C.D. Howe Institute

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Canada's Choice: Crisis of Capital or Renewed Federalism

by

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Foreword

When, in May 1991, the C.D. Howe Institute launched "The Canada Round," a series of publications on the economic dimensions of the constitutional crisis, we were determined to foster an informed and reasoned debate. To that end, we attempted to give voice to diverse economic and political perspectives on the issues.

Thanks to the willingness of the many experts from across Canada to participate in the series, we believe that we have largely succeeded in achieving our goal. The greatest thanks must go to John McCallum, Professor of Economics and Dean of the Faculty of Arts at McGill University, who agreed to undertake the arduous and delicate task of overseeing an in-depth examination of issues that go to the very foundation of what this country is about. The success of the series would not have been possible without his sure leadership, his sound advice, and his inspiration.

Given the urgency of the choices Canadians face, the future of Canada seemed the appropriate topic with which to inaugurate the C.D. Howe Institute's annual Benefactors Lecture series. I am very pleased to acknowledge the benefactor of this event, ScotiaMcLeod Inc., a valued member of the Institute, whose support enables us to make copies of this lecture available free of charge in both English and French.

Informed citizens are effective citizens. Whatever the choices they ultimately make, the Institute continues to seek to be a resource on which they can draw, to help them make those choices in an atmosphere of thoughtful and rational discussion.

The text of this lecture was copy edited by Barry A. Norris, and prepared for publication by Brenda Palmer. As with all C.D. Howe Institute publications, the opinions expressed here are those of the author, and do not necessarily represent the views of the Institute's members or Board of Directors.

Thomas E. Kierans
President and Chief Executive Officer
C.D. Howe Institute

Dedication:
Philippe Laheurte, 1957–91

Many thousands of Quebecers knew Philippe Laheurte, who died in a tragic car accident, as one of the province's finest athletes, as well as a successful entrepreneur. Beginning in 1982, I knew him as my student, research assistant, and close friend — and also as my first and foremost instructor on the realities of the new and emerging Quebec. Indeed, Philippe was the embodiment of this new Quebec: on the one hand, energetic, outward-looking, and highly competitive; on the other hand, open, tolerant, and welcoming to all who chose to make Quebec their home. Whether or not he would have agreed with the contents of this lecture, I know that Philippe Laheurte would have endorsed my use of his name in an attempt to counter media stereotypes and to convey these Quebec realities to the reader from outside Quebec.

John McCallum
Montreal, June 1992

Introduction

When Tom Kierans, President of the C.D. Howe Institute, asked me to deliver this lecture, he stressed that the talk should be highly personal. There are two possible interpretations of this request. One is that Tom Kierans attaches immense importance to my personal thoughts. Alternatively, the more this lecture is billed as personal, the less will its contents be associated with the C.D. Howe Institute. Though leaning very strongly to the latter interpretation, I was nevertheless pleased and honored to accept the Institute's invitation to deliver this lecture.

In my year as editor of the Institute's "The Canada Round" series, I have made many friends and acquired, at most, one or two enemies.[1] High on the list of these new friends are the people who work for the Institute. I am impressed by their successful fusion of university-level analytical rigor with a real world common sense that is not always the strong point in academia. Also, I salute my friend, Angela Ferrante, notwithstanding our occasional disagreements: it is not easy to be charged with balancing the books when the boss has a capacity to spend rivaling that of the Reichmann brothers. Although in one sense I am offering a personal perspective, that perspective nevertheless has been shaped by the 58 authors who contributed to "The Canada Round," as well as by my colleagues at McGill University and many other individuals.[2]

This lecture is divided into three major sections: fears, hopes, and challenges. The fear is that a move to Quebec separation could lead to a crisis of solvency for parts of English-speaking Canada and a crisis of liquidity for Quebec. The hope is that a truly federal system will preserve a strong country, while at the same time allowing all of Canada's diverse regions or provinces enough room to develop and flourish in their own distinctive ways. The challenge will be to make the system work, to create a political, economic, and social union that will satisfy the long-run hopes and aspirations of all Canadians.

1 Although the ratio of friends to enemies is good, one should not forget the old adage: friends come and go; enemies accumulate.

2 My particular thanks go to David Brown for his excellent work as the principal liaison person at the C.D. Howe Institute; to David Laidler, who introduced me to the Institute; to my colleague and co-author Chris Green; and, for their ideas, to Marcel Côté, Pierre Fortin, and John Richards.

Before addressing these major themes, I begin by describing five lessons I have learned from my work on "The Canada Round" series.

The Importance of a Forum for a Fair Debate

One thing I have learned is that it is essential to provide a forum for a fair debate. In those volumes of the series that examined the economics of the breakup of Confederation, we always gave the last word to a Quebec francophone, and, where appropriate, we began with "the View from Bélanger-Campeau." While we did well in generating a fair debate, we focused too much on the costs of breakup to Quebec and not enough on the costs to the "Rest of Canada" (ROC). We underestimated the strength of the "let Quebec go" school of thought. Yet, as I will argue in this lecture, the costs of breakup could be greater for ROC — or at least for substantial segments of ROC — than for Quebec.

It is worth noting in passing that 300 of Canada's leading chief executive officers (CEOs) seem to be saying the same thing. According to an Angus Reid survey carried out in November 1991, three-quarters of those CEOs polled who are based in Ontario predict long-run negative effects of Quebec separation for ROC. Precisely the same proportion of Quebec-based CEOs predict long-run negative effects for Quebec.[3] The opinions of these people deserve particular attention, for it is they who make the investment decisions that determine the rise or fall of wealth and jobs in Canada.

Economists Should Be More Humble

A second lesson for me is that economists should be more humble. Roughly speaking, the more important the question, the less competent are economists. When it comes to big questions — such as the economic impact of the breakup of a country — we economists are forced to overcome our traditional disdain for interdisciplinary work and enlist

3 The 300 CEOs included in the survey are with companies jointly employing more than one million Canadians. The corresponding proportion for CEOs of companies based in the West and the East was two-thirds (there was no breakdown between West and East).

the aid of legal scholars, political scientists, historians, and the like. What is more galling, we must admit that we are not necessarily the senior members of the team. Not only that, we must acknowledge that even a multidisciplinary team with the most impeccable academic credentials may prove inadequate to the task. This is because once divorce proceedings are launched, a new dynamic — possibly involving acrimony, passions, and emotions — is likely to set in. Economists have little in the way of professional competence on questions of passion and emotion.

Noneconomists Should Also Be More Humble

Having entered this *mea culpa*, or plea for humility, on the part of my own profession, I am perhaps slightly better placed to recommend greater humility by others as well. I refer, in particular, to those who think they are imbued with such wisdom as to know what is best on every conceivable subject for every nook and cranny of this vast and diverse country. This reference is partly to the Canadian nationalist view that is centered in, but not exclusive to, Toronto, and also to the "Ottawa knows best" school of thought that is to be found principally, no surprise, in Ottawa.

Linguistic Policy Can Be Explosive

I come now to the fourth and second-to-last lesson I have learned from "The Canada Round." If ever I had doubted this point before, the discussions and negotiations surrounding our linguistic minorities volume[4] left no doubt in my mind that anything to do with language was potentially explosive. The central lesson is that free trade in language leads, sooner or later, to the disappearance of the weaker language — that is, French. This is utterly unacceptable to the vast majority of Quebecers, and Canada would cease to exist if ROC tried to force Quebec to accept such a policy. On the other hand, once this basic point is accepted, the future looks relatively bright. Right now, I believe, powerful forces in Quebec are working toward a gradual liberalization

4 John Richards et al., *Survival: Official Language Rights in Canada*, The Canada Round 10 (Toronto: C.D. Howe Institute, April 1992).

of the province's language laws. Also, as time goes by, fewer Quebecers will remember the days when they were told to "speak white" — that is, English — while increasing numbers of English-speaking Canadians will have attended French immersion school. All of this offers an important ray of hope for the future of our country.

The Grass Is Not Necessarily Greener...

Many ROCers, if one may use that expression, seem to believe they could simply wash their hands of Quebec and live happily ever afterward as a somewhat smaller but happier and more united country. Some Quebecers, on the other hand, seem to believe that sovereignty would place much greater powers in the hands of the government of Quebec — and that these powers could and would be used to achieve full employment and a long list of other desirable goals. While a humble economist should not dismiss any scenario as literally impossible, my work on "The Canada Round" has convinced me that the grass is unlikely to be greener on the other side.

ROC and Quebec are a couple hopelessly entangled by some $100 billion in bilateral trade, joint debt exceeding $450 billion, joint assets of substantial but unknown value, a common currency, and two centuries of common rules, institutions, and legislation. Disentanglement would be immensely costly and complicated for both parties. More generally, if only because of history and geography, Quebec and ROC will be sharing the same bed for many years to come, whether or not they enjoy the relationship and whether or not they are legally married.[5]

Yet there remains the nagging feeling that a durable and satisfactory marriage should be more than a marriage of convenience. It should certainly involve mutual respect and, if possible, at least an element of mutual affection. I return to this theme later in the lecture. First, however, I take up the question of fears, and in particular the idea that a move toward Quebec independence might ultimately fail, but not before it had weakened all regions of Canada and exacted a heavy toll in terms of both dollars and bitterness.

5 To say otherwise is to agree with the New Brunswicker who supposedly wanted Quebec to separate because that would knock eight hours off the driving time to Toronto.

Fears: A Solvency Crisis and a Liquidity Crisis

Whether in 1992 or at a later date, divorce proceedings could be initiated by a positive vote in a Quebec referendum on sovereignty. The referendum result might well depend mainly on the relative oratorical skills of the major players, as well as on chance media events like the "Yvette campaign" of the 1980 Quebec referendum.[6] On the other hand, there would be time for a sober second thought, since a pro-sovereignty referendum vote would almost certainly be followed by a period of negotiations prior to any bilateral or unilateral move to Quebec independence.[7] The events of that period of negotiations would provide Canadian citizens, both inside and outside Quebec, with important additional information as to the true costs and benefits of Quebec separation. This additional information would be conveyed by the state of the negotiations, and also by the response of markets and economic agents.

It is my belief that if these divorce proceedings were initiated, they would probably not be carried through to completion. Instead, there would be a reluctant, bitter, and costly reconciliation. Economic and political developments during the postreferendum period of negotiations would probably be such as to convince all parties that the true cost of separation would be substantially higher than what they had expected or what they would be willing to pay.

