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Celebrating Flexibility:
*An Interpretive Essay on the
Evolution of Canadian Federalism*

by

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Foreword

Canada's particular brand of federalism is increasingly under scrutiny and often outright assault: Alberta balks at federal directives on health programs, Ontario is increasingly resentful of its traditional role as generous equalizer, Quebec wants to be recognized as a distinct society, New Brunswick wants more flexibility to deal with retraining and welfare, and Native Peoples demand the right to self-government. From all quarters, the Canadian federation faces pressure to change, to adapt, and to evolve.

I am pleased that Thomas J. Courchene — Jarislowsky-Deutsch Professor of Economic and Financial Policy at the School of Policy Studies, Queen's University, and a Senior Fellow of the C.D. Howe Institute — has chosen the future of Canadian federalism as the subject of the 1995 Benefactors Lecture. Indeed, as the title of the lecture suggests, Courchene celebrates the proven flexibility of Canada's federal system. He points out that the history of federal-provincial relations offers many examples of delegation, administrative arrangements, or shared decisionmaking to solve problems. Everything from tax collection agreements to immigration accords have been possible—and all without resort to constitutional amendment.

Looking forward, Courchene sees the federation as becoming even more flexible. Specifically, this means moving toward more decentralized decisionmaking both because it needs to and because that is what Canadians across the country seem to want. That decentralization is occurring at precisely the same time that Quebecers prepare for a rendezvous with their (and the rest of Canada's) future may suggest some interesting solutions to an apparent impasse.

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I would like to thank our benefactor for this year's lecture, Imasco Limited, and, in particular, its Chairman, Purdy Crawford, whose support has enabled us to make copies of this lecture available free of charge.

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Thomas E. Kierans
President and Chief Executive Officer
C.D. Howe Institute

On the eve of “la Fête nationale” in 1990, the process of executive federalism torpedoed the Meech Lake Accord. On October 26, 1992, Canadian citizens had their chance to speak out on constitutional reform: The result was a resounding “no” to the reforms embedded in the Charlottetown Accord and, in the process, a “no” to the Canadian tradition of elite accommodation. Not long thereafter, the Chrétien Liberals swept into power. While no doubt there are many reasons for the Liberals’ continued high ratings in the opinion polls, one of them is that the “c” word is not part of their vocabulary, in spite of the imminent Quebec referendum on independence.

Yet the emerging reality is that the Canadian federation is in the throes of perhaps the most dramatic reshuffling of its powers in the postwar period, and probably since Confederation.¹ Central to the remarks embodied in this essay is that these fundamental changes are occurring through the political process rather than through changes in the written constitutional word. Nonetheless, for all intents and purposes, they are tantamount to amendments in the formal redistribution of powers under the Constitution. While these political/institutional reallocations of competences are not, in principle, unidirectional, in Canada’s case they are clearly tilted in a decentralist direction. Indeed, the decentralist dynamic that has been unleashed has implications that promise to go well beyond Meech or Charlottetown. That this overwhelming of the federal-provincial status quo by the forces of decentralization is occurring in precisely the time frame in which Quebecers

I wish to express my appreciation to the C.D. Howe Institute and to Imasco Limited for the privilege of presenting the 1995 Benefactors Lecture. It is a pleasure to acknowledge the encouragement and insightful comments en route by Thomas E. Kierans, President and Chief Executive Officer of the Institute, as well as valuable suggestions from William Robson and Daniel Schwanen, Senior Policy Analysts at the Institute. I also want to register my indebtedness to two previous Benefactors Lectures: Harris (1993), on the structural adjustments facing Canada, and Simeon (1994), on the challenges related to the design of a new Canadian social contract. In an important sense, my essay integrates these perspectives and then brings them to bear on the evolution of Canadian federalism.

1 This is not to downplay the significance of the Charter of Rights and Freedoms. The Charter’s role, however, is largely to redefine, via the courts, citizen-state relationships, not to alter federal and provincial competences in any fundamental manner (even though one can mount an argument to the effect that it has served to curtail some of Quebec’s pre-existing powers).

are preparing themselves for a rendezvous with their (and the rest of Canada's) future is, at the very least, intriguing.

Admittedly, the proximate cause of this reconfiguration of Canadian federalism typically is attributed to the 1995 federal budget. I have noted elsewhere (Courchene 1995a) that the 1995 budget can be considered as an exercise in downsizing, deregulating, desubsidizing, privatizing, contracting out, and decentralization. But important as this exercise might be for the future of Canadian federalism, the budget was still more importantly a harbinger of far more fundamental global and domestic forces — forces that are impinging on nation-states everywhere and that, henceforth in this essay, I refer to as “globalization and the knowledge/information revolution” or the new “techno-economic paradigm” (TEP).

In this essay, I attempt to grapple with the implications for the future of Canadian federalism of these pervasive and irreversible changes in the global political and economic order. But an assessment and analysis of the implications of globalization and the knowledge/information revolution is preliminary to the core question: Is Canadian federalism sufficiently flexible to accommodate these challenges? As should be obvious from the title of this essay, my answer is decidedly in the affirmative. That not everyone is likely to agree with such an assessment is part of the rationale for calling this an “interpretive essay.” A larger part of the rationale is that accommodating these global forces likely will imply, initially at least, a degree of decentralization most Canadians have hitherto never experienced, let alone contemplated. Thus, aspects of the analysis will be speculative. Intriguingly, whether the division-of-powers pendulum will shift back toward the center will depend on the provinces. Are they willing to assume the enhanced responsibilities that accompany enhanced powers? If not, then, in the (slightly altered) words of Roger Miller's hit song of the 1960s, “powers swing like a pendulum do.”

The critical subtheme underlying this essay is that Canadian federalism has always been incredibly flexible. Always, that is, until 1980, when we abandoned the creativity emanating from federalism as *process* and embarked on a strategy that implied that all of our problems could be solved by reconfiguring federalism as *structure* (that is, constitutional amendment). As I implied in the introductory paragraphs and as

I elaborate below, the ongoing evolution will be principally process driven, not structure driven.

In more detail, the essay proceeds as follows. Before delving into the salient features of the new global order and its implications for the Canadian federation, attention is directed to two brief backgrounders. “Federalism as Process” celebrates the creative and flexible manner in which Canadians historically have managed their federal system. “Federalism as Structure” focuses on the period since 1980, when Canadians became enamored with structural approaches, involving constitutional amendments, to solving societal challenges. As I have already noted, Canadians’ fascination with federalism as structure has, however, considerably diminished; the future, at least as far as the division of powers is concerned, again lies in the direction of federalism as process.

I then address the implications of globalization or the new technoeconomic paradigm for the federal nation-state. Attention is directed first to the manner in which the new TEP is eroding the nation-state from above. Although the focus here is on the passing of powers and sovereignty upward to the supranational level, the implications also carry over into the internal workings (that is, the division of powers) of federal nation-states. This is followed by a description and analysis of the forces that are eroding the nation-state from below. An important aspect of this passing of powers downward is what has come to be referred to as the “regional/international interface.” The section concludes with some analytical reflections that focus on the resurgence of the concept of region (or subnational governments) as a key variable in the process of global integration. Specifically, the essence of an economic region lies in the nature of the “untraded interdependencies” or “locational positive externalities” that it provides.

On balance, the implications of the new TEP for federations probably point in a decentralist direction, but the evidence is mixed. In Canada’s case, however, there is no uncertainty. Accordingly, in the section entitled “The Center Cannot Hold,” I focus on two of the factors that are ensuring that decentralization is winning out in this country — fiscally triggered decentralization and the shift toward north-south rather than east-west trading patterns.

Then, in the section entitled “Are the Provinces ‘Economic Nations’?” I attempt to link the internal features of the Canadian federal

economy with the earlier regional literature. My analysis focuses on the recent literature dealing with minority nationalisms, and I advance two hypotheses. The first is that the provinces are beginning to act like traditional economic nation-states and, in fact, are offering differentiated versions of untraded interdependencies, which is consistent with the regional literature. As the special focus on New Brunswick makes clear, this applies not just to the “have” provinces and Quebec but to “have-not” provinces as well. The second hypothesis is that the decentralization of aspects of the social policy envelope may be triggering a fundamental change in English Canada’s view of its relationship to Ottawa and, therefore, to the federation. Specifically, English Canadians may be in the process of rethinking the notion that the federal government is the embodiment of both “nation” and “state.”

In the section entitled “Citizen and Institutional Challenges,” I focus initially on whether the ongoing decentralization is reversible. The message here is straightforward: in order for the decentralization to continue, let alone be permanent, the provinces must accept responsibilities commensurate with their enhanced powers. This means they will have to play a key role in ensuring that their various programs become integrated into a national network and, more generally, that they advance their residents’ rights on the social policy front. The possible implications of this for some specific areas, including the nature of institutional evolution, occupy the remainder of the section.

A brief conclusion completes this interpretative essay.

The Way We Were: Federalism as Process

Given Canadians’ post-1980 preoccupation, even obsession, with formal constitutional amendment as the solution to federal and, indeed, societal problems, it is appropriate to remind ourselves that federalism is both a *structure* of government (the formal division of powers) and a *process* (a set of administrative arrangements, conventions, transfers, federal provincial agreements and the like) that implements the structure. While a constitution obviously is the cornerstone of any federal system, the ensuing analysis is patterned more in line with the observations of Carl Friedrich (1968, 7):

federalism should not be seen only as a static pattern or design, characterized by a particular and precisely fixed division of powers between government levels. Federalism is also and perhaps primarily the process...of adopting joint policies and making joint decisions on joint problems.

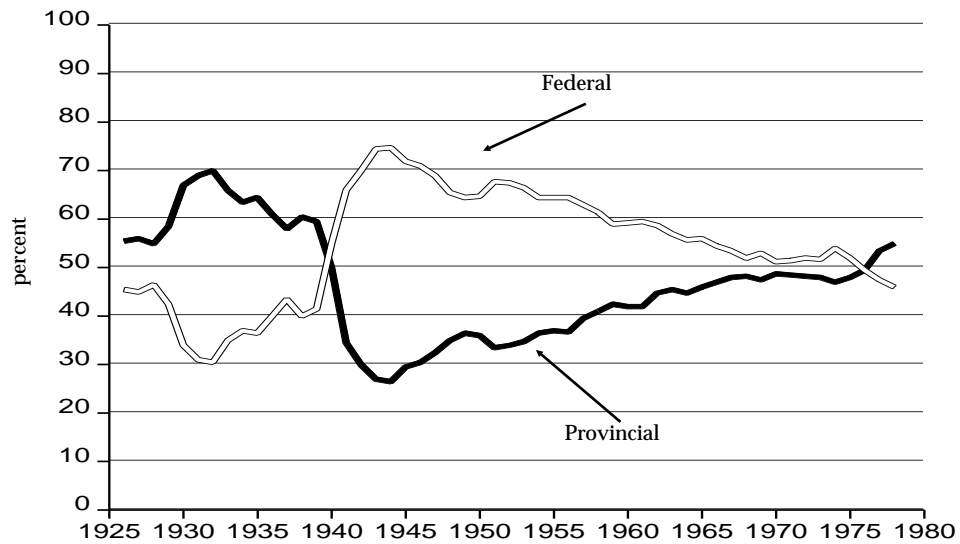
With this as backdrop, in this section I want to engage in what surely is a most un-Canadian activity — namely, celebrating how creative and adept Canadians have been in tailoring their federal system to both internal needs and external forces. While my focus is on the vast array of instruments and procedures that have been brought to bear on the process dimension of federalism, implicitly, if not explicitly, the ensuing analysis also celebrates the incredible flexibility of those elements in Canada's constitutional structure that have allowed these processes to flourish.

Indeed, it is convenient to begin this analysis with an overview of how the Canadian Constitution has been able to accommodate dramatic swings in centralization and decentralization without much, if any, resort to formal constitutional amendment. This is clearly evident from Figure 1. Panel A depicts the distribution of own-source revenues between Ottawa and the provinces over the 1925–80 period while panel B reproduces this revenue distribution with transfers included. In terms of after-transfer revenues (panel B), the provincial share peaked at nearly 80 percent in the early 1930s. Wartime centralization dropped the provinces' share precipitously — to just over 30 percent in the early 1940s. The postwar history is largely one of the provinces' regaining their revenue independence. By 1980, provincial-local government own-source revenues exceeded federal own-source revenues (panel A), while after-transfer provincial-local revenues were touching 70 percent. Apart from a few exceptions to be noted later, all of this is the result of various administrative arrangements (the result of federalism as process) undertaken without any major change to the written constitutional word.

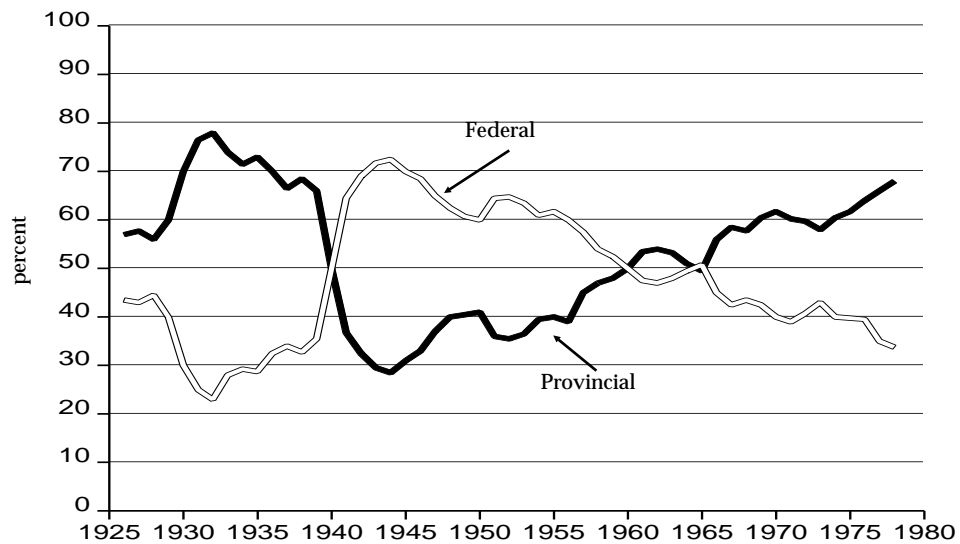
The second observation is also related to these revenue swings: Canada, perhaps more so than has any other federal state, has used intergovernmental transfers to accommodate the needs of, and the challenges facing, its federation. Indeed, changes in the *magnitude* of, and *incentives* within, these intergovernmental transfers are the process equivalent of formal changes in the distribution of powers. Conditional

Figure 1: *The Ebb and Flow of Centralization, 1926–78*

A: Distribution of Own-Source Revenue, by Order of Government (National Accounts Basis)



B: Distribution of Revenue after Transfers, by Order of Government (National Accounts Basis)



Source: Bastien 1981, figures 1 and 2.

grants enhance not only provincial revenues but also the federal government's authority and reach in areas of provincial jurisdiction. Unconditional grants, on the other hand, typically enhance both provincial revenues and autonomy. In the 1960s, Ottawa used the spending-power/conditional-grant route to create a "national" welfare state. As these programs became established, the transfers became progressively unconditional, the last component of which is the block funding of welfare under the recently announced Canada Health and Social Transfer scheduled to become effective in fiscal year 1996/97. It is, of course, true that the provinces have not always welcome these initiatives — that is, they have not always welcomed the federal government's exercising its spending power. Medicare is a good example. Effectively, Ottawa made a generous offer that, eventually, the provinces simply could not refuse. However, with respect to other federal initiatives — for example, the Canada Assistance Plan — the provinces willingly signed on.

The third, related observation deals with the decentralization of income taxation. In the mid-1950s, Quebec opted, as was its constitutional right, to establish its own separate personal income tax. To accommodate this — that is, to prevent the double taxation of Quebecers — Ottawa responded with a series of tax abatements that eventually led to the current system of income taxation. In brief, Quebec, in asymmetric fashion, maintains its own personal income tax; the other nine provinces "share" their income tax with the federal government; Ottawa controls the basic parameters; and, in return for provincial acceptance of this control, Ottawa collects the provincial portion of the shared tax free of charge. The result, for the nine provinces, is a decentralized yet harmonized tax system, one that typically is held up as a model for a decentralized federation.

On the corporate tax side, three provinces (Quebec, Ontario, and Alberta) have mounted their own tax systems; the other seven provinces "share" their taxes with Ottawa. Despite the fragmentation that one might expect to arise in such a situation, all ten provinces have agreed to an allocation formula for corporate profits that ensures that there will be no double taxation or zero taxation of corporations that operate in more than one province. This has resulted in a far more harmonized corporate tax system than the more centralized US federation has been able to deliver.

