

Fall 2006



# Update

on Québec's Economic  
and Financial Situation

**Update on Québec's Economic and Financial Situation  
Fall 2006**

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## **Message from the Minister of Finance**

Today, the Québec government is providing an update on the economic and financial situation chiefly to satisfy its commitment to improve transparency in public finances.

In the 2006-2007 Budget Speech, I undertook to publish a monthly report on financial transactions. We have acted on that commitment and now Quebecers can follow the government's financial situation on a regular basis. In fact, the monthly report on financial transactions as at August 31, 2006 is being released along with this document. Québec is the first province to display this degree of transparency.

Last March, I also undertook to provide an update, during the fall, on Québec's economic and financial situation. This document discusses the performance of Québec's economy and public finances for 2006-2007. It also shows the progress that has been made.

Since 2003, we have been very rigorous in managing public finances. We have limited growth in public spending to 3.9% per year, the second-lowest growth in Canada. And we have accomplished this while reinvesting in Quebecers' priorities, namely health, education, infrastructures, the regions and families. We have set up the Generations Fund so that finally Québec can deal with its debt load. We have modernized the state and reduced Quebecers' tax burden.

These efforts have been acknowledged. Last June, the credit rating agencies Moody's of New York and DBRS of Toronto raised Québec's credit rating, returning it to its level during the second half of the 1980s.

Nonetheless, the international economic situation is uncertain. Québec must remain vigilant and the government must stay the course to foster prosperity while continuing to manage public monies rigorously.

Michel Audet



## Summary

The Update on Québec's Economic and Financial Situation presents the adjusted financial framework for 2006-2007 and the new economic outlook. It also shows the results of the management of Québec's public finances.

### **Public finances: continued rigorous management**

The government is achieving its objectives regarding public finances. Continued rigorous management and a balanced budget remain the Québec government's priorities.

#### ***Balanced budget in 2005-2006***

The preliminary results for 2005-2006 given in the 2006-2007 Budget indicated that the budget would be balanced. The financial statements tabled today confirm this. The final results for 2005-2006 show a small surplus of \$37 million.

Budgetary revenue is adjusted upward in particular because of year-end strength in corporate tax revenues.

However, additional spending of \$315 million has been recorded, in particular because of a new valuation of the actuarial liability of the retirement plans for government and public sector employees. The government has also adjusted certain accounting allowances to improve the quality of financial information and, in certain cases, satisfy the requirements of the Auditor General. These allowances concern doubtful accounts of Revenu Québec and losses on guaranteed financial initiatives in the case of Investissement Québec. In addition, the government has taken into account the additional impact of the June 2006 pay equity agreements with its employees.

#### ***2006-2007: the budget remains balanced***

The updated financial framework indicates that the budget will remain balanced in 2006-2007, with a surplus of \$21 million currently forecast.

The government's revenues are adjusted upward by \$462 million in particular because of additional profits from Hydro-Québec's sale of its interest in Transelec Chile, additional revenues from federal transfers arising from measures announced in the May 2006 federal budget, and tax revenues greater than those forecast so far, confirming that the economy is in good shape.

**MAIN ADJUSTMENTS TO THE GOVERNMENT'S FINANCIAL FRAMEWORK IN  
2006-2007 SINCE THE 2006-2007 BUDGET SPEECH**

(Millions of dollars)

	<b>2006-2007<sup>P</sup></b>
<b>BUDGETARY BALANCE SHOWN IN THE 2006-2007 BUDGET</b>	<b>0</b>
<b>ADJUSTMENTS TO BUDGETARY REVENUE</b>	
- Adjustments to own-source revenue, excluding government enterprises	130
- Sale of Hydro-Québec's interest in certain corporations	869
- Deposit to the Generations Fund	- 500
	<u>369</u>
- Government enterprises, excluding Hydro-Québec	- 154
- Federal transfers: impact of the May 2006 federal budget	117
- <b>Total</b>	<b>462</b>
<b>ADJUSTMENTS TO BUDGETARY EXPENDITURE</b>	
<b>Program spending</b>	
- New actuarial valuation of the retirement plans	- 60
- Increase in allowance for doubtful accounts at Revenu Québec	- 193
- Increase in allowance for losses on guaranteed financial initiatives at Investissement Québec	- 48
- Pay equity	
▪ Additional impact of the June 2006 agreements	- 76
▪ Self-funding of the June 2006 agreements	76
	<u>0</u>
- <b>Subtotal</b>	<b>- 301</b>
<b>Debt service</b>	<b>0</b>
<b>Total</b>	<b>- 301</b>
<b>ADJUSTMENTS TO CONSOLIDATED ORGANIZATIONS</b>	<b>- 140</b>
<b>ADJUSTED BUDGETARY BALANCE FOR THE PURPOSES OF THE BALANCED BUDGET ACT</b>	<b>21</b>

P: Projected.

Expenditure is up by \$301 million because of the recurrence of adjustments to expenditure regarding the retirement plans and allowances for losses on guaranteed financial initiatives and on doubtful accounts at Revenu Québec which were recorded at the closing of the 2005-2006 financial statements.

### □ Continued rigorous spending management

The financial framework is based on growth in program spending of 3.9% in 2006-2007, i.e. the growth forecast in the budget last March.

With the exception of the adjustments to spending mentioned above, no other increase has been allowed. Accordingly, the various pressures on spending will be funded from the forecast growth in spending.

- Note that with the pay equity agreements reached last June, the government is granting overall an additional pay increase of \$1 billion from now until 2009-2010 to some 360 000 people, compared to what had been forecast in the financial framework of the budget last March.
- In addition, in response to the major difficulties the forest industry is currently experiencing, the government will implement measures to assist the workers, communities and companies affected.

The government is thus staying the course regarding rigorous spending management.

### □ Additional deposit of \$500 million in the Generations Fund

In addition, acting under the provisions of the legislation regarding debt retirement and creating the Generations Fund, the government will deposit an additional \$500 million in the Generations Fund from the gain arising from Hydro-Québec's sale of its interest in Transelec Chile.

Including the returns it will generate, this deposit will reduce the debt by an additional \$2 billion by March 31, 2026. As a result of this decision, the balance in the Generations Fund will approach \$600 million by March 31, 2007, confirming the government's commitment to reduce the debt burden for the benefit of future generations.

### ***2007-2008: continued budgetary rigor and a budget that remains balanced***

For 2007-2008, the government intends to keep the budget balanced in accordance with the policy it has followed since 2003-2004.

Accordingly, the government will continue to manage spending rigorously while investing in Québec's major priorities, particularly health, education, infrastructures, families and reducing the tax burden.

The next budget will present the financial situation for 2007-2008 and 2008-2009.

## **Québec's economy: slight downward revision to forecast growth**

Overall, with the exception of some sectors like lumber, Québec's economy is doing well despite a difficult international context characterized by high prices for petroleum products, a strong dollar, greater competition from emerging countries in Asia and an expected slowdown in the American economy. In particular, consumer demand and business investment remain high, which support employment and tax revenues.

### ***Dynamic domestic demand***

In 2005, households increased their purchases of goods and services by 3.5% in real terms, the best performance in six years. This performance is attributable in particular to the tax cuts made by governments and the strength of employment.

This year and next, real consumption by households should grow even more than forecast in the 2006-2007 Budget. In addition, the pay equity settlement will improve the financial situation of many thousands of government sector employees.

The difficult situation of the forest sector should not obscure the fact that, in Québec, the context currently favours investment: profits are rising and the capacity utilization rate is very high in many industrial sectors such as primary metals, machines and computer products.

In addition, the strong Canadian dollar encourages the purchase of machinery and equipment that to a large extent is imported from the United States. Accordingly, businesses are expected to increase their investments by 7.1% in 2006.

Furthermore, sustained by good economic growth, job creation should remain close to an annual level of 50 000 jobs from now to 2007. In this context, the unemployment rate is expected to be near 8% in 2007.



## ***A constraining international environment***

After declining from 2001 to 2003, exports reversed trend and began growing in 2004. However, the strong Canadian dollar, greater competition from China on the US market and the expected slowdown in American economic growth next year will restrict export gains. Export growth is accordingly expected to range between 3% and 4% from now until 2007, which is less than what was forecast in the last budget.

Whereas the 2006-2007 Budget forecast that Québec's economy would grow by 2.5% in 2006 and 2.4% in 2007, recent economic developments indicate that these forecasts will have to be reduced to 2% in 2006 and 2007.

Nonetheless, at 4.4% in 2006 and 2007, nominal GDP growth is revised upward compared to the last budget. These adjustments to nominal growth will help support the government's tax revenues despite the slowdown in real economic growth.

### **QUÉBEC'S ECONOMIC OUTLOOK**

(Percentage change)

	<b>2005</b>	<b>2006</b>	<b>2007</b>
<b>Gross domestic product</b>	3.9	4.4	4.4
— 2006-2007 Budget	4.5	4.2	4.0
<b>Real gross domestic product</b>	2.2	2.0	2.0
— 2006-2007 Budget	2.2	2.5	2.4
<b>Consumption</b>	3.5	3.2	3.0
— 2006-2007 Budget	3.7	2.7	2.3
<b>Housing starts</b> (thousands)	50.9	45.5	38.5
— 2006-2007 Budget	50.9	42.9	38.1
<b>Exports</b>	2.5	2.7	3.9
— 2006-2007 Budget	3.8	4.2	4.7
<b>Canadian dollar</b> (US¢)	82.5	88.6	86.2
— 2006-2007 Budget	82.5	85.1	81.6
<b>Price of a barrel of crude oil</b> (US\$)	57	68	62
— 2006-2007 Budget	57	62	62



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## **Introduction**

In 2003, the Québec government undertook to inform Quebecers as accurately and as clearly as possible on the state of public finances.

Last March, the 2006-2007 Budget Speech announced the publication of monthly reports on financial transactions and the publication, during the fall, of an economic and financial update for 2006-2007, along with an update on tax expenditures.

Today, the purpose of Update on Québec's Economic and Financial Situation is to set out:

- the adjustments to the financial framework since last spring;
- the adjustments to the economic scenario since the last budget;
- the progress made in achieving the government's major objectives regarding public finances.

Moreover, the government is tabling the 2005-2006 Public Accounts in the National Assembly today, and releasing an updated report on tax expenditures.



## **1. Update to the Financial Framework**

The 2006-2007 Budget tabled last March forecast a balanced budget for fiscal years 2005-2006 to 2007-2008.

Achieving a balanced budget depended on rigorous spending management. Spending growth was forecast to be limited to 3.9% in 2006-2007, less than the growth in nominal GDP.

The budget also initiated an unprecedented effort to reduce the debt burden with the creation of the Generations Fund. This fund, which receives income in particular from royalties on water power, will reduce the debt burden to 25% of GDP by 2025.

Since last spring, a number of developments have had an impact on the government's financial framework, in particular:

- the changes in the economic situation (described later in this document);
- the results of fiscal year 2005-2006;
- the measures of the May 2006 federal budget;
- Hydro-Québec's sale of its interest in Transelec Chile;
- the pay equity agreements with government and public sector employees.

Although these developments have a significant impact on the government's financial framework, they do not jeopardize the achievement of a balanced budget.

Indeed, the government has applied and will continue to apply rigorous spending management, while keeping fully to the objective for spending growth announced in the last budget for 2006-2007.

## Final results for 2005-2006: a surplus of \$37 million

The 2005-2006 Public Accounts, tabled today in the National Assembly, confirm that the budget was balanced in 2005-2006. In fact, the final results show a small surplus of \$37 million.

TABLE 1

### ADJUSTMENTS TO THE GOVERNMENT'S FINANCIAL FRAMEWORK IN 2005-2006 SINCE THE 2006-2007 BUDGET SPEECH (Millions of dollars)

	2005-2006
<b>BUDGETARY BALANCE FOR 2005-2006 SHOWN IN THE 2006-2007 BUDGET</b>	<b>0</b>
<b>ADJUSTMENTS TO BUDGETARY REVENUE</b>	
<b>Own-source revenue</b>	
- Corporate taxes	402
- Consumption taxes	- 210
- Other	75
- <b>Subtotal</b>	<b>267</b>
<b>Federal transfers</b>	- 3
<b>Total</b>	<b>264</b>
<b>ADJUSTMENTS TO BUDGETARY EXPENDITURE</b>	
<b>Program spending</b>	
- New actuarial valuation of the retirement plans	- 60
- Increase in the allowance for doubtful accounts at Revenu Québec	- 122
- Increase in the allowance for losses on guaranteed financial initiatives at Investissement Québec	- 68
- Additional impact of the June 2006 pay equity agreements	- 108
- Other	68
- <b>Subtotal</b>	<b>- 290</b>
<b>Debt service</b>	
- New actuarial valuation of the retirement plans	-93
- Other	68
- <b>Subtotal</b>	<b>-25</b>
<b>Total</b>	<b>- 315</b>
<b>ADJUSTMENTS TO CONSOLIDATED ORGANIZATIONS</b>	<b>88</b>
<b>BUDGETARY BALANCE FOR 2005-2006 SHOWN IN THE PUBLIC ACCOUNTS</b>	<b>37</b>



### ***Budgetary revenue greater than expected at year-end***

Compared to the forecast of the March 2006 budget, budgetary revenue is adjusted upward by \$264 million. The adjustments are attributable, in particular, to higher revenue on account of corporate income tax, reflecting the strength of corporate profits in recent years.

