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Abstract: This paper reviews the issues that would arise if Quebec were to separate from Canada. It also presents quantitative estimates of the likely orders of magnitude of their economic impact both on Quebec and the Rest of Canada.

Its overall conclusion is that Quebec would be much harder hit than the rest of Canada if Quebec separates. Real output in Quebec could easily be depressed in the short run by as much as 10 percent and in the long run by 5 percent. In the short run, the output loss would be triggered by a crisis of confidence resulting from separation. In the long run, output loss would be caused by the required transfer of resources to the foreign sector (necessitated by the elimination of the existing fiscal gain in transactions with the federal government), by the emigration of anglophones, and by higher public debt charges resulting from the increased debt burden. The transfer would be made more difficult by the need to ad just in the soft and dairy sectors and by the probable loss of Churchill Falls's power, but it could be facilitated by increased taxes.

For the rest of Canada, the economic costs, which can be quantified, would be substantially lower than for Quebec. And for Canada there also would be some offsetting economic gains. The net short-run costs would only be about one to two percent of GDP and would result mainly from the short-run loss of confidence caused by the separation of Quebec. The long-run quantifiable costs would be small – probably less than the quantifiable benefits.

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The bottom line for Quebec sovereignty

Canada's prosperity threatened by Quebec sovereignty

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

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

Since Quebec sovereignty threatens our hard-won economic success, both Canadians and Quebeckers need to understand fully its economic consequences. The negotiation of trade agreements, the transition costs and the long-run economic impacts – all of these issues must be considered to gain a proper appreciation of the economic consequences of Quebec sovereignty.

Sovereignty-association is a non-starter

Quebec is an integral part of the Canadian economy. Even if Quebec were to separate, bidirectional flows of goods and services, capital and labour would have to be maintained. Continued trade would require some accommodation on both sides, but Quebec would be wrong to assume that Canada has no choice but to negotiate economic association on Quebec's terms. The backlash in the rest of Canada from Quebec's separation and hard-ball bargaining on both sides could easily lead to a mutually destructive trade war.

Sovereignty-association seems to be the preferred option of many Quebecois for economic relationships with the rest of Canada. It has the attraction of preserving the continued free circulation of people and goods between Canada and Quebec. The two pillars of sovereignty-association are a customs union and a monetary union.

No customs union

The existing Canadian customs union has evolved over years in response to the shifting balance of regional and sectoral economic and political forces. It would be highly unrealistic to expect it to persist if political ties between Quebec and Canada were ruptured. Its continuation requires a federal government for resolving disputes. There can be no economic union without a political union.

Moreover, if Quebec were to separate, a continued customs union would not necessarily be in Canada's self-interest. A customs union would require Canada to give up control over its external tariff and to adopt a common commercial policy. But it would not make economic sense for Canada to retain the same duties on clothing, textiles and footwear as Quebec, where more than half of the industry is centred. For the rest of Canada, interprovincial trade in textiles and clothing represents economic welfare reducing trade diversion and not welfare increasing trade creation.

The textile and clothing industries, which are the largest and most important of Quebec's" soft" industries are able to operate only behind high tariff walls and, even then, only after being propped up by Voluntary Export Restraints (VER) under the Multi-Fibre Agreement (MFA). Effective rates of protection for textiles average 16.6 percent; most Favoured Nation (MFN) customs tariffs for most clothing are 25 percent. Import penetration in the market for textiles and clothing has been limited to 30 to 33 percent through restraints on 80 percent of imports.

Other contentious trade issues would have to be resolved to maintain a customs union with Canada. Quebec's dairy farmers supply almost half of Canada's industrial milk at inflated prices under the shield of supply management marketing boards. As a result, Quebec has a trade surplus with the rest of Canada of more than $700 million in dairy products, not including fluid milk. Quebec-Hydro, benefiting from a long-term contract with Newfoundland, reportedly resells Churchill Falls's power for $800 million per year profit (Gorham, 1991, p.E6). Neither of these situations would be allowed to continue if Quebec were to become a foreign country and trade regulations were to change.

In a Canada without Quebec, Western Canada, which traditionally supports free trade and criticizes the way resource industries are treated, would be more influential in the determination of national trade policy. Quebec's departure would break the Ontario-Quebec axis in support of manufacturing.

