

# UPDATE

## **ON QUÉBEC'S ECONOMIC AND FINANCIAL SITUATION**

FALL 2007

Update on Québec's Economic and Financial Situation  
Fall 2007

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## HIGHLIGHTS

For the second year in a row, the government is fulfilling its commitment to provide, with the *Update on Québec's Economic and Financial Situation*, a fall update on the economic and financial situation.

### □ Financial framework

Once again, the government is meeting its objectives regarding public finances. Thanks to the government's rigorous management, the budget will remain balanced over the financial framework forecast period.

The budget will remain balanced while incorporating, as of 2006-2007, the financial impact of an accounting reform that the government is implementing immediately. This reform is further to the *Report of the Task Force on Government Accounting* consisting of representatives of the Auditor General of Québec and the ministère des Finances. The Task Force, whose formation was announced in the last budget, is submitting its report almost two months earlier than stipulated at the time the two parties signed an agreement on May 18, 2007.

Accordingly, the final results for 2006-2007 indicate a budgetary surplus of \$109 million, including the impact of the accounting reform, as well as the previously planned payments of \$500 million to the Generations Fund and \$1.3 billion to the budgetary reserve.

Subsequently, the strength of domestic demand prompts an upward adjustment to government revenue of \$588 million in 2007-2008 and \$690 million in 2008-2009.

— This additional budgetary revenue, which reflects the Action Plan for the Manufacturing Sector announced last November 23, will fund the costs associated with the accounting reform and the new actuarial valuations of the retirement plans. It also enables a rise in the growth of program spending from 3.0% to 3.5% in 2008-2009 to increase the government's capacity to deal with the pressure on spending, including the pressure relating to the funding of the Québec infrastructure plan announced last October 11.

## □ Accounting reform

The government is announcing that it is moving ahead immediately with an accounting reform to act on the recommendations contained in the *Report of the Task Force on Government Accounting*. In particular, the reform includes the consolidation of the health and education networks in the government's financial statements. For 2007-2008, the accounting reform results in a shortfall of \$663 million, funded in part by higher revenue.

Accordingly, today the government is tabling the *2006-2007 Public Accounts*, the *Update on Québec's Economic and Financial Situation* and the document entitled *The Québec Government's Debt* taking into account the adjustments arising from this accounting reform and its impact on the financial results and the government's debt.

Before the reform, the financial statements complied with the government's accounting practices and, to a large extent, generally accepted accounting principles (GAAP). The reform makes the final adjustments needed for the government's accounting practices to comply fully with public sector GAAP.

By incorporating all of the recommendations into its accounting practices, the government continues to improve the transparency of public finances.

## □ Economic outlook

Québec's economy is experiencing good growth despite a challenging international context that is hampering exports. The economy is doing well thanks to strong growth in domestic demand.

- In particular, sustained by government action, consumer demand for goods and services, housing starts and business investment are higher than forecast in the 2007-2008 Budget.
- The economy's good health is reflected in strong job creation and substantial growth in personal income, boosting the government's tax revenues.

According to the revised forecasts, economic growth will thus amount to 2.0% in 2007 and reach 2.2% in 2008. The favourable economic situation, together with the government's disciplined management of public finances, will enable it to improve public services while keeping the budget balanced.

## INTRODUCTION

Since 2003, the government has undertaken to improve the clarity of information available to Quebecers on the situation of public finances.

Accordingly, the government:

- is introducing an accounting reform that reflects the recommendations of the Task Force on Government Accounting, whose report is being released today, and announces its implementation. This reform applies as of 2006-2007 and will change how the government accounts for its revenue and expenditure, as well as the presentation of the debt;
- is tabling the *2006-2007 Public Accounts* today in the National Assembly;
- is tabling the *Update on Québec's Economic and Financial Situation*, which reports on, compared to the last budget:
  - adjustments to the financial framework of the 2007-2008 Budget, including the impact of the accounting reform;
  - how the economy is performing;
- is tabling the document entitled *The Québec Government's Debt*.

Moreover, the government wishes to reiterate that it intends to continue working to improve the delivery of public services and support for the economy. To that end, in the coming months, it will examine the recommendations of the following task forces, whose formation were announced, and will specify to what degree it intends to act on them:

- the **Task Force on Health Funding**, chaired by Claude Castonguay, will propose new options for adequately funding Quebecers' health system;
- the **Task Force on Business Investment**, chaired by Pierre Fortin, will advise the government on ways to boost business investment to support economic growth;
- the **Task Force on User Fees**, chaired by Claude Montmarquette, will examine the issues and advise the government on the formulation of a new policy on user fees;
- The **Task Force on Tax Assistance for the Resource Regions and the New Economy**, chaired by Robert Gagné, will assess the impact on Québec companies of the scheduled end of the fiscal measures for the resource regions and those for the new economy.





**PART ONE:  
THE GOVERNMENT'S FINANCIAL FRAMEWORK**



# 1. THE GOVERNMENT'S FINANCIAL FRAMEWORK

## 1.1 Overview of the three-year budget plan

Because of the economy's good shape, the strength of own-source revenue and tight spending control, the *Update on Québec's Economic and Financial Situation* forecasts, as announced in the last budget, that the budget will be balanced in each year of the budget plan.

The budget will remain balanced while incorporating the financial impact of the accounting reform implemented further to the recommendations of the Task Force on Government Accounting presented in section 2 of this document.

TABLE 1

### Summary of adjusted budgetary transactions – Fall 2007

(Millions of dollars)

	2006-2007	2007-2008 <sup>P</sup>	2008-2009 <sup>P</sup>
<b>BUDGETARY REVENUE</b>	<b>60 433</b>	<b>61 715</b>	<b>62 070</b>
% change	8.5	2.1	0.6
<b>BUDGETARY EXPENDITURE</b>			
Program spending	- 51 889	- 54 104	- 55 991
% change	5.4	4.3	3.5
Debt service	- 6 925	- 6 989	- 7 158
% change	0.7	0.9	2.4
<b>Total</b>	<b>- 58 814</b>	<b>- 61 093</b>	<b>- 63 149</b>
% change	4.8	3.9	3.4
<b>NET RESULTS OF CONSOLIDATED ORGANIZATIONS</b>	<b>201</b>	<b>41</b>	<b>129</b>
<b>REVENUE DEDICATED TO THE GENERATIONS FUND</b>	<b>84</b>	<b>453</b>	<b>740</b>
<b>IMPACT OF THE ACCOUNTING REFORM<sup>1</sup></b>	<b>89</b>	<b>- 663</b>	<b>- 150</b>
<b>BUDGETARY BALANCE BEFORE PAYMENTS TO THE GENERATIONS FUND AND USE OF THE BUDGETARY RESERVE</b>	<b>1 993</b>	<b>453</b>	<b>- 360</b>
Budgetary reserve <sup>2</sup>	- 1 300	200	1 100
Additional payments to the Generations Fund	- 500	- 200	—
Payments of revenue dedicated to the Generations Fund	- 84	- 453	- 740
<b>BUDGETARY BALANCE – FALL 2007</b>	<b>109</b>	<b>0</b>	<b>0</b>

P: Projections.

1 The impact of the accounting reform is detailed in Table 10 in section 2.

2 A negative amount indicates an allocation to the reserve and a positive amount, a use of the reserve.

The budgetary surplus in 2006-2007 amounts to \$109 million, including the \$89 million impact of the accounting reform.

For 2007-2008 and 2008-2009, robust tax revenues will help fund the costs of the accounting reform, the Action Plan for the Manufacturing Sector and the new actuarial valuations of the retirement plans, in addition to raising the growth in program spending from 3.0% to 3.5% in 2008-2009. This also reflects the downward adjustment to the cost of debt service.

More specifically, the government's budgetary revenue amounts to \$61.7 billion in 2007-2008, i.e. \$48.4 billion from own-source revenue and \$13.3 billion from federal transfers. For 2008-2009, budgetary revenue will be \$62.1 billion.

— The weak growth in revenue in 2008-2009 is attributable in particular to the additional reduction in personal income tax of \$950 million as of January 1, 2008 announced in the last budget.

Budgetary expenditure is expected to reach \$61.1 billion in 2007-2008 and \$63.1 billion in 2008-2009. More specifically, for 2007-2008, program spending will total \$54.1 billion and debt service, \$7.0 billion.

— Program spending growth is limited to 4.3% in 2007-2008 and 3.5% in 2008-2009.

It is important to note that, as mentioned in the last budget, the strong growth in budgetary revenue in 2006-2007, attributable for the most part to the additional earnings booked by Hydro-Québec, means that:

— additional deposits of \$500 million in 2006-2007 and \$200 million in 2007-2008 can be made to the Generations Fund;

— and that \$1.3 billion can be allocated to the budgetary reserve in 2006-2007, which will be used in particular to balance the budget in 2008-2009.

## 1.2 Final results for 2006-2007: a surplus of \$109 million

Compared to the forecast in the 2007-2008 Budget, the final results for 2006-2007 show a surplus of \$109 million. The upward adjustment to budgetary revenue is sufficient to fund all of the increase in budgetary expenditure.

- Budgetary revenue is adjusted upward by \$128 million. This adjustment is attributable essentially to higher revenue at year-end, mainly from personal income tax.
- Budgetary expenditure is up by \$78 million. This adjustment reflects:
  - an increase in program spending of \$120 million;
  - a downward adjustment of \$42 million to debt service.

Lastly, inclusion of the financial impact of the accounting reform in 2006-2007 improves the budgetary balance by \$89 million.

TABLE 2

### Adjustments to the budgetary balance since the 2007-2008 Budget (Millions of dollars)

	<b>2006-2007</b>
<b>BUDGETARY BALANCE SHOWN IN THE 2007-2008 BUDGET</b>	<b>29</b>
<b>ADJUSTMENTS TO BUDGETARY REVENUE</b>	
- Own-source revenue excluding government enterprises	120
- Government enterprises	- 2
- Federal transfers	10
<b>Total</b>	<b>128</b>
<b>ADJUSTMENTS TO BUDGETARY EXPENDITURE</b>	
- Program spending	- 120
- Debt service	42
<b>Total</b>	<b>- 78</b>
<b>ADJUSTMENTS TO CONSOLIDATED ORGANIZATIONS</b>	<b>- 59</b>
<b>IMPACT OF THE ACCOUNTING REFORM</b>	<b>89</b>
<b>BUDGETARY BALANCE - FALL 2007</b>	<b>109</b>

### 1.3 Strong tax revenues allow spending growth to rise from 3.0% to 3.5% in 2008-2009

The update to the financial framework indicates that the budget will remain balanced over the financial framework forecast period.

Since the 2007-2008 Budget, domestic demand has been stronger than expected, which, along with positive adjustments to federal transfers, have resulted in additional revenue of \$588 million in 2007-2008 and \$690 million in 2008-2009, taking into account the Action Plan for the Manufacturing Sector. In addition, the cost of debt service is reduced by \$255 million in 2007-2008.

With this new leeway, the government will fund, for these two years, the impact of the accounting reform and the new actuarial valuations of the retirement plans, as well as a rise in program spending growth from 3.0% to 3.5% in 2008-2009.

TABLE 3

#### Adjustments to the budgetary balance since the 2007-2008 Budget<sup>P</sup> (Millions of dollars)

	2007-2008	2008-2009
<b>BUDGETARY BALANCE SHOWN IN THE 2007-2008 BUDGET<sup>1</sup></b>	<b>0</b>	<b>0</b>
<b>ADJUSTMENTS TO BUDGETARY REVENUE</b>		
<b>Own-source revenue</b>		
- Strength of tax revenues	625	625
- Action Plan for the Manufacturing Sector	- 125	- 43
<b>Government enterprises</b>	—	—
<b>Federal transfers</b>	88	108
<b>Total</b>	<b>588</b>	<b>690</b>
<b>ADJUSTMENTS TO BUDGETARY EXPENDITURE</b>		
<b>Program spending</b>		
- New actuarial valuations of the retirement plans	- 191	- 191
- Rise to increase growth in 2008-2009 from 3.0% to 3.5%	—	- 296
<b>Debt service</b>	255	—
<b>Total</b>	<b>64</b>	<b>- 487</b>
<b>ADJUSTMENTS TO CONSOLIDATED ORGANIZATIONS</b>	<b>11</b>	<b>- 53</b>
<b>IMPACT OF THE ACCOUNTING REFORM</b>	<b>- 663</b>	<b>- 150</b>
<b>BUDGETARY BALANCE - FALL 2007</b>	<b>0</b>	<b>0</b>

P: Projections.

1 After payments to the Generations Fund and use of the budgetary reserve.

### 1.3.1 Revenue adjustments

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

The recent economic situation indicates that over the next two years, domestic demand will be stronger than forecast in the 2007-2008 Budget. Sustained by the government's action, personal spending by households, housing starts and business investment are expected to make a greater contribution to economic growth in 2007 and 2008. Accordingly, the number of jobs created and growth in pay will be higher than forecast.

Strong domestic demand is positive for growth of the major tax bases and the revenues associated with them. Indeed:

- employment growth leads to an upward adjustment in wages and salaries paid in the economy and boosts revenues from personal income tax;
- sustained by strong job growth, upward adjustments to consumption and housing starts result in additional revenue from the Québec sales tax;
- revenue from corporate taxes is higher than expected because corporate profits have risen by more than anticipated.

TABLE 4

#### Adjustments to own-source revenue excluding government enterprises since the 2007-2008 Budget<sup>P</sup>

(Millions of dollars)

	2007-2008	2008-2009
<b>Strength of tax revenues</b>		
Personal income tax	375	450
Québec sales tax	150	125
Corporate taxes	100	50
<b>Subtotal</b>	<b>625</b>	<b>625</b>
Action Plan for the Manufacturing Sector	- 125	- 43
<b>TOTAL ADJUSTMENTS</b>	<b>500</b>	<b>582</b>

P: Projections.

On the other hand, the rapid appreciation of the Canadian dollar against the US dollar also raises significant challenges for companies, particularly in the manufacturing sector. In this regard, the government has already taken a number of major steps to improve their competitiveness. In addition, last November 23 it announced the Action Plan for the Manufacturing Sector. Compared to the 2007-2008 Budget Speech, this plan will reduce own-source revenue by \$125 million in 2007-2008 and by \$43 million in 2008-2009.

