

Messing with the Rule of Law: Political Decisions and Business Behavior in Canada and Spain

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Abstract: Political decisions taken at different levels of government affect businesses' choices regarding the prospective location of their operations and investments. Decisions made by a national or sub-national government may cause established firms to exit a given market or economy if they deem that those decisions could jeopardize their future business operations or viability. The cost of these re-locations may be considerable for companies, national or sub-national economies, and consumers alike. Legal insecurity and breaching the rule of law are two consequences of political decisions which carry a high economic risk in contemporary democracies. This paper will employ both a comparative and a political economy perspective to analyze two recent cases in which sub-national political behaviour prompted a run off of firms or capital: (a) The lead up to the 1980 and 1995 referenda in Quebec and their aftermath, and (b) the decision by the government of Catalonia to hold a referendum to try to secede from Spain in 2014. It will then explain the findings in the light of the institutional theory of government and business interaction.

1. Introduction

Political decisions are an important factor affecting firms' choices to locate its facilities and how to carry out its operations. When those decisions can be predicted, investors include them among other elements in the firm's value assesment process. When they cannot be predicted, they usually decrease the firm's value as a consequence of the risk and uncertainty it is forced to operate with. Territorial secession increases these risks due to the uncertainties derived from the institutional transformation which is taking place. Secession plans carry with them the same risks. We will look at two cases -Quebec/Canada, and Catalonia/Spain- in which the political risk associated with secession projects is or has been very high. We will also study how this political risk has affected Quebec's and Catalonia's firms and how they have reacted by taking the decision to remain in those regions or relocate outside them. Finally, we will compare the political dynamics of secession and the firms' reactions to them in both jurisdictions, in order to shed some light over the economic consequences of political risk derived from a separatist process.

2. Theoretical and political background

When speaking of the location decisions of economic activities, we usually refer to three approaches: neoclassical, behavioral and institutional.¹ In the neoclassical theoretical context, the main determinants of industrial location are those affecting the expected benefits, such as labour costs, externalities and market size. In the behavioral context, agents face the same decisions as in the previous case, but

¹ Manjón-Antolín, Miguel, and Josep Maria Arauzo, *The Annals of Regional Science*, August 2011, Volume 47, Issue 1, p. 133.

here the theory stresses the uncertainty in which agents operate. This leads to an emphasis in factors such as the firm size, experience or residence among those relevant for the location decision. The institutional theory points out a number of institutions the firm operates within: customers, suppliers, competitors, trade unions, public administrations, governments. Therefore, levels of unionisation, wage bargaining structures or regulation are paramount in the institutional approach.

We want to look into the effect of those political decisions that contribute to an increase of political risks and uncertainty, so the institutional theory is the fitting approach to the study of firms' location and relocation decisions, since it is the one taking into account the political context in which economic agents made these decisions.

For our purposes, it is also worth distinguishing between *uncertainty* and *political risk*. Beaulieu et al.² define political uncertainty in the context of a referendum as the situation in which the outcome "could not be anticipated by financial markets before the actual referendum took place." On the other hand, political risk would be the risk to a firm profitability caused by decisions external to the industry, usually consisting on government's actions or inactions.

This differentiation is essential in the cases we are examining, since both uncertainty and political risk may lead to two very different effects. Firms in Quebec were exposed to political uncertainty before the 1980 and, particularly, the 1995 referenda, since the outcome could not be predicted. This hindered the decisions

² Beaulieu, Marie-Claude, Jean Claude Cosset, and Naceur Essaddam, "Political uncertainty and stock market returns: evidence from the 1995 Quebec referendum", *Canadian Journal of Economics / Revue canadienne d'Economie*, Vol. 39, No. 2, May / mai 2006, p. 621, n. 1.

regarding firms staying or relocating depending on the results, for those cases in which results mattered. Likewise, Spanish and Catalan firms are facing uncertainty regarding the result of a possible referendum which could lead to Catalonia seceding from Spain.