A free trade agreement would probably be about as far as Canada would want to go to accommodate Quebec. And this agreement would not be an act of magnanimity; it would be in Canada's interest. But it would require Canadians to put aside any hard feelings resulting from a break and could thus not be considered a certainty.

Under a free trade agreement there would have to be border control points between Canada and Quebec to enforce rules of origin and commodity taxes. Even in the European Economic Community there are still border controls on the flow of goods.

Trade arrangements with Canada would not be the only difficulty facing Quebec. The Canada-United States Free Trade Agreement would not automatically apply to an independent Quebec. While the United States would probably be receptive, Quebec would still have to negotiate its own agreement. There is no guarantee that a new agreement would be as favourable as the existing Canada-United States Agreement. As a Canadian province, Quebec has been spared the full extent of scrutiny by U.S. trade negotiators. Government procurement could become a target. Trade barriers affecting alcoholic beverages and agricultural supply management could come under renewed attack. The United States might also investigate the much heavier degree of government intervention under Quebec Inc. American negotiators may want to discuss low-cost electricity provided to industrial uSE7rsuch a Norsk Hydro (Globe and Mail, 1991) and the promotion of Quebec businesses by the Caisse de depot. They may even wish to negotiate environmental safeguards on the development of James Bay Il. Even barring these contentious issues, the negotiation process would be time-consuming. Quebec could not expect to jump to the head of the United States' trade negotiation queue. The U.S. Congress would also want to make sure its views are reflected in any negotiations. All of this could take years and would contribute to a climate of uncertainty which would undermine economic performance.[1]

Maybe a monetary union

The Belanger-Campeau Commission argued that the Canadian dollar could be maintained as a sovereign Quebec's currency through legislation declaring the Canadian dollar legal tender in Quebec (Commission, 1991a, p.58). Jacques Parizeau has gone even further: he said that Canada can do nothing to stop Quebec from using the currency (Macdonald, 1991). For Quebeckers worried about their life savings being eroded by a depreciating Quebec dollar, this could well be the deciding issue for Quebec sovereignty.

But Parizeau is wrong: If Quebec chooses to separate, there is no guarantee that it could continue to use the Canadian dollar. Only the Canadian government can run a Canadian dollar monetary system. It alone can print the currency that people want to hold and make the rules under which the payments system operates. While a quarter of the Canadian money supply is now in Quebec, paper money wears out and must be replaced on a regular basis. The average life of $2, $5 and $10 bills is currently less than one year, and the average life of a $20 bill, less than two years. Only the Canadian government can supply replacement currency.

Even if Quebec were to separate amicably, problems would arise for Canada if Canada allowed Quebec to use the Canadian dollar. It would be impossible for the Canadian regulatory authorities to guarantee the solvency of the Canadian financial system if Quebec financial institutions could clear through the Canadian Payments Association and if the Office of the Supervisor of Financial Institutions did not have supervisory authority over them. The bankruptcy of a major Quebec institution could occur without warning and could bring down the Canadian financial institution with which it had clearing arrangements.

In addition, the Bank of Canada's conduct of monetary policy would be more difficult if a large proportion of Canadian currency and Canadian dollar bank accounts were outside its control. Unlike Canadian financial institutions, Quebec financial institutions could not be compelled to report regularly to the Bank of Canada. This would make it more difficult for the Bank of Canada to rely on current monetary indicators to gauge the stance of monetary policy. More importantly, monetary policy would have to be altered to respond to changes in the money supply caused by inflows and outflows of Canadian dollars from Quebec (resulting from, among other things, different macroeconomic policy stances in Quebec and Canada). This change could conflict with the domestic objectives of monetary policy, such as the pursuit of price stability.

A sovereign Quebec would also encounter problems if it used Canadian currency. The only way Quebec could acquire additional Canadian currency would be by running a balance of payments surplus, which would require either a current account surplus or an increase in foreign indebtedness. Ultimately, Quebec would have to transfer real resources to Canada in exchange for paper currency.

If Quebec were to separate on acrimonious terms and try to-avoid bearing its share of the public debt, the reaction of the rest of Canada would be understandably hostile. In that situation, there are some, admittedly extreme, steps that the Canadian government could take to prevent Quebec from using the Canadian dollar. Existing Canadian currency could be recalled and new notes issued. Restrictions could be put on the export of Canadian currency. Regulations could be established to deny Quebec financial institutions direct access to the Canadian Payments Association.

