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 links. The fifth section looks at the trade sector and current account balance and related external debt. The sixth section compares the Quebec economy to that of the rest of Canada. The seventh section provides an international comparative perspective for the Quebec economy. The eighth section looks at fiscal deficits and debt and presents some estimates of deficits and debt for a sovereign Quebec. The ninth section provides a comparison of Quebec's fiscal position and capacity with other provinces. The tenth section discusses the impact of uncertainty over sovereignty on the borrowing costs of the Quebec government. The eleventh section offers an overall assessment on the viability of a sovereign Quebec.

Recent performance and prospects of the Quebec economy

Performance

The Quebec economy grew strongly in 1987 and 1988, slowed in 1989, and turned down in 1990 (table 15). From 1987 to 1990, real growth in Quebec has been the same as in the rest of Canada, averaging about 3 percent. The growth has been slightly higher in Real Domestic Product per capita in Quebec where population growth has been slower. Business fixed investment has been the leading sector. Hydro-Quebec and the aluminum industry have been the biggest investors. At 9.3 percent in 1989, the unemployment rate was down substantially from its 1983 annual high of nearly 14 percent.

The strength of the Quebec economy was reflected in a greater degree of confidence among business leaders and citizens in the viability of the Quebec economy. This confidence was reinforced by the Canada-U.S. Free Trade Agreement which was perceived as lessening the dependence of the Quebec economy on trade with the rest of Canada.

The relative strength of Quebec's investment spending has contributed to the growing confidence of sovereigntists. Table 16 shows the industrial composition of the increased investment. Within manufacturing, a sector which exhibited solid growth, particularly over the last five

TABLE 15

RECENT ECONOMIC PERFORMANCE IN QUEBEC
(Percent Change)

	1987	*1988*	*1989*	*1990*
Real Demand				
Consumer expenditures	3.9	3.7	3.1	0.9
Bus. fixed investment	16.5	12.4	10.4	0.1
Residential construction	16.9	-1.3	-8.2	-1.6
Government expenditures	1.3	3.2	2.0	3.1
Final domestic demand	5.4	4.1	2.9	1.2
Gross domestic product	4.8	4.5	2.5	0.9
Other Indicators				
Housing starts (000)	73	59	49	47
Consumer price index	4.4	3.7	4.2	4.3
Employment	3.3	2.8	1.0	0.8
Unemployment rate (%)	10.3	9.4	9.3	10.1

Source: Statistics Canada except for 1990 real demand which is a forecast from Caisse de dépôt (1991, p.29).

years, the increase has been fairly narrowly based. Four industries—primary metals (primarily aluminum), paper and allied products, chemical and chemical products, and transportation equipment—account for 75 percent of the increase in investment. Primary metals and paper and allied products alone account for 58 percent of the increase. Outside of manufacturing, the increase has been more broadly based, with communications, trade, and financial and commercial services accounting for large shares of the increase. Investment in financial services was particulary strong. Miscellaneous utilities, which includes electrical utilities, has recorded substantial increases in investment spending. While it has picked up over the last five years, its growth has been relatively slow during the past decade. The pattern of spending on the James Bay hydroelectric development has been a determining factor behind the growth in this series. The relatively narrow base of Quebec's investment growth suggests that the growing confidence of sovereigntists in Quebec's economic future is not very solidly based.

TABLE 16

CAPITAL AND REPAIR EXPENDITURES IN QUEBEC (Millions of Dollars)

	1980	1985	1990	Change in Investment 1980-1985	1985-1990	1980-1990	Average Growth Rate 1980-1985	1985-1990	1980-1990
Primary Industries									
Agriculture	692	736	796	44	60	104	1.2	1.6	1.4
Forestry	107	69	94	-38	25	-13	-8.5	6.5	-1.3
Mines, Quar. and Oil	681	577	644	-104	67	-37	-3.3	2.2	-0.6
Construction	356	446	749	90	303	393	4.6	10.9	7.7
Subtotal	1836	1827	2283	-9	456	447	-0.1	4.6	2.2
Manufacturing									
Food and Beverage	315	355	444	40	89	129	2.4	4.6	3.5
Tobacco	30	64	X[a]	34	X	X	16.1	X	X
Rubber	52	83	115	32	32	64	10.0	6.8	8.4
Leather	7	6	7	-2	2	-0	-4.8	4.8	-0.1
Textiles	115	108	136	-7	28	21	-1.3	4.7	1.7
Knitting Mills	25	11	13	-14	2	-12	-15.1	2.9	-6.5
Clothing	21	22	27	1	5	5	0.7	4.0	2.3
Wood	109	151	149	42	-2	41	6.8	-0.2	3.2
Furniture and Fixtures	17	18	28	1	10	11	0.8	9.2	4.9
Paper and Allied	581	995	1669	414	674	1089	11.4	10.9	11.1
Printing and Publishing	53	72	87	20	15	34	6.5	3.7	5.1
Primary Metal	570	1217	2455	647	1238	1885	16.4	15.1	15.7
Metal Fabricating	113	115	118	2	3	5	0.4	0.4	0.4
Machinery	69	119	192	50	73	123	11.5	10.1	10.8
Transportation Equip.	154	188	530	35	342	377	4.2	23.0	13.2
Electrical Products	85	195	277	109	82	191	18.0	7.3	12.5
Non-metallic Minerals	130	121	270	-9	149	140	-1.4	17.4	7.6
Petroleum and Coal	171	137	243	-34	107	73	-4.4	12.3	3.6
Chemical and Chem. Prod	330	405	864	75	459	534	4.2	16.4	10.1

TABLE 16 *(continued)*

	1980	1985	1990	Change in Investment 1980-1985	1985-1990	1980-1990	Average Growth Rate 1980-1985	1985-1990	1980-1990
Misc. Manufacturing	40	55	X	16	X	X	6.8	X	X
Capital Charged to Op.	231	332	631	101	299	400	7.6	13.7	10.6
Subtotal	3217	4769	8363	1552	3594	5146	8.2	11.9	10.0
Utilities									
Transportation	1141	1494	1540	353	46	399	5.5	0.6	3.0
Communication	937	1089	2025	153	935	1088	3.1	13.2	8.0
Misc. Utilities	2837	2146	4118	-690	1971	1281	-5.4	13.9	3.8
Subtotal	4915	4730	7682	-185	2952	2767	-0.8	10.2	4.6
Trade, Fin. and Commercial									
Trade	348	541	865	193	325	518	9.2	9.9	9.5
Finance	362	1053	2623	691	1570	2261	23.8	20.0	21.9
Commercial Services	1110	1713	2711	602	998	1600	9.1	9.6	9.3
Subtotal	1820	3306	6199	1486	2892	4378	12.7	13.4	13.0

[a] This information is not available.

Source: Statistics Canada, *Private and Public Investment in Canada*, Catalogue 61-205. Data for 1990 are revised intentions not actuals.

Prospects

The Quebec economy is currently suffering from the same recession which hit Canada last spring. The downturn has been most severe in Ontario and, to a lesser extent, Quebec, where the country's manufacturing sector is concentrated. The Quebec 1991 budget forecast shown in table 17 called for a more than 1 percent decline in real output this year (Quebec, Ministry of Finance, Appendix D, p.18). The actual decline would have been greater except for the continuation of large investment projects in the aluminum industry. The current recession is likely to be much milder than the one in 1981-82. The recession in Quebec, as in the rest of Canada, was precipitated by increases in interest rates and in the Canadian dollar, with the resulting sharp decline in the interest-sensitive sectors of investment, housing, and consumer durables. It was exacerbated by the recession in the United States which lowered demand for exports. The introduction of the Goods and Services Tax in January and Quebec's use of the opportunity to piggyback and increase its own sales tax also depressed consumer spending. Exports were also weak as the economies of trading partners weakened. Demand for pulp and paper, which represents about one-fifth of Quebec exports, was particularly depressed. Employment is forecast to decrease this year and unemployment to rise to approximately 12.4 percent.

The Quebec budget forecasts that the Quebec economy will recover from 1992 to 1994 with growth averaging around 3.5 percent. This is slightly weaker than the growth of the total Canadian economy, which is forecast in the federal budget to be 3.5 percent in 1992 and to average 4 percent from 1993 to 1996 (Canada, Department of Finance, 1991a, p.51). The Quebec recovery will be fuelled by the same factors behind the Canadian upturn, namely a drop in interest rates and an increase in U.S. growth. Aided by Quebec government mortgage assistance as well as lower interest rates, residential construction should be the leading sector in 1992. Consumer expenditures, while hampered by the application of the Quebec sales tax to services in 1992, should also still strengthen. Exports are expected to rebound as the U.S. economy recovers. By 1993 business investment should pick up strongly, spurred by the reimbursement of sales tax on investment purchases. In spite of the recovery, unemployment is forecast to remain high, averaging more than 11 percent from 1992 to 1994. Quebec's predicted unemployment rate is significantly higher than the Canadian unemployment rate projected by the federal government.

Other forecasters, such as the Conference Board, have a similar view of Quebec's short-term prospects (Conference Board, 1991, pp.15-17). It must be emphasized that these forecasts were based on the assumption that Quebec would remain part of Canada and that the economic upheaval which would be associated with separation would be avoided. These forecasts indicate that Quebec is currently in a recession and that it will take some time before the economy fully recovers. Quebec is experiencing an extremely fragile economic climate which puts a premium on prudent economic policy. It is not the best time to be subjecting the Quebec economy to the shock of separating from

Canada. Nevertheless, the confidence of Quebeckers in the economic viability of a sovereign Quebec has evidently not yet been shaken by the downturn, as it was during the 1981-82 recession following the 1980 referendum.

