Canada And Québec In A New World: The PQ's Economic Proposals

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I. Introduction

The PQ document, *Québec in a New World*, contains a number of economic proposals that Canadians[1] will need to respond to in the event that the referendum on sovereignty is successful. Our objective in what follows is to examine these proposals with a view to determining what Canada's response to them might be. The paper does not debate the logic of the PQ position, or its suitability for Québecers. Its sole concern is in determining what is in the best interests of Canadians in the event the "yes" side triumphs. It proceeds by asking: if a PQ government, fresh from a referendum victory, wishes to negotiate the economic association provisions in this document, what should Canada's position be?

The PQ's economic plans can be grouped into four categories. The first proposal is to replace the current Canadian economic union with a new Québec-Canada economic arrangement. We look at the trade and factor mobility provisions of this proposal in Section II, and at the monetary provision in Section III. The document indicates that Québec intends to assume its share of the federal government debt. Thus in Section IV, we look at how the division of the debt might be accomplished. Sovereignty obviously implies a transfer of taxation and spending powers from Ottawa to Québec. In Section V, we look at what these reallocations would mean for the present system of intergovernmental fiscal transfers and, in Section VI, we look at the issue of shared public goods.

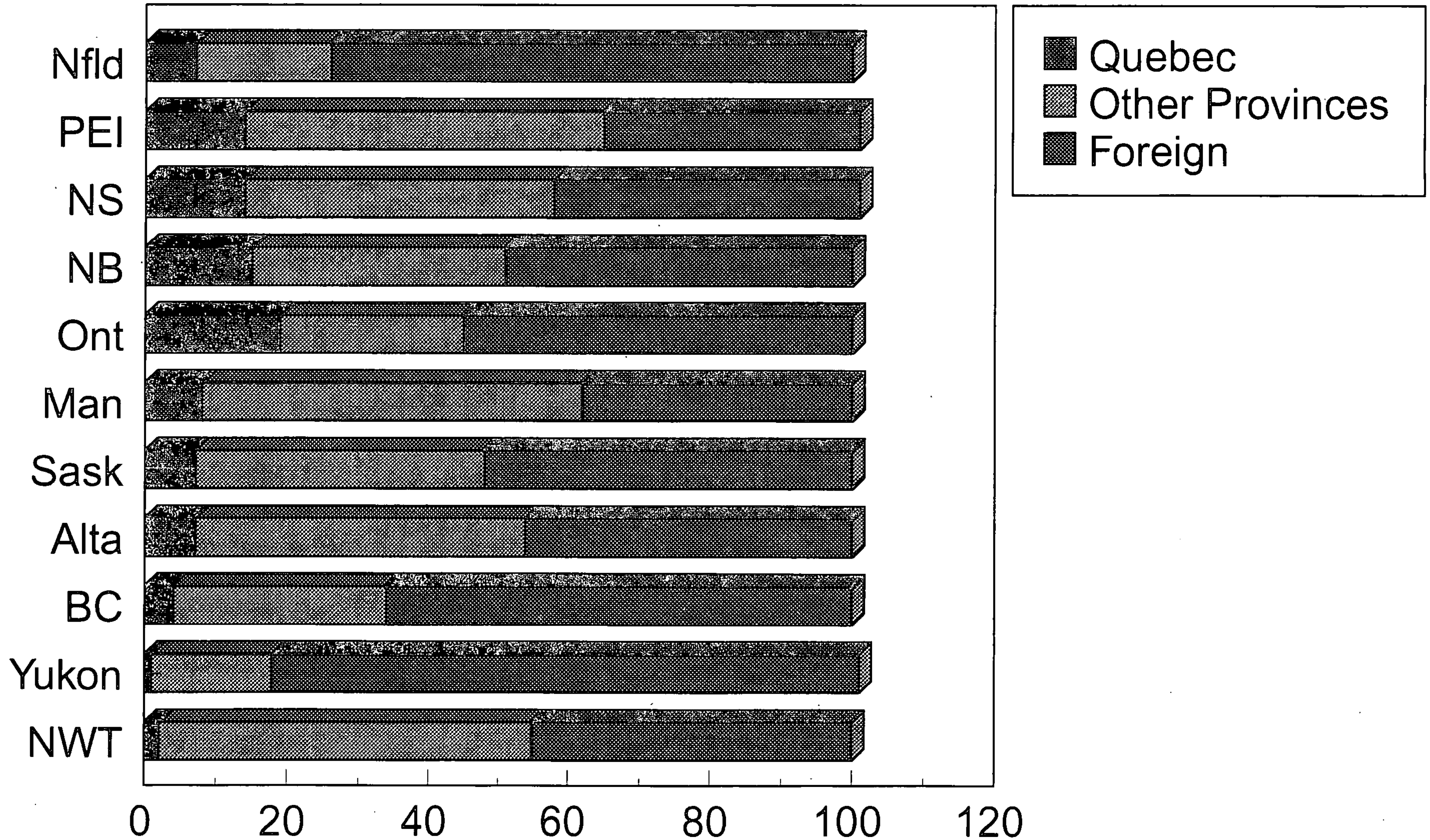
II. A Québec-Canada Economic Space

The PQ document proposes creating what it calls a Québec-Canada economic space. This arrangement would feature free movement of goods between Québec and Canada; a common trade policy towards other countries; free movement of services, capital, and people (including the right of both Canadians and Québecers to hold dual citizenship); and retention of the Canadian dollar as a common currency. The PQ would create four institutions to manage this arrangement: a council of ministers designated by each country, with decision-making powers; a secretariat to administer the union; a tribunal to resolve disputes; and some form of Québec participation in the Bank of Canada.

Canada's response to these proposals will be conditioned by two important facts. First, the Canadian market is more important to Québec than the Québec market is to Canada. Figure 1 illustrates that Québec was the least important of the three export destinations for all eleven provinces and territories in 1989, generally by a considerable margin. Ontario was the most dependent on the Québec market (19% of exports), followed by New Brunswick (15%), Nova Scotia (14%), and PEI (14%). For Newfoundland, the four western provinces, and the two territories, sales to Québec were 7% or less of total exports. By comparison, Québec shipped 54% of its total exports of goods and services to other provinces (mainly Ontario) in 1989, while 46% were sold internationally.

FIGURE 1

Total Exports by Destination (%)



The clear implication is that future Canadian trade policies must give more priority to international and internal links than to those with Québec.

