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INTEGRATION, FEDERALISM AND COHESION IN THE EUROPEAN COMMUNITY: LESSONS FROM CANADA

J. Frank Strain

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GENERAL SUMMARY

This study was completed during the 1991-92 academic year while the author was visiting The Economic and Social Research Institute in Dublin. For a Canadian economist interested in the impact of economic and political integration on peripheral and relatively underdeveloped regions, it was an exciting year to be in Ireland. During the period leading up to the signing of the Maastrict Treaty in February and throughout the subsequent referendum campaign in Ireland advantages and disadvantages of economic and political integration were raised and debated. Although most of the debate focused on familiar issues, a number of points raised were new (at least from the perspective of a Canadian visitor) and important. Significantly, these have direct relevance for ongoing work on the impact of economic and political integration on the relatively underdeveloped and peripheral regions of Canada.

The unfamiliar issues which arose in discussions of the Maastrict Treaty were not the only striking features of the European integration debate. Indeed, the absence of attention to problems which have perennially dominated Canadian debate over integration was still more notable. These problems were not neglected in Europe because they were parochial and uniquely Canadian. Rather, they were neglected because Europe and Canada have had very different experiences with integration. There is much Europe and Canada can learn from each other.

The purpose of this study is to review the Canadian experience with integration and draw out lessons of relevance in Europe. The study emphasises three important characteristics of Canada – a strong allegiance to local political institutions, ethnic nationalism, and regional disparities – and the important role these characteristics have played over the history of the Canadian union. These characteristics pose very real and serious problems for institutions designed to increase economic and/or political integration. In Canada, a wide variety of policy measures have been adopted over the 125 year history of the federation to limit conflict between distinctive communities and ethnic groups and to redress disparities. Some of these policies have been relatively successful but others have not.

Canada has experimented with two, often contradictory, approaches to limit conflict which can arise out of strong local allegiances, ethnic nationalism, and regional disparities. The first attempts to limit conflict by limiting the policy making powers of central institutions. The decentralised institutional structure allows distinctive communities and ethnic groups to control their own affairs, especially in areas where interests are likely to conflict (subsidiarity). The second approach attempts to foster a sense of "fair sharing" of the gains from union by redistributing income across communities and redressing regional disparities in market incomes, unemployment rates, and public service provision. The history of the Canadian union is dominated by a search for an appropriate mix of these two approaches.

In Europe where strong local allegiances, ethnic nationalism, and regional disparities are even stronger than in Canada, these characteristics of the union are likely to pose still more serious problems. As a consequence, an integrated Europe will also have to search for an appropriate mix of these two general approaches to preserving union. The examination of the impact of the Canadian policy experiments on peripheral and relatively poor regions reported in this study should be of considerable interest.

In the early years of the Canadian federation Canadians relied almost exclusively upon a decentralised division of powers to limit conflict. But regional disparities and a perception that the gains of union were not being "fairly shared" soon forced central institutions to redistribute income across regions. Canada experimented with a wide variety of redistributive programmes including direct transfers to persons, regional development programmes, and intergovernmental transfers. Although these did reduce disparities in standards of living they were less successful in reducing disparities in market incomes. Moreover, the increase in central control sparked conflict which threatened to break the union apart.

The 125 year search for an appropriate mix of the two general approaches has not ended. Indeed, Canadians will face a referendum on the future of the union on October 26,1992. Thus, the Canadian experience cannot be used to establish an ideal policy package for an integrated Europe. However, as the examination of the various Canadian initiatives in this study shows some policies have worked remarkably well in Canada.

One programme, in particular, has come close to the ideal sought by Canadians: the Canadian Equalisation programme. This programme, which is run by the central government, provides an unconditional transfer to local governments to increase the yields of the local tax bases to levels close to the average in the union. By unconditionally transferring income from rich to poor regions the programme fosters a sense of "fair sharing" while at the same time empowering disadvantaged communities and ethnic groups to pursue the policies they consider in their own interest.