TABLE 17

MEDIUM-TERM ECONOMIC OUTLOOK FOR QUEBEC
(Percent Change)

	1991	*1992-94*
PRODUCTION		
- Gross Domestic Product	2.9	7.5
- Real Domestic Product	-1.1	3.5
COMPONENTS OF DEMAND		
- Non-residential Investment	5.2	7.8
- Housing Starts (000)	41.4	45.2
- Retail Sales (adjusted for GST)	-1.1	6.5
COMPONENTS OF INCOME		
- Wages and Salaries	2.4	6.6
- Personal Income	4.8	6.3
- Corporate Profits	-19.0	22.7
LABOUR MARKET		
- Labour Force	0.1	1.7
- Employment	-2.5	2.5
- Unemployment Rate (%)	12.4	11.2

Source: Quebec, Ministry of Finance (1991, Appendix D, p.18).

Population growth

The population of Quebec is expected to grow more slowly than the rest of Canada even if Quebec remains part of Canada. The lower population growth caused concerns in Quebec about the declining demographic and economic importance of Quebec within Canada.

Long-term population projections for Quebec and Canada, prepared by Tom McCormack of Strategic Projections Inc., an economic consulting firm specializing in demographics, are displayed in table 18. The projections reflect the current age and sex structure of the population and use age and sex specific mortality and fertility rates. International immigration is based on the federal government's announced 250,000 annual target. The slower growth of the Quebec population is evident in the decline in the share of total Canadian population from 25.3 percent in 1991 to 23.2 percent in 2011. The lower population growth for Quebec stems from the lower birth rate of Quebec women, the lower rate of international immigration to Quebec, and net emigration to the rest of Canada. The proportion of the Quebec population over 65 years old is expected to increase by four percentage points. Quebec will have to increase its spending on health and pensions relative to the rest of Canada.[1] The aging and relative decline in Quebec's population is expected to continue after 2011, when the leading edge of the baby boom population begins to reach retirement age.

The population projection considered assumes that Quebec will remain part of Canada. If Quebec were to become sovereign, there could be even less international immigration to Quebec and greater movement to the rest of Canada, especially among anglophones. A Centre de Recherche sur l'Opinion Publique (CROP) poll conducted in April indicated that 44 percent of English-speaking Quebeckers would not continue to live in an independent Quebec (Fontaine, 1991, p.A1). This would be an acceleration of the outflow identified in a recent study by SECOR Consultants which estimated that more than two hundred thousand anglophones have left Quebec during the last 15 years, since the Parti Québécois first came to power in 1976 (Picard, 1991). The decline in Quebec's demographic weight would be accentuated by an accession to sovereignty, making it more difficult to finance government spending and service the increased public debt of a sovereign Quebec.

Industrial structure and interregional trade links

A critical factor in determining the economic viability of a sovereign Quebec is its industrial structure and trade links.[2] The destination of Quebec shipments of manufacturers in 1984 is provided in table 19.

TABLE 18

POPULATION PROJECTIONS FOR CANADA AND QUEBEC (Thousands)

	1991	2001	2011
Canada			
Population	26,932	29,981	32,431
International			
-Immigration	220	250	250
-Emigration	40	59	59
Population over 65 (%)	11.7	12.7	14.3
Quebec			
Population	6,818	7,261	7,509
Population Quebec/Canada (%)	25.3	24.2	23.2
International			
-Immigration	41	46	46
-Emigration	2	3	3
Net Interprovincial Immigration	-13	-13	-13
Population over 65 (%)	11.2	12.8	15.1

Source: Projections provided by Tom McCormack, Strategic Projections Inc (May 1991).

Industries where interregional shipments account for a large proportion of total shipments (more than 40 percent) are tobacco products, rubber products, leather and allied products, textile products, clothing, and chemical and chemical products. Of these, textile products and clothing are the most important as measured by the value of interregional shipments. Foreign shipments are particularly important relative to the total for paper and allied products, primary metals, and transportation equipment. These shipments comprise Quebec's most important exporting manufacturing industries. In the aggregate, foreign shipments account for a lower proportion of total shipments than interregional shipments (21.3 percent compared to 26.5 percent).

Tables 20 and 21 provide information on the destination of manufacturer's shipments for the rest of Canada and for Ontario compared to Quebec. The relatively low proportion of manufacturer's shipments going from the rest of Canada or Ontario to Quebec, except in tobacco products and primary textiles, is noteworthy. The larger proportion of foreign shipments is also significant. Industries with a particularly high degree of foreign shipments are rubber products, wood, paper and allied products, machinery, transportation equipment, and electrical and electronic products. The extent to which Ontario has come to depend on foreign exports of transportation equipment is striking —76 percent of shipments of transportation equipment are outside of Canada, and transportation equipment accounts for about 63 percent of Ontario's foreign shipments of manufacturers.

The industrial breakdown of the $3.3 billion interregional trade surplus of Quebec's manufacturing industries is shown in table 22. The large surpluses in textile products, clothing, paper and allied products, primary metals, refined petroleum and coal products are noteworthy. Given the closure of a refinery in the east end of Montreal, it is likely that more recent data than 1984 would no longer show a surplus for refined petroleum and coal products. The large deficits in food industries and transportation equipment are also worth noting.

The extent to which the total $3.3 billion trade surplus is accounted for by the surpluses in the five "soft" industries (leather and allied products, primary textiles, textile products, clothing, and furniture and fixtures) is striking. These industries are labour-intensive and subject to strong foreign competition. Textiles and clothing, which are the most important of these industries, are protected by high tariffs and Voluntary Export Restraints (VER) under the Multi-Fibre Agreement (MFA). Effective rates of protection for textiles average 16.6 percent and Most Favoured Nation customs tariffs for clothing are as high as 25 percent. Import penetration in the market for textiles and clothing has been limited to 30 to 33 percent and 80 percent of imports are subject to restraint. Under the 1986 change to the VER, growth in base levels in previously restrained items was limited to 2 percent from 1987 to 1991. Also, the base levels for the four major exporters—Hong Kong, South Korea, Taiwan, and China—were reduced by 0.2 percent (Canadian International Trade Tribunal, 1990). The restraints are a more important source of protection than the high tariffs. Murray Smith estimates that the combined tariff equivalent of the tariffs and the VER ranges from 30 to 70 percent (Smith, 1991, p.6).

TABLE 19

DESTINATION OF QUEBEC SHIPMENTS OF MANUFACTURERS, 1984

	Rest of Canada		*Foreign*	
	$ Million	*% of Total*	*$ Million*	*% of Total*
10 Food Ind.	1720	20.3	659	7.8
11 Beverage Ind.	227	19.3		
12 Tobacco Products	503	67.3		
15 Rubber Products	256	66.7		
16 Plastic Products	287	32.7		
17 Leather & Allied Prod.	193	43.7		
18 Primary Textile	517	33.7		
19 Textile Products	624	51.7		
24 Clothing	1445	45.7		
25 Wood	342	14.3	487	20.4
26 Furniture & Fixtures	340	37.6		
27 Paper & Allied Prod.	1260	21.5	2883	49.2
28 Printing, Publish. & Allied	587	23.5		
29 Primary Metal	1222	26.1	2138	45.7
30 Fabricated Metal Products	695	21.5	860	26.6
31 Machinery	219	21.6	231	22.8
32 Transportation Equipment	692	16.1	2682	62.3
33 Electrical & Electronic Prod.	948	31.9	995	33.4
35 Non-metallic Mineral Prod.	144	12.8	120	10.7
36 Refined Petrol. & Coal Prod.	1371	26.6		
37 Chemical & Chemical Prod.	1579	44.5	320	9.0
39 Other Manufacturing	223	26.1		
ALL MANUFACTURING INDUSTRIES	15075	26.5	12132	21.3

Source: Statistics Canada, *Destinations of Shipments of Manufacturers 1984*, Catalogue 31-530, April 1988. Totals do not add because data is incomplete due to confidentiality.

TABLE 20

DESTINATION OF REST OF CANADA SHIPMENTS OF MANUFACTURERS, 1984

	Quebec		Foreign	
	$ Million	% of Total	$ Million	% of Total
10 Food Ind.	2152	9.3	1979	8.5
11 Beverage Ind.	93	2.8	483	14.3
12 Tobacco Products	233	27.7	0	0.0
15 Rubber Products	274	12.9	662	31.2
16 Plastic Products	237	9.0	317	12.0
17 Leather & Allied Prod.	142	17.1	0	0.0
18 Primary Textile	461	38.7	241	20.1
19 Textile Products	187	14.2	135	10.2
24 Clothing	304	15.1	152	7.6
25 Wood	272	3.6	3142	41.4
26 Furniture & Fixtures	163	7.7	316	14.9
27 Paper & Allied Prod.	784	6.8	6167	53.1
28 Printing, Publish. & Allied	245	4.0	145	2.3
29 Primary Metal	592	5.0	2882	24.5
30 Fabricated Metal Products	546	6.1	1003	11.2
31 Machinery	314	5.4	1805	30.9
32 Transportation Equipment	1118	3.3	24700	73.5
33 Electrical & Electronic Prod.	867	10.0	2662	30.8
35 Non-metallic Mineral Prod.	307	7.4	535	13.0
36 Refined Petrol. & Coal Prod.	586	3.2	1057	5.8
37 Chemical & Chemical Prod.	1532	11.2	1924	14.1
39 Other Manufacturing	334	8.7	624	16.3
ALL MANUFACTURING INDUSTRIES	11744	6.8	50310	29.1

Source: Statistics Canada, *Destinations of Shipments of Manufacturers 1984*, Catalogue 31-530, April 1988. Totals do not add because data is incomplete due to confidentiality.

