Conclusion

The only strong conclusion that can be drawn from the survey of the pre-Bélanger-Campeau literature presented in this chapter is that there is still a scarcity of up-to-date hard analysis on the costs and benefits of Confederation and on the economic impact of Quebec sovereignty. Most of the serious studies were done in the late 1970s when the election of a Parti Québécois government and the prospects of a referendum on sovereignty-association focused attention on the issue. These were the studies done by the Canadian Unity Information Office and the C.D. Howe Institute's Accent Quebec Program. The empirical information and many of the conclusions contained in these studies are now largely out-of-date. The more recent studies have been completed quickly and are not as rigorous. Good economic studies of all aspects of the economic consequences of Quebec sovereignty are desperately needed so that important decisions about the future of the country will not have to be made without an adequate understanding of the facts. As we will see in the next chapter, the Bélanger-Campeau economic studies provide some useful additional information, albeit from a largely sovereigntist perspective, but the need for further objective analysis still remains urgent.

Chapter 3

The Bélanger-Campeau's Sovereigntist Economic Studies

Introduction

THIS CHAPTER PROVIDES A CRITIQUE and summary of the background economic studies prepared for the Bélanger-Campeau Commission by outside experts, the secretariat of the commission, and the Ministry of Finance (Commission sur l'avenir politique et constitutionnel du Québec, 1991b). The authors of the studies include some of Quebec's most distinguished economists. The nine studies considered deal with trade relations, public finances, labour markets, macroeconomic policy coordination, and monetary options.

It is important to consider these studies in detail because of their key role in shaping the opinion of the Quebec elite on the economic consequences of sovereignty. Because the studies have not been translated into English and have only been published in limited quantities, they have not received wide dissemination outside of Quebec, even among economists. English Canadians need to be familiar with the main arguments made in these studies if they are to be informed participants in the national debate on the economic consequences of Quebec sovereignty.

The studies done by the individual economists contain much useful analysis and are generally well done, albeit from a largely sovereigntist perspective. The Secretariat drew on the other studies to produce a more political, less analytical and even more sovereigntist paper than those of the individual economists.

All the studies share two assumptions: transitional costs of Quebec sovereignty will be minimal if economic rationality prevails in the establishment of economic relations with the rest of Canada, and the long-run costs of Quebec sovereignty are negligible. Nothing in these studies supports these assumptions. A thorough assessment of these studies is thus in order.

The studies take a consistently optimistic approach. In chapters on trade relations, for example, it is taken as a matter of course that trade relations between Quebec and the rest of Canada and the United States would be unaffected by separation. Canada is expected to be willing to agree to a common market with Quebec. The United States is portrayed as ready to conclude a free trade agreement with Quebec immediately. The studies do not mention the possibility that hard feelings engendered by the separation could make reestablishment of trade between Quebec and Canada difficult. Nor do they mention that trade negotiations are time consuming and that the United States may have other priorities than negotiating a free trade agreement with Quebec and that when it did it would most likely want to negotiate changes that would be disadvantageous for Quebec. The costs of negotiations with both Canada and the United States are completely ignored. The importance of harmonization of policies with Canada to preserve a common market is stressed, but there is no appreciation of how difficult this would be for two separate states.

Another example of optimism is the view that Quebec could unilaterally decide to establish a monetary union with Canada by declaring the Canadian dollar legal tender and by establishing clearing arrangements with members of the Canadian Payments Association. The possibility that such a monetary union may not be desired by Canada and that Canada could block it by refusing to supply currency and clearing arrangements is not even considered. Aside from this central optimistic assumption adopted by the secretariat in its papers, the study by Bernard Fortin on the monetary options contained a very good discussion of the advantages of monetary union.

A final example of optimism bordering on outright deception is the analysis of the financial position of a sovereign Quebec. The secretariat of the commission estimates that, before taking into account the division of assets and liabilities, the budgetary position of a sovereign Quebec would be basically unaffected (using 1990-91 as the reference year). This result is difficult to reconcile with the secretariat's own estimate in study 7 that Quebec's net fiscal gain would be $2.7 billion in 1988.

The secretariat also proposes that Quebec should only assume 18.5 percent of the public debt based on its share of assets (defined in an unconventional way to include the cumulated deficit) instead of its 25.4 percent population share. The secretariat argues based on the opinions of two experts in international law that this is compatible with international law. A closer reading of the legal opinions reveals that almost any share agreed to by the two parties would be compatible with international law. The secretariat's proposal thus has no special legal status even though the secretariat certainly seeks to create the impression that it does.

While the increased debt under the secretariat's proposal would raise Quebec's budgetary deficit to $9,282 or 5.8 percent of GDP and would increase Quebec's debt burden as a share of GDP from 26.4 percent to 63.9 percent, it would leave the Quebec debt to GDP ratio well below the 72.1 percent ratio of Canada. It would also be comparable to the level of European countries. In effect, the secretariat chose a share of the debt much lower than Quebec's share of population to enable it to present an artificially rosy financial position for a sovereign Quebec.

Important exceptions to the optimistic approach are the papers on trade by Pierre-Paul Proulx and Guilain Cauchy, those on labour markets by Pierre Fortin, and those on international financial integration by Daniel Racette.

The secretariat's historical analysis of the fiscal benefits Quebec derived from Confederation ignores the massive transfers from the Prairies to the rest of Canada as a result of regulated oil prices. The study therefore substantially understates Quebec's fiscal benefits from Confederation from 1973 to 1985. For recent years, the estimates of benefits are more reasonable, with Quebec enjoying a fiscal benefit of $409 per capita in 1988.

In my critique, I examine the nine studies separately.

Study 1

"The Maintenance of Access to External Markets: Some Judicial Questions Raised under the Hypothesis of Quebec Sovereignty," by Ivan Bernier

(Commission, 1991b, pp.1-17)

This study provides the opinion of Ivan Bernier, a noted Quebec international legal specialist, on several questions on Quebec's right of access to international and Canadian markets under the existing trade treaties if Quebec were to become sovereign. The treaties considered are the General Agreements on Tariffs and Trade (GATT), of which Canada is a member, and the Canada-U.S. Free Trade Agreement. His opinion is based on solid legal grounds, as one would expect from so eminent an international legal authority. He only enters on shaky ground when he speculates about the likely results of the political process.

According to Bernier, under GATT there are two ways for a newly independent state to become a member: 1) accession by means of negotiations under article XXXIII, and 2) accession by means of succession under article XXVI. The problem with negotiations is that they are often lengthy and require the approval of two-thirds of the members. Succession was established to accommodate newly independent countries resulting from decolonialization. To qualify under succession, Quebec would have to accept Canada's engagements for the territory of Quebec and would in turn be recognized as a member of GATT retroactively from the date of independence.

Bernier also addresses the question of what membership in GATT would do to ensure continued access to Canadian markets. Under GATT Canada could apply to Quebec the existing tariffs applied to GATT members, unless of course Quebec were to conclude a customs union or free trade agreement with Canada. GATT would prevent Canada from placing quantitative restrictions on imports from Quebec. Exception to this would be restrictions related to classification or quality control and agricultural products. This would include agricultural products under supply management. GATT protection would also not apply to government purchases and internal subsidies to national production, unless Quebec were to sign the three codes dealing with these problems that came from the Tokyo round. In the case of subsidies, Quebec could respond to Canadian subsidies by using its compensating rights under article VI.

Bernier speculates on which international regulations would apply if Quebec were to try to use the right of succession to gain membership in the Canada-U.S. Free Trade Agreement. He notes that before the 1978 Vienna Convention the principle was *tabula rasa*, that is, treaties binding the predecessor state did not bind the successor state. Afterwards, as a result of pressure from Third World states, the suggested principle was one of continuity of the full rights of the treaty for the successor state. Nevertheless, Bernier argues Quebec should not expect to gain full accession to the free trade treaty because neither the rule prior to the Vienna convention nor the new rule would apply to the successor state, Quebec. Bernier convincingly asserts that a trilateral treaty would be radically different than a bilateral treaty. He neglects to mention that neither Canada nor the United States have yet signed the Vienna convention. Bernier argues that the agreement would become applicable to Quebec by right of succession after agreement was reached with Canada and the United States on the necessary changes. In the interim, the agreement would become de facto applicable. However, in doing so he goes beyond the grounds of a legal opinion and into the realm of political speculation.

The final question that Bernier considers is how would the Americans react to a Quebec request to join the Canada-U.S. Free Trade Agreement. This is obviously an exercise in pure political speculation. The position he adopts is extremely optimistic. He argues that it is improbable that Canada and the United States would try to take advantage of Quebec's accession to sovereignty to exclude Quebec from the agreement, to impose more burdensome conditions on Quebec, or to demand that Canada and Quebec renegotiate the agreement. He trustingly believes that the United States would favour a solution that would impede the development of instability and conflict in Canada. He claims that the simplest solution would be to extend to Quebec the application of the existing agreement as is.

Bernier notes that the U.S. could try to resolve the contentious issues of trade in alcoholic beverages or agricultural supply management, but he believes that this would not be very probable because it would be difficult to impose a new regime in these areas without doing the same to the rest of Canada. What Bernier overlooks is that these areas would be under the jurisdiction of a sovereign Quebec, but not under the jurisdiction of the Canadian federal government. The U.S. appreciates the difficulty of the Canadian federal government has in committing the provinces, so they made allowances for this in the free trade negotiations. In negotiating with a sovereign Quebec, there would be no need to make such allowances.

Bernier claims it would be curious for the U.S. not to negotiate with Quebec given its readiness to negotiate an agreement with the Mexicans. This is perhaps true, but Bernier should not underestimate the relative importance of Mexico and Quebec in U.S. eyes. Mexico is a country with over 85 million people. The U.S. knows that it either has to conclude an agreement or be faced with an even greater inflow of illegal immigration from Mexico. The potential for political instability is also many times greater in Mexico than in Quebec.

Bernier's assessment of the likely U.S. reaction to a Quebec request for membership in the Canada-U.S. Free Trade Agreement is naive. Although he is correct that the U.S. would eventually want to have a free trade agreement with Quebec, a number of issues would have to be resolved before concluding an agreement. The greater degree of government intervention in the economy in Quebec would attract the critical attention of U.S. negotiators. Furthermore, a free trade agreement with Quebec may not be the U.S. government's highest priority. The administration could not conclude an agreement with Quebec without a negotiating mandate from Congress. The current trade bill gives the administration the authorization to negotiate fast track agreements with Canada, Mexico, and GATT; it could be used for a similar agreement with Quebec. But Congress extracted a commitment from the administration that it would be consulted about the specifics of the agreement—presumably about any agreement with Quebec as well. Once an agreement is reached and if Congressional concerns are not taken into account, the Administration could have trouble getting the final agreement approved by Congress. The bottom line is that the

whole process could take a long time and in the interval Quebec industry would find itself deprived of access to the U.S. market under the free trade agreement. Bernier's discussion shows no appreciation of the realities of the U.S. political and legislative process.

Study 2

"The Access of Quebec to External Markets and the Canadian Economic Space," by the Secretariat

(Commission, 1991b, pp.19-54)

This study, which was prepared by the secretariat of the Bélanger-Campeau Commission and draws on the legal opinion that Bernier gives in his study, focuses on the implications of Quebec sovereignty for its external economic relations with Canada, the United States and the rest of the world.

According to the secretariat's study the Quebec economy is very open, with 33 percent of its production and 48 percent of its manufacturers' shipments going outside the province. Exports of goods and services are divided with 60 percent going to the rest of Canada and 40 percent to other countries. The United States accounts for 80 percent of Quebec exports outside of Canada. The dependence of the Quebec economy on markets in other provinces at 20 percent of production is higher than the average of the other provinces. This degree of dependence remained constant from 1974 to 1984. No comparisons are made with the rest of Canada as a whole. It is these comparisons that are most relevant from a point of view of the relative degree of external dependence of a sovereign Quebec. The secretariat also notes that the importance of markets outside of Canada has grown under the auspices of GATT and that this is likely to continue under the free trade agreement, but that the rest of Canada will always be a major market for Quebec production.

The judicial and institutional framework for Quebec foreign trade

The secretariat's study discusses GATT, which regulates Quebec's access to international markets, in some detail, emphasizing the reduction in tariffs on industrial products from an average of 40 percent in 1947 to 5 percent in 1987 and the liberalization of trading rules. The secretariat itemizes the gaps in GATT coverage: partial rather than full access to public sector markets, quantitative restrictions in certain sectors, and the exclusion of services. The secretariat's overall conclusion is that GATT guarantees substantial access to the markets of other countries to all signatories independent of their size. Furthermore, if a compromise could be reached on agriculture, the Uruguay round would probably be concluded, which would significantly liberalize trade in services, public sector markets, textiles, and agricultural products.

The secretariat summarizes the main aspects of the Canada-U.S. Free Trade Agreement and emphasizes the respects in which it goes beyond GATT. The secretariat notes that the free trade agreement will increase the degree of integration of Quebec with the United States, but that, even when the FTA is fully implemented in 1999, the degree of integration will be less than with the rest of Canada.

The Canadian economic space

The secretariat stresses the importance of maintaining the existing Canadian economic space with its almost complete free flow of people, goods, services, and capital, which constitutes a real common market. The Charter right of all Canadian citizens to establish themselves and earn their living in any province is mentioned. The extent to which this is qualified by rules concerning accreditation and the exercise of trades and professions is noted, as is the importance of the transferability of social programs such as unemployment insurance, medical care, and pensions in facilitating mobility.