Such extreme measures would only be taken if there was a complete breakdown of relations between Quebec and the rest of Canada. But Quebeckers must know that they would not hold all the trump cards in negotiations with Canada if bargaining were to get really tough.

Even in a climate of good faith bargaining, a monetary union between Quebec and Canada would be hard to sell to the rest of Canada. To persuade English Canadians of the need for a monetary union, Quebeckers could appeal to English Canadians' pocket books: they could argue that a monetary union was necessary for Quebec to assume its share of the Canadian dollar denominated public debt. Obviously, Quebec would experience more difficulties in carrying its share of the debt load if it had its own currency. But Quebec would have to accept its fair share of the federal government debt as a quid pro quo for a monetary union.

English Canada could be expected to embrace a monetary union with Quebec only reluctantly, if at all, and to yield little, if any, say in the formulation of monetary policy to a sovereign Quebec. Other provinces would find it very difficult to accept Quebec representation on the central bank if they were excluded. In addition, even if a monetary union were established, it might not last. In the past, monetary unions without political unions have always eventually collapsed (Howitt, 1991, p.22).

If no agreement were reached on a monetary union, the lack of a common currency between Canada and Quebec would be more troublesome for Quebec than Canada. The smaller and more open an economy is and the less diversified and the more variable economic activity is, the smaller the benefits from a floating exchange rate in fostering adjustment are and the higher the costs in increased transaction costs and volatility are. Bernard Fortin's estimate that a separate Quebec currency could cost Quebec $40 billion if future costs are discounted to the present illustrates this point (Commission, 1991b, p.288).

The Bank of Canada has already gained the confidence of the international financial community for the stability of the Canadian dollar. Quebec would have to earn such confidence for its new currency. The only quick way to gain confidence would be to peg the Quebec dollar to either the Canadian or U.S. dollar. In so doing, Quebec would lose the capacity to conduct an independent monetary policy. Separation would definitely not be the road to monetary independence for Quebec.

Confrontation over the division of debt

On one issue, Quebec would have an advantage over Canada-the division of the $400 billion national debt. The debt is an obligation of the government of Canada. Quebec would have to be persuaded to assume its one-quarter proportional share based on population.

Currently, we are getting mixed signals from Quebec on how they propose to split the debt. Jacques Parizeau, the Parti Quebecois leader, said in Toronto last December that "we will ...haggle for a few weeks before we come to something like a quarter." But one of the background studies of the Belanger-Campeau report argued that Quebec's share of debt should be only 18.5 percent based on federal assets and revenues in Quebec (17.5 percent if pension liabilities are included). The size of the deficit Quebec assumes will make the difference between an almost balanced budget and a huge deficit. Each 1 percentage point share is worth roughly $4 billion.

There also seems to be some resistance in Quebec to the idea of replacing federal market issues with Quebec issues. The preferred option in Quebec is to leave the federal debt as it is and only to reimburse the federal government for the interest in order to avoid the unnecessary costs of issuing new bonds. But the unmatured debt outstanding has an average term to maturity of only four years. So it would be possible to refinance most of the debt in five to ten years without incurring additional financial costs. The real reason that it would be advantageous for Quebec not to have to assume directly its share of the debt is to avoid an increased risk premium for Quebec government securities. Also, it would strengthen Quebec's hand in future negotiations because Quebec would have the option of threatening to withhold payments if the bargaining were not going its way.

As a last resort, the federal government always has the extreme option of reneging on the roughly 17.5 percent of federal public debt held in Quebec. But this option would disrupt financial markets and it would undermine the federal government's credit rating. It would be used only if there was a complete and acrimonious breakdown of negotiations over the distribution of the debt.

A related issue would be the division of national assets. Presumably those federal government assets having a fixed location, such as buildings and land, would be assigned to Quebec or to the rest of Canada based on their location. But mobile assets would be subject to more disagreement. Breaking up commercially viable crown corporations would be controversial, and if not done carefully could lead to decreases in output and employment. A fair split of assets and liabilities would require that all assets and liabilities be evaluated and that agreement be reached on a fair overall sharing ratio, such as population.

