CANADIAN FRAGMENTATION: THE COSTS

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The Charlottetown Agreement should allow us to put several years of constitutional discord behind us, and to move to address other pressing national challenges -- building a stronger economy, creating jobs, and improving Canada's ability to compete in international markets.

While no one knows what will happen in the future, there is a real possibility that failing to approve the Charlottetown Agreement will result in constitutional crisis and several more years of preoccupation with constitutional matters. Worse still, rejecting the Charlottetown Agreement increases the likelihood that Quebec will move toward separation. And this, in turn, could very well set forces in motion that would lead to further fragmentation of the rest of Canada.

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 strain on the Canadian economy. 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). While difficult to predict, the medium to long-term effects could also be serious.

The material in this section looks at the possible economic costs to Canada if the Charlottetown Agreement is not endorsed, and the country subsequently moves toward break-up. It deals with three principal issues:

- the main types of costs likely to be incurred from fragmentation of Canada;
- examples of such costs;
- a discussion of some of the specific estimates that have been made of the economic impacts of break-up.

1. CATEGORIES OF COSTS

- It is difficult to quantify the costs of separation and the possible rupture of Canada's economic and political 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, particularly in the short-term;

  - a period of higher interest rates, as domestic and foreign investors demand "risk premiums" because of the uncertainty, increased threat 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, resulting in solvency problems for some;

- increased difficulty of doing business in Canada caused by possible disruptions to east-west transportation and communications networks;

- 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;

- for producers in some provinces, the possible loss 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;

- the possible rupturing of existing provincial treaties and agreements; or, alternatively, the need to renegotiate laws and regulations relating to comity between provinces;

- higher transaction costs if a separate Quebec were forced, or chose, to adopt a new currency; and,

- increased levels of migration, particularly away from Quebec and the Maritimes and toward Ontario and the Western provinces.

2. SOME EXAMPLES

- It is highly likely that the uncertainty, rising interest rates, deferred investment, and deterioration in confidence caused by separation would, result in slower economic growth. A very conservative assumption is that with separation, gross domestic product would be 2% lower than under the option of renewed federalism. If GDP was 2% lower 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, perhaps sharply. If we assume, again very conservatively, 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 $270 billion (Bank of Canada Review, July 1992, p. S71). If half of all mortgages were renegotiated during the period of uncertainty associated with separation, then the cost to Canadian homeowners of 2% higher interest rates would be an extra $2.7 billion in annual mortgage interest payments.

  - Total outstanding consumer credit amounts to $100 billion (Bank of Canada Review, July 1992, p. S70). Most of this is short-term credit. A 2% rise in interest rates would cost up to $2.0 billion in extra annual consumer interest charges.

- Total outstanding business credit amounts to about $490 billion (Bank of Canada Review, July 1992, p. S73). 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 $4.9 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.

- Combined federal and provincial government borrowing will be in the range of $50 billion in 1992, and perhaps $45 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 almost $2 billion in extra annual interest charges on the amounts borrowed in 1992-93.

- In all of the above examples, if the period of uncertainty caused by separation persisted, or if interest rates rose by more than 2%, the additional interest payments facing homeowners, businesses, and governments would continue to rise, particularly as longer-term debt was rolled over and new loans were taken out.

- 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 13.8 million persons. If an additional 1% of the labour force became unemployed during the period of turmoil surrounding separation, this would mean that another 138,000 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 $3.9 billion. With an average tax rate of 32%, governments' tax revenues would be $1.25 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 $166 million.

- A 1% drop in the Canadian dollar 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 6% owing to the spectre of Quebec separation, then the rate of consumer inflation (holding all other variables, such as interest rates and GDP, constant) would be about 2% higher.

- The additional accounting and transaction costs resulting from the use of separate currencies 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.[1] The rest of 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. 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 not disappear following breakup. Both Quebec and the ROC would probably continue to enjoy high per capita incomes by international standards, but fall well below their full potential.

[1] Bernard Fortin, "Les options monétaires d'un Québec souverain", Éléments d'analyse économique pertinents à la révision du statut politique et constitutionnel du Québec, Document de travail, Numéro 1 pour la Commission sur l'avenir politique et constitutionnel du Québec, 1991, p.288.