Section 121 of the Constitution Act of 1867 is cited as guaranteeing the free circulation of goods within Canada. In combination with the federal government's power over commercial policy and customs, the Canadian provinces were able to form a customs union to avoid the need to control goods at provincial borders. On the other hand, the secretariat notes that provinces have interfered with the free flow of goods through product standards, public sector purchasing policy, and other measures. Provincial efforts at harmonization and agreements have helped to reduce the restrictive effects of these measures, but they remain limited. Examples of provincial restrictions cited are preferential policies of provincial liquor control boards, the requirements of local production of beer, and supply management marketing boards for milk, poultry, and eggs.

The free flow of services is not guaranteed by section 121, but by the general freedom to do business anywhere in Canada. The secretariat attributes the free flow of capital to the exclusive responsibility of the federal government for money, banking and the rate of interest. The existence of a common currency and a national system of banking are regarded as being of particular importance, as is the freedom of firms to invest anywhere in the country. The tax collection agreements are mentioned as another important element of harmonization. The Macdonald Commission proposal for a code of economic conduct to protect the Canadian common market to which the federal and provincial governments would adhere is discussed. But the Macdonald Commission did not recommend that such a code be enshrined in the Constitution because the Canadian economic union works well enough and the restrictions on interprovincial trade do not have a large enough impact on economic activity to justify an in-depth constitutional reform.

The maintenance of Quebec's foreign trade

The secretariat observes that the trade relations of a sovereign Quebec with countries other than Canada and the U.S. would be governed by GATT. This section of the study draws heavily on Bernier's opinion discussed above. Succession under article XXVI of the General Agreement is the preferred route to membership in GATT. If done, Quebec would have to adopt the Canadian tariff schedule at the time of separation and membership would be retroactive to the same date. The secretariat says that Quebec's participation in GATT would be conditioned by Quebec's arrangement with the rest of Canada. Quebec and Canada could adopt a common commercial policy and speak with one voice at GATT. In my view, however, this is not very likely given the difficulty of coming to a common agreement on commercial policy. The secretariat mentions the 25 restraint agreements for textile and clothing under the multi-fibre agreement which would have to be renegotiated, but neglects to mention the controversy which would arise between Canada and Quebec, with its extensive textile and clothing industry, over renegotiation. More generally, the secretariat does not seem to attach very much significance to the time and resources which must go into reaching trade agreements.

The secretariat emphasizes that the continued participation of Quebec in the Canada-U.S. Free Trade Agreement is essential to the maintenance and improvement of the competitive position of Quebec business. Again relying on Bernier's opinion that succession would not apply and that a third party joining a bilateral treaty would change radically the existing bilateral treaty, the secretariat argues that in theory a sovereign Quebec could be required to renegotiate and sign the free trade agreement with the U.S. But, it is argued, the agreement could become applicable to Quebec by right of succession if Canada and the United States were agreeable. And the U.S. would be likely to accept Quebec in the agreement without substantial modifications to avoid the development of instability and conflicts in Quebec. A refusal by the U.S. would interfere with the establishment of a common commercial policy between Canada and Quebec and would force Quebec to look for political and economic links elsewhere. It would also be against the American interest in guaranteed access to Quebec hydroelectricity. The secretariat supports Bernier's view that the U.S. would not take advantage of the situation to resolve outstanding issues such as trade in alcoholic beverages and agricultural supply management. But in my view, the difficulties of reaching an agreement quickly with the U.S. are significantly underestimated. The secretariat shows no appreciation of the way trade policy is made in the U.S. and the different roles of the administration and Congress. It also does not recognize the tough-minded mood on trade policy now prevalent in Congress as evidenced by the difficulties the administration had in getting the recent trade bill approved by Congress.

The secretariat candidly acknowledges that the degree of integration and harmonization between Quebec and the rest of Canada would be difficult to maintain because a sovereign Quebec could follow different policies than the rest of Canada. The maintenance of the common market would require that the national policies of Quebec and Canada continue to be harmonized in areas such as money, internal and external commercial policy, and legislation and regulations affecting the free flow of goods, services, persons and capital. As for mechanisms which would regulate policy coordination, the secretariat concentrates exclusively on those which would not require reassociation with Canada, thereby showing that it would still be possible to maintain the most important features of a common market without a formal agreement. The secretariat does argue though that such an agreement would be in

the best interest of both partners. Also, the absence of a general agreement would not preclude sectoral agreements as the 170 existing bilateral treaties between Canada and the United States demonstrate. But the secretariat does not mention that these treaties have been negotiated and have evolved over more than one hundred years. It would be unrealistic to expect such a complicated web of treaties to emerge between Quebec and Canada except over a very long period of time. It takes much time and effort to negotiate and ratify a treaty.

The secretariat addresses the key issue of money based on the discussion contained in the paper by Bernard Fortin (study 6). The two questions considered are whether to adopt a Quebec currency and how to determine monetary policy if Quebec continues to use the Canadian dollar. The costs of establishing a Quebec currency which are cited are transaction costs and exchange risk. An estimate of the magnitude of these costs in the European Economic Community (ECC) of one percent of GDP, which is discussed more fully in study 6, is mentioned. The secretariat reports that the application of this figure to Canada gives a cost estimate of a separate Quebec currency of $1.6 billion in 1990. This is obviously a very rough and not particularly reliable estimate. The costs could easily be higher for an economy as small and as open as Quebec. The secretariat correctly observes that it would be difficult to maintain a true common market with Canada without a common currency. It also warns that a separate currency for Quebec would run counter to the global trend to fewer currencies or currency blocks and fixed exchange rates.

The secretariat juxtaposes the gains of a common money with the loss of monetary autonomy. It also acknowledges that a Quebec currency that was tied to the Canadian or U.S. dollar would not give much autonomy to Quebec monetary policy. A sovereign Quebec would have to establish confidence in the Quebec currency and could not pursue a more expansionary policy without being subject to sanctions from international markets.

To conserve the monetary elements of the existing common market, the secretariat argues a jointly determined monetary policy is not necessary and the only condition that must be met is the use of a common money. This could be done through the establishment of legislation that would retain the Canadian dollar as legal tender in Quebec. Quebec financial institutions could make arrangements for banknotes and change through the Canadian payments association. According to the secretariat, nothing could stop Quebec from conducting its transactions in Canadian dollars. But, although the Canadian government could not stop Quebec from using Canadian dollars, it could certainly make it difficult by refusing to supply currency and to establish clearing arrangements. The proportion of Canadian currency circulating in Quebec would wear out over time and would have to be replaced. It would be virtually impossible to run a Canadian dollar-based monetary system in Quebec without access to Canadian currency on a continuing basis. The secretariat fails to anticipate these difficulties in its report. The secretariat notes that Quebec could seek to negotiate a say in the Bank of Canada decisions, but it is realistic in recognizing that such a say would not be great and would be of secondary importance. The secretariat raises the issue of Quebec's share of the seigneurage or profits of the Bank of Canada, which would also be tied up with the question of the division of assets and debt. The secretariat argues strongly that a monetary union would be the best option for both Canada and Quebec if Quebec were to separate. This is undoubtedly true, but the monetary union would be stronger and better if Quebec were to remain in Canada.

The secretariat argues that a customs union is also necessary for the preservation of the most complete free trade between Canada and Quebec. This could be done by ratifying an agreement that would reestablish the free trade currently sanctioned by article 121 of the Constitution Act of 1867 and by renouncing tariffs and quantitative restrictions allowed under GATT. If this were not done, $100 billion in trade would be affected, raising prices to consumers and reducing productivity. The establishment of customs controls between Quebec and Canada would in themselves impose important costs on travellers and business enterprises. A free trade agreement would not be sufficient to avoid such controls because of the need to verify the origins of goods to make sure they were produced within the free trade zone.

The secretariat recognizes that a free trade agreement would result in a divergence of commercial policies. It acknowledges that Canada might not wish to retain a protectionist regime for textiles, clothing and dairy production which are concentrated in Quebec. But it also notes that other provinces, including particularly Ontario, benefit from pro-

tection. In the case of industrial milk, the secretariat argues that, while Canada could modify the system of provincial quotas and import restraints, the negative effects for Quebec producers would be limited by the nature of the industry and by GATT. Under article XI of GATT, the secretariat argues, Canada could not put in place restrictions which would reduce the proportion of imports in domestic consumption to a level lower than before restrictions were in place. Canada could import more from less costly third country producers, but this would be damaging to the Canadian industry. I think that the application of article XI in the case of a breakup of a country is debatable. If Quebec were to separate, it would be in Canada's interest to allow domestic dairy producers to increase production in return for lower prices. It would be difficult to see GATT seriously impeding the process. The secretariat is realistic in observing that, in the context of the current GATT negotiations, the Canada-U.S. Free Trade Agreement and the trilateral negotiations with Mexico, protection will have to decrease in the future.

Concerning the free circulation of people, the secretariat makes the interesting observation that Quebec anglophones are 15 times more mobile than Quebec francophones and would benefit most from the preservation of mobility rights. The secretariat suggests that the way to preserve freedom of movement would be through new mechanisms which would maintain the right of establishment and work presently in the Canadian Charter of Rights and Freedoms. The secretariat also argues that a maintenance of labour mobility would require that rights to the main social programs such as unemployment insurance, medicare, and pensions continue to be transferable across boundaries. In my view, this would be highly unlikely.

The secretariat maintains that after becoming sovereign Quebec would have to maintain in force most of existing federal legislation and to respect subsequently the appropriate degree of harmonization. Specific important examples cited are the regulation of banks, competition policy, trademarks, copyrights, bankruptcy, and transportation regulations. Taxes including income taxes and the GST would have to continue to be harmonized. On a more technical level, it would be necessary to harmonize the post office, weights and measures, industrial property, and telecommunications. The secretariat, however, fails to acknowledge the great difficulty of harmonizing policy in all of these areas. Nor does it mention that if Quebec loses its voice in the determination of Canadian policy, a policy of harmonization would give a sovereign Quebec less say in all these important policy areas than it had as a province.

Study 3

"An Examination of Quebec Trade with the other Canadian Provinces, the United States, and the rest of the World," by Pierre-Paul Proulx and Guilain Cauchy

(Commission, 1991b, pp.55-165)

Proulx and Cauchy's study is a thorough and comprehensive examination of Quebec's trade relations with the rest of Canada, the United States, and the rest of the world. It builds on some of the earlier studies of Proulx. It is primarily descriptive and presents the most up-to-date data on Quebec trade flows including some previously unpublished data from the Statistics Canada and the Quebec Bureau of Statistics. Proulx and Cauchy make use of the neoclassical framework of international trade theory as embodied in the Hecksher-Ohlin theorem to shed some light on Quebec's trade flows. Proulx and Cauchy do not discuss the desirability of Quebec sovereignty.

Interprovincial trade

Proulx and Cauchy begin the study with a brief survey of the literature on Quebec's trade. They then quickly turn to a review of the most recent data on Quebec trade. For interprovincial trade, data from the Quebec Bureau of Statistics and Statistics Canada on the destination of manufacturers' shipments were used. Proulx and Cauchy note that in 1984 Quebec was the region most dependent on interprovincial shipments. The high but decreasing dependence of Quebec on Ontario is noted. The importance of the proximity of markets and transportation costs in determining Quebec's trade with the other Canadian regions is emphasized. The high degree of self supply that Quebec shares with Ontario is also noted. Proulx and Cauchy observe that Quebec and Ontario are the only two Canadian provinces that have a surplus in trade in manufactured goods. They cite the $3.3 billion surplus in 1984 and indicate the importance of clothing, metal fabrication, and paper and allied products. The large deficits in food and machinery are noted. The fact that Ontario is Quebec's most important domestic market—receiving 64 percent of Quebec interprovincial shipments in 1984—is highlighted.

International trade in the primary and secondary sectors

Primarily using data published by the Quebec Bureau of Statistics, Proulx and Cauchy explore Quebec's international trade in the primary and secondary sectors. According to them, Quebec was traditionally seen as an exporter of primary materials and as an importer of manufactured goods. But more recent data show that Quebec has performed well in exporting manufactured goods internationally compared to the rest of Canada and even to all other industrialized countries. While Quebec is somewhat less open than the rest of Canada, Quebec has a respectable position as an exporter, ranking seventeenth in importance near Switzerland, Sweden and Australia. The United States is Quebec's largest trading partner outside of Canada, receiving 77 percent of Quebec's exports in 1987. But Quebec does relatively little trade with the dynamic markets of Japan and South East Asia. Proulx and Cauchy argue that Quebec should seek to diversify its trade more in this direction.

Quebec's overall deficit in international trade is contrasted with Canada's overall surplus. Proulx and Cauchy make no mention of the difficulties that such a deficit might pose for a sovereign Quebec.

Proulx and Cauchy list the fifteen most important exports and imports of Quebec. On the export side, newsprint is the most important, but aluminium and alloys are catching up. On the import side, automobiles are in first place. The deficit in trade in automobiles was $1.4 billion in 1989. Proulx and Cauchy find this disturbing and characterize the automobile industry as the Achilles heel of Quebec's external trade. They overstate their point.

Quebec's position at the national and international level in 1984

Proulx and Cauchy use the 1984 data on trade from Statistic Canada's provincial input-output table to give a more precise estimate of Quebec's interprovincial and international trade flows. The data show that Quebec comes second—far behind Ontario—in trading volume, accounting for 25 percent of shipments to Canada and 17 percent of foreign exports. Quebec had a deficit in interprovincial trade of $1 billion in 1984 and a deficit of $3.2 billion internationally for a total deficit of $4.2 billion. Again Proulx and Cauchy do not comment upon the significance of such a deficit for a sovereign Quebec. The dominance of Ontario in service trade is noted. It is the only province to have a surplus. In contrast, Quebec is in balance on service trade. Quebec's 1984 surplus of $1.1 billion in textiles and clothing is noted. Proulx and Cauchy comment that it is regrettable that more recent data are not available to assess the impact of the Canada-U.S. Free Trade Agreement.