The fourth observation expands on the earlier reference to the asymmetry of the income tax system — that is, to the fact that Quebec has its own personal income tax, and Quebec, Ontario, and Alberta have their own corporate tax systems. One of the more creative arrangements of the Canadian federation has been its tolerance of asymmetry and its counterpart, “opting out.” Setting aside the fact that important aspects of *structural* asymmetry were incorporated into the *British North America Act* itself as well as (for example) into the act that brought Newfoundland into Confederation, asymmetric relationships have always been an essential feature of the Canadian federation. Despite English Canada’s embracing the principle of symmetry during the Meech and Charlottetown rounds as a fundamental feature of Confederation, asymmetry will prevail. Given the constellation of pervasive forces embodied in the new TEP, it is inconceivable that Ontario, for example, should be constrained to do only what Prince Edward Island, with one-eightieth of its population, can or wishes to do.²

In terms of the evolution of the federation, one of the most significant episodes of asymmetry/opting out occurred in the 1960s, when Quebec insisted on receiving (and obtained) significant additional tax point transfers in lieu of cash transfers from Ottawa; in the process, Quebec opted out of several federal programs and mounted them itself. As a result, Quebecers pay substantially lower federal personal income taxes (and higher provincial taxes) than do other Canadians and, as a consequence, receive proportionately fewer cash transfers. (It is important to note in this context that Ottawa offered the same deal to the other provinces but they declined to take it up.) While I have more to say about asymmetry in the next section, suffice it at this point to assert that asymmetry is better viewed as a *solution*, not a problem, in terms of the history and future of Confederation. Suppose, in the absence of asym-

² By way of illustration, it is convenient to compare Quebec and Prince Edward Island. Quebec has its own personal income tax, corporate income tax, pension fund, provincial police force, stock market, deposit insurance corporation, and on and on. Prince Edward Island has none of these. But, if it wished, it could have them all. This, then, is *de facto* asymmetry, not *de jure* asymmetry, since both provinces have identical constitutional powers in these areas. Beyond this, Quebec also has asymmetrical powers, such as its own legal (civil law) framework.

metry, Quebec had been prevented from mounting its own personal income tax system (Ottawa could have, for example, forced Quebecers into double taxation). Where would we be today? Presumably, the status quo would have reflected some combination of separate Quebec-type provincial personal income taxes and the shared personal income tax system. Almost assuredly, this would have been an inferior solution. Asymmetry allowed Quebec to mount its own tax and allowed the other provinces to have a far more integrated system than would otherwise have been possible. The essence of the following section is that, absent asymmetry, these sorts of administrative or process innovations simply would not have been possible in the 1980s.

My fifth observation relates to equalization, a program that I and others have argued is an integral part of the glue that binds Canada together as a nation. In 1982, on the occasion of its twenty-fifth anniversary, the principle of equalization became enshrined in the Constitution. Yet, the inception of equalization in 1957 was a process development, a product of ordinary legislation.³ Over time, as the equalization system

³ The formal wording of the equalization provision in the Constitution reads as follows: "Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable tax rates." However, this conception of the role of equalization has evolved over time. At its inception, in 1957, it represented a novel approach to a specific program. Until that time, the provinces received "tax rental payments" from Ottawa for "renting" their taxes to the federal government. There were several options from which the provinces could choose, one of which was an equal-per-capita transfer. In 1957, however, the federal government altered the rental payment. Henceforth, the provinces would receive 10 percent of personal income taxes, 9 percent of corporate income taxes, and 50 percent of federal succession duties collected in the provinces. In part, this arrangement was motivated by a desire by Ottawa to prevent the spread of separate provincial income tax systems. But given that 10 percent of the value of income taxes collected in Ontario was greater in per capita terms than 10 percent of income taxes collected in Newfoundland, an additional program was needed to compensate for the move away from the former population-related transfers. Enter equalization. The inaugural program brought all provincial revenues from these three tax sources up to the level of the average of the wealthiest two provinces. Moreover, since the tax revenues accruing to the richest province (Ontario) could be spent as the province wished, the decision to make equalization payments unconditional followed logically. While we may take pride in the fact that equalization is now an enshrined principle in our federation, its inception was, in Friedrich's terms "primarily the process of adopting joint policies and making joint decisions on joint problems."

became more comprehensive, its role likewise evolved. As Banting (1992) has pointed out, whereas the typical social contract in continental Europe emerged from the interplay of class politics, the Canadian social contract emerged from the quest for interregional equity, of which equalization remains the cornerstone.

By way of a sixth observation, Ed Safarian has claimed (1980, 18) that “executive federalism,” the apex of which is the First Ministers’ Conference, is “Canada’s contribution to the art of federalism.” Saddled with a Senate that lacked the moral and representative authority to bring provincial input into federal decisionmaking, the federation had to innovate once again, the result of which is the endless meetings of federal and provincial executives as they manage the incredible number of policy interdependencies that arise in this diverse federation. While executive federalism has fallen on hard times recently, the nature of decisionmaking in the new global order is, as I detail later, bound to be executive driven, so that executive federalism’s star is likely to rise once more. The key point here is, again, that executive federalism is an innovative *process* response to a real *structural* problem (such as the lack of some version of a Triple-E Senate).

My seventh observation relates to immigration — in particular, to the 1978 Cullen-Couture agreement, which granted Quebec authority over the selection of immigrants to that province. Even though immigration is a shared power under the Constitution, this agreement amounted to an effective transfer of power to Quebec with respect to the status quo. Moreover, it was asymmetric in that similar agreements were not signed with other provinces. Not only is this the exercise of a creative process, it is yet another example of an initiative that would not have been possible in the 1980s, when the emphasis shifted to federalism as structure, replete with symmetry.

Perhaps the most important postwar process instrument has been the exercise of the federal spending power. Whether through unconditional cash transfers such as equalization payments, or incentive-oriented transfers such as shared-cost programs, or regulations such as the prohibition of residency requirements under the Canada Assistance Plan, the exercise of the federal spending power has played a critical role in forging national programs in the social policy area as well as in preserving and promoting the internal common market. To be sure, the

spending power has not been an unmixed blessing, but in many areas and on many occasions it has been used creatively. Indeed, one way of viewing the ongoing challenges the Canadian federation faces is to find alternative processes to compensate for the (fiscally triggered) demise of the spending power.

All of these observations relate to the general area of federal-provincial economic and financial relations. Those more familiar with other areas presumably can add their own examples of cases where delegation, administrative arrangements, shared decisionmaking, or other initiatives that fall under the general rubric of process have been implemented creatively to address joint problems. Moreover, these process innovations do not preclude accompanying constitutional amendments. For example, formal amendments to the Constitution transferred responsibility for unemployment insurance (1940) and old age pensions (1951) to Ottawa. The old age pension legislation was especially interesting because it involved “concurrency with provincial paramountcy,” a concept that was extended to include survivors’ and disability benefits in the further 1964 amendment (sec. 94a), which facilitated the establishment of the Canada and Quebec Pension Plans (CPP/QPP). Thus, this amendment specifically allowed for asymmetrical relationships, the result of which was that Quebec embraced its own pension plan while the other nine provinces and Ottawa set up the CPP. In a sense, this constitutional amendment was “process driven.”

These constitutional amendments aside, the lesson of the past is clear: Canadians have displayed a rare genius in accommodating their political structures to emerging internal and external forces. More to the point, with the exceptions noted in the previous paragraph, these innovations were the result of process, not structure, although in many cases they were tantamount to a *de facto* alteration of the division of powers in the federation.

Meech and Charlottetown: Federalism as Structure

The *Constitution Act, 1982*, together with the Charter of Rights and Freedoms, was not merely the most significant amendment to the

Constitution since 1867, but also a defining constitutional moment for all Canadians. Unfortunately, as a defining constitutional moment, it tore down as much as it built.

For many Canadians, perhaps even the majority, the Charter served to redefine their conception of Canada. As Alan Cairns (1984, 374) has noted, the language of rights is a Canadian language, not a provincial language, and the resultant freedoms are countrywide in scope, enforced by a national Supreme Court, and entrenched in a national Constitution. The result has been a dramatic shift in the relationship between the citizen and the state and, as a consequence, in the very conception of federalism. Specifically, the Charter triggered a “nonterritorial” conception of the federation, one that had little to do with traditional federal-provincial cleavages but, rather, with cleavages between these newly enshrined pan-Canadian interests on the one hand and vested interests or elites on the other.

The implications were radically different for Quebec. With the *Constitution Act, 1982*, the “compact theory” of Canadian federation came to an abrupt end — the most significant amendment to the Canadian Constitution since Confederation was enshrined without the imprimatur of the legislature representing one of the “two founding nations.” For Quebec, as if this symbolic defeat were not enough, the implications of the Charter itself added injury to insult. Pierre Trudeau’s promise of *le fédéralisme renouvelé*, which played a critical role in securing the federalist victory in the 1980 referendum, turned out to diminish, not enhance, Quebec’s powers. In effect, Quebecers became “full citizens” of Confederation by virtue of a set of enshrined rights adjudicated by a national Supreme Court, under which some of Quebec’s “collective rights” legislation might have to rely on a “notwithstanding clause” open to criticism by “chartists” in the rest of Canada.

Clearly, it was inevitable that something akin to the Meech Lake Accord and its core proposal to enshrine Quebec as a “distinct society” would be attempted. The irony of the Meech debacle was that, as a result of the *Constitution Act, 1982*, this proposal to treat Quebec asymmetrically was embedded in a symmetric (unanimous) ratification formula. In the event, some provinces simply exercised their newly acquired equality or symmetry to defeat the asymmetrical accord. In effect, one

could argue that Quebecers voted “yes” to Canada in 1980, and Canadians voted “no” to Quebec in 1990!

Obviously, matters could not end there. Almost immediately, Canadians engaged in a truly monumental exercise in consultative and executive federalism, the end product of which was the Charlottetown Accord and its resounding defeat in the October 26, 1992, referendum. And on October 30, 1995, Quebecers will vote on their future as Canadians.

Of interest for purposes of this essay is the manner in which this series of events altered Canadians’ conception of the federal system. For one thing, the equality symbols of the Charter and the *Constitution Act, 1982*’s requirement of unanimity in the amending formula for key issues caused symmetry to become a constitutional buzzword, almost to the point of ignoring that asymmetry was one of the cornerstones of the previous order. More important still is that Canadians began to look to constitutional amendment as the solution to most of their problems: through the Charlottetown Accord, the attempt was made to enshrine in the Constitution a truly astonishing number of areas, many of which could have been (and historically were) dealt with through ordinary legislation. Clearly, we had lost our way. It was as if all of our problems were solvable by designing or redesigning aspects of our constitutional architecture. If policy was inadequate in a particular area, the problem must be structural, not political. It was not just that we abandoned federalism as process for federalism as structure, but that the normal process evolution that would have occurred was effectively stymied. Thankfully, Canadians put an effective end to all of this on October 26, 1992. To be sure, this still left the Quebec issue unresolved, but it did spell the end of evolution by constitutional amendment.

The central message of the remainder of the essay is that federalism as process is once again in the driver’s seat. This is not only appropriate but absolutely critical. The complex and evolving nature of the implications of the new TEP for federal states makes it impossible to conceive, let alone implement, an ongoing series of structural responses to these challenges. Flexibility is of the essence. So are creative and imaginative responses. But this is process evolution, and Canadians know how to do this.

I now turn to an elaboration of the nature of these challenges, beginning with changes in the emerging global economic order.

Globalization and the Federal Nation-State

With this section I begin the process of documenting and assessing the salient features of the new “techno-economic paradigm.” The reference in this context to the TEP has some advantages in that it conveys the notion of a paradigm shift — that is, a shift that goes well beyond the economic sphere to impinge on the institutional order and on society in general. Harris (1993) refers to these and similar developments as representing a fundamental shift in the wealth-generation process; Lipsey and Bekar (1995) prefer the term “deep structural adjustment.” Whatever term one uses to describe these irreversible and pervasive forces, it is necessary to document their implications before framing the nature of the challenges they pose for federal nation-states — Canada, in particular. In the analysis that follows this, I focus on the ability of the Canadian federation to adapt or acclimatize itself to these forces.

Because the literature on the new world economic order is, like globalization itself, literally mushrooming, the ensuing analysis will of necessity be selective. By way of a convenient summary, Table 1 draws from my earlier writings in this area (see Courchene 1995d). The text itself covers many of the same issues but couches them in terms of the manner in which TEP forces impinge on the workings of federal nation-states. In general, the theme is that, as a result of globalization, powers are being transferred upward, outward, and, in some cases, downward from the central governments of nation-states. But globalization is more complex than this. For example, the process of transferring powers upward can — and, as will become apparent, often does — have important consequences for the internal workings of federal nation-states. Nonetheless, the analysis proceeds by focusing, first, on the forces impinging on nation-states from above; second, on the special implications arising from the emergence of knowledge as the cutting edge of competitiveness; and, third, on the forces influencing the nation-state from below.

Eroding the Nation-State from Above

The process of passing economic and political powers “upward” is hardly new. Historically, one of the most momentous shifts upward of

economic and political space was the transfer from local to national, a transition that began in earnest in the middle of the nineteenth century and that, for many federal states, was not really completed until after the Second World War (Sturges 1995, 23). In Britain, this process, as it related, for example, to prisons and railways, was ably documented by Sidney and Beatrice Webb (see Webb and Webb 1922, for example) who referred to the upward shift in political power as “nationalization,” a term that, for the Webbs, included not only the takeover by the state of private services but also the centralization of local government functions in the hands of the national government (Sturges 1995, 3). This process was at the core of the emergence of the nation-state as the pivotal political and economic institution for both citizen-state and state-state relationships.

Under the TEP, this upward transfer of power is now accruing to supranational bodies. To use the Webbs’ terminology, “nationalization” is giving way to “internationalization.” International economic integration and the informatics revolution are creating markets that are truly global — what Kenichi Ohmae (1990) calls the “borderless economy.” Unlike nationalization, internationalization is private sector driven (largely through transnational enterprises, or TNEs). Essentially, then, globalization represents a shift in the locus of decisionmaking not just from nation-states to transnational actors, but also from national governments to the private sector (Cable 1995, 37).

In response to this new environment, in which economic space is transcending political space, nation-states are “confederalizing” by forming supranational political and institutional entities. Confederal institutions are not new but, as Elazar (1994, 2) notes, the “difference between earlier and contemporary confederations is that the primary purpose of earlier confederations was military security, while in post-modern confederations it is economic.” While this process, too, is eroding the power of nation-states, it is conceptually different from that of transferring sovereignty to transnational actors and global markets. Some analysts call this “sovereignty pooling,” as nation-states come together to create various supranational “public goods” such as international regulatory standards for global banks. Fundamentally, however, this pooling is also driven by globalization.

**Table 1: Globalization and the Knowledge/Information Revolution:
Variations on the New Techno-Economic Paradigm (TEP)**

Variations on the New TEP	Definition	Characteristics	Policy Implications/Challenges
A. "Nothing is 'overseas' any longer (Ohmae 1990, vii).	The increasing internationalization of production, initially in manufacturing but increasingly in services as well.	Decouples firms from the factor endowments of any single country.	<ul style="list-style-type: none"> — Wreaks havoc on national welfare states that have geared incentives to national production systems. — What is the nature of a welfare state when production is international?
B. Shift from multinational enterprises (MNEs) to transnational enterprises (TNEs).	TNEs no longer subject to host-country controls, unlike MNEs.	Two polar models: the "national treatment" model, as under the FTA and NAFTA, and the "single-country (home-country) rule" model, as in the European Union (EU). In theory at least, the former is sovereignty enhancing while the latter implies policy homogenization.	<ul style="list-style-type: none"> — Canadians eventually will realize that the genius of the FTA lies in the sovereignty-enhancing national treatment principle. — It is the international private sector that is globalizing, not the public sector. Pressures mount for governments to transfer powers upward so that political space is more contiguous with economic space.
C. Globalization as the internationalization of cities.	Economies of scale and scope associated with the information revolution imply that international cities have become the connectors outward to, for example, London, New York, and Tokyo, and inward to their regional hinterlands.	<ul style="list-style-type: none"> — Represents one way in which the "institutional structure" is globalizing. — May be a temporary phenomenon as the spread of the information revolution allows for a greater dispersion of economic power and activity. 	<ul style="list-style-type: none"> — An integral part of the process by which power is being transferred downward from nation-states. This is especially so since, in Canada at least, international cities are "constitutionless." — An integral part of the regional/international interface.
D1. Globalization as the knowledge/information revolution: Knowledge.	Knowledge is increasingly at the cutting edge of competitiveness.	<ul style="list-style-type: none"> — Skilled labor is more like capital than like traditional labor. — Disappearing middle class. — Shift in the "wealth-generating process" (Harris 1993). — For resources to remain important, they must embody knowledge (or high-value-added techniques). 	<ul style="list-style-type: none"> — Dramatic implications in all countries with respect to the distribution of income. — Even resource-rich economies must make the transition to human-capital-based economies and societies. — Social policy, as it relates to human capital and skills formation, is indistinguishable from economic policy.

