8% in 2028. The province is now targeting a net debt-to-GDP ratio of 27.5% to 32.5% by 2038.

GRAPH 1
A Balanced Budget in Five Years



*After deposits of revenues in the Generations Fund and before use of the stabilization reserve.
Sources: Quebec Ministry of Finance and Desjardins Economic Studies

- The government now expects to borrow $24.2B in 2022–2023, $29.5B in 2023–2024, $28.6B in 2024–2025, and $76.9B in 2025–2026 through 2027–2028.
- The government's economic growth forecasts remain more optimistic than Desjardins's. Nevertheless, in an alternative recession scenario, the government estimates that the budget balance will deteriorate by nearly $4B from the baseline scenario in 2023–2024 and 2024–2025.
- Overall, the budget delivers on the government's commitments made during last year's election campaign. Tax cuts will give many households a definite financial boost. However, everything has a cost. In this case, the budget includes cuts to deposits in the Generations Fund, which has proven to be a valuable debt management tool over the years.
- Bond yields remained largely unchanged after the budget was released and are expected to continue to move based on global risk appetite in the short term. Combined with a large, diversified and liquid borrowing program, meeting budget targets in the coming years should prevent financing costs from deteriorating significantly.

Our impressions

From the cost-of-living crisis to the lack of affordable housing, to the persistent hiring challenges businesses are facing, not to mention the climate transition, Minister Girard's list of priorities was intimidating, to say the least. A recession will be increasingly difficult to avoid. Concerns about the economic outlook were already high, and have recently risen to a new level given the current challenges facing the banking sector. It is reassuring that Canadian financial institutions are well capitalized and diversified, and subject to strict regulation, which puts them in a very good position. But economic difficulties elsewhere are likely to be felt at least indirectly in Canada and Quebec, hence the pressure

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there was on the government to present a pragmatic budget while addressing the many priorities as judiciously as possible.

This starts with economic expectations. On this front, the province's economic outlook wasn't materially different from what was presented last fall. With real GDP growth forecast at 0.6% this year, the government's projection is in fact somewhere between the average of private sector forecasts and the most optimistic of these forecasts (0.9%). By contrast, we anticipate a 0.2% decline in real GDP for 2023 in our *Economic & Financial Outlook* published on March 16. The government once again presents an alternative pessimistic scenario, albeit a less severe one than the one it presented in its fall update. This scenario now assumes a 0.8% contraction in nominal GDP (compared to 1% previously), which would have a cumulative impact of $4.9B on budget balances over five years. The contingency reserve—which totals $6.5B over this time horizon—is sufficient to cover this risk. However, there's some uncertainty about the impact of a recession on the government's bottom line. This is evidenced by the fact that the Auditor General's report estimated an even greater impact than what the contingency reserve would cover.

An adequate contingency reserve is good. More conservative planning assumptions are even better. This is because they force some choices. On that front, the budget accurately reflects the government's commitments early into its second term, namely tax cuts, a more effective health care system and enhanced productivity. The campaign promise to lower the two bottom tax rates, which was put on hold in the fall update, is being delivered at a cost of $9.2B. It fulfills a long-standing wish that Quebec taxpayers no longer have the highest tax burden in North America. Whether the current reality lent itself to this announcement will continue to be the subject of much discussion.

The anticipated recession—albeit shallow—will put pressure on public finances, and for many households, the tax cut will increase savings or support imports. Another scenario would see these tax breaks spent completely and quickly, at a time where the economy is still suffering from excessive inflation. In this case, the tax breaks would end up fueling inflation more than they would boost economic growth. In short, the real benefits of this measure are highly uncertain given the near-term challenges.

It's true that, in the longer term, one of the main arguments in favour of tax cuts is that they increase the incentive to work, both in terms of the labour force participation rate and hours worked. If that was the intended goal, the government could have instead boosted work incentives such as the worker deduction. Arguably, this would have more directly targeted the labour shortage, which many identify as the biggest economic problem in Quebec.

It's also clear that funding tax cuts by curtailing deposits in the Generations Fund has the potential to raise intergenerational equity issues and contravene the principles behind the Fund's very existence. Overall, there are several major issues, as mentioned above, and it's difficult to argue that the tax burden on Quebecers—albeit a heavy one—was the priority one at this time.