Major upward revisions of the expected cost of divorce would occur on both sides of the negotiating table. A sovereign Quebec could well do just fine in the long run, but, being in the eye of the storm, Quebec would face a major and probably unsurmountable *liquidity* crisis during the period of transition. On the other hand, significant sections of ROC — notably Atlantic Canada and possibly Saskatchewan and Manitoba — could face long-run decline and *insolvency* if separation occurred. The effects of this future insolvency would be felt right away, as markets

6 This refers to a well-attended meeting of "traditional women" in the Montreal Forum following a statement by a pro-sovereignty advocate implying that federalist women in Quebec were necessarily "wimps."

7 For example, the Bélanger-Campeau Commission recommended that Quebec become a sovereign state one year from the date of a pro-sovereignty vote in a referendum.

would react immediately with cancelled investment projects, lower real estate values and credit ratings, and out-migration of people and firms.

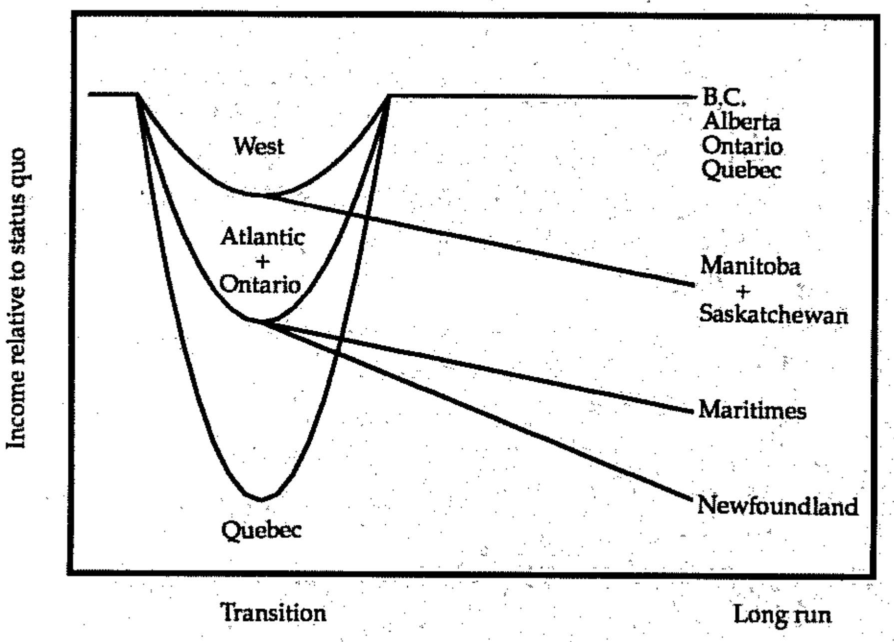
This hypothesis is portrayed in Figure 1, which illustrates the long-run effects of Quebec separation, as well as transitional costs, for the ten provinces. Transition costs are greatest for Quebec, while long-run costs are greatest for the six smaller provinces. For the four largest provinces, including Quebec, the figure suggests that the long-run economic impact of Quebec separation may be neutral.[8] Notice that there is no numerical scale on either the vertical or horizontal axis of Figure 1. A "humble economist" cannot predict either the length of the transition period or its dollar cost. This is not to imply, however, that the hypothesis is without content: the short-run and long-run costs of Quebec separation would be large enough to produce a solvency crisis for the four to six smallest provinces, as well as a liquidity crisis for Quebec.

The Setting: Legitimacy, Legal Continuity, Trade, and Debt

Before analyzing these two possible crises of solvency and liquidity, let me consider the general setting for Quebec-ROC post-referendum negotiations. Key to this setting would be the perceived legitimacy of the process, as well as questions of legal continuity, trade relations, and the federal debt.

8 There are various competing factors working in opposite directions, with the net effect impossible to predict in theory. Long-run effects would also depend on whether or not Canada's system of interregional redistribution remained intact, a topic that is discussed at some length later in this lecture. In general, long-run effects receive little attention in this lecture, except with respect to our insolvency hypothesis for the six smaller provinces. For an overview of the subject, see Economic Council of Canada, *A Joint Venture: The Economics of Constitutional Options*, Twenty-Eighth Annual Review (Ottawa: Supply and Services Canada, 1991). For an analysis suggesting that Western Canada would suffer long-run costs if Canada broke up, see E.J. Chambers and M.B. Percy, "Natural Resources and the Western Canadian Economy: Implications for Constitutional Change," in Norman Cameron et al., *From East and West: Regional Views on Reconfederation*, The Canada Round 6 (Toronto: C.D. Howe Institute, 1991), pp. 59–85.

Figure 1: ***Income Levels under Quebec Separation***
(relative to the status quo)



As José Woehrling emphasizes,[9] the perceived legitimacy of the process leading to Quebec independence would be a major factor determining both the degree of acrimony and the ultimate success or failure of the operation. Given a decisive pro-separation response to a clear referendum question, ROC, as well as "No" voters within Quebec, may accept the inevitable and act to minimize the costs of transition to Quebec sovereignty. Quebec history suggests, however, that the likelihood of a substantial majority in favor of a toughly worded pro-separation question is low. If, instead, a Quebec government were to proceed on the basis of a slim majority on a wishy-washy question, the process would lack legitimacy for many people. At least in the first instance, ROC might refuse to negotiate.

Legitimacy could also be a problem on the matter of who would speak for ROC. Since the impact of Quebec separation on the various

9 Woehrling's study was originally prepared for the Bélanger-Campeau Commission. It is summarized in Stanley H. Hartt et al., *Tangled Web: Legal Aspects of Deconfederation*, The Canada Round 15 (Toronto: C.D. Howe Institute, 1992).

provinces is likely to be extremely uneven (see Figure 1), and since the period following a pro-sovereignty vote might well be a time of marked dissension within ROC, it is far from clear that the constituents of ROC would be able to agree on who, if anyone, should negotiate with Quebec on their behalf. Also, the scale of the negotiating agenda would be enormous — perhaps equivalent to three Canada Rounds and two Canada-U.S. Free Trade Agreements (FTAs) all at the same time.[10] Since, so far as one knows, there exist no blueprints for such negotiations in Ottawa today, the negotiators, or at least the ROC delegation, would be starting from scratch.

In short, if, as seems likely, Quebec were to call for negotiations on the basis of a relatively weak mandate for separation, ROC's *will* to negotiate would be limited by a perceived lack of legitimacy in the process. Moreover, ROC's *capacity* to negotiate might be limited by internal dissension and would certainly be limited by the sheer volume of issues that would be on the table.

While people generally take the legal system for granted, in the aftermath of a vote for Quebec sovereignty there would be massive uncertainty as to the rules that would govern present and future economic relations between Quebec and ROC.[11] Nobody would know what kind of arrangements on trade and a host of other issues would or could be negotiated. Further uncertainty would result from the possibility that Quebec could move to a unilateral declaration of independence, in which case two rival legal systems would confront each other on the territory of Quebec. Each citizen and each firm would then have to decide to which "legality" to subscribe. No one would be able to predict for how long these two rival systems would be in competition or what would be the ultimate outcome. There would be further uncertainty as

10 One might argue that umbrella agreements on principle could be reached quite quickly, with details to be worked out later. It would seem, however, that it is often because of the fine print that agreements come unstuck or fail to be made.

11 Stanley Hartt, in *Tangled Web*, describes this uncertainty as follows:

> [M]assive uncertainty as to the regulatory and legal framework under which trade could be pursued would produce a reluctance to do business with Quebec. This disinclination would have its foundations not in mean-spiritedness but in an inability on the part of business people and their legal and accounting advisers to know the rules of trading and how to ensure the enforcement of claims.

to whether or not the Canada-U.S. FTA and the auto pact would require renegotiation by Quebec and/or ROC.

Under these circumstances, it seems apparent that investment projects involving Quebec-ROC trade would be cancelled, or at least postponed pending clarification of the legal environment. The financial viability and creditworthiness of ROC firms that depended heavily on the Quebec market would be in question, and a similar condition would apply to Quebec firms dependent on the ROC market. If only to reduce their exposure to these risks, ROC firms would shift from Quebec suppliers to other sources, while Quebec firms would attempt to shift away from ROC sources.

Canada-Quebec negotiations on federal debt and asset sharing would involve three basic issues: Quebec's share of the debt, Quebec's share of the assets, and the mechanism by which Quebec would assume its agreed-on share of the federal debt. While the first two issues certainly pose major problems,[12] it is the third point — the mechanism for transferring the debt — that could turn out to be the most difficult of all.

In the first place, ROC would be unable to disentangle itself from Quebec in the matter of the federal debt. To replace, say, $100 billion of Canada debt with $100 billion of Quebec debt, it is clear that Quebec would have to issue an additional $100 billion of bonds. A newly independent Quebec would be unable to do this right away. The replacement would have to take place over a period of a decade or more. In the meantime, during this decade or more of shared debt, ROC and Quebec

12 These matters are discussed at some length in Paul Boothe et al., *Closing the Books: Dividing Federal Assets and Debt If Canada Breaks Up*, The Canada Round 8 (Toronto: C.D. Howe Institute, 1992). Estimates of Quebec's share of the federal debt range from one-sixth (Bélanger-Campeau) to one-third (the "historical benefits" approach of Paul Boothe et al.). While extreme negotiating positions cannot be ruled out, sensible or feasible estimates of Quebec's share of the debt are probably (in my opinion) in the much narrower range of 23–25 percent. It would be logical to divide assets in the same proportions as debt, but here there are horrendous valuation problems. What is the value of Banff National Park or Montreal's Jacques Cartier Bridge or federal government buildings in Hull? These questions and thousands more could lead to the gainful employment of armies of accountants and economists for a decade or more. The problem, though, is that the financial markets would demand a global resolution of the issue in considerably less than a decade. One possible solution, assuming there was enough good will, would be to make a quick initial allocation of the assets, followed by detailed studies that could result in financial adjustments at a later date.

would share in capital market nervousness over the viability and creditworthiness of not one but at least two newly sovereign states. Moreover, ROC, which would probably retain full legal liability for the debt in the first instance, would naturally be concerned that Quebec might not honor its debt repayment commitments, or that Quebec could use the threat of noncompliance to gain leverage in other areas. As I argue in a moment, fears on the part of ROC that Quebec would be unable to meet its debt repayment commitments could turn out to well founded.[13]

To return to my earlier metaphor, the essential problem from a ROC point of view is that a quick and definitive divorce with Quebec on the debt issue is impossible. Whether the two partners liked it or not, their fortunes and their lifestyles would be intertwined by $450 billion of joint debt for many years to come. All of these considerations would dismay the holders of this debt. In the words of Lloyd Atkinson:

> The inevitable question on the mind of the foreign investor would be: "Do I really want to play in the traffic while Canadians sort out these matters? Would it not be better to park, temporarily at least, my investments elsewhere?"[14]

The implications for interest rates and the exchange rate are clear enough. Also, it is worth emphasizing that substantial interest premiums would not be limited to Quebec's share of the federal debt. ROC, unlike Canada, is not a known and respected entity in international capital markets; an interest premium would be required to compensate for the risk that ROC might not even exist for very long.

