

**FEDERALISM AND THE NEW
ECONOMIC ORDER:
A Citizen and Process Perspective¹**

By

Thomas J. Courchene

*Jarislowsky-Deutsch Professor of
Economic and Financial Policy*

Queen's University

and

Senior Scholar

Institute for Research on Public Policy

Montreal

I: INTRODUCTIONⁱ

The power and pervasiveness of
globalization and the knowledge/information
revolution (henceforth referred to as the new

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Adjustment Grants monitored by the Commonwealth Grants Commission is the most comprehensive among federal nations. The fiscal equalization principle that guides the Commonwealth Grants Commission (CGC) is as follows: That each State should be given the capacity to provide the average standard of state-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenues from its own sources (CGC, 1995, 1). Operationally, the system equalizes revenues both upwards and downwards to the common standard and then does the same for states' expenditures or fiscal needs.

Thus, the Australians have latched on to a highly egalitarian equalization program and, more generally, a centralizing system of intergovernmental transfers that meshes well with the underlying homogenous and egalitarian nature of their federation. Indeed, Richard Bird (1986, 242) noted that Had Australia not been established initially as a federal country, it seems rather unlikely that it would be one today. The genius of the Australian approach to federalism is they have creatively employed the flexibility of the federal form to replicate selected key features of unitary states.

B. Germany

The German federation is also highly centralized, but in a quite different way than Australia. The key institutional/constitutional feature of German federalism in the upper house or Bundesrat, which is a House of the Länder in that it is made up of direct representatives of the sub-national governments. All legislation pertaining to the Länder must receive the imprimatur of the Bundesrat. This is clearly a version of joint decision making alluded to by Friedrich (above) or, more generally, a version of co-determination, of which more later. But the implementation of this legislation rests with the Länder. In federalism jargon, Germany is often referred to as engaging in Administrative federalism, in contrast to the Legislative

federalism that prevails in, say, Canada where the provinces have wide legislative responsibilities. Not surprisingly, therefore, all major tax rates in Germany are set centrally with no variations allowed at the Länder level (although the Länder Administer or collect these tax revenues). Apart from a relatively minor range of Länder and municipal taxes, most Länder revenue comes from revenue-sharing arrangements with the centre. The major shared or joint taxes include corporate and personal income taxes, capital taxes and the VAT. Some of this revenue sharing follows the principle of derivation, some is allocated on equal-per-capita terms and some (especially for the new Länder) is based on equalizing principles. Beyond this revenue sharing, there is a second and overarching tier

continues to exert a strong hold on the political culture, notwithstanding the stresses of unification.

By way of anticipating the later analysis on supra-national integration, one might also note that constitutional provisions have been introduced for the Länder to play a role in EU integration negotiations in those areas that fall under their jurisdiction. Indeed, since the Länder are responsible for implementing many of the EU directives, they now have established mini-embassies in Brussels. This, too, represents a process innovation that allows the Germans to approach the implementation of policies within the confederal EU in much the same way and spirit as they implement the policies within the German federation. Indeed, this co-determination approach seems on the surface to resonate well with the co-determination features of corporate governance (in particular the presence of labour unions on corporate boards of directors), although implying any causal relationship between them is neither intended nor particularly relevant for the issue at hand.

C. Canada

In contrast to Germany, the Canadian provinces have no formal role in the operations of the central government: the Senate (upper chamber) is appointed for life (up to age 75) by the government of the day and, as a result, is not a federal chamber in any meaningful sense. Hence, provincial concerns and issues tend, by default as it were, to be articulated through the provinces and their respective premiers. Indeed, Canada also differs from the typical federation in that the Canadian constitution embodies an extensive exclusive provincial power.

government relaxed the conditionality. Currently, all vertical transfers are rolled into a single block-fund, where the monies can be spent where the provinces wish. However, there remains in place a set of social policy principles to guide all provincial spending in these policy areas.