The housing crisis seems more pressing, as we expect housing starts to fall 20% this year, perpetuating the decline seen in 2022. Insufficient supply is one of the main causes of the surge in housing costs, which have been compounded by the pandemic and soaring interest rates. While the federal government has been working on the issue, having recently launched the Housing Accelerator Fund, Quebec needs to act as well, in particular to ensure better funding for the construction and renovation of social and affordable housing. The budget allocates $1B to build 5,250 units (3,300 of which were previously announced through the AccèsLogis program). The budget specifically earmarks funds to build another 1,500 affordable housing units. This additional supply will certainly be welcome, but it's unclear whether it'll be enough.

We should stress that many of the solutions to this urgent problem involve synchronizing and aligning efforts already underway rather than relying solely on funds from the budget. Initiatives such as better alignment of programs at different levels of government and improved financial partnerships with various stakeholders—including driving the development of non-conventional models such as a collaborative approach to construction—will continue to require attention.

On the energy transition front, the Inflation Reduction Act (IRA) in the United States has set the tone with its massive tax credits to support the development of clean energy. Quebec's budget increases the amount allocated to the 2030 Plan for a Green Economy by $1.4B. This includes initiatives to protect water resources and biodiversity, although there are few announcements that directly target IRA provisions.

While the federal budget to be released on March 28 will likely include several initiatives in this area, Quebec will also have to be agile, particularly when it comes to the manufacturing of equipment and components in support of the energy transition, the production of critical and strategic minerals, as well as the production (and recycling) of electric vehicle batteries. On this last point, we had outlined in an *Economic Viewpoint* that Quebec was particularly well positioned to host electric battery and recycling plants, but it's also true that competition will be fiercer in light of the IRA. This includes competition with other Canadian provinces, as demonstrated by Ontario being chosen by Volkswagen to build its first battery plant outside Europe.

Finally, Budget 2023 marks the grand return of the Balanced Budget Act (BBA), the application of which means that a return to balanced budget by 2027–2028 is mandatory. However, the budget also announces new measures regarding the debt target. First, the targets will from now on relate to net debt definition (as opposed to gross debt until now). Second, the government is targeting a net debt burden of 30% of GDP (plus or minus 2.5 percentage points) in 2037–2038. Certain provisions within the BBA will also be subject to reforms that will be specified in the future. These include the elimination of the stabilization reserve, updates to the deficit threshold that triggers the requirement to table a deficit reduction plan, and the rules governing the implementation of such plan.

In addition, the government announced withdrawals to the Generations Fund, to the tune of $2.5B per year in 2023–2024 and 2024–2025, via a reduction in the financing program's size. The debt servicing cost savings resulting from these withdrawals are estimated at $801M over five years. As interest rates may remain sustainably higher than before the pandemic, and given potentially volatile financial market returns, this is a sound decision. However, the government will still need to clarify its intentions regarding the Generations Fund.

Worsening financial indicators for 2023–2024

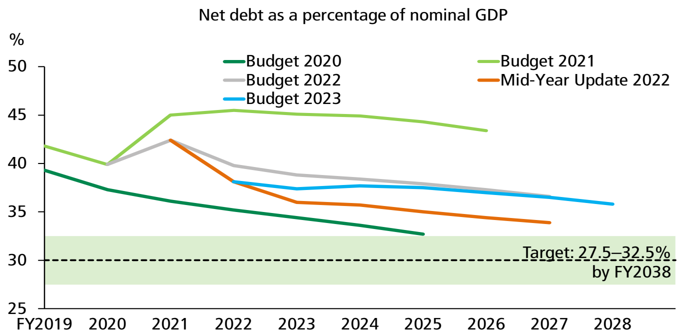
Quebec's budget outlook has worsened in the medium term. Despite an improvement in its deficit for 2022–2023, the province is now expecting to run a deficit of $4B (0.7% of nominal GDP) in 2023–2024, compared to $2.3B (0.4%) in the previous update after deposits in the Generations Fund. The projected $3B (0.5%) budget deficit for 2024–2025 is also higher than anticipated in the Fall 2022 Fiscal Update. Beginning in 2025, the budget balance outlook improves, versus prior plans ending in a surplus (after deposits in the Generations Fund) in 2027–2028. Before these deposits (i.e., for public accounts purposes), a budget surplus is now expected in 2024–2025, two years later than indicated in the December update.