The second fact is that Canada will be a member of the North American Free Trade Association (NAFTA) the day after sovereignty takes effect, while Québec will not. Since it is clearly in Canada's interest to maintain NAFTA membership, the issue is how to fit a Canada-Québec economic association into this larger framework. If Québec seeks full membership in NAFTA, as the PQ suggests it will, and if the application is successful,[2] an important portion of the Canada-Québec economic space would fall automatically under NAFTA.[3] There would be free trade in goods; no common trade policy with respect to non-member countries; detailed rules of origin; a considerable degree of free trade in services; some amount of capital and labour mobility; a host of special provisions with respect to government procurement practices, telecommunications, monopolies and state enterprises, and so forth; and access to administrative services and dispute resolution mechanisms.

There is much to recommend this arrangement to Canada. It would preserve the present gains from trade, or, put differently, it would avoid the potentially costly trade diversion that would result from imposing tariffs and other restrictions on Canada-Québec trade. NAFTA's dispute resolution mechanism, essentially unchanged from what it was under the Canada-US Free Trade Agreement, has proven to be reasonably effective and efficient. It could serve as a relatively low-cost way of resolving the inevitable Canada-Québec trade disputes, obviating any need for bilateral institutions such as those the PQ envisions. Joint membership in NAFTA might actually improve Canada-Québec economic links if, as is often suggested, international rules and tribunals can bring down trade barriers that, to date at least, have defied constitutional provisions and intergovernmental negotiations.

The PQ proposals for economic integration go well beyond the NAFTA arrangement, however. As noted, they envision a common external tariff, free flow of capital and people, and use of the Canadian dollar as a common currency. The question thus arises as to whether there are net economic benefits to pushing Canada-Québec economic integration beyond that found in NAFTA. In particular, are the gains from further integration worth the additional negotiation and monitoring costs that a special bilateral relationship would necessarily involve? These queries are also relevant if Québec does not obtain membership in NAFTA, for whatever reason. In that event, Canada would have to consider what form of economic association it wishes with Québec, and what institutions would govern it.

The proposal for a common set of tariffs and other restrictions on trade with other nations is appealing in that it would make customs inspections, such as exist between Canada-US and Canada-Mexico, unnecessary. There is a potential cost to the proposal, however, beyond the additional negotiation and administration costs. The Canadian tariff structure has long been a source of regional grievance. Given that the Western provinces would be a dominant part of the economy after sovereignty, Canada would almost certainly wish to alter its tariff structure, particularly as it applies to trade with Pacific Rim countries. Thus it would be important that negotiations with Québec not end up replicating the present external tariff structure.