On the other hand, revenues from consumption taxes were lower than forecast in the last budget in particular because of lower sales of tobacco products and the effect of higher prices on fuel sales.

The other adjustments mainly reflect improved revenues from mining royalties.

### ***An upward adjustment to expenditure***

The financial statements also show expenditure up by \$315 million since the budget last March. These adjustments reflect the impact of the new actuarial valuation of the liability for retirement plans of government and public sector employees, as well as certain accounting adjustments that enable the government to improve the quality of budgetary information and, in certain cases, comply with the requirements of the Auditor General.

#### **□ New actuarial valuation of the liability for retirement plans**

A new actuarial valuation of the liability for the eight largest retirement plans, including the Government and Public Employees Retirement Plan (RREGOP) and the Pension Plan of Management Personnel (RRPE), was carried out. Following this valuation, the expense relating to the retirement plans for the public and parapublic sectors is adjusted upward by \$153 million in 2005-2006.

Program spending relating to the retirement plans is adjusted upward by \$60 million because of the increase in the value of the actuarial liability. The new actuarial valuation also results in an increase in debt service of \$93 million chiefly because of the upward adjustment to the interest rate applied to the actuarial liability.<sup>1</sup>

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<sup>1</sup> The interest rate applied to the actuarial liability corresponds to the discount rate used in the actuarial valuation to calculate the present value of benefits for which the government is responsible and which will be paid in the future.

TABLE 2

**IMPACT ON BUDGETARY EXPENDITURE OF THE NEW ACTUARIAL VALUATION OF THE RETIREMENT PLANS**

(Millions of dollars)

	<b>2005-2006</b>
Program spending	– 60
Debt service	– 93
<b>TOTAL</b>	<b>– 153</b>

**☐ Adjustments to expenditure to improve the quality of budgetary information**

The government has recently stepped up its efforts to combat tax evasion, in particular, by intensifying the tax control activities of Revenu Québec. These activities have resulted in more assessments being issued and an increase in the government's revenues. On the other hand, the expense for doubtful accounts has been raised by \$122 million to reflect the risks inherent in recovering these debts.

In addition, the allowance for losses on the government's guaranteed financial initiatives has been adjusted upward by \$68 million since the budget last March to better reflect the risk incurred by the government. This allowance is now adjusted annually, taking into account past experience and the available information relating to Investissement Québec's portfolio of financial interventions.

**☐ Pay equity agreements**

Moreover an additional amount of \$108 million has been recorded in the financial statements for 2005-2006 regarding the period 2001-2002 to 2005-2006 to reflect the agreements reached in June 2006 with government and public sector employees concerning pay equity.

## **Response to the Auditor General's comments**

Since it took office, the government has acted to improve the quality of financial information disclosed in its financial statements, thereby acting on some of the restrictions and comments previously formulated by the Auditor General in his report accompanying the government's financial statements.

The Québec government has in particular:

- changed its method of accounting for transfer revenue from the federal government by adopting accrual accounting rather than cash accounting;
- made changes to better fund the allowance for losses on guaranteed financial initiatives.

The government's objective is to provide the public with the most accurate financial information possible. Other changes may be made in the future if they prove relevant and necessary.

In his opinion accompanying the publication of the 2005-2006 Public Accounts, the Auditor General issued two restrictions. The Auditor General is of the view that:

- the Québec government's reporting entity is incomplete since it does not include the financial data of entities of the health and education networks;
- some accounting practices used to prepare the government's consolidated financial statements differ from the generally accepted accounting principles (GAAP) formulated by the Canadian Institute of Chartered Accountants (CICA).

The government does not agree with these two restrictions.

- Concerning the reporting entity, it is important to note that the question of the inclusion of the health and education networks in the government reporting entity raises complex issues. To determine whether the results of these networks should be incorporated with those of the government, many criteria must be evaluated, in particular the degree of independence regarding the management of operations.

In the case of these networks, the government considers that it is not required to include them in its reporting entity since it does not have the authority to appoint a majority of the members of the boards of directors or the chief executive officers of these entities and, consequently, they enjoy complete independence in the management of their financial resources. However, it is important to note that since fiscal year 2003-2004 the government has provided information on their financial situation in an appendix to the financial statements.

- As for the accounting practices, governments can adopt their own accounting practices for the preparation of their financial statements. Nonetheless, the government is always prepared to consider the standards recommended by the CICA. Accordingly, for the 1997-1998 accounting reform and, this year, with the accounting for government of Canada transfers, the government drew on the standards recommended by the CICA to establish its new accounting practices.

The Auditor General of Québec has recently raised various issues regarding the Balanced Budget Act. The ministère des Finances is sensitive to the Auditor General's concerns and will act to dispel any ambiguity as to the scope of the Act, without reducing the rigor it imposes on the management of public finances.

TABLE 3

**OPINION OF THE AUDITOR GENERAL ON THE FINANCIAL STATEMENTS**

RESTRICTIONS AND COMMENTS REGARDING THE FINANCIAL STATEMENTS	OPINION OF THE AUDITOR GENERAL	ACTIONS TAKEN AND GOVERNMENT COMMENTS
<b>Improvements made</b>		
1) The government has not revaluated its actuarial obligations and its liability for the retirement plans.	Restriction in 2004-2005.	The government has produced new actuarial valuations.
2) The government does not use an appropriate method to calculate allowances for losses on guaranteed financial initiatives.	Restriction since 1998-1999.	The government has improved its calculation method.
3) The government does not adequately recognize debts arising from government of Canada transfer revenues.	Comments since 2003-2004.	As recommended, the government now applies accrual accounting for these revenues.
<b>Differences of opinion</b>		
4) The government does not include entities of the health and education networks in its reporting entity.	Restriction in 1998-1999 and since 2001-2002.	The government has presented the information on the networks in an appendix to the financial statements since 2003-2004. These networks are completely independent regarding the management of their financial resources.
5) The government has not adopted the CICA's guidelines for determining its accounting practices.	Comments in 2003-2004 and 2004-2005 and restriction in 2005-2006.	As in the past, the government continues to use its capacity to define its own accounting practices.

## The budget remains balanced in 2006-2007

The update to the financial framework indicates that the budget remains balanced in 2006-2007, with a surplus of \$21 million currently forecast.

The government's revenue is adjusted upward by \$462 million because, in particular, of the additional profits from Hydro-Québec's sale of its interest in Transelec Chile, additional revenues from federal transfers arising from measures announced in the May 2006 federal budget, as well as slightly higher tax revenues despite the downward adjustment to economic growth.

Expenditure is up by \$301 million because of the recurrence of adjustments to expenditure regarding the retirement plans and allowances for losses on guaranteed financial initiatives, as well as doubtful accounts at Revenu Québec that were recorded at the closing of the 2005-2006 financial statements.

With the exception of the expenses mentioned above, no increase is allowed.

- Consequently, the additional cost arising from the pay equity agreements reached last June and the spending pressures will be funded within forecast expenditure growth.
- Note that with the pay equity agreements reached last June, the government is granting overall an additional pay rise of \$1 billion from now until 2009-2010 to some 360 000 people, compared to what was forecast in the financial framework of the budget last March.

Accordingly, the financial framework for 2006-2007 is based on program spending growth of 3.9%, i.e. the increase forecast in the budget last March. The government is staying the course regarding spending management.

Lastly, the government will make an additional deposit of \$500 million in the Generations Fund from the gain arising from Hydro-Québec's sale of its interest in Transelec Chile. Including the returns it will generate, this deposit will reduce the debt by an additional \$2 billion by March 31, 2026. This decision will allow the Fund's balance to reach almost \$600 million by March 31, 2007, confirming the government's commitment to reduce the debt burden for the benefit of future generations.

TABLE 4

**MAIN ADJUSTMENTS TO THE GOVERNMENT'S FINANCIAL FRAMEWORK IN 2006-2007 SINCE THE 2006-2007 BUDGET SPEECH**  
(Millions of dollars)

	<b>2006-2007<sup>P</sup></b>
<b>BUDGETARY BALANCE SHOWN IN THE 2006-2007 BUDGET</b>	<b>0</b>
<b>ADJUSTMENTS TO BUDGETARY REVENUE</b>	
- Adjustments to own-source revenue, excluding government enterprises	130
- Sale of Hydro-Québec's interest in certain corporations	869
- Deposit in the Generations Fund	- 500
	<u>369</u>
- Government enterprises, excluding Hydro-Québec	- 154
- Federal transfers: impact of the May 2006 federal budget	117
- <b>Total</b>	<b>462</b>
<b>ADJUSTMENTS TO BUDGETARY EXPENDITURE</b>	
<b>Program spending</b>	
- New actuarial valuation of the retirement plans	- 60
- Increase in allowance for doubtful accounts at Revenu Québec	- 193
- Increase in allowance for losses on guaranteed financial initiatives at Investissement Québec	- 48
- Pay equity	
▪ Additional impact of the June 2006 agreements	- 76
▪ Self-financing of the June 2006 agreements	76
	<u>0</u>
- <b>Subtotal</b>	<b>- 301</b>
<b>Debt service</b>	<b>0</b>
<b>Total</b>	<b>- 301</b>
<b>ADJUSTMENTS TO CONSOLIDATED ORGANIZATIONS</b>	<b>- 140</b>
<b>ADJUSTED BUDGETARY BALANCE FOR THE PURPOSES OF THE BALANCED BUDGET ACT</b>	<b>21</b>

P: Projected.

## **Adjustments to budgetary revenue in 2006-2007**

### **□ Own-source revenue excluding government enterprises**

The discussion of the economic situation given in Section 2 of this document shows that forecast economic growth for Québec in 2006 and 2007 is adjusted slightly downward. However, the bulk of these adjustments stems from weakness in exports; the main components of domestic demand remain vigorous. This is reflected in upward adjustments to wages and salaries, consumption and corporate profits.

Accordingly, the adjustments to the tax bases and the recurrence of the adjustments made at the closing of the 2005-2006 financial statements result in an upward adjustment to own-source revenue, excluding government enterprises, of \$130 million compared to the forecasts of the budget last March.

TABLE 5

#### **ADJUSTMENTS TO OWN-SOURCE REVENUE EXCLUDING GOVERNMENT ENTERPRISES SINCE THE 2006-2007 BUDGET**

(Millions of dollars)

	<b>2006-2007<sup>P</sup></b>
Corporate taxes	170
Personal income tax	85
Retail sales	- 50
Tobacco	- 75
<b>TOTAL ADJUSTMENTS</b>	<b>130</b>

P: Projected.

Concerning the main sources of revenue, these adjustments are essentially attributable to:

- An increase of \$170 million in revenues from corporate taxes. This adjustment reflects in part the recurrence of revenues received at the end of 2005-2006.
- An upward adjustment to salaries leading to a positive adjustment to personal income tax of \$85 million. This adjustment also reflects the impact of changes to the tax treatment of trusts under new provisions announced last June as well as the additional impact of the June 2006 pay equity agreements.
- Despite the rise in consumption, the delay noted in tax receipts since the beginning of the year for the QST has resulted in a downward adjustment of \$50 million. This adjustment results, in particular, from higher growth in input tax rebates.

- Lastly, revenues from the tobacco tax are revised downward by \$75 million. This adjustment results from the impact of the implementation of new provisions of the Tobacco Act, introduced last May, on sales of tobacco products. It may also reflect the rise in smuggling of these products.

#### **☐ Revenue from government enterprises**

Hydro-Québec sold its interests in a number of corporations for a total of \$869 million, most of which stems from the sale of its interest in Transelec Chile for an estimated \$855 million.<sup>2</sup> The gain resulting from this transaction may be revised once it is finalized.

Profits of government enterprises, other than Hydro-Québec, are adjusted downward by \$154 million to reflect, in particular, the reduction in the profits of Loto-Québec because of a decline in the use of video lottery terminals.

#### **☐ Impact of the 2006 federal budget on federal transfers**

Compared to the forecast in the 2006-2007 Budget, revenues from federal transfers to Québec are adjusted upward by \$117 million. This adjustment stems from decisions announced by the new federal government in its May 2, 2006 budget.