Certain aspects of the BBA will be restored, and the government is aiming to return to a balanced budget as required by law. This includes a plan to reduce the deficit (after deposits in the Generations Fund) by $1B annually from 2023–2024 until 2027–2028. The government also wants to adjust other features of the existing Act, such as abolishing the stabilization reserve and introducing new deficit reduction rules. In addition, the province will aim to improve "budget flexibility," presumably including parameters governing the revenue losses required to trigger a deficit elimination plan.

Projected debt has been adjusted based on changes in the deficit. As a percentage of GDP, Quebec's net debt is expected to increase from about 37% of nominal GDP during the current fiscal year to 38% in 2023–2024. Then, it will gradually decrease to 35.8% in 2028, close to the projections put forward at the end of last year. The province is now targeting a net debt-to-GDP ratio of 27.5% to 32.5% by 2038 (graph 2). It has also introduced an intermediate threshold of 33% for 2032–2033.

The government now expects to borrow $24.2B in 2022–2023, $29.5B in 2023–2024, $28.6B in 2024–2025, and $76.9B in 2025–2026 through 2027–2028 (table 1). Debt refinancing accounts for 45% and 58% of the total for 2023–2024 and 2024–2025, respectively. At March 31, 2023, before the contribution of swaps, Quebec's debt should be 77% denominated in Canadian dollars, 12% in euros and 8% in US dollars. For 2023–2024, the government anticipates that just 16% of its debt will be vulnerable to a change in interest rates. The province also says that the average maturity of issues in 2022–2023 is 17 years, and that the average maturity of the outstanding debt is expected to be 12 years as of March 31st. Moreover, given the demand for Quebec's green bonds, the government has committed to remaining a regular issuer. Quebec Infrastructure Plan (QIP) spending is now more focused on 2023–2024 and 2024–2025 (graph 3 on page 4). These plans are further adding to the projected upward pressure on provincial debt. The QIP is still focused on building schools and health care facilities as well as public transit infrastructure.

GRAPH 2
A Similar Net Debt Trajectory to the Previous Budget



Sources: Quebec Ministry of Finance and Desjardins Economic Studies

TABLE 1
New Forecasts

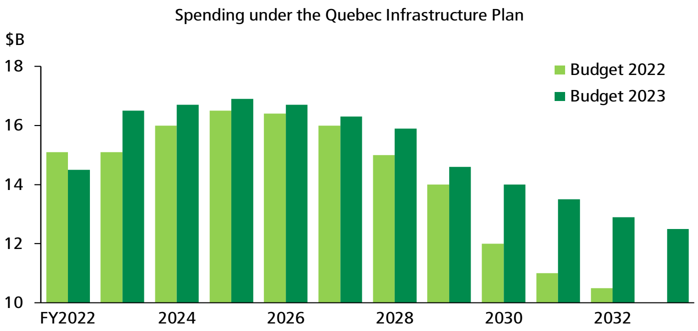
$B (EXCEPT AS INDICATED)	2023–24	2024–25	2025–26	2026–27	2027–28
Financing program					
Fall 2022 Update	27,622	32,008	32,477	27,303	—
Budget 2023	**29,543**	**28,648**	**29,029**	**24,267**	**23,642**
Net financial requirements					
Fall 2022 Update	11,538	12,617	15,021	15,237	—
Budget 2023	**18,647**	**15,671**	**14,899**	**14,101**	**15,227**
Real GDP growth (%)*					
Fall 2022 Update	0.7	1.6	1.6	1.5	—
Budget 2023	**0.6**	**1.4**	**1.6**	**1.5**	**1.4**
Nominal GDP growth (%)*					
Fall 2022 Update	2.8	4.0	3.7	3.2	—
Budget 2023	**2.7**	**3.8**	**3.7**	**3.3**	**3.3**

*FY2024 is calendar year 2023, etc.
Sources: Quebec Ministry of Finance and Desjardins Economic Studies

Economic outlook largely unchanged

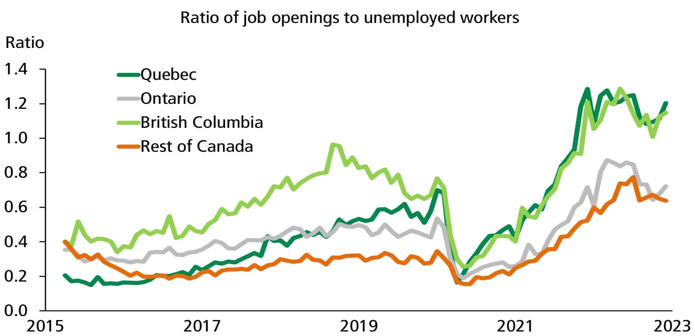
Quebec has not materially revised its 2023 economic outlook. The government expects real GDP growth of 0.6% this year, compared to the 0.7% projected in December. That said, this growth rate does represent a slowdown caused by the effects of higher interest rates and a less favourable global environment. Nonetheless, Quebec's economy has certain advantages,