International and interprovincial trade of different sectors of production for Quebec and other provinces in 1974, 1979, and 1984

Proulx and Cauchy use data compiled by the Economic Council of Canada on interprovincial trade including primary, secondary, and tertiary trade to compare the performance of Quebec exports in Canadian and international markets. Quebec's share in interprovincial exports has decreased from 28.2 percent in 1974 to 23.5 percent in 1984—the only region in which interprovincial exports decreased during this period. In contrast, Quebec's share of foreign exports increased from 17 percent to 18 percent during the same period.

Interregional comparisons

Proulx and Cauchy report on a comparison of interprovincial shipments of manufactured goods and shipments of primary and secondary goods to the U.S. by using results from Proulx's recent study for the Borderlands Group. The most important finding is that Quebec's shipments to the U.S. increased much more rapidly than to other provinces. They conclude that Quebec's economic space has evolved to reflect a north-south orientation which is more dynamic and less artificial than the east-west axis. Quebec interprovincial shipments of manufactured goods increased only 2.9 percent on average from 1974 to 1984, whereas international exports increased 14.7 percent. Proulx and Cauchy examine in detail the 75 percent of Quebec exports that go to bordering regions of the U.S., particularly several New England states, where Quebec exports are increasing most rapidly. Proulx and Cauchy contend that the challenge for Quebec is to diversify its exports because the markets of Canada and the United States are less dynamic.

Comparison of the impact of interprovincial and international trade on the Quebec economy

Proulx and Cauchy report estimates of the impact of international and interprovincial trade on the Quebec economy using the Quebec Bureau of Statistics input-output model. They conclude that international exports are more profitable than interprovincial. Dollar-per-dollar they produce more employment income, more value added, more provincial and federal government revenue. They also argue that, while they generate slightly less employment, in the longer run employment in competitive international scale export industries represents a better bet on the future than employment in protected industries focused on domestic markets. This is incontestable. The problem is how it can be accomplished. On this Proulx and Cauchy are silent.

Services

Proulx and Cauchy examine trade in commercial services using unpublished data provided by Statistics Canada which have been regionalized based on the location of the head office. Payments and receipts of these services are concentrated in Ontario and Quebec. Consulting engineers and consulting services are the principal industries responsible for Quebec's surplus of commercial services. Quebec has half of the employees of exporting consulting engineering firms. Quebec is way ahead in foreign fees. Proulx and Cauchy observe that the economic aggregates are more sensitive to exports of commercial services than exports in general.

Conclusions

Proulx and Cauchy conclude that if the trade balances of various goods are examined to ascertain the comparative advantage of Quebec, positive balances in international trade would be found for airplane motors and parts, telecommunications equipment and material, and aircraft parts. Surprisingly, they do not mention the positive balances in paper and allied products and primary metals, leaving the impression that Quebec's comparative advantage is in high tech products. They omit the other products because they confine their analysis to the fifteen most important products.

In interprovincial trade, Proulx and Cauchy report that positive balances are found for hats and clothing, wood, and paper and allied products. In their view, the surpluses in these sectors are in the process of disappearing following the Canada-U.S. Free Trade Agreement. The strength of Quebec in paper and allied products and primary metals is expected to continue even in a period of political and economic transition.

Proulx and Cauchy claim that it is necessary to go beyond trade balances to establish the comparative advantage of Quebec. New theories of international trade which take into account market imperfections, economies of scale, and efforts to capture rents and externalities using subsidies should be considered, subject of course to the constraints of GATT and the Free Trade Agreement. Considerable analysis is necessary to clarify the economic policy for a confederal or sovereign Quebec. They end their paper with a plea for more research on Quebec trade to guide policies for innovation, research and development, and education and training. While they offer no concrete proposals, they definitely come down on the side of an active industrial policy for Quebec to improve its trade position. In so doing, they overlook the extent to which such policies have been tried and found wanting in the past.

Study 4

"The Question of Employment in Quebec: the Photo and the Film," by Pierre Fortin

(Commission, 1991b, pp.167-241)

General

Pierre Fortin's study is a useful survey of the Quebec labour market, which he also uses as a vehicle to provide some of his own views on incomes policy and monetary union. Its perspective is largely comparative, with Ontario being the main focus, providing many interesting and revealing comparisons.

The body of Fortin's study has two main parts: the first, the photo, provides a snapshot of the Quebec labour market in 1989 (or 1988 in certain cases); the second, the film, explores the evolution of the Quebec labour market over a longer period starting in the 1960s, focusing on the factors underlying the increase in the gap between the unemployment rate in Quebec and Ontario.

It is only in his conclusion that Fortin's sovereigntist leanings become apparent. He also advocates his personal prescriptions for stabilization policy and offers his optimistic speculations on the Quebec labour market in the 1990s. In contrast, the earlier sections of the study are more descriptive and analytical and draw on Fortin's extensive research on the causes of structural unemployment in Quebec.

Overall, there is little—if anything—in this study which could be viewed as undermining the federalist cause. Indeed, much of the material provided underlines the relative weakness of the Quebec labour market. Although Fortin does not emphasize the financial difficulties a sovereign Quebec could face, his material could be used by federalists to make a convincing case that weaknesses in the Quebec labour market would be exacerbated by sovereignty and would impede adjustment to the economic restructuring likely to be necessitated by sovereignty.

The photo

This section of the study is primarily descriptive and cannot be seriously faulted. Fortin relies mainly on data from the labour force survey to profile the state of the Quebec labour market in 1989 (or 1988), supplemented by comparable data for the U.S. and other countries where necessary. Even in a good year, such as 1988, Quebec had one of the highest unemployment rates in North America, surpassed only by the Atlantic provinces, and British Columbia in Canada and by Louisiana and West Virginia in the United States. He also notes that Montreal has the highest unemployment rate of urban agglomerations of more than 200,000 people.

Quebec ranks as one of the worst areas in North America in the creation of jobs. In particularly damning terms, Fortin calls this the Achilles heel of the Quebec economy. Compared to Ontario, Quebec had a deficit of 430,000 employees in 1989 on account of higher unemployment and lower labour force participation. Data on gross flows are used to show that people are unemployed more frequently and longer in Quebec than in Ontario.

Fortin shows that the industrial distribution of employment is similar in Quebec and Ontario, but that Quebec's distribution is more concentrated in the traditional sectors of textiles, clothing, wood, and paper while Ontario's is more concentrated in industries related to the production of motor vehicles. Workers' levels of education reveal striking gaps: workers with less than a grade nine education account for 24 percent of labour force in Quebec compared to 14 percent in Ontario, and workers with a university degree account for only 10.5 percent of the labour force in Quebec compared to 13.5 percent in Ontario. That this education gap has increased over the last ten years is not mentioned. The obvious point that Quebec needs to invest more in human capital is made. The extent to which the labour force participation of women in Quebec (62 percent) falls behind that in the United States (66 percent), and Ontario (71 percent) is emphasized.

The film

In this section, Fortin presents descriptive material on the labour market, but he goes beyond this to analyze labour market trends. He analyses the increase in the Quebec unemployment rate from 1.8 percent in 1948 to 9.3 percent in 1989, the increase in the gap between the Quebec and Ontario unemployment rates from 1 percentage point to 3.75 percentage points after the 1981 to 1982 recession, and the increase in the Quebec-Ontario gap in the employment population ratio from 30 employees per 1,000 persons after World War II to 80 employees since 1983. The paradox of the outward shift in the vacancy-unemployment relationship in the 1970s and 1980s is cited.

Five factors are offered by Fortin to explain the outward drift in the vacancy-unemployment relationship and the increase in structural unemployment:

1) the demographic congestion caused by the entry of baby-boomers and women into the labour force;

2) the increased generosity of unemployment insurance;

3) higher salaries in construction and the public sector, and the increase in the minimum wage and related spillover effects on other sectors;

4) profound structural change in the Quebec economy;

5) the persistence of unemployment caused by the continuing battle against inflation.

The first four of these factors are the standard ones cited in the empirical literature on the determinants of structural unemployment. Fortin himself has contributed significantly to this literature, providing his own quantitative estimates of the importance of these factors in earlier studies which he cites. His assessment of the importance of at

least the first three of these factors would be accepted by most analysts. The fact that the first three factors caused a significant increase in the Quebec unemployment rate, and that the increase has since largely reversed, is widely recognized.

In contrast, Fortin's fifth factor and his discussion of its overwhelming relative importance in explaining the increase in structural unemployment in Quebec and in the Quebec-Ontario gap would not be accepted by most macroeconomists, particularly those at the Bank of Canada and the Department of Finance. They would argue that there is a Non-Accelerating Inflation Rate of Unemployment (NAIRU) below which the unemployment rate cannot go without giving rise to accelerating inflation. The unemployment rate in 1989, which is the reference year for Fortin's analysis, is believed to be below the NAIRU because of the increasing inflationary pressures that were manifest and is thus not sustainable. For Fortin's fifth factor to be valid, the rate of unemployment has to be above the NAIRU.

Another factor not mentioned by Fortin is the lesser mobility of Quebec labour because of language and culture. If changes occur which affect employment, such as technological change or an increase in trade, a province such as Quebec with a less mobile labour force will experience a greater increase in structural unemployment.

Fortin's discussion of the first factor of demographic congestion is good. He estimates that, at the height of the demographic bulge at the end of the 1970s, the high unemployment rate of youth raised the overall unemployment rate by 1.5 percentage points. His assessment that the increased participation of women has not raised the unemployment rate since the rate of unemployment of women and men is similar is uncontestable. Finally, his view that the impact of demographic congestion in raising the unemployment rate through the 1970s was reversed in the 1980s is generally accepted.

Fortin's treatment of the second factor of unemployment insurance is informative. His calculation of the increase in the implicit subsidy rate of unemployment insurance in Quebec from 30 percent to 330 percent as a result of the 1971 unemployment insurance changes and the subsequent decline from 194 percent to 109 percent as a result of the 1989 reforms is striking. Fortin cites the range of estimates of an increase in the unemployment rate of 0.5 to 1.5 percentage points for the 1971 unemployment insurance changes with his own estimate of 0.7 percent at the bottom end of the range. In my view, the rise in average unemployment rates after 1971 makes the high end of the range more likely.

Fortin makes five telling observations on the impact of unemployment insurance:

1) the 1971 changes came just before the shift out in the vacancy-unemployment relationship and the increase in the unemployment rate;

2) the 1971 change provided a large incentive to join the labour force just before the big increase in the participation rate;

3) the implicit subsidy rate increased in Quebec (330 percent) more than in Ontario (230 percent);

4) the unemployment rate in the U.S. where there was no increase in unemployment insurance did not rise as in Canada;

5) the 1989 unemployment insurance reform which lowered the implicit subsidy rate to 110 percent should have a negative effect on the participation rate and unemployment rate.

On the third factor of the salary increase, Fortin observes that between 1966 and 1979 salaries in construction and the public sector increased much more rapidly than in other sectors in Quebec and the corresponding sectors in Ontario. He estimates that salaries in these two sectors, which account for 25 percent of Quebec employees, were raised artificially by 5 percent in 1980 which in turn increased salaries in the rest of the economy by 2 percent. The total economy-wide increase was thus around 3 percent. Assuming an elasticity of demand for labour of .5 percent, he estimates that the salary increase would reduce employment by 1.5 percent or 8 employees per thousand persons over fifteen years of age. However, as Fortin notes, the increase in salaries was reversed by the recession of 1981 and 1982 so it does not help to explain the deterioration in the Quebec labour market. Similarly, Fortin estimates that the large increase in the minimum wage in the 1960s and the early 1970s caused an increase in the unemployment rate of youths of 2 to 3 percentage points, but was also reversed.

On the fourth factor of structural change, Fortin emphasizes the profound structural changes which the Quebec economy has undergone and which have narrowed the productivity gap with Ontario from around 15 percent in the late 1960s to about 5 percent in recent years. These structural changes involved a movement out of the traditional

mining sector, the manufacturing sectors of leather, textiles and clothing, and maritime transport into the modern durable goods sector (metal fabrication, transportation equipment, machinery, and electrical products) and services (consulting engineering, computer services, transportation, communications and finance). Fortin also mentions the exodus of the anglophone economic elite of Montreal as being an important change. Fortin does not offer any quantitative estimates of the impact of structural change on the Quebec unemployment rate. He also does not discuss how the problems of structural change can be exacerbated by Quebec's relatively immobile labour force.

Concerning the fifth factor of the impact of the battle against inflation, Fortin's discussion is unsatisfactory. He presents no convincing evidence of the importance of hysteresis (the tendency of any increase in the unemployment rate for whatever reason to become the normal operating level of the economy after enough time has elapsed). He also makes a puzzling statement that the phenomenon of hysteresis is symmetric by which he means that a prolonged period of low unemployment at the cost of slightly higher inflation would melt away the hard core of inactivity, instability and poverty. This flies in the face of the opinions of most macroeconomists who no longer accept the existence of a permanent trade-off between unemployment and inflation.

