CANADA'S ECONOMIC UNION

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CANADA'S ECONOMIC UNION

THE ADVANTAGES

As a single economic and political unit, Canada has an important presence in the world economy. More than a century of shared economic history has fostered many linkages among Canada's regions and provinces and an extensive flow of east-west commerce. By any measure, Canada has also built up an impressive record of economic achievement.

The material in this section addresses several key aspects of the economic union:

- the elements of the economic union;
- the main benefits of economic union;
- size of economy and market;
- interprovincial trade;
- mobility of people within Canada; and
- Canada's accomplishments in international perspective.

1. ELEMENTS OF THE CURRENT CANADIAN ECONOMIC UNION

Despite its imperfections, Canada has a robust economic (and monetary) union that has contributed immeasurably to the country's economic success and social development. Among the key elements which define Canada's existing economic union are the following:

- The Constitution itself, notably section 121, which prohibits internal barriers to trade in goods.

- The existence of a single currency and monetary authority, which adds enormously to the efficiency of the Canadian economic union.

- National laws affecting key aspects of the environment for Canadian economic activity, including import regulation, competition policy, banking, intellectual property, and consumer product safety.

- National standardization in areas such as weights and measures, which facilitates trade.

- National income-support programs such as Unemployment Insurance and the Canada/Quebec Pension Plan, which enhance the mobility of Canadians across the country.

- An extensive network of hundreds of interprovincial and federal-provincial agreements -- covering areas such as securities regulation, training and tax collection -- constitutes a vital part of the fabric of the Canadian economic union.

2. MAIN BENEFITS OF ECONOMIC UNION

Regions or countries opt for economic integration primarily because they want to capture benefits they cannot achieve as separate economic units. The benefits of economic union fall into four main categories:

- Market integration: Creation of a common market eliminates barriers that impede economic efficiency and dynamism. This allows for greater specialization, leading to higher productivity and incomes.

- Sharing of costs: Gains can result when governments agree to co-operate, harmonize and share responsibilities within an economic union in order to provide lower-cost services or increased services for the same cost. Areas where costs, or "overheads," are reduced with economic and political integration include defence, communications, airports and other infrastructure, weights and measures, technical standard-setting, and lower transaction costs based on a common currency.

- Pooling of risks: Risks are shared among regions within an economic union. An economic and political union comprised of several provinces creates a more diverse national economic base. This helps to cushion the impact of economic shocks on any one region, and creates a basis for stabilization programs and inter-regional transfers. Fragmenting an existing economic union into separate entities will increase each province or region's susceptibilities to economic shocks.

- Increased bargaining power: Larger economic and political units enjoy more bargaining power in international trade negotiations and international institutions such as the GATT, the IMF and the OECD.

3. SIZE OF ECONOMY AND MARKET

- Canada's gross domestic product is approximately C$700 billion. Canada is the seventh largest economy within the OECD.

- Quebec accounts for approximately 23.5% of Canadian GDP, or an estimated $165 billion. Without Quebec, Canada would still rank as the seventh biggest OECD economy, slightly ahead of eighth-ranked Spain. A separate Quebec would rank 14th in size among OECD economies.

- According to the General Agreement on Tariffs and Trade, Canada is the seventh largest exporter in the world, accounting for just under 4% of global merchandise trade.

- GATT also ranks Canada as the seventh biggest importer in the world, representing about 3.8% of all global merchandise imports. As a major importing country, Canada enjoys significant influence in international trade negotiations because of the size of its market. If Canada broke up into two or more countries, the resulting separate entities would have less influence in international trade bargaining because their markets would be smaller than the integrated Canadian market.

4. INTERPROVINCIAL TRADE

- According to estimates made by the Economic Council of Canada, interprovincial trade in goods and services represents almost 20% of total Canadian economic output.

- Interprovincial trade directly accounts for 2 million jobs (out of an employed labour force of 12.5 million). Many more jobs are linked indirectly to the existence of interprovincial commerce.

- Most of the goods and services produced within each Canadian province are consumed locally by citizens of the province itself. The rest is "exported," either to other provinces or to foreign countries.

- Table 1 below summarizes the proportion of total provincial output exported to other provinces and to foreign markets. The table shows that most provinces depend heavily on other provinces as markets for their goods and services.

- Six provinces -- Prince Edward Island, New Brunswick, Nova Scotia, Quebec, Manitoba, and Alberta -- ship more of their exports to other Canadian provinces than to foreign countries.

Table 1
Distribution of Gross Provincial Output*

	% Output Exported to Other Provinces	% Output Exported to Foreign Markets
P.E.I.	30.1%	10.9%
Manitoba	29.5%	11.1%
Alberta	25.4%	14.7%
New Brunswick	24.8%	18.5%
Saskatchewan	22.2%	24.8%
Nova Scotia	20.7%	10.2%
Quebec	20.2%	14.6%
Ontario	17.4%	20.2%
B.C.	12.4%	18.1%
Newfoundland	12.2%	17.9%

* All data for 1984, the latest available.