Reductions in the public service

The federal Public Service would have to be cut back sharply if Quebec were to separate, perhaps not by as much as one-quarter, which is proportional to Quebec's quarter population share, but certainly substantially. The impact would be greatest in the Ottawa area. Currently 53,000 federal public servants work on the Ontario side of the Ottawa River and 18,000 on the Quebec side. While some public servants in Quebec would be hired by the Quebec government, many public servants would become unemployed, including many of the 25,000 Outaouais residents with federal jobs in the Ottawa area. Unemployment would rise until displaced public servants could find new jobs. Property values in Ottawa could be expected to decline unless there was an inflow of people from Quebec. Hull and the Outaouais region would be even harder hit. Those remaining in Quebec could not expect to keep their federal jobs, and many would probably decide to move to Ontario. The closure of federal offices in Hull and the sale of homes by those moving to Ontario would produce a real collapse in property values.

Elimination of federal fiscal transfers

Quebeckers must recognize that they are a principal beneficiary of federal government fiscal transactions. Even the Belanger-Campeau Commission estimated that in 1988 Quebec received a net fiscal gain of $409 per capita, or $2.7 billion, from its transactions with the federal government (Commission, 1991b, p.335). An independent Quebec would not get an equivalent amount of foreign aid from Ottawa.

The end of bilingualism

If Quebec were to leave Canada, it would probably mark the end of bilingualism in Canada. Canada has operated as a buffer between French-speaking Quebec and English-Speaking North America. An independent Quebec would have to deal directly with the United States without the accustomed support from Canada. French documentation and labelling would no longer be obligatory for suppliers of goods to Canada, eliminating a non-tariff barrier to trade. The Quebec economy would have to bear the full cost of language requirements itself.

Higher telephone rates for Quebec

Telephone rates are currently set by the CRTC for the whole Bell Canada region encompassing Ontario and Quebec. If rates were to be set separately for Ontario and Quebec, they would have to be increased substantially for Quebec because of the cross subsidy between toll and local service. Toll service costs only a fraction of the price charged to consumers; local service costs double the price. Since French-speaking Quebec accounts for only around 30 percent of the long distance calls in the Bell Canada region, telephone rates would have to increase sharply in a sovereign Quebec.

Territorial disputes

The most divisive issue of all is the territorial boundary of a sovereign Quebec. With the transfer of Hudson's Bay Company lands to Quebec under 1898 and 1912 federal legislation, Quebec's territory has grown since Confederation from 193,000 square miles to 595,000 square miles today. This territory includes James Bay and its hydroelectric facilities, which have been central to the development strategy of a succession of Quebec governments. The federal government still has a strong legal claim on this territory under the terms of the transfer (Varty, 1991). Gordon Robertson has asked how the right of self-determination of the aboriginal people of this territory could be denied if Quebec were to exercise its own right of self-determination through a referendum (Robertson, 1991, p.B3). Other issues that could be raised are the possibility of a transportation corridor between the Atlantic provinces and the rest of Canada and the right of unimpeded access through the St. Lawrence Seaway. On the other hand, Quebec has made a claim to Labrador based on its rejection of the 1927 decision of the Judicial Committee of the Privy Council settling the Canada-Newfoundland boundary.

A territorial dispute would quickly turn negotiations over sovereignty sour; it would almost guarantee an acrimonious and mutually destructive split. Even the possibility of force and violence could not be ruled out. That virtually no countries have broken up without violence is worrisome.

Upheaval in the transition

The consensus among many Quebec economists and businesspeople, as reflected in the Belanger-Campeau report, is that in the long run, there would be no economic costs of sovereignty, and short-run transitional costs could be minimized if both sides to the split behaved rationally. This consensus is based more on wishful thinking than on facts.

The process of separation would be very costly. A strong central government in the rest of Canada and Quebec and sound economic policies would be necessary to control the damage. Even so, economic disruptions and hardship would be great. Many people would move from Quebec to Canada, adding to the flow of 200,000 anglophones who have left Montreal during the last 15 years. Property values in Quebec would be depressed. Confidence in the Canadian and Quebec economies would be shaken. Capital would flee the country until reined in by high interest rates. The stock market would dip and maybe even crash. The solvency of the financial system would be severely tested. Business investment plans would be shelved pending the resolution of the uncertainty. There could be at least a mild recession in Canada and a much worse one in Quebec.[2]

In addition to the dangers of balkanization, English Canada would have to guard against a nationalist backlash which could result in the introduction of interventionist and protectionist policies and an increase in fiscal deficits. These policies could transform the short-term economic costs of Quebec independence into long-run permanent losses. For its part and to its credit, Quebec seems to be committed to pursuing market-oriented and fiscally responsible policies regardless of the resolution of the current crisis (and in sharp contrast to Ontario). Quebec has been one of the biggest boosters of the Canada-United States Free Trade Agreement and is supportive of a trilateral pact with Mexico. Such sound and outward-looking economic policies strengthen its ability to weather the economic storms of separation.

