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EXECUTIVE SUMMARY

The fundamentals and fiscal policy of federalism

The debate over fiscal imbalance has occupied Canadian politicians for a number of years, particularly in Québec. Fiscal imbalance is not a new concept and has been already studied in the literature on fiscal federalism. In this paper, we present a broader view of fiscal imbalance in the context of the economics of federalism. Since Ottawa's consenting to important increases in its transfers to the provinces, there has been much less talk about this complex of problems. Did fiscal imbalance really ever exist? This study aims to get a fix on the question by looking at the recent history of fiscal federalism in Canada.

The first part of this report deals with the foundations of federalism and their implications in terms of fiscal policy. Federal systems have evolved over the decades, but the principle of division of duties remains at the heart of the political model. This system seeks to exploit the entirety of the national market in order to secure economies of scale, scope, network and coordination in the delivery of public services and to have all citizens of the country benefit from them.

In Canada, the issue of natural resources and the North-West Passage in the Arctic Sea allows for an illustration of the advantages of federalism. The purchase of military equipment, research to assemble data to back up Canadian territorial claims and to locate natural resources, and construction of a deepwater harbour are a few of the expenditures made possible because the Canadian government can use its taxation power across the country. A single province, if it were independent, would not be in a position to manage all the expenditures essential to the affirmation of its sovereignty on that territorial portion of the Arctic Sea to which it may lay claim. It would have to enter into an agreement with the rest of Canada to pay the portion of expenses it would have to assume, and do so without being able to count on more than its regional taxation power.

In a federation, a number of activities conducted by the member States have an impact on neighbouring States. Because States estimate that part of the benefits of certain expenditures in strategic sectors get away from them, they will tend to under invest in these areas. To avoid such an under-funding of public-expenditure programs, the central government tends rather to make transfers to the States. In cases where these transfers are in fields under the jurisdiction of the States, the central government will let States manage the sums transferred.

In a federation, the division of jurisdictions is not as watertight as the drafters of the national constitution would have wished. There is therefore always a risk of an overlap of the activities of the central government and those of the governments of the federated States. Regardless, that problem must not be exaggerated. Oftentimes what may appear to be an overlap is in fact a complementarity. In the area of health care, for example, Health Canada handles drug licensing and in so doing generates savings of scale and scope for all the provinces. A province wishing to secede would have to take charge of that responsibility; there would then not be an elimination of an overlap but rather duplication of duties and therefore a squandering of resources.

The notion of fiscal imbalance

To obtain an optimal allocation of resources across the country, the federal government should theoretically, take charge of taxation, and afterwards transfer part of the amounts collected to the member States. The decision of the federated States to manage their own fiscal policy is above all a political decision based on the idea that they need to control part of their revenues in a sovereign way. In Canada, the existence of a complex tax system in each member State and the use of taxation as a means of attracting people and investments diminishes the economic performance of the overall country.

Another basic dimension of federalism concerns the gaps in wealth among the member States. To reduce wealth disparities and ensure all the country's citizens a level of comparable public services, the central government, thanks to its power to tax nationally, can redistribute the product of taxes through transfers to the poorer States, thus securing the horizontal equity of the Federation. If the poorer States wish to offer more generous public services than those linked to the transfers, they will have to impose a greater tax burden on economic agents, which risks hampering economic growth.

Canada ranking among the most fiscally decentralized federations, the existence or not of a fiscal imbalance between the central government and the federated governments is difficult to establish. In effect, it becomes very difficult to define what the fiscal imbalance is, since all the member States possess their own fiscal policy, which sometimes competes with that of the federal government and the other provinces.

However it is not in the nature of Canadian federalism to find itself in a situation of vertical fiscal imbalance where the provinces would be systematically penalized. On the contrary, during the 1980s and 1990s, the federal government, although heavily in debt, continued to make massive transfer payments to the provinces. Obviously, these provinces did not demand of Ottawa that it take control of its finances in order to put an end to this form of fiscal imbalance, it being in their favour. To illustrate that earlier form of fiscal imbalance, in Québec, from 1981 to 1995, the cumulative total of the deficits incurred by the federal government amounted to more than \$162 billion.

The situation was reversed in 1995, when Jean Chrétien's cabinet decided to bring to an end the debt spiral of which the Canadian government was caught. From 1995 to 1997, federal expenditures overall fell by 7%. During the same period, transfers to the provinces dropped by 23%. We are therefore right to think that the provinces had to absorb the most important cutbacks associated with the straightening out of federal finances. To alleviate the impact of the cutbacks, the federal government allowed provinces more leeway in managing federal funded programs, but it was too little given the size of the transfers' cuts.

The Québec Commission on Fiscal Imbalance

In the early 2000s, the government of Québec created a Commission on Fiscal Imbalance. The Commission concluded that there truly did exist a vertical fiscal imbalance in Canada and that this would intensify over time if observed trends continued. But it is relatively easy for provinces to present requests for increased transfers to the central government. This Commission would have been much more credible if the Québec government had demonstrated that it managed its budget properly, did everything in its power to foster economic growth and had envisaged how new revenues could be collected, particularly by reviewing the rates for government services like electricity. In addition, while the steps taken by the Québec government could give the population the impression that the province found itself alone in its relationship with Ottawa, in reality the case of Québec was not unique, and certain conclusions of the Commission could have been endorsed by other provinces.

At the point when Québec was preparing its argument with regard to a vertical fiscal imbalance, the federal government, faced with criticism from the provinces concerning the funding of health care, submitted funding proposals that led to the 2003 Accord on Health Care Renewal. Québec was successful in 2004 in signing another specific agreement with Ottawa on Health care. That agreement was based on «asymmetric federalism», meaning a flexible federalism that allows for the existence of arrangements tailored to the uniqueness of Québec. With this Accord and also by putting forward strong arguments, the federal government concluded at that time that there was no vertical fiscal imbalance in Canada.

A new division of fiscal resources

With Ottawa maintaining its surplus position and the provinces insisting on the existence of a fiscal imbalance, the Conservative government elected in 2006 judged that the moment had come to review again Ottawa's transfer policy. It turned to equalization. To take account of the growing gap engendered by the energy boom in the Western provinces, important changes were introduced to that program in 2007.

Further to the health-care and equalization agreements, to which must be added the creation of new trust programs and a significant increase in transfers reserved for infrastructure, federal transfers to the provinces rose by almost 45% between 2005 and 2010-2011. In Québec, from 2005-2006 to 2010-2011, transfers from the federal government increased by 54%, climbing from \$12.5 billion to \$19.3 billion. The equalization payments received by Québec went from \$4.8 billion to \$8.5 billion.

Québec is receiving, in 2010-2011, nearly 60% of the equalization payments made by the federal government. There are some who minimize the importance of equalization, arguing that Quebecers are getting back “the money from their taxes.” This is completely inaccurate. The equalization is paid out of the federal government's general revenues, which come from Canada as a whole. Québec's share in those revenues is 20%, the same as its share in the Canadian GDP. Québec gets back that 20%; the rest of the equalization received is paid by Canadians living in the provinces that do not receive equalization, like Alberta, British Columbia and generally Ontario. Thus, for each dollar transferred to Québec under the equalization program, it costs Québec taxpayers only \$0.20. That amounts to an annual net benefit of \$6.8 billion, which results from Québec being part of the Canadian federation.

Some state that we should reduce, even eliminate, Québec's dependence to equalization payments. This would imply strong measures such as increasing the tax burden and cutting expenditures to stimulate economic growth. Further, to increase its revenues, Québec could set rates for public services that reflect costs. Lobbies, unions and other associations would strongly oppose some of these measures. A profound cultural change, often described as a second Quiet Revolution, would be needed to eliminate the dependence on equalization payments.

As we see, the financing of the Canadian federation does not evolve in a linear way. Depending on the times, the provinces either have benefited from federal-government largesse or have had to make do with a cutback in federal transfers. One thing cannot be denied: maintaining sound government finances in Ottawa profits the entire federation, among other ways in the form of lower interest rates.

The finances of an independent Québec

After having clearly established the fiscal advantages that belonging to a larger whole entails for the federated States, the study finally deals with the fiscal impact that the separation of Québec from the Canadian federation would involve. The most recent evaluation of that impact was produced by the Parti Québécois in 2005, on the initiative of the then Member of the National Assembly for Rousseau, François Legault. Although the analysis is obsolete, the methodology used illustrates the flaws of the separatist approach in evaluating the government finances in a sovereign Québec.

There is a belief among separatists that, in leaving the Canadian federation and repatriating the taxes paid to the government federal, Québec find itself with an important surplus of revenues plus would be able to eliminate any deficit and ensure funding of all current provincial programs, plus those it would inherit from the Canadian government. That thesis goes against all economic logic. Québec contributes 20% of the revenues of the Canadian government while a big part of federal spending in the province is done on a per-capita basis, meaning that Québec receives 23.5% of the moneys paid out by Ottawa. Moreover, programs like defence, international relations, transport and others entail important economies of scale, scope, network and coordination, economies that would be lost if Québec decided to go it alone.

The Legault study estimated the net budgetary gains of independence at \$13.8 billion for the period 2005-2006 to 2009-2010. The central assumption of the study is that of “business as usual”. Investments, population, jobs and financial markets would not be affected by this major political change. Such a hypothesis is quite simply not believable. Other scenarios should have been presented to illustrate the impacts of the uncertainties generated by the separation of Québec from the rest of Canada.

But even while allowing that separation would not bring about negative economic impact, when more realistic hypotheses than the ones retained in the study are adopted, the anticipated gains disappear.