Because of the decentralized nature of the Canadian federation, Canada has had to engage in creative measures to preserve and promote its socio-economic union. For example, all provinces adhere to a mechanism for allocating corporate revenues across provinces for those enterprises that operate nationally. And recently the provinces and Ottawa have signed a *Framework to Improve the Social Union for Canada* (generally referred to as SUFA, for the social union framework agreement). The key coordinating Canadian institutional instrumentality has been what federal scholars refer to as executive federalism—namely, the frequent meetings (over 1,000 annually at last count) of federal and provincial officials (or executives) in areas of mutual concern and interest. In addition, the provinces have mounted their own national institution, the Annual Premiers Conference, which is moving the provinces toward addressing some pan-Canadian goals. Nonetheless, the internal Canadian socio-economic union remains less uniform than that of Australia, for example.

In line with the general theme of this section, Canada's system of intergovernmental transfers as well as the several intergovernmental agreements are in effect designed to accommodate the decentralist nature of country as well as its commitment to be a sharing community.

D. The United States

To round out this brief comparative survey, we now turn to the United States, which is the federal system that probably suffers least from vertical fiscal imbalance, in part because US

states engage in a narrower range of activities than do Canadian provinces, for example. What is most fascinating about the US approach to intergovernmental transfers is the *absence* of a formal revenue equalization program although, on the expenditure side, regional considerations enter into allocation decisions (for example, with respect to defence), as they do in other federations.

One view of the US approach is that the Americans simply ignore any horizontal fiscal imbalances. Another view is that there really are no horizontal imbalances since any meaningful per-capita revenue differences across states will be capitalized in property values, wages and rents. Wallace Oates, one of the foremost scholars of US federalism, takes this latter view of horizontal fiscal imbalances and equalization:

[E]xisting fiscal differentials (e.g., varying levels of taxable capacity) across jurisdictions will tend, to some extent at least, to be capitalized into property values so that those who choose to live in fiscally disadvantaged areas are compensated by having to pay lower land rents; from this perspective, horizontal equity under a federal system is, to some degree, self-policing. The need for equalizing grants in a federation is thus questionable. Perhaps it is best to regard their role as a matter of taste. (1983, 95-96).

John Kincaid (2002) presents yet another perspective on the absence of an equalization scheme in the United States, one based on individual mobility:

Americans are ... mobile; nearly one-fifth of the population changes its county of residence each year. This is an historic pattern, not one induced by globalization. This mobility weakens federalism insofar as it weakens citizen ties to states and localities and erodes sectional and regional subcultures; however, it also strengthens federalism insofar as mobility spurs interstate competition for innovation and efficiency in state and local

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the NEO in ways that maintain their overarching and long-standing socio-political goals.

But what are these Adictates@ of the NEO. To this I now turn.

III: THE IMPLICATIONS OF THE NEW ECONOMIC ORDER ON FEDERAL

only do networks proliferate in all domains of the economy and society, outcompeting and outperforming vertically organized corporations and centralized bureaucracies (Castells, 2001), but they are finally providing meaningful substance to the concept of a global economy, namely an economy with the capacity to work as a unit in real time on a planetary scale (Castells, 1996,92). Castells then goes on to observe:

The emerging forms of governance of international markets and other economic processes involve the major national governments but in a new role: states come to function less as sovereign entities and more as components of an international polity. The central functions of the nation-state will become those of providing legitimacy for and ensuring the accountability of supranational and subnational governance mechanisms. *Nation-states will increasingly be nodes of broader networks of power* (1997,304-5, emphasis added).

These (essentially non-territorial) networks of power range both horizontally (among and between nation states) and vertically (up, down and across the hierarchy of cities, regions, nations, and supra-national institutions). Thus, governance and power are being distributed across these networks and more generally across society, economy and polity. Paquet (1997,30) notes that these relationships can shift from being hierarchical to being heterarchical, very

of the new societal order can serve to transfer powers upward, e.g., the emergence of the Euro as a supra-national currency. Note in this context that a transfer upward from the provinces need not imply a transfer to the central government B the externalities could also be internalized by coordinated pan-provincial initiatives (Courchene, 1996).