Problems could arise for English Canada if the United States were to insist on renegotiating the free trade agreement with Canada if Quebec were to separate. The United States might try to tighten up the auto pact safeguards to the detriment of Canada's transplants or to gain improved access to markets for cultural industries. But the United States could also seek to extract these concessions within the context of the trilateral negotiations with Mexico. Quebec independence would not necessarily provide the US. with a unique opportunity to address outstanding grievances.

Disruption in the medium term and longer run

Once through the initial transition period, both Quebec and Canada would continue to be hurt.[3] It would take a long time to make up for the investment lost as a result of the crisis in confidence in the transitional period. Investment loss stemming from plant location decisions might never be regained. Furthermore, even a small risk premium in borrowing costs caused by Quebec's heavier debt burden and its currency risk could serve to dampen investment spending permanently and to reduce potential output.

There would also be the deadweight loss from the time and effort that the best brains and talents in the country would have to spend reorganizing and sorting out Canada's affairs. While this would strictly be a transitional cost, it would extend over such a long period that it could be considered a medium-term and even a long-run cost. More than 170 treaties govern Canada's relations with the United States. A similar web of treaties would have to be developed for Quebec and for Quebec's relations with Canada. Quebec would also have to negotiate many treaties with other countries to take the place of those that Canada already has. Negotiations can be very costly and time consuming. For example, the negotiation of the free trade agreement with the United States took more than two years, and during this period the Trade Negotiators Office had an annual budget of $10 million and employed more than one hundred people. The total cost of the negotiations, including expenditures for communications and for other departments, is estimated to be approximately $30 million by the time the trade agreement was implemented. Negotiations are not always as expensive as the free trade agreement. But to renegotiate 170 treaties with the United States and a similar amount with Quebec would be very costly. All the time and effort that would be required to negotiate and renegotiate treaties would be much better spent working to improve Canada's international competitiveness and other pressing domestic problems.

Quebec

In the long run, Quebec would probably continue to be much harder hit than the rest of Canada. Quebec is more dependent on trade with the rest of Canada than the rest of Canada is with Quebec (26.5 percent of Quebec's manufacturers' shipments went to the rest of Canada in 1984, compared to only 6.8 percent of the rest of Canada's shipments to Quebec). Quebec-Canada trade would be disrupted by the growth of barriers to the free flow of goods and services. Without a political union, it would be impossible to prevent a deterioration in the economic union. Quebec's trade position is weak even as a part of, Canada. Its most important export industry-paper and allied products-is threatened by environmental concerns and regulations. Quebec's weak external position would be exacerbated by sovereignty. The importance of the vulnerable and highly protected "soft" sectors of textiles and clothing and furniture in Quebec manufacturing would accentuate Quebec's problem of adjustment. Quebec dairy farms, which provide almost half of the industrial milk for the country at a high price under supply management, would also definitely be at risk. Quebec would also lose access to a secure supply of petroleum. If a separate currency were established, increased transaction costs (estimated by Bernard Fortin to be 0.6 percent of GDP) would further cloud the trade picture. The only unambiguous strength of the Quebec economy is the export of hydroelectricity, but even it could be affected by territorial disputes with Canada and the lames Bay Cree and by any efforts by Newfoundland to cut off Churchill Falls's power. Domestic sales of hydroelectricity to industrial users and the associated exports could also be curtailed if Quebec were forced to eliminate subsidies to reach a trade agreement with the United States.

Given the much higher degree of government intervention in the economy in Quebec than in the rest of Canada, Quebec might have difficulty negotiating a favourable free trade agreement with the United States. Quebec would also have less bargaining clout in international negotiations more generally. In any event, the external position of Quebec would be weak, and structural adjustment policies of the type advocated by the International Monetary Fund and World Bank would be required to strengthen the current account.

The Quebec economy has several weaknesses which would be exacerbated by independence. Quebec would lose the benefit of net fiscal transfers from the federal government. The budgetary deficit of the Quebec government would increase to well over $10 billion if Quebec were to take over the existing federal structure of revenues and expenditures. The loss of economies of scale in the provision of some government services such as defence and external relations could very well result in increased spending and an even higher deficit.

