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Closing the Books

Dividing Federal Assets and Debt If Canada Breaks Up

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The Canada Round:
A Series on the Economics of
the Breakup of Confederation — No. 8

John McCallum, Series Editor

C.D. Howe Institute

Dividing the Debt: *Avoiding the Burden*

John F. Chant

The division of the Canadian debt between Quebec and "the Rest of Canada" (ROC), if the breakup of Canada becomes a fact, would occur under most unfavorable conditions. The credit ratings of both Canada and Quebec would be lower than Canada's is now because of the reduced opportunity for diversification.[1] Moreover, Quebec would become responsible for both its current provincial debt and its share of the present federal debt. Thus, the cost of capital for the sum of the parts of what used to be Canada would be much higher than it was before the breakup, and international and domestic holders of the public debt would feel betrayed because they would be left with instruments lower rated than they were previously.

Against this background, debt division could not be an easy process, and though clearly an economic issue, it would be dominated by politics and emotion. To some Quebecers, the debt represents a burden carried forward from an unacceptable political regime. To other Canadians, Quebec would have to assume a "fair" (and large) share as compensation for benefits received from being

The author is indebted to David Brown, Lenore d'Anjou, Tom Kierans, John McCallum, and Barb Clark for their helpful comments.

1 See Paul Boothe and Richard Harris, "Alternative Divisions of Federal Assets and Liabilities," in Robin W. Boadway, Thomas J. Courchene, and Douglas D. Purvis, eds., *Economic Dimensions of Constitutional Change*, vol. 2 (Kingston: John Deutsch Institute for the Study of Economic Policy, forthcoming), pp. 453–473; and Paul Boothe and Richard Harris, "The Economics of Constitutional Change: Dividing the Federal Debt," Western Centre for Economic Research Series on Constitutional Change, research paper 1 (Edmonton, 1991).

part of Confederation. It seems inevitable that the division would occur with acrimony and recrimination.

In this atmosphere of antagonism, the overall costs of separation would rise needlessly. Use of the debt as a pawn in discussions of breakup could foreclose effective options for bargaining if separation cannot be avoided. Moreover, both parties might use the debt after breakup to distort the policy options in other areas. In these less than ideal circumstances, the combined costs to ROC and Quebec could leave a debt "burden" that substantially exceeded the value of the debt being divided.

This paper, therefore, explores ways of minimizing the total costs of dividing the debt. To do so, one must consider the problem in three phases:

- Pre-separation *posturing*: the staking out of the positions to take should the separation of Quebec become a fact. Since the separation would not be a fact at the time this posturing took place, the positions need not be binding.
- *Bargaining* upon breakup: the negotiations about dividing the debt that would occur if separation became accepted as a fact. The result of such negotiations would eventually become binding in the sense that it would constitute the agreement of separation between Quebec and ROC.
- Post-separation *enforcement*: the terms of separation, like any other agreement, could not be completely definitive. There would undoubtedly have to be continuing negotiation between the parties, with each trying to minimize its costs in terms of those dimensions that could not be specified precisely initially.

Falling prey to the dangers present in each of these phases could substantially increase the costs of dividing the debt.

The Process of Dividing the Debt

The problems to be avoided in dividing the debt can be illustrated by following the process from posturing through negotiation to

enforcement of the separation agreement. The limitations of this analysis should be recognized. The problems described here are unquestionably possible. Unfortunately, it is not clear that they represent the worst case. This paper is limited by scope of the imagination; reality may not be so constrained.

Posturing

Not surprisingly, pre-separation posturing has already begun. The stakes are large, and the positions each party takes at this stage will define one limit for post-breakup bargaining, if it becomes necessary.

The Bélanger-Campeau Commission has endorsed division of the debt on the basis of a complex formula that recognizes the government's acquisition of assets, future pension obligations, and the share of future tax liabilities that would be required to service the accumulated deficit. Various authors have made calculations using four different bases for dividing the debt.[2] Quebec's share ranges from $68 billion (21 percent of the debt) under a modified Bélanger-Campeau approach to $110 billion (30 percent) under the assumption that the debt should be divided according to historical benefits from Confederation. Intermediate shares of 25 percent and 23 percent are produced by using calculations based on population and income respectively.

Not surprisingly, the alternative endorsed by the Bélanger-Campeau Commission minimizes the burden for Quebec. Such a strategy makes clear sense. As in any other bargaining, Quebec has an interest in taking an extreme position so as to leave room for compromise once ROC states its position. Moreover, the position taken on debt division also affects bargaining for continued union; an extreme position on the former increases the perceived costs to Canada of breakup relative to those of continued federation.

2 See Paul Boothe, Barbara Johnston, and Karrin Powys-Lybbe in this volume; Boothe and Harris, "Alternative Divisions of Federal Assets and Liabilities"; and idem, "The Economics of Constitutional Change."

All the incentives for Quebec to take an extreme position are mirrored for ROC. Like Quebec, it must treat the posturing stage as a prelude to the first round of the post-breakup bargaining. It also has an incentive to use its position on debt division to impress on Quebecers the cost of separation.

The posturing stage may seem unnecessary. Both parties could wait until the completion of negotiations about the terms on which Quebec could remain in Canada. Yet these negotiations cannot be complete without spelling out the alternatives. Thus, statements about positions after separation are as much part of negotiations at this stage as are the terms of continuing affiliation.

Bargaining

If post-breakup bargaining for dividing the debt begins, each party would turn to the public pronouncements of positions it put forward as part of the posturing round. (They may not be the positions that the parties would have chosen had bargaining begun without a history.)