The Federal Transfer System at Risk

The principal mechanism pointing to insolvency in four to six provinces in the event of Quebec separation begins with an unwillingness or

13 John Chant has proposed an interesting scheme designed to protect ROC's interests on this issue. However, this plan would not shield ROC from the effects of a liquidity crisis in Quebec. The possibility of such a crisis is discussed later in this lecture. See John Chant, "Dividing the Debt: Avoiding the burden," in ibid., pp. 84–92.

14 Lloyd C. Atkinson, "A Comment," in David E.W. Laidler and William B.P. Robson, *Two Nations, One Money? Canada's Monetary System following a Quebec Secession*, The Canada Round 3 (Toronto: C.D. Howe Institute, 1991), p. 53.

inability on the part of Ontario to continue financing federal transfer payments to "have-not" provinces. A second mechanism is the fact that Atlantic Canada would be cut off from the rest of Canada, with the possibility of a double set of trade barriers. At present, the federal transfer system costs Ontarians $13.5 billion per year, or some $3,900 per household. At the other extreme, as can be seen in Figure 2, net federal transfers to Newfoundland currently amount to a staggering $17,000 per household per year. Other provinces lie between these two extremes.

Most Canadians are proud of this redistributive network, and my point is certainly not to criticize it. It does bear emphasis, however, that the amount of this redistribution is very large by world standards. While Ontario currently devotes 4.8 percent of its gross domestic product (GDP) to such transfers, Canada's aid to less-developed countries amounts to a little less than one-half of 1 percent of GDP. Meanwhile, the European Community's (EC) so-called structural funds, which are used in part to redistribute income to poorer countries, currently amount to one-quarter of 1 percent of the Community's GDP. Under the proposed post-Maastrich budget, which the Europeans seem to consider radical, this figure may rise to as much as one-half of 1 percent of GDP by 1997—or little more than one-tenth of the corresponding figure for Ontario.[15]

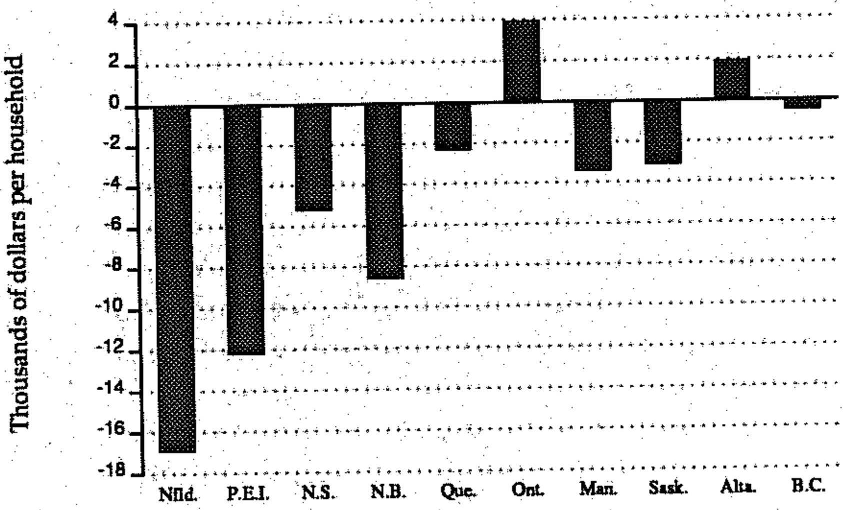
There are at least three reasons why the breakup of Canada might put this transfer system at risk. First, the following recent quote from Ontario Premier Bob Rae suggests that the system may already be in some danger:

> We shall have to *renegotiate the very financial basis of Canada,* because unless we do, we won't have the tools we need to deal with the changes in our economy...The country, economically, is not an extension of Ontario any more....We have now to determine our own future and destination in the new Canada, and we have to ensure that Ontario has the means to deal with its needs [emphasis added].[16]

15 Figures for Europe are from *The Economist*, February 8–14, 1992, p. 46.

16 This passage is taken from Thomas J. Courchene, "Globalization and the Quebec Economy: Challenges and Choices" (Speaking notes prepared for a conference entitled "Le Québec et son avenir: le défi économique," Le journal *Les affaires* en collaboration avec la *Revue Commerce*, Montreal, March 1992).

Figure 2: *The Impact of the End of Federal Redistribution, by Province, 1990*



Sources: Economic Council of Canada, *A Joint Venture: The Economics of Constitutional Options*, Twenty-Eighth Annual Review (Ottawa: Supply and Services Canada, 1991), p. 81; and Statistics Canada data on GDP and number of households, by province, 1990.

Second, the Ontario economy would be weakened further, and perhaps very substantially, during the process of transition to Quebec independence. Because of history and geography, Ontario and Quebec are natural economic partners, with more than $65 billion of bilateral trade in goods and services — or approximately $10,000 per household per year.[17] Despite the greater glamor of trade with the Pacific Rim or even the United States, basic east-west trade remains fundamental to the Canadian economy. Although the latest available statistics predate the Free Trade Agreement, it is still interesting to note that, between 1984 and 1988, Ontario-Quebec trade grew significantly faster than either province's trade with the rest of the world.[18] Announcements of the

17 In 1984, the latest available year, total Quebec-Ontario trade in goods and services amounted to $39.2 billion, consisting of $21.2 billion of Ontario exports to Quebec and $18.0 billion of Quebec exports to Ontario. Assuming that the value of this trade grew at the same rate as GDP over the 1984–92 period, estimated total Quebec-Ontario trade in 1992 is $67.2 billion.

18 As indicated in the previous footnote, the figure of $65 billion includes services as well as goods, and the latest available year is 1984. On the other hand, figures for...

death of east-west trade are at least premature. With all of this trade at risk, with the FTA and the auto pact also in some doubt, and factoring in the other transitional problems involving legal uncertainties, the sharing of the federal debt, and the response of financial markets, Ontario may feel even less able to shoulder the burden of redistribution to Atlantic Canada than is the case today.

The third reason why Quebec separation might put the federal transfer system at risk has to do with the postbreakup shape of the Canadian economic union. Since this issue is considered at greater length elsewhere,[19] I offer only a brief sketch of the main argument, with particular reference to the implications for the federal transfer system. Let me consider three possible outcomes for the postbreakup Canadian economic union.

The first possibility, sovereignty-association, has considerable appeal in terms of economic rationality, but it would be very difficult or impossible to achieve. Sovereignty-association would imply an extremely high degree of Quebec-ROC entanglement, with joint control of some of the most important levers of power by the two "senior" governments, Quebec and Ottawa. It seems extraordinarily unlikely, at least to me, that Ontario, Alberta, and British Columbia could be persuaded to accept such "junior" status relative to Quebec. Moreover, the proposal would be anathema to the "let Quebec go" school, which would discover that not only had Quebec not gone, but that Quebec was in fact operating at a higher level than before. A proposal by Vilaysoun Loungnarath for an EC-style supranational judicial body, presumably with authority exceeding that of the Supreme Court of Canada, would be particularly

Note 18 - cont'd.

...shipments of goods in 1988, as well as comparisons with 1984, were released recently by Statistics Canada (*The Daily*, April 29, 1992). For Ontario over the 1984–88 period, rates of growth of shipments to the domestic (Ontario) market, to Quebec, and to the rest of the world were, respectively, 30.6, 35.1, and 25.0 percent. For Quebec over the same period, rates of growth of shipments to the domestic (Quebec) market, to Ontario, and to the rest of the world were, respectively, 23.9, 37.8, and 30.5 percent.

19 John McCallum, "Canadian Economic Union after Breakup," *Inroads*, forthcoming, 1992.

unwelcome.[20] If Quebec and ROC cannot negotiate renewed federalism, they are unlikely to agree on sovereignty-association.

If sovereignty-association cannot be achieved, then the second option is a substantial deterioration of the existing Canadian economic union. A Quebec-ROC FTA, similar to today's Canada-U.S. FTA, would be a leading contender under this option. A major problem here is that Ontario, as Quebec's natural economic partner, would be one of the biggest losers from such an arrangement. Ontario, already suffering from cyclical and structural economic problems, may well be unable and/or unwilling to accept this further economic setback, particularly in the context of the other transitional problems that I just discussed.

This leads me to a third and admittedly rather hazy option, in which Ontario exerts its economic muscle and moves to a bilateral agreement with Quebec, probably bringing the other ROC provinces or regions along with it in the first instance. The result could be a system in which four or five sovereign or quasi-sovereign regions, including Quebec, reconfederate and delegate a limited number of powers to a central, apolitical authority. This is the Economic Council's "confederation of regions" model, and from the standpoint of Ontario the attractions of such a system are simply put.

First, it might be the only way to preserve the Canadian economic union without making the status of the Ontario government "junior" to that of the government of Quebec. Second, if, as assumed by the Economic Council, the system eliminated federal redistribution to "have-not" provinces, then Ontarians would save some $13.5 billion per year, or substantially more than the current provincial deficit. On the other hand, a confederation of regions arrangement would be so loose that its stability and continuing existence would be in doubt. Over time, parts of what is now Canada might drift off and join the United States — assuming the United States would take them in.

At present, Canadians redistribute money through the federal system using an equalization formula and other arrangements that hardly anyone understands. If Canada were to move to the confederation of regions model, any interregional redistribution would become

20 Vilaysoun Loungnarath, "A Comment on Hartt and de Mestral," in Hartt et al., *Tangled Web*, pp. 57–67.

an explicit item in the budgets of the "have" provinces. Even if regional redistribution were to remain intact in the first instance, once it becomes explicit rather than implicit, over time it could drop to levels similar to what we see in the European Community.