One of the assumptions of the “Legault budget” is that the federal government would accept that Québec’s share in the liabilities of the Canadian State amount to 18.2%, whereas the weight of the Québec population in Canada is in fact 23.5%. Further, the study supposes that the federal government would agree to keep on its balance sheet the share of Québec’s debt – that is to say, an independent Québec would only have to pay to the government of Canada the interest on that debt. Since Quebecers have benefited, as have all Canadians, from the public goods offered by the federal government, it makes more sense to estimate Québec’s share in the national debt at 23.5%. Moreover, the Canadian government would certainly refuse to keep Québec’s share of the debt on its balance sheet, because that would amount to a subsidy paid to Québec following its separation from Canada. Québec will quite simply be required to refinance its share of the debt on the markets. Québec would thus find itself with a debt exceeding 100% of its gross domestic product (GDP), which would bring with it a drop in its credit rating and an increase in interest charges. Further, the Legault study does not tackle the question of currency.

Generally speaking, *Les Finances d'un Québec souverain* tends to underestimate the expenditures that Québec would have to assume to maintain the services of the federal government. The document does not demonstrate how it will be possible to maintain those services with only 17.4% of federal spending while current federal spending in Québec hovers around 23.5%. The transfer of numerous functions of the federal government to Québec and of federal civil servants to the provincial civil service is a colossal undertaking, but one that is presented, in the Parti Québécois document, as a simple accounting transaction. The many examples of research conducted on the question of mergers of organizations demonstrate that these are complex and are accompanied by a downsizing that leads to a net reduction in employment. Very often the complexity of the integration has produced synergies or cost-cutting that were considerably lower than forecast.

Another aspect that is not considered in the “Legault budget” is that of start-up and training costs for the new responsibilities assumed by an independent Québec. Unlike the hypothesis concerning elimination of overlap, Québec’s independence would bring with it a duplication of costs, with functions already assumed by the federal government being taken charge of by the government of the new country. All these start-up costs would have to be estimated in any complete study of the question.

When we consider other hypotheses than those selected in the study piloted by Mr. Legault, the estimated surplus turns into a deficit that would force the government of an independent Québec to make some very difficult decisions. Various existing programs would have to be reconsidered if tax increases or even an untenable deterioration of the government’s financial situation were to be avoided.

In conclusion, even if Quebecers believe, much as the residents of a number of other provinces do, that they do not always receive their fair share of federal funding, it is clear that Québec has no economic and financial interest in leaving the federation. Negotiations about dividing up the tax pie and jurisdictions are an integral part of the federal regime. In all federations, the member States cannot always be fully satisfied with the fiscal arrangements and with the division of responsibilities between themselves and the federal government. Nevertheless, as we believe we have shown, the advantages of belonging to a federation largely outweigh the disadvantages peculiar to that political system.

INTRODUCTION

The present study deals with the financing of the Canadian federation, more specifically with the question of the alleged fiscal imbalance between the government of Québec and the federal government. The concept of fiscal imbalance, which is not new and which has already been a subject of analysis in the literature on fiscal federalism, arose in public discussions in Canada in the early 2000s. The Parti Québécois, in power at the time, persisted in maintaining that the “revenues are in Ottawa and the needs and therefore the expenditures are in Quebec City.”

The financing of a federation is much more complicated than this simplistic formula suggests. Moreover, unlike the hypothesis on which sovereigntists have for a long time based their proposals, economic logic does not support the thesis according to which repatriation of revenues collected by the federal government in Québec and of the expenditures assumed by the latter in the province would make it possible for an independent Québec to produce revenue surpluses, surpluses that would solve the problem of the provincial government’s lack of resources. Québec profits within the Canadian federation from the wealth of Canada as a whole and benefits from substantial economies of scale associated with the collective goods supported by the federal government – in other words, by all Canadians.

It is essential, first of all, to take a look at the major principles of fiscal federalism. We can thus set the discussion of fiscal imbalance in Canada in a global context. The first part of this study bears therefore on the foundations of federalism. This political model enables regions to pool resources in order to finance expenditures that profit everyone. We will see the advantages of a federal regime and also the difficulties that it can present in terms of division of powers and revenues. We will additionally present a brief comparison of Canadian federalism with the other types of federalism in the world so as to illustrate in particular the question of the centralization and decentralization of areas of jurisdiction.

The second part of the study will analyze the evolution of the financing of the Canadian federation across the years. We will dwell notably on the principle of equalization, the principal tool of the federal government for better sharing the wealth among the provinces. We will also examine more closely the debate on the fiscal imbalance between the provinces and the federal government. Finally, in the last section, we will analyze the advances on the Québec government’s finances of the province’s participation in the Canadian federation and the errors separatists make when estimating the impact of independence on the economic and financial situation of the future country.

THE FUNDAMENTALS OF FEDERALISM

Federalism is a form of organization of the State that incorporates a number of characteristics and institutional practices particular to it. One of those characteristics is the separation of powers between the federal State and the federated States. A federation may be born of the union of a number of States within the same federal State or of the division of a unitary State into two or more federated entities. The governmental duality thus created calls on a double loyalty of citizens: one with respect to the Federation, the other with respect to the member State. A federal regime exists in several countries, including Germany, Switzerland, the United States, Belgium, Austria, Russia and Canada. Federalism may take several forms, depending on the country and the time. In Germany the one adopted is decentralized, whereas Austria opted for a more centralized model.¹ Either way, the federal regime is an alternative solution to the model of the unitary State.

Alexis de Tocqueville, following his travel in the United States, was among the first commentators to extol (in his *Democracy in America*, published in 1835) the virtues of federalism, which allows for a division of duties between the central power and the States. The former takes care of the major sectors that concern the entire country, such as international trade, while the latter, closer to the citizens, are responsible for regional issues. Federal systems have evolved over the decades since, but the principle of division of duties remains at the heart of that political model. This system seeks to exploit the whole of the national market to secure economies of scale, scope, network and coordination in the delivery of public services and in so doing benefit all the citizens of a country. Because it would lose these economies, it would cost each region much more to assume the expenditures of the central government so as to maintain a comparable level of public service.

Belonging to a federal regime entails numerous advantages for the member States. But frequently, in countries where that regime has been adopted, there are tensions between the regional governments and the central State. Indeed, the fiscal translation of federalism in a way that reflects the jurisdictions of each level of government is neither simple nor easy; grey areas necessarily remain. Nevertheless, by and large, the advantages are such that federal regimes are generally stable. Federalism has been the subject of various analysis aimed at identifying its characteristics, advantages and limitations.²

The role of the central State

One of the basic principles of federalism is therefore the division of duties among the levels of administration. Each entity specializes in activities where it possesses a comparative advantage, so that it can ensure efficient production of public services. To the central State is entrusted the responsibilities that affect national interest, such as defence, a collective good that profits all citizens. The central State is in a position to secure important economies of scale and coordination by using its taxation power to purchase military equipment and to recruit and train soldiers on behalf of the country's citizens as a whole. By developing a competent staff, the central government can realize scope economies for the deployment of the different army corps. The experience acquired

1. (<http://www.taurillon.org/>)

2. In a reference work published by the prestigious Brookings Institution in 1974, "The Economics of Public Finance", we find a study of federalism that remains an essential reference. In the work of the MacDonald Commission we also find reference studies on federalism, including the study "Fiscal Federalism" edited by M. Krasnick, Volume 65, published in 1986 by the University of Toronto Press. A number of studies have joined this list, including an in-depth review of the literature by W.E. Oates, "An Essay on Fiscal Federalism," in *Journal of Economic Literature*, Vol. 37, No. 3, September 1999, pp. 1120-1149.

in the purchase of military equipment and during training with the troops of allied countries also produce network economies essential to the efficient management and use of the army for civil tasks as well as for protecting the territory. These savings would not be achievable if each member State in the federation possessed its own army.

In Canada at this moment, the issue of natural resources and the North-West Passage in the Arctic Sea allows for an illustration of the advantages of federalism. The purchase of military equipment (giant ice-breakers, patrol boats, and so on), research to assemble data to back up Canadian territorial claims and to locate natural resources, and construction of a deepwater harbour are a few of the expenditures made possible because the Canadian government can use its taxation powers across the country and its bargaining leverage with equipment suppliers to achieve important economies of scale. A single province, if it were independent, would not be in a position to manage all the expenditures essential to the affirmation of its sovereignty on that territorial portion of the Arctic Sea to which it may lay claim. It would have to enter into an agreement with the rest of Canada to pay the part of expenses it had to assume, and do so without being able to count on more than its regional taxation power.

Another example: centralized management of telecommunications services allows for the definition of national standards and of regulations thanks to which we benefit from a common technology and similar ways of doing things that produce scale and network economies. Also, pollution not being only a regional issue, it is essential that the central government enact standards for the country as a whole, while not preventing each member State from having its own regulations, especially for questions of a local character. Likewise, transportation among the States is a responsibility that falls to the central government so that it can ensure services that benefit all the economic agents on the national territory. On the other hand, local transportation, such as public-transit systems in an urban agglomeration, essentially benefits the citizens of one State and therefore come under the responsibility of the regional government.

Environment may be a subject of tension between the central government and the federated States if the targeted objectives are not the same. In the U.S., for example, California has often been forward-looking and has forced the automobile industry to reduce vehicle emissions while the central government had a more permissive attitude. Currently in Canada most of the provinces have more ambitious emission-reduction objectives than those of the federal government – which should instead be a leader and encourage the more polluting provinces to revise their objectives. Eventually, the conflict will have to be decided on by the voters.

In the majority of federations, the responsibility for international trade is entrusted to the central government. First, companies doing business on the whole of a federation's territory will want to benefit from great trading fluidity, which presupposes coordination among the member States for the establishment of commercial standards. On the international market, the federal government, thanks to its size possesses a stronger bargaining power than that of a member State. Which is why, for some decades, the tendency has been towards the grouping of countries within commercial unions. In addition, the aim of the central government, through the signing of commercial agreements or participation in major international organizations, will be to optimize the use of the entirety of the country's resources for the profit of all the member States. Each of these may thus benefit from the development of natural resources in another member State, either through trade channels or because those resources contribute to enriching the country as a whole.