First, because of the use of the latest economic and tax data, Québec's equalization entitlements have been adjusted upward by \$185 million.

Second, the changes the federal government has made to federal personal income tax will reduce revenue from federal transfers to Québec by \$70 million in 2006-2007. The changes made to federal income tax raise the value of the special Québec abatement (16.5%) a portion of which is subtracted from cash transfers for health, post-secondary education and other social programs and, for the rest, refunded to the federal government on account of the former youth allowance program.

Lastly, the federal government also announced that it would set up four trusts for post-secondary education infrastructure, public transit infrastructure, affordable housing and housing for off-reserve natives. Québec's share of these trusts amounts to \$577 million and must be used by March 31, 2009.

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<sup>2</sup> The Monthly Report on Financial Transactions as at June 30, 2006 showed an estimated gain of \$806 million.



## ***Continued rigorous spending management***

The financial framework is based on growth in program spending of 3.9% in 2006-2007, i.e. the increase forecast in the budget last March.

Apart from the adjustments to expenditures made at the closing of the 2005-2006 financial statements, no other increase is allowed. The government is staying the course regarding spending management.

TABLE 6

### **PROGRAM SPENDING GROWTH OBJECTIVE IN THE 2006-2007 BUDGET SPEECH**

(Millions of dollars)

	2005-2006	2006-2007 <sup>P</sup>
<b>PROGRAM SPENDING OBJECTIVE IN THE 2006-2007 BUDGET</b>	<b>48 940</b>	<b>50 873</b>
<i>% growth</i>	2.7	3.9
<b>Adjustments</b>		
– New actuarial valuation of the retirement plans	60	60
– Increase in allowance for doubtful accounts at Revenu Québec	122	193
– Increase in allowance for losses on guaranteed financial interventions at Investissement Québec	68	48
– Pay equity		
▪ Additional impact of the June 2006 agreements	108	76
▪ Self-financing of the June 2006 agreements	—	– 76
– Other	– 68	—
– <b>Total</b>	<b>290</b>	<b>301</b>
<b>PROGRAM SPENDING OBJECTIVE, FALL 2006</b>	<b>49 230</b>	<b>51 174</b>
<i>% growth</i>	3.3	3.9

P: Projected.

## □ Pay equity agreements with government and public sector employees

Last June, the Québec government reached an agreement with its employees on pay equity. Overall, some 360 000 people, mainly women, will receive pay rectifications on account of equity. The amounts due are retroactive to November 21, 2001 and bear interest.

The financial framework of last March included \$390 million in 2005-2006 to fund the pay rectifications. Thereafter, \$457 million was stipulated. An amount of \$673 million had been entered in the 2004-2005 financial statements for the period from November 21, 2001 to March 31, 2005.

The agreements reached by the government and its employees will ultimately mean a recurring cost of \$825 million, i.e. \$368 million more than forecast in the financial framework of the last budget. From now to 2009-2010, more than \$1 billion will be paid to government and public sector employees.

TABLE 7

### IMPACT OF THE JUNE 2006 PAY EQUITY AGREEMENTS ON GOVERNMENT SPENDING

(Millions of dollars)

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Amounts funded in the 2006-2007 Budget	673 <sup>1</sup>	390	457	457	457	457
June 2006 agreements	707	464	533	630	744	825
<i>Difference</i>	<b>34</b>	<b>74</b>	<b>76</b>	<b>173</b>	<b>287</b>	<b>368</b>

<sup>1</sup> Allowance entered in the 2004-2005 Public Accounts to cover the period from November 21, 2001 to March 31, 2005.

Because of the size of these adjustments, the government consulted with all the unions beforehand to inform them of its decision to ask the Commission de l'équité salariale that the payments be spread over seven years, namely from November 21, 2001 to November 21, 2008. Given the size of the amounts involved, the major labour organizations indicated to the government that they would abide by the decision of the Commission.

The Commission is currently studying the government's request. Spreading the pay equity rectifications over seven years would enable the government to comply with both the Pay Equity Act and the Balanced Budget Act.

In 2006-2007, the agreements between the Québec government and its employees will produce additional spending pressure of \$76 million. As indicated above, this additional cost will be funded from the forecast growth in spending, i.e. 3.9%. For subsequent years, the government will generate the leeway needed to fund this new spending.

**☐ Responding to the challenges of forest sector workers, companies and communities**

In addition, in response to the major difficulties the forest industry is currently experiencing, the government will implement measures to assist the workers, communities and companies affected.

***Debt service of the Consolidated Revenue Fund***

Forecast debt service remains unchanged from the amount included in the 2006-2007 Budget. The effect of short-term interest rates that are higher than forecast in the last budget is offset by the impact of a variety of factors: new actuarial valuation of the retirement plans, lower medium and long-term interest rates and the Canadian dollar's better performance versus the American dollar and the yen.

***Additional deposit of \$500 million in the Generations Fund***

As indicated above, Hydro-Québec's sale of its interests in certain corporations produced a gain of \$869 million, including an estimated \$855 million for the sale of its interest in Transelec Chile.

In view of the importance of accelerating the reduction of the burden of Québec's public debt, the government has decided to deposit an additional \$500 million into the Generations Fund from the gain realized by Hydro-Québec on this sale. This decision is logical and responsible given that:

- these revenues are not recurring;
- under the legislation on debt retirement and the Generations Fund, the government can pay part of the proceeds of asset sales into the Fund.

The decision to invest an additional \$500 million in the Generations Fund will have a major multiplier effect since the money will be invested by the Caisse de dépôt et placement du Québec and will grow at a higher rate of return than the one paid by the government on its borrowings. This decision will add almost \$600 million to the Fund's balance by March 31, 2007, confirming the government's commitment to reduce the debt burden for the benefit of future generations.

TABLE 8

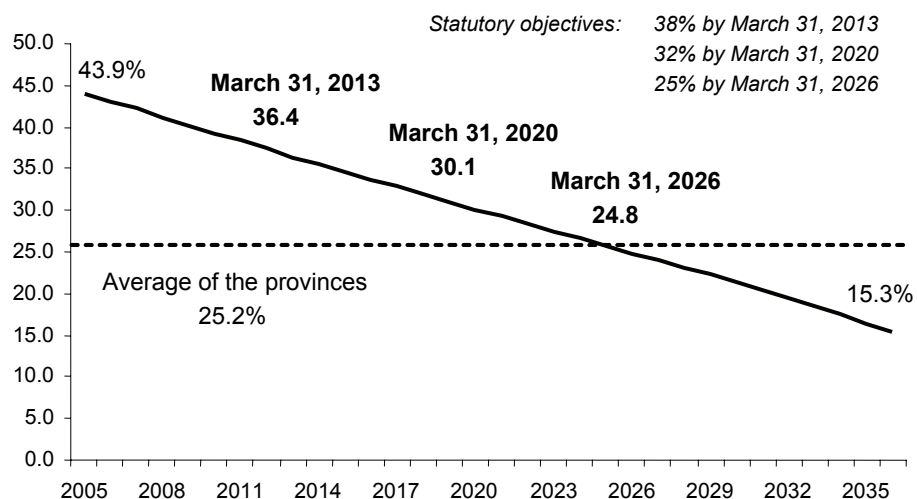
**ADDITIONAL DEPOSIT OF \$500 MILLION IN THE GENERATIONS FUND**  
(Millions of dollars)

	<b>Balance as at March 31, 2007</b>
<b>2006-2007 BUDGET</b>	74
<b>NEW DEPOSITS</b>	
- Unclaimed property managed by the ministère du Revenu	5
- Additional deposit of \$500 million	500
<b>TOTAL</b>	<b>579</b>

Accordingly, this deposit will contribute to achieving the objectives set in the legislation. By March 31, 2026, Québec's debt is forecast to represent 24.8% of GDP, less than the target of 25% of GDP stipulated in the legislation. Including this new deposit, more than \$32 billion will be accumulated in the Generations Fund by March 31, 2026.

CHART 1

### REDUCTION OF THE DEBT BURDEN (Per cent)



Source: Ministère des Finances du Québec.

## The budget will remain balanced in 2007-2008

For 2007-2008, the government intends to keep the budget balanced, in accordance with the policy followed since 2003-2004.

Accordingly, the government will continue to manage spending tightly while continuing to honour its commitment to invest in Québec's major priorities, in particular health, education, infrastructures, families and tax relief.

The next budget will present the financial situation for 2007-2008 and 2008-2009.

## Fiscal imbalance

Moreover, the Québec government continues to participate actively in efforts to correct the fiscal imbalance in Canada. As part of his May 2, 2006 budget, the federal Minister of Finance reiterated the federal government's commitment to "restore fiscal balance" in Canada and announced that the federal government would move ahead with financial proposals in its 2007 budget.

Since last spring, two very serious reports for the discussions concerning settlement of the fiscal imbalance have been released: first, the report by the Advisory Committee of the Council of the Federation on the fiscal imbalance and the, the report by the federal government's Expert Panel on Equalization. Federal and provincial Ministers of Finance discussed the measures to take to resolve the fiscal imbalance at their meeting last June. Another meeting is planned by the end of the fall.

## Results and detailed forecasts for 2005-2006 and 2006-2007

The following tables provide more detailed information on the major items that compose the government's adjusted financial framework.

TABLE 9

### THE GOVERNMENT'S FINANCIAL FRAMEWORK – FALL 2006

(Millions of dollars)

	2005-2006 <sup>1</sup>	2006-2007 <sup>P</sup>	% change
<b>BUDGETARY REVENUE</b>			
– Own-source revenue excluding government enterprises	41 189	42 477	3.1
– Revenue from government enterprises	4 554	4 973	9.2
– Total own-source revenue	45 743	47 450	3.7
– Federal transfers	9 969	10 913	9.5
– <b>Total</b>	<b>55 712</b>	<b>58 363</b>	<b>4.8</b>
<b>BUDGETARY EXPENDITURE</b>			
– Program spending	– 49 230	– 51 174	3.9
– Debt service	– 6 874	– 7 205	4.8
– <b>Total</b>	<b>– 56 104</b>	<b>– 58 379</b>	<b>4.1</b>
<b>NET RESULTS OF CONSOLIDATED ORGANIZATIONS</b>	<b>429</b>	<b>37</b>	<b>—</b>
<b>BUDGETARY BALANCE FOR THE PURPOSES OF THE BALANCED BUDGET ACT</b>	<b>37</b>	<b>21</b>	<b>—</b>
<b>Net results of the Generations Fund</b>	<b>—</b>	<b>579</b>	<b>—</b>
<b>CONSOLIDATED BUDGETARY BALANCE</b>	<b>37</b>	<b>600</b>	<b>—</b>
<b>Consolidated non-budgetary surplus (requirements)</b>	<b>– 246</b>	<b>– 1 972</b>	<b>—</b>
<b>CONSOLIDATED NET FINANCIAL SURPLUS (REQUIREMENTS)</b>	<b>– 209</b>	<b>– 1 372</b>	<b>—</b>

N.B. A negative amount indicates a financial requirement and a positive amount, a source of financing.

P: Projected.

1 The results for 2005-2006 differ from those shown in the public accounts because they are presented according to the 2006-2007 budgetary structure.

TABLE 10

**REVENUE OF THE CONSOLIDATED REVENUE FUND**  
 (Millions of dollars)

	2005-2006	2006-2007 <sup>P</sup>	% change
<b>OWN-SOURCE REVENUE</b>			
<b>Own-source revenue excluding government enterprises</b>			
– Income and property taxes			
▪ Personal income tax	16 449	17 394	5.7
▪ Contributions to the Health Services Fund	5 047	5 331	5.6
▪ Corporate taxes	4 787	4 519	– 5.6
– Consumption taxes	12 438	12 983	4.4
– Other sources	2 468	2 250	– 8.8
– <b>Total</b>	<b>41 189</b>	<b>42 477</b>	<b>3.1</b>
<b>Revenue from government enterprises</b>	<b>4 554</b>	<b>4 973</b>	<b>9.2</b>
<b>Total</b>	<b>45 743</b>	<b>47 450</b>	<b>3.7</b>
<b>FEDERAL TRANSFERS</b>			
– Equalization	4 798	5 539	15.4
– Transfers for health	3 185	3 570	12.1
– Transfers for post-secondary education and other social programs	1 034	1 020	– 1.4
– Other programs	952	784	– 17.6
– <b>Total</b>	<b>9 969</b>	<b>10 913</b>	<b>9.5</b>
<b>BUDGETARY REVENUE</b>	<b>55 712</b>	<b>58 363</b>	<b>4.8</b>

P: Projected.