TABLE 21

DESTINATION OF ONTARIO SHIPMENTS OF MANUFACTURERS, 1984

	Quebec		Foreign	
	$ Million	% of Total	$ Million	% of Total
10 Food Ind.	1502	12.1	525	4.2
11 Beverage Ind.	0	0.0	299	14.9
12 Tobacco Products	233	27.7	0	0.0
15 Rubber Products	0	0.0	220	14.9
16 Plastic Products	221	10.7	225	10.8
17 Leather & Allied Prod.	0	0.0	0	0.0
18 Primary Textile	436	41.0	152	14.3
19 Textile Products	174	15.6	89	8.0
24 Clothing	221	15.6	32	2.3
25 Wood	109	6.1	407	22.6
26 Furniture & Fixtures	154	8.7	237	13.4
27 Paper & Allied Prod.	665	11.4	1950	33.3
28 Printing, Publish. & Allied	236	5.4	59	1.3
29 Primary Metal	532	5.6	2174	23.0
30 Fabricated Metal Products	512	7.4	887	12.7
31 Machinery	302	7.1	1515	35.4
32 Transportation Equipment	934	3.0	23912	75.9
33 Electrical & Electronic Prod.	786	10.2	2329	30.3
35 Non-metallic Mineral Prod.	279	10.5	473	17.9
36 Refined Petrol. & Coal Prod.	0	0.0	857	9.7
37 Chemical & Chemical Prod.	1345	13.1	1083	10.6
39 Other Manufacturing	322	10.2	513	16.3
ALL MANUFACTURING INDUSTRIES	9701	8.0	38051	31.3

Source: Statistics Canada, *Destinations of Shipments of Manufacturers 1984*, Catalogue 31-530, April 1988. Totals do not add because data is incomplete due to confidentiality.

TABLE 22

INTERPROVINCIAL TRADE SURPLUS OF QUEBEC MANUFACTURING INDUSTRIES, 1984
(Millions of Dollars)

	Exports	Imports	Balance
10 Food Ind.	1720	2152	-431
11 Beverage Ind.	227	93	134
12 Tobacco Products	503	233	270
15 Rubber Products	256	274	-18
16 Plastic Products	287	237	50
17 Leather & Allied Prod.	193	142	51
18 Primary Textile	517	461	56
19 Textile Products	624	187	438
24 Clothing	1445	304	1141
25 Wood	342	272	70
26 Furniture & Fixtures	340	163	177
27 Paper & Allied Prod.	1260	784	475
28 Printing, Publish. & Allied	587	245	343
29 Primary Metal	1222	592	630
30 Fabricated Metal Products	695	546	149
31 Machinery	219	314	-95
32 Transportation Equipment	692	1118	-426
33 Electrical & Electronic Prod.	948	867	81
35 Non-metallic Mineral Prod.	144	307	-164
36 Refined Petrol. & Coal Prod.	1371	586	784
37 Chemical & Chemical Prod.	1579	1532	47
39 Other Manufacturing	223	334	-111
ALL MANUFACTURING INDUSTRIES	15075	11744	3331

Source: Statistics Canada, *Destinations of Shipments of Manufacturers 1984*, Catalogue 31-530, April 1988.These figures are not exact because Statistics Canada withholds some information on interregional shipments in order to preserve confidentiality.

TABLE 23

EMPLOYMENT AND VALUE ADDED IN SOFT INDUSTRIES IN QUEBEC, 1987

	Employment			*Value Added*		
Industry Group	*Number*	*% of Total Manufact. in Quebec*	*% of Total Industry In Canada*	*$ Million*	*% of Total Manufact. in Quebec*	*% of Total Industry in Canada*
Leather and Allied Products	8162	1.6	37.5	237	0.8	36.0
Primary Textiles	13976	2.7	53.9	610	2.0	42.1
Textile Products	16009	3.1	46.0	677	2.2	47.7
Clothing	65539	12.6	58.5	1891	6.2	55.9
Furniture and Fixtures	20446	3.9	33.2	695	2.3	31.3
TOTAL	124132	23.9	48.5	4111	13.6	45.0

Source: Statistics Canada, *Manufacturing Industries of Canada, National and Provincial Areas*, Catalogue 31–203, 1987.

Information on the structure of the "soft" industries in 1987 is provided in table 23. These industries employ over 124,000 people and account for about 24 percent of total manufacturing employment in Quebec. Their share of total value added is much less than their share of employment, only accounting for 13.5 percent of value added. These "soft" industries are concentrated geographically in Quebec—48.5 percent of employment and 45 percent of value added in these industries were located in Quebec.

Employment in the soft industries, particulary in textiles and clothing, has declined in the face of tough competition, going from 155,000 in 1974 to 124,000 in 1987. But the adjustment has been slowed by high tariffs and especially by quotas. Further adjustment will be required. In a sovereign Quebec, the soft industries would be highly vulnerable to changes in Canadian commercial policy. Moreover, changes are likely as Canadian consumers cannot be expected to bear the costs of protecting Quebec soft industries.

To assess the possible impacts of Quebec sovereignty, it would be useful to have current data on effective rates of protection by industry and on average effective rates for Quebec and the rest of Canada to assess the possible impacts of Quebec sovereignty. Unfortunately, such data are not publicly available.

External balance and debt

No good timely information has been published on Quebec's external balance or external debt. Data are available on manufacturer's shipments. In 1984, the latest year for which data are available, Quebec had a surplus in interregional trade of $3.3 billion or 3.3 percent of GDP with the rest of Canada. It was the only province other than Ontario to run a surplus. Data are also available on energy trade. In 1987, Quebec imported more than $2 billion in oil and around $700 million in natural gas, but it had net exports of hydroelectricity of about $600 million. Hydroelectricity is a definite strength of the Quebec economy. Finally, there are data on interregional trade in agriculture and mineral products. In 1984, Quebec had a deficit of $523 million in agriculture products and $2.7 billion in its trade in minerals with other provinces. The Statistics Canada provincial input-output model contains consistent information on Quebec's interprovincial and international trade balances covering all goods and services. It indicates that, in 1984, the most recent year available, Quebec had a deficit in its interprovincial trade of $1 billion and in international trade of $3.2 billion, for a total deficit of $4.2 billion or 4.2 percent of GDP (Proulx and Cauchy, 1991, pp.73-74).

The Provincial Economic Accounts provide relatively timely estimates by province of net exports, a key component of the current account balance. Unfortunately, since net exports are measured residually, the data also include a statistical discrepancy to make expenditures add up to income. This discrepancy makes the data somewhat suspect as an indicator of net exports. Nevertheless, since they are the only complete data which are available, they are shown in table 24. Canada ran a large surplus on net exports of $7.2 billion, or 1.1 percent of GDP in 1989. This surplus does not include the large deficit on interest and dividends which transforms it into a current account deficit of $16.6 billion, or 3 percent of GDP. Following a period of deficits, Quebec's surplus on net exports was so small in 1989 as to be in virtual balance. In contrast, Ontario ran a very large surplus of $15.5 billion, or 5.7 percent of GDP, following a string of similar surpluses. The rest of the country, including Ontario, has been running surpluses amounting to around 1.5 percent of GDP.

These piecemeal and somewhat unreliable data do not provide a definitive reading on Quebec's external balance. But they do suggest that Quebec's position is much weaker than Canada as a whole or the rest of Canada. A sovereign Quebec could therefore have trouble servicing its external debt if it did not take steps to strengthen its current account balance. A surplus of net exports on a GDP basis large enough to offset Quebec's deficit on interest and dividends would probably be in the neighbourhood of 2 to 3 percent of GDP. Given that in 1989 Quebec's net exports were in approximate balance, it would be necessary to transfer approximately 2 to 3 percent of its domestic consumption to net exports in order to produce a more sustainable current account balance.

TABLE 24

NET EXPORTS PLUS STATISTICAL DISCREPANCY FROM THE PROVINCIAL ECONOMIC ACCOUNTS

	1986	*1987*	*1988*	*1989*
Canada				
-millions of dollars	3840	3639	8502	7215
-percent of GDP	0.8	0.7	1.4	1.1
Quebec				
-millions of dollars	-1396	-2358	858	151
-percent of GDP	-1.2	-1.8	0.6	0.1
Ontario				
-millions of dollars	11106	10170	14563	15496
-percent of GDP	5.5	4.5	5.8	5.7
Rest of Canada incl. Ontario				
-millions of dollars	5236	5997	7644	7064
-percent of GDP	1.4	1.4	1.7	1.4

Source: Statistics Canada, *Provincial Economic Accounts.*

In the absence of any data on Quebec, information on Canada's current account balance and external debt is presented in table 25. The large Canadian current account deficit is striking. At 2.6 percent of GDP in 1989, it is larger in relative terms than the current account balances of all the Group of Seven countries except for the United Kingdom. Even the much discussed current account deficit of the United States is not as large in relative terms. Many years of current account deficits have made Canada a large net debtor on the international investment account. In 1989, the most recent year for which data are available, net external debt was $229 billion, or 35 percent of GDP, or 141 percent of exports.