In short, in the aftermath of Quebec separation, a variety of forces could work to reduce Ontario's capacity and willingness to finance Canada's transfer system at today's level of generosity. Public opinion would also play an important role; if only because the evolution of public opinion in the context of Quebec separation seems virtually impossible to predict, this discussion should certainly not be seen as a forecast. Nevertheless, it seems safe to say that Quebec separation would place the federal transfer system at considerable risk.

A Solvency Crisis for Four to Six Provinces?

What would happen if transfers to the "have-not" provinces were eliminated? The effects on regional economies and on the regional distribution of Canada's population would be profound, especially if this change occurred abruptly.

On the basis of two studies in "The Canada Round," something on the order of 1 million Canadians would move out of the seven poorer provinces (see Table 1). First, Doug May and Dane Rowlands, using a government of Newfoundland econometric model, estimate that Newfoundland would lose half its population (286,000 people) and that the Maritime provinces might lose a quarter of their population (438,000 people) if they lost their federal transfer payments.[21] Second, Chris Green and I assume that the rate of out-migration of Quebec anglophones would be twice the rate that was observed during the 1976–81

21 Doug May and Dane Rowlands, "Atlantic Canada in Confederation: Uncharted Waters with Dangerous Shoals," in Cameron et al., *From East and West*, pp. 1–56. The authors estimate their numbers for Newfoundland only, and then they offer the opinion that the figures are likely to be "at least 30 percent higher" for Newfoundland than for the Maritime provinces as a whole. I have taken a more conservative approach, assuming that the Newfoundland numbers are 100 percent higher than for the Maritimes.

Table 1: *Possible Population Movements after Quebec Separation*

	Population, January 1991 (thousands)	Induced Migration (thousands)	Induced Migration as % of Population
Newfoundland	572	–286	50.0%
Other Atlantic Canada	1,754	–438	25.0
Quebec	6,812	–245	3.6
Manitoba and Saskatchewan	2,088	–104	5.0
Total	*11,226*	*–1,073*	*9.6*
Ontario	9,840	+680	6.9
Alberta and British Columbia	5,687	+393	6.9
Total	*15,527*	*+1,073*	*6.9*

Sources: Norman Cameron et al., *From East and West: Regional Views on Reconfederation*, The Canada Round 6 (Toronto: C.D. Howe Institute, 1991); and John McCallum and Chris Green, *Parting as Friends: The Economic Consequences for Quebec*, The Canada Round 5 (Toronto: C.D. Howe Institute, 1991). Also see text.

period (245,000 people, or 3.6 percent of the population of Quebec).[22] Finally, judging in part from the losses indicated in Figure 2, it is assumed quite arbitrarily that Manitoba and Saskatchewan would lose 5 percent of their population (104,000 people) if they lost their federal transfers.[23]

Adding up these numbers, we have just over a million people leaving seven provinces. If one were to assume that all of these people went to the three richest provinces — although, in fact, many might

22 John McCallum and Chris Green, *Parting as Friends: The Economic Consequences for Quebec*, The Canada Round 5 (Toronto: C.D. Howe Institute, 1991). Arguably, this is a conservative assumption, because we make no allowance for francophone out-migration despite the large increases in taxation and/or cuts in public services that would accompany the transition to Quebec independence, which I describe later in the lecture.

23 The "have-not" provinces of Saskatchewan and Manitoba are in a special situation. If it is assumed that the West joins a confederation of regions as a unified political unit, then continuing redistribution to the "poor West" will depend on the generosity of the "rich West." According to the Economic Council estimates reported in Figure 2, Saskatchewan and Manitoba would lose approximately half of the net receipts they currently receive from the federal government if the "rich West" paid the same amount to their poorer Western cousins as they now contribute to the system as a whole through the federal government.

move to the United States — that would represent about a 7 percent increase in the combined population of Ontario, British Columbia, and Alberta. This, however, would not be the end of the story.

The initial wave of out-migration, accompanied by higher taxes and/or lower public services, could launch an unraveling process leading to further waves of out-migration and a process of continuous decline. Such a process, illustrated in Figure 3, feeds on itself as higher taxes induce further out-migration, further reductions in investment and the tax base, and, hence, further rounds of higher taxes and out-migration.[24] The population movements shown in Table 1 indicate that such an unraveling process is likely to be most potent in Atlantic Canada, followed by Saskatchewan, Manitoba, and Quebec. Linguistic considerations would, however, limit the scope of this unraveling in Quebec as compared with the other provinces.

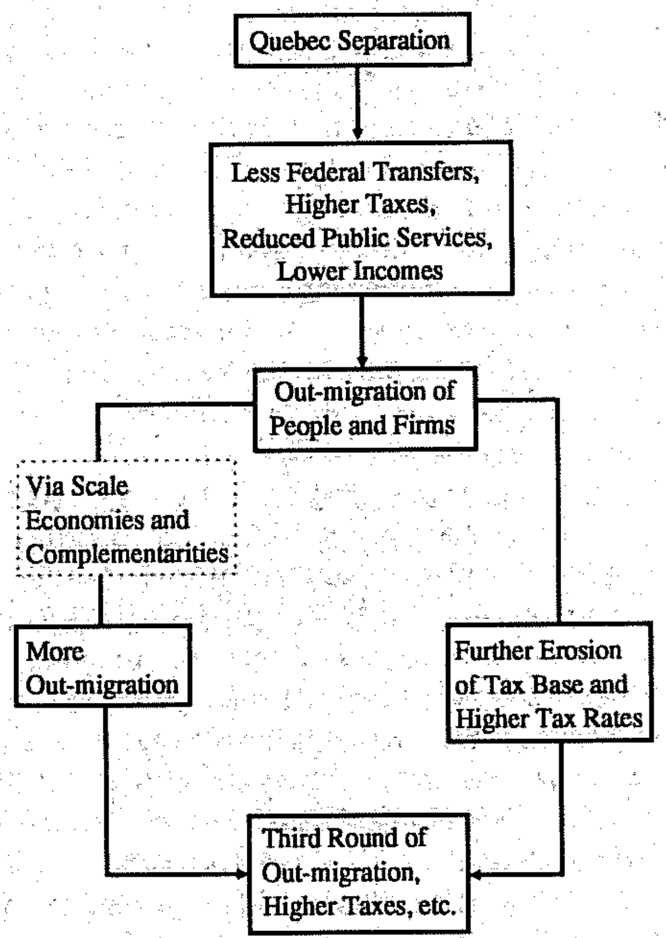
It is in the nature of markets that the effects of shifts in expected future economic conditions are catapulted back to the present through immediate changes in asset prices, interest rates, and investment decisions by firms and households. In the present context, the risk of long-run decline and insolvency would have an immediate impact on markets and economic decisions in the affected provinces. To the extent that such risks were regarded as significant or substantial, there would be immediate cancellations of investment projects, reductions in real estate values and share prices of local firms, and a reluctance on the part of banks and other financial institutions to lend money to local governments and firms. Hence, expectations of future decline would have immediate effects on the economy today, thereby causing decline to set in faster than it otherwise would.

A Liquidity Crisis for Quebec?

Transition problems relating to legal uncertainties and the federal debt would be shared between Quebec and ROC. There are, however, a

24 There is an extensive literature on the idea that relatively small shocks can have cumulative or snowballing effects. For references and further discussion, see McCallum and Green, *Parting as Friends*, as well as David M. Brown, "Efficiency, Capital Mobility, and the Economic Union," in David M. Brown, Fred Lazar, and Daniel Schwanen, *Free to Move: Strengthening the Canadian Economic Union*, The Canada Round 14 (Toronto: C.D. Howe Institute, 1992), pp. 38–98.

Figure 3: *A Possible Unraveling Process for "Have-Not" Provinces*



number of Quebec-specific issues that would make the transition period especially difficult for Quebec.

Separation or the threat of separation would bring a series of negative and regionally concentrated shocks, with a substantial cumulative effect. Because ROC would no longer be willing to subsidize Quebec's dairy farmers, that industry would lose about a third of its market for industrial milk and something on the order of 5,000 jobs. The economic base of Hull and the Outaouais region is the federal government. That entire region would be at risk. Montreal, already suffering from high rates of unemployment and poverty, would lose more head offices and population, with negative effects on construction, service industries, and employment. Montreal's clothing, textile, aerospace, and other defense-related industries would be in considerable peril. The trade risks and legal uncertainties discussed earlier would be particularly acute for Montreal and Quebec as a whole.

Aboriginal and monetary questions are potentially explosive. Territorial claims by aboriginal peoples in northern Quebec could have implications for Quebec's recognition as a sovereign state, its capacity to borrow, and conceivably even the borders of a sovereign Quebec. Although most Quebecers believe that a sovereign Quebec would continue to use the Canadian dollar, some experts believe that under certain conditions Quebec could feel forced to issue its own dollar.[25] Indeed, when Canadian business economists were asked in a recent poll whether there would be a separate currency, only 30 percent said "no."[26] Uncertainty on this currency question could induce people to move their assets out of Quebec, thereby increasing the difficulty of Quebec's transition to sovereignty.

Even if one rules out such disaster scenarios and makes optimistic assumptions, a sovereign Quebec would face a budgetary deficit on the order of $17 billion, or just over 10 percent of GDP. Moreover, as shown in Table 2, Quebec's total financial requirements would be much larger than this because of borrowings for Hydro-Québec and other agencies, and also because of the need to replace a part of the old Canada debt with Quebec debt. If Quebec agreed to replace, say, $100 billion of Canada debt with Quebec debt over a period of a decade, then $10 billion per year would be added to Quebec's financing requirement. If one also includes $9 billion of provincially guaranteed borrowing in fiscal year 1991/92, then Quebec would face a borrowing requirement of $36 billion, or 23 percent of GDP. In comparison with this $36 billion, total Quebec borrowing in 1991/92 (a record year) amounted to $12 billion. The details of all these budgetary calculations are described in an appendix.

25 Such arguments were advanced by David Laidler and William Robson and by Lloyd Atkinson in *Two Nations, One Money?*.

26 The answers to the question "Would there be a separate currency?" were: "yes" 43 percent, "no" 30 percent, and "maybe" 28 percent. The respondents were members of the Canadian Association for Business Economics, and the survey results were reported in *CABE News*, Spring 1992, p. 11. When the same question was put to members of Association des économistes Québécois, their answers were quite different: "yes" 31 percent, "no" 66 percent, and "maybe" 3 percent. My thanks to Bill Robson for bringing this survey to my attention.