Not surprisingly, the poor communities are very strong supporters of the Canadian equalisation programme. The Canadian experience with personal transfer and regional development programmes has convinced many in the poorer communities in Canada that these programmes should be set at the provincial level. Regional development programmes which are centrally administered are shaped not only by the interests of the poor regions but also those of the rich. As a consequence, the centralised programmes are rarely as effective as a local programme with the same funding. Personal transfer programmes too tend to reflect the preferences and conditions in larger and richer regions. Locally run programmes are typically better designed to match local needs and preferences. The Equalisation programme provides the additional funds poor regions need to establish their own regional development policies (these are, of course, subject to centrally established trade regulations) and personal transfer programmes.

More surprisingly, the more affluent areas of Canada also strongly support the Equalisation programme. In part, this is because the programme reduces conflict and the threat of breakup (thus preserving the gains from union) while at the same time keeping most policy making authority in the hands of the local governments in the richer regions. In part, it is because the programme generates a variety of other benefits enjoyed by residents of the richer regions.

The strong support for Equalisation in both rich and poor regions of Canada is evident in a section of the Canadian Constitution which makes the programme a fundamental cornerstone of the union. A new Constitutional accord (which will be the basis for the October 26 Referendum in Canada) will strengthen commitment to the equalisation principle.

Unfortunately, discussion of Equalisation and other intergovernmental transfer programmes in Europe has narrowly focused upon its potential to limit inefficient fiscally induced migrations and as an insurance policy to insure against the impact of random shocks under a fixed exchange rate / common currency regime. This study suggests that Equalisation can limit conflict and thus help preserve the gains which accrue from economic and political integration. In a union like the EC, with strong local allegiances, ethnic nationalism, and regional disparities, minimising conflict is extremely important. The Spanish Equalisation proposal rejected at Maastrict may need to be reconsidered in future discussions of economic and political integration in the EC.

INTRODUCTION

The Treaty of Rome (1957) explicitly attempted to lay "the foundations of an ever closer union among the peoples of Europe". In the years that followed Europe moved slowly, although not always steadily, toward closer union. First, a common market. Then a Europe without economic frontiers. Soon, monetary union. By 1997 the peoples of Europe will be united as never before and political decisions will, by necessity or by law, incorporate a "Community dimension".

At each stage in the evolution of the Community member states have had to make difficult decisions even though the consequences of these decisions could not be known with certainty. Increased integration involved gains and loses. Consequently, at each step decision makers had to identify these costs and benefits and assess their significance. This was never an easy task given the uniqueness of the European experiment.

The future will undoubtedly involve debate about further integration in Europe and more difficult choices will have to made. Should European institutions be democratised? Should Community institutions be given more legislative responsibilities? Should the Community budget be enlarged? What should be done to assure the cohesion of the Community? How should the Community deal with the uneven pattern of economic development? Should the Community tax system be harmonised? If so, how? These and many other difficult questions will have to be answered.

Although the European experience is, in many respects, unique, other peoples of the world have had to address similar questions about integration. There is much Europeans can learn from their experience. In this paper the experience of one union – the Canadian union – is reviewed and an attempt is made to draw some lessons from the Canadian experience which might inform European debate about future integration.

There are a number of reasons why the Canadian experience should be of particular interest in Europe. First, the institutions adopted in Canada to secure economic, monetary, and political union have helped Canada become one of the most prosperous countries in the word. Second, the Canadian union involves two major ethnic/linguistic communities (English and French speaking Canadians) which poses real problems for the political system governing integration. Third, the Canadian federal union is currently in crisis and is about to undergo dramatic changes. As a consequence, Canadian public finance economists, political scientists, and policymakers have been devoting more energies to critically analyse that country's institutions than their counterparts in other federations. Fourth, the issues being addressed in Canada are similar to those currently facing the European Community. All parties in Canada want to preserve economic and monetary union, to minimise the conflict which can arise due to significant regional variation in culture, language, and types of economic activity, and to meet the challenges of a more competitive world economy as efficiently and equitably as possible. Moreover, these goals must be pursued in an economic and monetary union with significant regional disparities (the per capita GDP in the poorest province is approximately one half that of the richest and unemployment rates differ by a factor of three). Finally, Canada has experimented with a wide variety of institutional arrangements and policy instruments and the current crisis reflects, in part, the failure of these institutions and policy instruments.

The review of the Canadian experience is necessarily selective and particular emphasis is given to the experience of the relatively poor regions of that country and to the Province of Quebec (home to the majority of French speaking Canadians) where there are special concerns about sovereignty. It is hoped that this selective approach will generate information of particular relevance to Irish policy makers as they formulate a "strategic approach" to change within the EC (NESC, 1989).