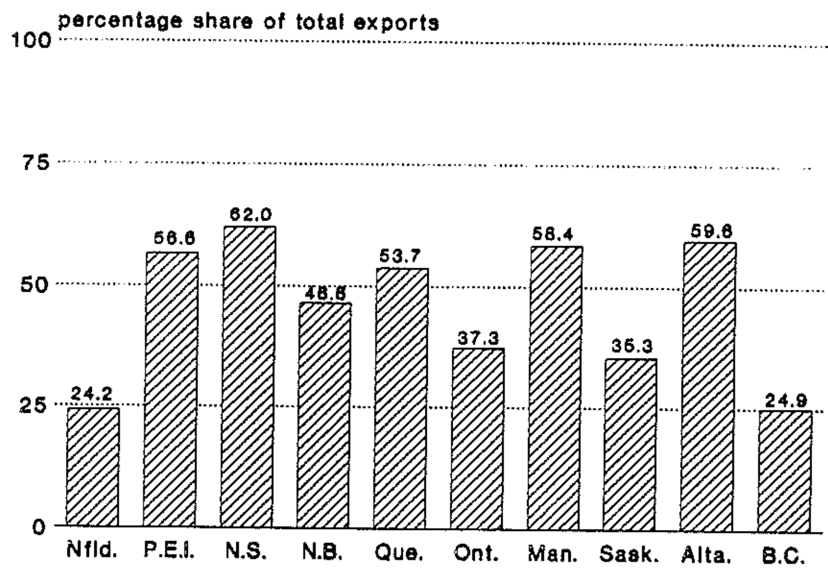
(Source: Economic Council of Canada, Annual Review, 1991, p.36)

- Among the three most populous provinces, only Quebec depends more on interprovincial trade than international trade. Ontario and British Columbia, in contrast, sell more to foreign markets than to interprovincial markets.

- Another way to highlight the importance of interprovincial trade is to show the share of total out-of-province exports from each province which is shipped to other provinces. Chart 1, below, summarizes this information for all ten provinces.

Chart 1

Total Interprovincial Exports, 1984
(as share of total exports)



Goods-producing industries only.

Source: Provincial Input-Output Accounts compiled by Statistics Canada (1984).

5. MOBILITY OF PEOPLE WITHIN CANADA

- The free movement of people across provincial borders represents an essential element of Canada's economic union. The ability to work elsewhere in the country increases the job opportunities available to millions of Canadians and enables many of them to earn higher incomes.

- Canada's mobility rates are among the highest in the world. On average, 4.5% of the population changes province of residence in any five-year period.

- During the 1980s, an average of 320,000 persons changed province of residence every year.

- The 1986 census found that the number of labour force participants who changed province was equal to 8% of all job changes made in that year.

- Quebec and Ontario have the lowest out-migration rates. In Quebec's case, language serves as a barrier to interprovincial mobility, since some 60% of francophones in Quebec are unilingual.

- For out-migrants from most provinces, Ontario is the most popular destination. Fully 69% of Quebecers changing province of residence moved to Ontario. Note that 7% of Nova Scotians, 16% of New Brunswickers and 23% of Ontarians changing province of residence between 1986 and 1991 moved to Quebec.

6. CANADA'S ACCOMPLISHMENTS IN INTERNATIONAL PERSPECTIVE

- Canada has the second highest standard of living among the 24 countries of the Organization for Economic Cooperation and Development (OECD).
- According to the United Nations Human Development Index, Canada had the second best quality of life of all UN member countries in 1990.
- According to The Economist magazine, Canada has the most sought-after passport of any country in the world.
- From 1961 to 1990, Canada's rate of economic growth was second only to Japan's among the seven leading industrial countries, the G7.
- Between 1960 and 1990, Canada had the fastest rate of employment growth of any OECD country.

QUESTIONS AND ANSWERS

As the discussion of constitutional issues gathers momentum over the coming months, it is vital that the advantages of economic integration and the Canadian economic union be kept in mind. All Canadians have an interest in ensuring that these advantages figure prominently in the debate about the future of the country.

These **Questions and Answers** aim to summarize some of the most important arguments bearing on the Canadian economic union.

The material below addresses the following questions:

- What are the steps toward economic integration?
- What are the main benefits of economic union?
- What key linkages among regions have developed under the Canadian economic union?
- What is the impact of economic union on growth and incomes?
- How does the economic union increase Canada's international bargaining power?
- How does the economic union reduce the economic vulnerability of individual regions?
- Do international trends favour stronger regional economic integration and policy harmonization?
- What are the defects in the existing Canadian economic union?

1. WHAT ARE THE STEPS TOWARD ECONOMIC INTEGRATION?

- There are several distinct levels of economic integration, each involving a greater surrender of autonomy on the part of the jurisdictions concerned as well as a strengthening of the roles of central institutions:

  Free-trade zone: All tariffs and quotas on trade and services among the countries involved are eliminated; each participant reserves the right to apply restrictive measures against trade with non-members.