#### **❑ Federal transfer revenue**

Federal transfer revenue is adjusted upward by \$88 million in 2007-2008 and \$108 million in 2008-2009. These adjustments are attributable essentially to the inclusion of the latest economic and tax data.

### **1.3.2 Expenditure adjustments**

#### **❑ Program spending**

For 2007-2008, the program spending objective is \$54.1 billion, i.e. \$191 million more than the objective announced in the last budget. This increase stems from the impact of the new actuarial valuations of the retirement plans.

New actuarial valuations of the retirement plans of public and para-public sector employees are carried out every three years to update the demographic and economic assumptions on which they are based (for instance, the life expectancy of benefit recipients, the pay of employees when they retire, etc.).

The purpose of these valuations is to determine the present value of the retirement benefits the government will ultimately pay to its employees, taking into account the conditions of their retirement plans and their years of service.

The new actuarial valuations, carried out as at December 31, 2005, result in a recurring increase in program spending for the government of \$191 million as of 2007-2008.

For 2008-2009, in addition to the recurring effect of this impact, the spending growth objective is increased from 3.0% to 3.5%, which will increase the government's capacity to deal with the pressure on spending, including the pressure relating to the funding of the Québec Infrastructures Plan announced last October 11.



TABLE 5

### Adjustments to the program spending objective since the 2007-2008 Budget<sup>P</sup>

(Millions of dollars)

	2007-2008	2008-2009
<b>PROGRAM SPENDING OBJECTIVE OF THE 2007-2008 BUDGET</b>	<b>53 913</b>	<b>55 504</b>
<i>% change</i>	4.1	3.0
<b>Adjustments</b>		
- New actuarial valuations of the retirement plans	191	191
- Rise to increase growth from 3.0% to 3.5% in 2008-2009	—	296
<b>Subtotal</b>	<b>191</b>	<b>487</b>
<b>PROGRAM SPENDING OBJECTIVE, FALL 2007</b>	<b>54 104</b>	<b>55 991</b>
<i>% change</i>	4.3	3.5
Nominal GDP growth in the calendar year (%)	5.9	4.0

P: Projections.

### □ Debt service of the Consolidated Revenue Fund

Compared to last May's budget, forecast debt service is adjusted downward by \$255 million in 2007-2008. The positive effects of the rise in the Canadian dollar in relation to other currencies account for most of this adjustment.

For 2008-2009, the debt service forecast in the budget remains unchanged. The additional spending generated by the rise in certain interest rates and by the new actuarial valuations of the retirement plans offset the benefits stemming from the improvement in the Canadian dollar.

## 1.4 Continued rigorous spending management

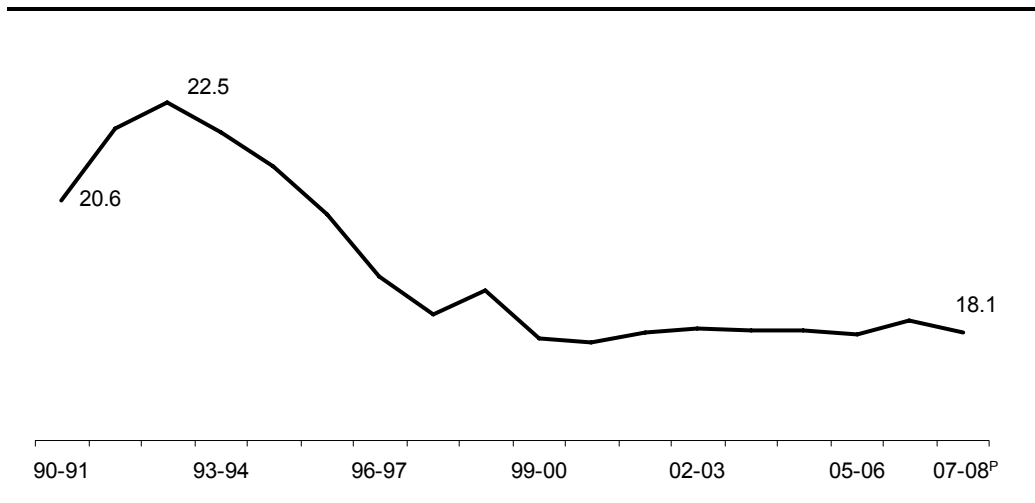
### □ Spending growing more slowly than the economy

From 2003-2004 to 2007-2008, average annual growth in Québec's program spending is 4.3%, less than that of nominal gross domestic product (GDP), at 4.5%.

Accordingly, in 2007-2008, program spending as a proportion of GDP amounts to 18.1%, one of the lowest levels in 35 years.

CHART 1

#### Program spending (As a percentage of GDP)



P: Projections.

## □ Québec ranks among the best provinces at controlling spending

Since 2003-2004, Québec's program spending has risen by an average of 4.3%.

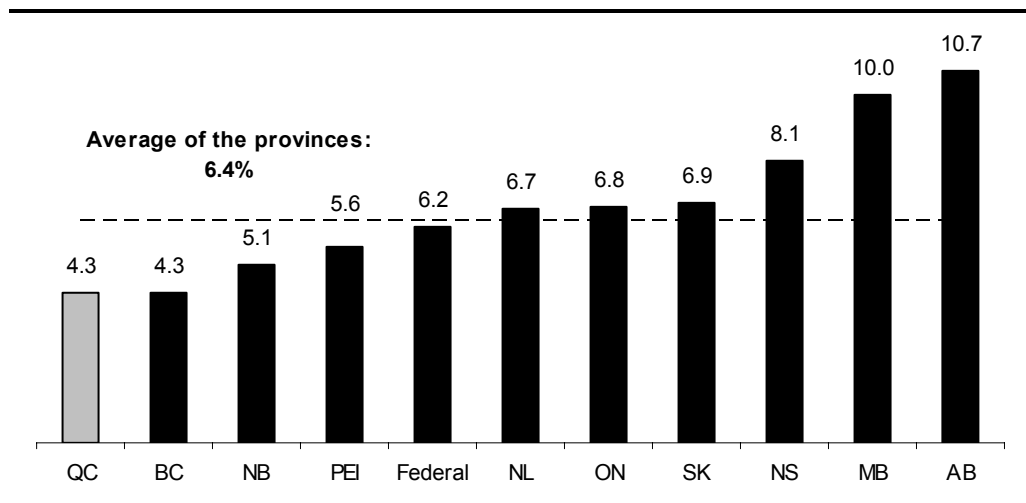
— By comparison, program spending in Ontario rose by an average of 6.8% per year, while that of the federal government grew by 6.2%.

In fact, along with British Columbia, Québec is the province with the lowest growth in its program spending.

### CHART 2

#### Average annual growth in program spending from 2003-2004 to 2007-2008

(Per cent)



Source: Ministère des Finances du Québec.

The government's success in controlling spending is based, in particular, on its efforts to modernize the state since 2003. The 2004-2007 modernization plan includes, among other things:

- reduction of the size of the public service from 75 800 to 60 100 full-time jobs by 2014;
- creation of the Centre de services partagés du Québec and of Services Québec to group the offering of government services and thus make life simpler for individuals and companies.

Thanks to the reduction of the size of the state and declining operating costs, the government has achieved aggregate savings of \$1.0 billion since 2006-2007. These savings can already be invested in Quebecers' priorities.

### □ Health and education priorities

Despite disciplined management of its spending, the government continues to invest in its priorities. Two thirds of the increase in program spending in 2007-2008 is allocated to the health and social services sector, a rise of \$1.5 billion or 6.5%.

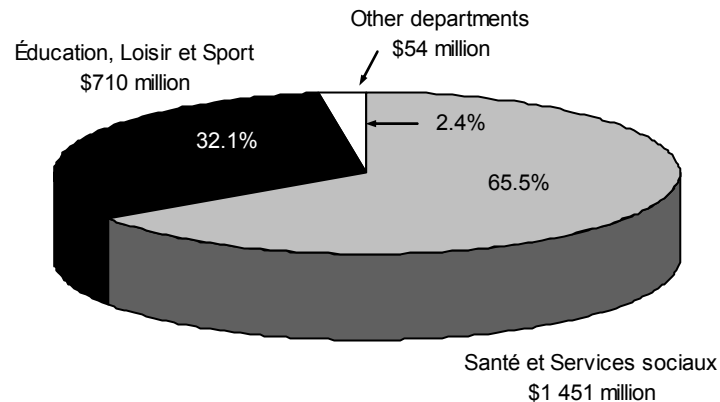
The budget of the ministère de l'Éducation, du Loisir et du Sport has also received a substantial increase of 5.6%, i.e. \$710 million.

Lastly, the small rise of 0.3% (\$54 million) in the budget of the other government departments is indicative of the government's disciplined spending management.

CHART 3

### Giving priority to health and education

(Distribution of the increase of \$2.2 billion in program spending in 2007-2008<sup>P</sup>)



P: Projections.  
Source: Secrétariat du Conseil du trésor.

## 1.5 Investments in public infrastructure

Since 2003, the government has been unstinting in its efforts to improve public infrastructures. As announced in the 2007-2008 Budget, the implementation of the Québec Infrastructures Plan initiates the first phase of a huge project to renew all of its fixed assets.

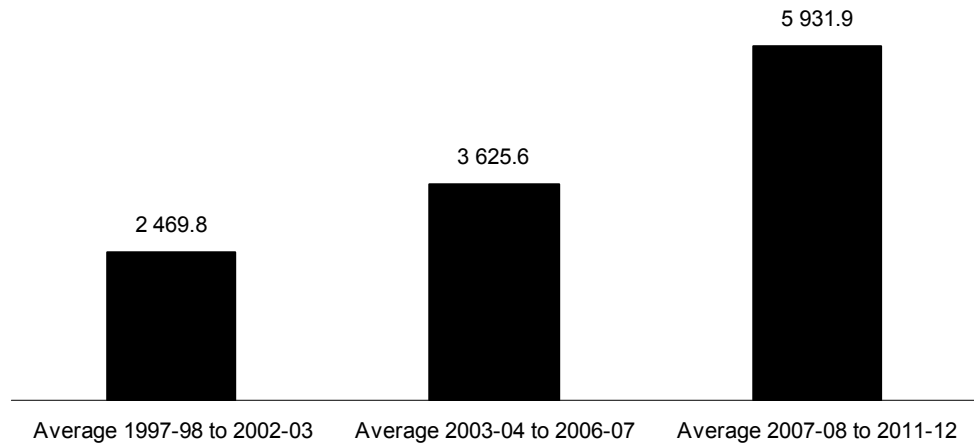
The imperative objective of this plan is to ensure the longevity of Québec's infrastructures. To achieve this, the government took two major steps last October 11.

- It announced that over the next 15 years, massive investments will be made to renovate and modernize public infrastructures. By 2012, investments of \$30 billion will be made under an initial five-year plan.
- It also tabled draft legislation on infrastructure management that will make maintenance and renewal of public infrastructures mandatory for the future by adhering to guidelines based on recognized standards.
  - This will ensure that within a maximum of 15 years, the accumulated maintenance deficit will be eliminated and will introduce a performance and management framework for major infrastructure projects.

Over the next five years, the Québec government's investment under the plan, to maintain and replace infrastructures, will amount to \$5.9 billion per year, i.e. more than double the investment made during the period from 1997 to 2003.

## CHART 4

### Evolution of the investments in fixed assets<sup>1</sup> (Millions of dollars)



<sup>1</sup> Excluding investments made by departments and budgetary organizations and by special funds other than the Road Network Preservation and Improvement Fund (RNPIF).

Source: Foundations for Success: Québec Infrastructures Plan, gouvernement du Québec, 2007.

A significant financial effort will be required to fund the Québec Infrastructures Plan. However, the government will see to it that the plan is funded within the budgetary objectives it has set, while making full use of funds from its partners, namely the federal government and the municipalities.

The federal funds will be used according to the infrastructure priorities and needs of Québec. To that end, Québec has asked the federal government for its share of new infrastructure funds to be paid as a bloc transfer rather than under a number of administrative agreements covering specific projects.

As the Québec Infrastructures Plan indicates, the investments made in the course of the first five-year investment plan will mean additional annual spending:

- of \$264 million in 2008-2009;
- and \$922 million in 2011-2012.

TABLE 6

### Impact of the Québec Infrastructures Plan and the completion of projects on the government's spending<sup>P</sup>

(Millions of dollars)

	2007-08	2008-09	2009-10	2010-11	2011-12	Total
Current investments	5 601	5 215	5 220	5 107	5 132	26 275
Investment and completion plan <sup>1</sup>	6 028	7 640	8 317	7 955	7 342	37 282
Annual impact of the investment plan	427	2 425	3 097	2 848	2 210	11 007
Cumulative impact of the investment plan	427	2 852	5 949	8 797	11 007	11 007
<b>Impact on spending</b>	<b>33</b>	<b>264</b>	<b>505</b>	<b>735</b>	<b>922</b>	—

P: Projections.

1 The investments planned under the first five-year investment plan amount to \$29.7 billion, to which will be added investments to complete projects previously announced for \$7.6 billion, giving a total of \$37.3 billion.

Source: Foundations for Success: Québec Infrastructures Plan, gouvernement du Québec, 2007.

To generate the leeway needed to fund this additional spending over the length of the plan, the government:

- will review its spending plan in light of the priority given to infrastructure;
- will continue its efforts to modernize the state in order to raise productivity in delivering services and thus achieve savings;
- will study the possibility of implementing specific new sources of funding.

## 1.6 Lasting reduction of the debt burden thanks to the Generations Fund

In the 2007-2008 Budget, the government reiterated its determination to deal firmly with Québec's debt load and, to that effect, announced the payment of additional contributions to the Generations Fund, namely:

- \$200 million paid in 2007;
- \$400 million per year, on average, during the period from 2010-2011 to 2025-2026, from the additional profits Hydro-Québec will earn on electricity exports.

Including these new contributions, the balance of the Generations Fund will approach \$2 billion by March 31, 2009.

In all, the additional contributions the government has announced since the creation of the Generations Fund in June 2006 will result in allocating a further amount of close to \$42 billion to the repayment of Québec's debt by March 31, 2026.