Net public debt as a proportion of GDP would rise from 35 percent of GDP in 1989 to 95 percent if Quebec's share of federal net debt based on population were facto red in. Sharing federal public debt charges based on population, instead of on revenue as is currently the case, would increase public debt charges in Quebec by 0.7 percent of GDP, or $1 billion.

An independent Quebec would have a larger gross public debt than any of the seven largest industrialized countries except for Italy. Of the smaller countries, only Belgium and Ireland would have higher gross debt. A sovereign Quebec would definitely be a high public debt country.

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

If Quebec were to lose the benefit of federal fiscal transfers and to assume its full one-quarter share of the federal dot, taxes would have to increase. An estimate of the required tax increase was offered in (Grady, 1991, chapter 4) of 2 to 3 percent of GDP. This increase would be accentuated by the need for increased spending on health nd pensions as the Quebec population ages. Fiscal belt-tightening would become the order of the day as structural adjustment policies were adopted to redress Quebec's weak external position.

If Quebec became a sovereign state, there would be a renewed exodus of the head offices of Canadian corporations out of Quebec. Quebec's business and entrepreneurial base would be further eroded. Canadian crown corporations such as Canadian National Railways, VIA and Air Canada would have no reason to be headquartered in a foreign country. Private firms such as Imasco, Montreal Trustco, and Power Corporation of Canada, which own Canadian financial institutions subject to restriction on foreign ownership, would under existing legislation be required to move their head office or divest. Similar restrictions apply to federally regulated telecommunication firms or their holding companies such as BCE Inc., Bell Canada, and Teleglobe, airlines such as Air Canada and broadcasting companies such Astral Inc. Other major firms such as Canadian Pacific, Seagram's Corporation, Molson and Alcan (and many smaller firms too numerous to name) might also decide to move. On the other hand, some Canadian firms may locate branch offices in Quebec as American firms have done in Canada.

Quebec's worsened growth prospects and its tax increases would encourage more anglophones to emigrate-almost half of whom have already expressed an intention to leave if Quebec were to become independent (Fontaine,1991,p.Al). Emigration would further undermine Quebec's economic performance because of the key role anglophones play in the Quebec economy, particularly in maintaining links with the English-speaking North American business community.

However, while a sovereign Quebec would be worse off than it was as a Canadian province, it cannot be denied that Quebec would still have a viable economy. Quebec would not be the smallest country in the OECD if it were to become independent. Measured by GDP in U.S. dollars in1988 converted at the average exchange rate, Quebec would only be slightly smaller than Austria and large than Denmark, Finland, and Norway. In population Quebec would it in between the same countries. Quebec's GDP per capita in terms f U.S. dollar purchasing power parity at $17,207 would make it the third highest income OECD country behind the United States and Canada. But, again, the real question for Quebeckers should not be whether a sovereign Quebec is viable economically, but whether Quebec would be better off economically.

A sovereign Quebec would definitely have serious adjustment problems, which could be addressed most effectively if business, labour, and government were induced by a crisis to work together for the greater good of a newly sovereign Quebec. The acceptance of a six month wage freeze next year by Quebec public servants and the multiyear strike-free labour contracts at Aciers Inoxydable Atlas (Parent, 1991) and MIL Group Inc. (Gibbon, 1991, p.3) provide examples of labour's willingness to cooperate in the current difficult climate. However, even a cooperative approach would not be sufficient to overcome the adjustment problems. Thus, a sovereign Quebec could still be in worse circumstances in the long run than Quebec the province, even if everyone cooperates in Quebec after separation.

The rest of Canada

The rest of the country would also be in worse circumstances in the long run if Quebec separates, but its situation would not be as bad as Quebec's. Key to the economic well-being of the rest of the country would be the need to resist centrifugal forces. Nevertheless, any reduction in access to the Quebec market would still have costs. Ontario and the Atlantic provinces would be most affected by any disruption in trade flows because of their greater dependence on trade with Quebec (8 to 9 percent of manufacturers' shipments from Ontario and the Atlantic provinces go to Quebec). The Prairies and British Columbia would be virtually unaffected (only 3.8 percent of manufacturers' shipments from the Prairies go to Quebec and only 1.7 percent from British Columbia). The so-called Pakistanization of Canada could particularly disrupt trade flows between the Atlantic provinces and the rest of Canada (8.9 percent of manufacturers' shipments from the Atlantic provinces go to the rest of Canada and 1.8 percent from the rest of Canada to the Atlantic provinces). Given the higher proportion of trade which could be affected, the Atlantic provinces would be hurt the most by any disruption in trade.