TABLE 11

**EXPENDITURE OF THE CONSOLIDATED REVENUE FUND**  
(Millions of dollars)

	2005-2006	2006-2007 <sup>P</sup>	% change
<b>PROGRAM SPENDING</b>			
- Health and Social Services	20 821	22 130	6.3
- Education and Culture	12 845	13 520	5.3
- Economy and Environment	5 758	5 890	2.3
- Support for Individuals and Families	5 080	5 180	2.0
- Administration and Justice	4 726	4 454	- 5.8
- <b>Total</b>	<b>49 230</b>	<b>51 174</b>	<b>3.9</b>
<b>DEBT SERVICE</b>	<b>6 874</b>	<b>7 205</b>	<b>4.8</b>
<b>BUDGETARY EXPENDITURE</b>	<b>56 104</b>	<b>58 379</b>	<b>4.1</b>

P: Projected.



## 2. Economic Outlook

This section updates the economic forecasts used in the 2006-2007 Budget. This update provides the basis for the financial framework discussed in the first section.

Overall, global economic growth remains strong but is expected to moderate next year. However, Québec, which exports almost 40% of its gross domestic product (GDP) abroad, with the bulk shipped to the United States, will benefit little from the global vitality.

Specific factors limit the growth in Québec's exports, such as the strength of the Canadian dollar, China's growing presence on the markets of Québec companies and, for 2007, the expected slowdown in American economic growth.

Still, despite the difficult international context, Québec's economy is doing well. In particular, consumer demand and business investment remain high, supporting employment and tax revenues.

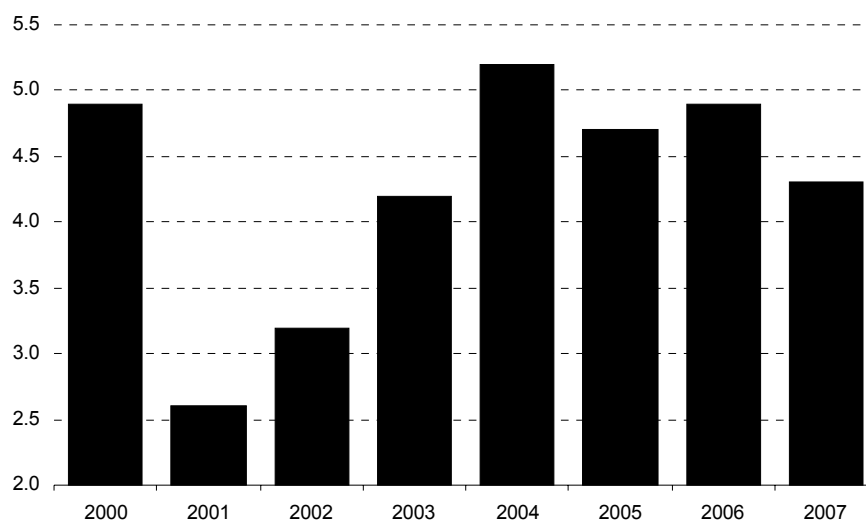
### The international economic context

#### *Economic growth will slow next year*

After hitting 4.7% in 2005, growth in global real GDP is expected to make further gains, rising to 4.9% in 2006.

CHART 2

#### **WORLD ECONOMIC GROWTH** (Real GDP, annual percentage change)



Sources: International Monetary Fund, Global Insight and ministère des Finances du Québec.

Economic growth has been particularly vigorous in the United States and China, the latter enjoying a substantial increase in its exports and investments. Japan and Europe are also extending the recovery that began in 2005. In these two economies, vigour in exports has spread to domestic demand. The strength of the global economy has been achieved in spite of certain factors:

- tighter monetary policy resulting in higher interest rates, in particular in Canada and the United States. These rises were justified by stronger inflationary pressures resulting from surging raw materials costs and higher capacity utilization rates;
- geopolitical uncertainties that continue to exert pressure on trade flows;
- high prices for energy, particularly oil.

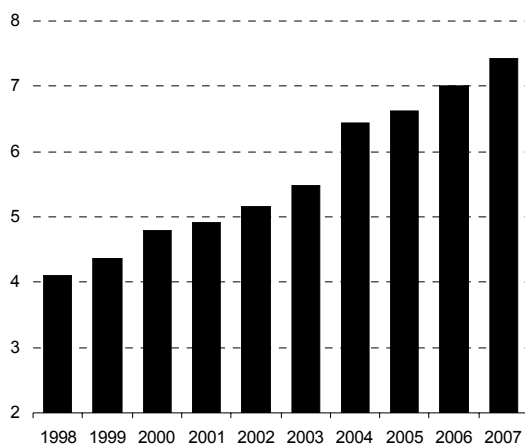
Looking forward, global economic growth should ease to 4.3% in 2007. The slowdown will be especially substantial in the United States, Japan and China. Nonetheless, the global economy will continue to expand faster than forecast in the last budget in 2006 and 2007, mainly because the slowdown in economic growth in Asian countries will be less pronounced.

### ▣ Crude oil prices will remain high

Vigorous global economic growth has helped push oil prices higher since 2003. The price of a barrel of WTI crude oil has risen more than 120%, averaging US\$67 since the beginning of the year.

CHART 3

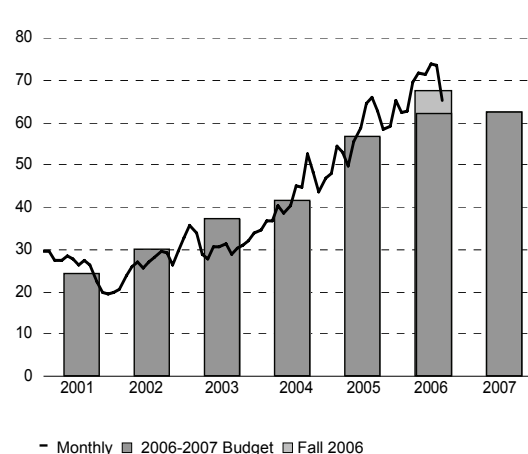
**STRONG CHINESE DEMAND FOR OIL**  
(Millions of barrels per day)



Source: International Energy Agency.

CHART 4

**THE PRICE OF OIL WILL REMAIN HIGH**  
(West Texas Intermediate, in US dollars)



Sources: Bloomberg and ministère des Finances du Québec.

China's rapid industrialization and the explosion in the number of cars in the country, together with strong American demand, have contributed strongly to pushing demand for oil higher. At the same time, delays in certain oil development projects have slowed supply growth that has not been enough to curb the rise in prices.

In addition, specific factors have accentuated pressure on prices over the past year. These include geopolitical uncertainty caused by the Iranian nuclear crisis, the conflict between Israel and Lebanon and the political situation in Nigeria.

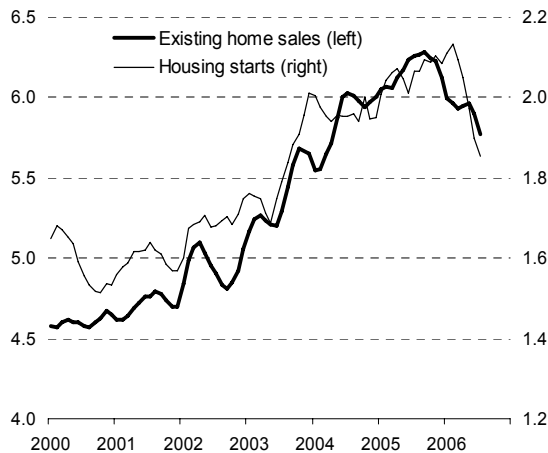
On the whole, despite the recent pullback, oil prices will remain high until the end of 2007, compared to the levels observed in the early 2000s, and will fluctuate around US\$60 per barrel. In 2006, prices will be US\$6 higher than those assumed in the last budget, while the forecast remains unchanged for 2007. Note that, in view of the great volatility in oil prices, there is no consensus among experts on the outlook. The most optimistic forecast a price of US\$50 next year while the most pessimistic expect prices to hit US\$77.

### Coming slowdown in American demand

Real American GDP rose 3.2% last year, sustained once again by strength in the housing market that has contributed indirectly to supporting consumer spending. The large increase in housing starts stimulated the purchase of durable goods, such as household appliances, while sharp increases in property values spurred mortgage refinancing and allowed households to withdraw substantial amounts of cash.

CHART 5

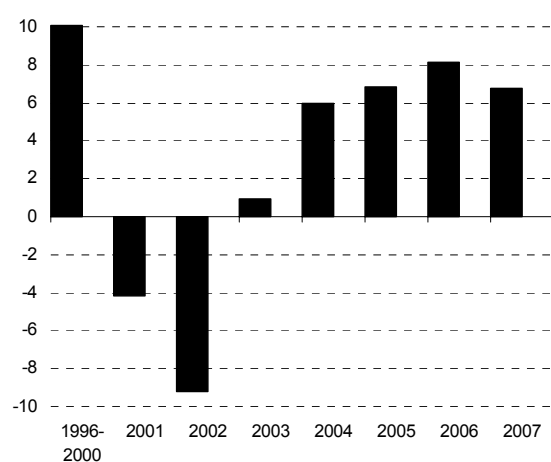
**DECLINE IN HOUSING STARTS AND HOUSE SALES IN 2006**  
(Volume, millions of units)



Source: Freddie Mac.

CHART 6

**ROBUST GROWTH IN 2006 IN NON-RESIDENTIAL INVESTMENT**  
(Per cent, in real terms)



Sources: Global Insight and ministère des Finances du Québec.

However, beginning this year, the residential sector is not expected to sustain American economic activity. Already, new and existing home sales are falling, as are new housing starts. In addition, property values have begun to stagnate. Economic growth could be reduced by 1% next year under the combined impact of the correction in residential investment and the resulting slower growth in consumer spending.

Nonetheless, the solid rise in non-residential investment will help mitigate the impact of the slowing real estate market on economic growth. Strong corporate profits will enable companies to increase their investments by more than 8% in 2006, the best performance since 2000, and by almost 7% in 2007.

In particular, investment in industrial and computer equipment will remain buoyant with rises of 8% in 2006 and 6% in 2007. In addition, the gradual reconstruction of civil infrastructures in New Orleans and oil infrastructures in the Gulf of Mexico will stimulate non-residential construction.

**□ The trade and budget deficits will remain large**

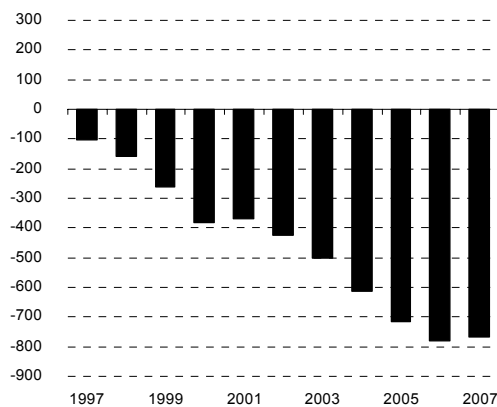
The US economy remains vulnerable because of major persistent imbalances.

First, the huge American trade deficit will grow in 2006 to US\$780 billion or 5.9% of GDP. This deficit will continue to be fuelled by imports of industrial and consumer goods from China. However, beginning in 2007, it will gradually decline as domestic demand moderates, reducing the rise in imports.

Second, the American budget deficit will persist over the coming years. It will reach US\$286 billion in 2007, or 2.1% of GDP.

CHART 7

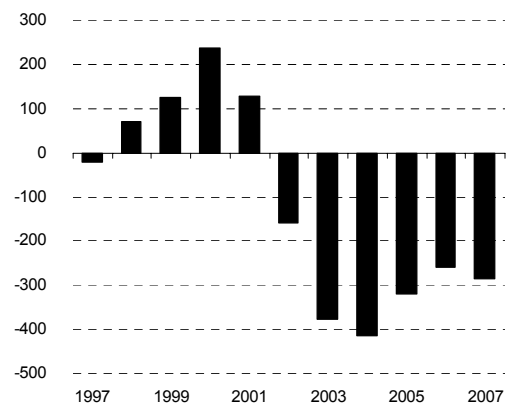
**AMERICAN TRADE DEFICIT**  
(Billions of US dollars)



Sources: Global Insight and ministère des Finances du Québec.

CHART 8

**AMERICAN BUDGET DEFICIT**  
(Billions of US dollars)



Source: Congressional Budget Office.

**□ A slight decline in the federal funds rate is expected**

Seeking to temper economic growth and purge inflationary pressures, the US Federal Reserve has raised the federal funds rate by 425 basis points since June 2004, bringing it to its current 5.25%.