Intriguingly, one can also make a case that part of the rationale for the upward or supra-national transfer of powers is to strengthen *national autonomy*. The argument runs roughly as follows. Global forces, including the ultra-mobility of capital, are progressively impinging on the ability of nation states to control key policy areas *within their own borders*. Hence, the resort to supra-national fora for oversight and regulation occurs in part in order to regain and/or re-assert some *domestic* control over these policy areas. For example, one of the reasons for the success of the EU is that Athe European Union does not supplant the existing nation-states but, on the contrary, is a fundamental instrument for their survival on the condition of conceding shares of sovereignty in exchange for a greater say, in world, *and domestic*, affairs in the age of globalization@

way or another, this reality has to be accommodated.

Thus far the discussion of the relationship between the NEO and federalism has focussed on the implications among and between cities, provinces/states/länder, nations and supra-national institutions and the consequent impact for the distribution of powers. I now turn to the relationship between the NEO and citizens and the resulting implications for federalism.

E. Citizens and the NEO

Citizens have emerged as the principal beneficiaries of the information revolution. In their role as consumers, they are clearly in the driver's seat, so much so that in *The Borderless World* Kenichi Ohmae (1990) actually defines globalization as consumer sovereignty.[@] Moreover, like-minded citizens, networking within and among countries, are emerging as

as Ottawa has done for substantial aspects of mining, forestry energy, etc. What does have electoral salience, and what is increasingly the essence of nation building in the NEO, are citizen-based issues as they relate to information empowerment, human capital development, and redressing the actual and potential income-distributional fallout from the new global order. The challenge for some federal systems, and certainly the Canadian federation, is that many of these citizenship issues fall under provincial jurisdiction. In some areas, Ottawa (more generally, central governments of federations) can mount a reasonable case on policy, if not on constitutional grounds, for becoming more involved in some of these areas. For example, with knowledge on the cutting edge of competitiveness, Ottawa *will* be a meaningful player in human capital development no matter what the constitution says, since the country's competitiveness is at stake. In many other areas, however, federal systems are likely headed for considerable jurisdictional in-fighting as central governments are going to be driven in the direction of catering to citizen-related issues, traditionally the domain of sub-national governments.

While this will presumably not be welcomed by many sub-national governments, there may be a window of opportunity for some win-win trade-offs. By their very nature, *Region states* both in Europe (Newhouse, 1997, 72-73) and in Ontario (Courchene and Telmer, 1998, Chapter 9) tend to be biased toward wealth creation rather than income redistribution. This means that they may well welcome an increased income-distributional role for the federal government, because the *quid quo pro* is that these region states can now more effectively pursue an allocative-efficiency or wealth-generation role.

While jurisdictional *Overlap* is more or less inevitable in modern federal systems, this electoral competition may lead to *Aduplication*, as well. Again the message is one of

emphasizing the importance of *Afederalism as process*.

G. Recapitulation and Transition

Having elaborated in turn on the inherent flexibility of the federal model in the previous section, and on the challenges to governments and governance arising from the NEO in the present section, we can now marry the two, as it were, in the context of addressing selected issues central to ensuring that federal nations can succeed in the new economy. In order to facilitate this, it may be useful for the reader to have a skeletal overview of the implicit federal model that will underpin the following analysis.

The model has five components or features. The first is the constitutional framework embodying the allocation of taxing and spending powers. Essentially, this will be taken as *Agiven* for the analysis, and the presumption will be that this allocation will lead to both vertical and horizontal imbalances.