Fortin's discussion of the five factors behind the increase in the unemployment rate in Quebec does not really resolve the issue to my satisfaction. As he points out, the first three factors were largely reversed, so they do not explain the persistence of the increase. Of the last two factors, neither of which Fortin was able to quantify in his study, only structural change seems to be relevant. The puzzle thus remains. Why did the rate of unemployment in Quebec go up so much more than in Ontario?

Conclusion

Besides summarizing the conclusions of his review of the Quebec labour market, Fortin puts forwards his views on Quebec labour markets in the 1990s. He expects that during the 1990s unemployment will decline progressively in Quebec. His view is based on several factors: the productivity catch up is over; the demographics will remain favourable to the employment of youth; social programs will be stabilized; and the realism of salaries and prices will persist as workers and firms gain a better understanding of the benefits of security and competitiveness. Fortin's analysis of prospects for labour markets in the 1990s is only impressionistic and not very systematic. It is not based on consistent long-term projections for the Quebec economy. Such projections would have to be conditional on a number of key assumptions, including the constitutional status of Quebec. It is notable that Fortin does not mention the possibility that the disruptions resulting from the accession to sovereignty could result in a deterioration of the Quebec labour market.

In his conclusion, Fortin also expresses his views on some topics which are not really fully developed in the body. First, he presents his own policy prescriptions for concerted action to restrain salaries and prices. Fortin argues that Quebec has benefitted from a form of spontaneous direct action on salaries and prices. To support this, he cites the more moderate increase in wages and prices in Quebec since 1982. In my view, this neglects the fact that some of the recent settlements with low wage increases such as the those for the public service, Quebec-Hydro and construction were imposed by the government. It also ignores an equally plausible and more simple explanation that the greater degree of wage restraint simply represents the impact of the greater degree of slack in Quebec labour markets over the period. Fortin believes that community spirit in Quebec would enhance the prospects for voluntary wage restraint. Fortin also argues that the countries with the best performance such as Japan, Germany, Sweden, Switzerland, Norway, and Austria are all countries that practice concertation among the social partners. Another interpretation, which I find to be more plausible, is that countries which create the best economic climate through anti-inflationary monetary policies such as Japan, Germany, Switzerland, and Austria are ones which have the best economic performance.

Second, Fortin argues that a monetary union is imperative for Quebec. In his view, this imperative is based on the integration of Quebec with Canada and the United States. His preference is for a fixed exchange rate tied to a weighted average of the Canadian and U.S. dollars which would be revised as the trade shares of Quebec evolved. But this is not really a proposal for a monetary union. There would still be transaction costs when changing from Quebec dollars to either Canadian or U.S. dollars, and there would still be a risk of a change of

parity. Fortin's discussion of monetary union is really inconsistent with his much better and more thorough discussion of the monetary options of a sovereign Quebec.

Third, Fortin tries to integrate his proposal for concertation with a monetary union in arguing that the only possible way to achieve full employment without inflation would be wage and price restraint based on a fair and flexible inflation target. He claims that this is the only form of independent monetary policy open to Quebec.

Study 5

"International Financial Integration and the Political Interdependence of National Macroeconomic Policies," by Daniel Racette
(Commission, 1991b, pp.243-282)

Daniel Racette's study is a good survey of the implications of integrated international financial markets for the ability of a sovereign Quebec government to conduct an independent monetary policy. It should help to pour cold water on the enthusiasm of Quebec nationalists who see sovereignty as a way to escape from the financial discipline imposed by the Bank of Canada.

Racette asks the critical question of the scope for independent national stabilization policies in a context of increasing globalization of markets. His thoughtful answer is that international competition imposes major constraints on macroeconomic policies and forces governments to exercise discipline in the use of these instruments. In the first part of the study, he examines the characteristics and consequences of the international integration of financial markets. In the second part, he considers the situation in the major industrialized countries in order to ascertain the context in which monetary and fiscal policy in North America will have to operate. In the third part, he presents his conclusions concerning the discipline imposed on governments in the conduct of their monetary and fiscal policy.

The integration of capital markets: phenomena and consequences

Racette argues that since the 1970s the international integration of international finance has developed greatly as a result of progress in communications and computers and the deregulation and opening up of national financial markets. The deregulation has included the breaking down of the barriers between different types of financial institutions, the dismantling of exchange controls, the opening up of markets to foreign financial institutions, the creation of "offshore markets," and the creation of many new and more flexible financial instruments. These changes all served to increase the mobility of capital and to improve the allocation of world-wide savings.

Racette contends that, as expected, the increasing integration has resulted in a closer correspondence between movements in real interest rates over the course of the last decade than over the two preceding decades. He also notes that different countries have different risk premiums for their interest rates. In 1989 Japan became the country with the lowest real interest rate of the Group of Seven. The United States and Canada have generally had to pay a risk premium in relation to Germany and Japan in recent years. The risk premiums result from the existence of sovereign governments with their own independent monetary, fiscal and taxation policy.

According to Racette, the risk premium can be divided into three parts. The first part is related to taxation and regulation. Investors seek after-tax rates of return which are higher than they can get in their own markets. Racette considers this part to be relatively unimportant because of the harmonization of tax policies. The second part is tied to the independence of fiscal policy. Governments can rely too heavily on deficit spending and impose a credit risk on their national borrowers. Racette reports that it has not been possible to identify empirically such an effect for industrialized countries. The third part of the premium reflects the independence of monetary policy. Since an independent monetary policy can lead to higher inflation and a depreciation of the exchange rate. Investors must take such an eventuality into account in assessing risk. By assessing these three types of risk and by determining the interest rate of a particular country, financial markets impose a price for not following disciplined macroeconomic policies.

The current situation in the major industrialized countries

Racette examines the experience of countries with what he considers undisciplined policies—namely the United States, Canada, and the United Kingdom—and those with disciplined policies—Germany and Japan.

In the United States in the beginning of the 1980s, the U.S. adopted an expansionary fiscal policy in the form of large tax cuts, while at the same time the Federal Reserve Board was trying to squeeze inflation through a tight monetary policy. This policy produced a strong recovery and a substantial reduction in inflation. It also resulted in a substantial increase in U.S. interest rates relative to the rest of the world and in an appreciation of the U.S. dollar which gave rise to a large account deficit. The Americans thus found themselves facing the problem of the twin deficits. The U.S. dollar subsequently depreciated, particularly after the September 1985 Plaza accord. This did not solve the problem. As Racette correctly points out, the solution to the problem requires a reduction in the budget deficit. The U.S. currently finds itself in a difficult financial situation on account of the slowdown, inflationary expectations, the savings and loan crisis, junk bonds, and the crisis in real estate. Racette observes that the U.S. has little room to manoeuvre. Budgetary cuts risk exacerbating the recession. Efforts by the Federal Reserve Bank to lower short term interest rates result in a drop in the U.S. dollar or an increase in long-term interest rates. International markets are waiting for a reduction in the budgetary deficit before reducing the risk premium on U.S. securities.

My own view is that while there is much that rings true in Racette's analysis of the U.S. situation, he overstates his case. An examination of the trends in short-term and long-term interest rates over the last year shows that the Federal Reserve Bank has been able to lower short-term interest rates at the same time as long-term interest rates declined and the U.S. dollar strengthened. Paradoxically, at the same time the U.S. budget deficit worsened. This would seem to be evidence that the Federal Reserve Bank has perhaps more influence over long-term interest rates than Racette recognizes.

Racette argues that the situation in Canada is currently worse than in the United States. In 1989 the Canadian external deficit was larger in per capita terms than that of the United States. Canadian external debt at 40 percent of GDP is much higher than the U.S. debt at 8 percent. Unlike in the past when Canada has borrowed abroad to finance development of resources and communications (as in the 1950s and 1960s), the recent Canadian external borrowing has been to finance consumption, and it results in large part from government dissavings. It is thus imperative, according to Racette, to reduce the budgetary deficit to lower the dependence of the economy on foreign savings. Racette observes that the current interest differential is 400 basis points and reflects risk premiums and tight money (as of mid July the interest differential has declined to nearly 300 basis points). He wonders what the differential would become if markets began to worry more about the monetisation of budget deficits.

In my view, Racette does not give enough credit to the high credibility that the Bank of Canada has achieved as an avid inflation fighter. The Bank has pursued a much tighter policy than the Federal Reserve Bank and has been successful at keeping underlying inflationary pressures below those in the U.S. over the last year. Thus it is difficult to attribute the risk premium relative to U.S. interest rates to greater inflation risk. The premium is no longer so much larger. and its size can more likely be attributed to tighter monetary policy and perhaps political risk stemming from the debate over Quebec's constitutional future or economic risk resulting from the huge Ontario budget deficits. Nowhere in Racette's paper is the subject of political risk even mentioned. Racette should warn Quebeckers about the possible significance of political risks in contributing to risk premiums in Quebec interest rates.

In the case of the United Kingdom, Racette argues that not only budgetary deficits produce interest rate premiums. Inflationary monetary policy reduced savings and increased investment and generated a large current account deficit and risk premiums in interest rates. Racette notes with interest the recent entry of the U.K. into the European Monetary System. He interprets this as a sign that the British have renounced their monetary independence in appreciation of the benefits of participation in European monetary discipline.

Regarding Japan, Racette observes that the surplus of first private savings and then, when private savings weakened, government savings were behind Japan's current account surplus that made Japan a major supplier of funds on international markets in the 1980s. The Japanese invested so much in the United States in 1989 that the U.S. dollar appreciated relative to the yen. He also remarks that the movement of Japanese capital from 1985 to 1990 partially reflected the adjustment of portfolios following the removal of restrictions on foreign investment. The Japanese have become the "world's key swing investors."

Turning to Germany, Racette, emphasizing the strength of the discipline on macroeconomic policy, notes that the Bundesbank is renowned for its pursuit of price stability and that the German federal government has the lowest debt in relation to GDP of all the industrialized countries. The high rate of savings has resulted in a current account surplus of around 4 percent of GDP since 1986. In spite of its large surplus, Germany has not played as big of a role in international capital markets as Japan and has been happy to concentrate its investments in Europe. In the future, German reunification will require an extraordinary investment of funds. This will reduce the funds available to North America. Racette cites the low and stable real interest rates in Germany as evidence of the benefits Germany derives from policy discipline.

Racette argues that the benefits of monetary indiscipline in terms of lower interest rates and higher activity are immediate, but in the long run, the costs are inflation and a deterioration in economic performance. International policy coordination is useful as a way of internalizing at the national level the international advantages of discipline.

Racette discusses with much interest the Delors plan for European monetary unification which will evolve from the present system of fixed parities to the adoption of a single currency around the year 2000. In this way, he argues, other European currencies can import the credibility of the Bundesbank.

Conclusion: the necessity of monetary and fiscal discipline

Racette concludes convincingly that the integration of international financial markets over the course of the 1980s has altered profoundly the environment in which international monetary authorities operate and has substantially reduced their room to manoeuvre in the use of stabilization policy. Financial markets will penalize countries with undisciplined macroeconomic policies by imposing risk premiums on interest rates or downward pressure on exchange rates. He reports that his analysis has succeeded in identifying risk premiums for undisciplined countries. These premiums will become heavier, he argues, because of the reduction in the availability of funds from Germany and Japan and the increased discipline in Europe from the strengthened institutional framework.

At the end of his study Racette finally expresses some views on Quebec sovereignty. He argues that the European model would be the most appropriate model to establish a viable and competitive monetary framework. If an agreement could be reached with Quebec's neighbours, in particular Canada, on a similar monetary framework with a central bank independent of governments and a common money, then Quebec would benefit immediately from the credibility that the agreement would bring. He recognizes that Quebec would lose its monetary independence, but he argues that this would be a relatively small price to pay compared to the benefits of monetary integration, namely monetary credibility, price stability, exchange rate stability, and minimum risk premiums in interest rates.

In my view it is difficult to understand what Racette's proposal has to do with Europe. In effect, he is indicating his support for a monetary union with Canada. It is strange that he feels compelled to camouflage this in terms of a reference to a European model, which does not even exist yet. A Canada-Quebec monetary union would be quite different from a European monetary union. Only two countries would be involved and one would be three times as large as the other. This is a far cry from a monetary union of twelve countries of relatively less disproportionate size.

Study 6

"The Monetary Options of a Sovereign Quebec," by Bernard Fortin
(Commission, 1991b, pp.283-302)

Bernard Fortin's study provides an excellent discussion of the benefits and costs for a sovereign Quebec of various different forms of monetary integration (or non-integration) with the rest of Canada. The analysis in the study, which is more qualitative than quantitative, builds on an earlier paper prepared by Fortin for the Quebec Ministry of Intergovernmental Affairs on the same topic (B. Fortin, 1979).

The monetary options of a sovereign Quebec

Fortin considers four options. They are listed in order of the degree of monetary integration with Canada:

1) a common currency with Canada with or without participation in the formulation of monetary policy (pure monetary union);

2) a Quebec currency with a fixed exchange rate in terms of the Canadian dollar (pseudo-monetary union with Canada);

3) a Quebec currency with a fixed exchange rate in terms of the U.S. dollar (pseudo-monetary union with the United States);

4) a Quebec currency with a floating exchange rate.

The common currency option would require Quebec legislation decreeing that Canadian money was legal tender in Quebec. Regulations for financial institutions would also need to be harmonized. Fortin envisages two possible scenarios for the institutional framework for the formulation of a common monetary policy. In the first, a supranational Quebec-Canada Council would replace the Board of Directors and Executive Committee of the Bank of Canada and policy could be conducted decentrally through Canadian and Quebec central banks. A formula would have to be negotiated on the sharing of the central bank profits (seigniorage).