D2.	Globalization as the knowledge/information revolution: Information.	Compresses both time and distance in terms of economic activity and, therefore, enhances global integration.	Privileges individuals in the sense that they now have the ability to access, transmit, and transform information in ways that governments of all stripes are powerless to prevent.	<p>— Arguably, this is inherently decentralizing.</p> <p>— The information revolution will also redraw the boundary between what is feasible in the public and private sectors — for example, it will eventually relegate the Canadian Radio-television and Telecommunications Commission to the sidelines, just as facsimile transmissions are marginalizing the post office.</p>
E.	Globalization as consumer sovereignty (Ohmae 1990).	“Performance standards are now set in the in the market place by those that buy the products, not those that make or regulate them” (Ohmae 1990, dustjacket).	This is a variant of the information revolution in D2 in that it implies that “receptors,” rather than “transmitters,” are in the driver’s seat.	<p>— Obviously, this transfers power from governments to consumers.</p> <p>— Of more interest here, however, is that, while the information revolution privileges citizens as “consumers,” it tends to disenfranchise them as “citizens,” since an important set of decisions relating to them is beyond the purview of the nation-state.</p>
F.	Globalization as regime theory.	In a sense, this is the oldest form of globalization. Regimes are the formal or institutional devices through which economic and political actors organize and manage their interdependencies.	Regimes have long been with us — in energy, airlines, minerals, and so on. They set standards, perform allocation functions, monitor compliance, reduce conflict, and resolve disputes.	Regimes restrict the autonomy of nation-states. Now, however, regimes are spreading into “soft” areas such as nontariff barriers, the environment, social charters, and rights for indigenous peoples.
G.	Globalization as ultra mobility.	Enhanced mobility is generic in that it underpins all conceptions of globalization as well as virtually all conceptions of a new TEP shift.	Since taxation or regulation of mobile factors becomes more difficult, and since globalization or ultra mobility implies an increase in the number and range of factors and commodities that are mobile, this constrains the instrument set available to policy authorities. In tandem with the spread of free trade arrangements, this constrains policymakers from using allocative instruments to deliver distributional goals.	Arguably, the optimal jurisdictional space for taxation has increased relative to that for spending. Thus, one now speaks of EU-wide corporate taxes or carbon taxes, for example. Yet the optimal spending jurisdiction has not yet become EU-wide. This creates the specter of EU financial transfers to member states — that is, an internationalization of Canadian-style fiscal federalism.

Source: Courchene 1995b.

Effects on the Internal Structure of Nation-States

While the nation-state is hardly about to wither away, and in some areas may well be strengthened, the process of transferring sovereignty upward and outward is ushering in a profound transformation. Intriguingly, this transformation “from above” also has major implications for the *internal* workings of nation-states — particularly federal nation-states. In full recognition that pursuing this line of analysis will complicate the later section dealing with passing powers downward, it is instructive, nonetheless, to broach these issues in the present context. At the very least, it will drive home the point that globalization is an extremely complex and multifaceted phenomenon.

The first general observation is that TNEs now compete with one another using truly global strategies: selling worldwide, sourcing components and materials worldwide, and locating activities across nations to take advantage of favorable cost opportunities. While this is hardly a novel observation — it is a straightforward application of the profit-maximizing rule in a world where economic borders have vanished — the implications for the internal organization of societies can be quite dramatic. Consider the following:

- The combination of internationalization of the economy, enhanced capital mobility, the shift from multinationals to TNEs (panel B of Table 1), and international trade agreements all serve to reduce the ability of states to pursue autonomous economic policies (Keating 1992, 48). For example, free trade with the United States may not alter Canada’s policy goals, but it does constrain the means by which they can be achieved. As Jeffrey Simpson (1987) noted, the Canada-US Free Trade Agreement (FTA) — as well as globalization itself — resonates much better with the defining constitutional rhetoric of the US Constitution (“life, liberty, and the pursuit of happiness”) than it does with ours (“peace, order, and good government”).
 - Traditional regional policy is likewise challenged. Rather than allocating resources to backward regions, nations increasingly will feel compelled to favor their most dynamic sectors and locations to maximize national competitiveness and, therefore, to enhance the
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probability of attracting TNE capital (Keating 1994b, 3). Phrased differently, the opportunity cost of federally driven, interventionist regional policy is, increasingly, international competitiveness. While this may well be viewed an appropriate and long overdue policy shift, it does alter regional-national linkages and identities, an issue that will be an important focus later in the essay. (Note that the thrust of this point is the altered nature of the national-regional interface, not that the regions will be hampered by globalization. Indeed, the opposite is the case, as the later section on New Brunswick should demonstrate.)

- The economic integration and economic liberalism that follow in the wake of globalization are altering the nature of the postwar welfare state. Traditionally, the role and incentives of the welfare state were geared to national “production” machines. With production becoming international, the nature of the welfare state has to be rethought. Beyond this, enormous economic restructuring is nudging societal preferences toward the creation of income and away from a redistributive ethos.⁴
- In terms of the broader organization of society, capital has become international while most types of labor remain constrained by the nation-state. As a result, unionization (at least in the private sector) is in decline. As Susan Strange (1988, 213) puts it, “the fact that a

⁴ In the Canadian context, the move by several provinces to pare down and/or rework their welfare systems has been linked either to the northern march of “rugged individualism” and the American Creed or to the collapse of federal transfer payments. The reality, however, is that this approach is rather widespread among nation-states, as the following quotation from Horsman and Marshall (1995, xiii) indicates:

This “techno-economic” revolution is beginning to alter the very concept of “work” in a modern economy, and that fact has huge and troubling implications for social organization. The Fordist paradigm, in which workers were paid enough to be able to buy the sorts of products they had a hand in making, and could give up a share of their income to finance an extensive welfare system for the unemployed, the retired, and the ill, is no longer tenable. Globalization has meant that factory workers in the US cannot compete with their counterparts in Korea and still maintain a high and growing standard of living. It has meant that governments cannot afford to administer huge social programmes on the proceeds of a declining manufacturing sector. Finally, it has meant new kinds of jobs in the West — in finance, real estate, computer software — for which an industrial workforce is untrained.

transnational company can move its plant...while a worker cannot move to another country has robbed labour unions in industrialized countries of their power.” This, too, represents a shift of powers and identities within nation-states.

Thus, the process of globalization is clearly undermining the nation-state as one of the principal ways of ordering relationships, of locating authority, and of channeling power (Horsman and Marshall 1994, xix). It may be going too far to suggest, as Strange does (1995, 57), that nation-states are being hollowed out, but she is no doubt correct that the “inner core of their authority in society and over economic transactions within their defined territorial boundaries is seriously impaired” (ibid.).

The second general observation is closely related. From the perspective that the nation-state evolved as a pact between citizens and governments within geographically distinct borders (Horsman and Marshall 1995, xvi), globalization and, even more so, the informatics revolution are reconfiguring the individual-state relationship. There are two components to this. The first is that the individual as consumer has acquired greater sovereignty. Indeed, Ohmae (1990) actually defines globalization as “consumer sovereignty” (Table 1, panel E). In tandem with generalized economic liberalization, the information explosion allows consumers the ability to access information and markets in ways that governments are increasingly powerless to prevent (Table 1, panel D2). This is one of the many avenues by which Elkins (1995) argues that individuals are incorporating multiple loyalties and, in the process, contributing to the “de-territorialization” of the existing order.

Democracy Deficits

The second component is perhaps even more relevant to the core of this essay. As powers and decisionmaking processes are being passed upward and outward from nation-states, individuals as citizens are beginning to feel disenfranchised.⁵ In the context of the European Union (EU), this has come to be referred to as the “democracy deficit.” However, this concept also has an important equivalent *within* nation-states. As sov-

⁵ This issue was one of the themes of Richard Simeon’s 1994 Benefactors Lecture.

ereignty becomes diffused and dispersed throughout society, governments increasingly operate through a series of contracts and/or negotiations among agents or complex networks of agents. Almost by definition, these tend to be hammered out at the executive level and, hence, presented to legislators as *faits accomplis*. Not even a people as concerned with individualism as the Americans can escape this, as the “fast tracking” of the FTA and the North American Free Trade Agreement (NAFTA) demonstrated. There is, of course, a substantial irony here. An important part of the result of the referendum on the Charlottetown Accord was the message that Canadians were fed up with these “behind-closed-doors” agreements where the choice was “yes” or “no”, with no possibility of modifying the text for fear of unraveling the seamless web. Yet the future will see more, not less, of these executive federalism or confederal-type processes, the Agreement on Internal Trade being the most recent example. However, the message that I want to extract from this (and one that will be elaborated on later) has been captured effectively by Horsman and Marshall (1995, xv):

As the diminution of single-state power becomes evident, and as embryonic supranational political arrangements come only slowly into being, citizens will tend to think more closely... about their own communities (variously defined...), seeking local political reflections of their concerns, even as the economies in which they are consumers move even closer toward global integration. They will seek political solutions, and democratic accountability, at ever more local levels as the world economy moves toward an even greater level of integration.

In effect, this provides a political accountability rationalization for the principle of “subsidiarity” — namely, that responsibility ought to remain at the lowest level at which it can be effectively exercised.

International Agreements

While the potential for greater decentralization of power within Canada will be a dominant theme of the remainder of the analysis, my third general observation pertaining to globalization probably runs in the opposite direction. The proliferation of international agreements across a broad range of policy areas could alter the internal distribution of

powers in federal nation-states — in particular, it could erode some aspects of the competences of existing subnational units, be they provinces, states, cantons, or *Länder*. Craven (1993, 11) identifies the core issue here: “Can the central [federal] government, simply through the exercise of its capacity in the field of foreign relations, significantly alter what otherwise would be the constitutional balance of power?” At the practical level, the area of social policy provides a convenient example. Once the purview of family and church, then local government, and still later provincial and national governments, social policy is becoming internationalized, as reflected, for example, by the NAFTA’s side agreements on social and labor policy and by the EU’s Social Charter. Moreover, as the growing frequency of the term “social dumping” in the EU implies, this issue changes from social policy to competition policy as it moves up the integration ladder.

At the division-of-powers level, the answer to Craven’s question in many federations is “yes.” Whether via the executive power or the foreign relations power (the power to enter into treaties), it is clear that the US, Swiss, and Australian federal governments have relatively free reign to maneuver and, in the process, to enforce compliance by sub-national governments (Courchene and Walsh 1995). The countervail, to the extent that it exists, is political, not constitutional. For example, there is a move afoot in Australia to establish a “treaties council” as an official agency of the Council of Australian Governments (that country’s equivalent of Canada’s First Ministers Conference) in order to allow the Australian states to have some input into federal treaties.

Canada is an exception here. The judicial precedent in this area dates back to the 1937 *Labour Conventions* case. In effect, while the federal government can enter into any international obligations it wishes, it can implement those obligations only as far as they are matters of federal constitutional responsibility. This may appear anomalous in a progressively integrating global economy, and some analysts (for example, Leslie 1995) suggest that the decision in *Labour Conventions* could eventually be overturned. But even were this to occur, the processes of formal provincial consultation in international trade negotiations are well established and the provinces are often exempt from such agreements (such as the Agreement on Government Procurement under the FTA).

The German Model

By far the most creative institutional response to the implications of international agreements for the internal distribution of powers in federal states is that by Germany. Fearful that their existing autonomy would be curtailed (without their explicit consent) by the processes of EU integration, the German *Länder* (states) implemented a twofold strategy.⁶

First, they sought to build into the Basic Law (the German Constitution) new measures to prevent the possibility of Bonn's transferring *Länder* powers to the EU against their will (as had been done in the 1980s with respect to European Community initiatives on education and broadcasting). The amendment to the Basic Law proposes that "[t]he Federation may by legislation and *with the consent of the Bundesrat* [effectively the *Länder*, since the Bundesrat is the Chamber of the *Länder*] transfer sovereign powers to inter-governmental institutions"; it concludes by saying that "insofar as the responsibilities of the *Länder*, as set out in the Basic Law, or their essential interests, are effected, provision should be made to allow the *Länder* to exert a central influence." To the best of my knowledge, this proposal will be, or has been, implemented.

Second, the *Länder* sought to complete their guarantee by seeing that the principle of subsidiarity was written into the EU treaty as a statement of European operative policy. This, too, has been implemented. It may seem anomalous that arrangements such as these would arise in what is arguably among the most centralized of the mature federations. Part of the explanation may be that, because Germany finds itself a federation within a confederalizing superstructure, these issues are more pressing than they are in other federations. Leonardy (1993) adds an important footnote here: these measures were not grounded in any hostility on the part of the *Länder* to the Maastricht Treaty; rather, "the matter at stake was and remains a straightforward and even natural contest over power-sharing within a federal state which is itself growing into the *fully accepted*, new federal structure emerging above it" (Leonardy 1993, 132 [emphasis added]).

⁶ The next few sentences are adapted from Green (1994, 292–293).

These German initiatives presumably will receive careful scrutiny in other federations. Whether they are importable in some version into other federal constitutions is, for present purposes, not as important as the fact that the inevitable spread of international trade and integration agreements may play havoc with the existing internal constitutional balance in federal systems.

Human Capital as an Economic Variable

Thus far, knowledge as an economic variable has been viewed as an integral part of the new TEP. Indeed, the bundling of knowledge into “intellectual capital” (patents, copyright, and trademarks) is part and parcel of the ability of TNEs to access global markets. In this section, I want to separate the human-capital component of knowledge from the intellectual-capital component, because focusing on the former allows some further insights into how the new TEP is influencing nation-states. In particular, three aspects merit highlight.

First, with knowledge increasingly at the cutting edge of competitiveness, aspects of social policy become indistinguishable from traditional economic policy (Table 1, panel D1). In turn, this means that, regardless of the wording of the constitutions of federal states, federal governments will become players in this area in some form because national competitiveness is at stake. For relatively centralized federations such as Australia, this poses little in the way of additional challenges. For decentralized federations such as Canada, the challenge is more daunting, since the provinces are responsible for much of the delivery of social programs. The required finessing involves maintaining the role of competitive federalism and provincial experimentation and, at the same time, ensuring that the “national” aspects of social Canada remain intact. If the provinces cannot rise to this challenge, then Ottawa will become a more active player. This will feature prominently in the later analysis.

The second aspect is that the educated or highly skilled echelons of the labor force (what Reich [1991] refers to as “symbolic analysts”) are becoming increasingly mobile internationally and, therefore, more like capital than like traditional labor. Among other things, it is increasingly

difficult to subject them to high marginal tax rates. We need not agree with Reich — who claims that these symbolic analysts are “seceding” from their country of origin (he refers to the United States) and networking with the global economy — to recognize that this complicates the political economies of all nation-states.

More complicating still is the third and related aspect: that the internationalization of production is undermining wages and employment for the less skilled and may also be unraveling the traditional middle class. This underscores the earlier point, that the internationalization of production is undermining the traditional welfare state. In tandem, the second and third observations imply a polarization of societal incomes, one consequence of which Cable (1995, 43) articulates: “We thus have one, potentially large, disadvantaged, alienated, and powerless element in society and another which is flourishing but has less of a stake in the success of any particular country.” Indeed, from the point of view of public policy, let alone from that of society as a whole, the most serious and daunting challenges posed by globalization and the knowledge/information revolution are their implications for income distribution.

Eroding the Nation-State from Below

In my own writings (Courchene 1992, 1994), I have invariably assumed that globalization also implies that associated (or decentralist) forces are eroding the nation-state from below. Other analysts (for example, Sturges 1985) are more wary of this view. A major part of the difference in approaches is that I have tended to focus my analysis on the Canadian federation, special and perhaps unique features of which point toward greater decentralization. Nonetheless, a few important analytical strands in the general literature do emphasize the potential for regionalization of the political economy of federal nation-states, and I shall address them in this section.

The first of these is cast in terms of the provision of public goods or framework policies. In the heyday of the nation-state, the central government provided such framework arrangements as monetary policy, trade and commercial policy, and defense. With the advent of the European Union, the NAFTA, and myriad other international agree-

ments, a supranational infrastructure is emerging that is providing many of these framework arrangements. That is, national public goods are being superseded by supranational public goods. This allows what Keating (1995) refers to as “minority nationalisms” to uncouple nation from state, as it were. In effect, the overarching international superstructure allows a subnational government to bypass its national government and to latch on to these international framework arrangements on the one hand and to pursue a more autonomous (“distinct society”) future on the other. The most commonly cited examples are Quebec, Catalonia, and Scotland (Keating 1995, 1994a). Belgium qualifies as well since, in converting to a federal system, it created decentralized provincial governments linked largely to the EU superstructure and, in the process, almost eclipsed the role of the central government. Were these supranational infrastructures to succeed in creating common, overarching currencies (the ECU in the European Union or perhaps some new form of dollar for an expanded NAFTA) the position of these minority nationalisms would likewise be substantially enhanced.

Peter Drucker foresaw much of this when he noted (see, for example, Drucker 1986) that we were witnessing, at one and the same time, an integrating global economy and a splintering global polity. This essay does not discuss ethnic nationalist movements, the part of the splintering polity that has received the most attention. (Obviously, an important corollary is that, despite the linguistic and cultural distinctiveness of the Catalonians and Québécois, I place them in the civic nationalism and even economic nationalism categories rather than in the ethnic nationalism category.) I also exclude discussion of the proliferation of civic nationalist states, although they do accord with the thrust of this part of the essay. Sturgess (1995, 6) notes, for example, that:

The newest nation state in Europe is Andorra, located high in the Pyrenees between France and Spain. Andorra has its own flag and a seat at the United Nations, and a population of 37,000 people. The nation state of Andorra is only possible because functional sovereignty is no longer necessary in Europe. The requirements of defence and macro-economic management are met elsewhere and the state functions as a symbolic expression of Andorran cultural identity.