  Customs union: This is similar to a free-trade zone, except that the member states agree to impose identical duties on imports from non-participants.

  Common market: A customs union that also embraces the free mobility of factors of production -- labour and capital -- across the borders of the participating countries or regions.

  Economic union: A common market that also involves some degree of harmonization of economic policy, with a central authority established to administer common policies.

  Monetary union: This is an economic union, with the added element of a common currency.

- Canada is a monetary union (i.e., an economic union, coupled with a common currency). The European Community is in the process of moving from a common market to a monetary union.

2. WHAT ARE THE MAIN BENEFITS OF ECONOMIC UNION?

- Regions or countries opt for economic integration primarily because they want to capture benefits they cannot achieve as individual economic units. The benefits fall into four broad categories:

  1) Market Integration: Creation of a common market eliminates barriers that are obstacles to efficiency and dynamism. Market integration allows for greater specialization, leading to higher productivity and real incomes.

  2) Sharing of Costs: Gains can result when governments agree to co-operate, co-ordinate, harmonize or share responsibilities within an economic union in order to provide lower-cost services or increased services for the same cost. Areas where costs and overheads are reduced with economic integration include defence, communications, airports, weights and measures, technical standard-setting, and -- in the case of a full monetary union -- the provision of a common currency.

  3) Pooling of Risks: Risks are shared among regions within an economic union. An economic union comprised of several provinces or regions leads to a more diversified overall economic base. This helps to cushion the impact of economic shocks and creates a basis for stabilization programs.

  4) Increased Bargaining Power: Larger economic units enjoy more bargaining power in international institutions and negotiations.

- One revealing sign that economic integration is widely perceived to create a "win-win" situation for all Canadian regions is that the Parti Québécois, despite being committed to independence for Quebec, nonetheless insists that it would strive to retain many of the features of the existing Canadian economic union, including a single currency, monetary policy, and common external tariffs.

- Similarly, the Quebec Liberal Party's Allaire Report, while calling for a broad decentralization of powers from Ottawa to the provinces, also stressed that: "There is no question of reconsidering the integrity and completeness of the Canadian economic market...the Quebec Liberal Party is proposing the creation of a true common market, a market that moves closer to integration than the current agreement between Quebec and the rest of Canada."

3. WHAT KEY LINKAGES AMONG REGIONS HAVE DEVELOPED UNDER THE CANADIAN ECONOMIC UNION?

- Canada's dependence on international markets has increased in recent decades. Despite this, east-west linkages within Canada remain a vital part of Canadian economic activity.

  - According to the Economic Council of Canada, interprovincial trade in goods and services still accounts for a larger proportion of Canada's gross output than international trade -- 19.3%, compared to 17.5%.

- Interprovincial trade directly accounted for about 2 million Canadian jobs (out of about 12.5 million employed) in 1990. The jobs of millions more workers are based at least in part on interprovincial trade and commerce.

- In the 1980s, Quebec exports to Ontario represented 11.7% of its gross provincial output. Ontario's exports to Quebec amounted to 7.5% of its output.

- Interprovincial trade in goods within Canada represents a larger percentage of gross output than inter-country trade in goods within the 12-member European Community.

- Another essential element of the economic union is the free movement of people across provincial borders. By international standards, mobility is very high in Canada -- second only to the United States among the G7 countries. In the 1980s, 320,000 people changed their province of residence every year. On average, 4.5% of the population of a Canadian province changes province of residence in any five-year period.

4. WHAT IS THE IMPACT OF ECONOMIC UNION ON GROWTH AND INCOMES?

- A higher level of economic integration serves to eliminate barriers that prevent companies and industries from being as efficient as they could be. It also fosters a competitive environment that encourages firms and individuals to exploit new opportunities. With integration, firms can specialize and achieve productivity gains, thereby increasing the living standards of citizens. Thus, economic growth and real incomes typically rise with economic integration.

- The free flow of labour within Canada provides important economic advantages for our citizens. The right to work anywhere in the country increases the job opportunities available to many Canadians, and thus raises individuals' income potential and ability to contribute to the general welfare. When workers move to jobs in which they are more productive, both individual and national incomes rise. Labour mobility also contributes to a more efficient allocation of resources and is an important mechanism by which a national economy can adjust to industrial change.

- The free flow of investment within a well-integrated common market, in addition to raising productivity, can play a role in accelerating the transmission of new technologies and innovations.

- Economies of scale resulting from a fully integrated Canadian domestic market increase the overall efficiency of the national economy, thereby raising aggregate living standards. Barriers and policies that stand in the way of full domestic economic integration have the opposite effect.

- Firms able to compete within a large, integrated home market are better placed to succeed in international competition.