Canadian and Quebec firms faced a second type of risk before the 1980 and 1995 referenda, which we have referred to as *political risk*. In none of these two events the rules which would govern the secession, should the pro-independent vote constituted a majority, were clear. That led the Quebec government of the Parti Québécois to campaign for the independence of Quebec hiding its stance behind a number of “moderate” political scenarios -political association with the Rest of Canada (ROC), currency union, agreement with the ROC on the share of national debt and value of assets each party would be entitled to, and so on- in order to make the possibility of secession more palatable to voters. The problem with these scenarios is that it was not up to the Quebec government to decide unilaterally on any of them. In case of disagreement on these matters, the leaders of the Parti Québécois declared, the process of secession would continue in one way or another.

In particular, the declared intentions on the part of the Quebec government to carry on with the secession process with or without the agreement of the ROC - therefore disregarding the Canadian Constitution and Laws- amounted to breaching the rule of law, a paramount example of political risk faced by citizens and firms alike, an one which could remain in the medium-long term, as compared to the short term political risk of an uncertain referendum outcome.³

³ The Supreme Court of Canada ruled in 1998 that neither the Canadian constitution nor international law allows Quebec to secede from Canada unilaterally ([1998] 2 S.C.R. 217), lowering the risk associated with a unilateral decision.

Similarly, the Catalan government has reiterated it will proceed with the secessionist referendum, after the Spanish Parliament refused to delegate the power to hold it to the Catalan Parliament. Should the referendum take place, it would constitute a blatant disregard for the Spanish Constitution and Laws. If we also take into account that a number of so-called civil society organizations with narrow or loose links to the Catalan government have proposed to take over the main institutions and public infrastructures in the region (airports, revenue service, ports, borders, security, communications and so on),⁴ and some political parties backing the government in the Catalan Parliament to “bring to a halt the Catalan economy”,⁵ it all amounts -more so than in the case of Quebec- to breaching the rule of law. This type of political risk is much more important in the Catalan case than the uncertainty derived from the unknown result of a secessionist referendum.

Lastly, we should pay attention to the degree a firm is exposed to these political uncertainties and risks. In this regard, firms that are more mobile (ie., financial and other services, firms with large foreign operations, and so on) will be less exposed than those which are less mobile (ie., firms in the mining or the natural resources industry, or with activities limited to local markets).⁶

⁴ *El País*, “Expertos en derecho cuestionan el plan de la Asamblea Nacional Catalana”, March 20, 2014.

⁵ *Crónica Global*, “Junqueras reitera sus amenazas de parar la economía catalana para forzar la consulta”, January 27, 2014, available from <http://www.cronicaglobal.com/es/notices/2014/01/junqueras-reitera-sus-amenazas-de-parar-la-economia-catalana-para-forzar-la-consulta-4327.php>

⁶ Beaulieu et al., “Political uncertainty and stock market returns”, p. 623.

3. Secession and political risk in Quebec

Many observers trace the the political instability in Quebec to the creation of the Parti Québécois in the late 1960s. Since then, a defeat in the 1980 referendum on sovereignty, the non-ratification of the Meech Lake Accord in 1990, the rejection of the Charlottetown Accord in 1992, and the defeat of the 1995 referendum on sovereignty, have contributed to the political uncertainty in Quebec.⁷ This type of uncertainty has an impact on the value of firms located in the province, since both the present value of their expected cash flows and their rates of return can be affected in case of secession. Also, this uncertainty could affect the fiscal, migration, trade and monetary policies, and the position of Quebec regarding the NAFTA.⁸ According to the institutional theory, these are all relevant factors which could influence the value of a firm as well.

While both Quebec and the ROC would be economically affected in case of secession, Quebec would be the most affected party, since it trades with the ROC more than 20 times than with, say, comparable American states, both immediate markets for its exports. In case of a negative reaction to the secession by the ROC resulting in protectionist measures towards Quebec, its economy would suffer. These retaliatory trade policies would be felt in industries throughout the province, which are essentially linked to the export of commodities and raw materials, though in a somehow lesser degree in the diversified economy of its Southern regions.⁹ This uncertainty, Duchesne et al. hypothesize, would lead to a certain reluctance to

⁷ Ibid, p. 624.