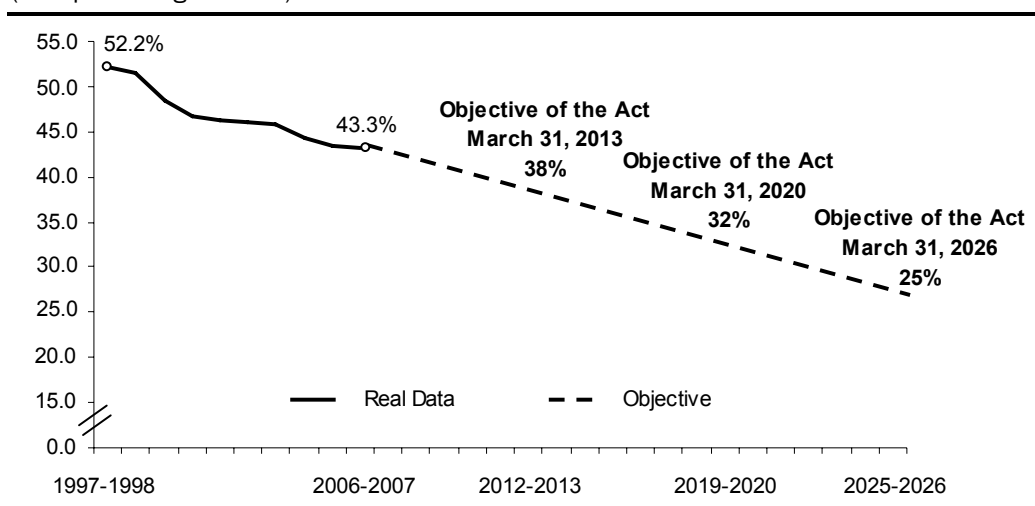
### □ Reduction of the debt burden to 25% of GDP by 2026

Even with the investments of the Québec Infrastructures Plan that will be made in the coming years, the government is maintaining its targets for reducing the debt burden. By 2026, the debt burden will be lowered to 25% of GDP. The additional payments to the Generations Fund announced in the last budget will help achieve this objective.

CHART 5

#### Reduction in the government's total debt<sup>1</sup>

(As a percentage of GDP)



1 Total debt for the purposes of the Act to reduce the debt and establish the Generations Fund.



## 1.7 Detailed results

The following tables provide more detailed information on the major components of the government's adjusted financial framework.

TABLE 7

### Revenue of the Consolidated Revenue Fund<sup>1</sup>

(Millions of dollars)

	2006-2007	2007-2008 <sup>P</sup>	% change
<b>OWN-SOURCE REVENUE</b>			
<b>Own-source revenue excluding government enterprises</b>			
- Personal income tax	18 197	18 420	1.2
- Contributions to the Health Services Fund	5 075	5 408	6.6
- Corporate taxes	4 796	4 704	- 1.9
- Consumption taxes	12 583	12 958	3.0
- Other sources	2 530	2 338	- 7.6
<b>Total</b>	<b>43 181</b>	<b>43 828</b>	<b>1.5</b>
Revenue from government enterprises	6 227	4 625	- 25.7 <sup>2</sup>
<b>Total</b>	<b>49 408</b>	<b>48 453</b>	<b>- 1.9</b>
<b>FEDERAL TRANSFERS</b>			
- Equalization	5 539	7 160	29.3
- Health transfers	3 649	3 748	2.7
- Transfers for post-secondary education and other social programs	1 070	1 406	31.4
- Other programs	767	948	23.6
<b>Total</b>	<b>11 025</b>	<b>13 262</b>	<b>20.3</b>
<b>BUDGETARY REVENUE</b>	<b>60 433</b>	<b>61 715</b>	<b>2.1</b>

P: Projections.

1 Before impact of the accounting reform.

2 This decline stems in particular from the fact that in 2006-2007, Hydro-Québec earned an exceptional profit of \$944 million from the sale of its interests in corporations.

TABLE 8

**Expenditure of the Consolidated Revenue Fund<sup>1</sup>**  
(Millions of dollars)

	<b>2006-2007</b>	<b>2007-2008<sup>P</sup></b>	<b>% change</b>
<b>PROGRAM SPENDING</b>			
- Health and social services	22 452	23 903	6.5
- Education, recreation and sport	12 715	13 425	5.6
- Other departments	16 722	16 776 <sup>2</sup>	0.3
<b>Total</b>	<b>51 889</b>	<b>54 104</b>	<b>4.3</b>
<b>DEBT SERVICE</b>	<b>6 925</b>	<b>6 989</b>	<b>0.9</b>
<b>BUDGETARY EXPENDITURE</b>	<b>58 814</b>	<b>61 093</b>	<b>3.9</b>

P: Projections.

1 Before impact of the accounting reform.

2 Including \$191 million to fund the cost of the new actuarial valuations of the retirement plans.

**PART TWO:  
ACCOUNTING REFORM**



## 2. ACCOUNTING REFORM

The government is announcing the implementation of an accounting reform. This reform incorporates all the recommendations of the Task Force on Government Accounting.

### 2.1 The Task Force's Mandate

When the 2007-2008 Budget was tabled last May, the Minister of Finance announced the formation of a Task Force on Government Accounting to propose a reform of its accounting practices.

The mandate of the Task Force, which consisted of representatives of the ministère des Finances, including the Comptroller of Finance, and of the Auditor General of Québec, was to in particular examine the changes needed to ensure that the government's accounting practices complied with public sector generally accepted accounting principles (GAAP).

The potential consequences of this reform on the following statutes were also to be examined:

- *Balanced Budget Act;*
- *Act to reduce the debt and establish the Generations Fund;*
- *Act respecting a budgetary surplus reserve fund.*

More specifically, the Task Force had a three-part mandate:

- an examination of the accounting, financial and administrative consequences of consolidating the health and education networks within the government reporting entity;
- examine the accounting, financial and administrative consequences of applying public sector GAAP;
- examine the impact of harmonization with public sector GAAP on the three statutes listed above.

## **2.2 Recommendations of the report**

The government has received the Task Force's report and has decided to act on it immediately by incorporating all its recommendations in the financial results of 2006-2007 and the financial forecasts as of 2007-2008.

Before the reform, the financial statements complied with the government's accounting practices and, to a large extent, with public sector GAAP. Application of the Task Force's recommendations will enable the government to present financial information that complies fully with public sector GAAP.

### **2.2.1 Broadening of the government reporting entity to include the health and education networks**

Of all the changes needed to comply with public sector GAAP, consolidation of the health and education networks is certainly the one that raises the most significant issues.

The government reporting entity is accordingly changed to encompass, as of April 1, 2006, the financial results of health and social services agencies, public health institutions, school boards, colleges and those of the Université du Québec and its constituents.

Moreover, consolidation of the entities of the networks also requires changing the classification at the accounting level of two entities whose main activity is to finance the networks, namely Financement-Québec (FQ) and the Corporation d'hébergement du Québec (CHQ). These two entities can no longer be recognized as government enterprises. Henceforth, they will be considered as government organizations resulting in particular in consolidating the debts they have contracted for the requirements of the networks with the government's debt.

### **2.2.2 Transfers**

The government records its transfers, commonly known as grants, according to its accounting practices, which are based essentially on public sector GAAP. Generally speaking, the accounting for transfers, whose annual amount for all departments exceeds \$40 billion, does not raise any problems.

However, the government will apply the recommendations of the Task Force to eliminate certain ambiguities of interpretation that were raised in two specific cases of transfers in recent years, namely:

- operating grants to universities and relating to student enrolment;
- transfers to municipalities, on account of financial compensation from the government in lieu of taxes.

Up to now, to obtain the final amounts to be paid, expenditures could be recorded in a subsequent year. Changes will be made so that henceforth, these expenditures will be recognized during the reference period used to calculate the expenditure and not, as was previously the case, on the basis of when they are authorized. This new approach fully reflects accrual accounting.

### **2.2.3 Accrual accounting for tax revenues**

The government own-source revenue consists chiefly of tax revenues, duties and permits. Tax revenues include personal income tax, corporate taxes, contributions to the Health Services Fund and consumption taxes.

According to the government's accounting practices, these revenues were recorded using the « modified » cash method of accounting, which lies halfway between cash accounting and accrual accounting.

Under the accounting reform, recognition of tax revenues will move from the “modified” cash method to the accrual method of accounting to better allocate, in each fiscal year, the revenues arising from the economic activity inherent in such period. This new method will be applied to all tax revenues except for corporate tax revenues. In the latter case, the current method, which stipulates recognition at the time the funds are received, will be maintained, in keeping with GAAP.

It should be noted that in 2005-2006, the government had previously changed its accounting practices to apply accrual accounting to revenues from federal transfers as well as to revenues from registration and driver's licence fees.

## 2.2.4 Retirement Plans Sinking Fund (RPSF)

The Retirement Plans Sinking Fund (RPSF) is an asset that will be used to pay the retirement benefits of public and para-public sector employees. This asset is administered by the Caisse de dépôt et placement du Québec.

The current accounting practice regarding the RPSF is based on accounting standards in effect since the 1997-1998 accounting reform.

With this accounting reform, the accounting practice for the RPSF is updated to reflect the latest recommendations of the Public Sector Accounting Board (PSAB).

- Accordingly, the value of the RPSF will henceforth be adjusted annually, to correspond to the market-related value, rather than just every three years when the actuarial valuations of the retirement plans are carried out.
- The annual investment income of the RPSF will be calculated on the basis of this market-related value adjusted over five years.

## 2.2.5 Status of certain organizations

In addition to Financement-Québec (FQ) and the Corporation d'hébergement du Québec (CHQ), whose government enterprise status was changed to that of government organization further to the consolidation of network entities, an analysis of the government's various public enterprises has shown that three of them no longer satisfy the criteria to be considered as government enterprises. They are:

- the Société de l'assurance automobile du Québec (SAAQ), for its activities other than automobile insurance;
- the Société de développement de la Baie James (SDBJ);
- the Société des établissements de plein air du Québec (SÉPAQ).

With the accounting reform, the classification of these entities from an accounting standpoint is changed given that they derive their revenue largely from government grants or from revenues of other government entities. Henceforth, they will be considered as government organizations and, in this regard, their revenue, expenditure, assets and liabilities will be consolidated line by line with those of the government.



## 2.2.6 Loans at advantageous conditions and allowance for losses on guaranteed financial initiatives

### □ Loans at advantageous conditions

Under certain financial assistance programs, the government at times makes loans to companies at advantageous conditions compared with those offered by financial institutions.

In the case where the advantageous conditions of these loans can be likened to a grant, public sector GAAP recommend that the « grant » portion be recognized under expenditure when the loans are made.

Under the accounting reform, the government's accounting practices will be changed so that the « grant » portion of a loan will henceforth be recognized on account of expenditure, at the time the loan is made, rather than being spread over the length of the loan.

### □ Allowance for losses on guaranteed financial initiatives (ALGFI)

In addition, further to the Task Force's recommendations, the government's accounting practices are also being changed so that the allowance for losses on guaranteed financial initiatives will henceforth be recognized at the time the loan is disbursed or the guarantee comes into effect rather than at the time the financial assistance granted to a company is authorized, whether such assistance is granted as a loan or a loan guarantee.

## 2.2.7 Inventories and prepaid expenses

With the exception of fixed assets, the government records goods and services under expenditure when they are acquired, even though they are not completely used during the fiscal year and applies this accounting treatment to organizations and special funds in the consolidation entries. In so doing, it can bring forward the recognition of certain expenditures.

Henceforth, the government will fully apply accrual accounting by recognizing in its balance sheet the inventories and prepaid expenses of non-budgetary organizations and special funds.

At the end of the fiscal year, the unused portion of goods and services acquired will be recognized under assets.

This move to accrual accounting implies few adjustments since most of the entities affected already manage the goods and services they acquire and show inventories and prepaid expenses in their financial statements. Moreover, departments are little affected by this accounting change since they carry out few operational activities that give rise to inventories and prepaid expenses.

### **2.2.8 Future social benefits**

Government employees enjoy various social benefits such as:

- vacation and sick leave;
- surviving spouse pension plan;
- future social benefits relating to a specific event, for instance, the exercise of parental rights and deferred pay leave.

The accounting for these various benefits, both in terms of the expenditure incurred and the assets and liabilities involved, is being reviewed to comply fully with public sector GAAP.

These changes imply that from now on the government will record:

- the asset and the liability relating to social benefits on the basis of actuarial methods, where required, and amortize the resulting actuarial gains and losses on an appropriate basis;
- the cost of social benefits relating to a specific event as soon as the event takes place rather than when the amounts due to the employee are paid.

### **2.2.9 Currency futures contracts and redemption of financial instruments**

Exchange gains and losses on currency futures contracts will henceforth be recognized in the statement of operations of the year in which they mature, rather than being deferred and amortized over the remaining term of the borrowings.

Exchange gains and losses on repurchases of instruments in foreign currencies will continue to be amortized over the remaining term of the repurchased instruments.

## **2.3 Application of the accounting changes**

The government has accepted the recommendations of the Task Force and is changing its accounting practices for the production of the government's consolidated financial statements as at March 31, 2007. Accordingly, it has been decided:

- to apply retroactively the adjustments resulting from this accounting reform without restating prior fiscal years.

## **2.4 Impact of the accounting reform**

### **2.4.1 On the budgetary statutes**

The Task Force on Government Accounting was also mandated to examine the implications of the changes made to the government's accounting practices on budgetary statutes. The government accepts all the recommendations the Task Force has made regarding these statutes.

The first law covered by this examination is the Balanced Budget Act. The purpose of the Act is set guidelines for the conduct of government budgetary policy over time. For the Act to adequately achieve its objectives, it must be based on results recorded in accordance with the accounting practices of public sector GAAP.

The application of the law must be devoid of ambiguity as to the definitions used, failing which the achievement of a balance budget will constantly open to question. It is suggested that the notion of accumulated surplus, for the purposes of the Act, be changed so that all amounts recorded directly to the debt representing accumulated deficits be taken into account in the balance established, for the purposes of the Balanced Budget Act, except for changes to the accounting practices to comply with a new CICA standard. In addition, the Act will also be amended so that the accumulated surplus for the purposes of the Act is set to zero as at April 1, 2006.

The second statute covered by this examination is the Act to reduce the debt and establish the Generations Fund. In this regard, the government has changed the definition of the total debt in the Public Accounts glossary to reflect the parameters that existed when the bill was being studied in June 2006. This solution will prevent future accounting standards from changing the objective to be achieved.

