

on the money it has borrowed in the past. But even a modest 1 percent rise in interest rates would send those costs much higher, as is indicated in the table below.

**Impact on Federal Deficit of 100-Basis Point Change in Interest Rates**

*Estimated Changes to Fiscal Position (billions of dollars)*

Year 1	Year 2	Year 3	Year 4
1.7	2.5	3.0	3.5

Source: Canada, Department of Finance, *The Budget Plan*, 65.

As the table indicates, a 1 percent rise in interest rates adds \$3.5 billion to the deficit by year 4. Finance Minister Martin forecast short-term interest rates in the range of 4.5 percent for the coming year, an estimate that may well have been reasonable in late January. But the bank rate rose by 26 basis points between February 4 and March 8 alone, in response to rising rates in the United States.

Moreover, the run-up in interest rates in February and early March does not take into account a possible further bump-up in interest rates due to uncertainty over the outcome of the Quebec provincial election. Premier Daniel Johnson, who must go to the polls by November 28, has been buoyed in recent weeks by an unexpected by-election win in Shefford and by polls showing his governing Liberals neck-and-neck with the PQ.

But those poll results are deceptive. With Liberal support heavily concentrated in anglophone ridings in the Montreal area, the Liberals need to be 6 to 10 points ahead of the PQ in order to have any chance of capturing a majority. The smart money would still seem to favour a PQ win when Quebec goes to the polls in a few months time.

The PQ has promised to hold a referendum on sovereignty within a year of forming a government. That means a PQ election win would translate into political uncertainty, which in turn would trigger higher

interest rates with the devastating consequences for the federal deficit outlined above.

But higher than expected interest rates are just one of the factors that threaten to derail Martin's deficit projections. Another unknown is the extent to which the growth in the underground economy will depress Ottawa's tax revenues below their expected levels, even as the overall economy moves into an expansionary phase.

**FIGHTING THE WALL**

There has been increasing discussion in the past 12 months of the possibility that Canada will run into a "debt wall" at some point in the not too distant future. This is the point where foreign lenders become unwilling to finance further public borrowing, triggering a forced downsizing of government and punishing tax increases that would make the "slash and burn" tactics of the past nine years of Tory rule look like child's play.

No one knows if or when Canada might "hit the wall." But what seems beyond dispute is that the country's finances are extremely precarious and are prone to be thrown off-balance by the slightest gust of wind from an unexpected direction.

Sure, we might get lucky. Quebecers might decisively reject sovereignty, the economic expansion might pick up steam, interest rates could stay low, the underground economy could peter out, and federal revenues could bounce back strongly. But if some or all of these happy events fail to materialize, Canadians may find out sooner than they might have expected that there are limits to the appetite of foreigner bond holders for Canadian debt.

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**No Room To MANOEUVRE**

*by Kenneth McRoberts*

Throughout Canada, governments are finding themselves with less and less room to manoeuvre. Strategies that worked well in the past are no longer available. Policies and systems that have been in place for decades are headed for radical change.

**BACKING OFF ELECTORAL COMMITMENTS**

Already, the Chrétien government is finding itself forced to back off commitments that it made during the election campaign just a few months ago. In devising his recent budget, Finance Minister Paul Martin tried to pursue a "balanced" course. Although he successfully resisted pressures for a substantial hike in taxes, there is every expectation that next time around he will have to give in. Martin was forced to declare the closure of armed forces bases that the Liberals had promised would stay open. And he announced a reduction in unemployment insurance benefits—a measure that apparently caused dissension in the Liberals' own ranks. Coupled with this, as Fred Lazar notes in his article, is the announcement of projected cuts in federal transfers to the provinces for higher education and social assistance. In this, the Chrétien government is following in the footsteps of its Tory predecessors.

At the same time, the Chrétien government has felt compelled to initiate a comprehensive review of social policy. During the election campaign it had attacked the PCs for having a secret agenda to scale down the social security system and had derided Campbell's claim that an

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election campaign was not the time to debate such changes. Now, as Janine Brodie notes in her article, the Liberals have embarked on a complete overhaul of the social welfare system.