Sharing the public debt will be critical in determining the long-run impact of Quebec's separation on the rest of Canada. For the impact to be relatively minor, Canada will have to ensure that Quebec assumes its full share of the debt.

A very serious disadvantage of Quebec separation for the rest of Canada would be the potential loss of international influence and prestige and the weakening of Canada’s bargaining position in international negotiations. This loss could have an adverse effect on Canada's trade and on other economic relations with the United States and other major trading partners. But the significance of our weakened international position should not be overstated. Canada without Quebec would still be the seventh largest country in the OECD and would retain its status as a junior member of the G-7, though with reduced influence.

The cost of renegotiating treaties with the United States and of concluding similar treaties governing our relations with Quebec would be very high. The $30 million price tag on the free trade negotiations with the United States shows that treaties can be very expensive. Equally important, the negotiations would divert attention from other pressing issues that need attention.

Other institutional restructuring would also be required. Federal government policies and regulations are designed to be applicable to all of Canada. Canadian business operates in an integrated economy. If Quebec were to separate, the federal government would have to be restructured; many laws and regulations would have to be changed. Corresponding changes would be required in private sector firms. Financial institutions and other regulated industries like telecommunications would have to change the most. All of this change would be very costly.

On the positive side, Canada would benefit from the end of net fiscal benefits to Quebec from federal government transactions with the Quebec government and residents. Without Quebec, the recipient of almost half of equalization payments, the cost of fiscal transfer payments to less well-off provinces would be much more affordable for the deficit strapped federal government.

The long-run economic impact of Quebec sovereignty on the rest of Canada would be conditioned as much by the policy responses of the Canadian government as by the direct impact of the act of separation itself. It would be important not to adopt protectionist and interventionist policies which would make the situation worse.

An estimate of the bottom line

Quantitative estimates of the economic impact of Quebec sovereignty on Quebec and the rest of Canada in both the short and long run are provided in table 1. It should be stressed that these estimates give only a rough indication of the orders of magnitude involved; they are not strictly additive. In addition, they do not take into account multiplier effects. Moreover, some important areas of impact are impossible to quantify and are thus only noted. It cannot be emphasized enough that the economic consequences of breaking up a county are so complicated and unpredictable that it is impossible to estimate them with any confidence. Nevertheless, in spite of their limitations, summary estimates are given to focus debate on the economic consequences of Quebec sovereignty.

The quantitative estimates highlight the fact that Quebec would be much harder hit than the rest of Canada if Quebec separates. Real output in Quebec could easily be depressed in the short run by as much as 10 percent and in the long run by 5 percent. In the short run, the output loss would be triggered by a crisis of confidence resulting from separation. In the long run, output loss would be caused by the required transfer of resources to the foreign sector (necessitated by the elimination of the existing fiscal gain in transactions with the federal government), by the emigration of anglophones, and by higher public debt charges resulting from the increased debt burden. The transfer would be made more difficult by the need to ad just in the soft and dairy sectors and by the probable loss of Churchill Falls's power, but it could be facilitated by increased taxes. The estimated impact of separation is very large: there is no policy that the Quebec government could pursue that could offset such a precipitous decline in output as that likely to be caused by separation.

For the rest of Canada, the economic costs which can be quantified are substantially lower than the costs for Quebec. And for Canada there are some offsetting economic gains. The net short-run costs would only be about one to two percent of GDP and would result mainly from the short-run loss of confidence caused by the separation of Quebec. The long-run quantifiable costs would be small – less than the quantifiable benefits. However, before English Canadians become too complacent about the consequences of Quebec sovereignty for the rest of Canada, it is important to stress that the estimates overlook three very important and costly items which defy quantification, namely institutional restructuring, pressure for protectionist and interventionist policies, and the loss of international bargaining clout. These costs would be sufficiently great to ensure a large economic loss for the rest of Canada from Quebec sovereignty.

A last warning

The economic costs of the separation of Quebec would be very high for Quebec. Although the costs are lower for the rest of Canada, they are still important, particularly the less tangible costs which are not readily quantifiable. Uncertainty over the eventual outcome of a split is one of the most important arguments against sovereignty. The Canadian economy is a powerful generator of wealth and jobs. It would be extremely foolish to break it up since Canada is not sure of the consequences.

