TD Economics

La belle province, le bel excédent:
How Quebec Soothed its Savage Debt Beast

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Highlights

- In just 6 fiscal years, Quebec has sliced its net debt to GDP burden from a substantial 51% to about 40%. Quebec is also the only Province to have lowered its actual debt level during that same period, which is a remarkable accomplishment.
- How did the Province achieve this feat? Sustained economic growth and revenue gains were necessary, but insufficient to bring the debt burden down. More of the heavy lifting was done on the expenses side.
- Indeed, restraint in capital expenditures and sub-trend program spending played primary roles in returning the Province to surplus, while one-off factors and use of the Generations Fund have helped lower the debt.
- This impressive turnaround has enabled the room to doll out stimulus in while shoring up investor and, likely, business confidence. This in turn should support Quebec's economic growth moving forward.

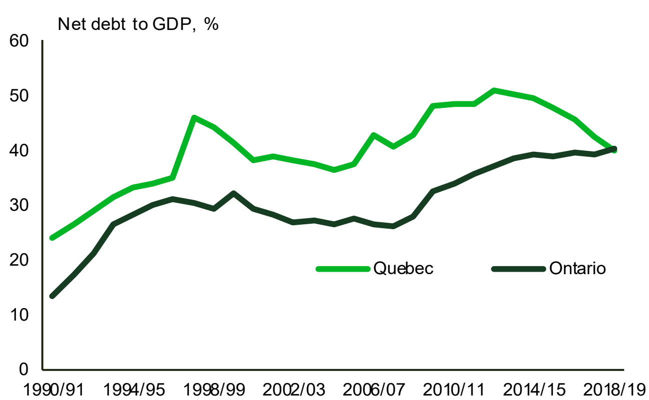
How times have changed. In FY 2012/13, Quebec's net debt to GDP ratio stood at a towering 51% - dwarfing the burden of any other provincial government. Fast forward to FY 2018/19, and Quebec's ratio resided at around 40%, equivalent to about a one-fifth reduction. While noteworthy on its own, consider the fact that in FY 2018/19, Quebec's net debt to GDP was below Ontario's for the first time since at least the early 90s (Chart 1). Equally as impressive, Quebec is the only Province to have lowered its absolute level of net debt since FY 2012/13 (Chart 2).

Of course, there remains work to be done, as Quebec's ratio is still elevated, and the Province has not yet hit its debt reduction goal (45% gross debt to GDP ratio by FY 2025/26). These remarks aside, what Quebec has achieved so far towards lowering its debt burden has been nothing short of remarkable. Investors and credit ratings agencies have certainly taken notice, as interest rates paid by Quebec on its debt have been consistently below Ontario's since early-2018 (Chart 3) and the Province received an upgrade in its credit rating from S&P in 2017.

Quebec's success in shaving its debt has paid dividends by allowing room for modest fiscal stimulus and helping shore up investor and, almost certainly, business confidence. In turn, these developments have supported economic growth. And, measures contained in the latest budget should to add a further boost to the economy moving forward.

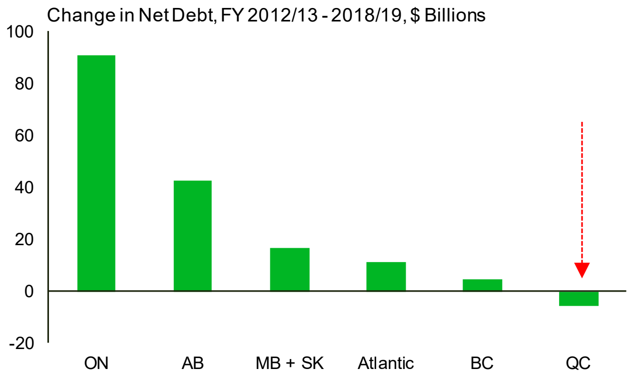
What has been the secret behind Quebec's fiscal turnaround, and notably the sizeable drop in the debt burden? In this report, we tackle the question head on.