Table 2: ***The Quebec Government's Financing Requirements in fiscal year 1991/2 and under Sovereignty: A Comparison***
(billions of dollars)

	Actual, fiscal year 1991/92	Under sovereignty
Quebec government deficit	3	17
As a percentage of GDP	1.9%	10.0%
Other borrowing		
Hydro-Québec & other guaranteed loans	9	9
Federal debt replacement	0	10
Total borrowing requirement	12	36
As a percentage of GDP	7.5%	23.0%

Source: Actual figures are from Quebec, *Budget 1991/92*. Sovereignty figures are explained in the text and in more detail in the appendix.

It may be useful to anticipate two misleading arguments that are sometimes advanced. First, it is not appropriate to compare this $17 billion deficit of an independent Quebec with the $11 billion deficit of Ontario today. If one calculates the deficit of an independent Ontario using the same methods as for an independent Quebec, one arrives at deficits on the order of 10 percent of GDP for Quebec and only 4 percent of GDP for Ontario. The main reason is that Ontario is a net contributor of some $14 billion to the federal system, while Quebec is a net recipient. Were Ontario to separate from Canada, admittedly an unlikely proposition, this $14 billion would show up as a positive item on the ledgers of an independent Ontario.

Second, in the context of this period of transition, it is false to argue that Quebec could undergo large expenditure cuts relatively painlessly by eliminating wasteful duplication or overlapping expenditures. As explained in the box on the opposite page, Rodrigue Tremblay's proposal to reduce expenditures would, if adopted, probably cause the loss of some 50,000 jobs, while reducing the deficit by only $1.5 billion rather than the $2.7 billion he calculates.

Two conclusions flow from these results. First, to avoid an Italian-style debt that would quickly spiral to 100 percent of GDP, Quebec

Overlapping Expenditures and Duplication: A Double-Edged Sword

In a recent study, Rodrigue Tremblay argues that a sovereign Quebec could save $2.7 billion per year by rationalizing federal and provincial expenditures and achieving efficiency gains in areas of overlapping expenditures.*

This conclusion can be criticized on two grounds. First, the numbers are essentially plucked out of the air. While there would undoubtedly be some savings of this type, there would also be some losses. On both counts, our knowledge of the magnitudes involved is essentially nil.**

Second, whether or not the eliminated programs are "wasteful," they are carried out by civil servants who would lose their jobs in the event of rationalization and restructuring. While it might be defensible to assume that all of these people would find other work in the long run, this is not a defensible assumption in the short run, particularly in the context of all the other shocks that would accompany Quebec separation. If we make the alternative and arguably much more realistic assumption that, in the short run, all of the people laid off would become unemployed — or would take the jobs of other Quebecers who would then become unemployed — then we arrive at the following estimates of the impact of Tremblay's proposal on jobs and the deficit:

A. *Impact on Jobs*	
Expenditure reduction	$2.7 billion
Wage and salary component of expenditures @ 60%	$1.6 billion
Direct job losses @ $35,000 per job	46,000 jobs
Indirect job losses @ 20% of direct job losses	9,000 jobs
Total job losses	55,000 jobs
B. *Impact on Deficit*	
Direct or gross impact on deficit	$2.7 billion
Minus: Additional unemployment insurance paid at $15,000 per job lost	–$0.8 billion
Minus: Loss in tax revenue at $7,000 per job lost	–$0.4 billion
Equals: Net impact on deficit	$1.5 billion

The conclusion, then, is that whether or not the eliminated expenditures were wasteful, the result would be a loss of jobs on the order of 50,000. Moreover, since it is Quebec that would now pay the full cost of unemployment insurance and bear the full brunt of lower tax revenue, the *net* impact on the deficit ($1.5 billion) would be substantially less than the *gross* impact ($2.7 billion).

* Rodrigue Tremblay, "L'impact fiscal statique et dynamique de l'accession du Québec au statut de pays souverain," Cahier 9207 (Département de sciences économiques, Université de Montréal, February 1992).

** For example, the one study Tremblay cites is also cited by the Economic Council of Canada, which draws the following conclusion (*A Joint Venture*, p. 73):

> [S]tudies are able to identify considerable overlapping of responsibilities between the two levels of government but cannot identify the true extent of wasteful duplication of services or assess the costs associated with the alleged ineffectiveness or incoherence of policies....As a result, we are left with anecdotal examples that infuriate the clients or taxpayers who are aware of them, but with no overall assessment of the extent of the problem.

would have to adopt a fiscal austerity plan of unprecedented severity. As described in the appendix, this plan would require cuts on the order of 15 percent in government expenditures, as well as similar increases in all major tax rates. Such a plan, coming on top of all of the other major problems I have discussed, would add very substantially to unemployment. Second, even after this unprecedented austerity, the government's financial requirement would still be well over $25 billion, or 15 percent of GDP. While there are various ways in which this borrowing could be reduced (again, see the appendix), it is still far from clear that Quebec would be able to finance the amount required.

Marcel Côté has argued that financial requirements of this magnitude would be a brick wall for Quebec.[27] The money could not be raised; Quebec's liquidity crisis would be binding. The province would have to crawl back to the negotiating table to seek reconciliation with the rest of Canada. As a result, Quebec would be weakened for years to come. Far better, then, not to travel down this road in the first place.

Although I agree with the essence of this argument, I think it should be qualified in two ways (Côté would not necessarily disagree with these qualifications). First of all, it is not just Quebec that would be seeking reconciliation. All of ROC would be hit hard in various ways, while four to six provinces could face possible insolvency. In other words, the process would weaken all regions of Canada, not just Quebec.[28] Second, one should not lose the perspective of the larger world context. Even in the middle of a very tough austerity program, Quebecers would still have one of the highest standards of living in the world. And even though the burden of the transition would be distributed very unequally, there is no physical or objective reason why Quebec as a whole could not go through a difficult austerity period on the road to independence. In other words, Côté's brick wall is only a brick wall because, taken as a whole, Quebecers are willing to pay only a very modest price in order to achieve independence.

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27 Marcel Côté, "Souveraineté: Les coûts de transition" (Notes for a conference Projet 90, Module Administration, Université du Québec à Montréal, March 24, 1992).

28 One might ask which parts of Canada would be the most or the least weakened by this process. I would not venture a guess on such a question, but if all parts are weakened, then from everyone's point of view, it is best not to proceed.

The reason for this fact is obvious. If Canada were the "evil empire" that was once the Soviet Union, or if French-English relations were comparable to the situation in Croatia or Ireland, then a large majority of Quebecers would probably be happy to pay the required price. Self-evidently, this is not the case. Indeed, it is only by proposing "soft questions" and denying the existence of *any* transition costs on the road to independence that the Parti Québécois hopes to convince Quebecers to vote for sovereignty. An example of this last point is a recent PQ advertisement depicting a modest house with a carport under a Canadian flag, alongside a much larger house with a two-car garage under a Quebec flag. At a minimum, the advertisement should have included a truth-in-advertising notice stating that Quebecers would undergo significant discomfort along the road to this larger dwelling. Needless to say, no such notice appeared.

There are, finally, two points that link our crises of liquidity and solvency. First, some Newfoundlanders and some Quebecers might be tempted to dismiss this analysis as "scare tactics" or even "economic terrorism." Let it be said, therefore, that the results for Newfoundland are based on the analysis of Newfoundland economists using a government of Newfoundland econometric model, while the Quebec deficit estimates are based mainly on estimates by Pierre Fortin, updated to the present day.

The second point in common is that some of the major shocks to both Quebec and Atlantic Canada are things that might happen anyway. For example, there are signs that federal transfers to "have-not" provinces might decline gradually over coming decades, while pressures from the General Agreement on Tariffs and Trade and the FTA may lead to a gradual phasing out of dairy industry quotas and protection for Quebec's clothing and textile industries. My general answer in both of these cases is the same: While a modern economy can usually absorb shocks that occur gradually over a period of many years, this is not the case when shocks are abrupt, major, and all in the same direction and at the same time.

Public Opinion: A Wild Card

How would public opinion respond to all these developments? Many Canadians, both inside and outside Quebec, who had earlier been persuaded that the breakup operation would be relatively simple and painless would suddenly discover that this was not so. Reaction would then certainly include shock, anger, and fear. But who or what would be the principal focus of this public anger? Quebecers might focus their anger mainly on "English Canada," the governor of the Bank of Canada, and world capital markets, but they might also blame their own government for leading them into this situation. Ontarians might blame mainly Quebec, but they could also blame the federal government or even their own government for failing to hold the country together, or they might assign a good part of the blame to "hardline" provinces such as Alberta, Manitoba, and Newfoundland.

History suggests that periods of extreme economic insecurity provide fertile ground for extremists. Public opinion in both Quebec and ROC could be influenced by emerging demagogues who would capitalize on the fears and insecurity of their constituents and play to the baser instincts of their societies. It should be emphasized that this is not a reference to respected political leaders such as Preston Manning and Jacques Parizeau, even though some people regard their policies as extreme. Rather, the statement applies to low-life types who are unable to achieve political respectability in normal times: ROC extremists of the kind that Mr. Manning wishes to exclude from his party, as well as corresponding Quebec extremists who are buried in the deepest, hardest core of the nationalist movement.

No one, it seems, and certainly not an economist, has the professional competence or the wisdom to predict with any confidence how all these forces would play themselves out. For what it is worth, though, I offer the opinion that Canada's tradition of peaceful negotiation and compromise would be strong enough to withstand considerable pressure. This tradition, in combination with intense economic pressures from all or almost all provinces, would, I think, convince the major parties to reconcile their differences and return to some form of renewed federalism. Hence, it is likely that a move toward Quebec independence would ultimately fail — but not before it had weakened all regions of Canada, extracted a high cost in dollars and jobs, and left a long legacy of bitterness and national disunity. Better, then, to avoid divorce proceedings altogether and work to improve the marriage. I turn now to that happier, more positive topic.

Hopes: True Federalism

The great majority of Canadians share certain basic values. Our history contains a number of black marks, some of which are still with us. Still, by the standards of the world, Canada is a caring society. Canadians are proud of that, and want to preserve and promote their health-care system and other social programs that are a reflection of Canadian values. Canadians want to create the conditions that will allow these social programs to flourish and grow. On this — but possibly not a great deal more — I think almost all of us can agree.