Fortin compares his proposal for sharing authority over monetary policy to the Federal Reserve System of the United States with its board, open market committee and regional banks. He also cites the Monetary Union of West Africa and the proposed European community (excluding the U.K.) system for the year 2000 as examples of such a system. He neglects to point out important differences and problems. The Federal Reserve System answers to only one political authority, the United States government. The West African and proposed European systems involve the participation of many states of comparable economic and political weight. The proposed Canadian system would involve only two partners and one would be three times the size of the other. In addition, it is quite possible that the separation of Quebec could engender such a backlash in the rest of Canada that it would be impossible to reach an agreement.

That Canada could refuse to share authority over monetary policy is acknowledged by Fortin. In this case, he argues, Quebec could always opt for something like the status quo. Quebec could still use Canadian money and leave the Bank of Canada to formulate the monetary policy of the monetary union. Quebec banks could continue to hold their reserves as deposits with the Bank of Canada. Fortin argues that the reserves and currency would be, in effect, debt of the Canadian government on which no interest was paid. As such, it would be a disguised tax that would increase the profits of the Bank of Canada. While Canada might object to particular formulas for profit sharing, there would be a critical share above which it would be in Canada's interest to agree to the proposal. Fortin cites the case of Ireland, which, after its independence from the United Kingdom in 1921, continued to use the pound sterling until 1928.

Fortin presents this option as if Canada would have no choice but to go along with it. Yet, if Canada did not agree, it would be relatively simple to prevent Quebec from using Canadian currency as legal tender. Canada could refuse to provide Quebec with the needed supplies of coin and currency. Canada could introduce a law which prevents individuals from taking more than a certain amount of currency outside of the country. The United States already has a law requiring that currency above a certain amount taken out of the country must be declared. If Quebec were to introduce its own coins and currency, there would no longer be a pure monetary union, but a fixed exchange rate system. Canada would not have to allow Quebec financial institutions to hold reserves at the Bank of Canada. Canada could prevent Canadian financial institutions from acting as clearing agencies for Quebec financial institutions. It is misleading to create the impression that a monetary union could result from a unilateral decision of Quebec. Canada would have to agree for the system to be workable for Quebec. Such agreement could be expected only if other outstanding issues, such as trade and the division of the public debt, were settled to Canada's satisfaction.

The second and third option of fixed exchange rate pegged to the Canadian dollar would require the creation of a Quebec central bank. Monetary policy would have to be conducted so as to preserve the fixed parity.

Under the fourth option of a floating exchange rate, the degree of flexibility could be greater or less and would be influenced by the intervention of the central bank on the foreign exchange market and by the monetary and fiscal policy adopted by the government.

The costs of a separate currency for Quebec

Fortin discusses the three traditional functions of money, as a unit of account, medium of exchange, and store of value. He emphasizes that the advantage of a money as a social institution depends on the size of the economic and geographic area within which it is utilized. He identifies three types of costs in Quebec-Canada transactions: 1) transaction costs stemming from the need to convert currencies, 2) accounting costs from the necessity to calculate prices in Canadian and Quebec currency, and 3) costs of risk and uncertainty associated with unexpected fluctuations in the exchange rate. He acknowledges that while it is difficult to quantify these costs, the costs are not negligible. They would be minimized under option two of the fixed exchange rate and be much higher in option four of the floating exchange rate.

The annual additional accounting and transaction costs resulting from the use of separate currencies in the European Community is around 1 percent of GDP. Fortin estimates that, taking account of the relative magnitude of Quebec trade, the additional costs of a separate currency in Quebec would be 0.6 percent of GDP—one billion dollars in 1990. Using a 5 percent real interest rate and a 2.5 percent long-term growth rate for Quebec, he estimates that the present value of the additional costs would be $40 billion, a far from negligible figure. Canada would also experience considerable additional costs if Quebec were to introduce a separate currency.

But the estimate of the additional costs of a separate currency for Quebec provided by Fortin is only the roughest of figures. Fortin does not even explain the basis of his calculation. Much more work would be required before any confidence could be attached to his estimate.

Fortin cites evidence from recent studies to show that future markets in currency only protect imperfectly against exchange risk and involve significant transaction costs. He argues that exchange risk is thus translated into an increase in transaction costs and into risk premiums in interest rates. This represents not only static costs, but also dynamic costs, with negative effects on economic growth. In the longer run, increases in interest rates reduce the stock of physical and human capital in the economy.

Fortin also argues that increased transaction costs cause inefficiencies in the same way that imposing tariffs does. It would be difficult, he argues, to have a common market without a monetary union.

The benefits of a separate currency for Quebec

In his discussion of the benefits of a separate Quebec currency, Fortin distinguishes between the transition period and the long run. Fortin argues that in the transition period Quebec would have to have a stable exchange rate to gain confidence in the new Quebec currency. There would thus not be much room for an autonomous monetary policy. A separate currency for Quebec would entail costs, but bring no benefits other than information on monetary aggregates.

Fortin considers the advantages of a separate currency once confidence is established. Fluctuations in the exchange rate can absorb asymmetric shocks which affect the economy, but, he argues, this advantage should not be exaggerated in the case of a small open economy such as Quebec.

Fortin argues that it is necessary to have an adequate understanding of the role and limits of monetary policy. When monetary policy is credible and fully anticipated and with full indexing, it does not have a significant impact on the standard of living, but only on inflation. He also warns that an expansionary monetary policy will raise—not lower—interest rates. It is only when monetary policy is not credible and can fool expectations that it can have an impact on the real sector of the economy. Fortin concludes that because of subjective and volatile variables, it is impossible to predict the impact of monetary policy.

Fortin cites the weak relation between the rate of growth of money and real GDP as evidence of money's lack of real impact. The only time money growth had a strong impact on real activity was in 1981, 1982, and again in 1990 because of the lack of credibility of monetary policy during those years. He argues that the objective of monetary policy should be limited to long-run price stability, which requires the establishment of clear and credible objectives defined in terms of the growth of the monetary aggregates.

While I share Fortin's long run objective for monetary policy, I think that the short run conduct of monetary policy is much more difficult than he suggests. In particular, I do not believe that we can rely completely on monetary aggregates as indicators of monetary policy. A much more eclectic approach which takes into account a wider range of economic indicators including interest rates, real activity, the unemployment rate, wage and price trends, and even the stability of the financial system is required. This approach is followed by the Bank of Canada.

Concerning the role of monetary policy in government finance, Fortin makes the valid point that financing government deficits by

printing money is equivalent to a tax on the holders of government debt. He argues that such a tax is inefficient and undemocratic.

According to Fortin, an independent monetary policy would enable Quebec to have a more stable and less inflationary monetary policy than that of the Bank of Canada. But inflation has been relatively low in Canada since 1983 and, to the extent the anti-inflationary policy of the Bank of Canada is pursued and becomes more credible, it will be possible in the long run to achieve a reduction in inflation without an increase in unemployment. Fortin acknowledges that, while it is possible for Quebec to pursue a less inflationary monetary policy, it is not certain.

The other possible advantage for Quebec of a floating exchange rate would be to allow an adjustment in the external value of the currency in response to external shocks such as changes in demand for exports. Fortin distinguishes between shocks that affect the Quebec and Canadian economies similarly and differently. He argues that devaluing currency in response to similar shock would be an attempt to export unemployment to Canada, which could lead to self-defeating reprisals.

On the other hand, Fortin argues that a depreciation in response to a shock which only reduces the demand for Quebec exports could facilitate the process of adjustment of Quebec's real exchange rate in the face of nominal wage rigidities. This could reduce any temporary unemployment created by the shock. The advantage of exchange rate adjustment would depend on the availability of alternative methods of adjustment. Fortin cites with approval a Bank of Canada study which shows that the terms of exchange between Canadian regions are already quite flexible. Furthermore, the mobility of factors, especially labour, can mitigate the impact of any shock.

Fortin fails to make the case that the limited mobility of francophone Quebec labour implies a greater role for exchange rate fluctuations in fostering adjustment in Quebec than in the rest of Canada where labour is more mobile.

Fortin's overall conclusion on the benefits of a separate currency for Quebec is that they are limited to a certain autonomy in carrying out anti-inflationary policies and in using of the exchange rate to increase the rapidity of adjustment to external shocks.

Monetary union with the United States

Fortin asks whether a monetary union or pseudo-union with the United States would be preferable to one with Canada. In response, he makes six points:

1) Monetary union goes along with a common market. In spite of free trade, Quebec is far from having a common market with the U.S.

2) Quebec has a much higher volume of transactions with Canada.

3) The transition costs of a monetary union with the U.S. would be greater than the costs of a union with Canada.

4) Quebec is more likely to experience shocks which do not affect the United States than those which do not affect Canada.

5) It is possible that Quebec would have experienced less inflation since 1980 if it had been in a monetary union with the United States, but it is necessary to determine if Quebec was subjected to more inflationary shocks during that period.

6) Some have suggested that a monetary union with the United States would result in lower interest rates for Quebec, but the interest rates are similar if one accounts for exchange rate expectations.

Fortin interprets these points as favouring a Quebec-Canada monetary union.

Conclusion

Fortin's conclusion is that a pure monetary union with Canada is the most advantageous option for a sovereign Quebec since it will simplify calculations and help to preserve the integration of markets. This option would be most advantageous for Canada to avoid an increase in the costs of exchange with Quebec. While sovereigntists may see this as an argument in favour of sovereignty-association, it is an even stronger argument in favour of a continuation of a federalist system given the uncertainty of a continued monetary union if Quebec were to separate.

The cost to Quebec of not running an autonomous monetary policy and not floating its exchange rate are regarded by Fortin as of limited importance, particularly since the external shocks facing Quebec are likely to be shared with Canada. He neglects to mention the adjustment problems caused by the lesser degree of labour mobility in Quebec.

Fortin does not see much justification for a fixed exchange rate with Canada. It would introduce transaction costs and exchange rate risk. Its only advantage is that statistics could be collected on the financial flows and stocks for Quebec. He regards this option as a fall-back position if Quebec and Canada could not agree on a monetary union.

The option of a fixed rate pegged to the U.S. dollar is considered to be viable by Fortin. But he sees it as less advantageous to Quebec than a fixed rate pegged to the Canadian dollar because of the lesser volume of trade and greater dissimilarities between the two economies.

Fortin does raise the interesting possibility that a North American monetary block with a common currency could become the preferred monetary option in the near future, thereby favouring the development of a real North American Common market. Fortin's rather convincing discussion of the benefits of a monetary union between Quebec and Canada also suggests that a Canada-U.S. monetary union would be beneficial from an economic point of view. The politics of such a monetary union would, of course, be another story. But, in any event, a North American monetary union is much more likely if Quebec remains part of Canada then at least two of the three possible partners are already using the same currency. A movement to monetary integration is not likely to be best served by a breakup of Canada.

Study 7

"An Analysis Of The Fiscal And Budgetary Activities Of The Federal Government: The Evolution And Interprovincial Comparisons," By The Secretariat

(Commission, 1991b, pp.303-352)

This study, prepared by the secretariat of the commission, provides estimates of the interprovincial breakdown of federal government expenditures, revenues and budget balances for the five Canadian regions. These data are frequently used indicators of the costs and benefits of Confederation. The secretariat utilizes the data from the provincial economic accounts because they are the only available data broken down by province. The data cover the 1961 to 1988 period. The secretariat also makes comparisons with fiscal balance data provided to the Commission by the Desjardin movement, the Parti Québécois, the Conseil du Patronat du Québec, the Asociatbn desconomistes Québécois, and other studies.

Methodology

The secretariat makes some ajustmnts tdhe provincial accounts data to eliminate certain biases inhe dæa:

- Federal sales tax, excise axes ad cutoms duties are reallocated on the basis of consamptin rathr than production.
- Investment income is excuded ince idoes not reflect obligatory tax revenue, but volntaryransa:ions.
- Public debt charges are excudedbecaus they reflect voluntary transactions.
- Tax point transfers are treæd afiscal tansfers.
- Oil import subsidies and exort txes areliminated to facilitate comparisons with provincs whch benefitted from the federal government's regulation ooil prices.

In my view, all of these adjustrentsexcept ie last are reasonable. As for the last, it would have ben mre reasnable to include the implicit subsidies resulting from rgulæd oil prices in the fiscal balances. The approach chosen by theomuission ubstantially underestimates the magnitude of the transfrs frm the Prairie region to the rest of Canada, thereby underestimatin Quoec's fical benefits from 1973 to 1985, when oil prices were reglate. Also not allocating federal government expenditures abroad t theprovines should be a source of slight bias.

From a methodological point c vie, one c the main differences from other approaches is that no explicit djustent is made to eliminate the deficit. Instead, the adjustrents temselves tend to reduce the magnitude of the deficit and the aqustedcorreed balances are compared with the national average. This is, in effect, a implicit adjustment for the deficit.

Expenditures

The secretariat analyses the disributin of ech major category of federal spending separately. Quebe has lwaysbenefitted least from federal expenditures on goods and servies in pite of the National Capital Region's presence in Quebe. A reent stdy by the Council of Atlantic Premiers confirmed that Quebe is th province in which

federal employment creation expenditures have been the lowest. Another recent study by the Quebec Ministry of Industry, Commerce and Technology concluded that, in taking account of total research and development expenditures, Quebec and Alberta had a negative balance.

In spite of its high share of unemployment insurance benefits, Quebec's share of transfers to persons is only the same in 1988 as its population share. The secretariat attributes this to the under-representation in Quebec of individuals eligible for family allowances and of veterans and public servants in receipt of pensions. The improvement in Quebec since the mid-1960s can be explained by the increase in old age pensions resulting from the greater numbers of old age pensioners in the Quebec population and from the introduction of the Guaranteed Income Supplement.

