

# Network Seminar on Economics

*St. John's, Newfoundland*

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## List of Participants

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### Moderator

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### Rapporteur

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#### **I. Background Issues:**

##### 1. Globalization

a) Globalization and Competitiveness in the 1990s, by Lorraine Eden.

b) the implications of globalization

2. the desires and expectations of Canadians in the coming constitutional round.

#### **II. The economics of three constitutional scenarios:**

1. the separation of Quebec

2. decentralization

3. strengthening of economic union.

#### **III. Regional equalization.**

## ***I Background Issues.***

### **1) Globalization.**

**P**rofessor Eden launched this discussion with a comprehensive analysis of the global economy and Canada's role in it. This report will begin with an updated summary of this presentation which Professor Eden herself has provided.

#### **a) Globalization and Competitiveness in the 1990s**

The global economy of the 1990s is in the midst of a number of state and market changes that will have significant effects on world trade, investment and growth patterns in the year 2000. These changes are occurring and will continue regardless of the current Canadian political situation. It therefore is crucial that Canadians, both in and outside of Quebec, understand the nature of these changes, how other countries are adapting, and what the costs of ignoring events outside our borders will be. Will Canada, with or without Quebec, be left behind in the world sweepstakes because we were paralysed into non-action by our domestic crises?

#### **The Globalization of Markets**

First, the nature of world markets is changing. The economic clout of the United States - what the political scientists call hegemony - is diffusing as Japan and the European Community (EC) attain similar levels of real income and wealth. One now commonly hears the term Triad being used to refer to the US, Japan and the EC, the world's richest triumvirate. Market forces are reducing the US to first among equals, a leader instead of a ruler, with Japan as the enigmatic power behind the US throne. Japan now holds 50 percent of global patents, finances the bulk of the U.S. budget deficit and is the largest aid donor to developing countries.

While per capita incomes are becoming more standardized among OECD countries, disparities within other regional blocs are widening. The Soviet Union's empire is disintegrating: the trade organization COMECON is dead and massive inflows of Western capital are needed to stem complete collapse. At the same time, the least developed countries are suffering from the prolonged effects of crushing debt burdens, low world agricultural and resource prices for their exports, and the complete cessation of investment inflows from multinationals (MNEs). Since the costs of last year's Gulf War are likely to fall most heavily on the US and the Gulf States, both superpowers should lose economic clout relative to other nations, e.g. Japan and the new Germany, over the next decade.

Second, markets are becoming globalized and increasingly dominated by MNEs. Almost all industries have global markets, competitors, customers

and suppliers. Firms are developing various forms of strategic alliances as a way of spreading the high overhead costs of innovation, linking with firms of complementary skills and resources, and achieving insider status in Triadic markets. Somewhere between 30 and 50 percent of world merchandise trade now moves within affiliates of MNEs at prices that are set internally; in Canada the figure is closer to 70 percent. Waves of mergers and acquisitions are reducing the numbers of major players in each industry, throwing large numbers of people out of work as firms downsize and narrow their product divisions. The fight among MNEs for an increasing share of global markets will be the key determinant of trade and investment patterns in the year 2000.

Third and interlinked with the other two factors is the current technological revolution based on microelectronics (CAD-CAM, microsoftware, information networking systems) and Japanese production methods (just-in-time, quality circles) that is affecting all markets. A firm can now be linked with its key operations, customers, suppliers and procurement officers worldwide. The start-up costs of the so-called lean production methods are extremely high, necessitating access to world markets, and this is driving the impetus to strategic alliances among firms worldwide. As a result, traditional economic factors affecting competitiveness, such as size and scale effects, wage rates and abundant natural resources, have become less important; knowledge inputs and proximity to markets are now key to success. Lower telecommunications costs are also overcoming non-tariff barriers, making previously untraded goods and services tradeable. Trade in business services is growing faster than trade in goods. Access to producer services such as engineering and telecommunications will therefore be a key factor affecting a firm's ability to compete in global markets in the year 2000.

### **The Drive for National Competitiveness**

Globalization is facing governments with a major policy problem: how to ensure that their firms remain competitive in an increasingly aggressive world. The focus is now on the creation of national competitiveness. How are states engineering national advantage in the 1990s?