The sources of strength in the bargaining round would differ between ROC and Quebec. ROC knows that it would be stuck with the debt should agreement not be reached. Under international law, it could refuse to accept Quebec sovereignty and continue to demand tax payments from Quebec residents. In practice, though, Canada could hardly hold back a Quebec unwilling to stay. Quebec, on the other hand, could walk away from its share of the debt with less cost. It would face a clear tradeoff: the cost of assuming a share of the present federal government's debt versus the costs of a credit rating reduced for failing to do so while maintaining payments on its own debt.

This asymmetry, which seemingly favors Quebec, does not include all the forces ROC could bring to bear on the process. The debt is only one of many economic issues that would have to be resolved at the time of breakup. ROC could use threats on other issues, such as access to its markets for Quebec exports or participa-

tion in financial markets, as part of the bargaining, redressing the balance on the debt issue.

Making other policies pawns of the debt issue would clearly have costs to Quebec, but each of these measures would also harm Canada. This bargaining over dividing the debt could easily produce costs exceeding the value of the debt to be divided.

Enforcement

The problems of dividing the debt would not end once the division had been made. A schedule would have to be devised for the turnover of Quebec's share. Immediate assumption in one step would increase the existing provincial debt by at least 130 percent. To make the market impact of the new debt more gradual, Boothe and Harris suggest that Quebec assume responsibility for its share according to the maturity of Canada's existing debt.[3]

Delay in transfer would, however, prolong ROC's exposure to risk. Until the debt matured, Canada would bear responsibility for servicing it and would depend on transfers from Quebec for a share of the cost. Moreover, at the maturity, Canada would require substantial transfers from Quebec in order to retire its share. Thus, Canada would have to protect itself against Quebec's failure to meet its obligations.

Such failure cannot be ruled out. Issues surrounding the debt might lead a separate Quebec to feel Canada's actions had imposed costs on it much higher than those it expected. Post-separation policies of the Bank of Canada, over which Quebec had no say, might, for example, force the Canadian dollar to levels higher than anticipated at the time of breakup, reducing Quebec's returns from its exports. It could be tempted to use the debt transfer as a lever to pressure post-separation Canada with respect to these or other policies that worked out to its disadvantage.

3 Boothe and Harris, "Alternative Divisions of Federal Assets and Liabilities"; and idem, "The Economics of Constitutional Change.

Unfortunately, the process would be unlikely to stop at this stage. As in the bargaining stage, Canada might resort to using other policies as pawns for negotiating the debt; for example, access to markets might be used to pressure Quebec to meet its debt-service commitments.

An Approach to Minimizing the Costs

The present approach of proposing formulas for dividing the federal debt induces each party to use whichever plausible formula best supports its position. But the formulas also encourage bargainers to establish extreme positions. Moreover, they shape public opinions as to the rightfulness of one cause or the other. Remember that although the division of the debt would have substantial economic consequences, the resolution of the issue has already passed from the economic into the political realm. This passage raises fears that all the pressures described will be active.

Can ROC and Quebec avoid this trap, which threatens to escalate the costs of dividing the debt? Indeed, there appear to be measures that could ease the burden of dividing the debt. They could be taken at both the posturing and the breakup stages.

ROC has the next move in the posturing stage. It should avoid the predictable step of presenting its preferred criterion for debt division, however credible. Instead, it should declare that it seeks Quebec's agreement to refer the issue to an independent arbiter when and if separation becomes a fact. The arbiter would be commissioned to review the two parties' competing positions and use them to determine the division of the debt.

This step would avert the problems in both the posturing and the bargaining stages. In the former, debt division would not be available for either side to use as a device to escalate the apparent costs of the other's preferred policy. In the latter, the use of an arbiter would similarly prevent other policies' being used as pawns in the bargaining over debt division.

The use of an arbiter would not solve the enforcement problem, but here Canada could protect itself. Boothe and Harris suggest that Quebec's posting securities would offer some surety in the bitter atmosphere that might follow separation.[4] Yet many kinds of securities would not offer complete protection. Outsiders might view intergovernmental obligations as different from marketable government securities. Partial default might not face sanctions as large as default on market issues would; as long as Quebec maintained its service of its other debt, it could conceivably stave off (or reduce) the usual market sanctions of lower credit ratings and higher interest rates on new issues.

Canada could, however, protect itself by specifying the types of securities that it would accept against Quebec's future obligations. It should require securities that:

- are senior to all existing Quebec provincial debt;
- are identical in other characteristics to marketable issues of outstanding Quebec debt; and
- have cleared all regulatory procedures necessary for them to be traded publicly in all markets in which Quebec debt currently trades.

Having such securities lodged with it would protect Canada in two ways. First, it could market them to cover any default in Quebec's payments. Second, any default by Quebec would represent a default on issues that are held by other investors and, like any other default on marketable debt, would lower Quebec's credit rating and raise interest rates on its subsequent issues.

Conclusion

Although dividing Canada's public debt would have economic consequences, it would likely be decided by political bargaining

4 Boothe and Harris, "Alternative Divisions of Federal Assets."

with little weight given to economic criteria. Such political bargaining could easily magnify the costs of debt division through spillovers to other policies. This potential for needless loss exists at all three stages of separation: posturing, bargaining, and enforcement.

The costs of dividing the debt could be minimized by both parties' agreeing on a two-stage procedure:

- the division of the debt between ROC and Quebec by a mutually acceptable arbiter whose decision would be binding on both parties; and
- Quebec's assumption of its share phased according to the maturity of existing government debt, with this assumption guaranteed by lodging senior marketable issues of Quebec debt with the federal government.

Such a policy has a chance of avoiding making a burden of debt division.