5. HOW DOES THE ECONOMIC UNION INCREASE CANADA'S INTERNATIONAL BARGAINING POWER?

- One of the strongest arguments for Canadian economic integration is that the regions and individual provinces, together in a united Canada, have more bargaining power in dealing with key trading partners and in international institutions than would be the case if the country were fragmented.

  - The advantages of economic integration are evident in international trade negotiations. Canadian negotiators are able to offer our trading partners improved access to the broad, diversified Canadian market. If Canada were divided into smaller separate jurisdictions, each would have a smaller market to bargain over, and thus exercise less influence in international trade negotiations than Canada as a whole now enjoys.

  - Two concessions made by Canada to win better access to the U.S. market during the free trade negotiations illustrate the advantages of having a national economic union. Under the FTA, Canada agreed: i) to provide the U.S. with certain guarantees with respect to access to Canadian energy, and ii) to modify duty remission schemes and certain other policies related to the Auto Pact. Only a single central government authority, able to negotiate on behalf of all regions of the country, could deliver on these issues. A fragmented Canada would not have been in a position to offer these concessions. Quebec could not have offered the energy concessions sought by the U.S. Nor would the Western Canadian provinces have been able to negotiate on Auto Pact issues.

- As a single economic and political entity, Canada is the seventh largest economy in the world. It is a member of the G7 and carries significant clout within the OECD, the GATT, the IMF and many other international bodies. Canada's influence within international institutions would be diminished if the economic union were fractured, or if a process of national economic disintegration were allowed to take place.

6. HOW DOES THE ECONOMIC UNION REDUCE THE ECONOMIC VULNERABILITY OF INDIVIDUAL REGIONS?

- A single economic union, superimposed on a regionally diverse economic base such as Canada's, is less vulnerable to the effects of economic shocks and cycles than a smaller economic unit with a narrower economic base. In Canada, for example, the impact on national income and welfare of declining natural resource prices may be at least partially offset by stronger performance in industries producing manufactures and tradeable services.

- A more diversified economy is better able to withstand negative external shocks and to cushion disadvantaged regions and individuals.

- Equalization payments to poorer provinces, and the ability to make inter-regional transfers more generally, would be compromised if Canada's economic union fragmented.

7. DO INTERNATIONAL TRENDS FAVOUR STRONGER REGIONAL ECONOMIC INTEGRATION AND POLICY HARMONIZATION?

- In recent decades, the global economy has become more interconnected and most countries have grown more dependent on trade, investment and other external linkages. At the same time, there has also been a parallel trend among many advanced countries toward regional economic integration, as awareness of the immense potential advantages of creating larger economic units has increased.

- Economic integration has proceeded farthest in Western Europe, under the European Community (EC) and the European Free Trade Association (EFTA). Average incomes in Western Europe, measured in 1990 prices, have risen from $4,860 in 1950 to $20,880 in 1990, at least in part because of the economic gains flowing from integration and expanded intra-European trade.

- The 12 member states of the European Community have moved further down the path of economic integration in recent years. In 1986, they agreed to establish a fully integrated single market by 1992. Known as the "Single Market Program," this initiative will further reduce barriers to trade and commerce within the EC, increase labour mobility, and harmonize policies and standards across EC member states. It has been estimated that the 1992 "Single Market Program" will raise the EC's real GDP by up to 6%.

- More recently, the EC has taken further steps toward economic and political integration by strengthening EC powers in a wide variety of policy areas and by adopting a plan for EC-wide monetary union (single currency and a central bank) by the end of the 1990s.

- To safeguard the benefits of closer economic integration, the EC countries have moved to strengthen the powers of the centre (the European Commission, European Parliament, and other Community institutions). They are also moving toward greater harmonization of national government policies in areas such as taxation, inflation, and fiscal policy.

- Apart from the 12 EC members, most of the European countries that are members of the European Free Trade Association have negotiated trade and economic agreements with the EC. Recognizing the significant benefits of belonging to a larger common market, several European countries are in the process of making formal application to accede to the EC -- among them Austria and Sweden. Finland, Norway and Liechtenstein expect to apply soon. Hungary, Poland, and Czechoslovakia signed "association agreements" with the EC in December 1991.

▸ The two principal thrusts of recent European experience have been i) to work toward a stronger economic (and political) union and policy harmonization across jurisdictions, and ii) to build effective central mechanisms to support the shift toward increased integration. For Canada, recent trends in the European Community point to:

1) the benefits of Canadian economic integration;

2) the importance of strengthening the Canadian economic union;

3) the need for effective and meaningful central powers of economic management to assure that the benefits of economic integration are realized; and

4) the virtues of building, within Canada, institutional and legal structures to encourage policy co-ordination and harmonization among our governments.

8. WHAT ARE THE DEFECTS IN THE EXISTING CANADIAN ECONOMIC UNION?

- Although the Canadian economic union is well established, it is not without imperfections. Apart from the natural barriers of distance and language, there are other, arguably more detrimental, obstacles to a greater integration of the Canadian common market. These artificial barriers encompass a broad array of government activities that either explicitly or implicitly impede the movement of goods, services, capital, and people across our internal borders.