The secretariat notes that Quebec maintained its population share of transfers to business from 1967 to 1981, but since 1981 Quebec's share has fallen sharply and has not gone above 60 percent of the national average. As an equalization-receiving province, Quebec has received a share of fiscal transfers to governments above its demographic weight and about 25 percent above the national average.

The secretariat concludes that Quebec's share of federal expenditures has been systematically below its demographic weight since 1961 except for the years 1978, 1980 and 1983. But in my view, two additional points are worth noting. First, from 1978 to 1983, Quebec's shares are very close to the national average. Second, shares of expenditure are not as good an indicator of the benefit Quebec derives from the federal government as the fiscal balance, which also takes into account revenues, is.

Budget balances

From 1961 to 1974, the secretariat states, the federal government was able to maintain its corrected budget balance at the national level in a surplus position. From 1974 to 1978, inflation increased spending more than revenues and caused a major swing into deficit. From 1979 to 1981, the federal government was able to bring its position back towards balance. The 1982 recession turned the situation around again and produced an unprecedented deficit by 1984. Fiscal restraint after 1984 brought the deficit back to surplus by 1988.

The per capita fiscal gain estimated by the secretariat for the five Canadian regions in relation to the national average is shown in table 7. Figure 1 provides a graph of the same information.

According to the secretariat, the data demonstrate that until the end of the 1960s, Quebec contributed proportionally more than other regions to the redistributional activities of the federal government, registering a net loss per capita of between $17 and $163. The situation reversed in 1968, after which Quebec recorded a net fiscal gain which steadily increased from $55 per capita in 1969 to $818 in 1982 (still well below the gain of the Atlantic provinces). The economic recovery after 1983 and federal fiscal restraint reduced the net gain substantially to $409 in 1988. The 1988 net gain per capita is 40 percent less than that of the Prairies and only one eighth of that of the Atlantic provinces. According to the secretariat, these results confirm other studies' results—that Quebec was a net contributor to fiscal federalism in the 1960s but a net beneficiary from the beginning of the 1970s, with a significant reduction in benefits since 1983.

Two points are worth making about the secretariat's estimates and conclusions. First, by excluding the oil import subsidy and export tax and the related transfers from the Prairies to the rest of Canada (which kept the domestic price of oil below the world price from 1973 to 1985), the secretariat ignores a massive transfer to Quebec mandated by federal government policy. At its peak in 1981, this transfer was worth $5 to $6 billion or approximately $800 per capita. Second, the secretariat fails to mention the large absolute magnitude of the transfers in 1988. A net fiscal gain of $409 per capita in 1988 is $2.7 billion dollars, a substantial amount by anyone's reckoning.

Limits of the analysis

The secretariat warns that fiscal analysis does not shed light on the global regional incidence of all federal economic interventions. Nor does fiscal analysis reveal what the impact on Quebec public finances would be of taking over federal revenues and expenditures in the event of sovereignty. And fiscal analysis reveals nothing about the advantages all regions of Canada derive from sharing economic space.

TABLE 7

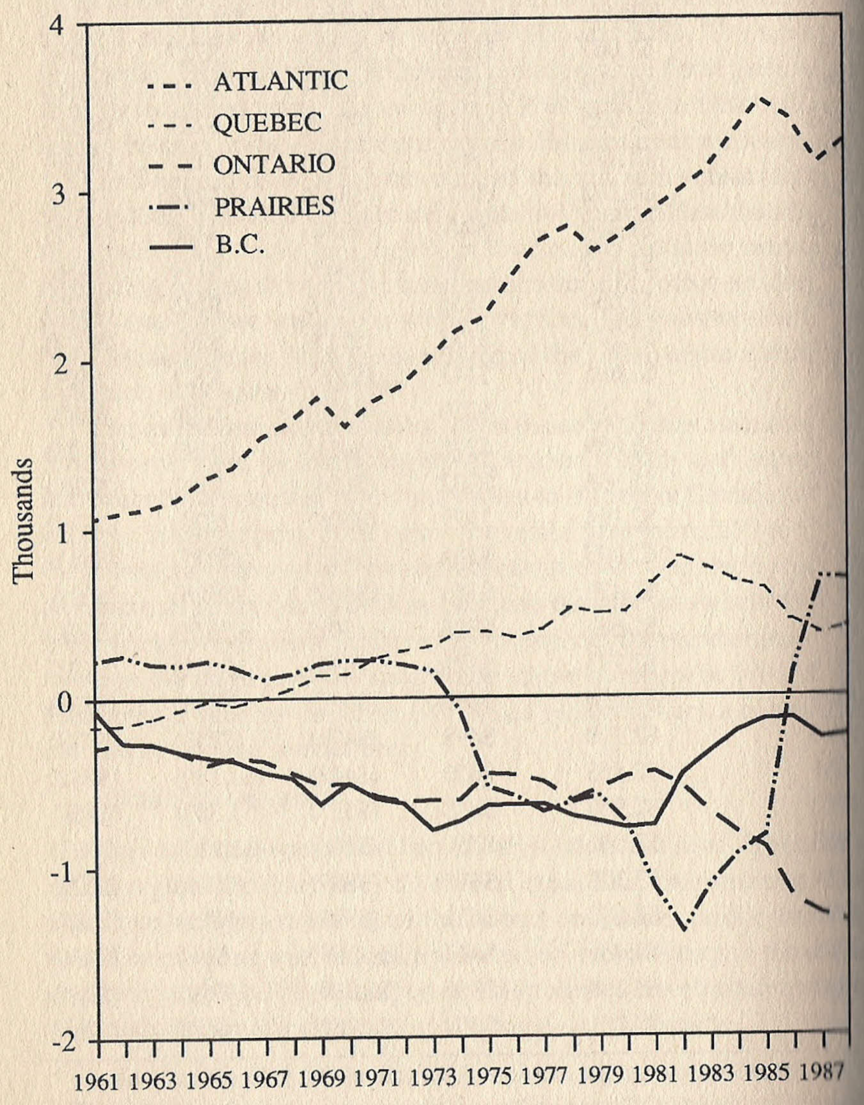
PER CAPITA FISCAL GAIN GAP IN RELATION TO THE NATIONAL AVERAGE

Year	*Gap*				
	Atlantic	Quebec	Ontario	Prairies	B.C.
1961	$1,067	($163)	($286)	$227	($64)
1962	$1,103	($153)	($260)	$256	($256)
1963	$1,125	($119)	($268)	$207	($264)
1964	$1,180	($64)	($316)	$197	($316)
1965	$1,302	($17)	($386)	$224	($344)
1966	$1,364	($40)	($344)	$186	($372)
1967	$1,542	$0	($368)	$114	($436)
1968	$1,634	$55	($440)	$143	($473)
1969	$1,775	$133	($515)	$203	($627)
1970	$1,605	$141	($509)	$221	($503)
1971	$1,751	$230	($580)	$224	($593)
1972	$1,839	$276	($611)	$193	($626)
1973	$1,998	$302	($606)	$161	($786)
1974	$2,164	$379	($609)	($74)	($734)
1975	$2,243	$386	($453)	($532)	($641)
1976	$2,476	$353	($460)	($586)	($639)
1977	$2,687	$396	($501)	($678)	($631)
1978	$2,773	$522	($610)	($621)	($702)
1979	$2,626	$490	($545)	($586)	($738)
1980	$2,719	$498	($471)	($753)	($778)
1981	$2,853	$670	($443)	($1,130)	($762)
1982	$2,969	$818	($535)	($1,387)	($459)
1983	$3,092	$754	($686)	($1,113)	($333)
1984	$3,302	$675	($807)	($936)	($209)
1985	$3,510	$631	($897)	($825)	($139)
1986	$3,406	$447	($1,199)	$144	($136)
1987	$3,138	$366	($1,290)	$693	($254)
1988	$3,271	$409	($1,337)	$687	($231)

Note: A number in parenthesis indicates a fiscal gain inferior to the national average.
Source: Commission sur l'avenir politique et constitutionnel du Québec (1991b, p.335).

FIGURE 1

CORRECTED BUDGETARY BALANCE GAP IN RELATION TO THE NATIONAL AVERAGE



Study 8

"The Presence of the Federal Government in Quebec: Federal Transfer Programs to the Provinces, the Functioning and Recent Evolution," by the Ministry of Finance of Quebec

(Commission, 1991b, pp.353-391)

Prepared by the Quebec Ministry of Finance, this study provides background information on the importance to Quebec of federal transfer programs to the provinces. The first five sections of the study provide a brief description of the programs accompanied by tables and graphs presenting the financial data. The final section, which is of most interest, raises some problems with the programs from the point of view of the Quebec government operating within the current federal structure. The ministry's study does not address the broader issues of the relevance of federal transfers for the desirability of renewed federalism or sovereignty.

The ministry lists the most important federal transfer programs, such as the established programs financing, equalization, and the Canada Assistance Plan, which transferred $4.6 billion, $3.7 billion, and $1.7 billion respectively to Quebec in 1989-90. The total amount of federal transfers received by Quebec in 1989-90 was $10.6 billion out of total federal transfers of $35.2 billion. Federal transfers to Quebec have stagnated since 1983-84, falling from 28.9 percent of GDP in 1983-84 to 21.6 percent in 1989-90. But I find these data misleading because they include only cash transfers and ignore the transfer of tax points which form a larger part of the transfer programs for Quebec than the other provinces because of opting out. The value of these tax points has been steadily increasing.

According to the study 43 percent of the transfers go to the three wealthiest provinces and only 57 percent to the remaining seven provinces, including Quebec. Because Quebec receives an extra 16.5 percent abatement of personal income tax points, the study's authors argue, the portion of cash transfers is less important in Quebec than in other provinces.

The Quebec Ministry of Finance discusses the financing of the Established Programs Financing Program, which provides funding for health and post-secondary education and reviews the evolution of transfers. It presents the formula for the total federal contribution ($212.65 in 1975-76, which is indexed annually according to the evolution of GNP, taking into account some limitations in specific years, and then multiplied by the Quebec population) and the subtraction of tax points. The study provides estimates of the impact of federal cutbacks in established programs financing from 1982-83 to 1990-91. The cumulative impact of the cuts was estimated to be $14.6 billion for Canada and $3.8 billion for Quebec. In 1990-91 alone the cuts were estimated to be $5.1 billion for Canada and $1.3 billion for Quebec. The study makes the important point that, given the reduction in the rate of increase of established programs financing, after seven or eight years cash transfers to Quebec will first disappear and then turn negative. But the reduction in transfers will reduce the federal share of funding of health and post-secondary education to 37 percent in 1990-91 from 47.9 percent in 1977-78 while maintaining constraints on provincial management of these programs.

Next, the Quebec Ministry of Finance describes the workings of the equalization formula, which raises the fiscal capacity of provinces up towards the level of the five provinces making up the standard (Quebec, Ontario, Manitoba, Saskatchewan, and British Columbia). In 1989-90 Quebec's equalization entitlements were $3.6 billion out of a total of $7.8 billion, which represents $533 per capita in Quebec compared to an average of $705 for recipient provinces. Unfortunately, the ministry argues, a ceiling limiting the increase of equalization to the cumulative growth of GNP will result in a $1,238 million reduction in total equalization in 1990-91, out of which Quebec will lose $749 million. They also note that, even after equalization, a gap of 13.8 percent in fiscal capacity exists and will be increased to 15.7 percent by the ceiling.

The ministry argues that federal transfer programs increasingly favour the better off provinces. As evidence, the ministry cites the fact that from 1984 to 1988 transfers grew at an annual average rate of 7.7 percent for non-equalization receiving provinces compared to 5.7 percent for equalization receiving provinces (and 8.1 percent for Ontario versus 3.5 percent for Quebec). This is attributed to four factors:

1) Cost sharing favours provinces which have a greater capacity to spend.

2) The cuts in established programs financing have been made on an equal per capita basis.

3) The less well-off provinces have had to increase their tax rates more than the other provinces.

4) Once the equalization ceiling was reached, the equalization receiving provinces have not received equalization for the tax increases.

The ministry neglects to acknowledge that the federal government has made some efforts to accommodate the less well-off provinces by applying the 5 per-cent limit only for increases in Canada Assistance Plan payments to non-equalization receiving provinces. Also, it is worth noting that restraining the increase in equalization to the growth of GNP cannot be considered severe restraint. Equalization would have grown more rapidly than GNP because of tax increases in the five provinces included in the standard, particularly Ontario. The slow growth of equalization in Quebec over the period stemmed in part from the end in 1985-86 of transitional payments which had been introduced to smooth the move to the 1982 equalization formula. Thus, the growth of equalization during this period does not reflect the longer run growth which would be generated by the formula. In my view, the ministry overstates its case, but still makes some valid points.

The ministry concludes that transfer programs need to be reviewed to improve redistribution and to stop impeding provinces' efforts to manage their expenditures through shared cost programs and standards. This is a federalist conclusion—in no way can it be interpreted as sovereigntist. Almost any other equalization receiving province might make the same argument.

Study 9

"A *Pro Forma* Analysis of Public Finances Under the Hypothesis of Quebec Sovereignty," by the Secretariat

(Commission, 1991b, pp.393-562)

This study, which was prepared by the secretariat of the commission, carries out a *pro forma* analysis of the public finances of a sovereign Quebec using 1990-91 as the reference year. *Pro forma* analysis is a technique used by accountants to prepare estimates of the financial statements of enterprises' performance under certain hypothetical assumptions. It is usually, as it is in this study, complemented by sensitivity analysis involving a base case and alternative scenarios.