Canada is the industrialized world's second largest debtor behind the U.S., which had net external indebtedness of $658 million U.S. in 1989. Canada's debt 1989 was $194 billion in U.S. dollars, larger than that of the other biggest international debtors, including Brazil (U.S. $112.7 billion), Mexico (U.S. $102.6 billion), Argentina (U.S. $61.9 billion), Poland (U.S. $40.1 billion), and Venezuela (U.S. $34.1 billion).[3] While Canada's external debt is large in absolute terms, it is less imposing in relative terms. As a share of GDP, net debt in Canada at 35 percent is much lower than Mexico (58 percent in 1988), Argentina (60.5 percent), Poland (63.9 percent), and Venezuela (57.7 percent), but higher than only Brazil (30.7 percent). Canada has a larger external debt, but it is better able to service its debt than many other debtor nations.

Net indebtedness in Canada is continuing to grow more rapidly than GDP because of the persistence of current account deficits, whereas the other large debtors are being forced by lenders to reduce their net indebtedness relative to GDP. Canada's debt service ratio (investment income divided by exports) at 13.6 percent is in the same range as those of heavily indebted developing countries which are not experiencing debt-servicing difficulties (average 14.7 percent in 1989). It is well below those of developing countries experiencing debt-servicing difficulties (average 25.6 percent in 1989).

Interestingly, if Quebec's share of Canada's external indebtedness were the same as its share of population, its net external indebtedness would be greater than that of Poland and Venezuela. Its indebtedness would also presumably be growing more quickly.

TABLE 25

CANADIAN CURRENT ACCOUNT BALANCE AND EXTERNAL DEBT

	1986	*1987*	*1988*	*1989*
Current Account Bal.				
Billions of Dollars	-10.2	-9.2	-10.2	-16.7
Percent of GDP	-2.0	-1.7	-1.7	-2.6
Investment Income				
Billions of Dollars	-16.4	-16.2	-18.9	-22.2
Percent of GDP	-3.2	-2.9	-3.1	-3.4
Percent of Exports	-11.9	-11.2	-11.9	-13.6
Net Int. Inv. Position				
Billions of Dollars	-180.8	-194.2	-204.6	-229.3
Percent of GDP	-35.8	-35.2	-33.9	-35.2
Percent of Exports	-130.9	-134.2	-128.9	-140.8

Source: Statistics Canada, *Canada's International Investment Position*, Catalogue 67-202.

This chapter raises some questions about the extent to which a sovereign Quebec would be able to generate a trade surplus to service its external debt. This issue should be addressed more thoroughly than is possible here. The first order of business would be to get Statistics Canada to see if it could prepare estimates of Quebec's external balance and external indebtedness by using the raw statistical data it uses in preparing the national estimates. If so, then it would be possible to examine Quebec's ability to service this debt by drawing on its current industrial base. Attention should focus on the extent to which the narrower industrial base of Quebec and the economic fluctuation within its key industries might compromise its ability to service the debt.

Economic comparisons with the rest of Canada

There has been much talk about the dynamism of the Quebec economy and the new breed of Quebec entrepreneurs. It is important to remember, however, that Quebec remains one of Canada's less well off equalization receiving provinces. This relative lack of economic clout would not preclude Quebec from going on its own, but it would make it more difficult.

Table 26 shows that GDP per capita in Quebec in 1989 is $22,684, which is 88 percent of the average in the rest of Canada, or 79 percent of Ontario, the province with which Quebec usually makes comparisons. Similarly, personal income per capita is $19,614, which is 91 percent of the rest of Canada, or 82 percent of Ontario. Personal disposable income (after direct taxes) is $15,110, which is 88 percent of the rest of Canada, or 80 percent of Ontario. Earned income per capita is $15,718, which is 89 percent of the rest of Canada, or 82 percent of Ontario. The gap is smaller for the average wage (wages and salaries per employee). The average wage in Quebec was 96 percent of the rest of Canada, or 87 percent of Ontario.

TABLE 26

THE QUEBEC ECONOMY COMPARED TO THE REST OF CANADA IN 1989 (Dollars)

	Canada	*Quebec*	*Ontario*	*Rest of Canada including Ontario*
Population (thousands)	26,223	6,692	9,579	19,531
GDP per capita	24,896	22,684	28,537	25,653
Personal Income per capita	21,093	19,614	24,017	21,599
Personal Disp. Inc. per capita	16,638	15,110	18,809	17,161
Earned Income per capita	17,131	15,718	19,096	17,615
Average Wage	28,744	27,883	32,001	29,017
Employment (thousands) December 1990	12,439	2,999	4,867	9,440
Unemployment Rate (%) December 1990	9.3	11.7	7.8	8.6

Source: Statistics Canada. All figures are annual averages except for employment and unemployment rate which are for December 1990.

The relatively weak position of Quebec is also apparent in the labour market. At the end of 1990, the unemployment rate in Quebec was 11.7 percent, more than 3 percentage points higher than in the rest of the country and almost 4 percentage points higher than in Ontario. The disadvantage is even greater if a comparison is made between the proportions of the populations that are employed. In Quebec only 44.8 percent of the population is employed, versus 48.3 percent in the rest of Canada and 50.8 percent in Ontario.

International economic comparisons of GDP and population

An international comparison of population and income in 1988 is provided in table 27. Quebec would certainly not be the smallest country in the Organization for Economic Cooperation and Development if it were to become independent. Measured by GNP in U.S. dollars in 1988 converted at the average exchange rate, it would only be slightly smaller than Austria and larger than Denmark, Finland, and Norway. In terms of population Quebec would fit in between the same countries. Quebec's GDP per capita in U.S. dollars calculated at $17,421 would place it thirteenth among the 24 countries belonging to the OECD. Using purchasing power parity exchange rates to calculate GDP per capita, which provides a more accurate estimate of living standards than actual market exchange rates, Quebec would rank third behind only the United States and the rest of Canada.

The rest of Canada would remain the seventh largest economy in the OECD measured by GNP in U.S. dollars. Canada would thus still remain one of the world's seven largest industrial economies even if Quebec were to separate, but Spain would not be far behind. Arithmetically, GDP per capita in Canada would increase with the separation of Quebec because GDP per capita in the rest of Canada is higher than in Quebec. By using purchasing power parity exchange rates, Canada would remain right at the top in terms of GDP per capita calculated, falling only behind the United States.

TABLE 27

INTERNATIONAL COMPARISON OF GNP AND POPULATION IN 1988 (U.S. Dollars)

Country	*Population (Millions)*	*GNP/GDP$ (US$ Billions)*	*GNP/GDP Current Exchange Rate*	*Per Capita Purchasing Power Parity Exchange Rate*
United States	246.329	4817.800	19,558	19,558
Japan	122.613	2843.400	23,190	14,288
Germany	61.451	1201.800	19,581	14,161
France	55.873	949.900	17,002	13,603
Italy	57.441	828.900	14,430	12,985
United Kingdom	57.065	822.800	14,413	13,428
Canada	**25.909**	**490.310**	**18,924**	**18,692**
Rest of Canada	**19.268**	**374.617**	**19,442**	**19,204**
Spain	38.996	340.100	8,722	9,343
Australia	16.538	247.100	14,940	13,412
Netherlands	14.765	228.300	15,461	12,832
Switzerland	6.672	183.700	27,581	16,700
Sweden	8.438	181.800	21,546	14,772
Belgium	9.879	150.000	15,180	12,623
Austria	7.595	127.200	16,748	12,506
Quebec	**6.641**	**115.692**	**17,421**	**17,207**
Denmark	5.130	107.500	20,912	13,555
Finland	4.946	105.200	21,266	13,792
Norway	4.211	91.200	21,654	16,322
Turkey	53.969	70.600	1,303	4,353
Greece	10.010	52.500	5,244	6,799
New Zealand	3.326	41.800	12,555	11,028
Portugal	10.304	41.700	4,265	6,750
Ireland	3.538	32.500	9,182	8,146
Luxembourg	0.375	6.600	17,592	15,558
Iceland	0.250	5.900	23,936	16,068

Source: OECD, *OECD Observer*, No. 164 (June/July 1990) and Statistics Canada, *Provincial Economic Accounts*, annual estimates 1985-89. Purchasing Power Parity Exchange rates for the rest of Canada and Quebec were assumed to be the same as those estimated for Canada by the OECD.

Fiscal deficits and public debt of a sovereign Quebec

The annual budget of Quebec provides the best accounting of the fiscal position of the province. Table 28 provides the Quebec government's budget forecast and some historical background on deficits and debt. The Liberal government has been successful since it came to power in 1985 in halving the deficit and financial requirements by 1989-90. The decline in the deficit slowed the growth of the public debt and brought down the public debt as a proportion of GDP from 29.3 percent in 1985-86 to 27.7 percent in 1989-90. Due to the recession, the deficit rose in 1990-91. and the debt-to-GDP ratio increased to 29 percent. This increase is projected to continue in 1991-92, but at nowhere near the rate that the deficit is projected to increase in Ontario.