As already noted, Québec membership in NAFTA would bring with it some limited degree of capital and labour mobility. Given that, in principle, factor mobility complements the gains from free exchange of goods and services, it certainly is worth exploring possible bilateral arrangements that would add to this mobility. This is especially the case since sovereignty will, to the extent that it leads to tax and regulatory environments in Québec that differ from those in Canada, reduce factor mobility from what it is currently. Again, these arrangements should only be pursued to the extent that the extra gains they bring are worth the additional negotiation and administrative costs they would inevitably entail.

The PQ document is not clear on what Québec would seek with respect to mobility rights. In one place (at 57), it talks about preserving the current mobility arrangements within Canada, while two pages later it refers to existing (and much more limited) Canada-US agreements on the free movement of people as a model. The distinction is important since the former arrangement would require a number of bilateral agreements and the institutions to support them, while the latter could be administered within NAFTA. The document is more explicit about capital mobility, asserting that it would be completely futile to try to limit these flows.

In sum, much of what Québec proposes in the way of a Canada-Québec economic space can be achieved automatically if Québec gains full membership in NAFTA. Thus once the division of the federal government debt and other outstanding issues are resolved, Canada should support Québec's application to this body. Any bilateral arrangements that would push economic integration beyond that in NAFTA today, or that can be reasonably anticipated to be part of NAFTA in the future, should be examined on their individual merits.

III. Monetary Arrangements

The Québec sovereignist position regarding monetary arrangements after a separation of Québec from Canada is to continue to use the Canadian dollar as legal tender, unit of account, and medium of exchange. Such a monetary strategy has clear advantages to Québec. It eliminates the need to "redenominate" money prices and financial instruments into alternative currency terms (either a Québec currency or some other currency like the US dollar), it eliminates the resource costs of a central bank and the credibility problems which would arise if Québec chose to issue its own currency, and it reduces uncertainty about monetary policy choice.

Several questions arise from the Canadian perspective with respect to the stated Québec sovereigntist position concerning monetary relationships. Should Canada actively oppose, actively support, or benignly ignore these Québec intentions in a post-separation environment? The Québec proposals are sufficiently vague as to encompass something as simple as a currency area in which Québec just uses the Canadian dollar as its medium of exchange, to more complex arrangements of cooperation and coordination in monetary policy choice and financial market regulation, to a full-fledged monetary union between Canada and Québec which replicates aspects of the pre-separation environment. Which of these options are to Canada's advantage or disadvantage?

As a starting point it must be recognized that it is not reasonably possible, nor is it desirable, for Canada actively to prevent Québec from continuing to use the Canadian dollar after separation. To prevent Québec from having access to Canadian dollars would require the implementation of foreign exchange market controls that would strictly limit the "exportation" of Canadian dollars. Controls of this sort would have to be applied to all transactions between domestic and foreign residents, not just those of Québecers, and would constitute a significant impediment to international transactions for Canadians. Accordingly, it is not reasonable to propose that Canada attempt to prevent the adoption of Canadian currency by an independent Québec.

More importantly, though, active opposition is simply not advantageous to Canada. A common currency area confers significant efficiency gains arising from reduced transactions costs and reduced exchange rate risk upon *all* participants in the area. Since important and substantial trade linkages would continue to exist between Canada and Québec, Canadian residents would only suffer from reduced efficiencies if Québec were to abandon a Canadian dollar monetary regime. Additionally, the Bank of Canada would be confronted with the problem of how to cope with a reduction in the supply of Canadian dollars that would need to occur as Québec ceased to use these dollars and the demand for the dollar fell by 20-25%. Thus, it is in Canada's own interest to actively support a continuation of the Canadian dollar currency area.

Given that Canada should be supportive of Québec's stated desire to continue using the Canadian dollar, how far beyond a simple currency area should Canada be willing to go in establishing a monetary system after Québec's independence? Should Canada support the idea of a full monetary union with Québec, or something less than this? A full monetary union would entail joint ownership of a common central bank, shared seigniorage revenue from money creation, jointly determined monetary and exchange rate policy, coordinated financial market regulation, common deposit insurance provision, and lender of last resort provision to both Canadian and Québec banking systems by the common central bank. Essentially this constitutes a replication of the fundamental characteristics of the monetary system prevailing in Canada prior to Québec independence.