By passing the Act to establish a budgetary surplus reserve fund, the government's objective was to transparently manage its budgetary policy on a multi-year basis. The accounting reform does not require an amendment to the Act. However, the government will propose legislative changes to simplify its application. In addition, it will become as flexible as in some other provinces with regard to allocating or using amounts from the reserve.

A bill will be tabled in the National Assembly to make the appropriate legislative amendments to the Balanced Budget Act and the Act to establish a budgetary surplus reserve fund.

#### **2.4.2 On the financial framework**

Overall, the accounting reform announced today will have a positive financial impact of \$89 million in 2006-2007 and a negative financial impact of \$663 million in 2007-2008, as shown in tables 9 and 10. For 2008-2009, the government is setting aside \$150 million to fund the potential impacts of this reform.

TABLE 9

**Impact of the accounting reform on results - 2006-2007**

(Millions of dollars)

	Before the reform	Impact of the accounting reform	After the reform
<b>BUDGETARY REVENUE</b>			
Own-source revenue	49 408	278	49 686
Federal transfers	11 025	- 10	11 015
<b>Total</b>	<b>60 433</b>	<b>268</b>	<b>60 701</b>
<b>BUDGETARY EXPENDITURE</b>			
Program spending	- 51 889	93	- 51 796
Debt service	- 6 925	- 75	- 7 000
<b>Total</b>	<b>- 58 814</b>	<b>18</b>	<b>- 58 796</b>
<b>NET RESULTS OF CONSOLIDATED ORGANIZATIONS</b>	<b>201</b>	<b>22</b>	<b>223</b>
<b>REVENUE DEDICATED TO THE GENERATIONS FUND<sup>1</sup></b>	<b>84</b>	<b>0</b>	<b>84</b>
<b>NET RESULTS OF NETWORKS</b>	<b>—</b>	<b>- 219</b>	<b>- 219</b>
<b>BUDGETARY BALANCE BEFORE PAYMENTS TO THE GENERATIONS FUND AND USE OF THE BUDGETARY RESERVE</b>			
	<b>1 904</b>	<b>89</b>	<b>1 993</b>
Allocation to the budgetary reserve	- 1 300	—	- 1 300
Additional payments to the Generations Fund	- 500	—	- 500
Payments of revenue dedicated to the Generations Fund	- 84	0	- 84
<b>BUDGETARY BALANCE - FALL 2007</b>	<b>20</b>	<b>89</b>	<b>109</b>

1 The \$8-million impact of the accounting reform is offset by the fact that the gains will be paid into the Generations Fund and, as a result, it does not affect the budgetary balance.

TABLE 10

**Summary of impact of the accounting reform on the budgetary balance**  
(Millions of dollars)

	<b>2006-2007</b>	<b>2007-2008<sup>P</sup></b>
<b>Budgetary balance before reform</b>	<b>20</b>	<b>663</b>
<b>Impact of the reform</b>		
- Consolidation of the health and education networks	- 219	- 185
- Transfers	66	- 6
- Accrual accounting for tax revenues	278	- 290
- Retirement Plans Sinking Fund (RPSF)	- 42	- 189
- Status of certain organizations	9	17
- Loans at advantageous conditions and allowance for losses on guaranteed financial initiatives	72	5
- Inventories and prepaid expenses	10	—
- Future social benefits	- 41	- 15
- Currency futures contracts and redemption of financial instruments	- 33	—
- Accrual accounting for the Generations Fund <sup>1</sup>	—	—
- Others	- 11	—
<b>Impact of the reform on the budgetary balance</b>	<b>89</b>	<b>- 663</b>
<b>BUDGETARY BALANCE AFTER REFORM</b>	<b>109</b>	<b>0</b>

P: Projections.

1 The \$8-million impact of the accounting reform is offset by the fact that the gains will be paid into the Generations Fund and, as a result, it does not affect the budgetary balance.

### 2.4.3 On the government's debt

The accounting reform has prompted the ministère des Finances to make changes to data on the debt. Detailed explanations are provided in the document entitled The Québec Government's Debt.

The changes made to the accounting of the Retirement Plans Sinking Fund and the Generations Fund increase the total debt for the purposes of the Act to reduce the debt and establish the Generations Fund by \$159 million as at March 31, 2007.

Line-by-line consolidation of certain entities, in particular Financement-Québec (FQ) and the Corporation d'hébergement du Québec (CHQ), the reclassification of the debt of the Société québécoise d'assainissement des eaux (SQAE) and of the future social benefits of government employees increase the gross debt by \$18 997 million.

Overall, taking into account its impact on the total debt, the accounting reform increases the gross debt by \$19 156 million.

The various components of the reform increase financial assets, net of other liabilities, by \$472 million. Consequently, the net debt rises by \$18 684 million.

Lastly, after including the fixed assets of consolidated entities, the net investment in the networks, and inventories and prepaid expenses, the components of the accounting reform taken as a whole increase the debt representing accumulated deficits by \$6 329 million as at March 31, 2007. As recommended by the Task Force on Government Accounting, this impact is not included in the "accumulated surplus" for the purposes of the Balanced Budget Act.

After the accounting reform, the debt representing accumulated deficits amounts to \$95 759 million, representing 33.9% of GDP.

TABLE 11

**Impact of the accounting reform on Québec's debt as at March 31, 2007**

(Millions of dollars)

	<b>Before the reform</b>	<b>Impact of the reform</b>	<b>After the reform</b>
Direct debt	90 340		90 340
Plus: Net liability for the retirement plans	32 677	167	32 844
Less: Generations Fund	- 576	- 8	- 584
<b>Total debt for the purposes of the Act to reduce the debt and establish the Generations Fund.</b>	<b>122 441</b>	<b>159</b>	<b>122 600</b>
Plus: Debt of entities consolidated line by line		15 723	15 723
Debt of the SQAE		2 522	2 522
Future social benefits		752	752
<b>Gross debt</b>	<b>122 441</b>	<b>19 156</b>	<b>141 597</b>
Less: Financial assets, net of other liabilities	- 18 934	- 472	- 19 406
<b>Net debt</b>	<b>103 507</b>	<b>18 684</b>	<b>122 191</b>
Less: Fixed assets	- 14 077	- 2 310	- 16 387
Net investment in the health and social services and the education networks:			
Loans and advances made to the networks by FQ and the CHQ		- 13 322	- 13 322
Accumulated deficits of the networks		3 439	3 439
Inventories and prepaid expenses		- 162	- 162
<b>DEBT REPRESENTING ACCUMULATED DEFICITS<sup>1</sup></b>	<b>89 430</b>	<b>6 329</b>	<b>95 759</b>
<b>As a percentage of GDP</b>	<b>31.6</b>	<b>2.3</b>	<b>33.9</b>

SQAE: Société québécoise d'assainissement des eaux.

FQ: Financement-Québec.

CHQ: Corporation d'hébergement du Québec.

1 Before the allocation of the amount posted to the budgetary reserve and after taking into account the net results of the Generations Fund.



**PART THREE:  
ECONOMIC OUTLOOK**



### **3. ECONOMIC OUTLOOK**

This section updates the economic forecasts used in the 2007-2008 Budget. This update provides the basis for the financial framework discussed in the first section.

On the whole, despite a slowing US economy and an international financial system shaken by the spreading sub-prime mortgage situation in the United States, the global economy will remain robust with forecast annual growth of almost 5% over the next two years.

In Québec, consumer demand and business investment remain high, supporting employment and tax revenues. In addition, Québec's economy will benefit over the next five years from the Québec Infrastructures Plan implemented by the Québec government. However, Québec's exports will continue to be limited by the sharp rise of the Canadian dollar and the significant slowdown of the American economy. In short, real GDP growth in Québec should reach 2% in 2007, rising to 2.2% in 2008.

#### **3.1 The international economic context**

##### **3.1.1 A robust global economy despite the turmoil on financial markets**

In recent months, international financial markets have been volatile as a result of foreclosures on American sub-prime mortgage loans. While the sub-prime loan issue was known at the time of the 2007-2008 Budget, it was difficult to foresee the extent of its impact on financial markets and the economy.

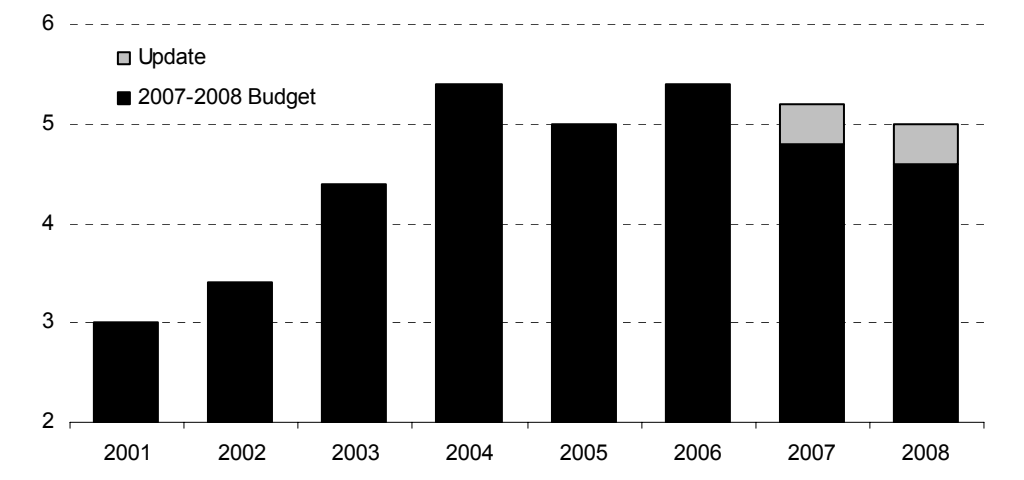
These events prompted the central banks of industrialized countries to adopt a wait-and-see attitude to monetary tightening and add liquidity to the financial system in order to reassure markets. This volatility also alerted central banks to the greater than anticipated slowdown of the American economy, in particular regarding lower growth of its imports.

Despite turbulence on financial markets, world economic growth will remain robust, supported by demand from emerging countries in Asia and Latin America. After rising by 5.4% in 2006, world real GDP should gain 5.2% in 2007 and 4.9% in 2008. This is an upward adjustment of 0.4% in 2007 and 0.3% in 2008 compared to the last budget.

## CHART 6

### World economic growth

(Real GDP, annual percentage change)



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

The greater vitality of the world economy is essentially attributable to the dynamism of the Chinese economy that exceeds forecasts. However:

- following a good economic performance in 2007, economic growth in the European Union will slow significantly in 2008;
- similarly, economic growth in the United States and Japan in 2008 will be less than forecast in the last budget.

In China, economic growth will exceed 10% for the fifth year in a row, despite attempts by the authorities to rein in the economy. The Chinese economy should grow by 11.5% in 2007 and 10.7% in 2008, rates that are at least 1.5% higher than forecast in the last budget.

In Japan, after reaching 2.2% in 2006, economic growth is expected to slow to 1.9% in 2007 and 1.7% in 2008. Gains in Japanese exports will be limited by slowing economic growth in the United States and Europe. Economic activity will continue to be supported by gains on the labour market that will stimulate consumer spending.

In the European Union, the economic slowdown that began in 2007 is expected to continue. After hitting 3.1% in 2006, growth in real GDP will slip to 2.8% in 2007 and 2.2% in 2008. In particular, economic growth will be hampered by the combined impact of the stronger euro compared with the American dollar, the rise in the price of oil and more restrictive access to credit following the sub-prime loan crisis.

TABLE 12

**Outlook for economic growth in the world**

(Real GDP, annual percentage change)

	2006	2007	2008
<b>China</b>	<b>11.1</b>	<b>11.5</b>	<b>10.7</b>
- 2007-2008 Budget	10.7	10.0	9.0
<b>Japan</b>	<b>2.2</b>	<b>1.9</b>	<b>1.7</b>
- 2007-2008 Budget	2.2	2.2	1.9
<b>European Union</b>	<b>3.1</b>	<b>2.8</b>	<b>2.2</b>
- 2007-2008 Budget	3.0	2.6	2.3
<b>United States</b>	<b>2.9</b>	<b>2.0</b>	<b>2.0</b>
- 2007-2008 Budget	3.3	2.0	2.6

Sources: International Monetary Fund and Global Insight.

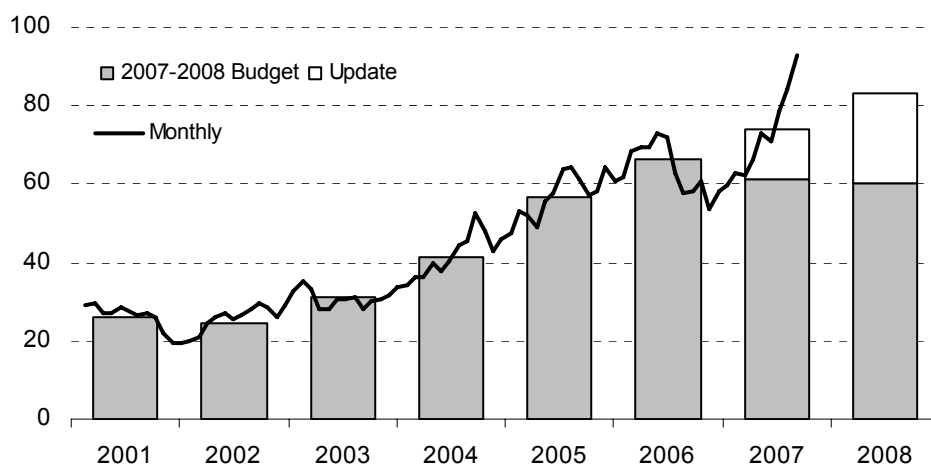
**□ The price of oil in the range of US\$85 per barrel in 2008**

The price of a barrel of crude oil recently flirted with US\$100 for the first time ever. The rise in crude oil prices began in early September 2007 with an unexpected drop in US oil reserves. In addition, acts of sabotage against pipelines in Mexico and the threat of hurricanes in the Gulf of Mexico added to uncertainty and helped to push prices up further.

CHART 7

**Expected monthly decline in the price of a barrel of West Texas Intermediate crude**

(US dollars)



Sources: Bloomberg and ministère des Finances du Québec.