⁸ Ibid., p. 625.

⁹ Duchesne, Erick, Munroe Eagles, and Stephen Erfle, "Constituency Homogeneity, Economic Risk and Support for Quebec Sovereignty: A Research Note", *Canadian Journal of Political Science / Revue canadienne de science politique*, Vol. 36, No. 3, July-August / juillet-août, 2003, p. 646.

the idea of separation on the part of the residents of economically homogeneous areas, while the support for separatism would not be so restricted in more economically diversified regions, and this is what they find evidence for.¹⁰

Some studies have found additional evidence for the aforementioned effects of the uncertainties and risks associated with the possibility of secession. Johnson and McIlwraith (1998) have estimated that a one percent increase in the number of supporters of Quebec independence is linked to a one basis point increase in the province's bond yields. Clinton (1998) finds evidence of the same yield differentials between the Quebec bonds and other Canadian provincial bonds, attributing it to a compensation to investors for the risk losses in case of secession, other things being equal.¹¹ Graham et al. observe that the valuation differential of firms located in Quebec and in the ROC was affected, in turn, by the sovereignty referendum of 1995, which lead them to conclude that the "Quebec discount" is -at least in part- due to the political uncertainty brought about by the separatist movement.¹²

Besides the possibility of secession, other policies in the "sovereignty" realm, such as the Charter of the French Language (Bill 101) might have prompted firms to leave Quebec to relocate in other provinces, since language compliance would be very costly for Quebec businesses, which also would face a shortage of managers

¹⁰ Ibid., pp. 647, 654.

¹¹ Studies quoted in Roger C. Graham Jr., Cameron K. Morrill and Janet B. Morill, "The Value Relevance of Accounting under Political Uncertainty: Evidence Related to Quebec's Independence Movement", *Journal of International Financial Management and Accounting*, Vol. 16, No. 1, 2005, p. 52.

¹² Ibid., pp. 63-64.

for the same reason. Both things would lead, in turn, to a lower profitability of Quebec firms compared to firms located in other Canadian provinces¹³

Semple and Green study the corporate headquarters relocation in Canada between 1970 and 1981, in the utility, real state and financial sectors, on the one hand, and in the manufacturing and service sectors, on the other hand. In the first case (utility, real state, finances), they discover a net gain of 1,845 headquarters for the City of Quebec. However, the figure for Halifax is 2,123, the one for Toronto 18,136 and, most importantly, Montreal suffers a net loss of 14,989 in the period. In the second case (manufactures and services), the City of Quebec experiences a net loss of 497 headquarters, and Montreal 5,529, while the net gains of Vancouver and Toronto are 2,519 and 13,305, respectively.¹⁴ Ontario, and Toronto in particular, are the largest beneficiaries of the exodus of firms from Quebec during the period.

These results are confirmed by another study which looks at the stock market's reaction to the announcements of business relocations from Quebec to other Canadian provinces. The study mentions a poll carried out shortly before the 1995 referendum among Quebec business executives, in which 90 percent of the respondents

“believed that Quebec would incur substantial costs following a yes vote; 83% believed that Quebec's economy would be severely negatively affected in the 5-year period after a yes vote; 65% believed that Quebec's economy would suffer long-term negative effects; 84% believed that a long period of political

¹³ Ibid., p. 59.