Clearly, efficiency gains to both Québec and Canada would arise from commonality in financial market regulation, deposit insurance provision and lender of last resort function. The sharing of seigniorage revenue between Canada and Québec would seem only fair. However, the issue of the conduct and choice of monetary policy makes the decision of whether to move to a full monetary union difficult. A simple currency area with no direct input of Québec into Canadian monetary policy choice would create difficulties for the Bank of Canada without at least some cooperation from Québec. To conduct monetary policy successfully, the central bank needs, at a minimum, information about the supply of and the demand for money which would not necessarily be forthcoming in a timely fashion from an independent Québec that has no input into Canadian policy choice. This consideration would indicate that some form of integration is desirable from a policy perspective. But to move to an environment of joint Canada-Québec policy choice creates its own problems. If Québec faces a set of external shocks that are different from that facing Canada, or at least impacts differently on the Québec economy than on the Canadian economy, the optimal monetary and/or exchange rate policy for Québec may differ from the optimal policy for Canada. In whose favour are conflicts of this sort to be resolved?

If full monetary union were to occur, would a Canada-Québec central bank be organized under equal joint ownership? Would Canada as the larger partner be entitled to a majority ownership position? In such an arrangement, would Québec have a veto over monetary policy choice? Consideration of these policy options is likely to generate considerable market uncertainty about the future course of monetary policy in Canada, and erode the current reputation of the Bank of Canada as an advocate of price stability. Such uncertainty and potential loss of reputation is highly costly. Accordingly, Canada should take the position of opposing significant reorganization of its central banking arrangements, at least until most of the uncertainty about the new environment has gone.

IV. The National Debt

The division of the national debt and assets between Québec and Canada will likely be one of the most contentious issues surrounding a departure of Québec from Canada. A variety of divisional rules have been proposed (see, for example, Boothe, Johnston and Powys-Libbe, 1992), but the actual task of disentangling assets and liabilities would be difficult. The question of what share of the net national debt would be assigned to Canada and to a sovereign Québec notwithstanding, an equally important question remains: how to actually accomplish such a division and what position should Canada take in this aspect of any negotiation.

The PQ document takes the position that outstanding federal government debt would remain the legal responsibility of the Government of Canada, but that a sovereign Québec would contribute its share towards the payment of interest and principal on that debt. Even if the question of what constitutes a fair share could be resolved amicably, this position is clearly disadvantageous to Canada after a Québec separation. Such an arrangement leaves the Canadian taxpayer ultimately responsible for the entire stock of debt issued by the Government of Canada. While the PQ government may be willing to assume responsibility for its assessed share of interest and principal payments, a current assumption of liability cannot bind future governments of a sovereign Québec to such an arrangement. Thus, Canadian taxpayers will bear the risk of any future default by Québec on these negotiated obligations. A default of this sort may not even be punished by international financial markets if international participants simply viewed it as a part of a continuing argument over fair share.

Additionally, the financial proposal by the PQ ties Canada to the promises of a sovereign Québec for an extended period of time. This link raises the prospect of continuing negotiation and renegotiation over what constitutes a "fair share" and the terms under which this share is to be retired. It also raises the possibility of a Québec default being used as leverage in a variety of other disputes, such as trade issues, that will arise over time between any two sovereign nations with close linkages.

From Canada's perspective the ideal solution to these problems is for an independent Québec to issue and sell its own debt instruments in internal and international financial markets to fund the repayment of its obligations to the rest of Canada. This action would allow the Government of Canada to retire the share of its national debt attributable to Québec, and would instantaneously disentangle the two nations. Unfortunately, such a solution may not be feasible. It may be unreasonable to believe that international financial markets would be willing to absorb an instantaneous debt offering likely in excess of $100 billion from a sovereign nation with little or no reputation in the market, at least without a substantial risk premium attached to the yields offered on such debt, even though the simultaneous retirement of Canadian government debt would create the necessary "room" in the market for the Québec government debt issue.