Spillover effects

A number of activities conducted by the member States have an impact on neighbouring States. Federalism makes it possible to take into account these spillover effects. Because States estimate that part of the benefits of certain expenditures in strategic sectors get away from them, they will tend to under-invest in these areas. To avoid such an under funding of public-expenditure programs, the central government could offer a cash transfer to the States that would enable them to obtain an optimal level of expenditures for the responsibilities that they incur.³ As that optimal level of expenditures is difficult to estimate, central governments tend rather to make transfers to the States, based on simple rules, to compensate at least in part for those leakage effects and recover on behalf of all citizens the benefits of the expenditures.

The classic case is that of education expenditures, which generally are the responsibility of the federated States. People educated in a State can go and work in the neighbouring States with the result that the State that has assumed the costs of a person's education does not glean the benefits. For that reason, the States could be incited to spend less on education if they reckon they will lose a significant part of the benefits. This would result in under-investment in education by the States to the detriment of the country as a whole. It is this phenomenon that justifies the federal government's intervention in education, at the financial and economic level, even though the delivery of services does not fall under its jurisdiction.⁴ The central government can thus back the development of human capital for the benefit of the country as a whole.

Federal government transfers to the provinces also generate spillover effects and as such may make that redistribution of wealth more acceptable to the richer provinces. For example, equalization payments from the federal government to the relatively poor provinces come in large measure from the richer provinces. But the amounts received may be used by the Maritimes to purchase equipment produced in Québec and Ontario, where Canada's large manufacturers are located. A number of interventions by the federal government have such effects, which benefit all the member States of the federation.

The risks of overlap

There exist in all federations examples of overlap of jurisdiction the extent of which varies based on the political model in place. Canada being one of the most decentralized federations in the world, the provinces enjoy important leeway in setting up programs. It can consequently be expected that there will be, at least outwardly, an overlap of the interventions of the two levels of government. The existence of such overlapping, if it were well established, should lead to agreements between the central government and the provinces designed to eliminate them and to reduce their cost. In Canada there have been a number of agreements of that type, agreements that Québec has profited from, for instance in the area of manpower training.

We have to be clear about what is understood by "overlap." The term is often confused with "duplication." And yet, it is very rare for a program from one level of government to duplicate one from another level. For that to be so, it would be necessary for the same service to be offered to the same user base by the two levels of government.⁵

3. J.M. Buchanan, "Federalism and Fiscal Equity," *American Economic Review*, Vol. 40, September 1950; and D. Netzer, "State-Local Finance and Intergovernmental Fiscal Relations," in *The Economics of Public Finance*, Washington, DC: The Brookings Institution, 1974.

4. If these federal expenditures in Canada are justified at the economic level, their constitutional legality does not achieve consensus, the Act of 1867 being silent on the subject. See N. Verrelli, "The Federal Spending Power," Working Paper, Institute of Intergovernmental Relations, Queen's University, May 2008.

5. M. Salvail, "Federal-Provincial Program Overlap," Department of Finance, Government of Canada, December 1992 (<http://dsp-psd.pwgsc.gc.ca/Collection-R/LoPBdP/BP/bp321-e.htm>).

Frequently, what may appear to be overlap is in fact a complementarity. In the area of health care, for instance, Health Canada concerns itself with the licensing of drugs and thereby generates economies of scale and scope for all the provinces. A province wishing to secede would have to take charge of that responsibility; there would not be an elimination of an overlap but a duplication of duties and therefore a squandering of resources.

In other cases of apparent overlap, a federal program similar to a provincial one is intended for a different user base. Finally, federalism evolves, and can always be improved by a more precise definition of certain jurisdictions. Indeed, areas of activity exist that can be qualified as grey areas and can be a source of overlap, the environment constituting a good example in this connection. If it is determined that there is effectively overlapping in a given sector and that turns out to be a waste of resources, the two levels of government may work on eliminating it or else ensuring management that restricts its effects.⁶ The better the jurisdictions are defined, the less overlap there will be. It is in Québec's interest, among other ways through the Council of the Federation, to partner with the other provinces in order to identify the true instances of overlap. Once the facts are established, the provinces can open negotiations with the federal government aimed at an agreement to abolish the spending program deemed to be useless and thus free up resources that can be earmarked for other uses, including tax reduction.

The concept of fiscal imbalance

The notion of *fiscal imbalance* appears early in the theory of fiscal policy in a federal regime. The issue is: which level of government would be economically more suited to take charge of certain expenditures and additionally to collect the revenues for financing an optimal level of those expenditures.⁷ Thus, the constituent States should have entrusted to them all the expenditures producing little in the way of leakage of benefits to other States. We think of, among other things, public transit in urban regions. In regard to revenues, economies of scale and scope can be secured if tax collection is entrusted to the central government, which would then see to making transfers to the federated States. Moreover, the federated States are not in the best position to levy taxes when the economic objects or agents one wishes to tax can move from one region to another. The federal government should therefore, theoretically, take charge of all taxation, and afterwards transfer part of the amounts collected to the member States.

The decision of the federated States to manage their own fiscal policy is above all a political one, based on the idea that they need to control part of their revenues in a sovereign way. The existence of a complex tax system in each member State and the use of taxation as a means of attracting people or investments disrupts the allocation of resources in a country and diminishes its economic performance. Personal income tax by the States is the path that causes the fewest distortions in the allocation of resources, whereas on resource allocation.⁸ In this regard, Canada, with Switzerland, is among the most fiscally decentralized federations, which makes the study of fiscal imbalance even more complex.⁹ It becomes in effect very difficult to define what fiscal imbalance is, since all the member States possess their own taxation, which is sometimes in competition with those of the federal

6. Special Joint Committee on a Renewed Canada (Beaudoin-Dobbie Committee), "A Renewed Canada". Study Group report. Ottawa, 1992. This committee proposed various measures for limiting overlaps.

7. J.M. Buchanan, "Federalism and Fiscal Equity."

8. W.E. Oates, "An Essay on Fiscal Federalism."

9. G. Hale, "Federalism and Canada's Economic Union: The Past 20 Years."

government and the other provinces. As another dimension of this decentralization, provinces can enact tax measures that cancel or counteract the policies of the central government. Thus, in terms of fiscal concerns, the Canadian federation, because of its decentralization and of past political decisions, is far removed from the economic model that allows for optimal allocation of resources.¹⁰

The central government can make the transfers that it deems essential for taking account of spillover effects and ensuring the delivery of basic services, such as health care, at a comparable level in each State. It can also ensure a better distribution of wealth among the States. But beyond this, it can leave to the member States the care of funding the services they decide to offer their citizens. This principle is acknowledged in the budget presented in March 2010 by the government of Québec, where the minister of Finance recognizes that more generous public services in Québec than in other provinces are reflected in heavier taxation.

The distribution of wealth

Another basic dimension of federalism concerns the gaps in wealth among the member States. A richer State is equipped to offer better public services with the same taxation level as that of a poorer State. Or, if it offers services comparable to those of the poorer States, it will do so while imposing on its citizens a tax burden much lower than that existing in the less affluent States. To reduce these disparities and ensure all the country's citizens a comparable level of public services, the central government, thanks to its power to tax nationally, can redistribute tax proceeds by assuring transfers to the poorer States, which enables them to offer standardized services on a nation-wide basis. This transfer mechanism, from the richer States to the less well-off ones, is part of the horizontal equity in a federation, that is to say, an equitable distribution of wealth among the member States. These transfers can be conditional on their use for certain services, such as those related to health care. Unconditional transfers allow the States to use the transferred amounts as they see fit.

Transfer payments from the central government should therefore even out the public services offered in the federation's different States. Those transfers are based on an equalization formula whose goal is to direct the transfers to the jurisdictions with a relatively weak fiscal capacity as compared to the national average. These transfers may thus diminish or eliminate the horizontal fiscal imbalance. Still, if the poorer States wish to offer more generous public services than those linked to the transfers, they will have to impose a greater tax burden on economic agents, which risks having the unintended consequence of chasing away investors or qualified human capital to the other States – and thus they find themselves poorer still.

In Canada, this wealth redistribution mechanism is known as “equalization.” The Royal Commission on the Economic Union and Development Prospects for Canada, (MacDonald Commission, 1982-1985) thus equalization:

One can have at the same time the economic and political advantage of belonging to a larger country endowed with greater financial, political and natural resources, and the social advantage inherent in the power of the provinces to set their priorities themselves in many areas of primary importance in regard to their particular cultural situation. Provincial autonomy is hollow if the province does not possess the financial resources necessary to exercising its autonomy. The economic integration of Canada as a whole offers the common advantage of the

10. Let us remember that in all provinces except Québec, the federal government collects provincial tax. It then sends the proceeds to the provincial governments, a formula that reduces the costs of collection. Québec collects its income tax itself. Some have proposed that the provincial government collect the tax and then remit it to Ottawa. That way of doing things could reduce collection costs. However, it would run counter to the optimization of resource allocation in the country as a whole.

most efficient use of collective resources and therefore allows the **members of the union to dispose of more considerable means in pursuing their common and distinct activities**. Association in a single country offers the advantages of strong economic integration and, thanks to equalization, at the same time allows the provinces to dispose of comparable tax revenues in effectively managing their social policies.¹¹

As regards Québec, the Commission added:

*In the framework of an equalization system, when people's mobility is hindered by linguistic or cultural obstacles that might prevent those people from taking full advantage of national economic integration, as in the province of Québec, the province in question does not suffer the consequences of lower fiscal capacity in the provision of its services or in the execution of its social policies.*¹²

Another advantage of federalism has to do with the ability of the central government to ensure the country's economic stabilization with means that exceed those of the member States, such as the borrowing capacity and that of spending on the territory as a whole.¹³ In effect, the central government can borrow at more advantageous conditions than the federated States can, and that to benefit of the entire country. The use of a common currency facilitates transactions of all kinds among the States. The federation's central bank will ensure the stability of the currency, a stability essential to a climate conducive to investments and economic growth.