The end of the hurricane season, the slowdown in the US economy and the recent decision by the Organization of Petroleum Exporting Countries to produce an additional 500 000 barrels per day since November 1 will help to bring the supply of oil more in line with demand and thus ease the upward pressure on the price of a barrel of crude by the end of 2007.

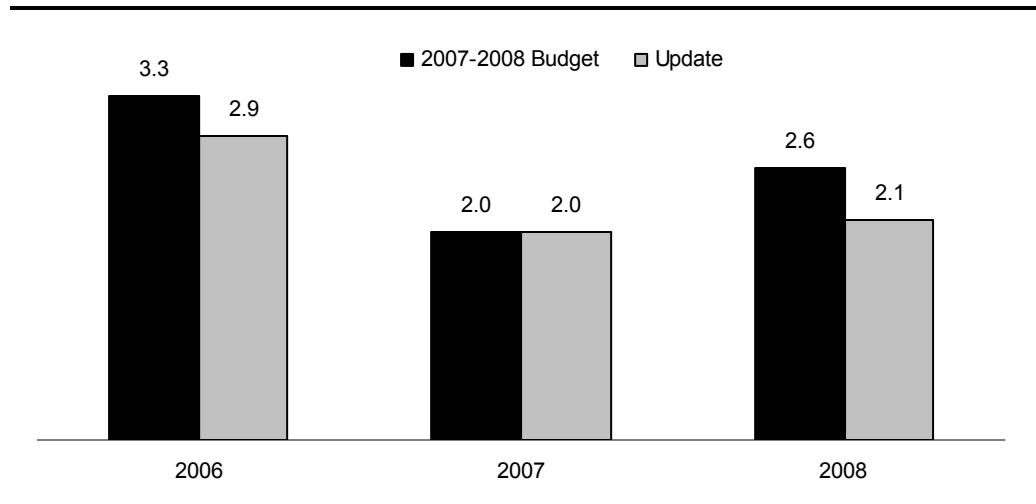
The price of a barrel of oil should fall below US\$85 by the end of 2008 as American demand continues to slow. However, strong demand from the Chinese economy should keep oil prices higher than expected in the 2007-2008 Budget. Accordingly, the price of oil is adjusted upward by \$13 per barrel in 2007 and \$23 in 2008.

### 3.1.2 A sharp downturn in the American economy

After reaching 2.9% in 2006, growth in real GDP in the US is expected to decline significantly over the next two years, to 2% in 2007 and 2008. Accordingly, growth is adjusted downward by 0.6% in 2008. This outcome is essentially attributable to the more severe correction than anticipated in residential investment and slower growth in consumer spending.

CHART 8

#### American economic growth (Real GDP, percentage change)



Sources: Global Insight and ministère des Finances du Québec.

The 2007-2008 Budget already reflected a continuation of the housing market correction that began in 2005 and its negative effects on the US economy.

However, the economic statistics released since the spring of 2007 indicate a worsening of the crisis. In particular:

- the number of property foreclosures in the United States is surging, adding substantially to the inventory of unsold houses, which will prolong the housing construction correction and further depress prices;
- this crisis is spreading to the financial sector as a whole. The problems linked to the securitization of sub-prime mortgages have led to a credit squeeze for businesses and consumers.

**❑ Difficulties in the residential housing sector are more severe than expected**

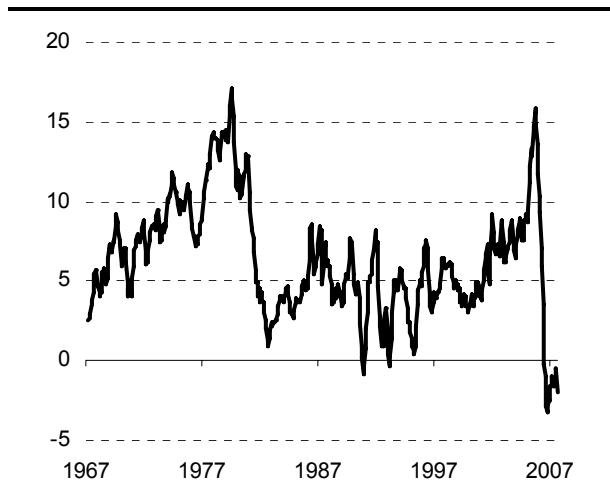
The drop in housing starts, the decline in home sales and falling prices for existing homes, which account for 80% of the market, have led to a major correction in residential housing that continues to affect the market.

- Housing starts have plunged 46% from their peak in 2006.
- Since 2005, sales of new homes have fallen by 45% while those of existing homes have fallen by 30%.
- Prices of existing homes have declined by 8% since July 2006, while new home prices have shed 9% since March 2007.

CHART 9

**Unprecedented drop in existing home prices in 2007 – United States**

(Annual change in existing home prices )

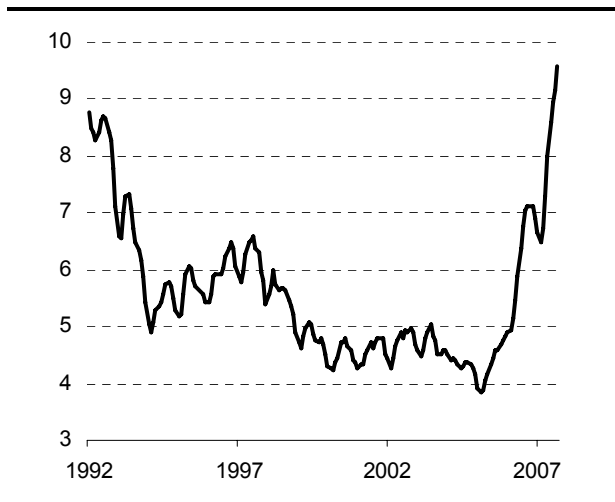


Sources: Global Insight and ministère des Finances du Québec.

CHART 10

**Inventories of unsold homes up sharply – United States**

(Existing homes – number of months of inventory<sup>1</sup>)



1: Number of months required to absorb current inventory of unsold homes.

Sources: Global Insight and ministère des Finances du Québec.

Given that nine months would now be required to absorb inventories of unsold homes, house prices and residential sales will continue to decline over the coming quarters.

This deterioration in the housing market crisis will result in a more substantial pullback in housing starts next year. Accordingly, after dropping by 15.3% in 2007, residential investment should fall 17.9% in 2008 compared to a forecast decline of 2.8% in the budget.



## Sub-Prime Mortgage Loan Crisis in the United States

The sub-prime loan crisis erupted last August following the rise in foreclosures on the sub-prime mortgage loan market in the United States.

To revive home sales, which were experiencing slowing growth in late 2003, new, riskier mortgage products became increasingly popular with marginally solvent borrowers. The value of sub-prime loans rose from US\$400 billion in 2003 to US\$1 400 billion in 2006.

The most popular type of sub-prime loan is the adjustable rate mortgage, where the interest rate resets two to three years after the year the loan is taken out. The recent drop in house prices has made it difficult to refinance a mortgage at better conditions. Resetting the loan at higher rates thus causes financial problems for a growing number of households.

Problems with repaying loans made in the United States have affected the confidence of international investors regarding not just mortgage-backed securities, but indeed all asset-backed securities.

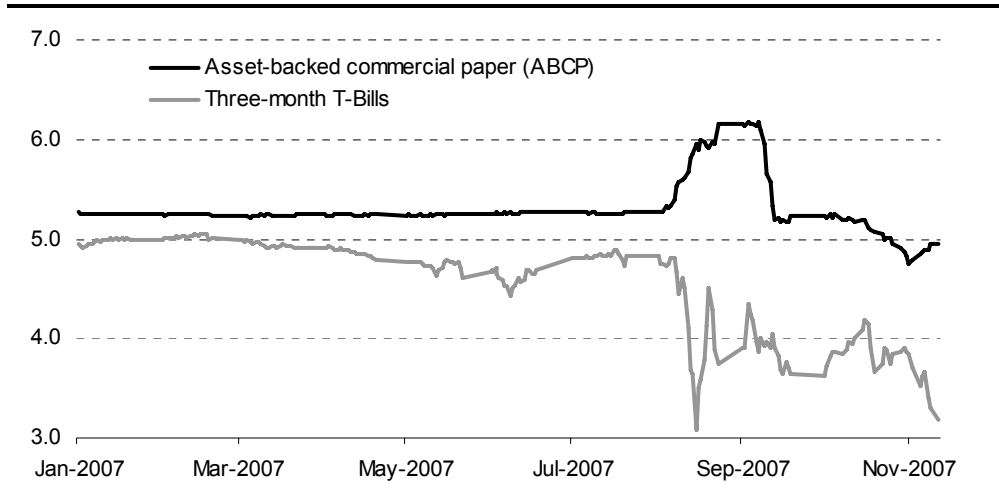
The crisis of confidence has turned into a liquidity crisis. As suspicion has grown, holders have tried to sell their securities but have found it difficult to find buyers, causing prices of the securities to drop and liquidity losses for issuers.

This crisis of confidence is affecting investment and consumption by tightening credit conditions.

In response to the credit squeeze, the US Federal Reserve has injected significant amounts of liquidity into financial markets.

CHART 11

### Yield on asset-backed commercial paper (ABCP) and on three-month US Treasury Bills (Per cent)



Source: US Federal Reserve.

## ❑ Moderate growth in consumer spending

Job creation has remained relatively robust in the United States, causing the unemployment rate to fall to an average of 4.6% this year. In addition, labour scarcity and good corporate profits have been beneficial for growth in wages and salaries.

Despite the liquidity crisis, which results in tighter credit conditions and a reduction in household wealth, consumer spending will be sustained by higher household income, which will rise by 3.9% in 2007 and 2.8% in 2008. Accordingly, personal spending should grow by 2.8% in 2007 and 2% in 2008.

## ❑ Intervention by the Federal Reserve

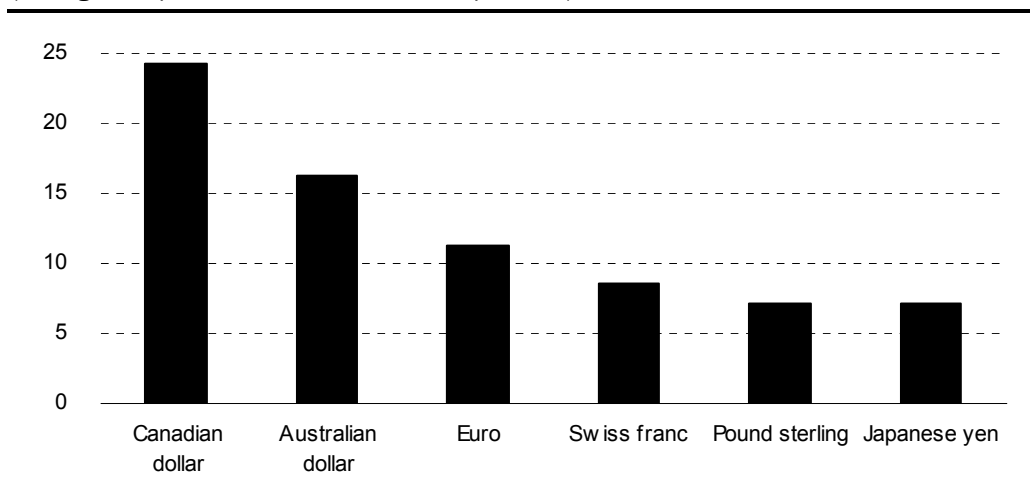
In response to tightening credit conditions stemming from sub-prime mortgage defaults, the Federal Reserve has injected liquidity into the financial markets. It has also cut the federal funds rate by 75 basis points, to 4.50%. These steps should mitigate the negative effects of the turbulence caused by sub-prime loan defaults and encourage economic growth over the coming quarters.

Reacting to the cut of 75 basis points in the federal funds rate, the American dollar has fallen sharply against major currencies, reaching a record low. Since the beginning of the year, the US dollar has fallen by more than 10% compared with major currencies, a drop of 30% since 2002.

CHART 12

### Currency appreciation since January 1, 2007

(Change compared with American dollar, per cent)



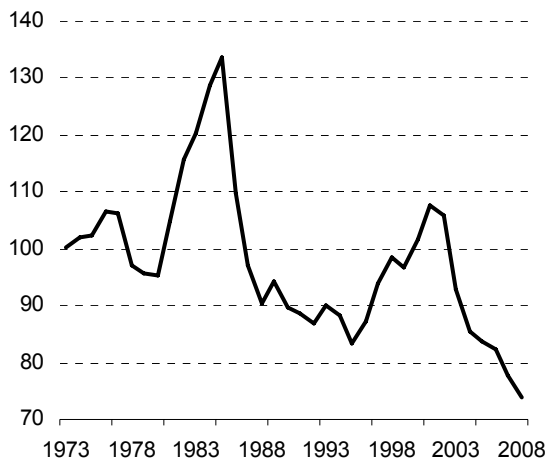
Source: Global Insight.

❑ **The depreciation of the American dollar will help reduce the trade deficit**

After setting a record of \$624 billion in 2006, i.e. 5.5% of real GDP, the American trade deficit began to shrink in 2007 and should continue doing so over the coming years. This decline is helped by the depreciation of the American dollar and by weakening American demand for imported goods, such as petroleum products and products from China. For the first time since 1995, the external sector should make a positive contribution to US economic growth in 2007.

CHART 13

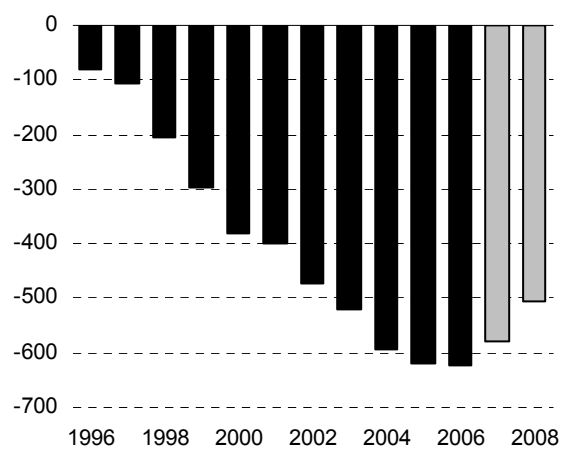
**All-time low for the American dollar**  
(Index weighted by major currencies , 1973 = 100)



Sources: Global Insight and ministère des Finances du Québec.