A second principle or component is a fiscal-equity or equalization program to address interprovincial or horizontal imbalances. A third component is a set of transfers to offset any vertical imbalance. Given that fiscal differences across provinces have been accommodated via the equalization provision, these vertical transfers could be equal per capita, and presumably the more centralized is the federation the more conditional these transfers will be.

The fourth component is an intergovernmental fiscal covenant. This is intended to encompass several sorts of arrangements that the NEO now makes more important. One of these is a *Acode of fiscal conduct*, designed to ensure that governments (national and sub-national) do not use their tax (and fiscal) autonomy to fragment the national economic union. Some might prefer a cast this in the larger context of an *Agreement on internal free trade*, which would include a fiscal code as a subset. A second component of the fiscal covenant would be an *Ainternal social union* which,

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economic fronts. This allows the public sector of federations to replicate some of the dynamic-adjustment, even dynamic-efficiency, properties of the private sector. Superior approaches to policy or to service design and delivery in one province will find their way to other provinces, where further experimentation will occur, and so on.

What are the pre-conditions for ensuring that these provincial initiatives are indeed welfare and adjustment enhancing? Conveniently, an overall framework which addresses this is Weingast's (1995) market-preserving federalism.⁶ According to McKinnon's (1997) elaboration of this framework, market-preserving federalism embraces four principles:

1. *Monetary Separation*: Provincial governments cannot own or control commercial banks;
2. *Fiscal Separation*: Provincial governments do not have access to open-ended and/or discretionary central government finances to cover their deficits;
3. *Freedom of Interstate Commerce*: Goods, services, people, firms and capital are allowed to move free and freely across provincial borders;
4. *Unrestricted Public Choice*: Provinces are allowed to compete with one another in designing and delivering alternative bundles of public goods and services and to finance them by alternative means of taxation. (Note that in the context of market-preserving federalism, unrestricted public choice is the same as competitive federalism).

The first two principles guarantee a hard budget constraints⁷ at the sub-national level, while the third ensures that provinces cannot inhibit the free mobility of goods and factors. PD0.002 across 246,9(,)-0.8(unf.4(e7.rTJTfirTf factors. PD0.00rna5ile 052-J-1cesnt, I

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widest range of policy areas are the order of the day in the NEO era.

B. Generating Hard Budget Constraints

Given that all of the euro members have agreed to the principle of monetary separation[@] (e.g. the Bank of France cannot bail out the French government), it is surprising that monetary separation remains an issue in the *internal* workings of some federations. Brazil and Argentina fall into this category. Both Rezende and Afonso (2002) and Serra and Afonso (1999) document recent Brazilian effects to privatize, liquidate, or transfer to central bank management those commercial banks that were controlled by the Brazilian states. Given the magnitude of the problem, it is some comfort that only 7 of the original 48 state-controlled banks remain in the hands of the state (Rezende and Afonso 2002,22). But this is still 7 too many.

Tommasi (2002) documents similar problems with province-bank linkages in the Argentine federation. He then goes on to describe provincial initiatives that serve to breach monetary separation in a creative, albeit inherently destructive, manner. The issue relates to the *bonos provinciales*, or low- denomination provincial bonds that a few provinces (e.g., Cordoba in the mid-to-late 1990s) introduced to help finance their government spending, e.g. the payroll for public sector workers. Canadians would view these *bonos* as a type of *Ascrip*.[@] Since these bonds do not pay interest, one would assume that they would immediately trade at a discount. However, what makes them generally

relatedly, it will provide an incentive for taxpayers to hold their provincial governments fiscally accountable. Rezende and Afonso (2002,20) have already made this case for Brazil: given that most of the municipal budgets come from transfers accountability at the local level was severely affected. It is far easier (but not necessarily easy) to implement hard budget constraints when sub-national governments can exercise control over their revenues and expenditures and, therefore, over their overall budget balance, because citizens will then find it meaningful to hold their governments accountable on both the tax and expenditure side. If there is no or little sub-national tax autonomy then incentives exist for citizens to join their province/state in lobbying the center for a larger share of the common-pool taxes. There is another downside to the absence of tax decentralization and citizen accountability, namely that the much heralded Tiebout approach to competitive federalism (voting with one's feet in response to jurisdictional offerings) is not really operable (Rezende and Afonso, 2002,20).