Generally speaking, decentralization in federated States has taken on importance both in the industrialized world and in developing countries. As the economy of a country develops, gains may emerge from greater fiscal decentralization in a federal regime.¹⁴ In the U.S., for example, the central government entrusted a significant share of responsibilities to the States in setting up a number of important programs. That decentralization depends on the assumption that local governments, closer to their populations, will be more receptive and better able to respond to the particular preferences of their fellow citizens. Nevertheless, decentralization has its limitations, and a federal system aims to unite the strengths of each level of government in the rendering of public services. It is therefore important to the governments of a federation to understand which functions are more efficient when they are centralized and which are more efficient when they are decentralized. This is a fundamental aspect of fiscal federalism here.¹⁵ However, the optimal level of decentralization cannot be established in a precise way. All the more so since the balance achieved must be acceptable at the political level. Negotiations between levels of government are therefore an integral part of a federal system in the search of maximum efficiency.¹⁶

Among the conclusions of the MacDonald Commission, we find that the commissioners favoured a functional approach of federalism rather than a rigid, ideological approach.¹⁷ The question of the centralization or decentralization of powers in the Canadian federation should be guided by the needs of the citizens and by looking for the most efficient way of satisfying these. It is therefore recommended that federal and provincial governments demonstrate flexibility. The commissioners did not propose changing the constitutional division of jurisdictions, but rather suggested a flexible federalism.

11. Professor J.F. Graham quoted in M. Krasnick, "Fiscal Federalism".

12. Ibid.

13. W.E. Oates, "An Essay on Fiscal Federalism."

14. R.W. Bahl and J.F. Linn, "Urban Public Finance in Developing Countries", New York: Oxford University Press for the World Bank, 1992.

15. W.E. Oates, "An Essay on Fiscal Federalism."

16. "Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance," The Council of the Federation, Advisory Panel on Fiscal Imbalance, Final Report, 31 March 2006.

17. Royal Commission on the Economic Union and Development Prospects for Canada, Report, Supply and Services Canada, Ottawa, 1985, Vols. I, II and III.

One of the most important of the Commission's recommendations bore on the negotiation of a free trade agreement with the U.S. The Liberal government of Québec and also influential holders of separatist beliefs were in favour of such an agreement, while other provinces, including Ontario, were less so. Québec made numerous representations to the federal government with a view to influencing the terms of the agreement. Paradoxically, while all Québec governments have in general made efforts to increase the autonomy of the province within the federation, the signing of a free trade agreement led the federal government to negotiate not only in the areas of shared jurisdiction but also in areas generally reserved for the provinces. The Free Trade Agreement with the U.S., and later on the one that included Mexico (NAFTA), led the provinces to eliminate a certain number of non-tariff barriers. The potential economic gains were sufficient to persuade Québec to agree to abandon certain powers affecting trade both on the Canadian and international market. What was involved was a highly pragmatic approach to the division of jurisdictions between the provinces and the federal government.

The literature on federalism demonstrates the multiple advantages for the States of being part of a federation. While we recognize the complexity of certain issues, such as the spillover effects among the States, we do not in practice achieve precise measurements of these phenomena or at a code of specific rules aimed at maximizing the advantages of a federation. There must be political agreements among the member States that will represent compromises and that cannot satisfy all the members always and completely.¹⁸ For example, the more prosperous States can agree to the central government carrying out a redistribution of wealth to the less affluent States, but there is a line that the richer States will refuse to cross.¹⁹ Again, it is clear that the withdrawal of a member State, especially if it belongs to the poorer States, will entail for it very significant costs and losses of revenue. These will have to be assumed by the citizens of the secessionist State, but also, in a much less pronounced way, by the other members of the federation owing to the losses of scale, scope, network and coordination economies. This is what may be called a lose-lose situation.

18. Compromises are unavoidable even when the States are independent, as is demonstrated by the arduous negotiations among the member countries of the European Union to solve the financial problems of certain of the Union's member States.

19. In Canada, the price-setting system for oil during the oil shock of the 1970s, introduced by the Trudeau government, is an example of abuse by the central government to the detriment of the wealthier provinces in addition to being a very bad policy in terms of resource allocation. This system consisted in imposing a tax on Western Canadian oil and using the proceeds to subsidize the price of oil imports, all this in order to reduce the price paid by consumers in Québec, Ontario and the Atlantic provinces.

THE EVOLUTION OF FISCAL BALANCE IN CANADA

It is not in the nature of Canadian federalism for it to find itself in a situation of vertical fiscal imbalance²⁰ in which the provinces would be systematically put at a disadvantage.²¹ On the contrary, in the years 1980 and 1990, the federal government, although heavily in debt, continued to make massive transfer payments to the provinces. Of course, these provinces did not demand that Ottawa take control of its finances in order to put an end to this form of fiscal imbalance, it being in their favour. The borrowings of the central government in part funded the provinces' current spending in health care and education. Something unheard of in the post-war period, the International Monetary Fund warned Canada of the dangers of excessive indebtedness. It needed the Liberals' coming to power and the determination of Finance Minister Paul Martin to stop that dangerous spiral of debt.

One of the principal sources of that debt was the overvaluation of Canada's potential growth at a time when, in the late 1960s and early 1970s, Ottawa was setting up costly social programs such as the health-care system, social assistance and unemployment insurance. At that time, Canada's per-capita wealth was more or less on a par with that of the U.S. That evolution of the Canadian economy could allow for the belief that the country was going to carry on getting rich at a sustained pace in the future. But three decades later, the standard of living in Canada is about 20% lower than that of the U.S. Growth in GDP has been lower than forecast, in part because of the weight of social programs and the high level of taxation needed to fund them. This is why certain remedial measures have had to be brought to bear in the course of time, among them a reform of unemployment insurance, which has grown less generous than it was in the early 1970s.

In 1977, in the face of the rising cost of federal-provincial shared-cost programs, the federal government, except for the Canada Assistance Plan, switched to a formula of lump-sum payments. It was reckoned that the shared-cost formulas did not encourage provinces to efficiently manage their programs. The weakness in the growth of the Canadian economy made funding social programs even more difficult, for which reason the central government had to incur an increasing debt.

To illustrate the fiscal imbalance in Québec's favour that existed in the 1980s and '90s, we see that the annual deficit incurred in Québec by the federal government ranged from \$7 billion to \$11 billion.²² That imbalance grew more prominent in the 1990s, when the federal deficit stood at around \$12 billion. In the period 1981 to 1995, the cumulative total of the deficits incurred by the federal government in Québec amounted to more than \$162 billion, part of which was financed by the federal government's borrowing. These amounts served among other things to fund current expenditures in health care and education. The adjustment of the federal government's finances begun in 1995 would translate into an appreciable decrease in its deficits registered in Québec starting in 1996.

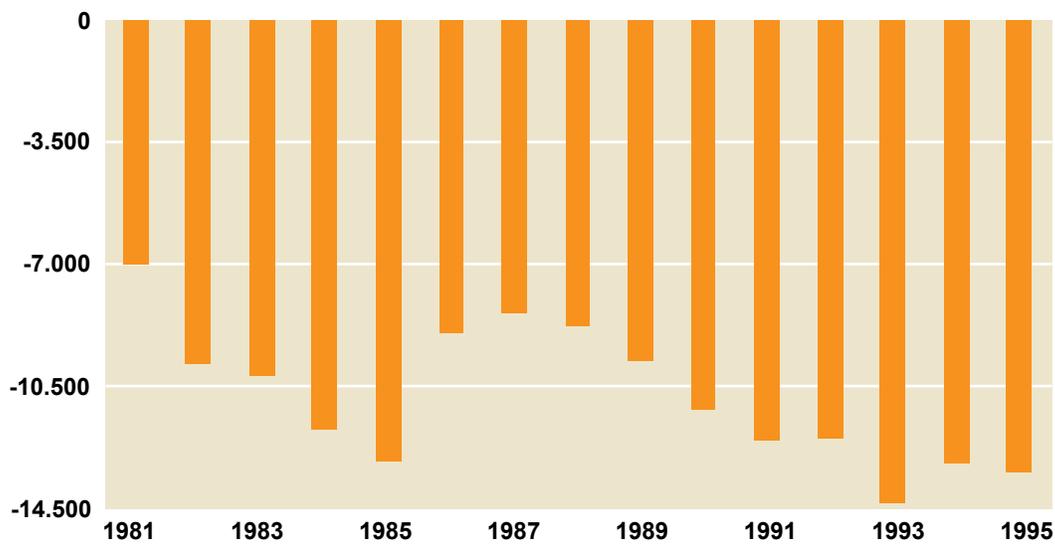
20. Vertical fiscal imbalance is defined as the gap existing between orders of government with regard to the adequacy of sources of revenue for expenditures required by their respective jurisdictions. This means that one of the orders of government collects more taxes than it needs to carry out its responsibilities, limiting by that much the ability of the other order of government to raise the revenues it needs to carry out its own.

21. "Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance."

22. Statistics Canada, Provincial and Territorial Economic Accounts, Table 7, 13-018-X in the Catalogue.

Beginning with the moment when the federal government decided to break the vicious circle of indebtedness, it had to make cuts in all its expenditures, including transfers to the provinces. From 1995 to 1997, federal government expenditures as a whole dropped by 7%.²³ All the economic agents in the country were called on to eliminate the deficit. The federal government among other things closed important institutions like the Economic Council of Canada and the Canadian Workplace Automation Research Centre. Certainly, reductions in transfers to the provinces between 1995 and 1997 were still more important, reaching 23%. Nevertheless, it was a question of an essential adjustment, since the provinces, including Québec, had profited for a number of years from a fiscal imbalance in their favour.