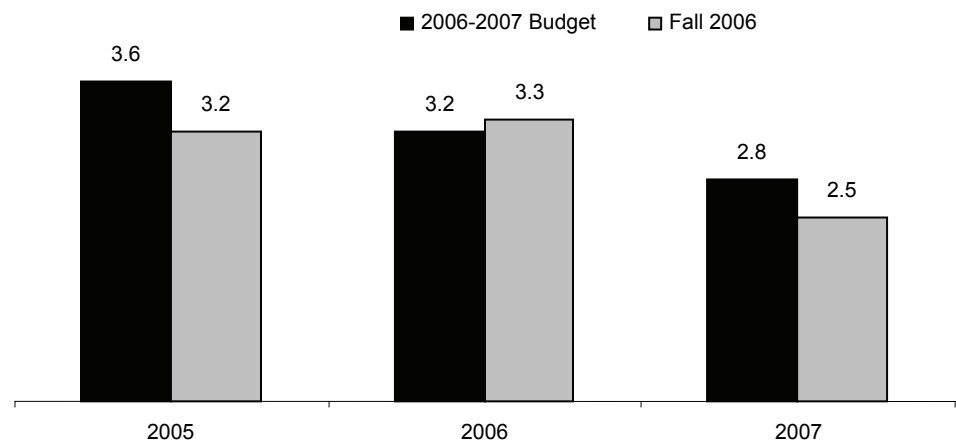
The easing of inflationary pressures, but especially more moderate economic growth in 2007, should leave room for the Federal Reserve to lower the fed funds rate by 50 points over the first half of 2007 to 4.75%.

**□ A more pronounced slowdown in economic growth is expected in 2007**

To sum up, American economic activity should grow by 3.3% in 2006. The slowdown in economic growth that began in the second half of 2006 will continue in 2007, reducing growth in real GDP to 2.5%. This is a downward adjustment of three tenths of a percentage point compared to the last budget, attributable to weaker household demand for consumer goods and properties.

CHART 9

**US ECONOMIC GROWTH**  
(Real GDP growth, per cent)



Sources: Global Insight and ministère des Finances du Québec.

## The Canadian economy

### *Good economic growth but unevenly distributed*

Real Canadian GDP rose 2.9% last year, sustained by strong growth in domestic demand, while export growth slowed as a result of a combination of unfavourable developments. These include the Canadian dollar's appreciation by more than 40% versus the American dollar since 2002 and China's growing presence on the markets of Canadian companies.

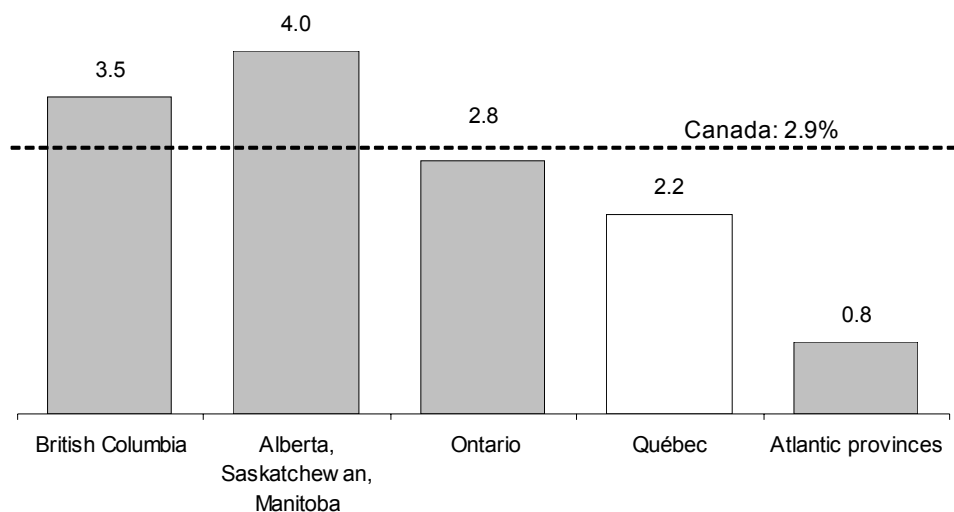
In particular, households enjoyed job gains and tax cuts. Personal spending grew 3.9% last year in real terms. It will reach 3.9% in 2006 and 3% in 2007.

In addition, high capacity utilization rates and the strength of the dollar encourage companies to purchase machinery and equipment, more than two thirds of which is imported. Accordingly, after rising 9.4% in real terms last year, total investment by companies will grow by 8.2% in 2006 and 4% in 2007.

However, the Canadian economy's strong growth masks significant disparities among the provinces. Accordingly, while for more than three years the manufacturing industry, found mainly in Central Canada, has been faced with rising competition and a stronger dollar, Western Canada has enjoyed rising demand for energy products, which has encouraged economic growth.

CHART 10

#### **UNEVEN ECONOMIC GROWTH AMONG THE PROVINCES – 2005** (Real GDP, percentage change)



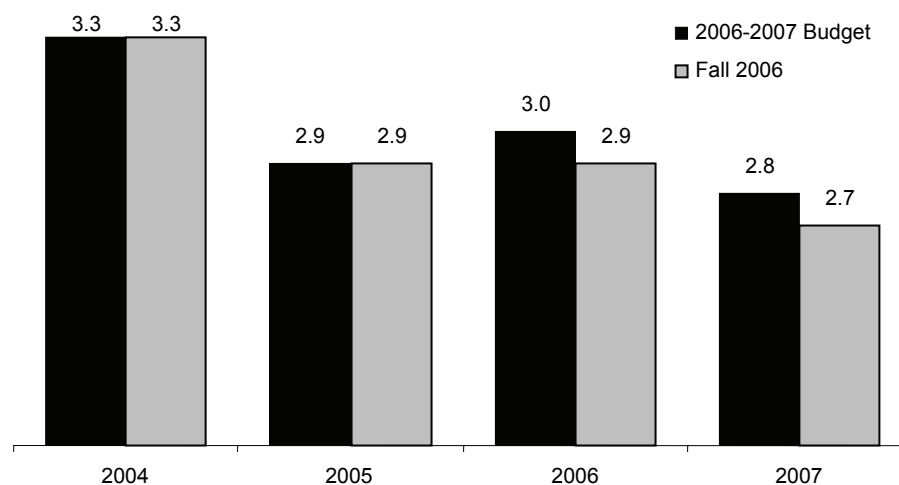
Source: Statistics Canada.

In particular, business investment has grown by an average of 11% in Alberta over the last three years, stimulated by major energy projects.

All in all, Canadian economic growth should reach 2.9% in 2006 and 2.7% in 2007, rates similar to what was forecast in the 2006-2007 Budget.

CHART 11

**GOOD ECONOMIC GROWTH IN CANADA**  
(Real GDP, annual percentage change)



Sources: Statistics Canada and ministère des Finances du Québec.

**Higher interest rates in Canada**

Faced with the risk of a resurgence in inflation related to very high capacity utilization rates, the Bank of Canada has raised the overnight lending rate by 225 basis points since the fall of 2004, bringing it to 4.25% currently. In late 2006, the Bank of Canada is expected to lower its leading rate by 25 points to counter the effects of the economic slowdown expected next year in the United States.

TABLE 12

**ADJUSTMENTS TO CANADIAN INTEREST RATES  
SINCE THE 2006-2007 BUDGET**

(Rates in per cent)

	2005	2006	2007
Three-month Treasury Bills	2.7	4.0	4.0
— 2006-2007 Budget	2.7	3.7	4.0
Ten-year Canada bonds	4.1	4.3	4.5
— 2006-2007 Budget	4.1	4.4	5.1

Sources: Statistics Canada and ministère des Finances du Québec.

After falling to 4.1% last year, long-term rates resumed rising in 2006. Ten-year Canada bonds should rise on average to 4.3% this year and 4.5% next year. These rates are slightly below those forecast in the last budget. This adjustment is attributable in part to greater demand for long-term securities, particularly by pension plans and Asian banks.

**The Canadian dollar is expected to ease slightly next year**

Moreover, the Canadian dollar is expected to ease slightly next year, which will support the export sector.

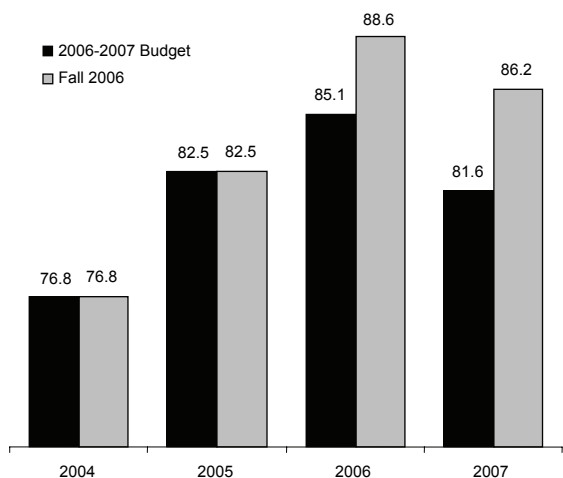
The dollar will decline because of:

- the spread between Canadian and US interest rates which will remain negative in 2006 and 2007, with short-term interest rates remaining lower in Canada than in the United States;
- a slight decline in prices of raw materials, in particular oil and metals.

Accordingly, the Canadian dollar is expected to average over US¢86 in 2007, US¢4.6 more than forecast in the last budget.

CHART 12

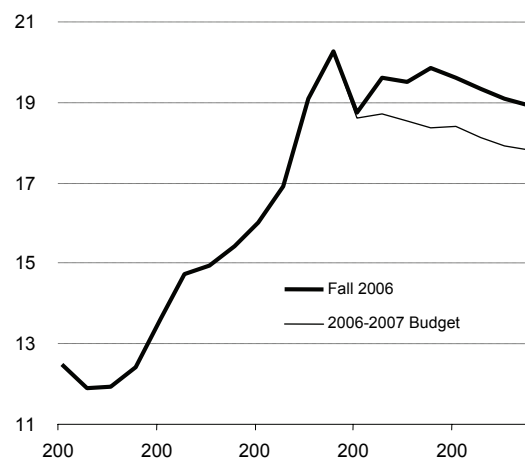
**THE CANADIAN DOLLAR IS EXPECTED TO EASE SLIGHTLY IN 2007**  
(US cents)



Sources: Statistics Canada and ministère des Finances du Québec.

CHART 13

**RAW MATERIALS PRICES WILL NO LONGER SUPPORT THE CANADIAN DOLLAR**  
(Index 1982-1990 = 100 in US\$)



Sources: Bank of Canada and ministère des Finances du Québec.



## The economic context in Québec

### *Québec's economy is resisting external pressures*

Overall, with the exception of certain sectors such as lumber, Québec's economy has resisted the rise in energy prices and the stronger Canadian dollar. The adjustment of companies to this situation and the high level of consumer confidence have enabled Québec's economy to continue growing.

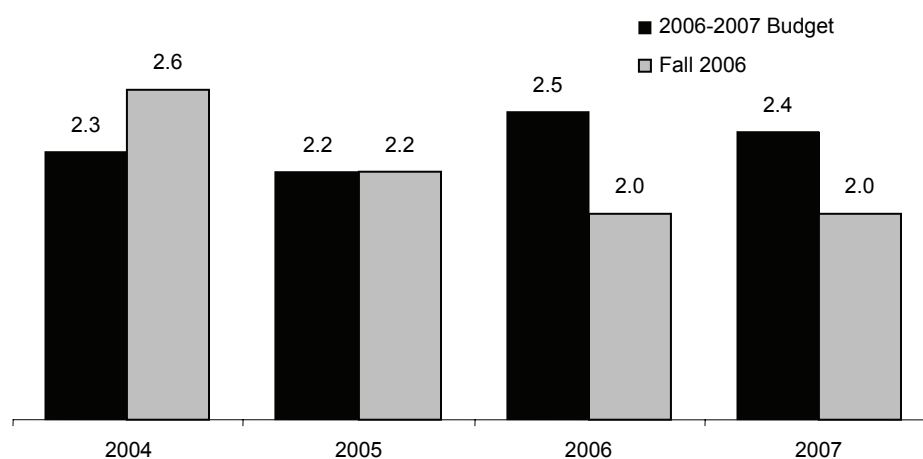
Domestic demand is very dynamic in Québec. In particular, consumer demand and business investment remain high, which stimulates employment. Consumption rose 3.5% in 2005, the best gain in six years. In addition, investment in machinery grew by 4.5% during the same year.

However, the international context is limiting strength in exports and accentuating growth in imports. On a net basis, the external sector has subtracted 1.7 percentage points from economic growth each year for the last four years, whereas it had added one point on average each year from 1998 to 2001.

Accordingly, after reaching 2.2% last year, economic growth should ease somewhat to 2% this year and next. This outlook is adjusted downward compared with the assumption used in the last budget, when real GDP growth of 2.5% was expected in 2006 and 2.4% in 2007. These adjustments result essentially from the larger-than-expected negative contribution of the external sector.