GRAPH 3
Infrastructure Spending Restored



Sources: Quebec Ministry of Finance and Desjardins Economic Studies

GRAPH 4
Quebec's Labour Market Is Now the Tightest in Canada



Sources: Statistics Canada and Desjardins Economic Studies

particularly a strong and extremely tight labour market (graph 4) in early 2023, which should mitigate the effect of economic weakness in other sectors.

The government's economic growth forecasts remain more optimistic than our recent projections, which call for real GDP to shrink by 0.2% in 2023. Nevertheless, in an alternative scenario where a recession begins this year and real GDP declines by 0.8%, the government estimates that the budget deficit will increase by $6.2B during 2023–2024 and $4.4B in 2024–2025, and that the budget won't balance in 2028.

While the alternative recession scenario for the next five years aligns with the alternative scenario presented in December's Fall 2022 Update, these estimates are still more optimistic than those in the pre-election report, which stated that, in a moderate recession scenario, revenues would likely decline by around $8.3B over five years.

What really matters is good risk management. To this point, the $6.5B in provisions for economic risks until 2028 should be enough to absorb the impact of the recession on government revenues. However, this is less than the $8B contingency in December's Fall 2022 Update.

The third tax cut will continue to stir debate

In keeping with the Coalition Avenir Québec's pre-budget statements and its 2022 election framework, the government will reduce the two bottom tax rates by 1%. This is expected to generate savings of up to about $800 for individuals during the current fiscal year and reduce revenues by $1.7B to $1.9B per year between 2023–2024 and 2027–2028. This measure makes up about three-quarters of the $12.1B in initiatives to "Grow Quebec's wealth" and nearly 40% of the costs of the new initiatives presented in the budget.

This kind of measure is contentious. From a cost-of-living standpoint, it should in theory give lower-income Quebecers—those struggling most with higher prices—a shot in the arm. However, many of them are already effectively paying little to no tax.

In addition to the individual income tax cut, the "Growing Quebec's Wealth" initiatives category includes a tax holiday for major investment projects and a continuation of the bio-food policy beginning in 2025–2026. To better address the labour shortage, the government will enhance support for teaching newcomers French and expediting the recognition of immigrants' credentials.

Out of the youth development initiatives, the largest individual measure is funding for improving youth literacy and numeracy. The budget also provides additional support for living expenses factored into the calculation of educational loans and scholarships. The total cost of the measures in this category is estimated at $2.3B by 2027–2028.

Money for vaccination and testing, and expanded home support service options, are the dominant health care system support measures. The total cost for this category is estimated at $5.6B over the next five fiscal years.

"Supporting Quebecers" includes a promise to build 1,500 affordable housing units over the next five years, funding to promote language and culture in Quebec and investments to make transit networks more accessible and efficient. The total cost of the measures in this category is estimated at $3.6B by 2027–2028.

Lastly, protection of water resources, dams and biodiversity makes up the vast majority of the environmental measures, totalling nearly $1B by 2027–2028.

Spending up again

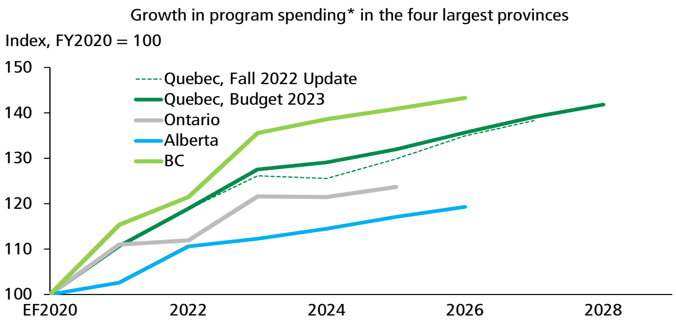
In addition to the new measures, program spending projections were increased by $1.4B for 2022–2023 and $3.7B for 2023–2024. Ultimately, total spending on Quebec programs since the pandemic is expected to continue to outstrip Ontario and Alberta throughout the forecast period (graph 5 on page 5). However, spending will remain lower than in British Columbia, at least through 2025–2026.