Instead, my focus is on subnational units of nation-states, and the substantive issue at stake is the tendencies that are leading to what might be called “glocalization” (globalization and localization).

Thus, it seems to be increasingly possible to substitute supranational structures for nation-state structures. But what is the rationale for associating greater powers with subnational governments? Enter the European regional science literature.

The Regional/International Interface

According to Michael Storper (1994, 22), the principal dilemma of contemporary economic geography is

the resurgence of regional economies and of territorial specialization in an age of increasing ease in transportation and communication of inputs and outputs and of increasingly scientific organizational rationalities of managing complex systems of inputs and outputs.

What accounts for this phenomenon?

Surprisingly, this question has not yet interested the mainstream economics profession in Canada or the United States.⁷ It has, however, long been an important issue in the European regional science literature. Setting aside the analytical aspects for the moment, the way in which I interpret the emerging regional reality in terms of contending for power and influence with national governments is captured in the following four points:

- While the earlier analysis indicated that it was the private sector, rather than the public sector, that was globalizing, to the extent that “institutions” are also globalizing this is occurring through a network of international cities — Toronto, Montreal, and Vancouver in Canada’s case. The economies of scale and scope associated with the explosion in information and services implies that these inter-

⁷ Marcel Côté’s “By Way of Advice” (1991) is an important exception, as are the writings of Jane Jacobs on the role of cities. Lipsey’s research (for example, 1995) on the determinants of growth for the Canadian Institute of Advanced Research will, I think, also eventually lead him in this direction.

national cities have become not only critical growth nodes but the essential “connectors” (to fall back on Jane Jacobs’ terminology) outward to global centers such as New York, Tokyo, and London, and inward to their regional hinterlands. Let me scoop some of my later focus on the Canadian federation by noting that it is important to recognize that, despite their increasing power and influence, these Canadian international cities are “constitutionless” — they are the creatures of their respective provinces. The challenges go much beyond this, however. The international city for Saskatchewan (Toronto for finance, presumably Vancouver for trade) is not located in that province; the international city for Nova Scotia (increasingly, Boston/New York) is not even in the same country! (It works in the opposite direction, too: arguably, Buffalo’s international city is not New York but Toronto.)

- Focusing on the role of international cities serves to emphasize two issues I raised earlier. The first relates to the existence of democracy deficits. It seems obvious that the burghers of Saskatoon would be willing to trade some of their influence in Regina for more influence in, say, Vancouver. Likewise, Torontonians presumably would relinquish some of their influence in Ottawa for a role in the corridors of Washington, DC. The second relates to Quebec. It seems to me that it is critical that a “distinct society” be anchored by an international city. Simply put, without Montreal, there would be no Parti Québécois, let alone a Bloc Québécois. No matter what one’s position is on the referendum issue, the unfortunate reality (for all Canadians, not just Quebecers) is that Montreal’s star as an international city now shines less brightly than it once did.
 - Relatedly, the focus on economic regions increasingly brings into sharp view either that their hinterlands extend beyond national borders or that they are linking up with similar regions in other countries. An example of the latter is the 1988 agreement among the “four motors” of continental Europe (Italy’s Lombardy, Spain’s Catalonia, France’s Rhône-Alpes, and Germany’s Baden-Württemberg). Significantly, these regions have more in common with each other than with other regions of their own countries. In addition to serving as a template for coordinating the common industrial and
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crossborder interests of these regions, the agreement also increases their lobbying power both in their home country and at the supranational level of the European Union.

- The United Nations has recognized the impact of all of this by noting (1990, iii) that “national boundaries have become increasingly irrelevant in the definition of market and production spaces while regions rather than countries are emerging as key policy arenas.”

By way of summary, the traditional national-versus-national conception of economic interface is yielding to the region-versus-international conception of economic relationships. Even more important, conceptually, is that comparative advantage is becoming associated with regional, not national, economies.

Analytical Reflections

It is much more difficult to sort out the underlying theory relating to regional growth than to document its existence. In general, the existing literature in this area (much of it European) falls into the “evolutionary economics school” rather than the “neoclassical school.” Specifically, the emphasis is not on equilibrium but on innovation, agents of change, and the role of institutional and structural elements. Indeed, the focus on path dependency, feedback mechanisms, and irreversibilities is central to this literature and predates the appearance of these concepts in mainstream economics, as reflected, for example, in the literature on endogenous growth (see Howitt 1994).

One important strand of this regional literature is the role of *local milieus* in generating networking,⁸ which, in turn, can be characterized by organizational principles and linkages that encourage flexibility, the creation and transmission of knowledge, skill formation, mutual trust among partners, reciprocity, solidarity, and so on (Lecoq 1991, 329). Thus, these “milieux innovateurs” are, at the same time, *organizational*

⁸ Networking can be defined as a set of organizational arrangements midway between horizontal coordination (markets) and vertical coordination (hierarchies). In a recent paper, Paquet (1995) refers to this genre of organization as “transversal” coordination.

(in the sense that they embody a set of institutions, rules, conventions and practices) and *territorial* (in the sense that they are embedded in the social and economic infrastructure of the region). Storper (1994) attempts to extend this analysis further by proposing that the success of Silicon Valley, Route 128, and other “hot spots” must reside in what economists call their “untraded interdependencies.” The untraded aspect is critical — to access these interdependencies, one must be part of the regional economy:

Thus, regional economies constitute nexuses of untraded interdependencies which emerge and become, themselves, specific but public assets of production communities (assets of coordination, ie. frameworks of collective action), and which underpin the production and reproduction of other specific assets such as labor and hardware. (Ibid., 21.)

Economists have a difficult time grappling with these concepts because their discipline is principally market based; thus, their focus is on “traded interdependencies,” which, almost by definition, are not location specific. Perhaps a better way to examine these untraded interdependencies is to view them as part of the continuum of public goods or, even better (as my colleague Art Stewart has suggested), as “locational positive externalities,” although these externalities could also be negative. For example, a firm locating anywhere in North America has access to an international public good — the principles of the NAFTA. If, among Canada, the United States, and Mexico, a firm chooses to locate in Canada, it gains access to Canadian public goods (such as medical coverage for its workers) but forgoes access to US and Mexican national public goods or infrastructures. In effect, these are nontradable public goods — one accesses them by location, not by markets. From this perspective, it would seem to follow quite naturally that where one locates in Canada will determine the nature of the regional or provincial public goods that the firm can access. Indeed, one can extend this further by proposing that the process of competitive federalism can be viewed as an attempt among subnational units to compete in the provision of untraded interdependencies. The new twist, drawing from the regional/international interface, is that this “competition” is no longer along east-west lines but along crossborder or international lines.

While this analysis is admittedly incomplete and tentative, the concept of untraded interdependencies or competing provincial/local infrastructures looms large in the ensuing analysis: the New Brunswick “miracle” is nothing other than the creation of an important constellation of untraded interdependencies or locational positive externalities.

Recapitulation

By way of summary, the new TEP is forcing a restructuring and rethinking across an incredibly wide range of fronts for federal systems:

- the diminished role of central governments not only in the provision of erstwhile “national” infrastructure (the FTA and NAFTA for Canada, “Europe 1992” and Maastricht for Germany, for example) but also in the instruments that can be used to achieve societal objectives (the required shift toward economic liberalism in the policy sphere);
- the role of international agreements in altering the internal balance of powers or competences in federal nation-states;
- the change in individual-state relationships, whereby individuals are being enfranchised as consumers and disenfranchised as citizens;
- the polarization of income distribution arising, on the one hand, from the internationalization of production and the disempowering of immobile routine workers from their former “middle-class” jobs and, on the other, from the “internationalization” of highly skilled labor and their integration into global employment opportunities;
- the shift from the traditional national/national interface toward a regional/international interface, and the recognition that comparative advantage is increasingly a regional, not a national, phenomenon; and
- the search for “belonging” in a global economy that tends to favor a focus on community, however defined.

These are the existing and/or emerging realities. And their effects will be profound.

How, then, should federal systems — Canada’s, in particular — respond to this constellation of challenges? That we do not know how these forces eventually will play out severely complicates any attempt

to approach a solution from the structural or constitutional-amendment side. As Paquet (1995) notes, the institutional order itself is an “emergent phenomenon,” and the coordinating mechanisms in this information age likely will be “distributed, decentralized, collaborative and adaptive.” In effect, this required flexibility is forcing us to return to “federalism as process” rather than continuing to emphasize “federalism as structure.”

To this point in the analysis, I have adopted a rather agnostic approach in terms of whether I believe the internal structure of federal systems will tilt toward centralization or decentralization. This is appropriate because there is a genuine tension between, for example, the potentially centralizing effects of the spread of international agreements on the one hand and the potentially decentralizing influence arising from a search for community and the implications arising from the regional/international interface on the other. But the direction in which the Canadian federation is evolving is not in doubt, at least over the near term: decentralization is in. To underscore this, I focus in the next section on two critical features of the Canadian reality of the 1990s that I have hitherto not addressed: the role of debts and deficits, and the cross-border nature of Canada’s regional economies.

The Center Cannot Hold

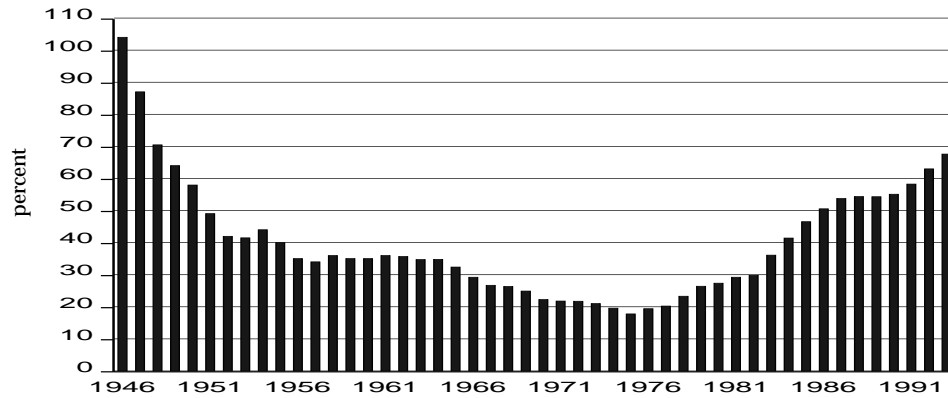
Fiscally Triggered Decentralization

Around the time of the 1973–74 energy shock (and not unrelatedly), a critical change took place in the postwar world economy. Until that time, the rate of growth of gross domestic product (GDP) had exceeded the average rate of interest on the public debt. This excess, as shown in panel C of Figure 2, had been under 4 percent in the immediate postwar period and had risen to nearly 8 percent in the early 1970s.

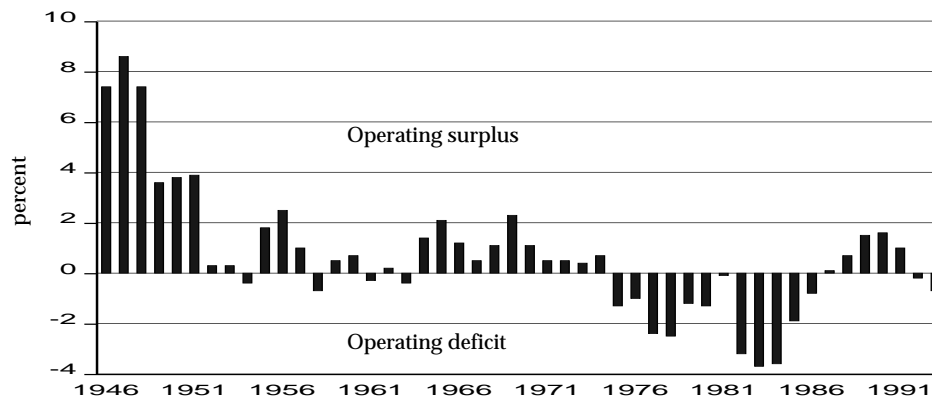
Under such conditions, the ratio of debt to GDP tends to decline naturally, since the denominator (GDP) is growing faster than is the cost of servicing the debt. Indeed, the debt-to-GDP ratio would fall even if the operating balance (the budget balance excluding debt servicing) were in deficit, provided that the sum of the operating balance deficit

Figure 2: Dynamics of the Federal Debt-to-GDP Ratio, 1946–93

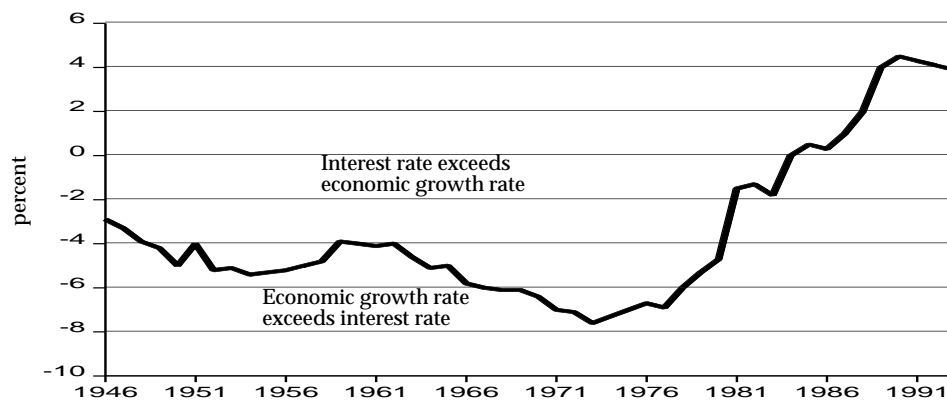
A: Net Federal Debt as a Percentage of GDP



B: Operating Balance as a Percentage of GDP



C: Effective Interest Rate minus Smoothed Growth Rate of Nominal GDP



Source: Canada 1994, 80.

(as a percent of the existing debt) and the rate of interest were less than the rate of growth of GDP.⁹

As panel B of Figure 2 reveals, however, the federal government generally ran operating surpluses, not deficits, until the mid-1970s, so that Canada's debt-to-GDP ratio fell dramatically. Admittedly, tax rates increased substantially during this period; nonetheless, this was the "golden era" of Canadian public finance — a comprehensive set of transfers to persons, governments, and businesses was put in place and the debt-to-GDP ratio was reduced from over 100 percent in 1946 to less than 20 percent in the mid-1970s (see Figure 2, panel A).

As already noted, the fundamentals began to alter markedly in the mid-1970s: interest rates began to rise relative to GDP growth rates — they have exceeded GDP growth rates over the past decade, sometimes by as much as 4 percent (see Figure 2, panel C) — and the federal government began to run annual operating deficits. Together, these caused the debt-to-GDP ratio to rise. Even during the prolonged economic boom of the 1980s, when the government's operating balance was in surplus, the debt-to-GDP ratio increased because the surpluses were not high enough to offset high interest rates relative to GDP growth (see Figure 2, panel A).

The 1995 federal budget predicts that the debt-to-GDP ratio will be 74 percent for fiscal year 1995/96. Combined with provincial debts, the overall debt-to-GDP ratio for Canadian governments is now above 100 percent (see Table 2, below). As indicated in footnote 9, when the debt-to-GDP ratio equals unity, the mathematics simplify to the following relationship: to keep the debt-to-GDP ratio stable, the operating

⁹ The mathematics are as follows:

$$\Delta b = b[(i - g) + OB/D],$$

where b = the debt-to-GDP ratio; Δb = change in the debt-to-GDP ratio; i = rate of interest; g = rate of GDP growth; OB/D = operating balance deficit as a percentage of the existing debt.

Note that when b nears unity (as it now does for the aggregate government sector in Canada), this expression essentially becomes $i - g + OB/GNP$ — that is, the debt-to-GDP ratio will increase if the sum of the rate of interest (i) and the operating deficit as a percentage of GDP (OB/GNP) exceeds the rate of GNP growth. Hence, if $i = 9$ percent and GDP growth is 6 percent, then there must be an *operating surplus of 3 percent of GDP* in order to prevent b from increasing further. Conversely, in the early 1970s, when GDP growth exceeded the rate of interest by 8 percent, the operating balance could be in deficit to the tune of 8 percent of the existing debt and the debt-to-GDP ratio would have remained constant.

surplus (as a percentage of GDP) must equal the difference between interest rates and the rate of growth of GDP. If interest rates exceed the GDP growth rate by 3 percent, there must be an operating surplus of 3 percent of GDP just to keep the ratio constant. And if the policy goal is to reduce the debt-to-GDP ratio, then the operating surplus must be correspondingly higher.