One major problem is that, as John Richards notes, Canadians have exhibited a "quite reasonable demand for a European-style welfare state combined with a quite unreasonable refusal to pay for it."[29] Canadians, it seems, are at or near their willingness to pay taxes, yet there are still large federal and provincial deficits. Moreover, at the same time as the education system needs improving, Canada's aging population will be making ever-increasing demands on the health-care system, the most expensive and probably the most cherished social program. In the light of these undeniable realities, how are we to maintain these social programs, let alone enrich and expand them into new areas like child care? Let me emphasize that this is not an ideological question reflecting some kind of corporate agenda. Probably no six Canadians are more concerned with these issues than the NDP ministers of health and education in Ontario, Saskatchewan, and British Columbia.

The general answer to this question is, I think, twofold, and maybe even uncontroversial. First of all, somehow or other, we have to harness the creativity of Canadians to find out how to do more with less — but without sacrificing basic values, objectives, and principles. In the 1990s, this has become a requirement for just about every government, company, and institution, certainly including my own. Second, partly in order to create more resources for social programs, we have to create an environment that will promote better economic performance in this country.

29 John Richards, "Suggestions on Getting the Constitutional Division of Powers Right," in Jean-Michel Cousineau, Claude E. Forget, and John Richards, *Delivering the Goods: The Federal-Provincial Division of Spending Powers*, The Canada Round 12 (Toronto: C.D. Howe Institute, 1992), p. 26.

Where opinions begin to diverge is in the implementation. I will try to persuade you that, to achieve these objectives, we should return to the federalism of the *British North America Act*. Let those provinces that wish to exercise their powers within their areas of jurisdiction do so. Next, let the risk of balkanization or fragmentation that might otherwise arise from this scheme be countered by a strengthening of the economic union and by the development of a modest social charter. And, finally, let these two unifying pillars — the economic charter and the social charter — evolve through a bottom-up process rather than through edicts from Ottawa. I will argue not only that a plan along these lines offers the best hope for sustaining and enhancing Canada's economic and social union, but also, as an extra dividend, that it offers the best hope for preserving "the political union that provides the heart and soul for all the rest."[30]

Let me also say that I am not advocating "strong form" asymmetrical federalism, meaning a prohibition on nine provinces to do what only Quebec would be allowed to do. As a Quebecer, such a system would not bother me, but as one who lived for eight years in Manitoba and British Columbia, I am convinced that such a scheme would never fly in the West — notwithstanding any artificial "Halifax consensus" to the contrary.[31]

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30 To quote John Helliwell, the conference rapporteur for the "Renewal of Canada: Economic Union" constitutional conference, which took place in Montreal, January 31–February 2, 1992. In making this argument, I draw very heavily on Richards, "Suggestions on Getting the Constitutional Division of Powers Right"; idem, "A Social Charter: Two Cheers but Not Three," in Havi Echenberg et al., *A Social Charter for Canada? Perspectives on the Constitutional Entrenchment of Social Rights*, The Canada Round 9 (Toronto: C.D. Howe Institute, 1992), pp. 64–87; idem, "The Case for Provincial Jurisdiction over Language," in Richards et al., *Survival*, pp. 9–56; Daniel Schwanen, "Open Exchange: Freeing the Trade of Goods and Services within the Canadian Economic Union," in Brown, Lazar, and Schwanen, *Free to Move*, pp. 1–37; and Brown, "Efficiency, Capital Mobility, and the Economic Union." I do not mean to imply, however, that these authors necessarily agree with me.

31 This is a reference to the federal government's "Division of Powers" conference that was held in Halifax on January 17–19, 1992. While some conference participants and media reports spoke of a consensus for "strong form" asymmetry, the following passage from the Executive Summary of the Halifax conference (p. 21) is consistent with the point of view expressed in the text:

> [T]here was a strong view that asymmetry in the take-up and administration of federal and provincial powers by Quebec and, *where desired*, for the other provinces and territories was not a problem [emphasis added]. (Note continues.)

On the other hand, the proposal certainly involves "weak form" asymmetrical federalism in the sense that not all provinces would choose to exercise the same powers. If that is what asymmetrical federalism means, then Canadians have been living under it for decades.

A Case for Federalism

Federalism, I think, is the best system for Canada. Federalism respects and values diversity. It works best when citizens in every province have genuinely dual loyalties, to their country and to their province or region.[32] Federalism also works best when citizens, in the words of the famous Victorian legal scholar Albert Dicey, desire union but not unity. In Dicey's context, unity can perhaps be equated with homogeneity or the absence of diversity. On the other hand, federalism is never easy or simple. To quote John Richards:

> If, as Montesquieu states, democracy is the most demanding form of government in terms of the responsibility placed on citizens and politicians, then federalism is the most demanding form of democracy.[33]

It is by turning away from federalism, this messiest and most difficult brand of democracy, that Canada could come unstuck. The greatest danger is that well-meaning Canadians, in the name of national

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Note 31 - cont'd.

The passage leaves one key question unanswered: Desired by whom? Another scheme is to balance "strong form" asymmetry against a weaker representation for Quebec in the House of Commons. This, I think, is a recipe for gradual secession, with effects not too different from those described earlier in this lecture.

32 Citizens in every province seem to exhibit this dual loyalty, albeit to different degrees. For example, a 1990 poll asked: "Do you feel you are more a citizen of Canada or more a citizen of this province?" In no province did more than one-third of the population assign greater attachment to either the country or the province. This in itself is strong evidence in favor of dual loyalties. The two extremes were Ontario, with only 38 percent of the population identifying primarily with their province, and Quebec, with only 33 percent of the population identifying primarily with Canada. Citizens of other provinces fell somewhere between these two extremes. (Richards, "Suggestions on Getting the Constitutional Division of Powers Right," p. 6).

33 Ibid., p. 7.

unity and an unhyphenated Canadianism, will seek to homogenize us all and substitute a single loyalty for the dual loyalty that is cherished by so many Canadians, both inside and outside Quebec. It is this tendency that we must resist because it is this that could destroy Canada.

We must also resist the temptation to compare the realities of Canada today with imaginary and utopian greener pastures characterized by the absence of conflict of any kind. Federalism comes to countries with an inherent potential for internal conflict. Federalism does not itself create the conflict, and neither would the removal of federalism remove the sources of the conflict.

Let me now return to my own trade and advance the thesis that we are also most likely to deliver the goods by returning to federalism and allowing provinces to exercise their powers in their areas of jurisdiction. Here, I will advance a three-pronged argument. First, Canadian history suggests that provincial powers have served us quite well. Second, it is only by insisting on provincial accountability in the delivery of social services that we will create the appropriate incentives for imaginative reform and enhanced value for the taxpayer's dollar. Third, on the subject of new national programs, we should admit that no one has a monopoly of wisdom on what is necessarily best for all of Canada. We should, therefore, encourage an evolutionary process of experimentation in which, through a process of trial and error, the most effective policies will ultimately prevail.

As a matter of theory, provincial powers on social policy could lead us in either direction. On the one hand, there could be a rush to the bottom, as provinces compete for industry by offering the lowest taxes and the worst social services. On the other hand, interprovincial competition could result in emulation of the most successful province by the rest of the country. While theory cannot guide us on this point, Canadian history suggests that the second of these mechanisms has predominated.

A neutral observer in the 1930s would probably have concluded that the United States was more likely than Canada to generate a European-style welfare state. The United States was more unionized than Canada, and the New Deal had created more generous social programs than existed in Canada. Yet the conclusion would obviously have been wrong. A good explanation, I think, has been advanced by Allan Blakeney:

> There is no fundamental reason for Canadians to be further to the left politically than Americans, yet we Canadians have undeniably undertaken more significant political experiments than the Americans. Why? The key to an explanation is that Canadian federalism has preserved enough powers at the provincial level for provinces to serve as social laboratories, whereas American federalism has so reduced states' rights that significant political experiments can only emanate from Washington....Had a Farmer-Labor government in Minnesota had the power to introduce a statewide medical care insurance program, then, after a decade or so, I suspect citizens elsewhere in the U.S. would have insisted on a national equivalent.[34]

The second strand of the argument has to do with accountability, and on this point I can do no better than to quote Richards:

> The division of powers within a federation can be compared to the creation of private property rights within a market. Industrial economies cannot approach their productive potential without the accountability and the reward to individual innovation that the institution of private property encourages. Analogously, a reasonably precise division of powers allows politicians to internalize the costs and benefits of policy innovations and management decisions and allows citizens to hold their politicians accountable for the results.[35]

I think this argument is dead on, but since it is couched in the jargon of economists, let me give you a concrete example from my own life, based on the wealth of experience that comes from 25 days on the job as Dean of the Faculty of Arts at McGill.

As matters now stand, I get a certain budget for the Faculty of Arts and am free to spend it more or less as I choose. I am accountable, however, since, after one to three years, I will be required to explain how or whether these expenditures have promoted the cause of excellent teaching and research at McGill. Since I naturally want to do a good job and get a big increase in my Faculty's budget — or possibly, depending on the overall situation, a small cut — I will do both the pleasant work and the unpleasant work that is necessary to get good value per dollar.

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34 Allan Blakeney, "Decentralization: A Qualified Defence," in J. Richards and D. Kerr, eds., *Canada, What's Left?* (Edmonton: Newest Press, 1986), p. 148 [Cited in ibid., pp. 18–19].

35 Richards, "Suggestions on Getting the Constitutional Division of Powers Right," p. 5.

Suppose, on the other hand, that a busybody Principal or Vice-Principal were to send me detailed instructions on how to run the Faculty of Arts — or, even worse, suppose they sent such instructions to the heads of the various departments within the Faculty. Who, in such circumstances, would be responsible for achieving excellence in the Faculty? Who would be willing to do the work that was necessary to achieve those ends? Answer: Nobody. Responsibility would become so diffuse that no one would be responsible. While I should hasten to point out that McGill is a pretty smart institution and I have neither received nor expect to receive any such instructions, nevertheless I think this example illustrates the principle of accountability as applied to provincial governments. Excessive intervention by the federal government or the courts reduces the accountability of the major actor, which is the provincial government.

This is certainly not to deny any role for the courts or the federal government. In particular, successful provincial management requires predictability in federal transfers. Ottawa and the provinces should, I think, enter into long-term agreements that are not unilaterally amendable. Moreover, the federal government plays an important role in social policy through the income tax system and the Canada Pension Plan. Nevertheless, primarily for reasons of accountability, I would argue in favor of greater autonomy in social policy for those provinces that wanted it — along with appropriate compensation.