TABLE 2
Budget by the numbers

IN B$ (EXCEPT IF INDICATED)	2021–22	2022–23		2023–24		2024–25	2025–26	2026–27	2027–28
	REEL	Update 2022	Budget	Update 2022	Budget	Budget	Budget	Budget	Budget
Total revenue	138.8	144.8	145.1	147.7	147.7	151.8	157.0	162.9	167.6
Own-source revenue	109.6	115.2	115.9	118.4	118.0	122.1	126.0	130.9	134.4
Federal transfers	29.2	29.6	29.2	29.3	29.7	29.7	30.9	32.0	33.2
Total expenditure	136.0	145.8	146.8	144.0	147.9	151.4	155.4	159.7	163.2
Program expenditure	127.3	135.3	136.7	134.6	138.4	141.5	145.4	149.1	152.1
Debt service	8.6	10.5	10.1	9.4	9.5	9.9	10.0	10.5	11.1
Provisions for economic risks	—	1.0	—	2.0	1.5	1.0	1.0	1.5	1.5
Balance	**2.8**	**-2.0**	**-1.7**	**1.7**	**-1.6**	**-0.6**	**0.5**	**1.7**	**2.8**
% of GDP	*0.6*	*-0.4*	*-0.3*	*0.3*	*-0.3*	*-0.1*	*0.1*	*0.3*	*0.4*
Generations Fund	3.6	3.3	3.4	3.9	2.4	2.4	2.5	2.7	2.8
Use of the stabilization reserve	0.8	0.4	0.4	—	—	—	—	—	—
Budget balance within the meaning of the Act	**—**	**-4.8**	**-4.6**	**-2.3**	**-4.0**	**-3.0**	**-2.0**	**-1.0**	**0.01**
% of GDP	*0.0*	*-0.9*	*-0.8*	*-0.4*	*-0.7*	*-0.5*	*-0.3*	*-0.2*	*0.0*
Net debt (% of GDP)	**38.1**	**36.0**	**37.4**	**35.7**	**37.7**	**37.5**	**37.0**	**36.5**	**35.8**
Gross debt (% of GDP)	41.8	40.4	40.2	40.4	41.5	41.5	41.2	40.8	40.6
Debt representing accumulated deficits (% of GDP)	20.9	19.3	20.5	18.5	20.2	19.6	18.8	17.9	16.9

Sources: Quebec Ministry of Finance and Desjardins, Economic Studies

GRAPH 5
Spending Growth Remains High in Quebec



*Program spending including COVID-19 response measures
Sources: Provincial Budgets, Statistics Canada and Desjardins Economic Studies

TABLE 3
Adjustments to the financial framework since December 2022

IN B$ (EXCEPT IF INDICATED)	2022–23	2023–24	2024–25
Budget balance – December 2022*	-5,225	-2,267	-2,665
New revenue	668	1,700	328
New expenditure	302	1,183	-1,061
Reduction in deposits in the Generations Fund	-98	1,574	2,177
Total – adjustments	268	2,092	3,566
"Growing Quebec's wealth"	502	2,081	2,311
"Developing the potential of youth"	34	345	499
Supporting the health care system	—	1,034	1,135
"Supporting Quebecers"	514	740	773
Environmental measures	15	122	166
New initiatives	1,064	4,323	4,885
Reduction of the contingency reserve	1,000	500	1,000
Budget balance – March 2023*	**-5,021**	**-3,998**	**-2,984**

*Before use of the stabilization reserve
Sources: Quebec Ministry of Finance and Desjardins Economic Studies

Bond spreads still tight

Quebec's long-term bond spreads barely moved immediately after the budget was released. Investors seem to have already priced in revenue improvements, as indicated by monthly data published by the government, as well as the new measures that had been widely publicized, including the province's intention to announce tax cuts.

Over the next few months, we expect Quebec's bond spreads to move in line with global risk appetite. All provincial spreads over federal government bonds narrowed in early 2023, amid positive economic surprises. However, they have widened since, amid the high market volatility recently.

Still, we expect Quebec bond yields to remain lower than in most other provinces. Quebec's long-term bonds have traded through Ontario's since mid-2017, and spreads over other countries' bond yields remained narrow during the height of the pandemic and in the immediate aftermath of the Silicon Valley Bank collapse. At least partly, this reflects the benefits of a large, liquid and diversified borrowing program. It also illustrates the benefits of debt reduction efforts, and of the achievement of budget targets in recent years.