CHART 14

### **ECONOMIC GROWTH IN QUÉBEC** (Real GDP, annual percentage change)



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

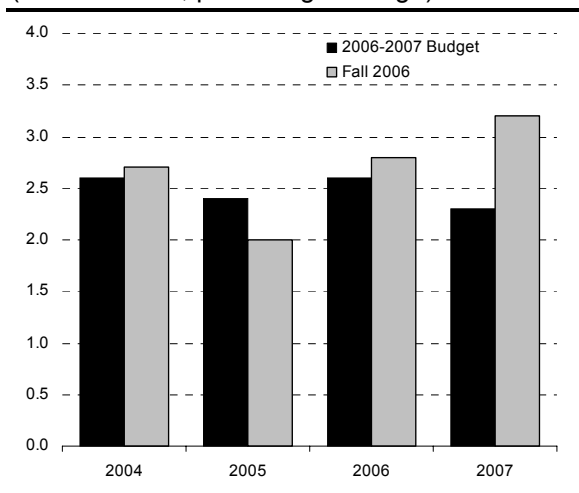
## Sustained growth in consumer spending

In 2005, Québec households increased their purchases of goods and services by 3.5% in real terms. This performance is attributable notably to:

- tax reductions. In this regard, the Québec government has cut personal income tax by almost \$2.9 billion over the last three budgets;
- lower prices for many imported goods such as furniture, electronic products and clothing;
- attractive credit conditions tied to low interest rates;
- good job creation.

CHART 15

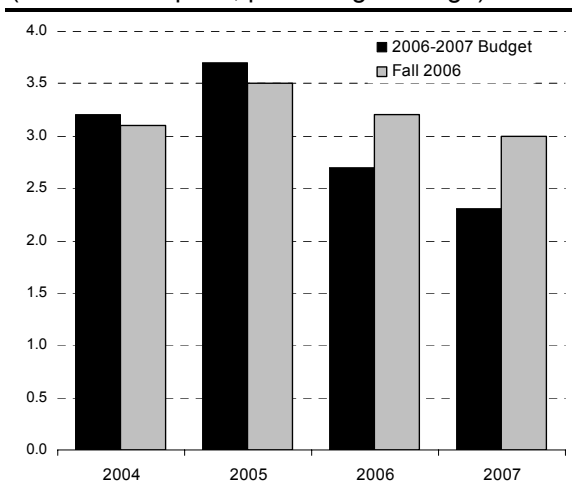
### GOOD GROWTH IN PERSONAL INCOME ... (Real incomes, percentage change)



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

CHART 16

### ... ENCOURAGES RISING PERSONAL SPENDING (Real consumption, percentage change)



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

This strength occurred despite the sharp price increases for energy products that restrained consumers' purchasing power. Confident of their economic situation, consumers decided to reduce their savings rather than substitute increased spending on energy for other consumer products.

Looking ahead, real household consumption should rise 3.2% this year and 3% next year, rates higher than those used in the last budget. In particular, households will enjoy new tax cuts that have been previously announced. In addition, the amounts paid on account of the pay equity settlements will improve the financial situation of many thousands of government and public sector employees.

## Housing starts at a robust level despite a further drop

After hitting a record of 58 400 in 2004, construction of new units fell to 50 900 last year.

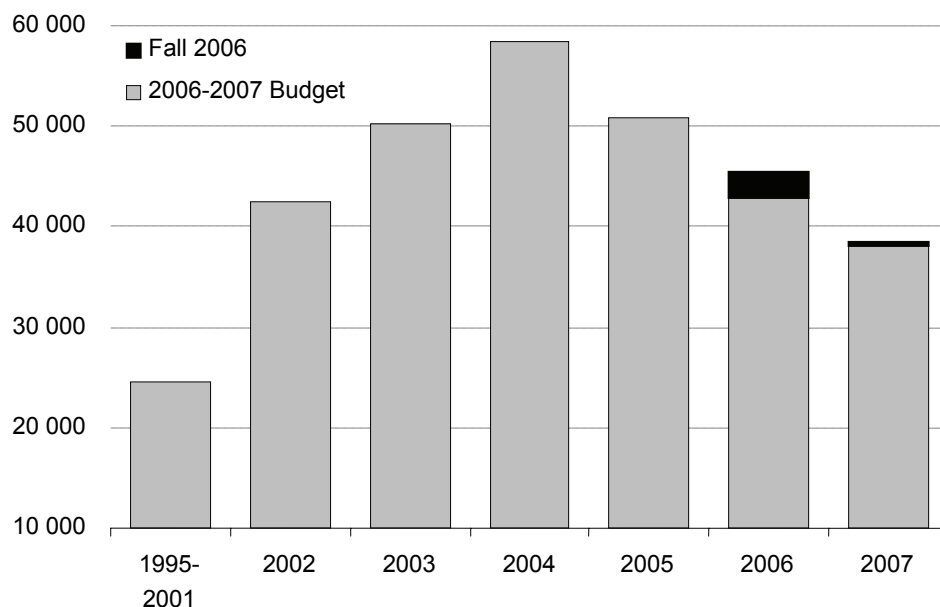
Factors contributing to this decline include the higher vacancy rate on the rental market, which for the first time in five years stood at 2% last year. In addition, the increase in supply on the resale market, up by close to 40% over the last three years, reduces the attraction of new construction with its higher prices.

These factors, coupled with the expected rise in mortgage interest rates, will make the context less favourable for new construction in 2006 and 2007. The interest rate on a five-year mortgage is expected to reach 7% in 2007.

Accordingly, the downward trend in housing starts will continue with the construction of 45 500 units in 2006 and 38 500 in 2007, levels compatible with expected household formation over the coming years. Note that these levels remain higher than what was observed in the late 1990s, when fewer than 25 000 units were started each year.

CHART 17

### THE DOWNWARD TREND IN HOUSING STARTS WILL CONTINUE (Number of units)



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

## Business investment remains dynamic

Companies are adapting to a changing international context. They have taken advantage of the strong dollar to increase their real investments in machinery and equipment by 13.5% in 2004 and 4.5% last year.

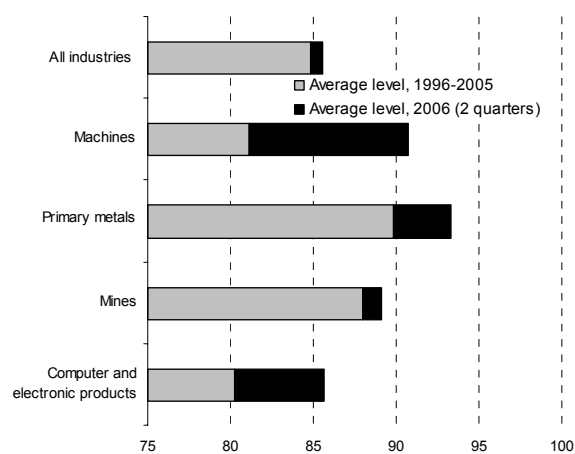
In the manufacturing sector, these investments have helped raise business output by almost 4% over three years despite a 6% decline in employment.

The Québec government's introduction of a 5% capital tax credit on new investments in manufacturing and processing machinery and equipment has also contributed to improving the climate for investment.

Moreover, the context will remain favourable for investment in the years ahead. Capacity utilization rates are very high in many sectors, mines, primary metals, machinery and computer products in particular. In addition, profit growth remains high and is expected to exceed 5% on average in 2006 and 2007.

CHART 18

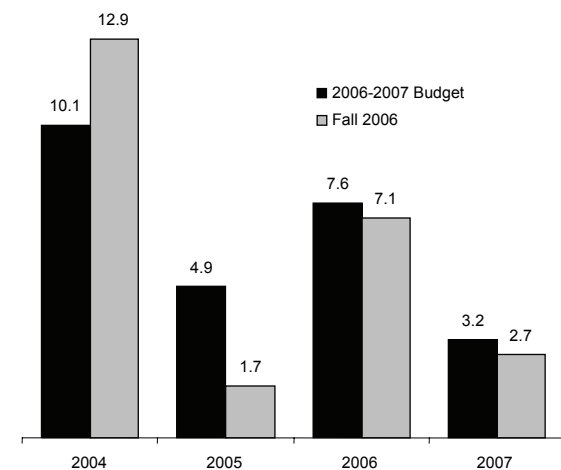
### CAPACITY UTILIZATION RATE OF INDUSTRIAL PRODUCTION (Canadian industries, per cent)



Source: Statistics Canada.

CHART 19

### NON-RESIDENTIAL INVESTMENT BY BUSINESSES (Percentage change, in real terms)



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

Investment by businesses should accordingly grow by 7.1% in 2006. With certain investments associated with energy projects levelling off, growth in investment by businesses will reach 2.7% in 2007. These projections are adjusted slightly downward compared to the last budget.

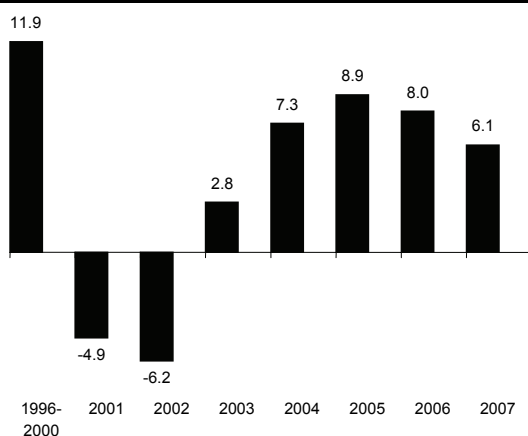
### The external sector is dampening economic growth

In 2005, exports rose 2.5% in real terms. This is attributable in part to strong American demand for Québec-made capital goods, including office machinery and equipment, and for telecommunications equipment. Investments in machinery and equipment in the United States rose by more than 8% on average in 2004 and in 2005.

The vitality of investment by American companies will continue to benefit our exports. However, the dollar's strength will limit the gain. Accordingly, exports should grow by 2.7% in 2006 and 3.9% in 2007 compared to growth of more than 4% forecast in the budget last March.

CHART 20

**INVESTMENTS BY AMERICAN COMPANIES IN MACHINERY AND EQUIPMENT**  
(Annual percentage change)

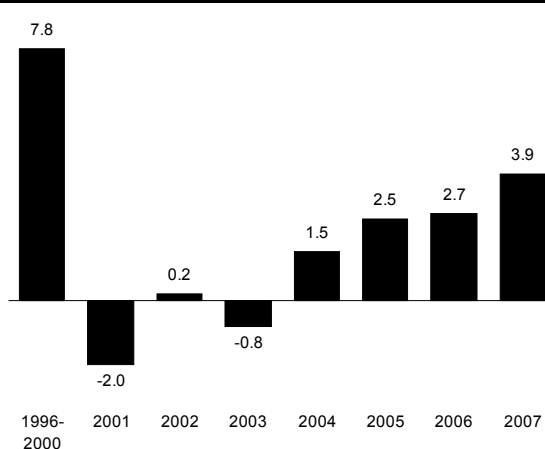


Sources: Global Insight and ministère des Finances du Québec.

CHART 21

**QUÉBEC'S EXPORTS**

(Annual percentage change)



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

Turning to imports, the strength of the Canadian dollar and the vitality of domestic demand in Québec will stimulate the purchase of foreign products and services by businesses and households in Québec. Accordingly, after gaining 5% last year, growth in imports should approach 4% by 2007.

All in all, the stronger growth in imports compared to exports will have an overall dampening effect on economic growth in Québec in 2006 and 2007. The external sector will subtract the equivalent of one percentage point from GDP growth in 2006, despite the recovery in exports since 2004.

## Good performance by the labour market

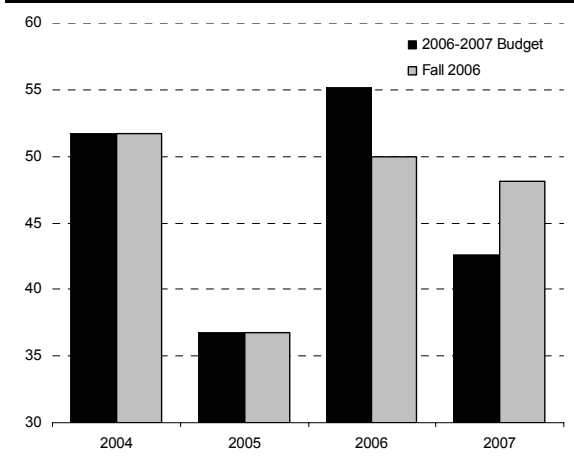
In 2005, 36 800 jobs were created in Québec. For the second year in a row, most of the jobs created were full-time. A significant percentage of job creation was in the trade, construction and business management sectors, administrative services and other support services. However, the difficulties of the manufacturing sector resulted in a loss of 14 500 jobs last year.