The secretariat assumes that all of the revenues currently raised by the federal government in Quebec would become revenues of the Quebec government and that all expenditures made by the federal government in Quebec would be assumed by the Quebec government. The analysis clearly distinguishes the impact of the sharing of assets and liabilities. The secretariat acknowledges the obvious: there would have to be negotiations to settle this question, and it is impossible to know in advance their result.

Pro forma balance sheet of the federal government

The secretariat proposes a method to construct a *pro forma* balance of the federal government for the purpose of the succession of states and for the provision of order of magnitude estimates of the elements in this balance. Pension liabilities and all other assets and liabilities are treated separately. The main source of data used is the Public Accounts of Canada, which is supplemented with data from Statistics Canada's National Balance Sheet, the Study on the Financial Reporting of Federal Government carried out by the U.S. General Accounting Office and the Auditor General, the Nielsen Report, and an exploratory study carried out for the commission by the accounting firm, Raymond, Chabot, Martin, Paré & Cie.

Table 8 shows the balance sheet prepared by the secretariat for the federal government's non-pension assets and liabilities. It is consolidated with the Bank of Canada's balance sheet. A few explanatory comments might be useful. The stars (*) indicate the categories of financial assets for which the secretariat has adjusted the Public Accounts data because of additional information. The $72 billion estimate for the value of non-financial assets is based on the Nielsen Report's $50 billion estimate for 1984 and then scaled up to reflect the growth in the federal government's capital stock to 1990. The accumulated deficit reflects the difference between assets and liabilities. Pension liabilities, which are not included in the table, amounted to $70,997 million as of March 31, 1990.

TABLE 8

***PRO FORMA* BALANCE SHEET OF THE FEDERAL GOVERNMENT FOR THE PURPOSE OF SUCCESSION OF STATES AS OF MARCH 31, 1990**
(Millions of Dollars)

ASSETS		LIABILITIES	
FINANCIAL ASSETS*	57,195	1) Currency in circulation	19,404
1) Exchange Fund and Foreign Currency Accounts*	21,228	2) Bank deposits	3,082
2) Loans, investments and advances and surplus of crown corporations*	26,312	3) Unmatured debt held outside of government accounts (excluding the Bank of Canada)	272,976
3) Accounts receivable*	5,993	-Treasury bills	106,890
		-Marketable bonds	121,659
4) Funds in transit	2,136	-Non-marketable bonds	42,804
		-Canada bills	1,446
5) Other assets	1,526	-Notes and loans	177
		4) Other Liabilities	34,127
NON-FINANCIAL ASSETS*	72,000		
TOTAL ASSETS	129,195		
ACCUMULATED DEFICIT**	200,394		
TOTAL OF ASSETS AND ACCUMULATED DEFICIT	329,589	TOTAL LIABILITIES	329,589

* Adjusted amounts.

** Accumulated deficit equals liabilities minus financial and non-financial assets. It is a concept taken from "A Study on Federal Government Financial Reporting," a joint study of the Office of the Auditor General of Canada and the United States General Accounting Office, March 1986.

Source: Commission sur l'avenir politique et constitutionnel du Québec (1991b, p.415).

Quebec's share of the federal balance sheet

The secretariat's proposed methodology for sharing assets and liabilities is based on the principle that part of the debt Quebec assumes should be based on its share of total federal assets. But one of the "assets" considered is the accumulated deficit, which is not really an asset. Furthermore, since the debt was not incurred to purchase assets, there is no reason why the debt split should be based on asset shares.

For financial assets, the secretariat lists the assets that Quebec would share either totally or as a minority shareholder. One criterion used is to select crown corporations which do business almost exclusively in Quebec. Another is to select corporations in which it would be useful for Quebec to retain a minority ownership. These criteria of picking and choosing result in the extremely low 3.8 percent share of financial assets as shown in table 9, which depresses Quebec's share of assets.

With respect to federal non-financial assets, the secretariat assumes that Quebec's share would be equivalent to the ratio between the value of these assets situated in Quebec and the total value of the assets located in Canada and elsewhere in the world. Since estimates of the geographic distribution of the value of these assets were not available, data from the Canadian Tax Foundation on the distribution of transfers to municipalities in lieu of taxes were used to estimate that $13 billion or 18 percent of federal non-financial assets were located in Quebec (table 9).

For the accumulated deficit, which again is not really an asset, the secretariat argues that it represents future tax liabilities and consequently should be shared based on Quebec's portion of total federal taxes, which is much less than Quebec's share of population. The secretariat argues that this criterion would be applied if Quebec were to remain in Confederation and that the criterion should not be changed if Quebec were to decide to leave. The secretariat is essentially arguing that Quebec should be able to enjoy the benefits of membership in the Canadian federation even if it leaves.

Another equally plausible interpretation of the accumulated deficit or indeed the net debt would be that it represents past deficits, which the secretariat's analysis in study 7 suggests were disproportionately higher in Quebec. These deficits could be considered net benefits purchased on credit which Quebec derived from Confederation. If Quebec were to decide to leave, it should pay back these benefits, resulting in a

much higher than per capita share of federal assets. The cumulative net lending from the federal government in Quebec (the Provincial Economic Accounts equivalent of the federal deficit in Quebec) from 1961 to 1989 was equal to 30.9 percent of the total compared to a population share of 25.4 percent.[1]

The specific quantitative estimate prepared by the secretariat is based on the Provincial Economic Accounts data on the provincial distribution of tax revenues. Inconsistent with the analysis in the secretariat's study 7 and the analysis later in this study, no adjustment is made to the data to distribute certain indirect tax revenue based on consumption instead of production. In calculating Quebec's share, the period after the 1972 tax reform is used. The final figure after an adjustment for the special Quebec abatements is 22.8 percent (table 9). The secretariat estimates that, by adding up the shares of the three components of assets, Quebec's share of total assets would be 18.5 percent.

To estimate Quebec's share of liabilities if there were no formal monetary union between Quebec and Canada, the secretariat assumes that Quebec would still use the Canadian dollar as legal tender. The secretariat argues that in this case, where there would be no formal sharing of Bank of Canada profits, the division of the debt should exclude that part of the debt held by the Bank of Canada. The secretariat thus applies its estimated 18.5 percent share of assets to the federal non-pension fund liabilities net of debt held by the Bank of Canada to yield an estimate of Quebec's share of non-pension fund liabilities (table 10). According to the secretariat, the government of Quebec would have to assume the interest only on the debt. The debt itself would remain an obligation of the federal government, and Quebec would only assume the obligations based on a schedule to be negotiated.

Quebec's share of pension fund liabilities was calculated by the secretariat based on the proportion of federal employees working in Quebec. The share was estimated separately for each federal pension fund; the total share amounts to 13.3 percent. This low pension share pulls down the Quebec share of total financial liabilities, including pension funds, to 17.5 percent. In my view, the pension liabilities of the federal government represent payments for past consumption of government services provided by public servants. As such, there is no reason why they should be treated any differently than other government liabilities. The location of the public servants entitled to the pensions should be irrelevant.

TABLE 9

QUEBEC'S SHARE OF TOTAL FEDERAL GOVERNMENT ASSETS AS OF MARCH 31, 1990
(Millions of Dollars)

BASE SCENARIO A		Share of Quebec	
	*Value of Assets in the Balance Sheet of Succession***	*% of Assets*	*Amount*
FINANCIAL ASSETS	57,195	3.8*	2,169
1) Exchange operations accounts and deposits in foreign currencies	21,228	0.0	
2) Loans, investments and advances and surpluses of crown corporations	26,312	8.2*	2,169
3) Accounts receivable	5,993	0.0	
4) Funds in transit	2,136	0.0	
5) Other financial assets	1,526	0.0	
NON-FINANCIAL ASSETS	72,000	18.0	12,960
TOTAL ASSETS	129,195	11.7*	15,129
ACCUMULATED DEFICIT	200,394	22.8	45,690
TOTAL	329,589	18.5*	60,819

*Percentage deducted from the amounts.

** See table 8.

Source: Commission sur l'avenir politique et constitutionnel du Québec (1991b, p.427).

The impact of the secretariat's proposed sharing of assets and liabilities on revenues and expenditures is provided in table 11. The additional revenue of $40 million is relatively small because of the particular financial assets selected. The increase in public debt charges of $7.1 billion would have a major impact on the budgetary position of the Quebec government.

In my view, the methodology proposed by the secretariat is arbitrary: it results in an unacceptably low 17.5 percent share of federal liabilities for Quebec. A fairer approach would be to agree to a global share based on population. All assets and liabilities would have to be evaluated. The specific assets or shares of specific assets taken by each party would then have to be negotiated. The value of the specific asset transfers should be tallied up and the appropriate amount of liabilities, which would be necessary to equalize the per capita value of liabilities net of assets of each party, would have to be transferred as a final settlement. This method would have the advantage of not being based on the existing arbitrary geographic distribution of assets.

TABLE 10

QUEBEC'S SHARE IN THE LIABILITIES OF THE FEDERAL GOVERNMENT AS OF MARCH 31, 1990
(Millions of Dollars)

BASE SCENARIO (A)		Share of Quebec	
	*Liabilities in the Balance Sheet of Succession**	*% of Liabilities*	*Amount*
MONETARY LIABILITIES			
- Currency in circulation	19,404	Variations in Quebec's Share would be determined by the balance of payments of Quebec	
- Bank deposits	3,082		
Total Monetary Liabilities	24,486		
FINANCIAL LIABILITIES			
- Unmatured Debt outstanding (excluding holdings of the Bank of Canada)	272,976	18.5	50,500
- Other liabilities	34,127	18.5	6,314
Total Financial Liabilities	307,103	18.5	56,814

Source: Commission sur l'avenir politique et constitutionnel du Québec (1991b, p.431).

TABLE 11

IMPACTS OF SHARING THE BALANCE SHEET OF SUCCESSION ON THE BALANCE SHEET, REVENUES AND EXPENDITURES OF THE GOVERNMENT OF QUEBEC (Millions of Dollars)

BASE SCENARIO A	Impact on the balance sheet of Quebec	Impact on budgetary revenues	Impact on budgetary expenditures
SHARING OF ASSETS			
- Financial assets	2,169	40	-
- Non-financial assets	12,960	_____	Imputed to the operating expenditures of departments
	15,129	40	
SHARING OF LIABILITIES			
- Unmatured debt outstanding (excluding (excluding holdings of the Bank of Canada)	50,500		Debt service 6,022
- Other Liabilities	6,314		144
- Pension funds	9,456		939
Total	66,270		7,104

Source: Commission sur l'avenir politique et constitutionnel du Québec (1991), p.435.

The estimation of Quebec's share of federal revenues and expenditures before the division of assets and liabilities

The secretariat calculated Quebec's share of federal revenues by applying the Quebec share of revenues in 1989 from the Provincial Economic Accounts to federal revenues from the Public Accounts for 1990-91. Using the interprovincial distribution of consumer expenditures and the tax base of the Goods and Services Tax, an adjustment was made to distribute certain indirect taxes based on consumption rather than production. The result was an estimated $24,461 million increase in Quebec revenues, amounting to 20.3 percent of total federal government budgetary revenues.

In estimating Quebec's share of expenditures, the secretariat distinguished three categories:

1) the public debt charges which was distributed based on Quebec's assumed share of the debt;

2) federal transfers to the provinces, which would not be an expenditure for Quebec, but a lost revenue;

3) other federal expenditures.

The secretariat allocated other federal expenditures based on an assessment of how much of a given program provided services to Quebeckers, on indicators such as the distribution of population or GDP where no information was available, and on the expenditures of other ministries and agencies attributable to Quebec for central agencies.

By adding up of Quebec's share of spending of all the ministries and agencies, the secretariat estimates that Quebec would have to assume $18,163 million in additional expenditures or 22 percent of total federal expenditures. This estimate does not include the additional public debt charges resulting from the division of assets and liabilities.

The secretariat considered two scenarios. In scenario one no cost savings from rationalization were assumed. In scenario two, based on estimates of Quebec and federal costs per employee or taxpayer in transport, communication and revenue collection, the secretariat calculated that $522 million could be saved.

Table 13 provides the *pro forma* summary financial statement of Quebec which incorporate the estimates of increases in revenues and expenditures but exclude any increase in public debt charges resulting from the distribution of assets and liabilities under both scenarios. The secretariat estimates the Quebec budgetary deficit would be increased by $499 million under scenario one and only $23 million under scenario two, for an average increase of $238 million. Using the Provincial Economic Accounts which suggested that the federal government's adjusted net balance in Quebec would be a net fiscal gain of $2.7 billion, it is difficult to reconcile these small increases with the secretariat's own analysis for 1988. It would appear that there are some federal expenditures revenues affecting Quebec which are not being taken properly into account in the secretariat's estimate of the increase in the budgetary deficit.