First, states are taking a multilateral approach through the Uruguay Round of the GATT. Stopped in December 1990 by the intransigence of the EC over agriculture, the extension of US fast track authority has given the world a two-year breathing space within which to craft a new set of rules to govern international trade. The breadth of this round (with services, trade-related investment and intellectual property measures, agriculture and textiles also on the table) is both its curse and its promise. Should the Round succeed, the trading system will have gone a long way toward adapting to the globalized markets in which we now live; should the Round fail, small countries like Canada that have little power over their export or

import prices will be at the mercy of stronger trading partners as discretion replaces rules-based trade.

Second, the globe is crystallizing into trade and investment blocs, hubs of countries clustering around hegemonic spokes as a way of increasing their total economic clout vis à vis other regional blocs. The EC is now negotiating the entry of EFTA and East European countries, talking about first and second rims of countries around the EC hub. Japan is fast developing a network of investment linkages tying the East Asian newly industrializing countries ever more closely into its economic sphere. The US is pursuing hemispheric free trade, building on the 1989 Canada-US free trade agreement (FTA), and the probable 1992 North American Free Trade Agreement with Mexico (NAFTA).

Third, countries are engaged in unilateral domestic policies designed to deregulate domestic markets, privatize state-owned firms, remove internal barriers to trade, and liberalize financial markets. The EC 1992 goal of completing the internal market is one example of this strategy. The perception that technology is key to economic competitiveness has led governments to subsidize high-tech industries, focus education spending on skilled labour categories such as engineers and technicians, and promote the use of new technologies in production. These policies engineer long run advantage by focusing on innovation, human capital and dynamic efficiency. Not all unilateral policies are procompetitive however. The US has been labelled the new bully of world trade for its use of the Super and Special 301 trade laws to brand countries as unfair traders and impose trade sanctions on non-cooperative countries. Should the Uruguay Round fail, the US will continue to use 301; the FTA may or may not be an effective Canadian shield.

#### **Implications for Canada**

The changes outlined above are both an opportunity and a worry for Canada, a small economy highly dependent on access to the US market. American neoprotectionist policies were a key reason for Canada's entry into the FTA and Canada's entry into the current NAFTA talks is also driven by defensive motives. We trade little with Europe and there has not been a rush of Canadian firms to get in before 1992. Little Japanese investment has been attracted here. The strategic trade policies being used by other states jockeying for competitiveness are also a problem. Canada has a poor rating in terms of outward orientation and innovative forward orientation policies, but in an era of fiscal restraint there are few tax dollars to spend on engineering our competitive advantages. As a result, we are being tied ever more tightly into a hub-and-spoke relationship with the US.

Canada's fiscal budget and current account deficits are proportionately larger than US ones, and inflation and unemployment rates higher. This spring's let's-get-our-house-in-order federal budget is widely perceived as

having been offset by the recent expansionist Ontario provincial budget. The current constitutional crisis has foreign investors nervous; given the mobility of international capital and our extensive foreign indebtedness (both in Quebec and the rest of Canada), our economic position is quite precarious in world financial markets.

It is imperative that Canadians understand that the economic consequences of political acts can be devastating. We have been the world's second richest country for several decades - it is too easy to assume that such wealth automatically regenerates itself. Should Quebec separate from Canada, the economic and political costs of the separation will make us both poorer countries. Our ability to cope with the realities of the world marketplace will be severely circumscribed; global markets will not wait for us and global firms will leave us. Other states will be engineering their long run competitive advantages; we will be busy destroying ours. We need to concentrate on building a better Canadian economic union, one that engineers our competitive advantages for the year 2000.

Lorraine Eden

#### 1.b) the implications of globalization

In the ensuing discussion Professor Watkins reminded participants that as long ago as the 1960s he and others had warned that increasing global economic integration would lead to domestic political disintegration. The *Canada-USA Free Trade Agreement*, he noted, is beginning to be seen as a catalyst of just this sort.

However, most of the participants who addressed this general hypothesis disagreed with Watkins. Although the FTA certainly strengthens North-South links at the expense of the traditional East-West ones in Canada, Professor Thirsk argued that in so doing it actually gets rid of one major source of Western Canadian alienation. Professor Howse pointed out that in the EEC we now see an interesting phenomenon quite inconsistent with Watkins's hypothesis: viz, along with economic integration has come a sort of national pride in an international project. Eden also reminded participants of an orthodox argument from Lipsey to the effect that the wealth derived from economic globalization could allow for the development and subsidization of social and political life in successful countries. Rounding out this discussion, Professor Feehan asked whether political disintegration in an era of globalization was really such a bad thing after all. Our natural impulse to believe that it is, he noted, is based partly on the question-begging choice of the word 'disintegration', rather than, say, the more neutral 'decentralization'. One positive consequence of political decentralization, he conjectured, could ironically be the re-emergence of nation-states.