Deficit (revenues less spending) of federal administration in Québec
(in billions of dollars – 1981-1995)



It is therefore correct to state that the provinces had to absorb the most important cutbacks associated with the straightening up of the federal government's financial position. In return, Ottawa granted them greater freedom in the use of transferred funds, but that measure was far from compensating for the impact of cutbacks on the province's finances. We are touching here on a criticism that has been made for a long time by the provinces, namely that the federal government establishes programs that it finances jointly with them, but imposes hard and fast rules on them. When it reduces its contribution, it continues imposing the same rules, with the result that the provinces cannot take measures to lessen the impact of the cutbacks. A well-known case is that of user fees for health care; provinces wishing to introduce such a measure would find themselves penalized by Ottawa.

23. Statistics Canada, Economic Accounts, Federal Administration Spending, Table 3, in *Canadian Economic Observer*, 11-210-X in the catalogue.
G. Hale, "Federalism and Canada's Economic Union: The Past 20 Years."

There is no doubting that these rules imposed by the federal government are part of the problematic of vertical fiscal balance in Canada. The provinces must be allowed more leeway in managing programs funded in part by the federal government.²⁴ Population aging, among other things, will create considerable pressure on health-care systems, and the provinces will have to find new ways of balancing supply and demand; to be successful they will need more room to manoeuvre. The budget brought down in March 2010 by the Québec Finance minister opened the door to such arrangements.

From 1997 to 2004, when new agreements on health care between Ottawa and the provinces were signed, expenditures of the federal government for goods and services rose 5.7% per year while transfers to the provinces were increasing at an average annual rate of 7.7%. Beginning in 2005, transfers to the provinces and to municipalities experienced a sharp increase of 14.2% a year to reach \$62.4 billion in 2008, while expenditures in goods and services were increasing by only 6.6% per year. A new balance was achieved at the time.

It has to be seen nevertheless that the straightening up of Ottawa's finances in 1995 profited Canada as a whole. Interest rates for borrowers like the provinces and public corporations decreased and we enjoyed a long period of economic growth. As the federal government had considerably reduced its debt level in proportion to the GDP, it was able during the recent recession to add to its deficit in order to finance impressive stimulus measures. All the economic agents in the country profited and Canada emerged better than most countries from one of the worst economic crisis in history.

Therefore, the financing of the Canadian federation does not evolve linearly. Depending on the period, the provinces have either been able to profit from the munificence of the federal government or had to deal with cutbacks in federal transfers. One thing is certain: maintaining sound government finances in Ottawa profits the entire federation in the form of lower interest rates and easier access to credit. Finally, a country where the governments' financial situation is advantageous attracts foreign investments. And these have always been an important component of Canada's economic growth.

24. K. Norrie, "Federalism and Canada's Economic Union: Lessons for the Future," in *Prospects for Canada: Progress and Challenges 20 Years after the Macdonald Commission*, ed. D.E.W. Laidler and W.B.P. Robson, Toronto: C.D. Howe Institute, 2005.

The debate over fiscal imbalance

In the early 2000s, the government of Québec created a Commission on Fiscal Imbalance. The task force headed by fiscal-law expert Yves Séguin concluded that there truly did exist a vertical fiscal imbalance in Canada and that this would intensify over time if observed trends continued. Those conclusions were based on the following arguments:²⁵

- The provinces are subjected to very important pressures in terms of expenditures, above all in the area of health care owing to population aging;
- The sharing of revenues between the federal and provincial governments is to Ottawa's advantage;
- The two major transfers existing between the federal government and the provinces, namely the Canada Health and Social Transfer (CHST) and equalization, are inadequate;
- The federal spending power is not sufficiently limited.

According to the Séguin commission, this imbalance was reducing the funding of certain priority services for citizens and thus affecting the quality and consistency of social programs and other public services. That argument was used to buttress the slogan that claimed that “the money is in Ottawa and the needs in the provinces.”

A report written by the Conference Board, at the request of the Commission, projected federal government surpluses linearly over twenty years, that is, supposing that the conditions that prevailed in the early 2000s remained stable for two decades. In 2019-2020, federal government surpluses would have reached \$90 billion, whereas Québec would be suffering a deficit of \$5 billion. These figures were certainly spectacular – but were meaningless – because over such a long period, a host of events would necessarily shatter the hypotheses underlying such a prediction. The exercise could convince the media, but in terms of fact did not really support Québec's argument. In that regard, the recession of 2008-2009 transformed the federal government's surplus into a considerable deficit, one in the order of \$40 billion.

Québec's responsibility

It is relatively easy for provinces to present requests for increased transfers to the central government, but to be credible they would have to demonstrate that they manage their budgets properly and do everything in their power to foster economic growth. Before establishing the Séguin commission, the Québec government should have asked itself some basic questions:

- **Economic growth**

The more prosperous a region is, the easier it is for it to finance its public-expenditure programs. Now, the Québec economy has lagged behind that of Canada as a whole in terms of growth and productivity. If Québec had enjoyed a growth comparable to Canada's from the 1970s up to the end of the 1990s, its GDP would have been markedly higher compared to the level observed at the time the Landry government launched the work of the Séguin commission.²⁶ That deficit in growth arose from the chronic weakness of private investments during the period. And that slow growth was manifested in a productivity that was

25. Y. Séguin, “Speaking Notes for the President of the Commission on Fiscal Imbalance,” March 7, 2002 (<http://www.desequilibrefiscal.gouv.qc.ca/en/presse/index.htm#8>).

26. See especially M. Boyer, “La performance économique du Québec: constats et défis,” CIRANO (Centre universitaire de recherche en analyse des organisations), The Burgundy Reports, February 2001; and G. Mathews, “L'essoufflement de l'économie québécoise face à l'économie canadienne,” *Recherches sociographiques*, Vol. 39, 1998.

anemic in comparison with the Canadian average and with that of the American States.²⁷ It would have been necessary to identify the causes of that lag and see what measures could be taken to stimulate private investment. For example, abolition of the tax on capital, sought for a long time by business circles, would have been conducive to investment growth.²⁸

- **Management of government finances**

The request for increased funding from the federal government rests on the hypothesis that the amounts currently spent and for which Québec receives federal financing are spent in a completely efficient way and that it is not possible to obtain more services with the same financial resources. But the Commission did not demonstrate the efficiency of the Québec government's spending. Before talking about fiscal imbalance, it would have been necessary to examine the management of public moneys in Québec to see if improvements were possible.

The governments that have succeeded one another in Quebec City have not been successful in bringing the administration's expenditures to a level that compares with that observed in other provinces in Canada.²⁹ At \$6,445 in 1999-2000, the budgetary spending per capita in Québec was among the highest in the country. It was a little higher than in New Brunswick, 20% higher than in Ontario and 17% higher than in British Columbia. Before asking the federal government to increase its transfers, the government of Québec should have carried out a serious examination of that spending.

- **Revenues and rate setting**

Finally, the government should have examined the entire question of the rate setting of public services, including the rates of Hydro-Québec. Pressure groups have promoted the view that since Hydro-Québec belongs to the citizens of Québec, rates have to be kept down and cross-subsidized by the commercial sector. This leads to bad business decisions and to a waste of the resource. Yet the government at the time decreed a freeze in Hydro-Québec's rates. More generally speaking, the rate setting of public services constitutes a very good method for ensuring a balance between demand and supply of public services. It does not constitute, as we often hear it said, a tax in disguise, but rather a price demanded of users in exchange for a service offered by the State or one of its agencies. This problem had already been raised in a document produced by the Finance minister of Québec – in 1993. This question remains of current relevance and was the subject of a recent study requested by the Québec government.³⁰ A revision of Hydro-Québec's rates as well as of other services to bring them up to the level of costs would have procured new revenues for the Québec government and partly answered the revenue needs revealed in the report of the Commission on Fiscal Imbalance.

As we see, the Québec government's approach included several gaps. It would have been more credible if Québec had demonstrated a willingness to improve the economic situation with concrete measures and to do its part in collecting new revenues.

27. R. Létourneau and M. Lajoie, "A Regional Perspective on the Canada-US Standard of Living Comparison," *International Productivity Monitor*, No. 1, Autumn 2000.

28. The weakness of the level of private investment in Québec is still subject of analysis. See *Québec Welcomes Investment*, Report of the Task Force on Business Development, Government of Québec, 2008 (http://www.gtie.gouv.qc.ca/en/documents/Report_InvestmentBusiness.pdf).

29. This problematic was not new. Already in 1993 the provincial finance minister had submitted a document entitled "Les finances publiques du Québec: vivre selon nos moyens" (Public Finances in Québec: Living According to Our Means), which examined Québec taxpayers' ability to pay in relation to the level of public services offered by the provincial government.

30. The task force on rate setting demonstrated that rates in Québec are lower than elsewhere in the country and that the Québec government relies less on rates than do those of other provinces. See the report *Mieux tarifer pour mieux vivre ensemble*, March 2008 (http://www.gtisp.gouv.qc.ca/RapportFR_GTTSP.pdf).

Québec is not alone

While the steps taken by the Québec government could give the population the impression that the province found itself alone in its relationship with Ottawa, in reality the case of Québec was not unique, and certain conclusions of the Séguin commission could be endorsed by other provinces. As the work of the Council of the Federation shows,³¹ a number of provinces wish to limit the spending power of the federal government. That power particularly worries the richer provinces, since it is they who, through the federal government, finance the relatively poor provinces like Québec.³² Thanks to the spending power, the federal government can create new shared-cost programs without the provinces' agreement. It can also unilaterally reduce its contributions to those programs, as the cutbacks of 1980 and 1990 demonstrate.

According to the provinces who oppose the spending power, the federal government should collect only the taxes it needs for its own programs, which would leave fields of taxation available to the provinces to finance theirs, in conformity with the division of jurisdictions provided for in the British North America Act of 1867. On the other hand, those who support the federal spending power assert that this argument does not take account of the economic disparities between the provinces and of the limited ability of some of them to accumulate enough money to fulfill their constitutional responsibilities. The poorer provinces therefore need federal funds to offer comparable social services while maintaining a reasonable level of taxation.³³ Finally, we showed earlier that the central government must transfer revenues to the provinces to avoid under-investment in sectors like education.