One possible intermediate solution to this problem would be to require that the government of Québec issue its own marketable debt instruments (in a form that is indistinguishable from its other liabilities) in an amount equal to the negotiated obligation to the rest of Canada. Some portion (not inconsequential) of this Québec-issued debt would be sold in international financial markets (the proceeds of the sale used to reduce Québec's obligation to Canada), and the remaining portion would be transferred to the Government of Canada from which the interest and principal payments would be used to meet Québec's remaining obligation to the Canadian national debt. The fact that a significant portion of this Québec debt would be held internationally would reduce risk exposure of Canadian taxpayers to the possibility of Québec default (partly because some of the debt would be held by non-Canadians and partly because default would be more costly to Québec, and hence less likely, as it would damage its reputation in financial markets) and would allow the Government of Canada the option of gradually reducing its exposure by re-selling this Québec debt over time if it so desired.

V. FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS

The PQ position paper treads quickly over this ground, pausing only to assure continuity of (federal government) services to individuals and businesses. Bolstered by the tax revenue that would otherwise flow to Ottawa, a sovereign Québec under the PQ would maintain and avoid interruption to such transfers to persons as old age security, unemployment insurance, and child tax benefits. In addition, a commitment is made to provide a government job for any federal civil servant from Québec. In support of the viability of the PQ program and of an economically costless transition to a sovereign state, Jacques Parizeau, in the recent Québec election campaign, claimed that Québec would realize a $3 billion annual gain from separation.

Parizeau's claim for the large economic benefits to Québec from sovereignty are particularly striking in that they are almost exactly opposite to the results of most fiscal balance accounting studies which predict significant losses to Québec. Estimates of the pluses and minuses in the fiscal flows between the federal and the provincial governments are available from many sources. Examples, all reporting net fiscal gains to Québec from federalism, include an estimate of a $3.0 billion difference between federal spending and taxes in Québec for 1990/91 (Gibson, 1994: 104); net intergovernmental transfers to Québec of $2.5 billion and net transfers to persons of another $1.5 billion in 1988 (Reid and Snoddon, 1992); from a more comprehensive base, net fiscal gains between $1.5 and $3.3 billion in 1988 (Mansell and Schlenker, 1992); and an estimate between $0.8 and $1.0 billion (Raynauld, 1990). Even a study from Québec's Belanger-Campeau Commission estimated a net fiscal gain of $2.7 billion in 1988, an amount equivalent to $409 per capita (see Grady, 1991).

At best, these calculations are relatively crude first-round estimates of the net financial flows among governments and among regions in the country.[4] However, despite differences in the methodology, the general results are notably similar in that they indicate that Québec realizes significant fiscal benefits, not losses, from federalism.[5] Parizeau may also have had other factors in mind when making his prediction — for example, potential savings from avoiding duplication between federal and provincial programs are often noted — but the data suggest that such savings are relatively modest. While the Belanger-Campeau Commission studies predicted savings perhaps as large as one billion dollars, others (e.g., Côté and McCallum, 1992) project limited savings from this source. Overall, the empirical information indicates that Québec is a net fiscal beneficiary of federalism and will lose those benefits if it chooses separation.

The loss of those net fiscal transfers will not be borne easily by Québec because it is already a low fiscal capacity, high tax and high debt province. But our concern is with the implications of this change for Canada. In the case of fiscal transfers, Québec's loss is a saving for Canada. Although there are much larger per capita net transfers to some other provinces, the size of Québec makes the sums relating to it large aggregate amounts. For example, in 1992/93, Québec received over $3.5 billion in equalization payments from the federal government — 45 percent of the total equalization payments made. Without Québec, the equalization bill is reduced by almost half. A consequence is that the cost of equalization is reduced, not only in aggregate but also per capita. Assuming that the other 1992/93 payments remained unchanged, the per capita cost would decline from $280 to $206 or by about a quarter. This reduction in the relative burden of equalization is a positive result because it increases the probability that the equalization system — very important fiscally and conceptually for some, especially for Atlantic, provinces — would survive as a mutual insurance scheme in a Canada without Québec.

Similar savings will be realized elsewhere because Québec is a net beneficiary of a variety of federal intergovernmental and personal transfer programs. Those savings will help reduce the cost of a range of national social programs that collectively are widely regarded as an important bonding agent, part of the "social policy railway" that has helped to link the country and may be important in keeping the rest of Canada together should Québec leave.

The importance of these savings should not be overstated. Because Québec is also a major contributor to as well as recipient of federal programs, the net benefits are all that are realized in the end (although the impacts may vary considerably among programs). Although amounts in the order of three billion dollars are not trivial, they need to be kept in perspective. Three billion is 4.3 percent of the $69.2 billion of federal expenditures on personal and intergovernmental transfers, and 1.85 percent of total federal spending in 1992/93. In the face of $40 billion federal deficits, and a huge federal debt burden that requires a quarter of the federal budget for interest payments alone, the government is looking for ways to reduce expenditures.