So far this year, Québec has added 50 100 jobs compared to the same period last year. Looking forward, supported by expected good growth in the economy, this recent trend will be maintained in 2006 and 2007. Job creation should reach 50 000 in 2006 and 48 100 in 2007. Furthermore, the percentage of the population holding a job has never been so high in Québec's history. For the third year in a row, the employment rate exceeds 60%, a record.

The good employment situation in general is also reflected in the unemployment rate which fell to 8.3% last year, the lowest level in the last 30 years. Looking ahead, the unemployment rate should fall further, to 8% in 2007.

CHART 22

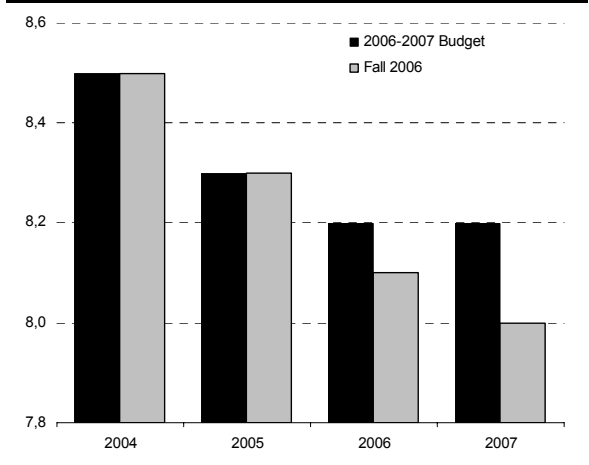
### JOB CREATION (Thousands)



Sources: Statistics Canada and ministère des Finances du Québec.

CHART 23

### FALLING UNEMPLOYMENT RATE (Percentage rate)



Sources: Statistics Canada and ministère des Finances du Québec.

## Good growth in nominal GDP

Moreover, after reaching 3.9% in 2005, growth in nominal GDP will continue to rise, to 4.4% in 2006 and 2007. These projections are adjusted upward compared to the last budget, despite the downward adjustments to projected real growth.

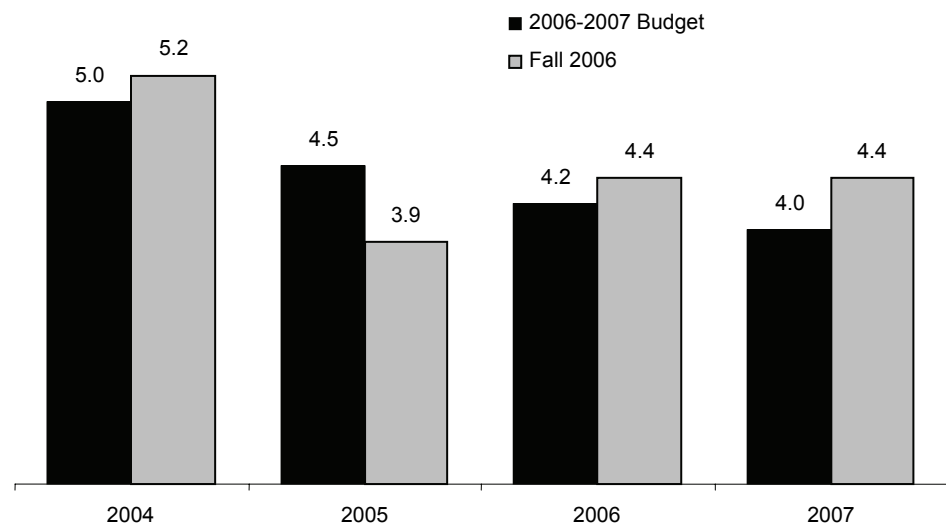
In particular, the high value of the Canadian dollar will cause prices of exported goods to rise slightly compared to imported goods. This will prompt an upward adjustment to the forecast price level associated with domestic production.

In addition, the vitality of domestic demand will be reflected in good growth in corporate profits and personal income, which, in the latter case, should rise by 4.5% in 2006 and 5.1% in 2007.

Furthermore, continued good conditions on the labour market will lead to an increase in wages and salaries of 4.4% this year and 5.1% next year. Note that in 2007, the pay equity settlements with government and public sector employees will help support growth in personal income, which will provide a boost for nominal GDP growth.

CHART 24

### NOMINAL GDP GROWTH IN QUÉBEC (Annual percentage change)



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

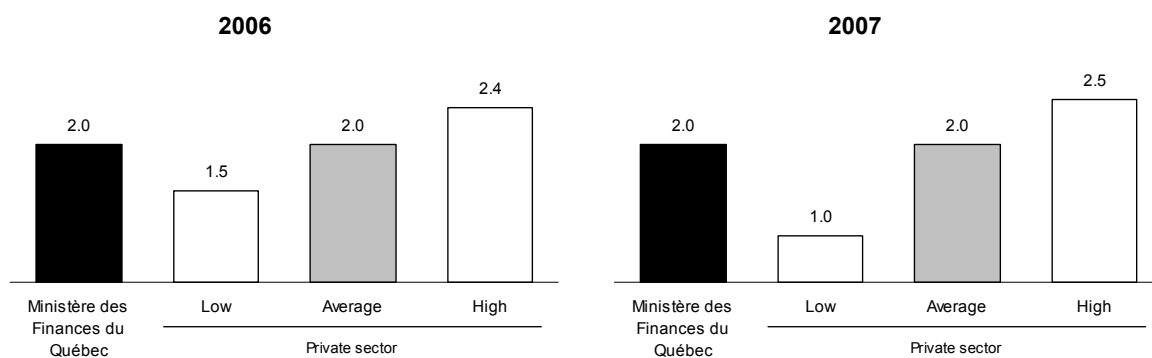
## Comparison with private sector forecasts

The forecast of economic growth in Québec by the ministère des Finances is the same as the average of those of the private sector both for 2006 and 2007. However, forecasts differ significantly among forecasters. Large differences exist, in particular concerning changes in the Canadian dollar and energy products.

This new forecast includes a downward adjustment to economic growth, as do the private sector forecasts.

CHART 25

### COMPARISON OF THE ECONOMIC FORECAST OF THE MINISTÈRE DES FINANCES DU QUÉBEC WITH THOSE OF THE PRIVATE SECTOR (Real GDP, percentage change)



Source: Ministère des Finances du Québec.



TABLE 13

**ECONOMIC OUTLOOK IN QUÉBEC**  
(Percentage change)

	2005	2006	2007
<b>PRODUCTION</b>			
Real gross domestic product	2.2	2.0	2.0
— 2006-2007 Budget	2.2	2.5	2.4
Gross domestic product	3.9	4.4	4.4
— 2006-2007 Budget	4.5	4.2	4.0
<b>COMPONENTS OF GDP (in real terms)</b>			
Consumption	3.5	3.2	3.0
— 2006-2007 Budget	3.7	2.7	2.3
Non-residential investment	1.7	7.1	2.7
— 2006-2007 Budget	4.9	7.6	3.2
Exports	2.5	2.7	3.9
— 2006-2007 Budget	3.8	4.2	4.7
Imports	5.0	4.3	4.1
— 2006-2007 Budget	5.2	4.3	4.2
<b>OTHER ECONOMIC INDICATORS<sup>1</sup></b>			
Nominal consumption	5.5	5.0	4.8
— 2006-2007 Budget	5.6	4.7	4.0
Housing starts (thousands)	50.9	45.5	38.5
— 2006-2007 Budget	50.9	42.9	38.1
Personal income	4.0	4.5	5.1
— 2006-2007 Budget	4.2	4.6	4.0
Corporate profits	1.5	7.8	3.1
— 2006-2007 Budget	3.5	5.7	5.4
Consumer prices	2.3	2.0	2.1
— 2006-2007 Budget	2.3	2.3	1.9
<b>LABOUR MARKET</b>			
Job creation (thousands)	36.8	50.0	48.1
— 2006-2007 Budget	36.8	55.2	42.6
Unemployment rate (%)	8.3	8.1	8.0
— 2006-2007 Budget	8.3	8.2	8.2

1 In nominal terms, unless indicated otherwise.



### **3. Public Finances: Concrete Progress**

In April 2003, the new Québec government inherited a difficult financial situation. Beginning in the June 2003 budget, the government acted to restore balance and transparency to public finances.

The government's action has produced concrete progress.

This action was organized around three themes:

- keep the budget balanced through rigorous management of public expenditure;
- modernize the state;
- take steps to reduce the debt burden.

The government's budgetary discipline has enabled it to invest in Quebecers' priorities:

- major investments have been made in particular in health, education, infrastructures and families;
- the tax burden on individuals and businesses, in particular SMEs, has been reduced to foster prosperity in every region of Québec.

#### **Budgetary rigor**

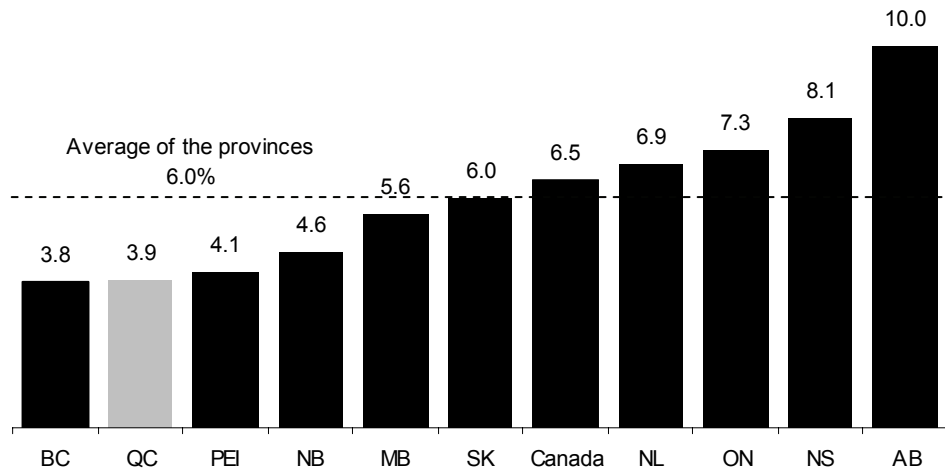
##### ***Rigorous management of public expenditure***

From 2003-2004 to 2006-2007, growth in program spending in Québec has averaged 3.9% annually, less than the growth in GDP (4.5%).

During the same period, program spending in Ontario rose by an average of 7.3% per year, while that of the federal government grew by an average of 6.5% per year.

CHART 26

**AVERAGE ANNUAL GROWTH IN PROGRAM SPENDING FROM 2003-2004 TO 2006-2007**  
(Per cent)

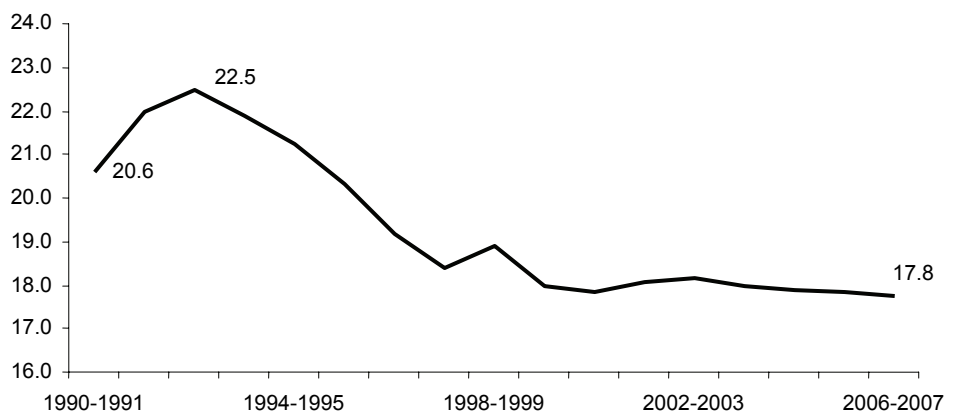


Source: Ministère des Finances du Québec.

In fact, next to British Columbia, Québec was the province that had the lowest growth in its program spending. Consequently, the Québec government's spending as a proportion of GDP is now the lowest it has been in 35 years (17.8% of GDP).

CHART 27

**PROGRAM SPENDING**  
(As a percentage of GDP)



Source: Ministère des Finances du Québec.

### ***The modernization of the state***

This stringent expenditure management has relied in particular on an unprecedented modernization of the state apparatus.

The Plan de modernisation 2004-2007 has already produced concrete results, including:

- reduction of the size of the public service from 75 800 to 60 100 full-time jobs by 2014;
- creation of Service Québec to simplify the life of people and companies;
- 42% reduction in management structures in the health and social services network;
- examination of public organizations;
- modernization of governance of government corporations;
- creation of the Centre de services partagés du Québec to integrate, with the aim of increasing efficiency, government administrative services.