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A related worry about globalization expressed by Watkins was that it tends to strengthen a country's strong sectors and weaken its weak ones. For Canada this would imply an even greater reliance on the resource sector, at the expense of, eg, high technology and manufacturing. Eden raised the spectre of Argentinization in our continuing reliance on resource industries with no long-run sustainable advantage. Howse was less pessimistic about the potential of this sector: citing the possibility of promising new industries built up around resource and environmental technology.

## **2) The Desires and Expectations of Canadians in the Coming Constitutional Round.**

The discussion under this heading was one that weaved itself through all of the others over the two days. Its most vocal participants were those challenging the increasingly popular view that Canadians are more than ever split along regional and national lines. Professor Trimble spoke often on behalf of the so-called 'Charter Patriots'- women, minorities, natives, &c- whose concerns are ignored by elite power struggles between these regional, provincial and national jurisdictions. She argued on different occasions for both more central direction and more local control. Trimble and Howse emphasized on numerous occasions that individual Canadians should not be lost in an equation that treats provinces as the natural partners in the federation. Provinces, said Howse, are after all artificial entities that are useful only insofar as they serve individuals' needs. Watkins asked where the evidence was that provincial premiers spoke for their people on national issues: certainly not in their decisions on Meech Lake and the FTA, where a majority of the premiers stood against the opinions of the majority of Canadians.

Conflicting evidence from polls was cited. Howse noted that a recent poll in *L'Actualité* showed that a clear majority of Canadians outside Quebec, including those in the West, desired a stronger central government. Data collected by the Spicer Commission was also said to point in this direction. In contrast, Professor Boothe referred to a series of Environics polls revealing an increasing regional affiliation of Canadians.

One important point of consensus emerged around the table, and, according to those present, it was indicative of the desires of the vast majority of Canadians: *no one challenged the sanctity of the principle of regional equalization programmes*. However, as will be discussed in section 3, below, there was much fruitful discussion on exactly what forms such programmes should take in a New Canada with or without Quebec.

## II Three Constitutional Scenarios:

### 1) The Separation of Quebec.

Most of the discussion of the economic consequences of Quebec seceding from Canada took place during the first session on Saturday morning. This was not a discussion of 'hard numbers', but rather, for the most part, of the political and economic dynamics of uncertainty.

#### *Consequences of Separation for Quebec Itself*

It seems that nobody around the table shared the view now popular within Quebec business circles (especially within the Quebec Chamber of Commerce) that independence would *benefit* the Quebec economy. Many agreed that the state of the Quebec economy is significantly different now as compared to 1980; and that, consequently, there are powerful new considerations telling against the viability of an independent Quebec. The principal economic worries expressed on Quebec's behalf stemmed from its public and private sector debt load which would be exacerbated by uncertainty in international financial markets. Boothe warned of the dangerous signals that, for example, wrangling over the dividing of the federal debt could send to international financial markets. Nervousness of foreign investors and bond-holders would hurt both Canada and Quebec; although most around the table thought that Quebec would suffer more. It was noted that the recent industrial boom in Quebec has been heavily financed on the international bond market. This would leave these firms, upon whose success confident nationalists are now relying, extremely vulnerable to jitters in international markets; much more so than would be the more established firms in the rest of Canada; and much more so than in 1980. Opinion was divided over how international bond markets would react to a Yes-referendum result or a declaration of sovereignty by the government of Quebec. Some thought it possible that in a short period -even in a few hours- electronic trading could cripple the Quebec economy. But others believed that rational expectations would lead the markets to react well in advance to such uncertainty, so that were independence to be declared little more would happen. (The *dropping* of the price of oil on the day war broke out in the Gulf was cited as an example of this phenomenon.) Of course if this theory is sound there should already be signs of financial markets reacting to the uncertainty of Quebec's future. Some anecdotal evidence was presented to suggest that Quebec firms are already finding these markets less accommodating.

There was some discussion, although none of it conclusive, about the prospects of an independent Quebec receiving a free trade deal with the USA. It was suggested that such a deal would have to be renegotiated, and that it was by no means certain that some of the Quebec-specific



provisions in the current FTA (eg, concerning the textile industry) would be ceded by the Americans in a new deal.