Searching for Scapegoats

There are all sorts of possible explanations of why Canadian governments have ended up with a debt-to-GDP ratio above 100 percent. Some attribute the rise since 1988 to the Bank of Canada's shift toward price stability and the consequent increase in interest rates required to bring inflation down. I believe that there is some truth in this (Courchene 1990). Others claim that the prevailing attitude in the 1980s that "deficits don't matter" was the real culprit, since it meant that politicians could not muster sufficient political support to restore fiscal integrity. There is truth in this also. Still others assert, again correctly, that, by focusing inward on constitutional issues for more than a decade, Canadians effectively blinded themselves to the emerging global realities. My favorite explanation, albeit related, is that Canada emptied its fiscal coffers in a futile effort to sustain the old paradigm or socioeconomic order.

Underlying these and other explanations, however, is something both simpler and more profound: Canadians failed to recognize that the dynamics underpinning the debt-to-GDP ratio had altered so fundamentally. In the good old days, we could run operating deficits and still witness declines in the debt-to-GDP ratio; now, we can run substantial operating budget surpluses and still see the debt-to-GDP ratio escalate.

To be sure, this is a global phenomenon: the new dynamics apply to virtually every developed economy. But unlike the set of forces outlined in the previous section of this essay, which were and are largely exogenous to Canada, the escalation of Canada's debt-to-GDP ratio was of our own making. Worse still, we are now caught in a vicious circle: our high debt-to-GDP ratio tends to put still more upward pressure on interest rates, a situation made worse by recent downgrades of federal and provincial government credit ratings. Harris (1993) approaches this from a different angle. Canada, he says, ran up its debt and deficits by using its resources as its "national collateral." Increasingly, however, the

national collateral that will be called on to service this indebtedness is Canada's human capital base. Unfortunately, in the international pecking order, Canada's resource capital ranks higher than its human capital. This, too, will put upward pressure on real interest rates. Needless to say, the concern about the continued survival of the Canadian nation-state also feeds into these interest rates. A rupturing of the Canadian state would exacerbate these dynamics for both surviving entities. Intriguing as all of this may be, the essential point is that we did this to ourselves!

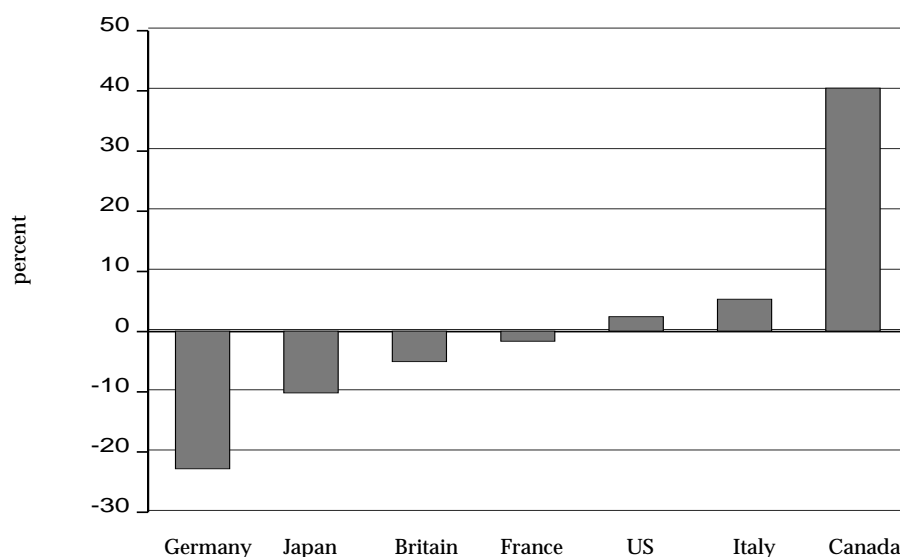
Canada Is Unique

Although all of this may simply be a rationalization of the stance taken by the 1995 federal budget, it is probably appropriate to note that Italy and Belgium have even higher debt-to-GDP ratios than Canada does. Why have these countries not been subjected to the same intense pressures that bond-rating agencies have brought to bear on Canada? In large measure, the answer has to do with two other related indicators. The first of these, net international indebtedness, appears in Figure 3. This is surely a case where a picture is worth a thousand words! Among the Group of Seven (G-7) major industrialized countries, Canada is clearly in a class of its own. The second relates to the current "draw" on international capital markets, as reflected in the current account balance. *The Economist* (August 12–18, 1995, 89), reports that Belgium's current account surplus is US\$6.9 billion and Italy's is in surplus by US\$15.6 billion — but Canada has a current account *deficit* of US\$14.1 billion.

In combination, these three factors place Canada in a unique situation. It has one of the highest debt-to-GDP ratios of any of the developed countries; it has a net international indebtedness ratio (to GDP) that probably exceeds that of *any* country in the world; and it is drawing on international capital markets to the tune of US\$14 billion per year to finance current operations. This is tantamount to a unilateral transfer of fiscal and financial sovereignty to the "kids in red suspenders." Not surprisingly, the "kids" are exercising that sovereignty, and the 1995 federal budget is merely the first installment.

As an intriguing aside, since these three factors were already clearly evident five years ago, why did international capital markets not flex their muscles earlier? The answer is, I think, rather straightforward.

**Figure 3: *International Indebtedness
of the G-7 Countries, 1991***
(as a percentage of gross domestic product)



Note: The data for Canada and the United States are from 1991; for Germany, Italy, Britain, and Japan, from 1990; and for France, from 1989.

Source: IRPP 1993.

From the onset of the Bank of Canada's conversion to price stability (1988) right through to 1992, Canada was the darling of the international capital markets. Canada's interest rates were well above comparable US rates and the Canadian dollar was appreciating from a low of 70 US cents in 1986 to a peak of nearly 90 US cents in 1992. Thus, the comparative returns from holding Canadian bonds rather than US bonds were very substantial. Foreign investors may have been concerned with domestic Canadian developments, but earnings in the teens dominated these concerns. After 1992, the situation was completely reversed. With inflation well in hand, Canadian interest rate premiums over comparable US bonds narrowed and the dollar began its descent into the low 70s (US cents). Holding-period yields for Canadian bonds were probably negative in the absolute and were certainly well below comparable US yields. Accordingly, foreigners bailed out of Canadian bonds, and their rationale for doing so focused on Canada's deteriorating fiscal environment.

The 1995 Federal Budget and Fiscal Decentralization

By the early 1990s, the federal government had so overextended itself financially that it had little recourse but to downsize and, in the process, to devolve and decentralize its power and influence. By devolution, I mean the shift toward embracing markets — deregulation, contracting out, privatization, and the like, as reflected in the 1995 budget.¹⁰ In effect, this is the federal public sector's equivalent of the dramatic restructuring that had already taken place in the private sector. While this is fully consistent with the dictates of the new TEP, it is surely the case that the debt and deficit overhang served as a critical catalyst.

Much more important for purposes of this essay is the fiscally triggered decentralization ushered in by the 1995 federal budget. The highest-profile vehicle for delivering this decentralization is the Canada Health and Social Transfer (CHST), which will begin in fiscal year 1996/97. Effectively, the CHST rolls the Canada Assistance Plan (CAP) and the existing block funding for health and postsecondary education (referred to as EPF, for Established Programs Financing) in a "super block fund."¹¹ Ottawa will then unilaterally cut the aggregate financial

¹⁰ This is inherently decentralizing since markets themselves are inherently decentralizing. For purposes of this essay, however, I refer to this as "devolution." I reserve "decentralization" for the downward transfer of powers within the government sector.

¹¹ Briefly, the major features of the CHST are as follows:

- A super "block fund" will be created, as noted, by rolling EPF and the CAP into the CHST.
- The CHST will be unconditional in terms of where the monies can be spent, but all monies spent on health must adhere to the five *Canada Health Act* principles, and welfare spending cannot require residency requirements.
- Entitlements under the CHST will decline from \$29.4 billion in fiscal year 1995/96 to \$25.1 billion in 1997/98. Cash transfers to the provinces will equal the value of the overall entitlement less the value of the tax points (13.5 personal income tax points and 1 corporate income tax point) associated with the program.
- Allocations by province for the inaugural year are based on CAP and EPF entitlements in fiscal year 1995/96. This means that the inequity arising from the cap on CAP, particularly for British Columbia and Ontario, will be carried over to the first year of the CHST.
- Beyond fiscal year 1996/97, Ottawa will "consult" with the provinces to develop a permanent method of allocating the CHST.
- Both levels of government will work together to develop a set of "mutual consent" principles and objectives to underpin the CHST.

For more detail, as well as an evaluation and assessment of the CHST, see Courchene (1995a).

entitlements under the CHST by \$2.5 billion in 1996/97 and by a further \$1.8 billion in 1997/98. Thus, in 1997/98, the provinces will receive \$4.5 billion less in CHST entitlements than they would have under a continuation of the CAP/EPF status quo. However, because these financial entitlements include both cash transfers and tax-point transfers and because the latter are predicted to grow year-on-year, the impact on cash transfers will be much more severe: in effect, federal cash transfers to the provinces under the CHST (or its CAP/EPF predecessor) will decrease from \$18.3 billion in 1995/96 to \$12.5 billion in 1997/98, a reduction of roughly one-third. This represents an enormous fiscal blow to provincial finances. (In passing, it should be noted that the other major federal transfer to the provinces, equalization, was left untouched.)

It is tempting to view the CHST as just the latest in the series of caps, freezes, and ceilings on federal transfers that Ottawa has introduced over the past decade — and it may not be the last, since the 1995 budget is silent on the evolution of the CHST beyond fiscal year 1997/98. But the CHST is different: it marks a critical watershed in the evolution of Canadian social policy.

There are several reasons for this. First, whereas previous federal transfer parings had been designed to limit the growth of entitlements, the dramatic CHST cuts are actually decreases in existing entitlements. In this sense, the 1995 budget is unprecedented. It is also the case, however, that, given the degree to which Ottawa was overextended fiscally, there was no possible way the provinces could have been exempt from significant cuts.

Second, bringing welfare into the CHST block fund increases substantially the ability of the provinces to design more comprehensive approaches to social policy. I welcome this aspect of the CHST because, as society moves from a focus on health to a focus on “well-being,” the demarcation between what falls into the health area and what comes under welfare is becoming increasingly blurred. The provinces need this additional flexibility to integrate their programs across these areas (see Courchene 1995a).

Third, Ottawa clearly will have a diminished role in the future evolution of social programs. To a degree, this is because some of the former social policy “principles” have been relaxed — although the five health care principles (comprehensiveness, universality, portability, public

administration, and accessibility) remain intact as does the prohibition of residency requirements for access to provincial welfare. More important, however, is that Ottawa will be putting fewer dollars into the kitty. This is the “golden rule” of federal-provincial relations — if Ottawa wants to continue to have a role in making the rules, it has to continue to supply the gold! Admittedly, if Ottawa were to allow cash transfers to fall to zero under the CHST, then even the existing social policy principles could be jeopardized — a result that few Canadians would want. For reasons elaborated elsewhere (Courchene 1995a), however, I do not believe that the federal government will allow this to happen.

Beyond these reasons, each of which points in the direction of greater decentralization, there are two further factors in play. First, the impending CHST has set in motion a powerful dynamic that will spread to other areas. Despite the series of plans by Human Resources Minister Lloyd Axworthy to divert funds from unemployment insurance (UI) premiums to training, the underlying logic of the CHST is that these funds should be integrated into the super block fund. If, as it has promised, the Ontario Conservative government of Mike Harris develops an active labor market strategy — one that integrates training, welfare, education, and, more generally, the transitions from school to work and from welfare to work — Ontario will not look kindly on a new federal training initiative that, by definition, can only apply to one component (UI beneficiaries) of that province’s population, and certainly not after the magnitude of the CHST cuts that the province will have to bear. Hence, I think it inevitable that training will come under provincial control.

The second factor is that, since the CHST will be unconditional (in terms of where the money is spent), the cuts essentially will be equivalent to a decrease in overall provincial revenues. In turn, this implies that the response of provincial governments to the CHST will be a wholesale restructuring. Indeed, this is well under way in most provinces: eight of them are forecast to have lower debt-to-GDP ratios in fiscal year 1995/96 than a year earlier (see Table 2). But the CHST will force further reorganization in that the downsizing, devolution, and decentralization that characterized the 1995 federal budget will be (and in part has already been) carried over to the provincial level. One aspect of this merits highlighting. In several provinces (Saskatchewan and

Table 2: Fiscal Positions of the Federal and Provincial Governments, fiscal years 1994/95 and 1995/96^a

	Net Public Debt		Net Public Debt Per Capita		Net Public Debt-to-GDP Ratio	
	1994/95	1995/96	1994/95	1995/96	1994/95	1995/96
	(\$ millions)		(\$ per person)		(% of GDP)	
Newfoundland	5,446	5,446	9,351	9,341	56.0	54.5
Prince Edward Island	963	960	7,158	7,070	39.7	38.0
Nova Scotia	9,200	9,037	9,822	9,592	49.9	47.7
New Brunswick	5,517	5,449	7,266	7,142	36.8	35.1
Quebec	74,471	74,900	10,228	10,212	44.6	43.2
Ontario	89,608	97,373	8,200	8,796	29.7	30.8
Manitoba	7,316	6,992	6,468	6,158	29.2	26.9
Saskatchewan	8,541	8,504	8,405	8,351	36.8	35.4
Alberta	18,511	19,436	6,815	7,067	22.5	22.7
British Columbia	18,803	19,529	5,126	5,196	18.8	18.6
Total provincial	238,376	247,625	8,150	8,370	31.8	31.7
Federal	546,139	578,860	18,673	19,566	72.8	74.0
Total federal, provincial	784,515	826,485	26,823	27,935	104.6	105.7

Note: Net public debt is government purpose debt net of the debt of self-financing Crown corporations. Net public debt is approximately the sum of all past years' deficits and surpluses. Federal net public debt is debt net of financial assets, while most provincial net public debt is not net of financial assets. Net public debt for some provinces includes a portion of unfunded pension liabilities.

Reporting differs by province. The above net public debt figures are reported as follows: Prince Edward Island, Nova Scotia, and New Brunswick, net debt; Quebec, total debt; Ontario, provincial purpose debt; Manitoba, general purpose debt; Saskatchewan, general government purpose debt; Alberta, gross General Revenue Fund debt (not net of Heritage Fund assets estimated at \$11.8 billion for fiscal year 1995/96); British Columbia, taxpayer-supported debt.

^a Year-over-year changes in debt positions need not reflect current deficit levels since the stock of debt is also adjusted to reflect exchange rate changes.

Source: Toronto-Dominion Bank, Department of Economic Research, *Report on Government Finances*, August 1995.

Alberta, for example), the delivery of health care is undergoing substantial decentralization. One of the factors facilitating this has been the application of information technology to the health sector. As a result of this within-province regionalization of health care delivery, the traditional federal-provincial tug-of-war over the level of transfers and associated medicare principles will be replicated in a provincial-local tug-of-war. Of necessity, this implies that the design and delivery of medicare will become even further removed from the federal arena.

It was not my intention here to assess the implications of the CHST but to drive home the point that the direction of federal-provincial relations is clearly decentralist. Whether this decentralization lasts will — despite the fiscal paring — probably depend more on the provinces than on Ottawa. If the provinces cannot deliver “national” programs, then Canadians will insist on some recentralization. I shall return to this later.

A Defense of Block Funding

To conclude this section, I want to present a different perspective on the CHST, one that posits that block funding was inevitable.¹² That is to say, even if the federal government had not been backed into a fiscal corner, a decentralization of the social envelope was inevitable.

Ottawa clearly played a critically important role in establishing this country’s social infrastructure. It established principles, it provided generous funding, and it built a framework within which provincial social programs would become “national.” However, as these programs matured and were redesigned to meet evolving challenges and needs, Ottawa’s role became less obvious. Since it does not actually deliver these social programs (except, perhaps, to First Nations), it is hardly in a position either to assess emerging challenges or to forge new directions. Instead, it has had to rely on the provinces and give them increasing leeway to maneuver. This was one of the rationales for the 1977 financial agreements, which, among other things, converted postsecondary education and health into a block fund. In recent months, we have heard a great deal about Saskatchewan’s closing of 52 hospitals and moving

¹² This draws on conversations with Arthur Kroeger.

toward “home care” for the elderly. In terms of the latter, Saskatchewan residents can receive \$1,000 per month for providing an elderly or disabled person with home care. Apart from the obvious savings involved, commentators have generally praised the initiative on social policy criteria. Such a scheme would have not been possible prior to the block funding of health, however, since before then only “accredited” institutions could qualify for federal dollars. I am confident that, in the not-too-distant future, commentators will likewise praise initiatives in the welfare area that would have been precluded under the old CAP arrangements.

Triggered in large measure by the fiscal overhang, the 1995 federal budget has launched the federation in a decentralist direction. But it has done much more than this. It has served to unblock the long-standing federal-provincial stalemate and has set in motion an evolutionary dynamic that will serve to redefine Canada and Canadian federalism in areas well beyond the social envelope. In the following section, I argue that the provinces also need greater autonomy to promote their economic and social interests.