To estimate the budgetary deficit of a sovereign Quebec, add the estimated provincial deficit in 1991-92 of $3.5 billion to Quebec's share of the estimated federal budgetary deficit of $7.8 billion ($30.5 billion times 25.4 percent population share). This calculation gives an estimated budgetary deficit for a sovereign Quebec of $11.3 billion. While a deficit of this magnitude may appear at first glance to be a crippling burden, it is not very much higher than the $9.7 billion deficit expected by Ontario in 1991-92. But this estimate of a sovereign Quebec's budget deficit is an underestimate since Quebec's share of the deficit may be larger than its share of population because it derives a net benefit from transactions with the federal government. Also, Quebec does not have the same capacity as Ontario to carry additional debt.

An additional source of data on Quebec's fiscal position is provided by the provincial economic accounts. Net lending or borrowing by the government sector in the provincial economic accounts gives another measure of the provincial deficit or surplus. The provincial economic accounts are also useful in that they show net lending or borrowing of the federal government in Quebec. Combining the federal with the other levels of government yields an estimate of what the national accounts

TABLE 28

QUEBEC BUDGET FORECAST 1991-92
(Millions of Dollars)

	1985-86	*1989-90*	*1990-91*	*1991-92*
Budgetary Deficit	3,344	1,659	2,795	3,480
Financial Requirements	1,671	816	1,482	2,200
Public Debt				
Direct	23,633	27,699	29,616	
Pension Funds	7,998	14,320	16,224	
Total	31,631	42,019	45,840	
Debt/GDP (%)	29.3	27.7	29.0	30.8
Public Debt Charges as percent of Revenue	14	13.2	13.4	13.6

Source: Quebec, Ministry of Finance (1991, Annex B).

deficit of the Quebec government would be if it were to raise all the revenues in the province and carry out all of the expenditures of government in the province. This estimate is, in effect, what the Quebec government deficit would be on a national accounts basis if it were sovereign and continued with all existing programs and taxes.

Table 29 shows that the provincial-local deficit on a provincial accounts basis has declined similarly to the public accounts deficit presented in the provincial budget; in 1989, it was $1.4 billion, or less than 1 percent of GDP. The federal government deficit in Quebec has also declined, but much less significantly. In 1989, it was $5 billion, or 3.3 percent of GDP. Combining these two deficits, the deficit of a sovereign Quebec would have been $6.4 billion in 1989, or 4.2 percent of GDP. (Note that the estimated Quebec government deficit on a provincial economic accounts basis is lower than the estimate on a public accounts basis for the same reasons that federal national accounts deficits are lower than federal budgetary deficits. For example, contributions to public service superannuation accounts are counted as revenues in the national accounts.)

TABLE 29

QUEBEC DEFICITS ESTIMATED FROM PROVINCIAL ECONOMIC ACCOUNTS

	1986	*1987*	*1988*	*1989*
Provincial-Local Govts.				
-millions of dollars	-2327	-1643	-105	-1425
-percent of GDP	-2.0	-1.3	-0.1	-0.9
Federal Government				
-millions of dollars	-5673	-4524	-4480	-4968
-percent of GDP	-4.8	-3.5	-3.1	-3.3
Total Government				
-millions of dollars	-8000	-6167	-4585	-6393
-percent of GDP	-6.8	-4.8	-3.2	-4.2

Source: Net lending of governments from Statistics Canada, *Provincial Economic Accounts.*

Table 30 shows the revenues and expenditures that underlie the Quebec deficit on a provincial economic accounts basis and compares the revenues, expenditures, and the balance with that in the rest of Canada and Ontario. In 1989, Quebec's deficit (4.2 percent of GDP) was larger than the rest of Canada's (3.3 percent of GDP) and especially larger than Ontario's (with running a surplus of 1.7 percent of GDP). The favourable fiscal position of Ontario is not expected to persist in light of the dramatic increase in the provincial government deficit forecast in the 1991 budget. Quebec's revenue share at 41.7 percent of GDP was significantly higher than the rest of Canada's (40.2 percent) and Ontario's (40.4 percent). Its expenditure share at 45.9 percent of GDP is also significantly above the rest of Canada's (43.3 percent) and especially above Ontario's (38.8 percent). Again, the 1991 Ontario budget will change this comparison.

TABLE 30

COMPARISON OF GOVERNMENT REVENUE, EXPENDITURES AND NET LENDING IN 1989
(Percent of GDP)

	Canada	*Quebec*	*Ontario*	*Rest of Canada including Ontario*
Revenue	40.5	41.7	40.4	40.2
Expenditure	43.9	45.9	38.8	43.3
Net Lending	-3.5	-4.2	1.7	-3.3

Source: Statistics Canada, *Provincial Economic Accounts.*

A sovereign Quebec would have to raise taxes or cut spending significantly to reduce its deficit. The deficit reduction would have to be at least equal to 1 percent of GDP, or $1.5 billion, to bring the deficit more into line with deficits in the rest of the country. Additional reductions in the deficit would be necessary to cover the loss of the federal fiscal benefits (1.25 to 2 percent of GDP) and to cover increased debt service. The debt service would increase if Quebec assumed a per capita share of federal debt (0.7 percent of GDP), if the risk premium on interest costs increased due to the large increment in Quebec government debt (0.2 percent of GDP assuming an 0.25 percent premium), and if taxes decreased because of any long-run declines in real output. These changes would add up to a total required reduction in the deficit of 2 to 3 percent of GDP, which is, coincidentally, roughly the same order of magnitude as the estimated required decrease in the current account deficit. If Quebec were to raise taxes by this magnitude, Quebeckers would have to reduce their spending significantly. There is also a risk that large tax increases would undermine Quebec's competitiveness. On the other hand, cuts in spending would reduce services to Quebec citizens.

It is possible to do some rough calculations of the debt burden of a sovereign Quebec. At the end of 1990-91, the gross public debt of the Quebec government, excluding debt held by retirement plan accounts, was equal to 18.8 percent of GDP. The net public debt of Quebec local governments was $16,250 million in 1990 or 10.3 percent of GDP.[4] Federal gross public debt at the end of 1990-91 would be approximately $430 billion (estimated by adding the difference between 1989-90 gross and net public debt to the 1990-91 net public debt of $388.5 billion estimated in the 1991 federal budget). Federal gross public debt excluding pension liabilities would be $359 billion (estimated by subtracting the 1989-90 estimate of federal pension liabilities of $71 billion from $430 billion), or 58 percent of GDP. The total gross public debt of a sovereign Quebec would thus be 87.1 percent of GDP, excluding the debt held by retirement plans (the sum of the provincial debt of 18.8 percent, local debt of 10.3 percent, and the share of federal debt of 58 percent). This rough measure of Quebec's gross debt burden is reasonably comparable with the gross public debt (excluding debt held in pension accounts) of other major industrialized countries compiled by the OECD shown in table 31. If Quebec were sovereign, it would have a larger gross public debt than Canada and any of the six other largest industrialized countries except for Italy. Of the smaller countries only Belgium and Ireland would have higher gross debt. A sovereign Quebec would definitely be a high public debt country.

Further light on the issue of the debt burden of a sovereign Quebec is shed by considering recent estimates of provincial-local net debt prepared by Irene Ip of the C.D. Howe Institute (Ip, 1991). Net debt differs from gross debt in that it is measured after subtracting financial assets. These estimates, which were painstakingly constructed to be interprovincially comparable, are given in table 32. According to these estimates for 1989, Quebec, with net debt equal to 35.1 percent of GDP, is, after Newfoundland, the most heavily indebted province in relative terms. Its debt was 24 percent of GDP higher than Ontario's and 25 percent of GDP higher than the rest of Canada's average for provincial-local debt.

Ip estimates that if federal debt were allocated to Quebec based on population, the combined debt ratio in Quebec would be 95 percent. In contrast, the combined debt ratio for the rest of Canada would only be 63.3 percent (calculated using Ip's data). By this measure, if Quebec were to separate and assume its per capita share of the federal public debt, Quebec would have a 50 percent higher debt burden than the rest of Canada.

TABLE 31

GROSS PUBLIC DEBT IN 1991
(Percent of GDP)

Country	*Debt/GDP*
United States	54.8
Japan	61.3
Germany	47.0
France	46.5
Italy	101.0
United Kingdom	34.2
Canada	73.0
Total G-7	57.4
Australia	7.2
Austria	54.0
Belgium	129.3
Denmark	55.8
Finland	13.0
Greece	86.5
Ireland	113.1
Netherlands	84.6
Norway	39.5
Spain	43.0
Sweden	40.9
Total Small Countries	54.8
Total	57.1

Source: OECD, *Economic Outlook*, December 1990.

Fiscal comparisons with other provinces

A comparison of consolidated provincial-local government fiscal balances in 1989 as a percent of GDP on a Financial Management System basis using data prepared by Irene Ip (1991, Table A6) is provided in Figure 3. On this basis, Quebec's deficit was smaller relative to GDP than Nova Scotia's and Alberta's, but larger than the other provinces', particularly Ontario's which ran a surplus. However, a continuation of a

high rate of spending growth in Ontario in the face of a recession is expected to push the Ontario budget deeply into deficit beginning in 1991. Quebec will not continue to record a larger deficit than Ontario, but should remain higher than most of the other provinces.