The pitfall of transferring tax points

To correct the fiscal imbalance, the Séguin commission proposed giving additional financial means to the provinces.³⁴ It was recommended that the Canada Health and Social Transfer (CHST) be abolished and that some tax room be freed up by means of a transfer of tax points. The commission also suggested reviewing the equalization formula, limiting the federal government's spending power and taking measures to ensure a stable funding of provincial expenditure programs.

The idea of freeing up tax room through a transfer of tax points to Québec won over a number of Québec politicians, from all parties. But this would be a serious mistake. Québec, as a poor province, contributes to the Canadian GDP to the extent of 20% while its population accounts for 23.5% of that of Canada.³⁵ The federal government's transfer payments being for the most part based on population,³⁶ Québec receives a share of 23.5%, appreciably higher than its share of the national GDP. As a result, a tax point on personal income at the federal level, given the greater wealth of the country in comparison with that of Québec, is worth more in per-capita tax revenues than a tax point repatriated to Québec.³⁷ The repatriation of tax points would cost Québec revenues. This is therefore not a measure that would allow for a reduction in fiscal imbalance – other means have to be considered, for example, modifications to the equalization formula.

31. See "Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance."

32. N. Verrelli, "The Federal Spending Power."

33. N. Verrelli, "The Federal Spending Power."

34. Source: <http://www.desequilibrefiscal.gouv.qc.ca/en/presse/index.htm#8>.

35. The richest province in the federation is Alberta. Containing 10% of the Canadian population, it produces 16% of the country's GDP. This province is an important contributor to the federal government's equalization payments to the relatively poor provinces, like Québec.

36. T. Kent, "The Federal Spending Power Is Now Chiefly for People, Not Provinces," Institute of Intergovernmental Relations School of Policy Studies, Queen's University, 2007.

37. Another way of describing that reality (in "Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance"): "... from a single point of the personal income tax, the highest-income provinces obtain about twice as many dollars as the lowest-income provinces."

Health-care agreements

At the point when Québec was preparing its sales pitch by creating the Commission on Fiscal Imbalance,³⁸ the federal government, faced with criticism from the provinces concerning the funding of health care, submitted proposals that led to the 2003 Accord on Health Care Renewal.³⁹ The Accord constitutes an action plan for improving access to quality care for all Canadians, with Ottawa undertaking to transfer to the provinces \$36.8 billion over a five-year period, from 2003-2004 to 2007-2008. This was a first step in improving the vertical funding of the federation. On an annual basis, the agreement amounted to about \$7.4 billion, approximately \$1.7 billion of it for Québec.

The following year, Québec, which has always favoured specific agreements with the federal government in fields coming under its jurisdiction, was successful, in signing another accord with Ottawa. That 2004 agreement was based on a “asymmetric federalism”, meaning a flexible federalism that allows for arrangements tailored to the uniqueness of Québec or of another province. That agreement allowed Québec to allocate the federal funds on the basis of its own priorities, still in observance of the main principles of the federal health-care program.⁴⁰

This 2004 health-care agreement is considered one of the key moments in the evolution of our federation.⁴¹ Indeed, the provinces played an important role in the application of that agreement. They were led to define and delimit the precise role of the federal government in the area of health care.

Following the signing of that agreement, Canada’s Finance minister judged that a vertical fiscal imbalance no longer existed in Canada. The provinces, notably Québec, obviously did not share that opinion.⁴² The federal government wanted to preserve its advantageous fiscal position, remembering the financial quasi-catastrophe of the 1990s. In addition, the long period of growth that Canada was experiencing reinforced the thesis according to which the two orders of government have access to all the major sources of tax revenues and enjoy complete autonomy in drafting taxation policies that allow for the funding of expenses falling under their respective responsibilities. According to the federal Finance minister, it is inaccurate to claim that there is a disparity in access to revenues. The provinces have access to tax bases from which the federal government cannot draw, such as proceeds from the sale of alcohol products, revenues from gambling, property tax and royalties on natural resources (in particular oil and gas royalties and the earnings of Hydro-Québec). A number of these tax bases have grown faster than traditional ones like personal income tax.⁴³

In this regard, in Québec, the earnings of the provincial crown corporation the Société des alcools du Québec (SAQ) paid in the form of dividends to the Québec government climbed from \$471.3 million in 2001 to \$867.2 million in 2010.⁴⁴ Those earnings experienced a continuous progression, except in 2005 because of a labour dispute.

38. “Fiscal Imbalance in Canada: Historical context,” Report, Commission on Fiscal Imbalance, Quebec City, 2002.

39. <http://www.fin.gc.ca/fedprov/2003a-eng.asp>

40. “Asymmetrical Federalism That respects Quebec’s Jurisdiction,” Health Canada, 2004.

41. T.J. Courchene, “Pan-Canadian Provincialism – The New Federalism and the Old Constitution,” *Policy Options*, November 2004.

42. In a series of studies on the question of fiscal imbalance entitled “The Fiscal Balance in Canada: The Facts,” published beginning in 2002, Department of Finance Canada maintains that the provinces have access to tax bases that allow them to finance their spending. www.fin.gc.ca/facts-faits/fbcfacts5-eng.asp or www.fin.gc.ca/facts-faits/fbcfacts-eng.asp.

43. “The Fiscal Balance in Canada: The Facts,” 2005.

44. Annual report of the SAQ.

Hydro-Québec earnings rose from \$1 billion in 2000 to \$3 billion in 2009.⁴⁵ Other rate hikes are forthcoming, with the result that profits should continue to increase when economic growth regains momentum. Since the early 2000s, Loto-Québec has brought in about \$1.4 billion on an annual basis.⁴⁶ Lastly, the debate over rate setting revealed that a number of services are under-rated in Québec;⁴⁷ the potential exists there for additional revenues that the Québec government plans to exploit in order to ensure a better allocation of resources.

This debate over fiscal imbalance brought up a major aspect of the Canadian federation's financing: if provinces like Québec wish, in their areas of jurisdiction, to offer more services than other provinces, it falls to the taxpayers of that province to fund those services. It is something of this principle that is found in Québec's 2010-2011 budgetary plan, in which we read:

*"We find that even taking into account the contribution of federal transfers, Québec assumes more expenditures than the other provinces. It is therefore not the federal transfers that finance these additional expenditures. ... Québec finances its additional expenditures through taxes, as well as by resorting to debt."*⁴⁸

But this statement must be qualified. If the health-care transfers or the equalization were appreciably less than the \$20 billion that Québec receives, that would have an impact on the preservation of services offered or the deployment of new initiatives. Québec already has too heavy a taxation, which harms its development. Moreover, the level of the provincial government's debt in relation to the GDP is reaching a critical level, which has recently been the subject of several public discussions. In sum, federal funding plays an important role in the Québec government's financial balance, and various restrictions would have to be imposed on provincial programs in the event of a significant downturn in federal transfers.

The \$5 daycare program, launched by the Parti Québécois government, is a good example of an initiative that manifested itself in new fiscal levies or higher rate setting. Within a federation it would be prudent for the costs of the programs a province wishes to launch to be evaluated so that it can be seen whether it has the wherewithal to pay for them. Then it would be up to the province to persuade the federal government that it should share in the funding of those programs. That approach would respect the ability of taxpayers to pay.

Finally, it must be understood that in financing new expenditure programs with its own revenues, the Québec government contributes to the already unfavourable economic position that the province occupies in Canada. The debate over the tax burden and its consequences for economic growth in Québec has taken place on different occasions, and the defenders of a government offering multiple public programs have to this point had the upper hand. We nevertheless note one exception: the tax reductions announced by the Charest government in 2007, in the middle of an election campaign.

45. Annual report of Hydro-Québec.

46. Annual report of Loto-Québec.

47. "Mieux tarifer pour mieux vivre ensemble."

48. Advisory Committee on the Economy and Public Finances, "Québec face à ses défis – Des services publics étendus. Une marge de manœuvre étroite. De nouveaux défis à relever," Fascicule 1, Government of Québec, December 2009, p. 21, quoted in the budgetary plan for the 2010-2011 budget of the Québec Department of Finance, 30 March 2010. The questions tackled by the Advisory Committee arise frequently in debates on public finance. In the document "Les finances publiques du Québec: vivre selon nos moyens" (Public Finance in Québec: Living According to Our Means), all the questions touching on the funding of government spending (taxation, rate setting, debt and federal transfers) are analyzed in detail. It reminds us of the necessity of taking into account the ability to pay of taxpayers in Québec and in Canada as a whole.

Revision of equalization

With the surpluses of the federal government persisting and the provinces insisting on the existence of a fiscal imbalance, the Conservative government elected in 2006 judged that the moment had come to again review the policy of transfers to the provinces.⁴⁹ It recognized that certain provinces, notably in the Maritimes and Québec, had reached the economic limits of their taxation capacity.

The health-care transfer having already been the object of revision, the Harper government turned to equalization. Created in 1957 and enshrined in the Constitution Act of 1982, equalization must level off the differences in fiscal capacity that may exist among provinces. Equalization payments enable less prosperous provincial governments to furnish their residents public services that are more or less comparable to those of other provinces, at similar rates of taxation.⁵⁰ To establish which provinces are entitled to equalization as well as the amount they should receive, the fiscal capacity of each province is compared with the average fiscal capacity of the ten provinces. If it is determined that the capacity of a province to generate own-source revenues is lower than the national average, that province will be entitled to equalization payments making up the difference.