### *Consequences for the Rest of Canada*

Although virtually everybody around the table expressed regret, and in some cases very deep regret, at the prospect of Quebec separation, there were different views about its economic and political effects on what

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would remain of Canada. Certainly the participants from Atlantic Canada could see no advantages and many grave dangers in such a 'Pakistanization' of Canada. Feehan tried to temper such concerns by warning against prejudging such a situation with the loaded reference to East and West Pakistan: he offered as a less threatening example the separation of Alaska and the rest of the USA. O'Neill countered with a warning against assuming that a Quebecless Canada could get along like Alaska and the USA. He noted that the Atlantic provinces are much more

reliant on transfer payments than is Alaska; and also, that unlike Alaska, the Atlantic provinces may have to deal with a hostile new country between themselves and the rest of Canada.

### *Prospects of a Quebec-Canada Economic Association*

It was widely agreed that an economic association between an independent Quebec and Canada would be desirable. But there was much scepticism around the table about its likelihood in the aftermath of separation. Political acrimony is one obvious reason why such an association would not be arranged. But others mentioned that there were bread-and-butter arguments, especially in the West, against a close economic association with Quebec. The economic interests of Quebec and the West are divergent, argued Boothe, so there is no reason to assume that the West would benefit from, say, the same terms of customs union. He noted in particular that many of the proposals in the Allaire and Bélanger-Campeau reports were directly against the West's interests (eg, the West but not Quebec would benefit from dismantling the auto pact and marketing boards). In addition, according to Boothe, the West would have no interest in currency union with Quebec (preferring instead a dollar tied to the US dollar); although he believed that Quebec could probably be a passive user of the Canadian dollar, just as Ireland had continued to use the British Pound for seven years after its secession.

While the discussions of this scenario were frank, and often tough, they were anything but upbeat. Watkins set all heads nodding in agreement when he articulated the fear of Canadians and Quebecers achieving the worst of all possible worlds in their coming negotiations and confrontations.

## 2) Decentralization

For some participants decentralization was the obvious answer to the question, 'What would a Canada with a happy Quebec look like?' Most of the discussion of this option came from the reaction to provocative analyses and proposals from Professors Boothe and Feehan. There seemed to be a general approval around the table for Boothe's distrust of a division of powers (like the current one) which allows one level of government to decide on standards while a government at another level pays. But it is probably safe to say that most were also sceptical of his confidence that a massive decentralization of powers would solve efficiency problems without necessarily sacrificing what is most important about national standards in social programmes. Boothe wondered whether the idea of National Standards had become a symbol without meaning. He urged that we look at programmes individually and decide which sorts of uniform standards are really necessary. In the case of health care, eg, he conjectured that what was most important was portability, and that this could be attained by coordination of provincially controlled health care programmes. Janda raised doubts about the possibility of such coordination between consenting provinces, which Boothe tried to counter with an idea of a federal role as referee and binding arbitrator. In response to concerns raised by Trimble, Feehan suggested a compromise between economists' emphasis on mobility and the needs of marginalized groups such as victims of domestic violence, handicapped people, and low-income elderly people. He argued that for marginalized people, who are generally the least mobile across provinces, national standards should apply; for most Canadians, however, national standards may not be necessary for many social programmes. Hobson added that this might suggest a role for federal transfers to individuals in areas such as social assistance and primary education where the recipients of services tend to be less mobile. He warned, though, that this might be seen as a serious federal intrusion into traditional areas of provincial jurisdiction, albeit one which is probably compatible with individual's Charter rights.

Another idea suggested by Boothe was that provinces could delegate powers up to the federal government if they wished. Janda, however, cautioned that this could well lead to the possibly intractable problems of an asymmetrical parliament: where some MPs (those from provinces running their own programmes) could not vote on programmes that have been delegated up to the federal government.