¹⁴ Semple, Keith, et Milford B. Green, “Déplacements interurbains des sièges sociaux au Canada”, *Cahiers de Géographie du Québec*, Vol. 27, No. 72, décembre, 1983, pp. 396-397.

and economic instability would follow; and [...] 81% believed that immigrants and investors would be deterred from coming to Quebec".¹⁵

As proof of the detrimental consequences for Quebec of the nationalist drive for independence, the study also refers to the exodus of firms and individuals from Quebec between 1976 and 1996: 500 head offices, of which 120 were large firms employing more than 100 employees. And most of the individuals leaving are young (between 20 and 34) and well educated (30 percent with some university education).¹⁶ The differentials in investment (capital stock ratios in Ontario and Quebec were very similar in the early 1960s) with Ontario and other negative socio-economic indicators are also attributed to the secessionist drive.¹⁷ Tirtiroglu et al. notice that the markets' reaction to relocations from Quebec to other provinces, in particular to Toronto, are positive (announcements of relocations lead to increases in the stock prices).¹⁸

Meanwhile, during the 1995 referendum campaign, the government of the Parti Québécois glossed over this unpleasant data, focusing instead on major cutbacks announced by the then Federal Liberal Minister of Finance Paul Martin. To trim the budget deficit of the early 1990s back to three percent, the federal government would reduce public expenses in most government programs, especially transfer

¹⁵ Tirtiroglu, Dogan, Harjeet S. Bhabra, and Ugur Lel, "Political uncertainty and asset valuation: Evidence from business relocations in Canada", *Journal of Banking and Finance*, Vol. 28, 2004, p. 2242.

¹⁶ Ibid.

¹⁷ Ibid., p. 2243.

¹⁸ Ibid., p. 2255.

payments to the provinces, a crucial element for the provinces' pension, unemployment, health care, education and welfare policies. During the campaign,

“Leaders of the Yes camp also emphasized how the ROC was becoming more right-wing and less compassionate [...]. The PQ will pledge, once Quebec is independent and able to divert federal tax payments from Ottawa to Quebec City, to provide a kinder, gentler government which will uphold social-democratic standards and show compassion for all Quebecers”.¹⁹

Notwithstanding the concealing strategy of the Quebec government, the aforementioned studies seem to confirm the damaging effect to the Quebec economy and the run off of firms from the province due of the uncertainties surrounding the secessionist project. However, Tirtiroglu et al. point out that only in a very few cases these firms indicate the political instability in Quebec as the reason for their relocation: this is a sensitive issue, and there is fear of a customer backlash.²⁰

We shall see that the fear of a customer backlash as the reason for a *noiseless* business relocation process, the discourse of the secessionist movement, and all the other political factors contributing to economic uncertainty that we observe in the case of Quebec are also present in the case of Catalonia.

¹⁹ Fry, Earl. H, “Quebec, Canada, and the United States: The Economic Dimension”, *The American Review of Canadian Studies*, Vol. 25, No. 4, Winter, 1995.

²⁰ Tirtiroglu et al., “Political uncertainty and asset valuation”, p. 2246.

4. *The prospect of secession as a source of political risk in Catalonia*

Since the return of democracy to Spain, the Catalan government has always been in the hands of the *Convergència i Unió* coalition (CiU) [Convergence and Union], except for two consecutive four-year terms in the 2000s. Traditionally, CiU has been a so-called moderate nationalist party and, though it always maintained an ambiguous relation with the Spanish central government, it never endorsed openly a secessionist project. The more radical parties supporting Catalonia's secession, such as ERC (Catalan Republican Left), were also minor parties in the parliament. After failing to obtain enough parliamentary seats in the Catalan elections of 2010 to govern with an absolute majority, the current Catalan premier, Artur Mas, of CiU, called a snap election in 2012, seeking that elusive goal. However, instead of running on the traditional CiU program based on liberal and conservative economic policies, he ran on a soberanist platform which called for a secessionist referendum. The reason for this ideological transformation was that the party sensed that it could not win an election with a program based on policies that were supposed to have caused the deep crisis the Spanish and Catalan economies were mired in. The parties in power in Europe and in Spain when the crisis hit were falling like dominoes at each election, so this soberanist turn on the part of CiU was interpreted as an opportunist move to transmute the economic crisis into a clash of national identities, in order to stay in power.