Chart 1: Quebec's Net Debt to GDP Has Sharply Improved Relative to Ontario's



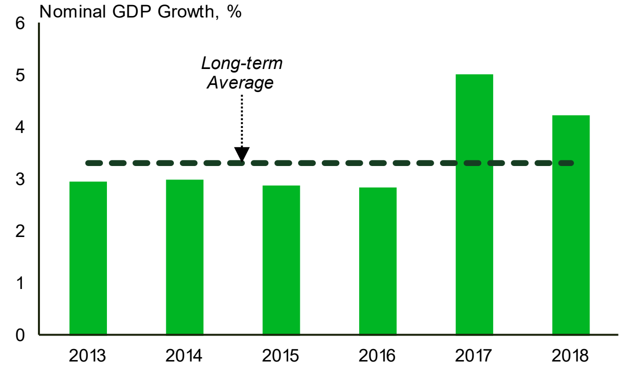
Source: Fiscal Reference Tables, Provincial Governments, TD Economics

Chart 2: Quebec is the Only Province to Have Lowered its Net Debt in Recent Years



Source: Fiscal Reference Tables, Provincial Governments, TD Economics

Chart 4: Strong Economic Growth a Recent Development for Quebec



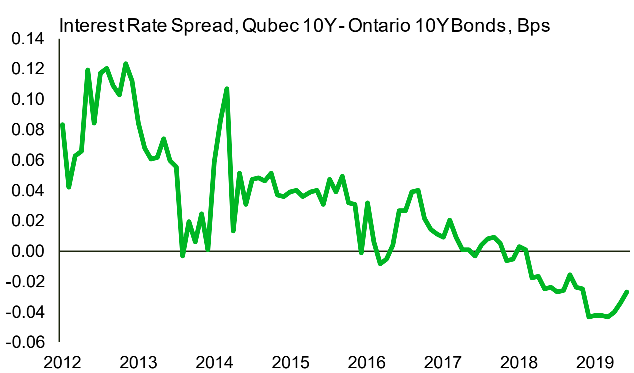
Source: Institut de la statistique du Québec, TD Economics

Economic growth was helpful, but not the main story

Changes in a government's net debt to GDP ratio are fueled by three drivers: changes in each of the operating balance, capital spending and, of course, GDP itself. While one can carry out analysis on each of these components, there needs to be recognition that they are inextricably linked. Case in point, changes in income/GDP are a major determinant of operating revenues.

In some cases of fiscal turnaround in Canada, economic growth has been an overriding catalyst. For example, in the mid-1990s, the federal government got the ball rolling by announcing a multi-year deficit reduction plan that was later accompanied by a boom in GDP growth in the order of 6% annually in the 1998-2001 period. Analysts point to the virtuous cycle created by cutting the operating deficit in terms of lowering debt service costs and enhancing confidence. The dot-com bubble, which was a global story, was also instrumental in driving GDP and revenue gains.

Chart 3: Interest Rates Paid by Quebec on its Debt Are Now Lower than Ontario's



Source: Bloomberg, TD Economics

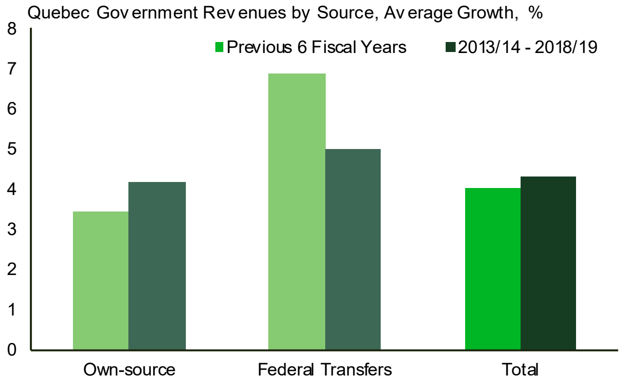
In contrast, Quebec has enjoyed solid but not spectacular economic growth during this recent experience. Quebec's economy turned in strong back-to-back performances in 2017 and 2018, boosted by strong job markets, a low dollar, rising housing demand, and a solid U.S. economy. However, this followed several years of comparatively mild growth (Chart 4). Indeed, from 2013-2018, nominal GDP advanced at a 3.5% rate – only slightly above the 10-year trend and in line with the pace seen during the prior 6 years, when the debt ratio climbed by 8 ppts. From these trends, it's clear that other factors did much of the heavy lifting in bringing the debt burden down.