Accordingly, thanks to the reduction of the size of the state and of operating costs, the government has so far achieved savings of \$500 million since 2004. This amount will rise over the years and can immediately be invested in Quebecers' priorities.

### ***A lasting reduction in the debt burden***

Moreover, the government had a duty to put an end to a situation that made Québec the most debt-ridden province. It had become imperative to deal with the burden of debt in the economy, especially as in the past, it had been used in large part to fund current spending. Accordingly, in the last budget, the Minister of Finance announced the creation of the Generations Fund.

Dedicated exclusively to debt retirement, the Generations Fund has specific revenue sources that do not have a negative effect on the tax burden.

The dynamic that has been set in motion will make it possible to achieve the debt burden reduction objectives set in the Act, with the debt not to exceed:

- 38% of GDP by March 31, 2013;
- 32% of GDP by March 31, 2020;
- 25% of GDP by March 31, 2026.

Including the additional deposit of \$500 million in the Generations Fund announced today, more than \$32 billion will have been accumulated for debt retirement by March 31, 2026.

## **Investing in Quebecers' priorities**

Rigorous spending management and the modernization of the state have not prevented the government from investing in Quebecers' priorities, in particular, health, education, infrastructures and families. They have also produced the leeway needed to reduce Quebecers' tax burden.

### ***Health***

In health, spending has risen by \$4.2 billion since April 2003 and now stands at \$22 billion. The government has allocated almost 70% of the increase in program spending to health funding. These funds have enabled:

- a significant increase in volumes of priority surgeries;
- an appreciable reduction in waiting times;
- improved services despite an increase in traffic;
- substantial investments in maintenance of capital assets.

### ***Education***

In education, spending has risen by \$1.6 billion. Investments in education have grown each year five times faster than during the mandate of the preceding government.

Since the fall of 2006, elementary school pupils receive an additional hour and a half of teaching per week. English is now taught starting in grade one and \$120 million has been invested for students with learning difficulties and their parents, enabling 1 800 specialists to be hired.

## Infrastructures

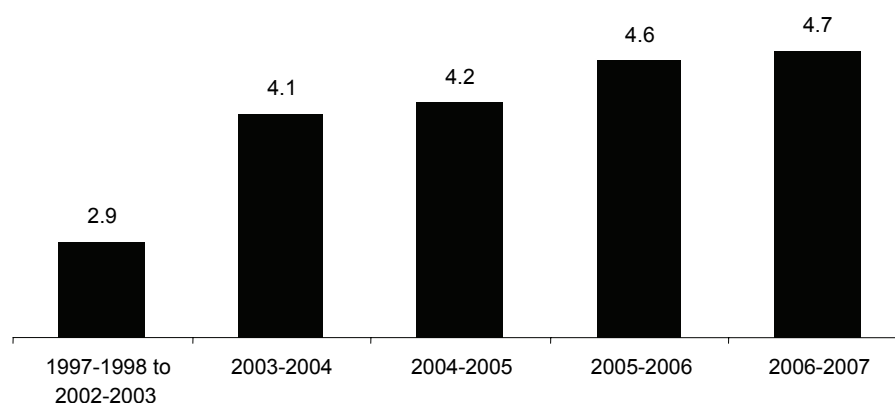
Since 2003-2004, the Québec government has also made unprecedented efforts to improve and maintain infrastructures.

In 2006-2007, \$4.7 billion is being invested in maintaining and developing our infrastructures, almost double the amount invested, on average, from 1997-1998 to 2002-2003. And these efforts will continue.

CHART 28

### ANNUAL INVESTMENTS IN FIXED ASSETS (Government's contribution, in billions of dollars)

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Source: Secrétariat du Conseil du trésor.

For instance, \$4.1 billion will be invested over the next three years to improve the road network. In 2006-2007, \$1.3 billion will be invested, including:

- \$421 million for development;
- \$879 million for road maintenance.

This amount of investment is an increase of more than \$500 million compared to the average invested during the period from 1997-1998 to 2002-2003.

- Roughly half of this increase is allocated to maintaining the road network and the rest to its development.

In addition, investments of more than \$1 billion will be made this year in health and social services establishments and \$784 million will be invested in education institutions.

TABLE 14

**PUBLIC INVESTMENTS IN FIXED ASSETS**

(The government's contribution in millions of dollars)

	Average, 1997-1998 to 2002-2003	2006-2007	Change
Health and social services establishments	575	1 007	432
Education institutions	704	784	80
Road network	649	1 197 <sup>1</sup>	548
Municipal infrastructures and public transit	261	623	362
Other public infrastructures	740	1 114	374
<b>TOTAL</b>	<b>2 929</b>	<b>4 725</b>	<b>1 796</b>

<sup>1</sup> The total budget for the road network amounts to \$1 300 million, including expenditures of \$103 million that cannot be capitalized.

***Families, housing and fighting poverty***

The government has also significantly increased the amounts invested to:

- support families;
- build new social housing;
- fight poverty.

**□ Improved support for families**

Families have received a substantial increase in financial support, in particular with:

- the implementation of Child Assistance in 2005;
- the implementation of the Work Premium in 2005;
- the development of 36 566 new day care spaces, for a total of 200 000 available spaces in 2006.

The financial support provided for families will reach \$4.7 billion in 2006, an increase of 29% compared to 2003.



In addition to this, last January 1, the Québec Parental Insurance Plan became effective, which provides more generous, more accessible and more flexible financial support for parents during maternity leave, parental leave or adoption leave.

TABLE 15

**FINANCIAL SUPPORT FOR FAMILIES  
PROVIDED BY THE QUÉBEC GOVERNMENT – 2006**  
(Millions of dollars)

Child Assistance	2 009
Work premium	196
Day care support <sup>1</sup>	2 034
Other measures <sup>2</sup>	444
<b>TOTAL</b>	<b>4 682</b>

1 Includes day care services in early childhood centres and day care centres, school day care facilities, as well as expenditures by school boards for kindergarten for five-year-olds and kindergarten in disadvantaged areas.

2 Chiefly, support for handicapped children, assistance of last resort (child supplements), shelter allowance, student financial assistance, tax credits for day care expenses, for adoption and fertility, zero-rating of the QST for children's diapers and items used to breast-feed or bottle-feed infants.

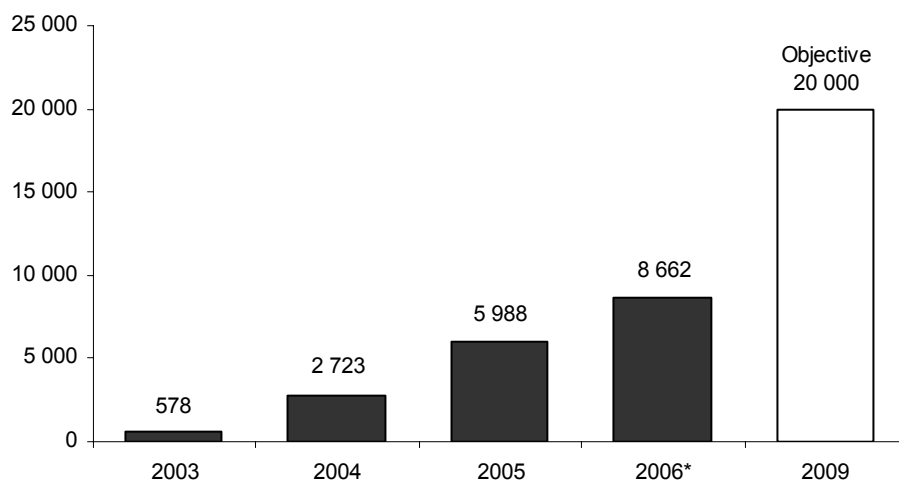
**□ Construction of 20 000 new social housing units**

Moreover, the measures the government has announced for social housing will add 20 000 new social housing units representing government assistance of \$1 billion for their construction. That represents an increase of 7 000 units over the government's commitment.

In addition, annual major renovation and maintenance budgets for the stock of low-rent housing have been increased by 20% per year and will reach \$82 million this year.

CHART 29

**CUMULATIVE NUMBER OF HOUSING UNITS DELIVERED AS AT DECEMBER 31 OF EACH YEAR**



\* As at June 30.

Source: Société d'habitation du Québec.

**□ Measures to fight poverty**

On this front, the government has satisfied the requirements of the Act to combat poverty and social exclusion by tabling a government action plan in April 2004. In particular, this plan has given rise to:

- annual indexing of social assistance benefits;
- the introduction of a base scale for social assistance since October 2005;
- extension to all families of the exemption of \$100 per month of child support payment income from the calculation of social assistance;
- an increase in the minimum wage from \$7.30 per hour in February 2003 to \$7.75 per hour on May 1, 2006.

In all, more than \$2.5 billion has been earmarked over five years, until 2008-2009, for people in poverty.

### ***Investments to sustain economic growth***

To encourage economic growth in all regions of Québec, the government made reducing the tax burden a priority, while maintaining adequate funding for public services.

Accordingly, the personal tax burden has been reduced. In addition, the government has acted to provide a more competitive environment for business and encourage wealth creation.

#### **☐ A significant reduction in the personal tax burden**

The personal tax burden has been cut by \$2.9 billion. As a result, the difference in tax burden with the Canadian average has been cut by more than half for personal income tax.

In 2003, the average difference in tax burden with the other provinces was \$2.2 billion. In 2007, the difference will be reduced to \$980 million, a drop of 55%. Accordingly, a taxpayer in Québec will pay only \$269 more in income tax on average than taxpayers in other provinces.

TABLE 16

**PERSONAL INCOME TAX – DIFFERENCE IN TAX BURDEN BETWEEN QUÉBEC AND THE OTHER PROVINCES BY APPLYING THE TAX STRUCTURE OF THE OTHER PROVINCES TO QUÉBEC<sup>1</sup>**

	2003	2007 <sup>2</sup>	
	(\$ million)	(\$ million)	(\$ per taxpayer)
<b>DIFFERENCE QUÉBEC – OTHER PROVINCES<sup>3</sup></b>			
- Ontario	5 627	3 502	962
- Alberta	4 433	3 303	907
- British Columbia	3 538	3 184	874
- Saskatchewan	2 234	1 292	355
- New Brunswick	1 526	462	127
- Manitoba	937	54	15
- Nova Scotia	689	-338	-93
- Prince Edward Island	1 099	-425	-117
- Newfoundland and Labrador	-677	-2 218	-609
<b>AVERAGE DIFFERENCE</b>	<b>2 156</b>	<b>980</b>	<b>269</b>

1 Including health contributions and family assistance measures (for instance, family allowances and refundable tax credits).

2 Including the measures of the 2006-2007 Budget of Québec and those of the budgets of the other provinces tabled by March 10, 2006, i.e. British Columbia and Manitoba.

3 The 16.5% Québec abatement is removed from the difference in tax burden.

Source: Ministère des Finances du Québec.

### A more competitive corporate tax system

Major efforts have also been made to improve the efficiency and competitiveness of the corporate tax system. The steps taken will ultimately reduce the corporate tax burden by almost \$450 million annually.

- The reduction of the tax on capital by more than 50% by 2009 will bring it to a more competitive level compared to the other provinces.
- Implementation of a new capital tax credit of 5% of the value of new investments in manufacturing and processing equipment will stimulate business investment and productivity.
- The government also acknowledges the importance of a preferential tax system for SMEs:
  - by reducing the tax rate on these businesses to 8% for the first \$400 000 of taxable income;
  - by raising the exemption threshold of the capital tax to \$1 million, thereby exempting 75% of companies from this tax.

## **Progress that has been acknowledged by the credit rating agencies**

The government's rigor and transparency and the progress achieved have been acknowledged. Last spring, two credit rating agencies, Moody's<sup>3</sup> of New York and DBRS of Toronto, raised Québec's credit rating.

Moody's based its decision chiefly on the following items:

- the substantial improvement in the financial situation over the past few years and the government's commitment to continue along the same path;
- rigorous spending management, in particular by settling the collective agreements until 2010;
- the implementation of a clear strategy to reduce the debt burden by creating the Generations Fund, which will reduce the debt/GDP ratio to 38% within five years;
- the size and diversification of Québec's economy.

## ***Commitment to rigorous management of public finances***

The acknowledgement of the good management of Québec's public finances, last spring, is attributable directly to the government's determination. Tough decisions were made, but they were motivated by the conviction that it was necessary to restore order to public finances to better prepare Québec to face the challenges that lie ahead.

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3 "Moody's raised the Province of Quebec's debt rating to Aa3 from A1, recognizing sustained improvement in the province's financial performance and the government's commitment to achieve further progress. Of key importance to the improvement in credit quality is the government's development of a clear strategy for debt abatement.", Moody's Investors Service, New York, June 14, 2006.