Having dealt with history and accountability, I come now to the third and final strand in my argument for traditional federalism. This is an argument that returns to the earlier theme of humility, but in the context of new national programs. The basic idea is that no one has a monopoly of wisdom and we are likely to be much better off if we allow processes of experimentation to take place. Suppose the Liberals or the NDP win the next federal election and introduce a new shared-cost national day-care program. As an example, suppose the objective of this program is to increase government-subsidized day-care facilities by 30 percent across the country. Under a strict interpretation of the Beaudoin-Dobbie proposal, a province wishing to opt out of this program with compensation would have to introduce its own program designed to achieve the same 30 percent increase in government-subsidized day-care facilities.

Suppose Alberta opposed this interventionist approach and preferred instead to offer tax credits to working parents. Parents would then be free to make their own day-care choices for their children. Or maybe Alberta would prefer to direct these same dollars to children in poverty — via tax credits to low-income families — rather than to day care. Alberta, under the Beaudoin-Dobbie proposal, would not be allowed to exercise these judgments, even though child care comes under provincial jurisdiction.

One can also tell this story the other way around. The federal government might introduce a national program offering subsidies to both profit and nonprofit day-care centers. "Socialist" Ontario, which would prefer to give subsidies only to nonprofit organizations, could be forced to adopt this "conservative" system or lose the federal dollars.

In my opinion, such strict rules make no sense. Provincial governments are closer to their citizens than is the federal government. Moreover, since no one knows for sure which system will work best, why not allow provinces to experiment with different approaches? Over time, as experience builds up, the country would tend to gravitate toward the system that worked best. In the meantime, interprovincial policy differences in policies affecting children would be a reflection of the diversity of Canada, not a sign that the country was falling apart. The contrary vision, that all provinces must meet federally imposed objectives, reflects an "Ottawa knows best" syndrome. I doubt that Robert Bourassa is the only Canadian to feel uncomfortable with this "domineering federalism."

In concluding this section, the argument I have presented for provincial rights in the area of social policy rests on three points: the relative success of this policy over the past 50 years of Canadian history, the importance of the accountability of provincial politicians, and the gains Canadians as a whole are likely to derive from a process of provincial experimentation in the area of new national programs.

The Economic and Social Union

The greatest risk in this provincial "free-for-all" that I have just described is that Canada could become fragmented and balkanized. The answer, I think, is to create economic and social charters that would serve as unifying pillars. Since I agree with John Richards on the social charter and Daniel Schwanen on the economic charter, I will provide only a brief summary of their proposals.

Richards proposes a modest social charter that expands on Part III (Equalization and Regional Disparities) of the *Constitution Act*, 1982. His proposal involves government commitments to pursue sound environmental policies and to support the retraining and mobility of workers who are adversely affected by market conditions or by measures to strengthen the economic union. In addition, he proposes a monitoring role for a reformed Senate, which would report annually to Parliament and provincial legislatures on the quality of essential public services and environmental policies. Hence, the proposal balances a strengthened economic union with a commitment to retrain those who are thereby harmed. On the other hand, Richards stops short of specifying the content of social programs because to do so "would inevitably have unintended consequences, confound means and ends, and retard beneficial intergovernmental competition."[36]

On the economic union, Schwanen begins by distinguishing among three kinds of barriers to trade. Type I barriers involve outright discrimination — for example, government procurement policy favoring local firms; type II barriers involve regulatory measures that indirectly impede mobility — for example, packaging rules that vary across provinces; and type III barriers involve policies that attract resources to one province at the expense of other provinces — for example, provincial subsidies to new investment. The removal of type I barriers typically involves measures to forbid discrimination, while the reduction of types II and III barriers requires measures to harmonize or coordinate economic policies.

Schwanen contrasts the "top-down" approach found in the United States and Germany, where the federal government frequently overrides state policies, with the "bottom-up" approach of Australia and the European Community, where actions are based on intergovernmental agreement. While Canada's approach should clearly be of the "bottom-up" variety, past efforts have not been very successful, and Schwanen recommends a new approach along the following lines:

36 Richards, "A Social Charter for Canada," p. 84.

Subject to limited and well-defined exceptions, all governments should be barred from erecting type I discriminatory barriers by a strengthened section 121 of the Constitution. Next, type II barriers should be addressed in two steps. First, a package of objectives should be adopted *unanimously* by the federal government and the provinces. Second, individual measures flowing from this package would be developed by teams of experts and adopted by a qualified majority of the governments. There would be no opting out. Finally, while some subsidies, or type III barriers, may be justified, governments should develop a code of conduct on this subject.

Challenges

I referred earlier to Canada as a caring society, and I conclude this talk by considering two challenges that will put this quality to the test in the years and decades to come. The first of these challenges has to do with the fate of Atlantic Canada; the second is the question of whether Quebec will remain a part of Canada in the long run. By expressing these matters as "challenges" for the future, one avoids the responsibility to provide any definite answers. This is just as well, since I have no definite answers, only a few sketchy thoughts. As we say in academia, these are likely to be matters for "future research" for many years to come.

Atlantic Canada

A major theme of this lecture has been that Quebec separation could lead to an abrupt curtailment of the federal programs that redistribute income to poorer provinces. The consequence, I have argued, would be large-scale depopulation, with Newfoundland, as the extreme case, losing half its population. *Whether or not Quebec separates*, however, these results clearly imply that the population of Newfoundland is approximately twice what might be called its "natural" or "equilibrium" level — that is, twice the level that it would be in the absence of net cash injections by the federal government. Qualitatively similar conclusions apply to the Maritime provinces but to a significantly lesser degree. And, as we saw in the quote from Premier Rae, there are signs that interregional redistribution on the current scale is under strain. Newfoundland

Premier Clyde Wells gave one response to this situation about a year ago. Noting that over the past 35 years Newfoundlanders' income had gone from 53 percent to 58 percent of the national average, Mr. Wells commented: "Obviously, it's not working. At that rate it would take us 300 years to catch up."[37]

True enough, but what is the message? If only such meager progress has been made despite the average Newfoundland household's being subsidized to the tune of $17,000 per year, does this mean that the subsidy should be increased to $30,000 or $50,000 per year? Or does it mean that the whole system has been a failure and some other policy should be tried? Is it true, as some would argue, that the younger generations of Newfoundlanders are not in fact helped by a system that creates and perpetuates a massive state of dependency?

I do not feel qualified to answer these questions, but in coming years the issue is likely to test the ingenuity of Canadian policymakers, as well as Canada's self-image as a caring society. As Doug May and Dane Rowlands express the point: "The way Canada accommodates the aspirations of the Atlantic provinces will largely define how Canadians write the social contract among income classes as well."[38] If Canada stays united, then it may be possible to bring about a gradual move to greater self-reliance, accompanied by generous transitional measures, in a planned and humane fashion. If Canada breaks apart, then change is much more likely to be abrupt and unplanned, with negative implications for the well-being of many thousands of Canadians, particularly in the Atlantic provinces.

Quebec and Canada in the Long Run

In conversations on the Constitution with fellow Canadians from outside Quebec, the comment I hear most often can be expressed as follows:

> All right, let's assume we muddle through on the Constitution this time around. But will it ever end? Won't we have to go through the same process all over again if the Parti Québécois comes to power? So why go through all these negotiations when Quebec is bound to

37 Quoted in *The Gazette* (Montreal), May 22, 1992, p. B3.

38 May and Rowlands, "Atlantic Canada in Confederation," p. 50.

> separate in the end? Why not get it over and done with right away and move to a quick divorce?

It is easier to ask this question than to answer it — but I will try. There are perhaps three answers at a relatively superficial level.

- First of all, the Parti Québécois does not operate in a political vacuum. It can only move toward independence if there is a substantial body of public opinion behind that venture. For example, at a time when support for separation was weak, the PQ government of Pierre Marc Johnson shelved the independence option indefinitely and ran on a platform of good government. Given the state of public opinion, this was the PQ's only option, other than political oblivion. This state of affairs could reinstate itself if we come to a constitutional agreement in 1992. Whether or not Quebec public opinion would in fact respond in this pro-federalist fashion is a question I take up in a moment, but it is certainly clear that Quebecers are as tired of constitutional talk as are other Canadians.
- Second, a central theme of this lecture has been that there is no such thing as a simple divorce, at least not when the couple is so hopelessly entangled as are Quebec and ROC. So even if only a quarter of my argument is correct, a major practical reason for avoiding divorce is that it would be very costly for all concerned.
- Third, while federalism is inherently messy, it comes to countries with an inherent potential for internal conflict. Federalism does not itself create the conflict. Neither would its removal remove the sources of that conflict. Canada is an inherently fractious country. Every region feels aggrieved and hard done by. At least to a degree, we just have to accept that we are probably destined to go on quarreling forever. But the grass is unlikely to be greener on the other side. The potential for conflict, both *between* a sovereign Quebec and a sovereign ROC and *within* a sovereign ROC, is at least as great as the conflict within Canada today.

Although these are all fairly good points, if I say so myself, they do not get to the root of the issue from a longer-run perspective. From that perspective, it is useful to begin by quoting Marcel Côté, an astute observer of the Quebec scene:

> Some say Québécois are inconsistent because polls have shown fluctuating proportions who favor outright independence, sovereignty-association, or some form of federalism. But that is not so. We have been remarkably consistent over the past decade. A quarter of us have supported Trudeau's concept of a centralized federation; a quarter have supported outright independence. The half in the middle have wanted to remain Canadians provided Quebec remains French. For this group, what has fluctuated is primarily faith in the willingness of Canadians outside Quebec to accept the legitimacy of our acting to preserve our language and culture.[39]

Related to this statement, two long-run facts augur well for the future of Canada. First, as documented so comprehensively by François Vaillancourt,[40] certainly no sycophant as far as Quebec anglophones are concerned, Quebec francophones are truly "maîtres chez eux." The French language in Quebec has never been stronger than it is today. Although there is always a long and variable lag between reality and public perceptions on such issues, Quebec francophones have reason to feel more secure than ever before on linguistic and cultural matters.

The second and related point is that, as time goes by, there will be a declining fraction of Quebec francophones who remember the days when they felt they were under the yoke of anglophone bosses. Indeed, the speed of the catchup of Quebec francophones in terms of relative income levels over the short period from the early 1960s to the mid-1970s is really quite miraculous and perhaps unprecedented in comparison with other disadvantaged groups.[41]

39 Quoted by Richards, "The Case for an Explicit Division of Powers over Language, pp. 11–12.

40 François Vaillancourt, "English and Anglophones in Quebec: An Economic Perspective," in Richards et al., *Survival*, pp. 63–94.