CHART 14

**Declining US trade deficit**  
(Billions of US dollars, in real terms)



Sources: Global Insight and ministère des Finances du Québec.

### 3.1.3 The Canadian economy continues to be stimulated by domestic demand

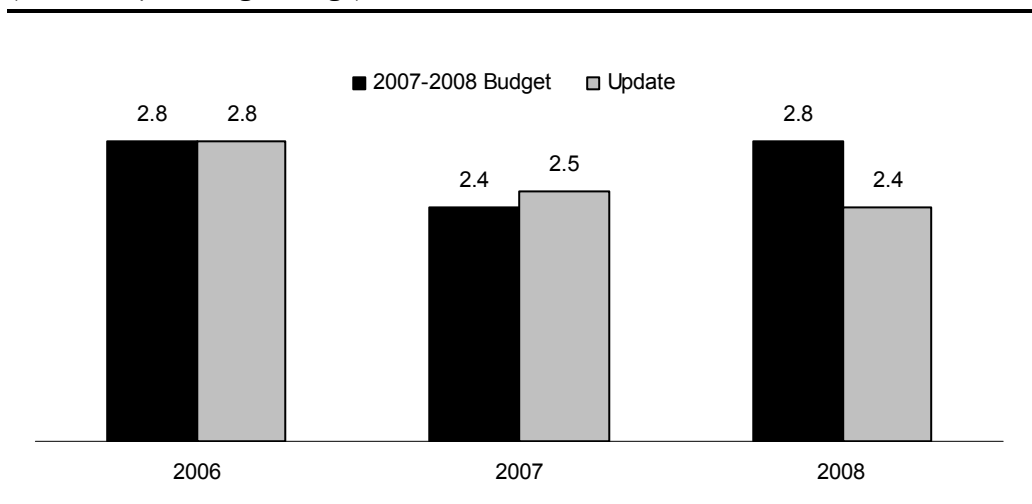
The Canadian economy continues to expand at a sustained rate. After growing by 2.8% in 2006, Canada's real GDP should grow by 2.5% in 2007 and 2.4% in 2008.

This outlook has been adjusted upward by 0.1% in 2007 and downward by 0.4% in 2008 since the 2007-2008 Budget. The growing strength of domestic demand has partially offset the more negative than anticipated contribution of the external sector that is adjusting to weak American demand and a high Canadian dollar. Since its low in 2002, the Canadian dollar has gained more than 60%. In 2008, domestic demand should remain vigorous thanks in particular to tax cuts and the reduction of one percentage point in the GST next January 1.

CHART 15

#### Economic growth in Canada

(Real GDP, percentage change)



Sources: Statistics Canada and ministère des Finances du Québec.

The situation of Canada's housing sector stands in contrast to the situation in the United States, since the Canadian market continues to show strength. Unlike the United States, sub-prime mortgages are uncommon in Canada and there is no significant excess supply of properties. In addition, despite the expected slowing of residential construction in Canada, home prices will continue to rise at a moderate pace.

## □ Vigorous domestic demand

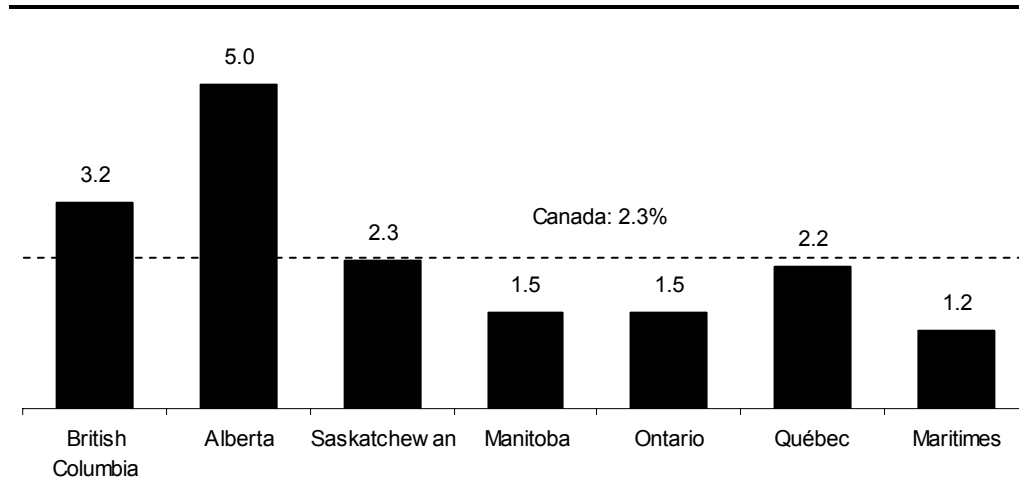
Domestic demand is sustained by high levels of business investment and confident consumers thanks to a dynamic labour market. In addition, governments continue to make substantial investments to improve public infrastructures and services, while running, for the most part, a balanced budget.

In addition, strong international demand for raw materials is a powerful stimulant for investment, mainly in Western Canada. Further, the price of oil has continued to rise substantially, generating even more interest in investing among businesses. In addition, the spin-off effects of these investments in the rest of the economy remain significant. And, while investment growth is uneven among the regions, job creation is more uniformly distributed among the provinces, despite Alberta's dominance.

CHART 16

### Employment growth by province in 2007

(Percentage change, average job creation from January to October 2007 compared to the same period in 2006)



Source: Statistics Canada.

Moreover, inflation in Canada, as measured by the Bank of Canada's benchmark index, remains moderate at 2.3% currently despite the strength of the labour market. Companies face major competitive pressures to control production costs, which limits pay rises. In addition, the recent appreciation of the Canadian dollar is putting downward pressure on prices of imported goods and services.

In 2008, the federal government will reduce the personal income tax rate and the goods and services tax, which should stimulate domestic demand, especially consumption spending.

### □ The Bank of Canada's key interest rate

Although the Bank of Canada sees the Canadian economy currently operating above its potential, on December 4, the Bank reduced its key interest rate by 25 basis points to 4.25%. This is in line with its view that inflationary risks have diminished due to the following factors:

- the appreciation of the Canadian dollar, which makes imported goods cheaper;
- the tightening of credit conditions in response to the liquidity crisis;
- the expected downward pressure on Canadian exports in line with the deteriorating outlook for US growth.

Moreover, the rise in long-term interest rates should continue, with the yield on 10-year bonds in Canada rising from 4.4% in 2007 to 4.7% in 2008. This increase stems essentially from rise in long-term rates in the United States that will begin with the return of inflationary pressure in 2008.

In short, there is little change to forecast interest rates in Canada since the 2007-2008 Budget.

TABLE 13

### Forecast interest rates in Canada

(Rate in per cent)

	2006	2007	2008
Three-month Treasury Bills	4.0	4.2	4.2
- 2007-2008 Budget	4.0	4.2	4.2
Ten-year Canada bonds	4.2	4.4	4.7
- 2007-2008 Budget	4.3	4.3	4.7

Sources: Statistics Canada and ministère des Finances du Québec.

## □ The loonie at par with the greenback

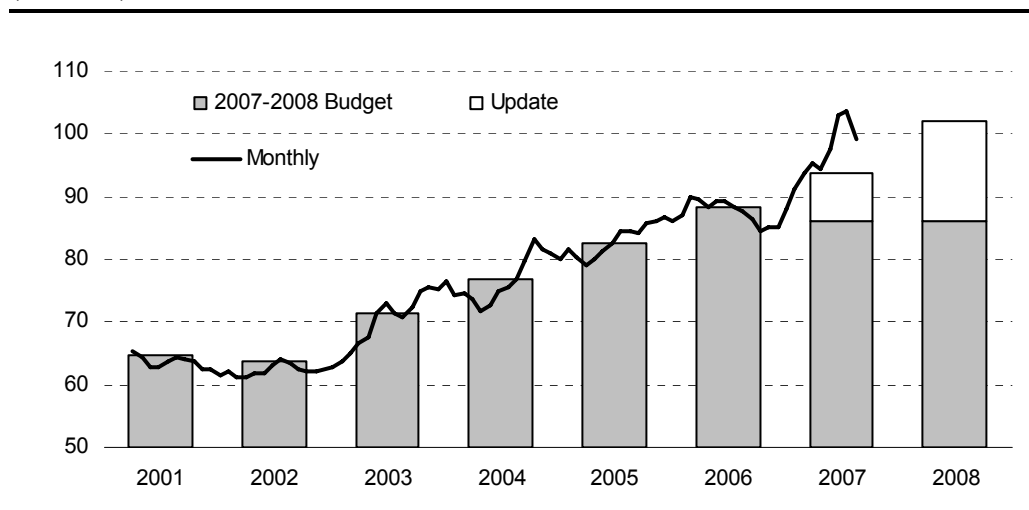
Since early 2002, the Canadian dollar has risen by more than 60% and moved above parity with the US dollar last October. Over the first ten months of 2007, the Canadian dollar has gained more than 20% and has averaged 92 American cents. The strong appreciation of the Canadian dollar since 2002 results from a number of factors:

- the significant increase in raw materials prices over the last few years. In particular, oil prices have quadrupled since 2001;
- the decline of more than 30% of the American dollar compared with major currencies, bringing it to a record low;
- the major improvement in public finances in Canada;

Accordingly, the Canadian dollar should average 95 American cents in 2007 and 1.02 American dollars in 2008. This is an upward adjustment of 9 cents in 2007 and 15 cents in 2008 compared to the 2007-2008 Budget forecast.

CHART 17

### Rise in the Canadian dollar (US cents)



Sources: Statistics Canada and ministère des Finances du Québec.

## 3.2 The economic context in Québec

### 3.2.1 Good economic growth despite weak exports

Québec's economy is enjoying good growth. While domestic demand is stronger than forecast in the last budget, the significant deterioration in the international economic climate in 2007 has offset most of the gains achieved by domestic demand.

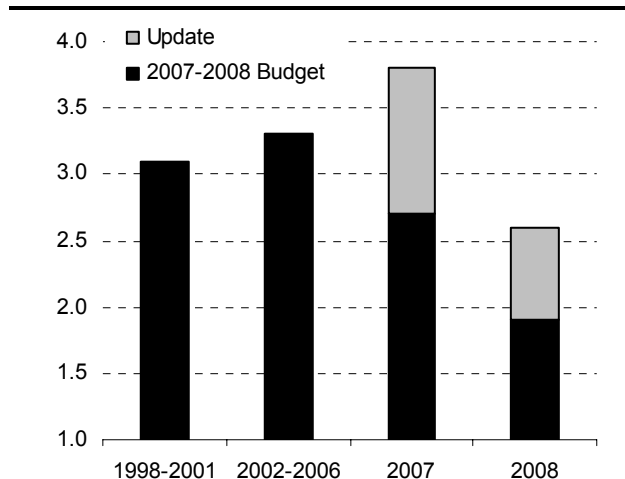
Over the next two years, consumer demand for goods and services, housing starts and business investment are expected to contribute more to economic growth than forecast. The tax reduction that takes effect January 1, 2008 and the Québec government's implementation of the Québec Infrastructures Plan will also help support Québec's economy.

Accordingly, after reaching 3% in 2006, growth in domestic demand will be 3.8% in 2007, an upward revision of 1.1% since the 2007-2008 Budget. In 2008, it will slip to 2.6%, which is still 0.7% higher than forecast in the last budget.

CHART 18

#### Final domestic demand<sup>1</sup>

(Annual percentage change)



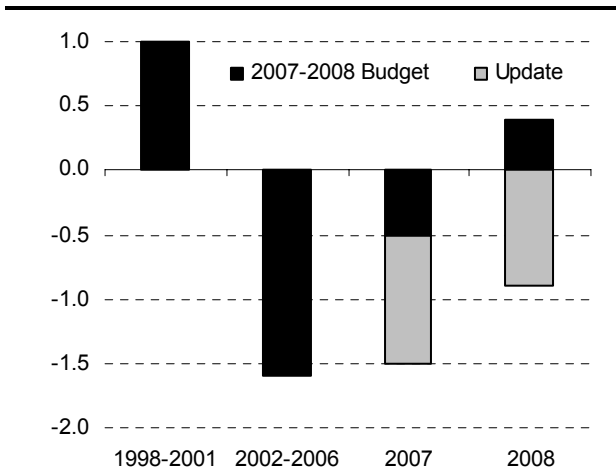
1 Final domestic demand is the aggregate of personal spending by households, residential and non-residential investment, and current spending by governments.

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

CHART 19

#### Contribution of the external sector to economic growth<sup>1</sup>

(Annual percentage change in real GDP)



1 The contribution of the external sector encompasses the change in exports and imports.

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



Moreover, Québec's very open economy, must continue to adjust to higher oil prices, the rapid and substantial appreciation of the Canadian dollar, growing international competition, including competition from emerging powerhouses such as China, and a temporary slowdown in American demand. These factors will apply substantial downward pressure on the external sector in 2007 and 2008.

The contribution of the external sector to economic growth, which encompasses the change in exports and imports, has been negative since 2002 because of the challenging international context. Whereas the external sector added a percentage point to economic growth in the late 1990s, it removed an average of 1.5 percent per year from 2002 to 2008.

### □ Good economic growth overall

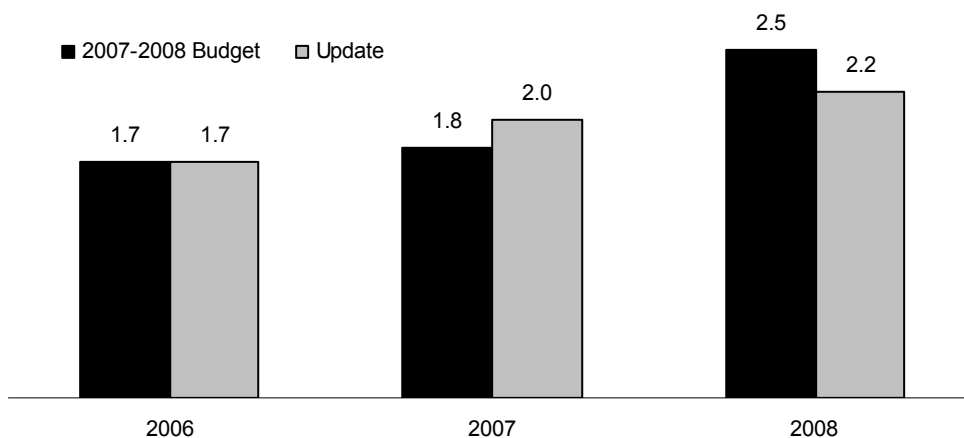
After hitting 1.7% in 2006, real GDP growth in Québec should reach 2% in 2007. This is an upward adjustment of 0.2% attributable to stronger personal spending and job creation than expected.