- Artificial barriers within the Canadian economic union prevent firms whose principal market is the home market from achieving important gains through specialization, economies of scale, and a more competitive business environment.

- Existing interprovincial barriers are estimated to impose an income loss equivalent to about 1% of gross domestic product (GDP) per year. This translates into an annual income loss of $7 billion for Canadians. Key internal barriers include:

  - discriminatory government procurement practices that favour in-province suppliers;

  - restrictions on out-of-province poultry and dairy products under existing provincial regulations;

  - carriers that transport goods across the country are restricted by having to obtain up to ten different provincial approvals to comply with multiple sets of regulations;

  - prohibitions or restrictions on the right of people in certain occupations and professions from working in other provinces (e.g., constructions trades);

  - restrictions on the sale of out-of-province beer and wine.

- The estimate that these barriers cost Canadians 1% of national income each year is a static measure and ignores potentially important dynamic effects. One example of a dynamic effect is the fact that internal market barriers make it more difficult to build truly competitive Canadian industries, because they encourage the emergence of sub-scale firms and industries that are focused on local, protected markets. The true, long-term economic costs of internal market barriers may be considerably higher than suggested by static measures.

- By encouraging sub-scale production, internal barriers impede the development of internationally competitive Canadian firms and industries, and thus weaken the ability of Canadian firms to succeed in larger markets.

- Canadians will gain if the current round of constitutional negotiations leads to the removal of internal market barriers and produces a stronger economic union.

- Another set of imperfections afflicting the Canadian economic union stems from a lack of harmonization, co-operation and coherence in federal-provincial policies. Because Ottawa and the provinces share powers in so many areas -- e.g., fiscal policy, labour force development, business and sales taxation, science and technology, industrial policy -- it is vital to find ways to streamline the process of joint-decision-making by the federal and provincial governments.

- It is also necessary to establish institutional and legal structures that will facilitate consensus-building and harmonization in key areas of shared jurisdiction.

- Since the 1960s, the shift in the balance of political and economic power has generally resulted in greater influence for the provinces vis-à-vis Ottawa. Accompanying this shift has been a parallel increase in the likelihood of federal and provincial policies and initiatives working at cross-purposes. This underlines the necessity for greater co-ordination and co-operation among governments.

- None of this rules out meaningful decentralization or a reduced federal government role in fields assigned to the provinces under the current Constitution or a revised Constitution. However, any decentralization must be accompanied by concrete arrangements to assure greater co-ordination or co-operation -- otherwise, the existing Canadian economic union, and the benefits it confers, will be threatened.

THE COSTS OF FRAGMENTATION

The political, institutional and economic changes that would occur in the event of a radical alteration in the relationship between Quebec and the rest of Canada would put serious pressure on the Canadian economic union. Such changes would have negative consequences for the economic well-being of Canadians in all parts of the country, particularly in the short-term (1-3 years).

The material in this section looks at the possible costs of separation and fragmentation. It deals with four principal issues:

- the main types of costs likely to be incurred from separation/fragmentation;
- examples of such costs;
- a discussion of some of the specific estimates that have been made of the economic impacts of separation;
- transitional issues likely to arise in the event of separation.

1. CATEGORIES OF COSTS

- It is difficult to quantify the costs of separation and the possible rupture of Canada's economic union. But it is certainly possible to identify the principal types of costs likely to be borne by Canadians if the country fragments.

- These costs include the following:

  - a slower rate of economic growth, at least in the short-term;

  - a period of higher interest rates, as domestic and foreign investors demand "risk premiums" because of the uncertainty, increased risk of default, and currency risk associated with the spectre of breakup;

  - currency volatility, triggered by the same investor responses;

  - higher inflation caused by depreciation of the Canadian dollar;

  - lost/foregone investment and jobs, as investors and businesses delay making investments, reduce investments, and pull investments out of Canada;

  - larger government fiscal deficits caused by higher interest rates and slower economic growth;

  - for some provinces, there could be a loss of certain transfer payments from the central government and wealthier provinces;

- increased difficulty of doing business in Canada caused by possible disruptions to east-west transportation and communications networks;
- increased difficulty of doing business in Canada because of possible increases in interprovincial trade barriers and disruptions to the integrated Canadian payments and financial system;
- greater divergencies and inconsistencies in tax policy and tax administration across jurisdictions;
- the possible loss, by producers in some provinces, of access to the markets of certain other provinces following breakup;
- the possible rupturing of existing international treaties and agreements to which Canada is a signatory, and which now provide for Canadian access to the United States and other foreign markets; and,
- higher transaction costs if a separate Quebec were forced, or chose, to adopt a new currency.