Social programs are under close scrutiny. We should expect that, with or without Québec, personal and intergovernmental programs (which account for more than half of non-interest expenditures) will look quite different in the future and are likely to be smaller. Any savings from Québec leaving will not be of a magnitude sufficient to preserve the existing (imperfect) structure, but will facilitate the funding of revamped programs and make a modest contribution to easing the overall fiscal burden. Of course, the difficulties of separation may place burdens on social programs in Canada (as well as in Québec) that would swamp any potential savings in the short term. In a Canada without Québec, the design and allocation of responsibility for social policy may be more critical than the magnitude of federal expenditures to the continuation of a national social policy and to keeping the rest of the country together. In addition, interprovincial transfers among the remaining provinces may be highlighted by Québec separation and tempt some other parts of the country to follow Québec's lead.

Québec's separation will end the Canadian government's transfers to Québec. Because Québec is a net beneficiary of those transfers, Québec will be left financially less well-off and Canada will realize a marginal gain that may help to preserve important programs like equalization. However, the rethinking and restructuring caused by Québec's leaving could well encourage further breakup. Unfortunately, it is entirely possible that any division, or further division, of Canada will disadvantage almost everyone.

VI. CONTINUING COMMON INTEREST

Even as separate nations, Québec and Canada will find some areas of common interest where cooperation will be mutually advantageous. Here, reference is made largely to those public goods and services for which costs are high and relatively invariant with the numbers served and spillovers can be substantial — the national parallel to the local fire station. Before turning to those cases, we mention in passing that there are numerous areas of common interest that will be sacrificed or diminished to Québec and eroded in Canada as a result of separation — for example, the advantages of pooling and spreading economic risks across more regions, savings from more homogeneous regulation and tax harmonization, greater bargaining power in international negotiations as one nation, and a lower cost of borrowed funds to a united Canada. Although the economic costs associated with these issues may be large, there are some areas for cooperation.

National defence is a major area for potential cooperation. While separation will divide the defence infrastructure and forces, we assume that they will have common rather than conflicting security interests. If so, there is potential for sharing the responsibility and burden of national security. Complications and costs may arise over time, however, as the two forces become more unilingual in different languages. There could be advantages to providing joint international peacekeeping units, but it can be expected that eventually there will be differences of opinion on their deployment. Over time, we can expect greater separation with Québec becoming just another player in continental or broader defence pacts.

International representation is another area for possible cost sharing. For both countries to be represented as broadly internationally as now will require considerable duplication. Sharing facilities, even representatives, is possible but it is unlikely to be an appealing option to a newly independent state wishing to demonstrate its sovereignty.

The St. Lawrence River is a feature of common interest, particularly for transportation purposes. Maritime services could be shared. This possibility applies also to the interests in the fishery there, to the environmental quality of the river and to fishery and river-quality management. Again, however, while there are considerable mutual interests, they need not always coincide and, when they do not, the negotiations will be rigorous.

A land link between Ontario and Atlantic Canada will become a new area of common interest. Assuming such a link is agreed to, the transport facilities (road and rail presumably, and possibly other modes) will serve both Québec and Canada. Opportunities for cost sharing and for ensuring quality service are obvious.

Other areas of common interest and potential cooperation can easily be mentioned. Some include air transport, communications, exchange of French- and English- language programming and educational materials, and Arctic passage and waters. In these areas as well as in those noted above, the potential savings from and motivation for any extraordinary arrangements are likely to be modest. Over time, relations between Québec and Canada on items of common interest can be expected to parallel those with other countries on similar questions.❑

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Endnotes

1. We follow the PQ document in using the term Canada to refer to Canadians outside Québec.

2. As a signatory to the current Agreement, Canada has the right to veto Québec's application. This could be a useful strategy to employ in the event that negotiations over Québec's share of the federal debt went badly.

3. There are some differences in bilateral relations within NAFTA, so there might be some scope for special Canada-Québec arrangements.

4. See the studies cited in Grady's review, for example, for a discussion of some of the problems with the fiscal balances approach.

5. Indeed, these studies generally show that all provinces but Alberta, British Columbia and Ontario are net beneficiaries from the expenditure and tax policies of the federal government.

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