I hasten to add that running deficits is not synonymous with the absence of hard budget constraints. At one extreme the Canadian provinces can borrow at market rates and are subject to the assessment of bond-rating agencies. As a relevant aside, these credit-rating agencies play an important role in increasing the transparency and accountability of Canadian provinces. I also hasten to add that the absence of bailouts need not preclude significant fiscal binges: the province of Ontario borrowed nearly \$60 billion over the period 1990-95, which must be a record for a sub-national government, anywhere, anytime. Yet in the process Ontario remained with the Maastricht debt guidelines and largely within the deficit guidelines as well.^{vii} Ontario re-achieved budget balance by the turn of the century. The moral of these stories is that good old fiscal coincidence (at the margin, the jurisdiction responsible for spending should also be responsible for raising the requisite revenues) and, therefore, citizen

accountability are among the necessary preconditions for securing that sub-national governments face hard budget constraints.

C. Securing the Internal Economic Union

Canadians are often told that goods, services and factors flow more easily across the borders of member states of the EU than across provincial boundaries in Canada. Actually, this should not be all that surprising since the primary rationale for the EU was and is to generate an economic union or a single market. In other words, the EU and the Common Market before it are basically *economic blueprints*, replete with the associated hundred-odd EU directives which are subject to administrative law. On the other hand the constitutions of federations are first and foremost *political blueprints* which are mediated, at least initially, by the political process. The NEO challenge in this respect is for federations to find creative ways to secure and promote their internal administrative (law).

already noted, the federal-provincial *Agreement on Internal Trade*, modelled in part at least after the Canada-US FTA and the NAFTA agreements.

All of this discussion has focussed on *process*. Yet much of the literature on the fragmentation of the Brazilian market argues that the problem is *structural*, namely the tax assignment that leaves origin-based VAT taxes in the hands of the states. Somewhat similar problems attach to the Agross receipts@ turnover tax of the Argentine provinces. Obviously, the most effective way to redress these problems would be via a redesign of the Constitutional parameters relating to fiscal federalism, in tandem with greater reliance on the judiciary for Apolicing@ the internal market. Just as obviously, the difficulty here is not analytical but political. Later I will propose an overall federalism Apackage@ that might finesse this and other related issues.

Securing the economic union is primarily an exercise in what the Europeans would call Anegative integration,@ essentially a series of Athou shalt nots.@ But in the face of increasing federal-provincial and interprovincial

interdependencies the need arises for Apositive integration,@ that is, a pro-active meshing of governmental programs and policies. To this I now turn.

D. Preserving and Promoting the Social Union

By virtue of citizenship, individuals merit equality of access to those public goods and services essential for success in the new economic order. If these essential public goods B education, health, welfare, training, etc. B fall under provincial jurisdiction, as they do in Canada for example, then issues relating to vertical and horizontal fiscal balance come to the fore. As already noted, this calls for some combination of unconditional equalization and conditional Acitizenship@ transfers. And unless supported by demonstrably objective criteria, these conditional transfers relating to specific policy areas should be equal per capita,

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document,⁸ and they successfully pressured their governments to sign on to the MRA. At that point, another issue arose: while all the states had signed the MRA, how could it be made *binding* on them, since they might rescind their signature in the future? The solution to this was especially creative. The states invited the Commonwealth government to pass the MRA legislation, which it did. Then the states also passed the legislation in their parliaments. Because of the federal paramountcy provision of the Australian constitution (sec. 51(xxxvii)), the legislation became binding on the states. In effect, it became constitutionalized. Sturgess (1993,10) elaborates on this process as follows:

... the Commonwealth is obtaining no power from the States under this very limited reference, other than to pass a single Act of Parliament once-for-all. It cannot pass further legislation in the same area, nor can it establish a bureaucracy through which to regulate the States. In that sense, there is no reference to *powers* at all.