2. SOME EXAMPLES

- It is highly likely that the uncertainty, rising interest rates, deferred investment, and deterioration in confidence caused by separation would, at least temporarily, result in slower economic growth. A reasonable assumption is that with separation, short-term gross domestic product would be 2% lower than under the option of renewed federalism. If GDP was 2% lower than the renewed federation "base case" for two consecutive years, for example, this would translate into a national income loss of about $30 billion -- equivalent to an income reduction of about $1,100 for each Canadian, or roughly $2,400 for each employed Canadian.

- The threat and possible reality of Quebec separation would almost certainly cause interest rates to rise. If we assume that interest rates are pushed up by 2% and remain at this higher level as long as the uncertainties and perceived higher risks associated with separation persist, the following are illustrative of the effects that might be expected:

  - Total residential mortgage credit outstanding amounts to about $250 billion (Bank of Canada Review, February 1992, p. S72). If half of all mortgages were renegotiated during the period of uncertainty associated with separation, then the cost to Canadian homeowners would be an extra $2.5 billion in annual mortgage interest payments.

  - Total outstanding consumer credit amounts to $86 billion (Bank of Canada Review, February 1992, p. S70). Most of this is short-term credit. A 2% rise in interest rates would cost up to $1.7 billion in extra consumer interest charges.

- Total outstanding business credit amounts to about $400 billion (Bank of Canada Review, February 1992, p. S70). If we assume that half of all business loans turn over during the period of uncertainty caused by separation, the cost to business borrowers could be up to another $4 billion in annual interest payments.

- Combined federal and provincial government debt now stands at approximately $550 billion. If 30% of this debt matured and was rolled over during the period of uncertainty caused by separation, the cost of the assumed 2% rise in interest rates would be an extra $3.3 billion in annual debt interest payments by Ottawa and the provinces.

- In all of the above examples, if the period of uncertainty caused by separation persisted, the additional interest payments facing homeowners, businesses, and governments would continue to rise as longer-term debt was rolled over and new loans were taken out.

- Combined federal and provincial government borrowing will be in the range of $50 billion in 1992, and perhaps $40 billion in 1993. An assumed 2% rise in interest rates would affect the rates charged for all fresh borrowing. Our governments would be forced to pay an extra $1.8 billion in annual interest charges on the amounts borrowed in 1992-93.

▸ Slower economic growth, higher interest rates and deferred business investment would slow job creation and contribute to higher unemployment.

- Canada's labour force consists of 13.7 million persons. If an additional 1% of the labour force became unemployed during the period of turmoil surrounding separation, this would mean that another 137,000 Canadians would be without jobs.

- If we assume that each of these individuals earns an average of $28,000 per year and is unemployed for one full year, the resulting loss in employment income would be $3.8 billion. With an average tax rate of 32%, governments' tax revenues would be $1.2 billion lower over the year.

- Finally, assuming that each additional unemployed person collects Unemployment Insurance in the amount of $1,200 per month, the monthly cost in terms of extra U.I. payments would be $164 million.

▸ A 1% drop in the <u>Canadian dollar</u> is generally thought to translate into a 0.3% rise in the consumer price index because import prices rise when the dollar depreciates. If the dollar declined 3% owing to Quebec separation, then the rate of consumer inflation (holding all other variables, such as interest rates and GDP, constant) would be about 1% higher.

▸ The additional accounting and transaction costs resulting from the use of <u>separate currencies</u> in the European Community have been estimated at around 1% of annual Community GDP. Assuming Quebec adopted its own currency, Quebec economist Bernard Fortin has estimated that the higher transaction costs would amount to 0.6%

of annual Quebec GDP. Using a 5% real interest rate and a 2.5% long-term economic growth rate for Quebec, the present value of these future additional transaction costs is about $40 billion. Canada would also experience increased transaction costs on its trade with Quebec if Quebec introduced a separate currency.

3. SOME SPECIFIC ESTIMATES OF THE COSTS OF BREAKUP

- It is clear that both a sovereign Quebec and the rest of Canada (ROC) possess sufficient economic strength to be viable countries in their own right. Even without Quebec, Canada would still rank as the seventh biggest economy in the OECD. A separate Quebec would be the 14th biggest. The critical ingredients in their past economic success -- a skilled labour force, a high degree of technological sophistication, a rich natural resource base, proximity to the United States, and the presence of a significant number of internationally successful enterprises -- would remain intact following breakup. Both Quebec and the ROC would continue to enjoy high per capita incomes by international standards.

- The issue at hand, however, is not whether Quebec and the ROC would be economically viable as separate countries, but instead the costs of breakup and the extent to which each would remain better off as part of a united Canada.

- Assessing the economic consequences of breakup is by no means a simple matter. While some impacts are measurable, others are impossible to quantify. Nonetheless, several recent studies have attempted to analyze the potential economic consequences. In this section we offer a brief review of the major findings of these studies.

a) **Quebec**

- The Economic Council of Canada (ECC) bases its 1991 study on a scenario of sovereignty-association, in which Quebec and its residents would no longer receive federal transfers and equalization payments, and federal spending on public goods and services in Quebec essentially would be eliminated. In turn, Quebec residents would no longer pay federal taxes. This scenario assumes a reasonably amicable breakup and no disruptions of Canada-Quebec trade. The Economic Council estimates the likely economic impacts as follows:

  - The short-run costs to Quebec would run to between 1.5% and 3% of provincial income, or between $2.5 and $5 billion of an assumed 1992 Quebec GDP of $165 billion.