The Decline of the East-West Economy

North-South versus East-West Trade

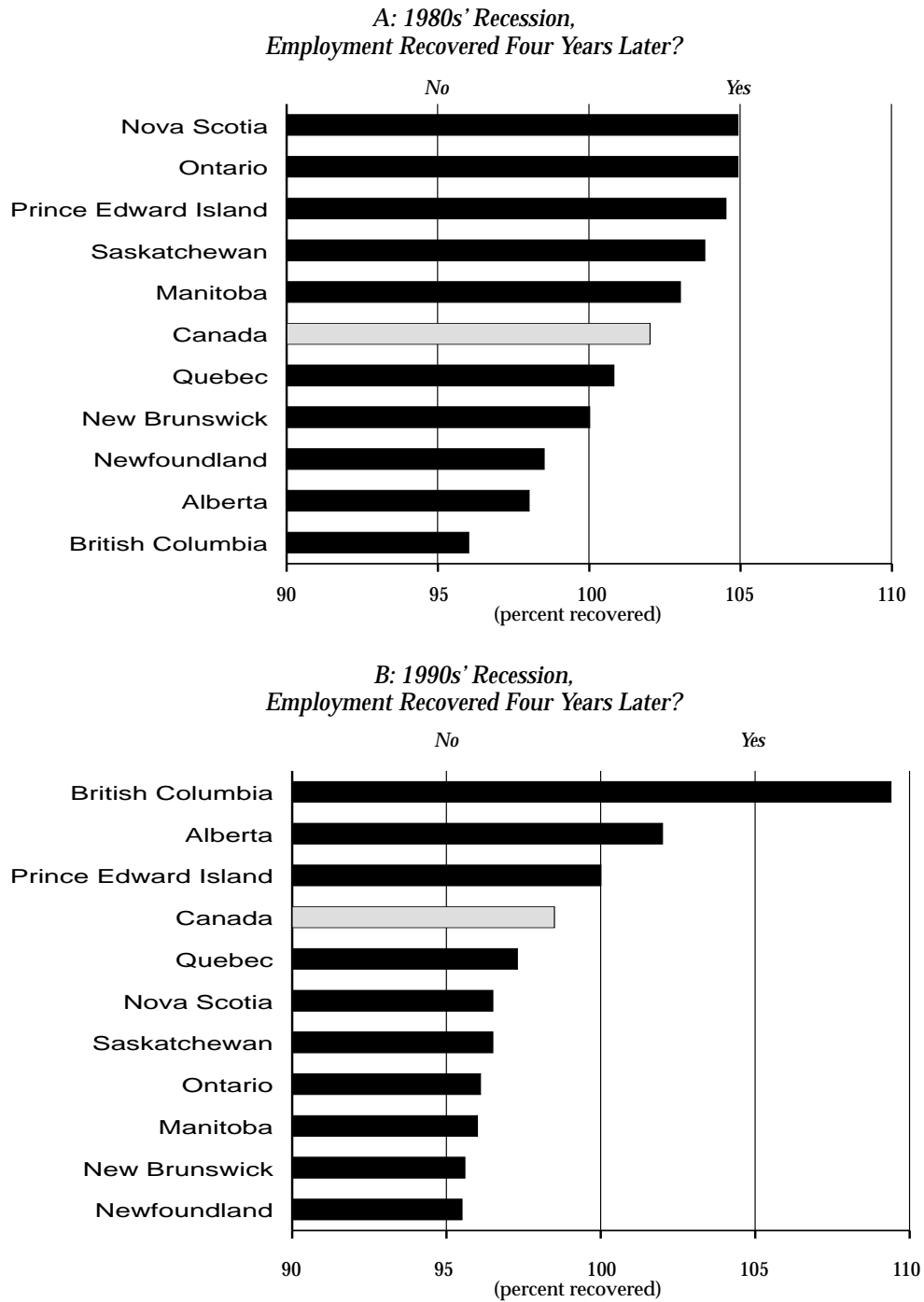
It is increasingly inappropriate (subject to a caveat that I shall introduce later) to view Canada as a single national (east-west) economy. Rather, it is becoming a series of north-south, crossborder economies or, at least, the north-south (more generally international) dimension is being superimposed in a dominant way over the east-west dimension. These crossborder economies are not just separated by geography but also by industrial structure. British Columbia is oriented toward the Pacific Rim and the US Pacific Northwest; the energy-based Alberta economy competes with the oil and gas-producing regions of the Gulf of Mexico; the breadbaskets of Manitoba and Saskatchewan keep a competitive watch on the US Midwest (and on US and EU agricultural subsidies!); the Great Lakes economies of Ontario and Quebec are integrated with each other and with their counterparts south of the border; and the fortunes of

Atlantic Canada likely will continue to be bound to the Atlantic rim and the Boston/New York axis. This is not meant to downplay the importance of east-west trade but, at the margin, the determining force and focus for all of Canada's regional economies is to be internationally competitive. Indeed, in many areas, this could also lead to greater east-west trade.

Two further aspects of this altered geo-economic space merit highlight. First, Canada's regions tend to trade more with the rest of the world than with the rest of Canada. In 1989, for example, 37.5 percent of Atlantic Canada's manufacturing and primary sector output was destined to markets outside Canada, compared with only 15.9 percent to other Canadian regions (Statistics Canada 1993). For Western Canada, the comparable figures were 33.7 percent and 11.8 percent, and for Ontario they were 33.6 percent and 18.7 percent. Quebec — intriguingly, in light of its sovereignty aspirations — is the exception, with markets in the rest of Canada having accounted for 27.1 percent of its manufacturing and primary sector output, compared with 26.5 percent for markets abroad. If these comparisons are broken down by province instead of by region, then Prince Edward Island and Manitoba join Quebec in having exports to the rest of Canada dominate exports abroad. Overall, exports by provinces to other provinces are only two-thirds of the value of their international exports.

The second aspect of the altered nature of Canada's east-west economy is the nonsynchronicity of regional business cycles, as shown in Figure 4. The upper panel asks the question: How much did employment recover, by region, four years after the peak that occurred just before the 1981–82 recession? The bottom panel poses the same question for the recession of the early 1990s. The recession of the early 1980s was largely commodities based, with devastating effects on British Columbia and Alberta. The recession of the 1990s, by contrast, was “industrial,” which left British Columbia, in particular, largely unscathed but which hit Ontario's Golden Horseshoe very hard. These two recessions may well be atypical, but it seems to me inevitable that, in future, the fortunes of Canada's regional economies will march in step with those of their international (crossborder) counterparts. At the very least, this complicates stabilization policy, including exchange rate policy.

Figure 4: *Employment and Recovery after Two Recessions*



Sources: Statistics Canada; Toronto-Dominion Bank, Department of Economic Research

The Helliwell and McCallum Analyses

Before I focus on some of the implications of this altered economic geography, it is important to elaborate on the caveat referred to above — namely, the much discussed results of recent research by McCallum (1995), Helliwell (1995), and a joint piece, Helliwell and McCallum (1995). Their research demonstrates that “the Canada-US border matters immensely for continental trade patterns” (Helliwell and McCallum, 1995, 44). Helliwell and McCallum use what economists call a “gravity” model, in which trade for any two jurisdictions is assumed to depend on the size of each, on the distance between them, and on whether or not trade crosses the Canada-United States border. They find that, for all ten provinces and for 30 of the larger US states, and taking account of size and distance, trade between two provinces is about 20 times the trade between a province and a state. They also report that the “border effect” is more important for Quebec than for the other provinces: “For given size and distance, Quebec trades 24.5 times more with other provinces than with the states of the US. This compares with 20.1 times for Canada as a whole” (*ibid.*, 45).

In one sense, these are astounding numbers, particularly in light of the vision of a “borderless economy” that I presented earlier; in fact, however, they do not contradict my assertion that Canada is becoming a series of north-south economies rather than a single east-west economy because the Helliwell-McCallum results are a snapshot in time (1988 and 1989), an average, not a description of what is happening at the margin. Indeed, when Helliwell and McCallum extend their analysis to 1993, they express surprise at the rapid growth of north-south trade: in 1989, east-west trade for Canada as a whole was 108 percent of north-south trade, but in 1993 it was only 64 percent of north-south trade. While Helliwell and McCallum apparently expected some deterioration in the ratio of east-west to north-south trade, these declines seem to them abnormally large and likely reflect inadequate post-1989 data on interprovincial flows. But the evidence of the shift to north-south trade is clear and perhaps even dramatic. Again, the point to be stressed is that provincial trade dynamics and policies increasingly are focused north-south (or perhaps outward), not east-west, and policy-making that fails to take this reality into account will go off the rails in spectacular fashion.

At the same time, however, Helliwell and McCallum show that the domestic market remains very important and, relatedly, that the pursuit of internal free trade remains an important policy objective. An even more important implication of their research concerns what might happen if Quebec were to secede from the federation. Because of the appearance of a real border dividing Quebec and the rest of Canada, trade between them would then fall into the north-south category (in the Helliwell/McCallum analysis), not the east-west category. While it is highly unlikely that the existing 24.5 to 1 Quebec ratio for east-west versus north-south trade would fall to 1 to 1, over time, and as different practices and institutional frameworks emerge, the ratio surely will tend downward. Quebec has the most to lose because it depends relatively more on the Canadian market than do the other regions, but it would not be the only loser.

Implications

The most important implication of adopting a north-south focus (or, in the jargon of the earlier section, a regional-international focus) is that, in an increasing number of areas, an economic vision that emanates from the center — a set of policies meant to apply to all provinces and regions — is no longer appropriate, since Canada's regions are too economically diverse. It is unlikely that Ontario, a Great Lakes economy, would want to redesign the social envelope, for example, including training and apprenticeship, in the same way as a Pacific Rim economy like British Columbia. This probably also applies to areas such as forestry, mining, energy, and the fisheries. The stuff of nationbuilding is no longer much associated with these areas, which in any case are increasingly subject to international agreements or regimes. Thus, in part, the evolution of Canada's federal system will likely involve greater decentralization, greater asymmetry, and greater east-west flexibility (including wage flexibility).¹³

A second implication is that the political economy of east-west transfers is being altered permanently. Under the old paradigm, the

¹³ Indeed, as this essay was in the editorial stage, the federal government announced that, henceforth, federal minimum wages would track provincial minimum wages.

second-round effects of transfers both east and west from Ontario eventually would find their way back to Ontario, since internal trade flowed east-west and Ontario was the principal north-south conduit; as a result, in the tradition of public choice theory, Ontario could “afford” to be generous. With trade increasingly becoming north-south, this is no longer the case, since the second-round spending effects now may well end up in California or North Carolina. In other words, an emerging challenge is how to mount an east-west transfer system over an increasingly north-south trading system.

This feeds directly into the third implication or observation. If, in the nineteenth century, Canadians from east to west were bound together by the National Dream of the transcontinental railway, and through most of the twentieth century by an “economic policy railway,” then today Canadians increasingly are tied together by a “social policy railway.” This is not to deny the value of the recently implemented Agreement on Internal Trade. It is, however, to argue that the agreement’s labor mobility provisions and, within this, the interprovincial mobility of licensing and certification of workers, needs to be strengthened. Even though we live in an era in which human capital is becoming increasingly important, we have made much of the fact that, until recently, Moosehead beer was not available in Ontario, when in fact we should be more concerned that the skilled workers who brew Moosehead beer may not be able to ply their trade in the rest of Canada. With the decentralization of key aspects of the social envelope, this challenge may become more daunting. I shall outline a few proposals later.

Summary

The message from earlier in this essay was that the new techno-economic paradigm is subjecting nation-states — particularly federal nation-states — to enormous strain and adjustment, much of it beyond their direct influence. The message from this section is that the specifics of the Canadian federation significantly magnify the adjustment that Canada will have to make. In effect, they tilt the adjustment in a decidedly decentralist direction. On the one hand, federal overspending combined with pressures from the capital markets have made it impossible for the center to hold. On the other hand, the emerging geo-economics of

provincial and/or regional economies are such that the center should not hold. The latter is intricately bound up with the processes of international economic integration and thus largely beyond our control. The former was, however, self-inflicted. The remaining substantive sections of this essay will focus on two further aspects of this evolution. The next section attempts to link aspects of the emerging realities of the Canadian federal system with the various issues and concepts raised in connection with the new TEP, as elaborated earlier. The final substantive section is more speculative, in that it attempts to address a range of challenges with which this shift toward decentralization must of necessity come to terms. Essentially, the underlying issues relate to aspects of the nature of, and limits to, further decentralization within the dual context of a decentralizing Canadian federal state and an integrating global economy.

Are the Provinces “Economic Nations”?

Lanphier and Richmond (1995, 313) define *Staatsnation* as “that aspect of a nation state which articulates a legal system which unites a people in some form of equality” and *Kulturnation* as “that aspect which provides definition in terms of values, common heritage, and symbol systems.” With some degree of misrepresentation, I shall associate *Staatsnation* with “state” (or country) and *Kulturnation* with “nation.” For Canadians outside Quebec (and some within Quebec), this distinction has, until very recently, never been relevant since Canada is to them the embodiment of *both* nation and state. For the Québécois, however, Quebec is the nation and Canada is the country; thus far, they have been unwilling to surrender either of them.

In analytic terms, the process of globalization has, in effect, transferred some of the “framework” functions of Canada as state to the supranational level. With Canada’s role as *state* thereby diminished, the Québécois now desire to “patriate,” as it were, further aspects of Canada as *nation* to Quebec City. No doubt this seems passing strange to the rest of Canada, since Quebec already has more powers than any subnational government of any member country of the Organisation for Economic Co-operation and Development (OECD) (Dion 1995). While I have not done the requisite research, I suspect that Quebec’s international rela-

tions are also more extensive than that of any subnational government of an OECD country: as of 1993, for example, its Paris office had 92 employees and its New York office had 39 employees (Keating 1994a, 5). Moreover, meaningful sovereignty in the new global economic order will have little to do with monetary, commercial, and trade policy — these will be driven by global forces. Rather, sovereignty increasingly will come to mean a society's ability to determine how its citizens will "live and work and play" (Courchene 1992, 82). In Canada, these are largely, but not wholly, provincial powers.

Hence, one interpretation of Quebec as a "distinct society" is its ability to assume all powers necessary to decide how its people live and work and play, including, for example, responsibility for training. So far, Canadians have refused to agree to this request, especially if it were to involve a formal constitutional amendment. The thrust of the previous section is that the ongoing devolution of the federation eventually will deliver not only training but a lot more, even if this devolution of powers is achieved through the process route (for example, delegation or other administrative arrangements) rather than through a formal constitutional amendment. But even the process route would have posed problems for the rest of Canada only a few years ago. I would argue, however, that this is no longer the case, and the purpose of this section is to explain why this is so.

At the analytical level, the answer has to do with the fact that globalization and decentralization are altering the concept of *nation* not just for Quebecers but for the rest of Canada as well. At the practical level, the degree of deficit shifting implicit in the 1995 federal budget (particularly the CHST) and the degree of adjustment that it will necessarily entail at the provincial level have changed long-standing conceptions of the roles of Ottawa and the provinces and the design and delivery of particular policy areas. Thus, the pressure on provinces to seek creative and innovative approaches and the willingness of citizens to accept them is likely to usher in a remarkable period of policy flexibility and tolerance. While my answer may not be persuasive, I am convinced that the analytical core of this topic — the beginning of the uncoupling of *nation* and *state* in the minds of English-speaking Canadians — is the most important issue to emerge in this essay.

The Nature of Minority Nationalisms

One consequence of the “democracy deficit” resulting from the implications of the new TEP is that citizens will focus more on various conceptions of community. Keating (1995, 101) expresses this as follows: “the decline of the traditional nation state creates a profound need, and potentially a space, for new principles of social cohesion and collective decision making.” After rejecting two potential candidates with which to fill this need — “identity [ascriptive] politics” and “exaggerated liberalism,” he focuses on minority or civic nationalisms:

The rise of minority nationalisms can be seen, not as an indicator of backwardness or a revolt against modernity, but as an effort to address these dangers [that is, the resort to identity politics or dogmatic liberalism]. In such cases, rather than xenophobic, racist or ethnically exclusive, it is a means of strengthening civil society to permit collective action in the face of the globalization of the market. These are the new civic nationalisms based upon common values, institutions and patterns of social interaction; *their limits defined by a territory rather than a group.* (Ibid., 102, emphasis added.)

This genre of analysis has led to a flurry of articles focusing on, for example, Quebec, Catalonia, and Scotland. The problem I have with these analyses is that, while they are driven by the implications of globalization, they tend to underplay the role of economics in their definition of these minority nations.¹⁴ Surely there cannot be any doubt that, from the point of view of its language, its culture, and its legal system, Quebec is a “distinct society.” But the preservation and promotion of its linguistic, cultural, and institutional uniqueness is not what Quebec is all about. The advancement of the French language in the rest of Canada may well be largely a cultural issue. In Quebec, however, French is inherently and profoundly economic as well as cultural. Indeed, my definition of the “distinct society” is one in which Quebecers are free to configure their society so that they can earn a North American standard of living while operating in French (Courchene 1992, 14). The reference to North America is critically important: Quebec was the first

¹⁴ It should be noted that Keating does give economic issues more play in his analysis than is the case for most commentators.

province to recognize that its economic future lay in the conception of a regional/international interface, and its continual demands for more powers — even its wholehearted support of free trade with the United States — are a reflection of this realization as well as a reason that Quebec is profoundly indifferent to the powers that other provinces wish to acquire.