In effect, the States are using the Commonwealth to jointly make an amendment to each of their constitutions at the one time. In practice, what the States are doing is ceding sovereignty to each other [and not to the Commonwealth].

While this particular option may not be available in other federations, there are other creative avenues that can be pursued. This is strong testament to one of the themes of this essay: *Where there is a national will, there is a federal way!*

Canada's approach to preserving and promoting its social union will be dealt with briefly in the context of intergovernmentalism or EU-style co-determination arising out of the combination of decentralization and policy interdependencies.

E. Co-Determination as Institutional Architecture

While duplication can and should be avoided, overlap and policy interdependencies are ubiquitous in modern federations. If federalism is, as the earlier quote from Friedrich suggests, a process of adopting joint policies and making joint decisions on joint problems, then intergovernmentalism or co-determination is an emergent institutional instrumentality in the new economic order. Indeed, the German federal system, with its Bundesrat serving as an upper house of the Länder,⁹ can be characterized as institutionalized co-determination.¹⁰ Other more decentralized federal systems need to create new institutions to deliver joint decision making. Canada's social union framework agreement (SUFA) represents a meaningful move in this direction. Among its provisions, some of which have noted above, are the following: a co-determined (federal-provincial) set of social policy principles; mutual recognition of skills/accreditation to develop an internal human capital union; principles designed to increase accountability, transparency and enhanced citizen participation; a commitment to co-operative and collaborative partnership on planning and implementing new initiatives; a recognition of the federal spending power, while providing provincial input into its design and implementation; and dispute avoidance and dispute resolution procedures which, among other things, would allow for third-party fact-finding. All in all a welcome and innovative step, save for the political downside of Quebec choosing not to become a signator to SUFA.

What greatly facilitated this vertical or federal-provincial co-determination in Canada was an earlier and still on-going exercise in horizontal co-determination or pan-provincialism. The apex of this process is the Annual Premiers' Conference. By having a fixed meeting time each year, by allowing ample lead time for placing issues on the agenda (and for developing position papers) and by rotating leadership across premiers where each Premier tries to push out the envelope, the APCs

are beginning to create a pan-provincial perspective across both the provinces and the premiers. Appropriately, there is increasing recognition that if horizontal overlaps and interdependencies cannot be internalized by pan-provincial policy coordination and collaboration, then Canadians may invite Ottawa in to internalize these policy externalities. This being the case, the premiers have ample incentive to adopt pan-provincial perspectives.

One often hears that co-determination will lead to an effective transfer of powers upward to the federal level. One cannot, of course, rule this out. However, one must not overlook the earlier-aided view of the European integration process, namely that it also furthers the national agenda of the EU member states. This also ought to be true within federations. Indeed, and unlike many of my fellow scholars of Canadian federalism, I firmly believe that the longer-term implications of SUFA will actually buttress the role and power of the provinces with Canadian federalism. This caveat aside, the larger issue here is that minimizing the negative spillovers arising from either or both of vertical or horizontal interdependencies is (or ought to be) a win-win situation for both levels of government.

reciprocal federalism

In an insightful article, Richard Zuker (1999) attempts to capture this win-win possibility with the concept of *reciprocal federalism*. The name is particularly apt since it recognizes, at base, that in many areas the provinces need Ottawa to act in certain ways in order that *provincial* policies become more effective. Similarly, Ottawa needs some help from the provinces in various areas in order that *federal* policies be more effective. No matter what label one places on such arrangements, it is obvious that there exist ample opportunities for mutual gain arising from some or all of co-determination, harmonization, coordination or even just from enhanced information sharing.