  - Elimination of explicit and implicit interprovincial transfers to Quebec would raise the total tax burden on Quebec residents by approximately 3.3% of GDP (assuming Quebec chose to provide exactly the same public services as today).

  - If Quebec maintained the same level of expenditures on public goods and government services as is currently provided by itself and the federal government together, total Quebec government spending in 1994-95 would rise to 47% of GDP.

(At present, provincial government spending alone amounts to 24% of GDP in Quebec.)

- There would be uncertainty with respect to whether an independent Quebec and Canada would form a monetary union. Also unclear would be the nature of Quebec's future access to the Canadian market. The ECC does not try to quantify the effects of these uncertainties.

▸ Economist Patrick Grady estimates that separation could reduce real output in Quebec by as much as 10% in the short run, falling to 5% in the long run.

- In the short term, the output loss would be triggered by a crisis of confidence resulting from separation.

- Key short-term negative economic impacts identified by Grady include higher interest rates; loss of Quebec's current favourable access to Canadian markets for dairy, textiles and other "soft" sectors; the end of net fiscal transfers from other provinces; and the costs involved in creating a separate Quebec currency (Grady assumes Quebec would not be able to use the Canadian dollar). In the long term, output losses would be linked to an assumed shift of people and capital out of Quebec.

- Grady estimates that the Quebec budget deficit would increase to more than $10 billion if Quebec took over the existing federal structure of revenues and expenditures.

- He also suggests that if Quebec were to assume one quarter of the federal debt and lost the benefit of federal fiscal transfers, net public debt as a proportion of GDP would rise from 35% of GDP in 1989 to 95%. An estimate of the required tax increase would be between 2% and 3% of GDP. (Note, however, that Quebec taxpayers already bear a significant part of the current federal debt, and also pay federal taxes to cover part of Ottawa's debt servicing charges.)

▸ Economists John McCallum and Christopher Green estimate that separation would have the following short-term effects on Quebec (they do not consider the effects on the rest of Canada):

- Separation is portrayed as having negative impacts in several areas:

  - loss of preferential access to Canada for Quebec's heavily protected dairy industry (Quebec has 48% of the national quota for production of industrial milk; the tariff equivalent of Canadian quota restrictions on dairy products ranges between 50-70%);

  - shift of some corporate head offices out of Quebec;

  - some reduction in the preferential access to Canadian markets now enjoyed by Quebec's clothing and textile industries (note that Canada's tariffs on most textile and apparel products are 15-30%);

- loss of jobs and economic activity, and declining asset prices, in Hull and adjacent areas of west Quebec;
- reduced access to Canadian markets for defence-related industries in Quebec;
- out-migration, particularly of skilled anglophones and allophones;
- negative effect on the construction industry of excess supplies of office and residential space in Montreal.

- McCallum and Green estimate that the rate of unemployment would be 1-2% higher in the first two years following separation; this would add $1-2 billion to the annual provincial deficit.

- The interest rate gap between Quebec and Canadian bonds is already about 60 basis points. They estimate that Quebec would have to pay another 100 basis points above this as an additional market risk premium, meaning that, at least for a few years, market interest rates in a post-separation Quebec would be 160 basis points higher than in the rest of Canada.

- Assuming that Quebec assumed a share of the federal debt proportionate to its share of Canadian GDP, the estimated total public sector debt of a sovereign Quebec would be 90% of GDP.

- Additional out-migration, equivalent to 2.7% of the Quebec population, is estimated to take place by the third year following separation.

b) Rest of Canada (ROC)

- The Economic Council does not provide a detailed analysis of how the uncertainty and loss of confidence likely to be sparked by separation would affect the rest of Canada. It does estimate that federal government spending as a proportion of GDP and the total tax burden facing residents of the nine other provinces would decline marginally following separation. The fiscal effects on individual provinces comprising the ROC would depend on their current contribution to equalization and other fiscal transfers (e.g., through Unemployment Insurance) to Quebec, the extent of their trade with Quebec, and whether higher trade barriers were imposed following separation.

- Patrick Grady, on the other hand, believes the costs of separation for ROC would be considerable and, in all likelihood, long-lasting.

  - Grady estimates the net short run costs to the rest of Canada at up to 2% of GDP. This would amount to an annual income loss of more than $10 billion. Lower GDP in the ROC would result mainly from an immediate loss of confidence triggered by separation, as reflected in higher interest rates and reduced investment.