TABLE 12

PRO FORMA BUDGET OF THE GOVERNMENT OF QUEBEC BUDGETARY BALANCE BEFORE SHARING THE BALANCE SHEET OF SUCCESSION 1990-91 FISCAL YEAR (Millions of Dollars)

	Expenditure Scenarios		
	I	*II*	*Average*
BUDGETARY REVENUES			
Actual Budgetary Revenues	33,571	33,571	33,571
Less: Revenues transferred from the Federal Government	6,797	6,797	6,797
Plus: Revenues recovered	24,461	24,461	24,461
PRO FORMA TOTAL REVENUES	51,235	51,235	51,235
BUDGETARY EXPENDITURES			
Actual Budgetary Expenditures	35,551	35,551	35,551
Plus: Additional Expenditures	18,163	17,641	17,902
PRO FORMA TOTAL EXPENDITURES	53,714	53,192	53,453
BUDGETARY BALANCE			
Actual Budgetary Balance	-1,980	-1,980	-1,980
Impact on Budgetary Balance before sharing the Balance Sheet of Succession	-499	+23	-238
PRO FORMA BUDGETARY BALANCE BEFORE SHARING THE BALANCE SHEET OF SUCCESSION	-2,479	-1,957	-2,218

Source: Commission sur l'avenir politique et constitutionnel du Québec (1991b, p.471).

Quebec's pro forma financial operations after sharing assets and liabilities

The secretariat estimates that, after taking into account the increase in public debt charges of $7,064 million, Quebec's budgetary deficit would increase from $2,218 million to $9,282 million. Financial requirements would increase by only $6,480 to $7,455 million because there would be a $822 million non-budgetary source of funds from Quebec's additional expenditures to public sector pensions.

To estimate Quebec's budgetary position, the secretariat assumes that 19.5 percent of liabilities are assumed by Quebec (scenario B), or that 17 percent of liabilities are assumed by Quebec (scenario C), or, in the base case, that 18.5 percent are assumed by Quebec (scenario A). This relatively minor range of variation in assumptions never approaches the population share of 25.4 percent—a reasonable, if not the most reasonable, alternative. In my view, ignoring the more difficult scenarios makes the secretariat's sensitivity analysis highly misleading: it gives Quebeckers a falsely rosy picture of what a sovereign Quebec may face. Nevertheless, the secretariat's estimates are presented in table 13.

The secretariat provides its estimates of the deficit and debt of both Quebec and Canada if Quebec were to become sovereign (table 14). The Quebec deficit would increase from 1.2 percent to 5.8 percent of GDP. Quebec debt as a percentage of GDP would increase from 26.4 percent to 63.9 percent.

In spite of the important share of the public debt assumed by Quebec, the secretariat argues Quebec's financial position would be better than Canada's. Quebec's debt to GDP ratio would only be 63.9 percent, compared to 72.1 percent for Canada. This surprising result merits some explanation. The secretariat notes that Canada would keep a proportionally larger part of the federal government's assets and hence a larger part of the debt. This is, of course, true. Assets are so much smaller than debt that a proportionally larger share of both adds up to an increase in the debt burden. In effect, the secretariat is proposing to leave Canada with a disproportionate share of the debt burden. It is no wonder that the financial position of Quebec improves and Canada deteriorates. Because the province of Quebec already has a much higher debt ratio than the other provinces (26.4 percent of GDP compared to 13.7 percent of GDP, according to the secretariat's figures), the increase in the debt ratio for Canada, including the nine provinces, is less than half of that for the federal government (table 14). The separation of Quebec would lower the average debt ratio of provincial governments by three percentage points.

TABLE 13

***PRO FORMA* BUDGETARY DEFICIT AND NET FINANCIAL REQUIREMENTS OF THE GOVERNMENT OF QUEBEC FOR 1990-91 FOR THREE SCENARIOS FOR THE SHARING OF THE BALANCE SHEET OF SUCCESSION (Millions of Dollars)**

	Base Scenario A	*Scenario* B	*Scenario* C
PRO FORMA BUDGETARY DEFICIT			
- Millions of dollars	-9,282	-9,615	-8,783
- Percentage of GDP	5.8	6.0	5.5
PRO FORMA NET FINANCIAL REQUIREMENTS			
- Millions of dollars	-7,455	-7,788	-6,955
- Percentage of GDP	4.7	4.9	4.4

Source: Commission sur l'avenir politique et constitutionnel du Québec (1991b, p.481).

On the basis of these artificially low estimates of the debt burden of a sovereign Quebec, the secretariat claims that the Quebec debt would be between 53 and 58 percent of GDP (56 percent for scenario A). Based on the OECD's definition, these estimates exclude debt to pension funds, so that the Quebec debt would be comparable to small countries' average debt of 55.6 percent and to European countries' debt of 57.4 percent (figure 2). This estimate is particularly surprising since the secretariat's estimates of gross debt for both Quebec and Canada (56 and 65.6 percent respectively) are well below the OECD's estimate of 71.0 percent for Canada's gross debt. Furthermore, the estimate of 71.0 percent is provided in the same OECD table from which the secretariat takes its estimates of other OECD countries' debt. Evidently, the secre-

tariat has omitted some component of debt for Quebec and Canada in its comparisons. The most likely candidate for exclusion is municipal debt, but they could have also inappropriately accounted for pension liabilities. The secretariat's international comparisons demonstrate only that it would be possible for Quebec to maintain an average debt level if Quebec were not to assume its fair share of the federal debt and not to count all of its existing debt.

TABLE 14

FINANCIAL INDICATORS FOR THE BASE SCENARIO A, 1990-91

	Quebec		Canada[3]		Federal Government	
	Actual	Scenario	Actual	Scenario	Actual	Scenario
DEFICIT[1]						
Millions of dollars	-1,980	9,282	-37,323	-28,041	-30,500	-23,198
Percentage of GDP	1.2	5.8	5.5	5.4	4.5	4.4
DEBT[2]						
Percentage of GDP	26.4	63.9	70.2	72.1	53.5	58.4
DEBT SERVICE[1]						
Percentage of GDP	2.8	7.2	8.2	8.4	6.3	6.8
Percentage of budgetary revenues	13.2	22.5	22.7	23.6	35.6	37.2

[1] In 1990-91.

[2] Debt as of March 31, 1990: Unmatured debt and pension fund accounts.

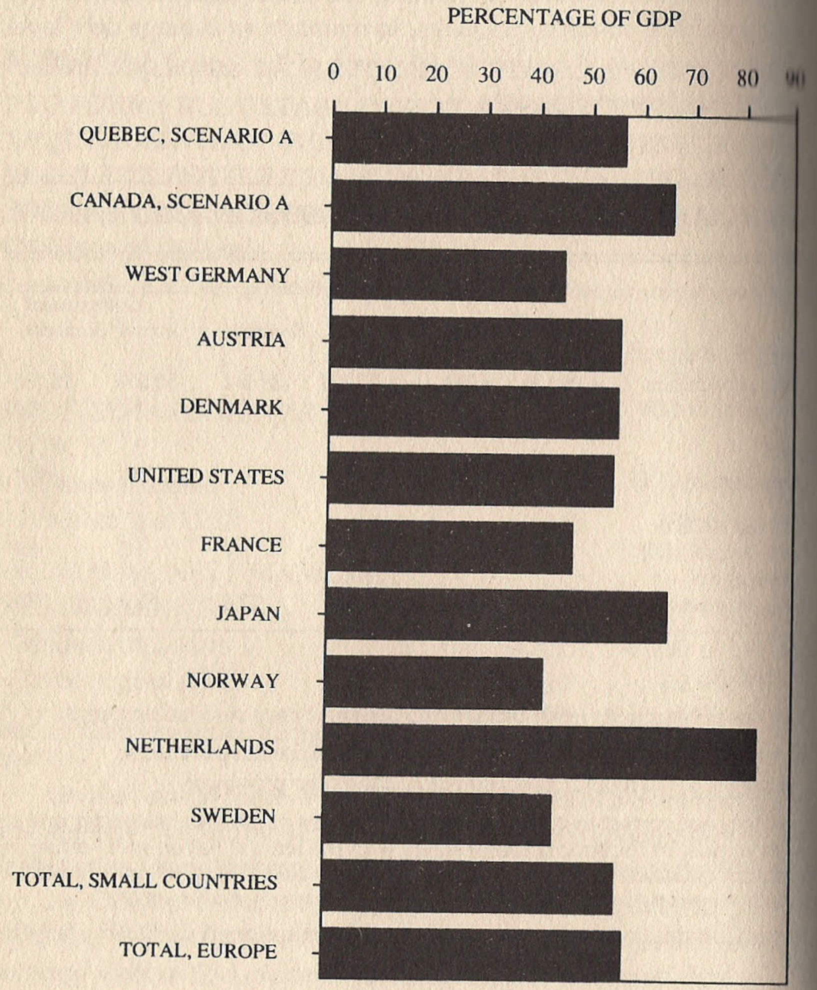
[3] Actual for Canada: the federal government and the ten provinces. Scenario A: the federal government and the nine provinces.

Note: It is not correct to compare financial indicators for Quebec under one of the scenarios for the succession of states with the federal government either in the actual situation or in case of one of the scenarios. Comparisons should be made between two governments exercising the same jurisdictions.

Source: Commission sur l'avenir politique et constitutionnel du Québec (1991b, p.484).

FIGURE 2

INTERNATIONAL COMPARISON OF GROSS PUBLIC DEBT/GDP (%), 1990



This is based on OECD data for national accounts gross financial liabilities less pension funds.

Source: Commission sur l'avenir politique et constitutionnel du Quebec (1991b, p. 489).

Conclusion

Without sharing assets ad liabilities, the secretariat concludes, the impact of sovereignty on thoublic finances of Quebec would be small, increasing the budgetary decit by only $200 million. In my view, such a small increase is surprisingnd difficult to square with the secretariat's own estimate of the federal ɔvernment's adjusted net balance in Quebec.

The secretariat does emhasize that Quebec would inherit a constraining structure of expeditures. Of the $18 billion in additional expenditures, two-thirds wald be made up of transfers to individuals, businesses, and local admirıstrations, and one-third would be operating expenditures. But the seretariat does not believe that this would hinder the rationalization of ɔending.

Sharing assets and liatlities obviously has fundamental implications for the Quebec govrnment's financial position. The secretariat stresses that it must be ɔcognized that Quebeckers are already supporting the federal debt ad interest payments through their contributions to federal revenues sthat, if after sovereignty they continue to pay a similar share, their leveɔf debt will not change. But this of course depends on what share of thelebt they assume. If they assume their per capita share of the debt, thei level of debt in relation to GDP would increase, and so would their ublic debt charges.

According to the secretant, the method it proposed to share assets and liabilities was judged to bconsistent with international law according to the opinion of two judiial experts. But the secretariat neglects to mention that almost anythingwhich would be agreed to by Quebec and Canada would be consistentwith international law. Naturally, therefore, the two experts were noable to rule out the secretariat's proposal. In fact, international law offe; no firm guidance on the most appropriate split of assets and liabilitis. The Vienna Convention on the Succession of States in Respect of Stte Property, Archives and Debt, 1983. has not been ratified by the majr industrialized countries. Moreover, its application to a new state crated from an existing state requires that the creation of the new state ɔnform to the principles of the Charter of the United Nations, which cmands the consent of the dismembered state. Also. debts to private crditors are not even covered by the Vienna convention. There is no onlegally sanctioned method of dividing assets and liabilities under international law. Everything would be up for grabs at the negotiating table. The secretariat is misleading Quebeckers by implying that its proposal has special merit because it is consistent with international law.

Using the secretariat's methodology, the liabilities assumed by the Government of Quebec would be directly proportional to Quebec's share of assets. The division of pension liabilities would be proportional to the share of federal employees working in Quebec and participating in the pension plan. This would amount to $9.5 billion, or 13.3 percent of the total federal pension liabilities of $71 billion. Since it was not possible to establish precisely the share of the federal government's non-financial assets (estimated to be $72 billion in Quebec), three scenarios with different shares were used to establish Quebec's share of federal government liabilities at 18.5 percent, 19.5 percent, and 17 percent respectively in scenarios A, B, and C.

In all of the scenarios, Quebec's share of federal debt would be less than its share of GDP. Thus the debt to GDP ratios of Quebec would be less than that of the federal government and the nine other provinces taken together. The ratio of assets would also be less given the method of division proposed. Quebec's ratio of debt to GDP would be comparable to that of most other industrialized countries of similar size. These results, of course, depend critically on the method chosen. If a per capita criterion were used, which would be fair, the debt ratios would be higher than the rest of Canada's and higher than most industrialized countries'. It all depends on your point of view. The secretariat's estimates and conclusions need to be seen for what they are and taken with a large grain of salt. Masquerading as objective analysis, they are really nothing more than exercises in numerology designed to assuage the legitimate concerns of Quebeckers about the economic impacts of sovereignty.

Notes

1. Paul Boothe and Richard Harris (1991,p.2) have independently proposed the similar alternative of basing the distribution on historical benefits from the net federal spending by province as measured by Mansell and Schlenker (1990).

Chapter 4

The economic viability of a sovereign Quebec

Introduction

THIS CHAPTER CONSIDERS THE economic viability of a sovereign Quebec using something like the methodology which would be applied by the World Bank or a credit rating agency evaluating sovereign risk. Since Quebec is not a sovereign country and all the required data do not exist, it is not possible to carry out detailed assessments of performance, prospects, and the adequacy of current policies. But it is possible to assess the recent performance of the Quebec economy and its likely prospects if it continues as a province of Canada. It is also possible to adjust existing data to provide an estimate of fiscal and trade balances and of public and external debt of a sovereign Quebec. These estimates give an idea of the magnitude of any disequilibria that are likely to emerge and the related financing problems that may arise. Focusing on these disequilibria and the structural adjustment policies necessary to resolve them is the essence of the World Bank approach.

The second section of this chapter examines the recent performance of the Quebec economy and its prospects. The third considers the prospects for Quebec's longer-term population growth. The fourth section reviews Quebec's industrial structure and interregional trade