G. Citizen-Based Federalism

Even a casual reader of the above analysis will recognize that one of the implicit, if not explicit, themes of this essay is that federalism needs to be apprized of the reality that its primary purpose is to privilege citizens. No doubt this fundamental truth motivated the original American *Federalist Papers*. However, this has never been more the case than in the new global order where citizens have emerged as the principal beneficiaries on both the political and economic fronts. Nonetheless, it is surprising how many papers on federalism essentially approach the subject from a federal-provincial or federal-provincial-municipal perspective with precious little attention devoted to making citizens a more integral part of the analysis. Assuredly, however, citizens now hold enough sway to ensure that federalism of governments, by governments and for governments shall perish from this earth!

There are countless ways to integrate citizens more fully and more formally into the institutions and processes of federalism. Earlier in the analysis, the importance of having sub-national governments accountable to their citizens was deemed essential not only for sustaining hard budget constraints, but

citizens, not governments. Hence, SUFA and the AIT need to be amended to allow for these citizen triggers, which in turn would come close to ensuring that citizens have a right to a social and economic union. This would be good economic policy, good social policy and good for federalism.

At this juncture, a subjective, but hopefully not provocative, proposal seems warranted. As I read the range challenges facing the Argentine federation B the tug of war between powerful governors and the central government, the widely variable per capita values of transfers across provinces, the absence of effective intergovernmental machinery (Tommasi, 2002) B and the consequent political difficulties in effecting meaningful change, it seems to me that one way around all of this is to bring citizens more fully into any future redesign/reform of federalism.^{viii} One can conceive of a federal model that would, via a system of intergovernmental grants of both the federal and citizenship variety, provide equality of access to key social services. Moreover, one could design both a social union and an economic union and couch these in terms of the inherent rights of citizens. Mutual recognition of credentials across provinces would be both good economics and good social policy in a human capital era, apart from adding further to the citizen perspective of federalism. And efforts to enhance transparency and accountability, while important in their own right, are also respectful of citizens. Were these or similar aspects of a citizens= perspective included in an overall federalism reform package, the appeal to citizens may well be such that they would not allow their governments to be non-signatories. As an instructive aside, on at least two occasions during Canada=s early 1980s constitutional deliberations (the Canadian Charter of Rights and Freedoms in 1981-82 and the Canada Health Act of 1984), Ottawa effectively went over the heads of the provinces and appealed directly to Canadians to ensure that these popular initiatives were ratified.

On second thought, this is likely to occur in any event, since the NEO, and particularly the information revolution, is dramatically altering the balance of power between governments and their citizens. Individuals are becoming much bets li-ed. u3tace lar0A 4T5

and regulations pursuant to, the FTA. Indeed, one of the reasons why federations may want to join regional FTAs is precisely because they find it too difficult politically to accomplish desirable goals (e.g. hard budget constraints) on their own. As noted earlier, membership in the euro, including adherence to the Maastricht guidelines, has imposed a degree of fiscal discipline on the Italian government that could not easily be imposed internally.

This caveat aside, the role of this final substantive section is to focus on those implications of regional integration agreements that are likely to differ from the implications dealt with in the context of free-standing federations adjusting to the NEO. I begin with the challenges arising from a federation of federations,⁶ as it were.

A. Cascading Federalism

As Watts (2003,129) has observed, a notable feature in the contemporary world is the number of federations that are themselves members of wider federal organizations: Germany, Belgium, and Austria as federations, and Spain, virtually a federation in all but name, are members of the broader European Union, itself a hybrid which is predominantly confederal in character but has some of the characteristics of a federation.⁷ Watts (2003,129-30) then elaborates:

This has had implications for the internal relationships within its member states, which are themselves federations. Among the issues that have arisen has been the role of the federated units within each of these federations in negotiations with the institutions of the wider European Union. Federated units within the member federations have established offices at the European Union capital in Brussels and have obtained direct representation not only in the Committee of Regions but in other councils of the European Union. This has introduced a new dimension into their

internal interdependence and an element of complexity into intergovernmental relations in these federations ... Indeed, Germany has been a pioneer both in terms of ensuring participation of the Länder in decisions within Germany concerning its relations with the EU, and in securing institutionalized participation of the Länder within the institutions of the EU itself. It should also be noted that a factor in the resistance within Switzerland to joining the EU has been concern about the possible impact upon the character of the Swiss federation.

