Intelligence MEMOS

From: Miville Tremblay

To: Quebec Election Watchers

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Re: **Tax Cut Promises on Quebec's Campaign Trail Seem Unwise**

A post-pandemic euphoria grips our politicians on the campaign trail. We would like to join in, but the tax cuts promised by both the Coalition avenir Québec (CAQ) and the Liberals are problematic.

They may have broad appeal, but they will only worsen inflation, which both parties wish to alleviate. What will a tax cut be worth, if it leads to higher mortgage payments?

Now is not the time to stimulate an overheated economy, as the Bank of Canada hikes interest rates to calm things down.

This sudden campaign trail generosity comes from reading the Department of Finance pre-election Report on the state of Quebec's public purse, with rose-coloured glasses.

Its five-year projections are to be taken with a grain of salt, even if they are based on assumptions that the Auditor General deems "plausible," because rarely has the economic situation seemed so uncertain.

There is a rapid budgetary recovery, thanks to the wind-down in COVID-19 spending, but even more to inflation-driven revenue increases.

We measure economic growth in real terms, but let us remember that the government taxes nominal income. Last year, real GDP grew by 5.6 percent, but nominal GDP by 12.5 percent. This year, the report expects 3.4 percent in real terms and 9.6 percent in nominal terms.

In the summary table of the report, the bottom line shows for the current fiscal year a deficit of only $729 million, instead of the $6.5 billion projection in the March budget. Although, it comes after a provision of $2 billion for economic risks and support measures, as well as a payment of $3.4 billion to the Generations Fund, Quebec's unique public debt reduction mechanism.

For the next four years, the forecast deficit varies from $1.3 billion to nearly $2 billion, but always after a provision of $2 billion and the large contribution to the Generations Fund. In short, if we knew for sure that we will avoid a recession and any unforeseen shock, we could hope for a balanced budget, as uniquely defined by the Quebec deficit reduction law, not a surplus that we don't know what to do with.

However, the risk of recession is high. Desjardins and RBC are planning for one next year, National Bank thinks we will avoid it. It would be prudent to keep the provision just in case.

The question of the Generation Fund calls for a nuanced answer. Next March Quebec's gross debt will reach 40 percent of GDP, beating the 45-percent target. This objective needs to be reviewed. It would be better to target net debt (gross debt less financial assets), which allows a comparison with the other provinces.

Last March, Quebec's net debt stood at 38 percent of GDP, compared to 33 percent for the provincial average. Rather than a numerical target, Quebec should aim for a ratio slightly below this average, whatever it may be, in order to be among the best students in class and keep the good graces of the markets in foul weather.

The CAQ finances its tax cuts by diverting 39 percent of the revenue flows dedicated to the Fund, whose goal is to reduce intergenerational inequity.

If the Fund is growing too quickly given the new target, it would be preferable, once inflation is under control, to devote part of that money to the other major intergenerational debt: climate change.

Quebecers shoulder the heaviest tax burden in North America, but with debt still high, borrowing to reduce taxes seems unwise.

We have all forgotten the pain of high inflation, after 30 years at 2 percent. Yet not everyone suffers equally. Those hit hardest have incomes that do not keep up with inflation – often retirees – or incomes so low that they have no leeway to absorb higher prices, without cutting essentials.

Conversely, the winners are those who have debt, which gets eaten away by inflation, particularly if they have a fixed rate mortgage, lower than inflation, or if their revenues keep up with inflation.

Economists recommend limiting any tax relief to the poorest households, but the political temptation of showering gifts to the middle class seems irresistible during an election campaign.

Liberal and CAQ promised assistance for low-income seniors is appropriate. CAQ lump sum payments to nearly all Quebeckers are inflationary, but at least they're non-recurring and roughly offset lagged income tax indexing.

The 1-percent cut in the first two tax brackets promised by CAQ and the 1.5 percent cut for the same brackets by the Liberals are difficult to justify. CAQ leader François Legault says the cuts will boost growth, even though the economy is already struggling to meet demand, and that they will promote labour market participation, when it has never been higher.

Both parties, which see themselves as "the party of the economy," were once more rigorous.

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