With a discourse resembling that of the Parti Québécois before the 1995 referendum, CiU tried to convince a majority of voters that the glum socio-economic period Catalonia was going through -skyrocketing unemployment rates, serious cutbacks in health care, education and welfare, investors equating Catalan bonds with junk, effectively preventing the Catalan government to resort to financial

markets to manage its public debt- had nothing to do with the economic mismanagement of CiU's and previous Catalan governments. The culprit was to be found in Madrid, the central government. According to this discourse, echoed and amplified by other pro-independency parties, movements and a majority of local media, if Catalonia were an independent state all these economic problems would be solved expeditiously.

It is possible that Artur Mas and his team thought that this strategy were the political equivalent to *kicking the can down the road*, but it actually turned out resembling more a *Pandora's Box*. Not only CiU did not obtain the cherished majority, but lost 20 percent of the vote and 12 seats in the Catalan Parliament, while more radical pro-independency parties such as ERC doubled their share of votes and seats. The Parliament was now much more polarized and fragmented, and Artur Mas needed the parliamentary support of ERC to keep the government. As a result, the secessionist drive of the separatist movement has grown exponentially in the last two years. So far, the ERC-backed CiU government is determined to hold a non-binding secessionist referendum in November of 2014.²¹ Both the Constitutional Court and the Spanish Parliament have denied the Catalan government legitimacy to hold such a referendum, which would be illegal according to the Spanish Constitution. The Catalan government's social entourage has replied calling for a civil disobedience campaign if the referendum cannot take place, and with plans to take control of the main political and economic institutions in Catalonia, something which would effectively mock any notion of the rule of law in the region, with potentially calamitous economic consequences.

²¹ *The Economist*, "Wars of Spanish secession", May 3, 2014.

How did the Catalan business community react to this state of affairs? As the institutional theory predicts, and we saw in the case of Quebec, most Catalan firms abhor uncertainty and risk stemming from political decisions. “In any diverse society, there are different points of view, but it’s clear entrepreneurs prefer to operate in a context of certainty,” declared the chairman of Abertis, a large operator of toll roads and airports, based in Barcelona.²² Xavier Mendoza, of the ESADE Business School, says that “one major reason for multinationals to locate in Barcelona is access to the Spanish market and being in the European Union,” and that “investors are not going to want to invest in Catalonia in a period of transition and instability.”²³ Business leaders fear a mass departure of large multinationals from Catalonia in case of secession,²⁴ and have appealed to negotiations between the Spanish and Catalan governments.

While only a few large companies have voiced their concern, fearing a consumer backlash or alienating clients in the rest of Spain²⁵ -as we saw in the case of Quebec- a few well-known ones have publicly stated they would move their headquarters out of Catalonia should the region split from Spain. Among them the publishing group Planeta, with more than €3bn sales in 2011. The chairman of the airline Vueling, Josep Piqué, declared that “Independence would be a tragedy for Catalonia and Spain,” and that “business owners should say in public what they

²² *The New York Times*, “As Secession Talk Swells in Catalonia, Business Leaders Remain Wary of Costs”, October 16, 2013.

²³ *The Guardian*, “Big business gets cold feet as Catalonia's vote for a breakaway hangs in the balance”, November 18, 2012.

²⁴ *The Guardian*, “Catalonian companies fear for future if region splits from Spain”, November 20, 2012.

²⁵ *Financial Times*, “Catalan business takes a nervous look at independence”, March 18, 2014.

have been saying in private.”²⁶ This is exactly what a large group of German business owners and executives living in Catalonia did in January of 2014, making a public statement known as the “Barcelona’s Declaration” which warned against the economic risks of Catalonia being displaced from the European Union as a result of its possible secession from Spain.²⁷

Also, as pointed out above and in the case of Quebec, business analysts think different industries would be affected in different degrees by Catalonia’s secession. Small business and services firms would not be particularly affected, but larger industrial companies would suffer from a much more difficult access to the Spanish and European markets, due to possible boycotts and the new trade tariffs.²⁸

There are also business associations aligned with the pro-independence movement. For instance, 53 percent of the members of CECOT, a small and medium business association in Terrassa, Catalonia, were in favor of independence when surveyed in 2012,²⁹ and 66 percent of the members of PIMEC, Catalonia’s biggest small business confederation, favored independence in a poll in the same year.³⁰

Meanwhile, some Catalan firms are voting with their feet. According to the Spanish Official Trade Registry, 1,060 companies moved their headquarters from Catalonia

²⁶ Ibid.