It is not clear that there is anything one can or should say about the optimal way to adjust to this multi-tiering. For example, it may be the case that some federal systems will use the rules and regulations of the regional FTA to attempt to ride herd on the sub-national governments. Other federations, driven by subsidiarity among other principles, may wish to follow the Germans in finding ways to ensure that their sub-national jurisdictions maintain much of their previous role and powers. Still others may look toward South-African style hour-glass federalism⁸ by favouring the centre and the municipalities at the expense of the provincial level as the response to adding a supra-national tier. While these are, by and large, societal decisions, it is likely that they will be influenced by the nature of the regional FTA, including both the organizing principle for the regional integration and the likely emergence of cross-border region states, which are discussed later.

In the EU, the fundamental organizational principle underlying economic integration is the single-market principle or home-country rule.⁹ In NAFTA, it is national treatment.¹⁰ Now national treatment is far more sovereignty-preserving than is home-country rule. Under national treatment a US firm can do in Canada exactly what a Canadian firm can do, while home country rule would allow a US firm to do in Canada exactly what it can do in the US. This latter approach drives the system toward uniformity, as perhaps benefits the quasi-federal EU, whereas national treatment leaves

effect, this would be a situation of *de jure* equality, but *de facto* asymmetry.

C. Exchange Rates and Regional Integration

The advent of the Euro heralds the emergence of currencies as supra-national public goods. It also signals an era of dramatic currency integration and consolidation. Richard Harris and I (1999) have attempted to make the case that it is in Canada's interests to pursue North American monetary union (NAMU), modelled largely along Euro lines. In Canada's case, with over 80% of its exports destined for the US market, anchoring NAMU around the US dollar is the obvious route toward currency integration. Mercosur is more complicated, in part because of its more diverse array of export markets. A more appropriate route might be to develop a Mercosur common currency that could either float on global markets or be fixed to the dollar, or to the Euro, or perhaps to a basket of both. The larger and more important point here is that investing so much time and effort and political goodwill into forming trading agreements like Mercosur must go hand in hand with designing regional frameworks for more enduring currency relationships. Indeed, the development of a stable currency area is in the economic interest of all of South and Central America, and indeed of North America as well.

Note that some of the implications arising from a common currency for nations in a regional FTA have already been addressed. Specifically, the market-preserving federalism model (McKinnon, 1997) detailed earlier was designed to apply to the EU in the context of the Euro. However, it would also apply to a regional FTA like Mercosur that also had a common currency. The dictates of a monetary union relating to prohibiting government bailouts and securing hard budget constraints are more stringent than those necessary for a regional FTA without a common currency. But the benefits are likely to be higher as well, and all the more so for nations that have histories of monetary instability.

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5. This refers to the dollar value of trade volumes. As McCallum (1995) and Helliwell (1998) have emphasized, the Canadian internal market is much more integrated (in an efficiency or economic union sense) than is the cross-border market. For example, corrected for population size and distances, Canada-st interprovincial trade is on the order of a magnitude larger than international trade.

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6. Lisée (2003) makes the region-state case for Quebec.

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7. This presumes that a version of the Maastricht Guidelines (deficits under 3% of GDP ratio of debt to GDP under 60%) is an appropriate yardstick for assessing Ontario-s fiscal performance.

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8. While the preamble to this sentence refers to Argentina, the proposal that follows is intended to be applicable more generally.

9. Here regional trading areas refers to supra-national arrangements.

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