In a similar vein, revenue growth decent but not great

Quebec's growth performance has been consistent with trends in revenue (Chart 5), as the overall take grew at a moderate 4.3% average pace from FY 2013/14 to 2018/19 – only slightly faster than the prior 6 fiscal years. As a share of GDP, revenues increased 1.2 ppts to 26.1% over the same time, also modestly higher than the 0.9 ppt gain observed in the preceding 6 fiscal years.

Digging into the details, growth in own-source revenues (i.e. personal and corporate income taxes, consumption taxes) managed to accelerate from 2013/2014 to 2018/19. This is due partly to the steps the government took to protect its revenue base, particularly earlier on when economic

Chart 5: Revenue Growth Up Only Slightly in Recent Years



Source: Fiscal Reference Tables, Quebec Government, TD Economics

growth was on the soft side. Measures taken by the government included ramped up efforts to fight tax evasion, raising taxes on alcoholic beverages and tobacco products and increasing levies on financial institutions. Additional steps included stopping the payout of input tax credits and reducing tax assistance offered to households and businesses. The latter involved halting or eliminating previously-introduced business tax relief and sharply reducing tax credits for firms. Households also endured adjustments to childcare subsides among other measures.

While own-source revenues comprise the lion's share of the provincial government's take, transfers from the federal government are an important source of funding, accounting for about 20% of revenues in the Province. From 2012/13 to 2018/19, growth in federal transfers averaged 5% year, a healthy pace though down from the robust 7% gain posted in the prior 6 fiscal years.

Generations Fund: allocating revenue for debt reduction

As a testament to its priority to lowering its debt burden, the government established the so-called Generations Fund in 2006. Created exclusively to lower the province's debt, revenues for the Generations Fund come primarily through water-power royalties (i.e. Hydro-Quebec) and a tax on alcohol products. These revenues are banked in the Fund, allowing it to accumulate value over time, and count against the debt in the government's accounting. While there is an element of risk associated with storing revenues in the Fund, instead of using them to lower the debt in a given year, this strategy has allowed the Province to earn additional income, through investment returns, to put towards debt payments.

Since inception, a total of $17 billion in revenue has been dedicated to the Fund, all of which has been earmarked to lowering the province's net debt. Notably, the CAQ government has used the Fund to lower the Province's gross debt by $10 billion as of April.

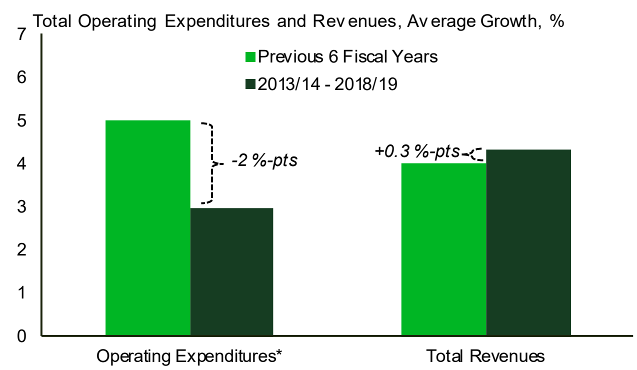
Since these deposits into the Generations Fund are subtracted from what the government reports as its budget balance, the improvement in the government's operating balance has been sharper than at first blush. Since FY 12/13, the Quebec government has reported a cumulative budget surplus of $5.7 billion. However, adjusting for the Fund deposits yields a total surplus of $17.0 billion.

All told, sustained revenue growth was a necessary ingredient in tackling the province's debt problem but was insufficient on its own. It's worth noting that the Province has reversed-course on tax policy in recent years, using their improved fiscal position to provide relief for households and businesses.

Spending restraint a key factor behind a lower debt

While hardly slash and burn, growth in operating expenditures has been quite a bit slower since FY 2013/14 (Chart 6). Indeed, total spending averaged a modest 3% rate from FY 2013/14 through FY 2018/19, notably slower than the 5% average seen in the prior 6 fiscal years.