## 3) Strengthening the Economic Union

Strictly speaking, this is not another constitutional option on the same plane as the two mentioned above or as asymmetrical federalism (which was not much discussed). It is in fact logically compatible with all

three. Nevertheless, Janda and Howse presented a strong case (at the seminar, and in their papers written for the seminar) for the viewing the goal of securing economic union as a fruitful way around the constitutional impasse. For one thing, this is a goal that is in the interest of all regions of Canada. And, perhaps more to the point, it is one that is high on Quebec's agenda. The strong emphasis in both the Allaire and Bélanger-Campeau reports on strengthening economic union, argued Janda, provides a unique window of opportunity in the coming round of negotiations; as does the fact that neither report specifies precise conditions for such a union. Howse believes that recent Supreme Court decisions make clear that the federal government already has the power to secure a stronger economic union by unilaterally removing inter-provincial trade barriers. (He discusses this and other measures in his paper for the seminar entitled, 'Completing the Canadian Economic Union: a proposal for action'.) It should be noted, however, that although Howse and Janda share the goal of strengthening economic union, they seem to envisage a very different role for the federal government. Whereas Howse would have it as the *guarantor* with exclusive powers over union, Janda sees the federal government as more of an *arbitrator* or *facilitator*.

For some participants who addressed this problem, strengthening economic union implies strengthening at least some powers of the federal government. The desirability of a national education strategy was mentioned often, as was a greater role for the central government in research and development. Other, however, disagreed strongly that education required a stronger federal presence. But against those who believe that decentralized control tends to be used more efficiently, Eden argued that the technological-communications revolution finally makes centralization more feasible - and that this opportunity has been seized already by multi-national corporations.

O'Neill began Sunday's session with a presentation of three fundamental economic principles for economic-political union:

- (1) That all partners receive a net overall gain from the union. Of course it can't be guaranteed that each partner gains from all policies all the time. There must be compensation, but this should be 'global', not policy by policy.
- (2) Allocative functions should be delegated on grounds of efficiency. (Boothe also underlined on more than one occasion the need to disentangle allocative and distributive functions: the reaction to the CF-18 decision was cited as an example of the bitterness that can be generated in a federation when this principle is not followed.)
- (3) Distributive functions must be jointly formulated and carried out at the more senior level.

### III Regional Equalization

The final session on Sunday morning was devoted largely to the future of equalization in a new Canada with or without Quebec. Many participants found this to be the most fruitful discussion. Feehan summarized the discussion in three points: (i) that there was consensus on the principle of equalization; (ii) that it would be desirable with or without Quebec in the federation; (iii) that outstanding disputes around the table centred largely on the question of who or what constitutes the appropriate 'vehicle' for (or recipient of) equalization - provinces, regions or individuals?

Professor Thirsk wondered whether it was really true that in helping provincial governments, equalization payments necessarily helped the needy individuals in those provinces. One effect of equalization may simply be lower provincial taxes. An alternative might be to redistribute directly to individuals. Howse, who is generally receptive to the idea of appealing to individual Canadians over the heads of their provincial governments, nevertheless cautioned that some of the best welfare instruments do work through community structures and could not be replaced by, say, a negative income tax. Hobson argued that transfers to provinces have a distinct role to play in ensuring horizontal equity in a federal system. Transfers to individuals will only be horizontally equitable where net fiscal benefits have been equalized across provinces. Otherwise, he said, residents of provinces with relatively high levels of NFBs will be treated favourably by the federal tax-transfer system since NFBs are not included in the federal base. Thus, in order to make transfers to people horizontally equitable, transfers to provinces are required to first ensure equalization of NFBs across provinces.

During the seminar there was frequent reference to the surplus from confederation. It seemed generally recognized: (a) that equalization can play a crucial role in maximizing such surplus by promoting the efficient allocation of resources within the federation; and (b) that there should be horizontal equity across provinces in the federation. Hobson suggested that one of the nice aspects of equalization is that the goals of efficiency and equity can be complementary: the equalization scheme that ensures the maximization of surplus (economic efficiency) also results in horizontal equity within the federation. He argued that two characteristics of the Canadian economy give rise to the need for equalization payments on grounds of efficiency and equity: the uneven distribution of resources, and the disparities in average incomes, across provinces. In this context, he urged, the purpose of the *ideal* equalization scheme (as distinct from the *existing* program, which he thinks is far from being ideal) would be to neutralize the resulting differences in net fiscal benefits across provinces. This, he said, could be achieved by equalizing fiscal capacities across

provinces. Boothe was sceptical about these claims for an efficiency basis for equalization. He believed that the main basis for federal equalization remains the desire to share between regions, and that this desire to share at least partly defines our nationhood.



# **Taking Stock**

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## **The Network Seminars on Canadian Federalism**



***The Network on the Constitution***



*edited by*  
***Donald G. Lenihan***

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