²⁷ *El País*, “El fin de la neutralidad”, February 15, 2014.

²⁸ *Financial Times*, “Catalan business takes a nervous look at independence”, March 18, 2014.

²⁹ “Resultat de l’enquesta a empreses sobre les relacions Catalunya-Espanya”, October, 2012, available from www.cecot.org.

³⁰ *Financial Times*, “Catalan businesses split on secession”, November 23, 2012.

to Madrid between 2011 and 2013. Companies coming from Catalonia represented a 21,4 percent of all those moving to Madrid from other Spanish regions.³¹ While hardly any of these companies referred in public to the political uncertainty in Catalonia as the reason for relocating outside the region -presumably for the aforementioned fear of consumer backlash and alienation-, this could be regarded as a likely explanation.

5. Conclusion and further work

The institutional approach to business location and relocation decisions takes into account not only internal factors but also all other external factors that could have an effect in the firm's value. Political decisions are a paramount example of these external factors, in particular when these decisions lead to unpredictable scenarios, that is, when they generate political uncertainty and risk. We are facing an extreme case of political risk when local or national governments cannot guarantee the rule of law in their territories. This kind of political risk was present in Quebec before the Canadian Supreme Court ruling in 1998 and is currently present in Catalonia. In both cases, a sub-national government threatened to break unilaterally with the laws and institutions which bounded the country together to advance its case for territorial secession.

A second type of political insecurity, derived from the unpredictable results of the secessionist referenda, is present nowadays in both jurisdictions. Here the most relevant uncertainties firms should deal with are those related to the possible changes in the fiscal, monetary and regulatory conditions they operate as a result

³¹ "Fuga de empresas de Cataluña a la Comunidad de Madrid", August 20, 2013, available from www.vozbcn.com.

of a possible secession and, in particular, the risks derived from ceasing to be a member of the free trade clubs with which most of the trade is done: NAFTA and the rest of Canada in the case of Quebec, the EU and the rest of Spain in the case of Catalonia.

We also observed differences in both regions regarding how favorable business owners are to independence depending on the firms mobility and industry where it is located. Both in Quebec and Catalonia, small firms in the services industry would be less affected by a secessionist process, and therefore are less reluctant to the idea of independence. Larger industrial companies, which are less mobile would be much more affected and, as a result, are more concerned by the risks the process entails. Large multinational companies in the services industry would also be affected but, being more mobile, they can relocate to other regions to keep serving their national and international markets untouched by any political changes. This is the likely explanation for the business relocation we observed both in Quebec since the 1970s and more recently in Catalonia.

Finally, it should be obvious by now that behind the mostly discreet -for fear of a customers' boycott- exodus of firms from Quebec and Catalonia towards other regions in Canada and Spain, respectively -and in particular to large cities widely seen as more business-friendly, such as Toronto and Madrid- lays the goal to operate in global and national markets in a stable legal context and without the uncertainties prompted by secessionist sub-national governments which sometimes seem to be only half-heartedly committed to the rule of law.

This paper has tried to gauge the common political risks firms face in two jurisdictions in which the secessionist drive plays a crucial political role. The

similarities are remarkable, both regarding the political risks firms have to face and the firms' reaction to those risks. However, further work has to be undertaken, in the case of Catalonia in particular, to better prove the link between businesses' relocation decisions and the uncertainties derived from the secessionist plans orchestrated by separatist sub-national governments. Some avenues of research that have already been mentioned in this paper and have been carried out in relation to Quebec look particularly promising: a systematic study of relocation (or non-relocation) decisions on the part of companies previously located (or remaining) in Catalonia, and the analysis of the stock market reaction to the relocation announcements of Catalan companies, in both cases during the current period of political uncertainty linked to the secessionist drive.