- 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) Royal Bank Study

- The Royal Bank of Canada has produced a comprehensive analysis of the Canada-wide costs of break-up.[2] The study argues that break-up would result in higher interest rates, disruption to trade flows and trade agreements, increased emigration, the dissolution of the Canadian monetary union, greater distortions and inefficiencies in tax systems, and disruption of existing inter-regional fiscal transfers. The Royal Bank analysis also predicts that fragmenting Canada would result in the emergence of two or more separate currencies, which would also impose heavy costs.

[2] Royal Bank of Canada, "Unity or Disunity: An Economic Analysis of the Benefits and the Costs," September, 1992.

Some of the specific economic impacts of a 1993 break-up of Canada as estimated by the Royal Bank are noted below:

- Investment declines 10% in the first year of separation, and 4% the following year; thereafter, investment growth is more sluggish than under the option of a united Canada over the remainder of the 1990s.

- Substantial increases in emigration from Canada (largely to the United States) are predicted. In the 1980s, 600,000 Canadians left the country. If break-up occurs, this figure could double over the 1990s. Many of these emigrants would be highly-skilled and well-educated prime age workers, whose participation in the Canadian economy is vital to its continued success.

- By the end of the 1990s, the Canadian economy is predicted to be 18% smaller than under the "base case" of a united Canada. Per capita incomes are 15% lower. **This translates into an annual loss of income of up to $3,900 for each Canadian, or $10,140 for each household.**

b) Other Estimates: Quebec

- The Economic Council of Canada (ECC) bases its 1991 study [3] 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. These assumptions are probably unrealistic. 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

[3] Economic Council of Canada, "A Joint Venture: The Economics of Constitutional Options", 1991.

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.[4]

- 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.

[4] Patrick Grady, "The Economic Consequences of Quebec Sovereignty", Fraser Institute, 1991, P.159.

- Grady estimates that the annual 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[5] estimate that separation would have the following short-term negative effects on Quebec:

  - 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;

[5] John McCallum and Chris Green, "Parting as Friends: The Economic Consequences for Quebec", C.D. Howe Institute, 1991.

- some reduction in the 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 impact on the construction industry from 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.

• 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.

- In a separate analysis, John McCallum[6] asserts that a sovereign Quebec would face a severe liquidity crisis.

  - McCallum calculates that a sovereign Quebec would have a budget deficit of $17 billion in 1992/93. Moreover, about $9 billion of provincially guaranteed borrowings in 1991/92 as well as another $10 billion (required to service approximately $100 billion in accrued federal debt) would have to be added onto the deficit.

  - This would result in a total borrowing requirement in 1992/93 of approximately $36 billion or 23% of GDP. In 1991/92, total Quebec borrowing was $12 billion.

  - Some analysts argue that Quebec could follow a fiscal austerity plan that would alleviate the potential spiralling deficit and debt problems. However, such a plan would have severe negative consequences for living standards and employment while still leaving a substantial deficit problem.

  - Marcel Coté, in "Souveraineté: Les couts de transition", argues that a sovereign Quebec could not possibly borrow the money needed to service its debts.[7] Simply stated, it would face a liquidity crisis.

[6] John McCallum, "Canada's Choice: Crisis of Capital or Renewed Federalism", C.D. Howe Benefactors Lecture, 1992.

[7] Marcel Côté, "Souveraineté: Les couts de transition", Notes for Project 90, Université du Québec à Montréal, 1992.

c) **Other Estimates: Rest of Canada (ROC)**

- In the same paper, McCallum[8] describes the negative effects of Quebec separation upon the ROC. He suggests that Canada's system of equalization is currently under fiscal pressure. This pressure will only intensify with Quebec's separation and a realignment of the Canadian federal system.

- McCallum describes how the federal system of equalization would be at significant risk upon breakup. This would especially impact the "have not" provinces. A reduction or elimination of transfer payments would inevitably result in a migration out of affected provinces. This migration would erode both the tax base and the level of public services provided by these provinces. Further, migration levels could continue to rise rather than fall after the initial shock to the transfer system, thus initiating a snowballing effect. As a result, "have not" provinces could experience long-run decline and insolvency because of the erosion of their population base.

- Finally, McCallum suggests that the migration factor would accelerate the downward spiral of both the ROC and Quebec. In a sense, increased migration would increase the risk, in people's minds, of future economic decline. This would result in a faster cancellation of investment, quicker changes to asset prices, and more pronounced and sustained increases in interest rates.

[8] See "Canada's Choice: Crisis of Capital or Renewed Federalism".

- Patrick Grady[9] 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 significant 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.

[9] See Patrick Grady, "The Economic Consequences of Quebec Sovereignty".