TABLE 32

PROVINCIAL-LOCAL NET DEBT IN 1989
(Percent of GDP)

Newfoundland	42.2
Quebec[a]	35.1
Nova Scotia	29.3
New Brunswick	25.8
Manitoba	25.3
Prince Edward Island	14.9
Saskatchewan	13.8
Ontario	11.1
British Columbia	4.9
Alberta	-6.0
Total Prov.-Local	15.9
Total Prov.-Local ex. Quebec	10.1
Federal	54.9
Total	70.8

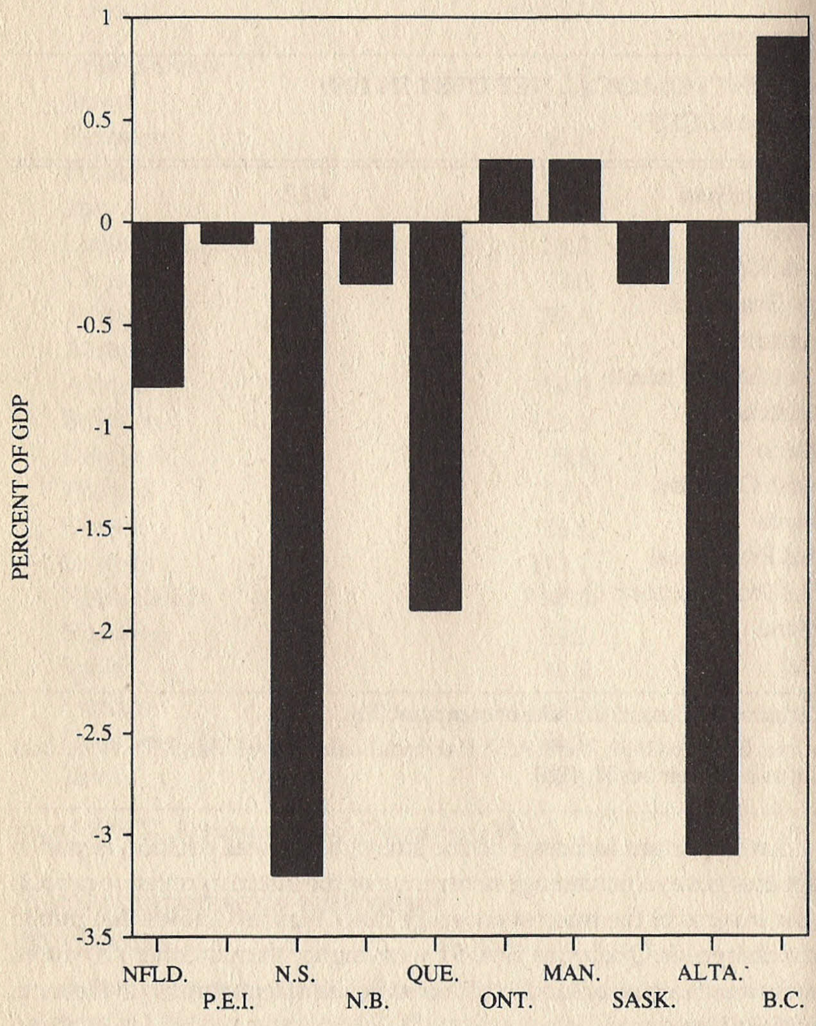
[a]Excludes QPP assets for sake of comparability.

Source: Irene Ip (1991, Table A.5). Provincial debt is as of March 31, 1990; local debt as of December 31, 1989.

An important indicator of the strength of fiscal position is public debt charges as a percentage of revenue or the interest/revenue ratio. It is the inverse of the interest coverage ratio. Figure 4 shows that public debt charges in Quebec in 1990-91 were higher than in other provinces except for Newfoundland and Nova Scotia (Department of Finance, 1991b, p.19).

FIGURE 3

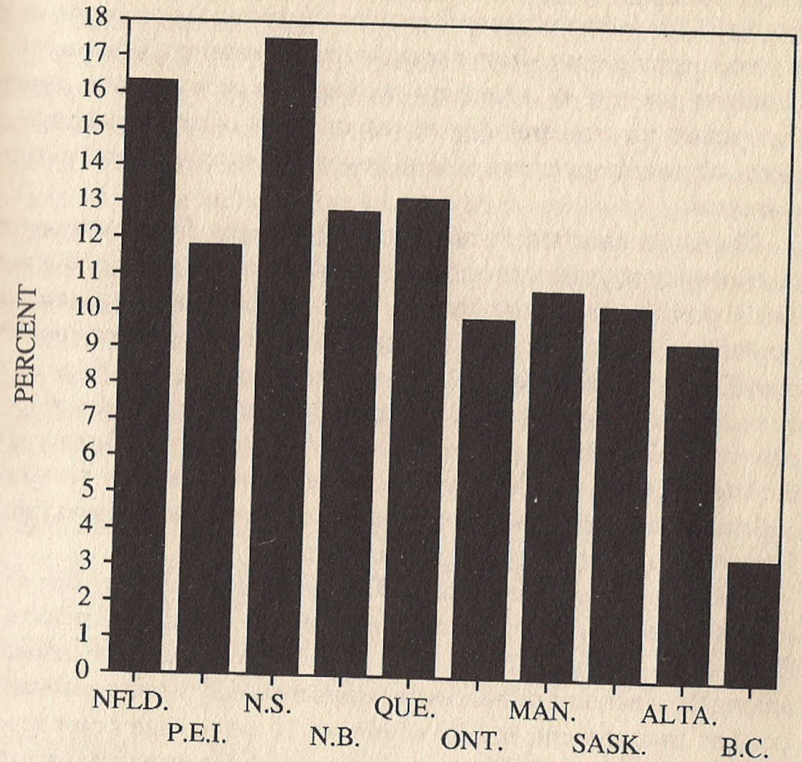
CONSOLIDATED PROVINCIAL-LOCAL SURPLUS/DEFICIT (-) IN 1989



Source: Financial Management System Basis (Irene Ip, 1991, table A.6)

FIGURE 4

PUBLIC DEBT CHARGES AS A PERCENT OF REVENUE IN 1990-91



Source: Department of Finance (1991b, p. 19).

Given that a sovereign Quebec would have to raise significantly more revenue than it does currently, it is important to consider its revenue-raising capability in relation to those of the other provinces. Several measures can be used to compare the abilities of the provinces to raise revenues. The first measure is the relative "fiscal capacity" of a province, which measures the ability of a province to get revenue from available sources. It is calculated both for own-source revenues and own-source revenues plus equalization. The second is the relative "tax effort" of a province, which measures the revenue that a province raises relative to the revenue it would raise if it were to levy taxes at the national average provincial tax rates. These measures were provided by the Federal Provincial Relations Division of the Department of Finance in June 1991.

The measure of relative fiscal capacity from own sources is shown in table 33. It is estimated for each province by taking the per capita yield of own-source revenues from a standardized tax system, which applies a uniform tax rate to a uniform tax base for each revenue source. Own-source revenue excludes interest revenues of provincial governments, all non-tax revenues of local governments, and federal transfer payments.

The large variation in relative fiscal capacity from own source revenues across provinces and the stability in recent years of the provincial positions is evident from the table. Quebec has a fiscal capacity greater than the Atlantic provinces' and Manitoba's, but 14 percent less than Canada's average and 21 percent less than Ontario's. Because of oil and gas revenues, Alberta has a strong position with an index of 134.5 percent. While Alberta's index is down from well over 200 percent in the late 1970s, it is still head and shoulders above the other provinces and more than twice as high as the indexes of Newfoundland and Prince Edward Island, the lowest income provinces.

Table 34 shows that equalization substantially reduces the disparity in fiscal capacity among provinces, bringing Quebec up to 92 percent of the national average. While Alberta remains the highest, the disparity among the other nine provinces decreases markedly when equalization is taken into account; it falls within an 11 percentage point range. Equalization brings all of the equalization receiving provinces up to the same level.

An indicator of tax effort is provided in table 35. It is calculated by dividing the revenues a province actually receives by the revenues that the representative tax system would yield in the province at average provincial rates. Tax effort varies considerably across provinces. Quebec has the highest level of tax effort at 111.2 percent; Alberta has the lowest level of tax effort at 74.4 percent. The Prairie provinces of Saskatchewan and Manitoba at 107.5 percent have relatively high levels of tax effort. The Atlantic provinces all have lower than average levels of tax effort. Ontario increased its level of tax effort from below the provincial average in 1987-88 to above the average in 1989-90, which is especially striking, given the importance of Ontario's tax increases in pulling up the national average. The decrease in the relatively high tax burden in Quebec during the same period is also noteworthy.

Nevertheless, in 1990 the tax burden in Quebec remained significantly higher than in Ontario. The top marginal personal income tax rate in Quebec in 1990 was 50.5 percent, compared to 48.2 percent in Ontario. Quebec's higher tax rate cost $964 more in income tax than Ontario's did for a couple with two children earning $50,000; and Quebec's cost $2,075 more than Ontario's for the same couple earning $75,000. A single individual would pay $540 more with an income of $20,000, $1,619 more at $35,000, $2,359 at $50,000, and $3,436 more at $75,000 (Quebec, 1990, pp.9-10). The differential would surely increase in a sovereign Quebec.

If tax effort were adjusted for the surpluses and deficits, the disparity in tax effort would widen since large deficits tend to be correlated with high tax effort. Unfortunately, data on the adjusted measure of tax effort are not available.