However, the anticipated slowdown in domestic demand in 2008, together with weaker economic growth than expected in the United States, is reflected in a downward adjustment of 0.3% to economic growth next year. Accordingly, real GDP will grow by 2.2% in 2008.

CHART 20

### Economic growth in Québec

(Real GDP, percentage change)



Sources: Statistics Canada and ministère des Finances du Québec.

### 3.2.2 Vigorous domestic demand

#### ☐ Favourable economic conditions for households

Households are enjoying favourable economic conditions for increasing their purchases of goods and services. Personal spending in 2007 should rise by more than 3% for the fifth time in six years, something that has not happened since the late 1980s.

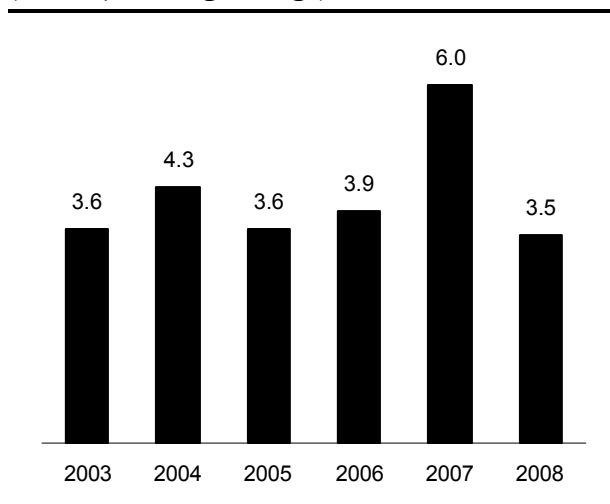
More than 80 000 jobs should be created throughout Québec in 2007. These favourable labour market conditions are reflected in good growth in wages and salaries and a high level of consumer confidence.

Moreover, the \$1.9 billion pay-equity settlement in the spring of 2007 has improved the financial situation of 360 000 public-sector employees and sustained their personal spending. Lastly, thanks to the appreciation of the Canadian dollar, Québec households are benefiting from lower prices on imported consumer goods.

The \$950-million tax cut the Québec government will put into place effective January 1, 2008, together with the announced reduction of the federal sales tax from 6% to 5%, will encourage households to buy more goods and services. This will offset the temporary effect of retroactive pay equity payments in 2007. Overall, consumer spending will grow by 2.9% in 2008.

CHART 21

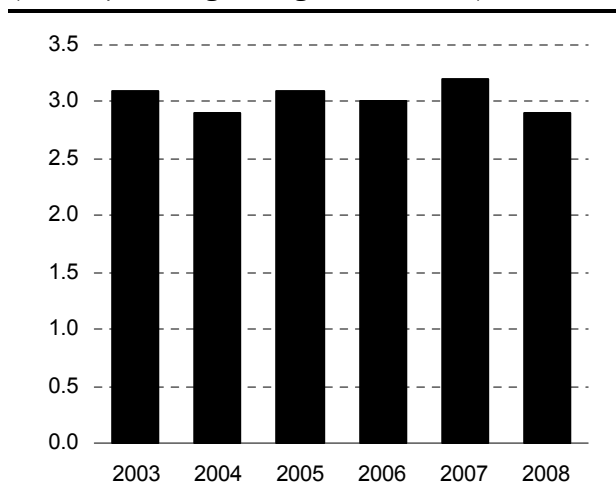
**Wages and salaries in Québec**  
(Annual percentage change)



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

CHART 22

**Household personal spending**  
(Annual percentage change, in real terms)



Sources: Statistics Canada and ministère des Finances du Québec.

#### ☐ A minor rebound in housing starts this year

Following two years of decline, housing starts should rebound slightly in 2007, supported by strong job growth. After hitting 47 900 units in 2006, housing starts should amount to 50 700 units in 2007. These levels are much higher than in the late 1990s, when construction of housing units averaged 25 000 per year.

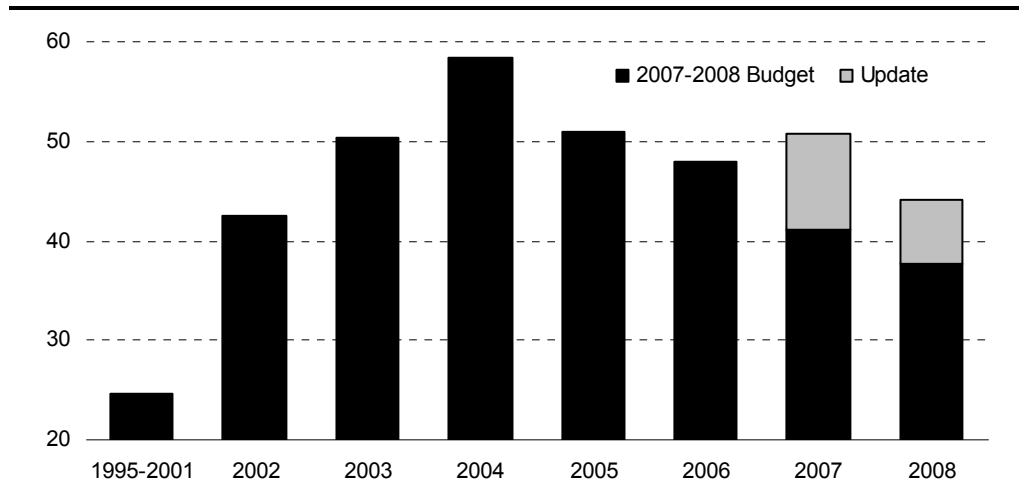
The vigour of residential investment affects not only construction of new housing, but also the resale market. The high number of resales is reflected in a rise in renovation spending in Québec.

In the longer term, demand for new construction will level off as credit becomes more expensive. Similarly, the increase in the inventory of unsold new housing units will lead to a gradual decline in housing starts in 2008. In addition, the recent rise in the vacancy rate of rental units indicates that the tight supply of housing seems to be easing. Accordingly, the number of housing starts is expected to decline to 44 000 units in 2008.

CHART 23

**Minor rebound in housing starts in 2007**

(Number of units)



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

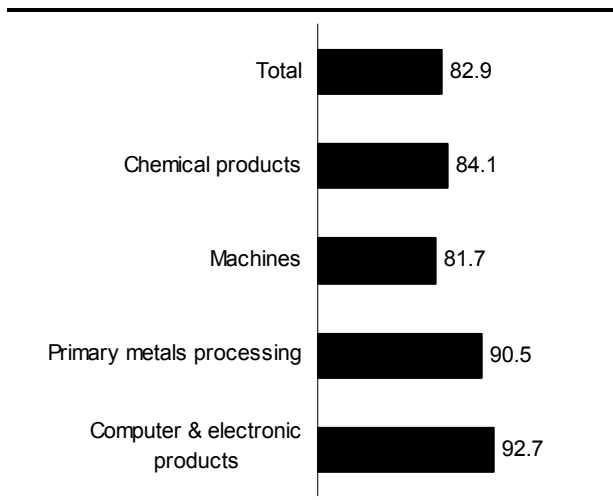
## □ Substantial growth in investment

In recent years, the rise of the Canadian dollar has enabled companies to acquire machinery and equipment, two thirds of which is imported, at lower cost. Moreover, industrial production capacity utilization, which is high in many sectors such as primary metals and electronic and computer products, has encouraged companies to boost their production capacity.

CHART 24

### Industrial capacity utilization in Canada

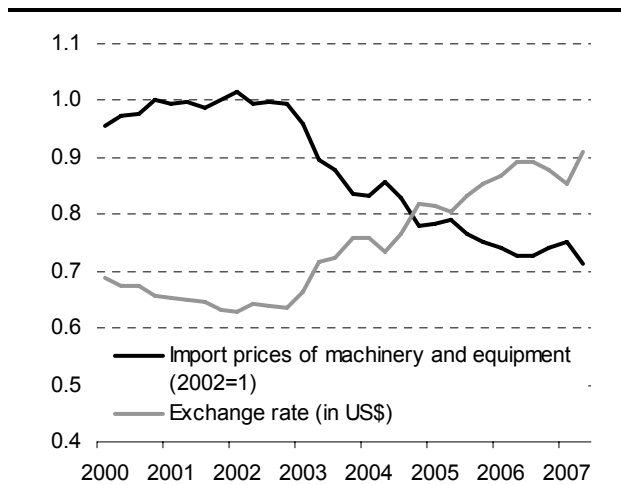
(Rate in per cent)



Source: Statistics Canada

CHART 25

### Import prices of machinery and equipment and exchange rate



Sources: Statistics Canada and ministère des Finances du Québec.

In addition, since 2003, the government has supported the development of companies and encouraged investment by eliminating the tax on capital for SMEs whose assets are less than \$1 million and by implementing a plan to gradually eliminate, by January 1, 2011, the tax on capital for all Québec companies regardless of sector or size.

Furthermore, the government is supporting a number of major economic development projects in Québec's regions. With its Québec Infrastructures Plan, the Québec government will invest substantial amounts over the next five years to develop and refurbish infrastructures.

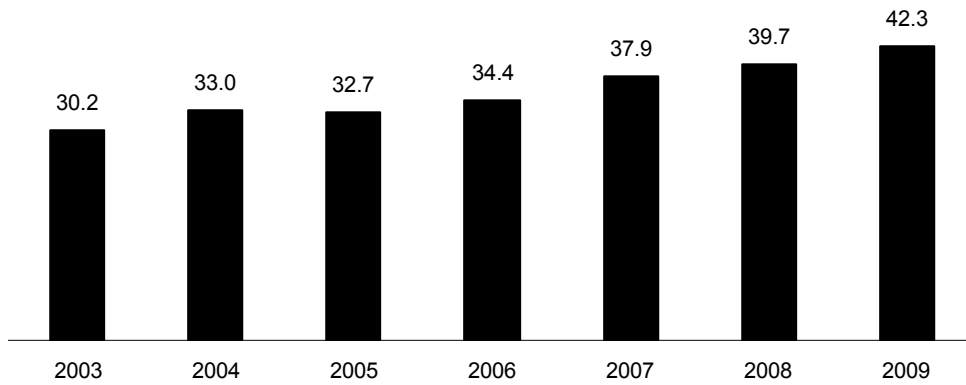
In the energy sector, investment remains high, under the impetus of major hydro-electric and wind-power projects. The result is that Hydro-Québec's investments have more than doubled in six years, reaching almost \$4 billion in 2006.

In all, public and private non-residential investments should reach \$37.9 billion in 2007 and \$42.3 billion in 2009, an increase of \$12.1 billion compared to 2003.

CHART 26

**Public and private non-residential investment**

(Billions of dollars)



Sources: Statistics Canada and ministère des Finances du Québec.

## Economic impact of the Québec Infrastructure Plan

### A contribution to economic prosperity

The Québec Infrastructures Plan will contribute to the economic prosperity of future generations in the medium and long term. In particular:

- Transportation infrastructures will facilitate trade for companies;
- Municipal infrastructures will represent a major business location factor;
- Health infrastructures will help improve the well-being of the population and workers;
- Education infrastructures will contribute to worker training, research and innovation, three key determinants of productivity and competitiveness.

In the shorter term, this plan will have an effect on the economic situation in Québec. In particular, it will help ease pressure resulting from the challenging international context. The \$30-billion Québec Infrastructures Plan, in addition to project completions amounting to another \$7 billion, will, while the projects are in progress, maintain and create 66 000 jobs.

- In particular, compared to the current level of investment, 18 000 new workers will be hired under the plan and almost 0.2 percentage points, on average, will be added to economic growth.

### Little risk of overheating

While the plan is ambitious, in proportion to GDP, investments in construction will remain, over the next five years, slightly below the rates recorded in the 1960s and 1970s.

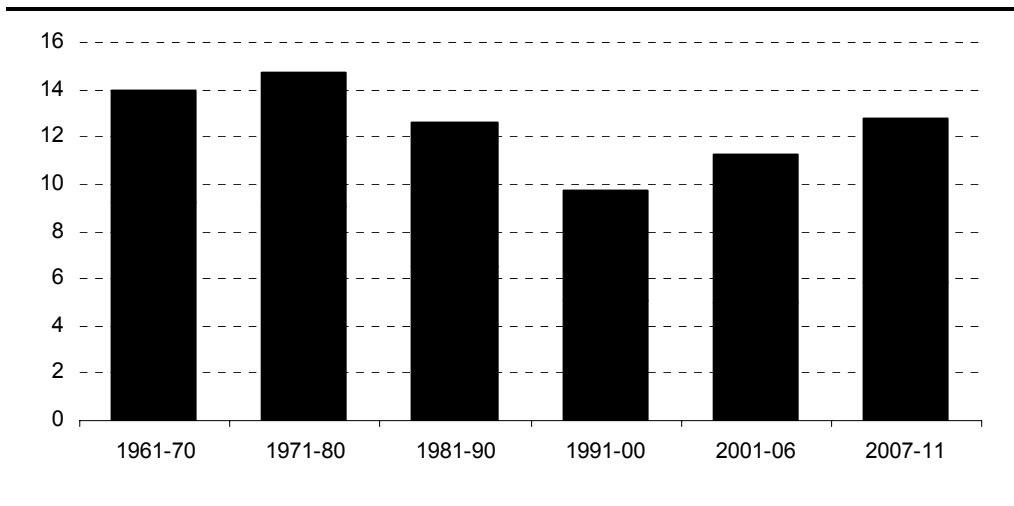
- During those two decades, total investment in construction accounted for 14% or more of GDP, while it will amount to less than 13% of GDP between 2007 and 2011.

Moreover, since the investment projects will extend over the next 15 years, companies will be able to adjust gradually, limiting the risk of labour shortages and price increases.

CHART 27

### Total public and private investment in construction

(As a percentage of GDP)



Sources: Statistics Canada and ministère des Finances du Québec.