Before pursuing the implications of this line of analysis, I want to focus on how the rest of Canada is coming to grips with the combination of *nation* and *state*.

Surprisingly, language may well have played an enormous role in defining the rest of Canada, as it has in Quebec. In this case, however, as Côté (1995, 6) points out, having to share a common language with an overwhelmingly dominant neighbor to the south made it impossible for a distinctive culture to emerge in English Canada as it did in Quebec. English Canada thus had to look for something other than language with which to establish its identity. Many argue that English-speaking Canadians have tended to define their distinctiveness by their relationship with government, as manifested by, for example, the national railway, Crown corporations, and, more recently, medicare and the social safety net (the “social policy railway” referred to earlier). Côté (ibid.) comments: “There is probably no other country in the world where, when asked what is it that binds the country together, one hears ‘the social safety net.’ A country held together by government spending!”

Côté’s comment was, I believe, delivered only partly in jest, and appropriately so since the forces of globalization (in its different variants) have succeeded in eroding these national symbols. This is part of the reason I referred earlier to the 1995 federal budget as a watershed in Canada’s socioeconomic and even cultural history: many Canadians perceive it as the beginning of the devolution of “Social Canada” to the provinces. At the recent Premiers’ Conference in St. John’s, Alberta’s Ralph Klein received some support for his two-tiered approach to health, if only in the form of complaints that Ottawa should not make the rules if it is intent on withdrawing funding. This is heady stuff, and it is forcing English-speaking Canadians who want to preserve a national symbol (in this case, medicare) to direct their focus and lobbying efforts toward the provinces. Analytically, English Canada is beginning to realize that the federal government may no longer be the embodiment of both nation and state. And by ending the near-century-old Crow Rate,

by pulling back on regional development agencies, and by curtailing regionally differentiated UI benefits (as it is likely to do), the federal government widens the uncoupling of nation and state even further because these measures cut deeply into long-standing Ottawa-centered regional identities. This is not to say that all Canadians are, in effect, becoming “Québécois,” but it surely is a step in that direction. When Alberta proposes a two-tiered health care system or when Ontario insists that Ottawa back off any new regulations for the provinces now that it has slashed transfers, this is not very different from Quebec’s wanting “even more powers.”

Several caveats must be aired at this juncture. First, Ottawa remains a powerful player across a broad range of fronts, even social policy. It controls Old Age Security and the Guaranteed Income Supplement. It can veto any changes to the CPP. It sets the overall progressivity of the personal income tax system, even for the provincial components (except for Quebec), and this includes delivering substantial child tax credits to low-income families. It designs and controls equalization, and has even exempted this key program from the transfer reductions in the 1995 budget. And even by fiscal year 1997/98, it will still be delivering \$12.5 billion in cash transfers under the CHST. Thus, the issue here is not that Ottawa is weak; rather, it is that, at the margin, the evident perception across Canada (and the not-so-evident reality) is that some of the national “glue” has been decentralized.

The second caveat is, in a sense, related. If the provinces fail to fulfill their newly enlarged role, Canadians may insist on a recentralization of powers. I broach this important issue later.

Finally, one could argue that Canadians still have as an important national symbol the Charter of Rights and Freedoms. Indeed, the Charter is so powerful a symbol that, for a time, it redefined the federation: instead of divisions along federal-provincial and interprovincial lines, as had been the Canadian tradition, new divisions emerged between so-called Charter groups and various vested interests. Now, however, with the dramatic cuts in federal transfers, the traditional cleavages are once again coming to the fore. Elsewhere (Courchene 1995c), I offer the opinion that, despite the Charter’s enshrinement of group rights, it will, over time and under pressure from globalization and powerful (monied) private interests, increasingly come to be interpreted instead as a

statement of individual rights. In other words, I agree with Seymour Martin Lipset (1990, 225–226) that the Charter is inherently a republicanizing document. Thus far, to be sure — and especially at the forum where I suggested this (McRoberts 1995) — I have found few sympathizers.

Recapitulating, the thrust of the argument is that the provinces essentially are being obliged to inherit from the federal government aspects of what passes for English-speaking Canadians' vision of *nation*. This is, however, still a far cry from addressing the question of whether the provinces are becoming "economic nations." To this I now turn.

The Provinces as Providers of Untraded Interdependencies

Earlier in the essay, I defined an economic region in terms of the existence of untraded interdependencies. Do the provinces have a role in the provision of these untraded interdependencies? At one level, the answer for decades has been an obvious "yes." Typically, this is referred to as "competitive federalism," whereby different provinces offer different bundles of services to their residents. The mushrooming of provincial experiments in health care and income assistance not only qualifies as competitive federalism, but also falls under the rubric of untraded interdependencies because individuals can access the different bundles of health care and welfare only by residing in a particular province.

But these cases probably have not been significant enough to qualify as untraded interdependencies in Storper's (1994) sense of the definition, at least not until recently. Traditionally, provincial governments have been passive players in the economic policy game. Ottawa set most of the parameters and the provinces acted largely as managers, not innovators or strategic players, in terms of the regional/international interface. Bay Street curried favor in the corridors of Parliament Hill, and almost never in Queen's Park.¹⁵ Quebec was the first province to break out of the mold with its shift toward "market nationalism" in

¹⁵ One intriguing exception was the Bay Street securities firms. By convincing Ontario that it was essential to have a "really secure industry" rather than a "real securities industry," they effectively wrote a protectionist provincial legislative ticket that led to their undercapitalization and to their eventually being gobbled up by the banks.

the mid-1980s. During the energy boom, Alberta broke away from the corporate income tax agreements and mounted its own corporate tax system, largely because it wanted to use corporate taxation as a development incentive.

The case of Ontario is more intriguing. During the prolonged economic boom of the 1980s, Ontario took it upon itself to be the social conscience of the nation and sharply expanded welfare benefits for its residents. In 1986, for example, four provinces had welfare rates for a four-person family (a couple and two children) that were higher than Ontario's; by 1993, Ontario was well ahead of the pack, with rates one-third higher than in British Columbia (where shelter costs are comparable) and more than double the rates in New Brunswick (Dominion Bond Rating Services 1995). When Bob Rae's New Democratic government's commitment to equality and wealth distribution, as opposed to wealth creation (Monahan 1995, 47), ran into a budget constraint, emphasis shifted to the regulatory side. It then introduced "employment equity," with which it hoped to use the allocative process (hiring) to redress distributive concerns for specified groups (based on race, sex, ethnicity, and disability). This is close to what Keating (1995, 101) calls "identity politics" — "the tendency especially in North America to reassert identity and allocate positions based on race, gender or other ascriptive principles. Common values are lost, moral relativism undermines democratic citizenship and social solidarity." This case would qualify as an example of a government's engineering untraded dependencies except that, because they were so profoundly at odds not only with the new economic order but with Ontario's position within North America, they would have remained untraded in every sense. On the economic front, at least, they were more akin to what economists call "locational negative externalities."

The new Progressive Conservative government of Mike Harris, not surprisingly, is in the process of sweeping all of this away. Ontario, long the principal beneficiary of north-south trade, is finally officially onside with the FTA and NAFTA. With its commitment to harmonize provincial sales taxes with the goods and services tax (GST) — and, in the process, to help redesign it — Ontario has acknowledged the problems of duplication and compliance costs. And by accepting the principle of CHST cuts (although presumably not *its* allocation of the cuts), Ontario

has recognized the importance of setting the federal fiscal house in order. In their own sphere, Ontario's Tories are following in the footsteps of "national" governments everywhere — fiscal integrity, tax reduction, government efficiency, devolution to the private sector — with an eye toward establishing a more solid economic foothold in the North American and global markets. The challenge is daunting since, among other things, taxes on office space in Toronto are the highest in North America (Zehr 1995). Given the decentralization of aspects of Social Canada, Ontario will also pursue its own approach to the creation of an integrated social envelope. In this and other areas, it is clearly moving in the direction of becoming an "economic nation." And Ontario's focus is not on how it compares with its neighboring provinces but on how it fares against the Great Lakes economies south of the border. This has been Quebec's *modus operandi* for some time now, but it is a new development in the rest of Canada. Ontario's desire for greater operational flexibility is not about beggar-thy-neighbor federalism, nor is it about decentralization for its own sake. Rather, it is about positioning Ontario more effectively *vis-à-vis* its competitors.

Something else has altered in a fundamental way. The three "have" provinces — British Columbia, Alberta, and Ontario — are largely onside with respect to managing their own economic destiny. These provinces' determination to march to their own drummers is driven only partly by the impending CHST cuts; the more significant trigger was the federal government's arbitrary 1990 decision to place a 5 percent growth cap on CAP payments to these provinces (for Alberta, in fact, it goes back to the Trudeau government's introduction of the National Energy Program in 1980). With Quebec added to this triumvirate, Ottawa now faces a solid front of provinces demanding decentralization. But to repeat, this is not, at base, a power struggle with Ottawa but a strategic attempt to generate locational positive externalities that will serve Canadians well in the global marketplace.

The engineering of untraded interdependencies in pursuit of comparative advantage is not, however, limited to the "have" provinces or to Quebec. I want to conclude this section with reference to the remarkable initiatives toward promoting an "economic nation" that have occurred in New Brunswick.

New Brunswick and the Regional/International Interface

Among the provinces, New Brunswick has emerged as the clear leader in terms of social and industrial restructuring. Much as I admire what is occurring there, I shall limit myself to a few observations. Recognizing that the status quo was unsustainable, largely because federal money was about to run out, New Brunswick decided that it had to become globally competitive — at least in some areas — in order to survive and prosper economically. With the help (or perhaps the leadership) of NBTel and Northern Telecom, among other firms, the province's investment in telecommunications infrastructure — in particular, digitization and fiber optics — has enabled it to become the leading such jurisdiction in North America.¹⁶ This initiative is now starting to pay off, with the recent decision by Xerox to establish a base in the province. To be sure, New Brunswick's advantage may be fleeting, since many jurisdictions are now following suit, and it will certainly have to keep running hard to stay ahead of the competition. But as long as its focus is on the North American, not just the Canadian, market, the province has a fighting chance to succeed. Few Canadians, let alone economists, would have predicted that a transfer-dependent economy such as New Brunswick's would be able to shift its focus from Ottawa to middle-America. This, too, is what the regional/international interface is all about.

At this juncture, a word about the relationship between geography and the regional/international interface is in order (Courchene 1995b). Under the old paradigm, New Brunswick was a "powerless place" in the true geographic sense. Its new telecommunications infrastructure does not make New Brunswick a "powerful place," but it does permit the province to acquire what Graham (1994, 419) calls "placeless power." From this, one has a vision of footloose industries being attracted to footloose jurisdictions: next year, the leadership in terms of placeless

¹⁶ A recent study (commissioned by New Brunswick) by Boyd Company Location Consultants (1995) compares New Brunswick with 25 US cities in terms of a range of factors relating to call center operations. New Brunswick comes out on top or near the top in terms of most categories, including telecommunications costs, fringe benefits, office space costs, weekly wages, and energy costs.

power could well shift to Utah, the US state that is New Brunswick's closest rival on the digitization and fiber optics front. Thus, geography in this sense is more akin to a "space of flows" rather than a "space of places" (Castells 1989). Indeed, the New Brunswick authorities already recognize this, as Delottinville (1994, 42) points out:

The New Brunswick government, NBTel and Northern Telecom recognize that advances in communications technologies have made the physical location of electronic commerce irrelevant. As a result, the marketing campaign has focused on New Brunswick *as a business solution rather than a location* [emphasis added].

This key distinction between New Brunswick as a "location" and New Brunswick as a "business solution" has relevance to the recent decision by United Parcel Service (UPS) to transfer personnel from Ontario and British Columbia, among other provinces, to New Brunswick.

As backdrop, it may be instructive to introduce here the notion of a "global maximum wage" (Courchene 1994, 241–242): if wage costs for a given activity rise above a certain threshold, that activity likely will go offshore. In the telecommunications industry, an example is the set of activities falling under the rubric of "call centers" — many US companies have already transferred their call-marketing-related activities offshore. Presumably, the problems that UPS faced in Ontario and British Columbia were related to high costs and inflexible labor markets. New Brunswick's comparative advantage was that it offered "low property taxes, no payroll tax and low workers' compensation rates" (Delottinville 1994, 43) as well as a labor force that did not demand a premium for being bilingual. In this sense, there is obviously a "locational" aspect to New Brunswick's drawing power. But when combined with its digital fiber optic network and its telecommunications services costs and discounts, New Brunswick effectively offers a "business solution" to problems that UPS and other companies face. While it may well be that New Brunswick has used subsidies as an additional lure (and all provinces are guilty here), largely overlooked is that, if New Brunswick had not filled the bill, as it were, this activity likely would have gone to the Caribbean or some other offshore location. Thus, New Brunswick can make a strong case that it kept these jobs in Canada. In typical

Canadian fashion, however, we still prefer to view New Brunswick as a problem rather than as a solution to a problem that arises in British Columbia and Ontario.

Two summary comments are in order. First, while the infrastructure for call center marketing can, in principle, be put in place anywhere, it nonetheless represents untraded interdependencies since one has to be in New Brunswick to access the infrastructure. Second, in pursuing this route, New Brunswick is still heavily dependent on Ottawa's providing some national public goods such as equalization, health care, and unemployment insurance. Hence, what is emerging in New Brunswick, and elsewhere in Canada, is a nested — international (the NAFTA, for example), national, and provincial — set of public goods. It is only within this hierarchy of public goods, or untraded interdependencies, that New Brunswick can be viewed as acting like an "economic nation." Nonetheless, this is a significant departure from the past and perhaps a turning point in the geo-economics of the federation.

Despite this focus on what I perceive as a success story in a "have-not" province, not all provinces are likely to become "economic nations" in the full-blown sense of the term. As I argue elsewhere (Courchene 1992b, chap. 3), important asymmetries will emerge. For example, I believe it inevitable that significant socioeconomic links will be forged across the Maritime provinces, links that may be extended to include Newfoundland. The same is likely to be the case for Manitoba and Saskatchewan, although their linkages may well be with neighboring provinces rather than with each other. If such linkages do not develop, these economically smaller provinces may find it difficult, because of the lack of scale economies, to take control over programs such as training. They may try to take control anyway, or attempt to forge the linkages that will enable them to develop the needed economies of scale, or leave control in the hands of Ottawa. But they should not be able to prevent other provinces from taking greater control over such programs. In my view, the combination of external globalization challenges and domestic fiscal challenges will force all provinces to recognize the inevitability of *de facto* (if not necessarily *de jure*) asymmetry. And it is precisely in this same vein that Quebec ultimately will acquire the powers it needs to preserve and promote its "distinct society."

The Citizen and Institutional Challenges

So far, this essay has been a typical exercise in political federalism, in that it has focused on governments almost to the exclusion of citizens. In this section, citizens' concerns, particularly on the social policy front, will be front and center. The larger context for this will be whether the provinces are up to the challenges that will accompany greater decentralization. The first part of this section addresses the question: Under what conditions might citizens embrace a greater degree of centralization? The second part, and the final substantial component of the essay, deals briefly with the new institutional arrangements that might follow in the wake of globalization and a more decentralized federation.

Decentralization and the Canadian Social Union

Canadians, by the rights inherent in citizenship, deserve a full-blown social and economic union.¹⁷ Yet, in the wake of the 1995 federal budget, it is almost surely the case that they are less certain of the future of the social safety net than at any time since the end of the Second World War. Earlier, I argued that significant aspects of this key symbol of the Canadian identity are being devolved from Ottawa to the provinces. In the process, however, no one has bothered to ask Canadians whether this is what they want. Simply put, and entirely appropriately, this places immense pressures on the provinces to earn the support of Canadians. For far too long, the provinces' demands for additional powers were not matched by the recognition that these should be accompanied by greater responsibilities — that, supposedly, was Ottawa's role. Now, however, and at the same time that the provinces are feeling aggrieved by the magnitude of the impending CHST cuts, Canadians are demanding that their provincial governments preserve and promote the social safety net. If the provinces fail to deliver — that is, if concerns about the “end of medicare” and a “race to the bottom for welfare” begin to bear fruit — Canadians likely will demand that Ottawa recentralize. No federal government could ignore such a move-

¹⁷ Much of this section is from Courchene (1995a).

ment — recall that Monique Bégin's 1984 *Canada Health Act* did not receive a single dissenting vote in the House of Commons. What, then, can the provinces do to ensure that the pendulum does not swing back in the centralist direction?

The first point to note in this connection is that postwar federalism has approached the promotion of an internal social union wholly inappropriately in that it has relied on federal dollars and a federal presence to do the job. But all that Ottawa can really deliver is a series of "thou shalt nots" — thou shalt not extra bill, thou shalt not impose residency requirements for access to welfare, and so on. In the language of the Charlottetown Accord, this is "negative integration." While this is important, it is not sufficient. What is also needed is "positive integration" — a pro-active meshing of provincial programs and systems, including full portability not only of social programs but also of skills and certification. Only the provinces can deliver this.