Pointing out the costs of sovereignty is not to blackmail anyone. Rather it is to try to warn both Canadians and Quebeckers of the possibly dire economic consequences of their political choices in order to foster a needed spirit of compromise. If successful, it will spare much needless economic pain all around.

If the warning is not heeded, Canada will have to pull together to make the best of a bad situation. If Canada must establish economic relations with a sovereign Quebec, then Canadians must keep their emotions under control and be guided by self-interest, not spite. An emotional response would only make a bad situation worse. Damage control is the only rational response.

Notes

* This paper is an edited version of the final chapter of *The Economic Consequences of Quebec Sovereignty* which was originally published by the Fraser Institute in 1991 (see http://global-economics.ca/ec_conseq.htm). It is being made available as a working paper to ensure that it remains readily accessible. The author is grateful to the Fraser Institute and especially Michael Walker for sponsoring and publishing the original study. He is also grateful to Barry Carin who provided support for an earlier series of reports that provided the basis for the study.

1. U.S. concerns in trade negotiations with a sovereign Quebec are discussed in more detail in Smith (1991) and Courchene (1991). The Quebec Inc. model is most fully developed in Courchene (1986).

2. Based on past recessions, the real output loss from the loss of confidence likely to be triggered by Quebec sovereignty could easily be in the range of 2.5 to 5 percent of GDP for Quebec and 2 to 3 percent of GDP for the rest of Canada. This range for the decline in output is based notionally on the 1981-82 and 1990-91recessions. Another way of looking at it is that interest rates could rise by some 4 percentage points to stem capital outflows. The average impact of a 1 percentage point decrease in interest rates simulated with 9 (macroeconomic models at a conference of model-builders was an increase in GDP of 0.2 percent in year 1 and 0.6 percent in year 3 (O'Reilly, 1983 and background papers). Assuming the impact of an increase in interest rates is the same magnitude and of opposite sign to a decrease and that model responses are linear, the impact of a 4 percentage point increase in interest rates would be a reduction of 0.8 percent in output in year 1 and 2.4 percent in year 3. To this impact could be added an additional reduction in investment resulting from uncertainty over sovereignty. Since business fixed investment in Quebec is around 11 percent of GDP, a 20-per-cent decline in business investment would amount to over 2 percent of GDP. A combination of the impact of interest rate increases and confidence-induced declines in investment could easily add up to an overall impact of 2.5 to 5 percent of output. This confidence-induced output loss would be exacerbated, especially in Quebec, by other output-depressing impacts.

3. John Helliwell and Alan Chung using a sophisticated econometric methodology have sought to quantify one aspect of the long-run impacts, the growth effects of national scale economies. They estimate that the growth in real GDP per capita would be reduced by 0.17 percent in Quebec and 0.06 percent in the rest of Canada (Helliwell and Chung, 1991, p.9). These are relatively small numbers and do not capture fully all the dynamic costs of breaking up the country.

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TABLE 1
SUMMARY OF THE ECONOMIC IMP ACT OF QUEBEC SOVEREIGNTY
(Percent of GDP/(-) Loss and (+) Gain)

	Quebec		**Rest of Canada**	
	Short Run	**Long Run**	**Short Run**	**Long Run**
Trade				
- soft sectors	-1.2	small-	small+	small+
- current account	-2 to -3	-2 to -3		
- Dairy farms	-0.5	small-	small+	small+
- Churchill Falls	-0.5	-0.5	+0.1	+0.1
Separate Que. currency	-1	-1	-0.3	-0.3
Existing Net Fiscal Gain	-2	-2	+0.6	+0.6
Public Debt Charges				
- Division of Debt	-0.7	-0.7	+0.2	+0.2
- Interest Rate Premium	-0.2	-0.2	0	0
Net migration	-1	-2	+0.3	+0.7
Confidence-induced Output Loss	-2.5 to -5	-2 to -3		
Institutional Restructuring	large-	large-	large-	large-
Pressure for Protectionism and interventionist policies	small-	small-	large-	large-
Lost International Bargaining Clout	large-	large-	large-	large-
Elimination of Bilingual Labelling and Packaging	large-	large-	small+	small+

Note: Small is defined as being less than 0.5 percent of GDP and large greater than 1 percent of GDP. All of these items are not additive.