To take account of the growing gap engendered by the energy boom in the Western provinces, important changes were introduced to the equalization program in 2007. One of the principal changes has to do with the treatment of natural resources. The revenues derived from oil and natural gas, until then excluded from the calculation, are now included at 50% in the formula. Moreover, since that reform, equalization payments have been based on a formula that allows for protecting the provinces against unanticipated drop in payments.⁵¹

As noted earlier, equalization varies with the fiscal capacity of a province. If economic conditions improve significantly in a given province, it will receive lower payments, or even not receive any. Thus, Newfoundland, which got \$861 million in 2005-2006, saw those payments stop in 2008-2009 owing to its oil revenues. The province has therefore become a contributor to the equalization payments made to provinces that have qualified for them. The federal government thus finds itself recovering part of the funds that supported oil exploration in the Atlantic, while Newfoundland shares its new wealth with other, less well-off, provinces.

The impact of these changes for Québec

Further to the health-care agreements and equalization, to which must be added the creation of new trust programs and a significant increase in transfers reserved for infrastructure, federal transfers to the provinces rose by almost 45% (from \$44.5 billion to \$64.7 billion) between 2005 and 2010-2011. In the case of Québec, transfers from the federal government climbed from \$12.5 billion in 2005-06 to \$19.3 billion for 2010-2011, amounting to an increase of 54%. The equalization payments received by Québec went from \$4.8 billion to \$8.5 billion, for an increase of 77%. Québec is therefore receiving, in 2010-2011, nearly 60% of the equalization payments made by the federal government. This is accounted for by its demographic weight and by its relatively weak fiscal capacity.

49. Review of the equalization formula followed the publication, in 2006, of the report by an expert panel on the question. See "Achieving a National Purpose: Putting Equalization Back on Track," Expert Panel on Equalization and Territorial Formula Financing, Government of Canada, May 2006.

50. M. Holden, "Canada's New Equalization Formula," Ottawa: Library of Parliament, November 2008.

51. Ibid.

There are some who minimize the importance of equalization, arguing that Quebecers are getting back “the money from their taxes.” This is inaccurate. The equalization is paid out of the federal government’s general revenues, which come from Canada as a whole. Québec’s share in those revenues is 20%, the same as its share in the Canadian GDP. Québec gets back that 20%; the rest of the equalization received is paid by Canadians living in the provinces that do not receive equalization, like Alberta, British Columbia and generally Ontario.⁵² Thus, for each dollar transferred to Québec under the equalization program, it costs Québec taxpayers only \$0.20. This makes for an annual net benefit of \$6.8 billion, resulting from the participation of Québec in the Canadian federation.⁵³

Some state that we should reduce, even eliminate, Québec’s dependence with respect to equalization. To do so, it would be necessary to combine an increase in revenues with a reduction in expenditures in such a way as to fill a hole of greater than \$8 billion in the Québec budget. There are some ways to achieve this. The first, which should be the main one, is to stimulate economic growth to the extent of filling the gap in wealth in comparison with that of Canada as a whole. Only private investments can thus swell economic growth. There have already been reflections on this question:⁵⁴ the lightening of taxation and of the weight of the State in the economy are essential conditions in increasing investment growth.

Another way would be to add to the revenue of Hydro-Québec by bringing rates up to the level of costs. Also, setting rates for public services that reflect costs would increase the revenues of the State. Finally, an in-depth revision of government expenditures that would bring Québec’s public apparatus to a level comparable to that of other provinces should be part of the strategy. The simple listing of these measures shows the enormous challenge that a reduction in Québec’s dependence with regard to equalization represents. Lobbies, unions and other associations would strongly oppose some of these measures. A profound cultural change would be involved, often described as a second Quiet Revolution. It would demand strong popular support, a support that seems quite improbable at the present time.

Thanks to the increases in transfers of the last few years, the Québec government has been able to clear a leeway of \$700 million. That space has been devoted to a drop in personal income tax. Announced in the middle of the 2007 provincial election campaign, the decision by the Charest government was harshly criticized, a number of commentators judging that Québec should have used that amount for the improvement of public services. The champions of that thesis have forgotten that equalization must above all enable provinces to offer comparable services with comparable taxation. And Québec’s taxation is one of the heaviest in America, which places the province at a disadvantage in its ability to attract or retain financial and human capital.⁵⁵ The lowering of income tax decided on by the Liberal government has allowed for an improvement in the province’s fiscal competitiveness.

52. Ontario, as a rich province, has always contributed to equalization in the past. Exceptionally, because of the devastating impact of the 2008-2009 recession, the province has been entitled to equalization payments. Once the recovery is well under way, Ontario should once again become a contributor to equalization.

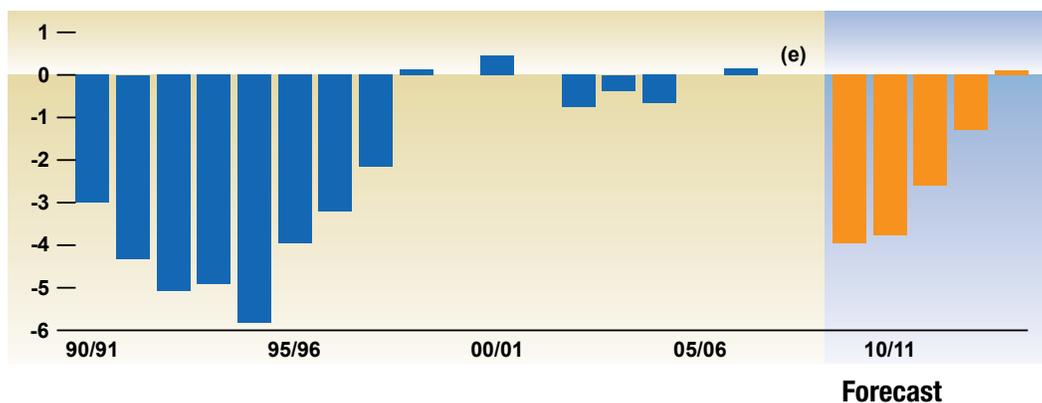
53. In 2009-2010, federal transfers accounted for 24.3% of the Québec government’s total revenues. Equalization comprised close to 50% of transfers or about 12% of total revenues. See 2010-2011 Budget Speech, “Summary of consolidated budgetary transactions, 2009-2010 fiscal year” (<http://www.budget.finances.gouv.qc.ca/Budget/2010-2011/en/documents/BudgetSpeech.pdf>).

54. *Québec Welcomes Investment*, op. cit.

55. A National Bank study estimates the marginal tax rates for 2009-2010 for the different provinces of Canada. In Québec the marginal tax rate, combining the provincial rate and the federal, amounts to 48.2%, compared to a national average of 44.7%. Québec’s marginal rate alone, at 24.0%, easily exceeds that of the other provinces, notably Ontario’s (17.4%).

The graph below gives an overview of the evolution of Québec's public finances in the period 1990-2010. The equalization revision in 2007 made it possible to eliminate the Québec deficit under the terms of the Balanced Budget Act. If we consult the historical data of the 2010-2011 Budgetary Plan, we find that the consolidated budget balance starting in 2006-2007 shows a surplus in the area of \$500 million up to 2008-2009. Afterwards, the world recession led to a deficit in the consolidated budget balance.

Evolution of Québec's public finances over the period 1990-2010
Budget balance (in billion of dollars)



Estimates and forecasts for the purposes of the Balanced Budget Act. (e) = estimate
Source: R. Kavcic, "Full-court Press," in Economic Research, BMO Capital Markets, March 19, 2009.

Thanks to the adjustment of its finances and its borrowing power, the federal government was in a position to increase the transfers to the provinces devoted to building public infrastructure at a point when the economy was going through one of the worst recessions since that of 1981-1982. We know that work in infrastructure construction or rebuilding is among the expenditures that have the most impact on economic activity.⁵⁶ In Québec, those transfers rose from \$748 million in 2008-2009 to about \$1.8 billion in 2009-2010 and 2010-2011. Those amounts contributed in a substantial way to countering the negative effects of the worldwide crisis on Québec's economy – another advantage of belonging to the Canadian federation.

The federal government's system of transfer payments to the provinces is in constant evolution. Despite the equalization adjustment, the Québec government has presented in recent years several claims to Ottawa on the subject of different elements in the transfer programs. For example, the issue of a compensation to the provincial government for the harmonization of the QST with the GST has yet to be resolved. The amount involved is in the order of \$2 billion, payable in a single instalment. At the time of writing, negotiations between Ottawa and Québec were continuing; an agreement should be struck in the near future. agreement between the two governments seemed imminent.

56. Y. Rabeau, "La stabilisation régionale au Canada" in *Les politiques budgétaire et monétaire*, Royal Commission on the Economic Union and Development Prospects for Canada, Vol. 21, Ottawa, 1986.

THE FINANCES OF AN INDEPENDANT QUÉBEC

Québec sovereigntists maintain that the federal government contributes to the relative poverty of Québec. In their view, leaving the Canadian federation would allow for growth in Québécois' standard of living. Thanks to the repatriation of taxes paid to the government federal, Québec's separation would generate an important surplus of revenues. That surplus would allow the government of Québec to eliminate any deficit and fund not only the programs it currently funds but also those it would inherit from the Canadian government.

In our opinion, that thesis goes against all economic logic. As we explained earlier, Québec contributes 20% of the revenues of the Canadian government – its share in the country's GDP – while a big part of federal spending in the province is done on a per-capita basis,⁵⁷ meaning that Québec receives 23.5% of the moneys paid out by Ottawa. Moreover, programs like defence, international relations, transport and others allow for important economies of scale, scope, network and coordination, savings that would be lost if Québec decided to go it alone.

The most recent assessment of the budgetary impact of the withdrawal of Québec from the Canadian federation goes back to 2005. The then Member of the National Assembly for Rousseau, François Legault, presented a study titled *Les Finances d'un Québec souverain*. That document is now obsolete, several developments having taken place since its appearance, including the revision of the equalization formula and the conclusion of agreements on health care. We should remember that the changes to the equalization program substantially increased the amounts received under it by the government of Québec. The government of an independent Québec would lose 80% of these amounts, that is at least 6,8 billion dollars (in 2010-2011). Be that as it may, the methodology used illustrates the flaws of the separatist approach in evaluating the government finances in a sovereign Québec. Indeed, when we adopt more realistic hypotheses than those on which the "Legault budget" is founded, we arrive at very different results.