TABLE 33

INDICES OF PROVINCIAL LOCAL FISCAL CAPACITY OWN SOURCE REVENUES

	1987-88	*1988-89*	*1989-90*	*1990-91*	*1991-92*
Newfoundland	60.4	62.4	62.7	62.4	63.1
Prince Edward Is.	64.1	65.0	64.4	63.8	64.6
Nova Scotia	76.0	75.3	74.9	75.0	75.6
New Brunswick	71.2	72.0	71.1	70.4	71.2
Quebec	85.4	85.7	86.0	85.6	86.1
Ontario	108.2	109.9	111.2	110.9	109.5
Manitoba	80.2	80.7	79.1	79.3	80.0
Saskatchewan	90.3	87.2	83.8	85.8	87.3
Alberta	145.6	136.5	130.5	133.0	134.5
British Columbia	103.9	105.2	106.5	105.2	104.9
All Provinces	100.0	100.0	100.0	100.0	100.0

Source: Federal Provincial Relations Division, Finance, April 1991.

TABLE 34

INDICES OF PROVINCIAL LOCAL FISCAL CAPACITY OWN SOURCE REVENUES PLUS EQUALIZATION

	1987-88	*1988-89*	*1989-90*	*1990-91*	*1991-92*
Newfoundland	91.8	91.8	91.5	91.2	92.0
Prince Edward Is.	91.8	91.8	91.5	91.2	92.0
Nova Scotia	91.8	91.8	91.5	91.2	92.0
New Brunswick	91.8	91.8	91.5	91.2	92.0
Quebec	91.8	91.8	91.5	91.2	92.0
Ontario	101.3	103.0	104.3	104.2	102.8
Manitoba	91.8	91.8	91.5	91.2	92.0
Saskatchewan	91.8	91.8	91.5	91.2	92.0
Alberta	136.2	127.8	122.3	125.0	126.3
British Columbia	97.2	98.6	99.9	98.8	98.5
All Provinces	100.0	100.0	100.0	100.0	100.0

Source: Federal Provincial Relations Division, Finance, April 1991.

TABLE 35

INDICES OF PROVINCIAL-LOCAL TAX EFFORT ACTUAL REVENUES AS A PERCENTAGE OF REVENUES AT NATIONAL AVERAGE TAX RATES

	1987-88	*1988-89*	*1989-90*
Newfoundland	108.1	106.0	99.8
Prince Edward Island	95.2	96.0	92.1
Nova Scotia	94.7	91.4	90.4
New Brunswick	91.7	97.8	97.6
Quebec	118.9	116.1	111.2
Ontario	98.3	100.1	103.2
Manitoba	115.1	111.7	107.4
Saskatchewan	104.5	103.1	107.5
Alberta	77.4	72.4	74.4
British Columbia	92.4	96.9	93.1
All Provinces	100.0	100.0	100.0

Source: Estimate for 1989-90 calculated using data on equalization entitlements dated February 14, 1991 provided by Federal Provincial Relations Division, Finance. Estimates for earlier years provided in September 1990.

Provincial-local expenditure per capita for all provinces for the 1989 calendar year from the Provincial Economic Accounts (the latest year currently available on a consolidated basis) are given in table 36. The table also provides indexes of the ratio of per capita expenditures in a particular province to the average for Canada. The variation in per capita spending is much less than the variation in fiscal capacity. Provinces tend to provide broadly comparable levels of public services. According to this measure, the greatest expenditure effort is made by Alberta and the least by Prince Edward Island. The Prairie provinces as a group have above average expenditure indexes and the Atlantic provinces below average. Quebec has a level of expenditure effort that is 6 percent higher than the national average and 14.5 percent higher than Ontario's. Again, projected expenditure increases in the 1991 Ontario budget should narrow the gap.

TABLE 36

PROVINCIAL-LOCAL EXPENDITURE PER CAPITA IN 1989

Province	*$ Per Capita*	*Index*
Alberta	7,175	119.0
Saskatchewan	6,787	112.6
Manitoba	6,491	107.7
Quebec	6,403	106.2
Newfoundland	5,732	95.1
Ontario	5,594	92.8
New Brunswick	5,416	89.9
British Columbia	5,407	89.7
Nova Scotia	5,384	89.3
Prince Edward Island	5,169	85.8
Canada average	6,027	100.0

Source: Statistics Canada, *Provincial Economic Accounts*

The impact of uncertainty over sovereignty on Quebec's borrowing costs

Financial markets pass judgment every day on the credit of borrowers. The yield on Quebec government bonds reflects yields on competing securities and the market's assessment of the appropriate risk premium for Quebec bonds. This assessment takes into account the prospects for Quebec, including the possibility of sovereignty and any difficulties in servicing the debt which could result. Using a series prepared by Richardson Greenshields for the Caisse de dépôt, an examination of the interest rate gap between Quebec and Canada long-term bonds over the last twenty years reveals that the gap widens during recessions and during periods of political uncertainty (figure 5). Recessions have been the most important factor causing increases in the gap. But it would be difficult to deny that political uncertainties have played some role.[5] It is difficult to identify clearly the separate effect of political uncertainty.

In the period leading up to the June 23, 1990 Meech Lake deadline and immediately after, the yield on Canadian long-term bonds increased by almost 1.5 percentage points more than the yield on comparable U.S. bonds. The Bank of Canada in its annual report attributes some of this increase to political uncertainty (Bank of Canada, 1990, p.29). Furthermore, as support in Quebec for sovereignty has gathered momentum since the failure of Meech Lake last summer, the gap between Quebec and Canada long bonds increased by about 50 basis points, from about 90 basis points to a peak of almost 140 basis points (figure 6). This gap was about 25 basis points more than the gap between Ontario and Canada long bonds. More recently (as of July 13), the gap has narrowed again to around 80 basis points as support for sovereignty has waned in the polls.

While it is not easy to interpret these changes, the market seems to be signalling that, while an independent Quebec may be viable, its debt is riskier than if it were to remain part of Canada. Also, Quebec would have to pay an interest premium for sovereignty. The reasons that the market might require such a premium should be evident from this paper's discussions of Quebec's fiscal deficits, its debt and external balances, and its industrial structure. It is not surprising that the Canadian Bond Rating Service announced in March that, even though it was not downgrading Quebec's credit rating from AA, it was putting all bonds issued by the Quebec government and its agencies on credit watch (Milner and Seguin, 1990, pp.A1-A2). There is just too much uncertainty about Quebec's future prospects. In contrast, Moody's has adopted a more cautious approach and announced that it will not alter Quebec's credit rating until there is "a formal adoption by the Quebec government of a series of constitutional reforms" (McKenna, 1991, p.B8).

An overall assessment of the viability of a sovereign Quebec

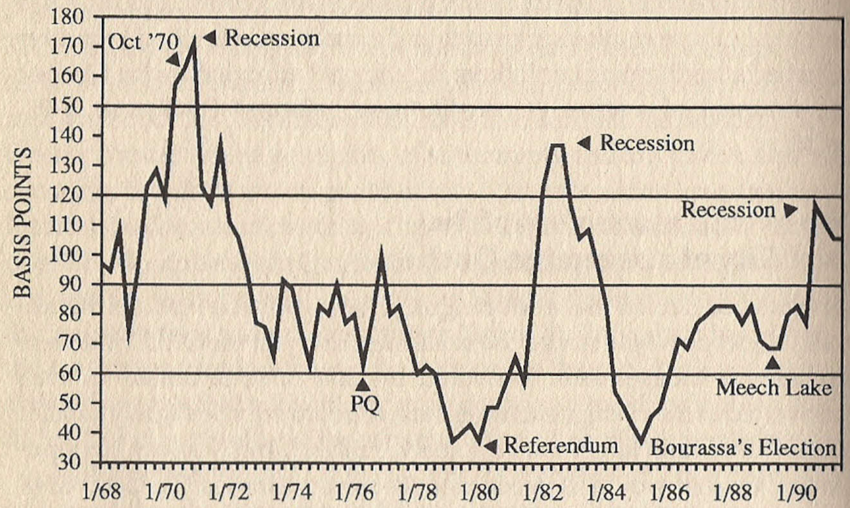
It cannot be denied that a sovereign Quebec would be viable economically. Quebec would not be the smallest country in the OECD if it were to become independent. Measured by GNP in U.S. dollars in 1988 converted at the average exchange rate, it would only be slightly smaller than Austria and larger than Denmark, Finland, and Norway. In population, Quebec would fit in between the same countries. Quebec's GNP per capita in terms of U.S. dollar purchasing power parity at $17,207 would place it as the third highest income of OECD countries, behind the United States and Canada.

Quebec is currently going through the same recession as the rest of the Canadian economy. However, the confidence of Quebeckers in the economic viability of sovereign Quebec has evidently not yet been shaken as it was in the 1981-82 recession following the 1980 referendum. Prospects are good for a strong recovery beginning in the summer of 1991, assuming that Quebec remains part of Canada and the economic upheaval associated with separation is thereby avoided. The best time to consider subjecting the Quebec economy to the shock of separation from Canada is not during a recession, even though the Quebec economy is viable.

The Quebec economy has several weaknesses which would be exacerbated by independence. The budgetary deficit of the Quebec government would increase to more than $10 billion if Quebec were to take over the existing federal structure of revenues and expenditures. The deficit on a provincial economic accounts basis would be $6.5 billion, or 4.2 percent of GDP.

FIGURE 5

GAP BETWEEN THE RATE OF RETURN ON LONG-TERM BONDS OF HYDRO-QUEBEC AND GOVERNMENT OF CANADA



Source: Richardson Greenshields.