- Grady notes that estimating the long term costs of separation is complicated by uncertainty surrounding three issues which defy quantification: institutional restructuring, the prospect of post-separation protectionist and interventionist policies, and the loss of international bargaining clout. While impossible to quantify, Grady believes these costs would be significant, and that the ROC would experience a net economic loss from separation.

- Grady also makes the important point that any loss or diminution in the ROC's access to the Quebec market would be costly to firms and workers. Ontario and the Atlantic provinces would be most affected by any disruption in trade flows because of their relatively greater dependence on trade with Quebec (8-9% of manufacturer's shipments from Ontario and the Atlantic provinces are destined for Quebec).

4. TRANSITIONAL ISSUES

- Three key transitional issues with economic consequences would arise in the event of Quebec separation:

  - the magnitude of the risk premium on Canadian and Quebec debt that would be demanded by financial markets;

  - the division of assets and liabilities between Quebec and the rest of Canada; and,

- the renegotiation of international treaties to which Canada is a party.

- **Risk Premiums:** Uncertainty about the impact of political change on taxes, investment income, capital flows, and macro-economic policies will cause investors to demand risk premiums on Canadian assets. The Economic Council identifies three types: political risk premiums, default risk premiums, and currency risk premiums. All would affect interest rates. The magnitude of such premiums would vary with the degree of perceived uncertainty and turmoil surrounding separation.

  - Political risk premiums could appear during the transition period, as well as before and after separation.

  - These premiums tend to be temporary in nature, but can also persist indefinitely. After the election of the Parti Québécois government in 1976, the spread between Quebec and Ontario bonds increased by 60 basis points in Canada and 100 basis points in the United States. The additional spread declined gradually over a period of two years.

  - So far, the current constitutional debate in Canada has not had a major impact on risk premiums on Canadian and provincial bonds, but there are indications that this is beginning to change.

  - Once a new set of Canada-Quebec arrangements is in place, the markets will reassess the creditworthiness of each of the governments that emerge and may impose default risk premiums based on criteria such as the level of debt as a proportion of GDP, the economic outlook, the tax burden, etc. Such default risk premiums, unlike political risk premiums, tend to be long lasting.

- Capital markets, particularly foreign holders of Canadian financial assets, may also demand a higher interest rate to compensate for the perceived greater currency risk attached to all assets denominated in Canadian dollars. Increased uncertainty would arise because of the prospect that the Canadian monetary and currency union might fragment and that more than one currency could eventually emerge. There is considerable evidence that currency premiums are important and volatile, although their size is difficult to measure.

- The persistence of higher risk premiums could have a significant cumulative impact on living standards in Quebec and the ROC over a generation.

▸ **Dividing Assets and Liabilities:** The division of the national debt would be a highly contentious issue. Dividing up federal government assets would also be problematic. Negotiations would approximate a "zero-sum game," since what one party might gain by obtaining a reduced share of the debt, the other would by definition lose by having to accept a relatively larger share. Negotiations over the sharing of liabilities and assets would be more difficult if, as is probable, they were carried out in a climate of conflict.

- International law provides no firm guidance on the distribution of assets and liabilities in such a situation. The parties involved would have to determine the principles to be followed. Whatever the approach, the parties would face the daunting task of appraising all assets and liabilities to determine their current market value.

- The accumulated federal debt will exceed $420 billion in the current fiscal year. There are, in addition, tens of billions of dollars of other federal liabilities (e.g., unfunded public service pension liabilities, loans provided by the Farm Credit Corporation and Export Development Corporation, guaranteed student loans, etc.). The federal government has more than $40 billion in financial assets; but no recent estimate of the value of physical assets is available. The assets and liabilities of the Bank of Canada would also have to be taken into account.

- Possible criteria that might be used to divide assets and liabilities include: 1) population; 2) GDP; 3) federal revenues collected in each province; or, 4) the proportion of the federal debt incurred on behalf of each province over time.

- Using these criteria to divide the federal debt, Quebec's share would vary between 21% and 31%, depending on the criterion chosen. The shares attributable to the other provinces also vary according to the method used -- for example, that of the Atlantic region ranges between 3.5% and 47%!

- Redistributing the federal debt burden among regions would make it more difficult to service the debt because regional revenues are less stable than federal revenues. Interregional risk pooling makes the federal government a more dependable source of revenue.

- **Renegotiating Treaties and Agreements:** It is likely that Quebec and the rest of Canada would have to renegotiate some international treaties such as the Free Trade Agreement with the United States. In addition, Quebec and the ROC would have to hammer out bilateral agreements to address the myriad trade, economic and technical questions that would arise between them.

  - There are 170 existing bilateral treaties between Canada and the United States. What would happen to these in the event of separation?

  - New or renegotiated treaties could very well be less advantageous than the current agreements, since both Quebec and Canada would each have less bargaining power, and probably be forced to make more concessions, than was the case when Canada entered into such international agreements.

  - The need to negotiate or renegotiate a large number of international agreements would add to the uncertainty surrounding separation.