A simplistic approach

To carry out such an exercise, various hypotheses should be presented concerning the economic impact of a major event such as the withdrawal of Québec from the Canadian federation. Those hypotheses lead to various scenarios. The study carried out by Mr. Legault and his team offers only one series of hypotheses relative to all the issues raised by this political shock; such an approach does not suit the complexity of the world of economics and management.

The principal hypothesis selected is that of "business as usual": it is supposed that attainment of independence will not affect economic activity. Investments, population, jobs and the financial markets would be practically indifferent to this major political change. Such a hypothesis is quite simply not believable. In effect, this scenario ignores the uncertainty generated by the settlement of trade agreements with Québec's principal customers, the impact of the transfer of federal debt on the level of taxation and the borrowing ability of the Québec government, as well as the probable hike in the cost of capital for Québec businesses. It is also supposed that big federally chartered Canadian companies in the financial, telecommunications and transport sectors, in addition to big exporters covered by NAFTA would not move their head offices or other activities to Canada in order to avoid the uncertainty concerning the laws and regulations that an independent Québec would adopt and the terms of trade agreements that it would succeed in negotiating with its neighbours.

57. T. Kent, "The Federal Spending Power Is Now Chiefly for People, Not Provinces."

Les Finances d'un Québec souverain does not tackle the question of currency. The study also shrugs off the surveys indicating that a not inconsiderable proportion of the population would leave the province in the event of its separation from the rest of Canada. These omissions undermine the credibility of the entire exercise.

The effects of independence on the government of Québec's budget

The sole scenario in the Legault study estimated the gross budgetary gain of independence at more than \$17.1 billion for the period 2005-2006 to 2009-2010. Subtracting from that total the Québec government deficits anticipated in the study (not realized in fact thanks partly to the new agreements negotiated with Ottawa), it arrived at a net revenue of \$13.8 billion. But when more realistic hypotheses are adopted, even while allowing that separation would not bring about any negative economic impact, the anticipated gains disappear.

Without entering into too many technical considerations, let us examine some of the study's calculations. The "Legault budget" supposes that the federal government would agree to Québec's share in the Canadian State's liabilities amounting to 18.2%, even when the weight of the Québec population in Canada is 23.5%. Better still, the study supposes that the federal government would agree to keep on its balance sheet Québec's share of the national debt, meaning an independent Québec would have to only pay to the federal government the interest on that debt.

As Québécois have benefited like all Canadians from the collective goods offered by the federal government, it is more appropriate to estimate Québec's share in the national debt at 23.5%. Moreover, if only for political reasons, the Canadian government would never agree to keep Québec's share of the debt on its balance sheet, because that would be tantamount to a subsidy paid to Québec following its separation from Canada. Québec would quite simply be required to refinance its own share of the debt on the markets. The new country would thus find itself with a debt exceeding 100% of its GDP, which would bring with it a decrease in its credit rating and an hike in interest charges. This realistic scenario reduces the surpluses estimated in the study.

To demonstrate the advantages of an independent Québec, the document would have had to compare the advantages of the present federative regime with those that are expected of independence. In addition to transfers from the federal government to Québec, it would have been necessary to take account of the scale, scope, coordination and network economies generated by the supplying of public services throughout the country.

Let us consider national defence. The United States and Canada would insist that Québec participate fully in the defence of the North American territory. The new country would want to assert its presence in the far north because of the riches it holds. A serious study of the finances of an independent Québec would have to evaluate what it would cost it to take part in the protection of the continental territory. Surely those costs would be markedly higher than the minimalist expenses predicted in the study published by Mr. Legault.

Broadly speaking, the study tends to underestimate the expenditures that Québec would have to assume to maintain the services of the federal government. The document fails to demonstrate how it would be possible to maintain those services with only 17.4% of federal expenditures, as the authors claim. If one wishes to maintain

unchanged the level of the collective goods offered by the government of Canada to Québec, it is much more realistic to use the proportion of the population – 23.5% – to establish the total of necessary expenditures, which would increase in a substantial way the spending of an independent Québec. Moreover, that was the basis opted for in a previous study done for the Parti Québécois.⁵⁸

The illusion of efficiency gains

Separatists have often stressed that sovereignty would allow for the elimination of the costs of overlap of the central government's programs and those of Québec, which would reduce the costs of the public apparatus. In fact, the question is much more complex than their words would suggest.

There have been a few studies on the overlap of expenditure programs in Canada.⁵⁹ Nevertheless, no recent study has established with any degree of accuracy the amounts that could be saved by reorganizing the jurisdictions of the two levels of government. Considerable work would be involved. In the study by M. Legault, on the basis of different accounting hypotheses it is maintained that gains in efficiency would allow for recurring savings in the order of \$2.4 billion. Those results are obtained even when it is supposed that the services currently supplied by Ottawa would continue and that the government of Québec would employ all Québécois currently working for the Canadian government.

As an example of the elimination of an overlap, the study cites the Canada-Québec agreement on manpower training. That case could have better served to demonstrate the complexity of a transfer of activities from one government to another. The federal government had anticipated start-up costs for the integration of operations by the Québec government. We can think here not only of the financial costs, but also of those that result from the loss of productivity and ability to render services stemming from problems of training and integration of resources, including computer systems. It was, in part, these problems that resulted in the new integrated unit exceeding its budget after a few months in operation in the summer of 1999.

Les Finances d'un Québec souverain ignores this aspect of the question. The transfer of numerous responsibilities of the federal government to Québec and of federal employees to the provincial civil service is a colossal undertaking which is presented here as a simple accounting transaction. The many examples of research conducted on the question of the mergers of organizations demonstrate that these are complex and are accompanied by a rationalization that leads to a marked reduction in employment. Very often it has been found that the complexity of the integration results in realized synergies or cost-cutting that are considerably lower than forecast.⁶⁰

58. An earlier study done for the Parti Québécois came to that conclusion that “the share consumed by Québec of the federal production of goods and services is therefore estimated on the basis of the share of Québec in the Canadian population.” C. Fluet and P. Lefebvre, “Mise à jour de l'étude intitulée: les conséquences économiques de la souveraineté du Québec: analyse exploratoire” (Update of the study [by Pierre Fortin] entitled “The Economic Consequences of Quebec Sovereignty: An Exploratory Analysis”), December 19, 2001 (http://www.saic.gouv.qc.ca/publications/documents_inst_const/57-FluetEtLefebvre.pdf), p. 9.

59. M. Salvail, “Federal-Provincial Program Overlap,” for a summary of studies on overlapping.

60. The difficulties of organization integration affect the private sector as well as the public. In the case of private corporations, see for example S.A. Christofferson, R.S. McNish and D.L. Sias, “Where Mergers Go Wrong: Most buyers routinely overvalue the synergies to be had from acquisitions. They should learn from experience,” *McKinsey Quarterly*, May 2004. See also the book by T. Straub, “Reasons for Frequent Failure in Mergers and Acquisitions: A Comprehensive Analysis”, Gabler Edition Wissenschaft, 2007.

Great Britain's National Audit Office has documented some cases where the costs of the mergers of departments have turned out to be higher than predicted and where the economies and synergies that were anticipated failed to materialize.⁶¹ In one of those studies the NAO concludes:

“Policy makers who propose mergers should give serious consideration to these costs in assessing whether a merger will represent value for money.”⁶²

More generally, the Institute for Government, an independent organization in the United Kingdom, is highly critical of fusions of departments or government bodies. The integration of human resources, computer systems and financial-management systems and the marriage of sometimes very different cultures are some of the major difficulties that must be subjected to in-depth analysis.⁶³ For the results of Mr. Legault's study to prove true, it would be necessary to obtain sharp increases in the productivity of Québec's bureaucracy. No empirical demonstration is offered, and other scenarios based on the analysis of concrete cases are not considered. Such scenarios would have given rise to markedly different results. The economies predicted would have been much less important than the \$2.4 billion expected, even nil.

Surplus becomes deficit

Another aspect that is not presented in the “Legault budget” is that of start-up and training costs for the new responsibilities assumed by an independent Québec. The creation of a new Department of External Affairs would entail important start-up costs for the development of a network of embassies, the establishment of relationships in various areas with other countries, and so on. Contrary to the hypothesis of an elimination of overlap, independence would bring with it a duplication of costs, with the government of the new country taking charge of functions already assumed by the federal government. All these start-up costs would have to be estimated in any complete study of the question.

When we consider other hypotheses than those selected in the study, the estimated surplus transforms into a deficit that would force the government of an independent Québec to make some very difficult decisions. Various existing programs would have to be reconsidered if tax increases or even an untenable deterioration of the government's financial situation were to be avoided.

61. National Audit Office, “Reorganising Central Government: OPSI-TNA Merger,” 2010.

62. National Audit Office, “The voice of experience: The full extent of the merger costs,” July 2006.

63. Institute for Government, “Managing Mergers of Public Bodies,” Guidance note four, 2010.

CONCLUSION

In summary, even if Quebecers believe, much as the residents of a number of other provinces do, that they do not always receive their fair share of federal funding, it is clear that Québec has no economic or financial interest in leaving the federation.⁶⁴ Negotiations about dividing up the tax pie and powers of intervention are an integral part of the federal regime. In all federations, the member States cannot be fully satisfied with fiscal arrangements and with the division of responsibilities with the federal government. Nevertheless, as we believe we have shown, the advantages of belonging to a federation largely outweigh the disadvantages peculiar to this political system.

64. Let us acknowledge that comparable tensions exist within a province. Municipalities and other institutions under a provincial government reckon that they are not treated fairly and regularly submit requests for financing to correct what they perceive to be a fiscal imbalance.