### 3.2.3 International conditions remain challenging

After falling from 2001 to 2003, international exports rose by an average of 2.8% over the following three years. However, because of a significant slowdown in American demand for products made in Québec and the much stronger Canadian dollar, growth in international exports is expected to fall by 2.8% this year.

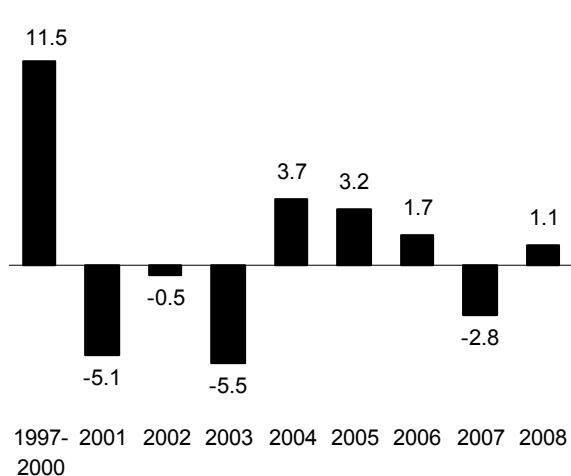
It should be noted that Québec's share of United States imports has fallen in recent years as other countries have increased theirs. While exports to the United States in 2000 accounted for 86% of total Québec exports, they represented only 78% in 2006. Accordingly, Québec has looked to other countries, such as Mexico, Russia, China and India, to stimulate its sales abroad.

In 2008, Québec's international exports should resume growing, with a rise of 1.1%.

International imports will continue to be supported by strong domestic demand in Québec. In 2007, however, they will be limited by the decline in exports, which have substantial import content in their production. In short, imports should rise by 1.8% in 2007 and 4.6% in 2008.

CHART 28

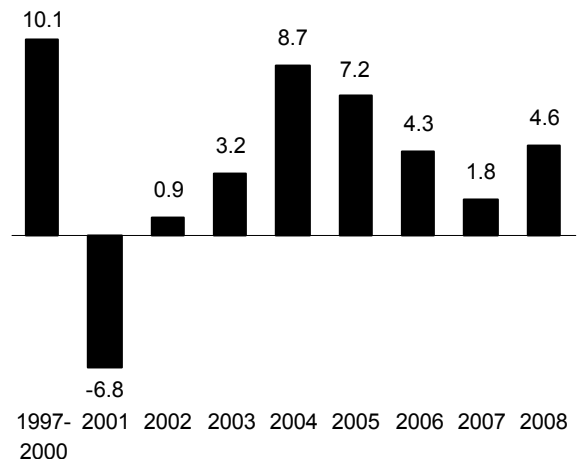
**International exports**  
(Annual percentage change, in real terms)



Sources: Statistics Canada and ministère des Finances du Québec.

CHART 29

**International imports**  
(Annual percentage change, in real terms)



Sources: Statistics Canada and ministère des Finances du Québec.

## **A challenging international context for export-oriented manufacturers**

### **A transformed international environment**

Since 2002, exporting manufacturers have been faced with a more challenging and more competitive international context.

- The Canadian dollar has appreciated by more than 60% since 2002, reaching parity with the American dollar in the fall of 2007.
- Oil prices have more than quadrupled, nearing US\$100 per barrel in November 2007.
- Globalization and more liberalized trade have given rise to new economic powers like China and India.
- Exporters must also deal with the current slowdown of the American economy.
- In Ontario and Québec, the manufacturing sector has been particularly hard hit.

### **Difficult economic performances for the manufacturing industry**

Unlike the rest of the economy which has experienced good growth, manufacturing output has changed little between 2002 and 2006. On average:

- decline of 0.5% in manufacturing output;
- rise of 0.9% in international exports of manufactured goods.

In addition, from 2002 to 2006, the manufacturing industry has lost 67 800 jobs, mainly in low-wage sectors such as clothing, textiles and furniture.

### **Québec's economy must adjust to this context**

Despite its negative effects on the external sector and the adjustments that are necessary in the economy, the rise of the dollar also has advantages for economic agents because:

- it enables households to increase their purchasing power by having access to lower-cost imported goods and services;
- it allows companies to purchase machinery and equipment, two thirds of which is imported, at lower cost;
- overall, it stimulates the adoption of new production processes.

### **Action taken by the Québec government**

The government is helping companies, supporting their efforts to invest and innovate. Initiatives totalling close to \$4.3 billion by 2011-1012 have been announced. This amount covers the following:

- \$1.8 billion to reduce the tax burden of manufacturing companies, including the elimination of the tax on capital as well as the capital tax credit for manufacturing companies;
- \$1.4 billion in the Support for the Forest Industry Plan;
- \$620 million in the Action Plan for the Manufacturing Sector;
- \$264 million under the strategy for the development of every region;
- \$200 million as part of the Québec Research and Innovation Strategy.

In addition, the Action Plan for the Manufacturing Sector provides manufacturing companies with \$500 million in additional liquidity in 2008.



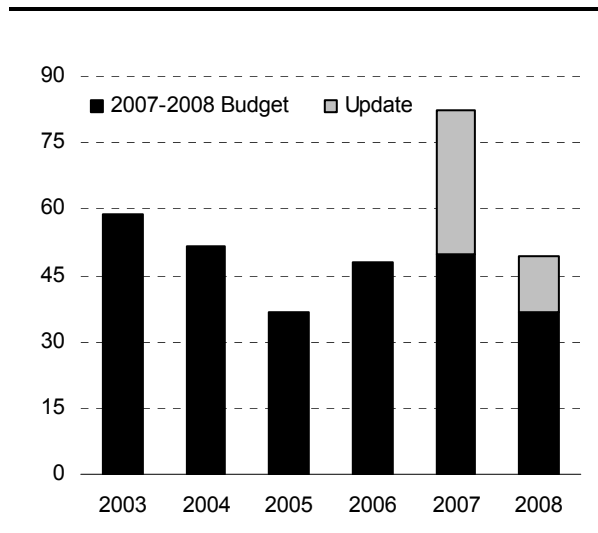
### 3.2.4 Strong employment growth in Québec

More than 80 000 jobs have been created throughout Québec since the beginning of 2007. Job creation has been particularly strong in the trade, finance, professional services, business and services management, food and lodging sectors, as well as in information, culture and tourism.

Looking forward, the economy's expected good growth will continue to stimulate employment. Job creation is expected to amount to 82 100 in 2007 and 49 500 in 2008. The generally good employment situation is also reflected in the unemployment rate, which fell below 7% this year, the lowest level in 33 years. The unemployment rate should average 7.2% in 2007 and 6.9% in 2008.

CHART 30

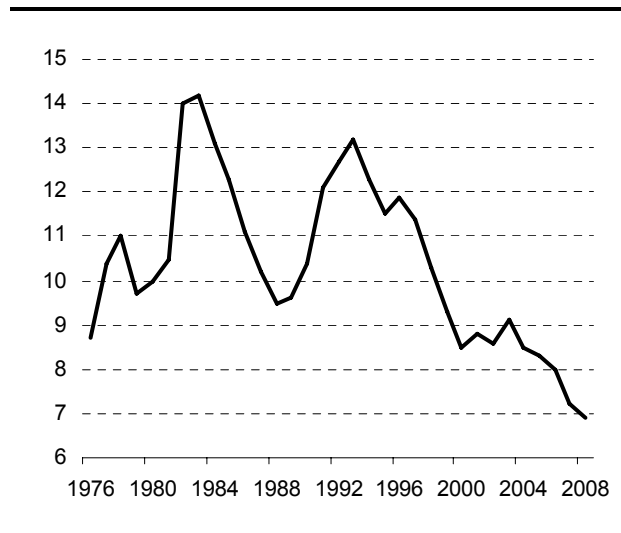
**Job creation in Québec**  
(Thousands)



Sources: Statistics Canada and ministère des Finances du Québec.

CHART 31

**Unemployment rate in Québec**  
(Per cent)



Sources: Statistics Canada and ministère des Finances du Québec.

### 3.2.5 Solid growth in nominal GDP

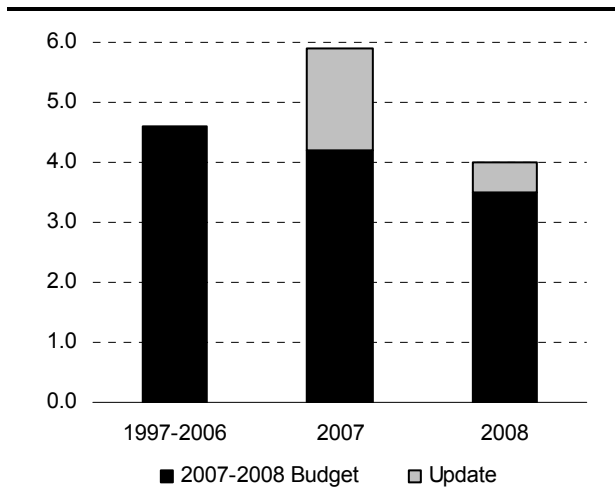
After hitting 3.7% in 2006, nominal GDP growth should accelerate to 5.9% in 2007. This is an adjustment of 1.7 percentage points compared with the assumption in the 2007-2008 Budget and is attributable essentially to better growth in household personal income and company profits.

Nominal GDP growth will slow to 4% in 2008, a rate is compatible with the average rate of the last ten years.

Moreover, with the reduction in the GST and lower prices for many imported goods, such as machinery and equipment, electronic products and clothing, inflation remains moderate in Québec's economy as a whole. The consumer price index should rise by 1.4% in 2007 and 2008.

CHART 32

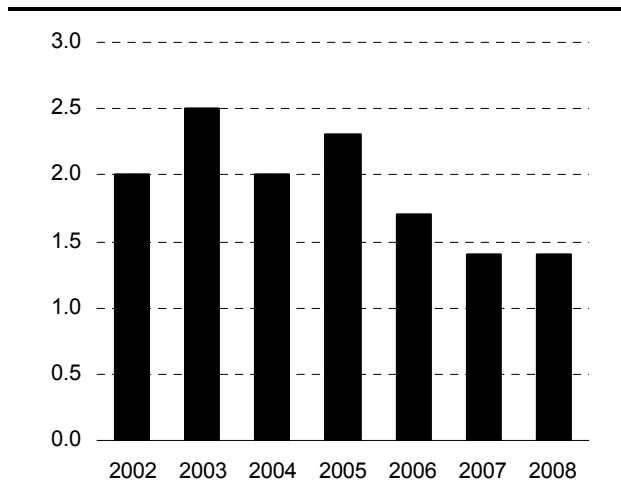
**Nominal GDP**  
(Annual percentage change)



Sources: Statistics Canada and ministère des Finances du Québec.

CHART 33

**Consumer price index**  
(Annual percentage change, index 2002=100)



Sources: Statistics Canada and ministère des Finances du Québec.

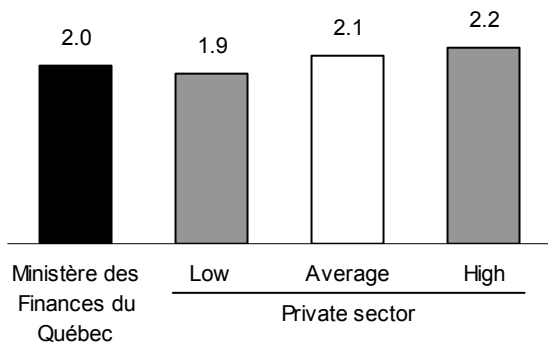
### 3.2.6 Comparison with the private sector

On average for 2007 and 2008, the economic growth forecasts of the update to the 2007-2008 Budget are similar to the average of those of the private sector.

CHART 34

#### Economic forecasts for 2007

(Real GDP, percentage change)

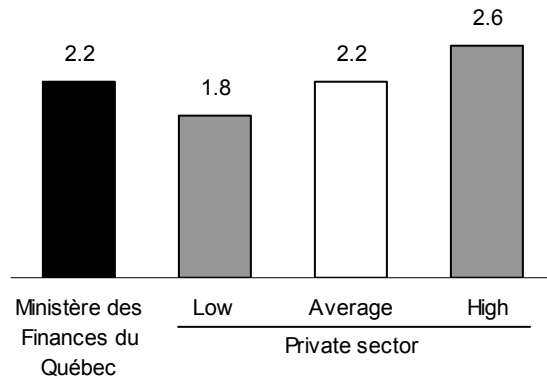


Source: Ministère des Finances du Québec.s

CHART 35

#### Economic forecasts for 2008

(Real GDP, percentage change)



Source: Ministère des Finances du Québec.s

TABLE 14

**Economic outlook for Québec**

(Percentage change unless otherwise indicated)

	2006	2007	2008
<b>PRODUCTION</b>			
Real gross domestic product	1.7	2.0	2.2
- 2007-2008 Budget	1.7	1.8	2.5
Gross domestic product	3.7	5.9	4.0
- 2007-2008 Budget	3.9	4.2	3.5
<b>COMPONENTS OF GDP (in real terms)</b>			
Consumption	3.0	3.2	2.9
- 2007-2008 Budget	3.0	3.1	2.4
Non-residential investment	6.1	5.6	4.6
- 2007-2008 Budget	6.5	4.0	1.6
International exports	1.7	-2.8	1.1
- 2007-2008 Budget	2.6	2.8	5.2
International imports	4.3	1.8	4.6
- 2007-2008 Budget	5.9	3.6	4.4
<b>OTHER ECONOMIC INDICATORS</b>			
Nominal consumption	4.3	4.6	4.1
- 2007-2008 Budget	4.3	4.5	4.0
Housing starts (thousands)	47.9	50.7	44.0
- 2007-2008 Budget	47.9	41.1	37.7
Personal income	4.4	6.0	3.8
- 2007-2008 Budget	4.3	5.2	3.3
Corporate profits	9.5	6.9	6.6
- 2007-2008 Budget	11.4	1.0	6.6
Consumer prices	1.7	1.4	1.4
- 2007-2008 Budget	1.7	1.8	1.8
<b>LABOUR MARKET</b>			
Job creation (thousands)	48.1	82.1	49.5
- 2007-2008 Budget	48.1	49.9	36.8
Unemployment rate (%)	8.0	7.2	6.9
- 2007-2008 Budget	8.0	7.8	7.8