Chart 6: Spending Restraint Was Key in Returning Quebec to Surplus



* Operating Expenditures = Program Spending + Debt Service Charges
Source: Fiscal Reference Tables, Quebec Government, TD Economics

Program spending accounted for the lion's share of this slowdown, with expenditures held to particularly paltry levels during the 3 fiscal years between 2014/15 and 2016/17. During this time, program spending averaged a mere 1.8% – the softest such rate since the late 90s – and clocked in as low as 1.1% in FY 2015/16.

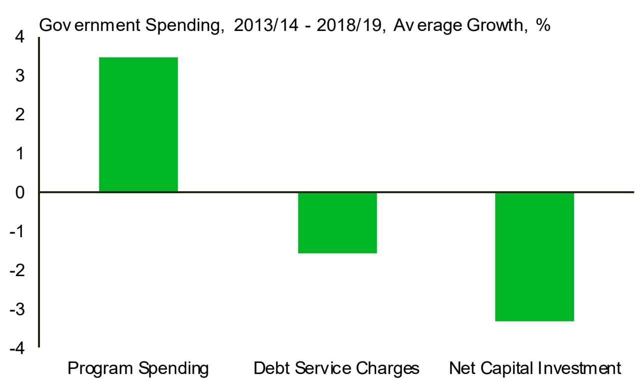
During these lean years, program spending growth was restrained across all major sectors, although the steepest slowdown occurred in categories outside of healthcare/social services and education/culture. Particularly severe restraint was imposed in the "administration and justice" and "support for individuals and families" categories. In addition to weaker departmental outlays, the government took several steps to rein in spending, including controlling public sector employee and physician compensation, and imposing a general freeze on staffing levels.

Falling debt servicing charges have also played an important role in restraining operating expenses, as they've dropped by nearly 2%, on average, since FY 2013/14. More telling, the net interest bite (i.e., debt service charges as a per cent of revenue) has fallen from a peak of 11.4% in FY 2013/14 to 7.8% last year.

Capital spending restraint and "other" factors had their roles to play too

Restraint was not merely contained to operating expenditures, as the government also tapped the breaks on capital investment. Indeed, net capital investment dropped by 3%, on average, from FY 2013/14 to 2018/19 (Chart 7). However, these declines were concentrated in the first 4 fiscal years, and policymakers have increased their investment the past 2 years, smartly coinciding with a pickup in economic growth.

Chart 7: Slower Program Spending and Investment Helped Lower Debt and Debt Servicing Charges



Source: Fiscal Reference Tables, Quebec Government, TD Economics

The government was also able to lower its net debt through special, one-off transactions. This included the offloading of a large capital investment from the provincial government to municipal authorities. In addition, through its equity in Hydro Quebec, the provincial government was able to lower its net debt as the utility's balance sheet improved during the 2013/14 – 2018/19 period. While not directly linked to revenues, operating expenses or capital expenditures, these transactions were important. Indeed, they helped slice some $6 billion of net debt from the government's books from FY 2013/14 to 2018/19.

Bringing it all together

Rather than one overriding factor, several things have come together to help Quebec's government lower its debt-to-GDP ratio. Sustained economic and revenue growth has certainly helped, partly because they allayed the need for countercyclical spending increases, although a larger portion of the improvement has come on the expenses side of the ledger. Restraint in capital expenditures coupled with sub-trend program spending growth have played primary roles, while one-off factors and use of the Generations Fund have also helped. This has enabled a virtuous cycle whereby debt service charges are dropping, putting even more downward pressure on the level of debt.

Moving forward, the government encouragingly plans to remain on the debt reduction track. Using reasonable economic assumptions, the latest provincial budget offers tax relief for families, measures to boost the economy's productive potential and stronger spending in priority areas. However, net debt to GDP is projected to drop under 40% this fiscal year to its lowest level in over a decade. All told, the Province has not yet slayed the deficit dragon. However, the government should be lauded for its steadfast commitment to continue to bring its debt burden lower, and its efforts could pay dividends for years to come.