41 In 1961, the average anglophone living in Montreal earned 51 percent more than the average francophone. By 1980, this gap had declined to 9 percent, or to zero if one corrects for differences in education and other personal characteristics. See Jac-André Boulet and Laval Lavallée, "L'évolution des disparités linguistiques de revenus de travail au Canada de 1970 à 1980," Document no. 245 (Ottawa: Economic Council of Canada, 1983); Jac-André Boulet and André Raynauld, "L'analyse des disparités de revenus suivant l'origine ethnique et la langue sur le marché montréalais en 1961," Document no. 83 (Ottawa: Economic Council of Canada, 1977); and Robert Lacroix and François Vaillancourt, *Les revenus et la langue au Québec (1970–1978)*, Dossiers du Conseil de la Langue Française 8 (Quebec, 1981).

What this means, I think, is that we have at least moved from what many Quebecers once saw as a repressive and unequal marriage to a marriage of convenience. The greatest challenge, though, is to move from a marriage of convenience to one of mutual respect — one that recognizes, among other things, the essential place of Quebec in both historical and contemporary Canada. In part, I have argued, this might be accomplished by a return to true federalism and a respect for diversity. If each of Canada's diverse and distinct regions has the space to do a good number of things in its own way, then each will reserve a substantial fraction of its dual loyalty for the country as a whole.

In part, though, the problem is also one of communication, and in recent years Canadians' communication skills have come close to an all-time low. If one asks what is the most vivid image of ROC in the minds of Quebecers, one thinks of Eric Lindros and a group of aging Ontarians trampling on the Quebec flag. To ask what the image of Quebec conjures up in the minds of English-speaking Canadians is to think of language laws that ban outdoor English signs or, perhaps, the CF-18 contract that was awarded to Montreal instead of Winnipeg. These are hardly the images of a healthy marriage.

It seems to me that the constitutional talks of the past five years have put us on a kind of conveyor belt that no one controls. This has led to reactions and counterreactions of the kind I have just described. As long as we can come to a constitutional agreement this summer, I think there is a good chance that Canadians will at last step off that conveyor belt. At that point, the realities of the strength of French in Quebec today, as well as the powerful forces of tolerance and good sense that exist in my province, will come into play. This is likely to lead to a relaxation of Quebec's language laws, a move that would send a very positive message to English-speaking Canadians. Moreover, if progress could be made on a Schwanen-type proposal for a low-key, bottom-up process of interprovincial cooperation to strengthen the economic union, then the Canadian federal system would be seen to be working to achieve tangible results. This too would send a positive message to Canadians both inside and outside Quebec.

In any case, let us hope that these positive developments will come about. Many parts of the world look to Canada as an example of tolerance and reconciliation among competing ethnic groups, and are envious of Canadian-style federalism. If we succeed in bridging our differences, which are really quite small by global standards, Canada could be a beacon and a model for aspiring federal states around the world. It is not for nothing that the United Nations concluded recently that Canada was the best country in the world. If, on the other hand, we fail to come to an agreement, it would be a tragedy for ourselves, our children and grandchildren, and other countries that look to us for inspiration.

Appendix: The Quebec Budget under Sovereignty

Contrary to the charge that economists never agree, Table A-1 suggests a certain convergence in terms of estimates of the budgetary position of a sovereign Quebec. Four of the six estimates shown — Fortin, McCallum, the Economic Council of Canada, and Côté — are in the $13–$16 billion range. The two outliers are Bélanger-Campeau at $10 billion and Grady at $22 billion. While the Bélanger-Campeau Secretariat

Table A-1: ***Estimates of Quebec's Budget Deficit in Year 1 of Independence***
(hypothetical estimates using fiscal year 1990/91 as the base year)

Bélanger-Campeau	$10 billion
Fortin	$13 billion
McCallum	$15 billion
Economic Council of Canada	$15 billion
Côté	$16 billion
Grady	$22 billion

Sources: Four of the estimates (all but "Economic Council" and "Côté") were taken directly from Pierre Fortin, "L'impact du passage à la souveraineté sur le déficit budgétaire du Québec" (Paper presented at a conference sponsored by *Les Affaires*, Montreal, March 23, 1992). Fortin made certain adjustments to the original estimates in order to make them comparable.

The "Economic Council" estimate is from Economic Council of Canada, *A Joint Venture: The Economics of Constitutional Options*, Twenty-Eighth Annual Review (Ottawa: Supply and Services Canada, 1991), p. 81. The figure of $15 billion is based on the Council's estimate of the impact of sovereignty on the Quebec budget, in combination with Fortin's estimate of the consolidated deficit under federalism ($9.8 billion).

The "Côté" estimate is from Marcel Côté, "Souveraineté: le coûts de transition" (Notes for the Conference, "Projet '90," Université du Québec à Montréal, March 1992, Mimeographed).

Other original sources are as follows: Secrétariat de la Commission sur l'avenir politique et constitutionnel du Québec [Bélanger-Campeau Commission], "Analyse pro forma des finances publiques dans l'hypothèse de la souveraineté du Québec," in Bélanger-Campeau Commission, *Eléments d'analyse économique pertinents à la révision du statut politique et constitutionnel du Québec* [Background papers], vol. 1 (Quebec, 1991); John McCallum and Chris Green, *Parting as Friends: The Economic Consequences for Quebec*, The Canada Round 5 (Toronto: C.D. Howe Institute, 1991); John McCallum, Remarks to Commission sur le processus de détermination de l'avenir politique et constitutionnel du Québec, Assemblée nationale, Quebec, December 4, 1991, Table 1; and Patrick Grady, *The Economic Consequences of Quebec Sovereignty* (Vancouver: Fraser Institute, 1991).

Table A-2: *Quebec's Deficit under Sovereignty: An Update of the fiscal year 1990/91 Estimates*

1. Fortin deficit estimate, 1990/91	$13.0 billion
2. Increase in provincial deficit (from $2.8 billion in 1990/91 to $3.9 billion in 1992/93)	+$1.1 billion
3. Impact of recession on federal deficit for 1992/93 ($9.9 billion); Quebec's share at 23.4%	+$2.3 billion
4. Lower-than-expected interest rate on federal debt ($3.8 billion); Quebec's share at 23.4%	–$0.9 billion
5. Higher federal net debt since March 1990 (March 1990 = $358.0 billion, September 1992 = $433.6 billion; Increase = $75.6 billion); Quebec's share of additional interest payments at 8% interest rate is .234 x .08 x 75.6	+ $1.4 billion
6. Estimated deficit of a sovereign Quebec, fiscal year 1992/93	*$16.9 billion (10% of GDP)*

Sources: Line 1 is from Table A-1; line 2 is from Quebec, *Budget*, 1992; lines 3 to 5 are from Canada, *Budget Papers*, February 25, 1992, pp. 71, 111. Estimated September 1992 net federal debt is the average of figures for March 1992 and March 1993.

was the pioneer in this area and did excellent work, it is nevertheless clear by now that it was excessively optimistic (from a Quebec standpoint) in a number of areas.[42]

It is important to note, moreover, that the figures just cited — apart from those of the Economic Council — are based on fiscal year 1990/91. Much has changed since March 31, 1990. Mainly because of the recession, the deficit of the Quebec government has increased from $2.8 billion to a projected $3.9 billion in fiscal year 1992/93. The recession has increased the federal deficit by much more than lower interest rates have reduced it. And the net debt of the federal government has increased by some $75 billion since 1990/91. All of these points are incorporated in Table A-2, which shows that the projected deficit of a sovereign Quebec is now about $4 billion higher than it would have been in 1990/91. So, if we take Fortin's relatively optimistic 1990/91 estimate ($13 billion) as our starting point, we now arrive at an estimate falling just short of

42 See, for example, Yvan Stringer, "Sharing Modest Thoughts on How to Share an Immodest Debt," in Boothe et al., *Closing the Books*, pp. 56–68; as well as the contributions of Stringer and Pierre Fortin to the *Les Affaires* conference that was held in Montreal on March 23, 1992.

$17 billion for fiscal year 1992/93. This is a substantial sum, amounting to just over one-tenth of Quebec's GDP.

It is also a larger sum than the deficits that Green and I projected for the first five years of sovereignty — in billions of dollars, they were, in years 1 to 5 respectively, 13.6, 16.3, 16.5, 15.5, and 14.3.[43] This is so despite the fact that I have used Fortin's relatively optimistic estimate as the point of departure. It follows, then, that the austerity package Green and I outlined in *Parting as Friends* is, if anything, too optimistic. In that study, we posited a package consisting of the following components: a 15 percent salary reduction and 5 percent employment reduction in the public and para-public sectors, a 10 percent cut in all transfer payments, and a 15 percent increase in all major tax rates.[44] Also, as I argued in the box on page 21, the short- and medium-run pain of these cuts cannot be reduced by the elimination of wasteful overlapping expenditures.

The discussion to this point has dealt with a debt and deficit problem. It remains to discuss the financing problem, or the possibility of a liquidity crisis. As shown in Table 1, in addition to a deficit of some $17 billion, a sovereign Quebec would face borrowing requirements of an extra $19 billion, implying a total financing requirement of some $36 billion, or 23 percent of GDP. Certainly it would be possible to cut back on hydro projects in the short run — although this would have further negative effects on employment — and there could be some additional borrowing room created by Quebec's recuperation of the federal market.[45]

One might also argue that Quebec could defer its substitution of Quebec debt for Canada debt.[46] It should be recognized, however, that around 40 percent of the federal debt is in the form of short-run treasury bills that mature within three to six months. To say that Quebec's obligation would be deferred is to say that, as the billions of dollars of existing Canada debt come due in the first year of Quebec sovereignty,

43 McCallum and Green, *Parting as Friends*, p. 70.

44 Ibid., p. 47.

45 Côté, ("Souveraineté," p. 31) suggests that this additional borrowing room could amount to $2 billion.

46 The assumption incorporated in Table 1 is that Quebec would make this substitution over a period of ten years, implying additional borrowing of approximately $10 billion per year during this period.

100 percent of the refinancing would be carried out by ROC. This would not sit well with the people of English-speaking Canada.

To conclude: Even on the basis of optimistic assumptions that rule out highly acrimonious scenarios, one cannot escape the conclusion that a sovereign Quebec would have to go through a fiscal retrenchment of unprecedented austerity. Even then, in the turbulent environment that is likely to accompany separation, it is far from clear that Quebec would be able to borrow the amount required. Hence, the likelihood is that a Quebec liquidity crisis would accompany an insolvency crisis for significant sections of English-speaking Canada.

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