Delivering a full-blown social union requires both "top down" (vertical) and "bottom up" (horizontal) integration. Whatever accomplishments postwar Social Canada may have to its credit, the delivery of a meaningful Canadian social union is not one of them. To repeat, a large part of the problem is that Canadians have looked only to Ottawa to deliver this social union. The provinces have been let off the hook far too easily and, as a result, Canada has fallen far behind in terms of the degree of positive integration on the social front that exists in other federations with a Canadian-type social contract. In Germany, for example, skills are full transferable and training fully accreditable across all *Länder*. Even the individualistic and decentralized Swiss do much better than Canadians on this score. In Australia, where distances are similar to those in Canada, the states have borrowed the European approach of "mutual recognition" of skills and certification to forge a social union. Why has Canada lagged behind? One of the reasons is that, just as conditional or tied grants have served to frustrate enhanced within-province integration of the social envelope, so too excessive reliance on the federal spending power as the principal instrument of a social union has served to downplay and even impede the equally important need to harmonize and promote fuller horizontal integration of Social Canada.

The time has come for the provinces to recognize that part of the *quid quo pro* for their being granted more social policy powers must be

greater responsibility to ensure that these programs become “national.” And the first opportunity for them to show their colors will be the federal-provincial negotiations to develop some “mutual-consent” principles to underpin the CHST. As noted, the provinces are still in a state of shock over the CHST and are hardly in a mood to sign on voluntarily to a set of principles with respect to it. Yet these negotiations must succeed. This may well be a flight of fancy on my part, but here is my view of how these events ought to unfold:

- First, even though these ostensibly will be negotiations between governments, it will quickly become apparent that the real issue is citizens’ “national” rights in the social policy arena. This is bound to inform and influence the negotiations.
- Second, the negotiations will focus on establishing “national” principles, not federal ones. On a personal note, when I was chair (1982–85) of the now-defunct Ontario Economic Council, I developed a motto of sorts: for programs to be national they need not be central. Although, a decade or so later, this view has become increasingly accepted, it nonetheless is an important “first” for Ottawa to have embraced this philosophy.
- Third, Ottawa must be willing to put “something” on the table that has to do with its proposals relating to the evolution of the CHST. My suggestion (Courchene 1995a) is that Ottawa “flat-line” cash transfers beyond fiscal year 1997/98 and develop an acceptable procedure for locking in some certainty with respect to these cash transfers.¹⁸ While this may appear to be wishful thinking, Ottawa is under substantial pressure here from citizens and provinces alike. For example, were Ottawa to decide to allow cash transfers to run to zero, this would signal its abandonment of social Canada, devastate the provinces fiscally, and run the risk turning the CHST into an unmitigated disaster.

¹⁸ Note that flat lining CHST cash at the fiscal year 1997/98 level (roughly \$12.5 billion) would mean that, by sometime early in the next century, the provinces would be better off, despite the CHST cuts, than they would have been under an extension of the EPF/CAP status quo (Courchene 1995a). In other words, they would suffer an up-front fiscal hit for longer-term benefits.

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- Fourth, this federal offer should (and presumably will) be contingent on the provinces' signing on to a set of CHST principles. Consistent with the philosophy that underpins block funding, the role of these principles should not be to constrain the ability of the provinces to engage in policy integration across health and welfare but to establish some acceptable minimums relating to access, coverage, appeals, and the like. Beyond this, Canadians will be looking for two further measures. The first must be an agreement to minimize interprovincial spillovers of the various provincial systems. For example, provinces must be prohibited from attempting to export welfare caseload to other provinces.¹⁹ Second, the provinces should continue the progress they have already made in the Agreement on Internal Trade with respect to the interprovincial portability of labor, skills, and certification. In my view, the best way to proceed would be to convert this into an interprovincial agreement on the mutual recognition of each other's standards, certificates, and so on (with private sector cooperation on setting the standards), and to incorporate it as an integral component of the CHST principles.
 - Finally, but hardly exhaustively, I think Canadians will be surprised to see several provincial premiers adopt pan-Canadian positions on these issues. For their part, since they will no longer be able to claim the high moral ground on these issues, federal representatives will have to share center stage with several provincial leaders.

These principles are not just my personal wish list, but a *sine qua non* for the federation and a necessary ingredient of the solution if Canadians are to transfer their allegiance on social policy matters from Ottawa to the provinces or, more precisely, from Ottawa to a joint federal-provincial focus. For their part, the provinces will have to dem-

¹⁹ Note that this is not just an issue between, say, Alberta and Ottawa; it also affects other provinces. An analogy is appropriate. Ottawa failed to step into the fray when Quebec would not allow Ontario construction workers to ply their trade in Quebec. However, Ontario introduced some draconian retaliatory legislation and, within a week or so, a Quebec-Ontario compromise was struck. While retaliation may not be the optimal approach to these issues, the example does reinforce the notion that powerful interprovincial pressure can and will be brought to bear on provinces that attempt to generate negative externalities on other provinces.

onstrate that decentralization can be consistent with the maintenance of national components of the social envelope if their demands for further decentralization in other policy areas are to be heeded.

Citizens and the New TEP

At this juncture, let me summarize the various avenues by which globalization is having an influence on individual Canadians:

- First, the role of citizens as consumers is being enhanced, in part because they are the principal beneficiaries of the personal computer revolution. In the language of this essay, they are acquiring power and even sovereignty in this area.
 - Second, with respect to the role of citizens as “workers,” the picture is cloudy. The mobile (“symbolic analyst”) components of the labor force may also be enhancing their opportunities since the global economy is becoming more open to them. Immobile labor, however, is in for a rougher ride, and the diminishing role of governments in the new techno-economic paradigm will surely compound their problems.
 - Third, individuals are being disenfranchised as citizens since important issues, including the spread of the new TEP itself, increasingly are beyond their control. One response to this is to form “communities” with like-minded citizens elsewhere. This is, in effect, the Greenpeace approach, whereby international linkages of like-minded citizens bring pressure to bear on selected issues but the composition of the group varies from issue to issue. While I will not focus on this option here, Stanbury and Vertinsky (1995) do so, and assess the pros and cons of this development in the context of their discussion of public policy and “democracy” issues relating to the Internet and the information superhighway generally. Another response, more closely associated with the thrust of this essay, is that individuals will begin to focus more on their various sub-national communities.
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- Fourth (and an avenue perhaps unique to Canada), the march of events has forced Canadians into a sort of “identity warp” as Ottawa makes it more difficult for them to look to the center for their regional, social, and perhaps even political identities. As a result, loyalties and identities are becoming dispersed, multiplied, and perhaps even fragmented.

While these issues take me well beyond my area of expertise, it seems, nonetheless, that the tensions both within and between these avenues serve — consistent with the theme of this essay — to open up the system toward innovation and flexibility, since there is progressively less a common focal point, let alone a status quo, around which these divergent channels can converge.

Institutional and Governance Evolution

Paquet’s (1995) reflection that neither vertical (bureaucratic) coordination nor horizontal (market) coordination will be fully adequate to meet the challenges of the evolving economic order seems to be on the mark: evolution in the institutional sphere is inevitable. It could not be otherwise given that power and sovereignty are being distributed upward, outward, and downward both within the political/government sphere and also between governments and the private sector. For one thing, governance will become more contractual, a natural result of which is that it will become more, not less, executive driven. For another, it will likely incorporate greater asymmetries than heretofore. And, of course, within governments, organizational structures will become less bureaucratic — that is, less hierarchical.

The related issue that I want to address in this final substantive section of the essay is the likely nature of the federal-provincial institutional interface. The analyses in the previous section focused on the likelihood of an increase in the number of interprovincial agreements, as the provinces wrestle with minimizing the negative spillovers arising from the exercise of increased policy responsibility. It seems inevitable that there will be a need for an interprovincial secretariat to provide information, coordination, and even policing across the provincial policy fronts. But what about the likely evolution of federal-provincial

institutional mechanisms? The policy interdependencies between the two levels of government are already high: further decentralization will increase them.

Canadians are already familiar with “cooperative” and “competitive” federalism. The former, essentially defunct even before the introduction of the CHST, was ill-defined but encompassed, for example, shared-cost programs: Ottawa provided financial incentives designed to ensure provincial cooperation in terms of attaining some “national” goal. More generally, it reflected joint federal-provincial cooperation toward some common objective; as such, it was a “common-interest” endeavor.

Competitive federalism, on the other hand, is alive and well. This relates to the freedom of governments to legislate (largely) as they wish in their own spheres of jurisdiction. The ongoing provincial experimentation in the health and welfare areas is an obvious example of competitive federalism in action at the horizontal level. At the vertical level, an example was the federal decision to embark on a GST in competition with provincial sales taxes (PSTs).²⁰ Unlike cooperative federalism, competitive federalism generates in its wake a set of policy spillovers or externalities, both positive and negative.

In a timely and perceptive paper, Richard Zuker (1995) introduces a new concept, “reciprocal federalism,” in part as an organizing principle in the wake of the decline of the federal spending power. In a sense, reciprocal federalism is complementary to competitive federalism, since it is designed to internalize the resulting externalities. Conceptually, however, it is much more. Fundamentally, it recognizes that the provinces need Ottawa to act in certain ways so that provincial policies can be more effective. Likewise, Ottawa needs some help from the provinces so that federal policies can be more effective. In this sense, the concept is as much one of self-interest as it is one of mutual interest.²¹ For

²⁰ Readers interested in the analytics of competitive federalism can consult Breton (1985).

²¹ My colleague Tom Kent believes that I may be going too far in linking reciprocal federalism more with competitive than with cooperative federalism. Associating cooperative federalism with shared-cost programs is too narrow a perspective. Kent’s view is that much of the essence of cooperative federalism during the Pearson era was also to internalize the policy interdependencies among and between the two levels of government.

example, for the provinces to engage in income taxation, they need to rely on Ottawa as a tax collector. For its part, Ottawa is willing to provide this service on the condition that the provinces adhere to certain federal guidelines, including the prohibition of tax credits and surcharges that would fragment the internal economic union. One could also make the case that the development of a set of principles underpinning the CHST would also be an exercise in reciprocal federalism since this conditionality would allow provinces to legislate within their own spheres of jurisdiction without impinging on the citizenship rights of Canadians residing elsewhere. And in a more fundamental sense, these principles will serve to pave the way for Ottawa to allow a more decentralized approach to the social envelope.

Consider the transferability of professional and occupational skills referred to in the previous section. There are two ways to go about this. One is for Ottawa to attempt to legislate some national norms or standards for each skill or occupation that would then be applied across the country. This would not only be very time and money consuming, but also very rigid. It would be far better if the provinces were to embrace the concept of “mutual recognition” of various provincial standards, subject to an “equivalence test” that could be appealed. But for mutual recognition to be binding, there may be a need for the provinces to get Ottawa to pass some overarching legislation on their behalf (as Australia has done). From the provincial vantage point, acceptance of mutual recognition could well be the trigger that allows the devolution of federal training monies. Thus, the concept of reciprocal federalism can be viewed as incorporating the full range of negotiations pursuant to the introduction of the CHST.

But reciprocal federalism transcends the social envelope. One excellent example relates to the harmonization of the GST and the various PSTs, which would be a positive-sum game for all concerned. Instead of 11 tax collection agencies, there would be only one. As with the shared personal income tax, revenues from the new GST would be shared. In the process of consolidation, the provinces probably would have an important say in how the GST could be simplified as well as in how any future tax rate increases would be implemented and shared. One way to do this would be to follow the recommendation of Boothe and Snodden (1994) to constitute a single national (federal and provincial)

GST collection agency. Compliance costs would be markedly reduced for those producers who now have to comply with two sets of indirect taxes, and input costs would be rebatable so that the overall system would enhance Canadian competitiveness. All in all, this is a “win-win” situation for both levels of government and for all Canadians.

Another example relates to fiscal and macroeconomic coordination between the two levels of government. On the fiscal side, with a debt-to-GDP ratio now over 100 percent, Canada’s public sector debt is a national, not just a federal, problem. On the monetary side, the country cannot afford to undergo another episode like the one in the late 1980s, when the Bank of Canada was pursuing price stability at the same time that booming Ontario was revving up spending growth to somewhere in the mid-teens. It seems obvious that both levels of government would be better served by greater macroeconomic coordination, but because business cycles across Canada’s regions are not synchronized, coordination cannot mean full harmonization. Instead, a first step might be federal-provincial cooperation to produce a Canadian version of Australia’s *National Fiscal Outlook*. This document is published prior to the budget cycle and projects government deficits (in terms of consistent accounting standards) for both the Australian Commonwealth government and state governments. These deficits are forecast under both high and a low GDP growth scenarios, and they assume there is no change in fiscal parameters. Canada’s “green paper” estimates, prepared each fall for Ottawa and the provinces, are roughly similar. Why not make these public? Even if they served only an information and a fiscal transparency role, this would be an important contribution to overall fiscal and macro coordination.

Clearly, the above discussion barely scrapes the surface of what promises to be a full-blown institutional evolution. For example, now that many provinces are decentralizing the within-province delivery of health care, this likely will usher in a local-provincial interface not unlike aspects of the existing federal-provincial interface. The essential message here is not all that different from that of other sections: the status quo cannot hold, and Canadians and their governments will have to develop innovative administrative and process arrangements to forge a new institutional order consistent with the domestic and global challenges they face.

Conclusion

Spurred on by the irresistible forces of globalization and the telecomputational revolution on the one hand and domestic exigencies relating to the debt/deficit overhang on the other, the evolution of Canada's federal system is well under way. At one level, globalization is inherently decentralizing because it enhances markets that themselves are inherently decentralizing. Within the government realm, the new techno-economic paradigm is transferring power and sovereignty upward, outward, and downward from central governments of nation-states. On balance, these forces are likely to tilt the division of powers in federal systems toward greater decentralization. This is particularly true for Canada, where past and present fiscal profligacy means that the center cannot hold and the north-south regionalization of the economy implies that the center should not hold.

The theme of the essay has been that Canada's federal system is sufficiently flexible and adaptable to accommodate these pervasive forces of change. The related subtheme has been that the sweeping and complex nature of this evolution cannot possibly be managed by a set of strategic changes in the formal distribution of powers. Hence, the appropriate route is process evolution. The good news is that Canadians have been here before. For most of the postwar period, Canadians have displayed a rare talent for tailoring their governance structures to meet emerging domestic and external challenges, and this was accomplished without significant changes to the written constitutional word. This is an indirect way of recognizing, even celebrating, a fundamental and often overlooked attribute of the Canadian system — our Constitution has proven to be a marvelously flexible framework. The challenge, then, is to recapture our creativity in using administrative arrangements, delegation of authority, changes in federal-provincial transfers, asymmetric relationships, executive agreements, and the like to ensure that the system continues to evolve in such a way that we can once again exert a degree of control over our political and economic future.

More speculative is the proposition that it is much easier to accommodate possible structural change if it occurs in the context of process evolution. This is particularly the case if it represents codifying or enshrining an existing practice, as occurred with equalization. Thus,

while process evolution will hold sway, it will not preclude some structural evolution.

In terms of the pressing issues of the day, the message in this essay is clearly mixed. If Quebecers insist on enshrining their “distinct society” in the Constitution, they may have to wait a bit. The good news is that, if Quebecers can be content with a “distinct society” *de facto* — defined as the ability to influence how they live and work and play — then their hour is at hand.

For the rest of Canada, the news is, in fact, probably more sobering. With the decentralization of key aspects of the social envelope and with the provinces moving in the direction of becoming “economic nations,” English-speaking Canadians may have to begin to rethink their vision of the federal government as embodying both “state” and “nation.”

Decentralization of the degree and to the extent that I have contemplated in this essay is anything but a “free lunch” for the provinces. For them, the challenge will be to show individual Canadians that they can take the national interest into consideration in their policies. Thus, in pursuing their own interests in the wake of their increase in autonomy (but not in revenues), the provinces must be prepared, along with Ottawa, to play a much larger role in creating “national” programs or national public goods. Potentially, this is very much a positive-sum game, since the postwar approach of relying only on Ottawa to deliver the national component of policy is decidedly inferior to an approach that combines both vertical (top-down) and horizontal (bottom-up) coordination and integration. The underlying message is, nonetheless, clear: if the provinces fail in this critical endeavor, Canadians almost certainly will demand that the pendulum of power swing back to the center.

As the philosopher of October, Yogi Berra, was reputed to have said, “if you don’t know where you’re going, you may end up somewhere else.” Actually, the problem is not that we don’t know where we are going, but that we can’t know where we are going because globalization itself is still in full evolution. It is clear, however, that we will end up somewhere else. But we do hold a trump. We have proven our ability to exercise creative and adaptive federalism. If we play this trump in terms of federalism as process rather than federalism as structure, the Canadian federation will continue to maintain its United Nations’ ranking as the most livable country on earth.

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