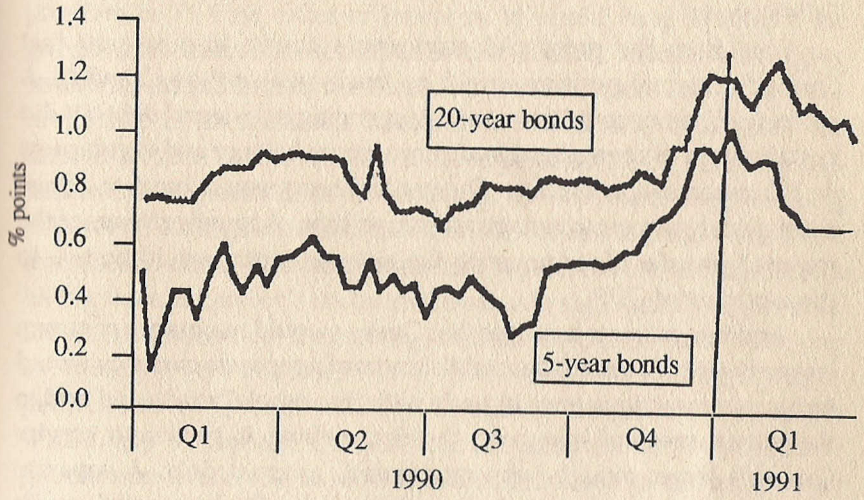
Net public debt as a proportion of GDP would rise from 35 percent of GDP in 1989 to 95 percent if Quebec's share of federal net debt based on population were factored in. Quebec would have a larger gross public debt than any of the seven largest industrialized countries except for Italy. Of the smaller countries considered, only Belgium and Ireland would have higher gross debt. A sovereign Quebec would definitely be a high public debt country. Slower population growth would make it more difficult for Quebec to bear its share of the debt than for the rest of Canada.

International and domestic lenders could be expected to exact an interest premium from the Quebec government to compensate for the greater risk of lending to a high-debt sovereign Quebec, as they were doing until recently when support for sovereignty began to wane. The benefits Quebec would be giving up in terms of greater stability of revenues resulting from federal transfers are evidently recognized by lenders.

In addition, Quebec's external position would appear to be weak. Although in 1984 (the latest year for which data are available) Quebec

FIGURE 6

RECENT INTEREST RATE GAPS BETWEEN HYDRO-QUÉBEC AND GOVERNMENT OF CANADA BONDS



Source: Reuters Historical Information, *Globe and Mail*, March 27, 1991, p. B4.

had a surplus of $3.3 billion in its trade in manufactured goods with the rest of Canada, its overall trade balance was in deficit by $4.2 billion, or 4.2 percent of GDP. And, $1.9 billion (or 56 percent) of the surplus in interprovincial trade in manufactured goods was concentrated in the five "soft" industries of leather and allied products, primary textiles, textile products, clothing, and furniture and fixtures. These industries are labour-intensive and subject to strong foreign competition. The most important of these, textiles and clothing, benefits from access to a protected Canadian market guarded by high tariffs and quotas which could not be expected to continue if Quebec were to become sovereign. Quebec's dairy farmers, who supply almost one-half of Canada's industrial milk and who benefit from supply management, might also suffer a substantial loss in market share.[6] Moreover, Quebec's international exports of manufactured goods, which are concentrated in paper and allied products, primary metals, and transportation equipment, are also vulnerable. Paper and allied products is currently suffering from the recession and from recycling. Transportation equipment would depend on Quebec's continued participation in the auto pact. Of Quebec's exports, only hydroelectricity is an unambiguous source of strength, but even it could be affected by territorial disputes with Canada or the James Bay Cree and by any efforts by Newfoundland to cut off Churchill Falls's power.

Data from the provincial economic accounts also suggest that Quebec's external position would be much weaker than Canada's. A sovereign Quebec could have trouble servicing its external debt if it did not take steps to strengthen its current account balance and to compress real incomes of Quebeckers. Quebec industry would have to adjust more quickly to meet international competition. A rough estimate of the required transfer of resources to the external sector would be two to three percent of GDP.

And this estimate assumes that Quebec would maintain a common currency with Canada. The establishment of a separate currency would increase transactions costs in trade with the rest of Canada and add to the nervousness of investors, thereby making it harder to service Quebec's large, though yet unmeasured, external debt. A separate currency would also make it more difficult for Quebec to pick up its share of the federal public debt; it would add an element of currency risk to the risk premium in interest rates. On the other hand, a devaluation of a Quebec currency may turn out to be the easiest way to get the Quebec public to accept lower real incomes.

This estimate also assumes that Quebec would be able to negotiate free trade agreements with the rest of Canada and the United States. This assumption is reasonable enough in the medium term after enough time has elapsed for agreements to be reached. But there could very well be costs for Quebec. The agreements, once they are reached, may not be as favourable to Quebec as current agreements are. The United States and Canada could both demand limitations on the extent to which Quebec would be able to pursue interventionist policies in support of domestic industries. Quebec government procurement policies which favour domestic suppliers and subsidized hydroelectricity are two possible sources of contention. The use of the Caisse de dépôt to promote the development of Quebec industry and the environmental consequences of James Bay II could also become sources of disagreement.

And the United States could also pursue its longstanding grievances over trade in alcoholic beverages and agricultural supply management.

Even though a sovereign Quebec would be viable, the government of the new state would have to embark on a structural adjustment program as its first order of business. It would have to reduce the government deficit by two to three percent of GDP. To resolve emerging structural disquilibria in the fiscal and trade balances and to gain the confidence of international investors, it would have to improve the current account balance by two to three percent of GDP. These reductions would require substantial cuts in government spending, resulting in lower levels of government services. The reductions might also entail increases in taxes. But the government would have to tread softly in hiking taxes as Quebec's tax burden is already significantly higher than the rest of Canada's and much higher than the United States'. Relying too heavily on tax increases would risk further undermining the competitiveness of Quebec industry. Reducing the government deficit would help to improve Quebec's current account deficit. The Quebec government would also have to facilitate the transfer of resources out of the "soft" industries. A free trade agreement with Canada and the United States would be essential if Quebec is to remain as prosperous as today.

A sovereign Quebec may be viable economically, but the economic policies required to ensure viability will require some very difficult structural adjustments and some unpopular policy-induced reductions in real incomes. The heavy cloud of uncertainty over the prospects of Quebec's economy was underlined by the Canadian Bond Rating Agency in its March announcement that it was putting all bonds issued by the Quebec government and its agencies on credit watch. It is surprising that the large international bond rating agencies, such as Moodys and Standard and Poors, have not echoed the concerns of the Canadian Bond Rating Agency. But they are not located in Montreal and are more distant from the scene.

The real question for Quebeckers is not whether they would be better off economically—because economics is not their sole motive for independence—but whether they are willing to pay substantially for independence. The next chapter brings together all the arguments as to why Quebeckers, and indeed all Canadians, would be worse off if Quebec were to separate.

Notes

1. This argument was made first and in more detail by Reuven Brenner (1991, pp.7-9).
2. The Department of Finance (1991c) has prepared a useful study of economic linkages among provinces which also examines trade flows.
3. Data on debt of other countries are taken from IMF (1990) and World Bank (1990).
4. The unpublished data on Quebec local government debt in 1990 were provided by the Public Institutions Division of Statistics Canada.
5. Montmarquette and Dallaire (1980) examined the increase in differentials in interest rate in Quebec and Ontario bonds after the 1976 PQ election using econometric techniques. Their conclusions were that the present value of the additional financing costs was 1.22 percent of the $2,656 million in borrowings over the November 1976 to February 1979 period and that it took two and a half years for the difference in financing costs to disappear. Boothe and Harris (1991, p.21) attempted to isolate sovereign risk premiums by comparing U.S. pay bonds for Canada, Alberta, B.C. Hydro, Hydro-Quebec, and Ontario with a U.S. Treasury bond of comparable maturity and coupon over the 1986 to 1991 period. While the risk premium has narrowed since the beginning of the year, Quebec-Hydro bonds, which in March 1991 were 100 basis points over U.S. Treasury's and 80 basis point over Canada's, traded at the highest risk premium since early 1990 of all the bonds considered.
6. Murray Smith estimates that the tariff equivalent of the dairy supply management regime is 50 to 70 percent (Smith, 1991, p.5).

Chapter 5

The bottom line for Quebec sovereignty

Canada's prosperity threatened by Quebec sovereignty

QUEBEC SOVEREIGNTY HAS MANY possibly dire economic consequences for Canada, especially for Quebec. Few would deny that Canada has been an economic success story. International leaders such as U.S. President George Bush and German Chancellor Helmut Kohl have taken the unusual step of expressing their concerns about a breakup of Canada (Beltrame, 1991 and Drohan, 1991). Although small in population, Canada has the seventh largest economy in the OECD. Canada's standard of living is the second highest after the United States. Canada is richly endowed with resources and has a diversified industrial economy. Drawn by our prosperity, immigrants from all over the world flock to Canada. Quebec has flourished economically in Canada; Quebeckers have shared in the bountiful income and wealth generated by the Canadian economy.

Canada has been doing well. Granted, Canada can do better, but it can also do much worse. Breaking Quebec off from one of the world's strongest economies is unquestionably a way to do worse.