Of course, the situation in which the Chrétien Liberals find themselves is not as bleak as that of the Ontario government of Bob Rae. A party with a long and distinguished history of advancing social democracy, in government as well as in the opposition benches, has had to abandon much of its reform agenda. Instead, it has become obsessed with building bridges to the business community and restoring investment confidence, especially through a massive effort to cut spending and prune the public sector.

**THE END OF "RENEWED  
FEDERALISM"**

On the "national unity" front, governments have also lost room to manoeuvre. As it prepares for its electoral showdown with the Parti québécois, the Liberal government of Daniel Johnson cannot deploy the double-barrelled strategy federalists used in the past: simultaneously decrying the economic dangers of separation and offering the promise of a "renewed federalism" in which all of Quebec's historical aspirations would be met. Now, only the first card is available. After the twin debacles of Meech Lake and Charlottetown, "renewed federalism" is no longer a credible proposition; federalists have no choice but to defend the status quo. No longer can they evoke such formulas for federalist reform as "cultural sovereignty," one of Bourassa's favourite themes. Premier Johnson has even gone so far as to declare that Quebec does not need any additional powers. For many, this hardening of the federalist option may seem refreshing, offering the promise of settling

the question once and for all. But, for a party seeking re-election, it does narrow the available strategies.

The Johnson government has tried to offset this with a new flexibility on the fiscal front, declaring that the deficit might be maintained if this is necessary to address the government's first priority: creating jobs. Yet, in making this change of face, the Johnson government is running up against its leader's history, especially as Treasury Board president, of treating deficit reduction as the government's first priority, and in trying to impose the cuts needed to bring it about. For that matter, continuation of Johnson's historical focus on cost-cutting is precisely what will be demanded by the Quebec business community with which his party has such close links.

In the effort to improve its electoral prospects, the Johnson government clearly is looking to the Chrétien government for support. To be sure, common party allegiance does not necessarily lead governments to help each other. Bourassa certainly could not count upon sympathetic support from his fellow Liberal in Ottawa, Pierre Trudeau. But Daniel Johnson's more orthodox federalism should win him some points with his Ottawa cousins. And the prospect of a PQ victory and return of the dreaded constitutional question must surely cause the occasional Liberal nightmare in Ottawa.

**LITTLE HELP FROM OTTAWA**

Yet, the financial pressures playing upon the Chrétien government are having their effects here too. Under pressure to cut spending, the government selected defence as a primary target and ended up closing the Collège Militaire Royal de St.-Jean, the only fully bilingual military school in the country. The rapid emergence in Quebec of a broad-based movement to protest Ottawa's decision evokes the Gens de l'air, a group of Francophone pilots

who in 1976 protested Ottawa's failure to grant them the right to use French in Quebec air space—in the process, contributing to the PQ's victory a few months later. Daniel Johnson could do without that! To be sure, the Chrétien government could make amends by reversing its decision, and give Daniel Johnson's representations credit for the reversal. But what about the other military college that was closed: Royal Roads of Victoria, B.C.? To restore the St.-Jean college but not Royal Roads would lead to a storm of protest in the West—shades of the CF-18 fighter contract episode. Yet, to restore both would be to undermine the credibility of the government's whole commitment to cost-cutting.

**ATTACKING THE STATE IN  
ALBERTA**

One government does seem to have a free rein to pursue its agenda as it sees fit. The government of Ralph Klein apparently is encountering no real obstacles in its campaign to radically downscale the state in Alberta. Yet it has this room precisely because it is undertaking a systematic attack on the state and public services.

Back in the 1960s the distinguished sociologist John Porter lamented the absence in Canada of a "creative politics." In contemporary Canada, where politicians are finding themselves forced to roll back the state and dismantle much of Canada's welfare system, and have exhausted all their options on the constitutional front, the notion that politics, and politicians, might be "creative" seems quaint indeed.

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