The opening chapter of this report provides a very general overview of the Canadian union. Chapter 2 introduces some of the major theoretical issues which arise in any discussion of integration. Chapter 3 reviews the Canadian experiment with federalism. The fourth chapter uses this review to draw out lessons for Europe and Ireland. Conclusions are offered in the final chapter.

Chapter 1

THE CANADIAN UNION: AN OVERVIEW

Most Europeans have at least some general knowledge of Canada. For example, Europeans know that Canada is a large and relatively prosperous country occupying much of the northern half of the North American continent. They know that Canada has a relatively small population, that Canada is largely populated by European immigrants, and that Canada has a history of conflict between its French and English speaking residents. However, many important features of Canadian society relevant to a discussion of integration in Europe are not generally appreciated.

The most important political characteristic of Canada is that it is a federal state. A federal political system – which involves the coexistence of two independent levels of government – is a characteristic Canada shares with a number of countries including the United States, Australia, and Germany. However, Canadian federalism is distinctive in that it is based on a political culture closer to that which exists in the European Community than to that of other federal nation states. In the European Community people see themselves as both European and as members of a nation state, but primarily, as members of a nation state. Canadians also experience dual loyalties, and they typically identify themselves as members of the local community and loyalty to the local state is often stronger than loyalty to the nation.

This characteristic is fundamental. In many federations the local governments exist only because a federal structure provides an effective administrative arrangement to deliver public goods and services within the nation state. In contrast, Canadian federalism is deeply rooted in the Canadian political culture. Most Canadians view their federation as a union, not a nation state, and even after 125 years, regularly question the desirability of membership in the union and discuss alternative forms of union in hopes of increasing the benefits of integration or reducing the costs. The Canadian political culture and the continued questioning of the union institutions makes the Canadian experience particularly relevant to Europeans interested in learning from the experience of other unions.

None the less, Canadians have much stronger loyalty to the country than European's have to the European Community. A recent poll (1990) asked Canadians "Do you feel you are more a citizen of Canada or more a citizen of your province?" Responses varied significantly across the 10 Canadian provinces but overall 49 per cent of Canadians stated that they felt more a citizen of Canada.[1] Thus, despite the critical importance of territorial politics in Canada, the politics of place is likely to be still more important in Europe.

The presence of two distinctive ethnic and linguistic communities within the Canadian union is another important characteristic of the federation. Approximately 25 per cent of Canadians are French speaking and this French speaking population is concentrated in a single province, the Province of Quebec. Because the francophone population in Quebec tends to define itself in nationalist terms and views the local Quebec government as its national government the Canadian union is particularly relevant to Europe (the Quebec legislature is actually called the National Assembly and their head of state is a Prime Minister; in other provinces Provincial Assembly and Premier are the titles used to describe the legislature and head of state). Nationalism introduces special tensions to a union.

Not surprisingly, the Canadian federation is relatively decentralised (especially in comparisons with other mature federations). As Table 1 illustrates both provincial/local government expenditures and employment levels exceed those of the central government. None the less, central government expenditure are in excess of 20 per cent of GDP and about 1 of every 10 Canadians are employed by the central government. Thus, by European standards, the Canadian union must be considered highly centralised.

Figure 1 presents a map of Canada to give a visual picture of Canada and the distribution of population. Like the European Community, Canada is a union of twelve political units. Of these the ten provinces – Newfoundland, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Ontario, Manitoba, Saskatchewan, Alberta and British Columbia – have their own independent governments. The Yukon and the Northwest Territories are not provinces but instead are ultimately subject to the authority of the Central Canadian Government.

[1] 41 per cent of Atlantic Canadians (citizens of the provinces of Newfoundland, Prince Edward Island, Nova Scotia, and New Brunswick) indicated their primary loyalty was to Canada. 33 per cent of Quebecois also expressed this view. 62 per cent of Ontario residents indicated primary loyalty to Canada, as did 50 per cent of Western Canadians (residents of the provinces of Manitoba, Saskatchewan, Alberta, and British Columbia).

Figure 1: Population of Canada By Province (thousands,1991)

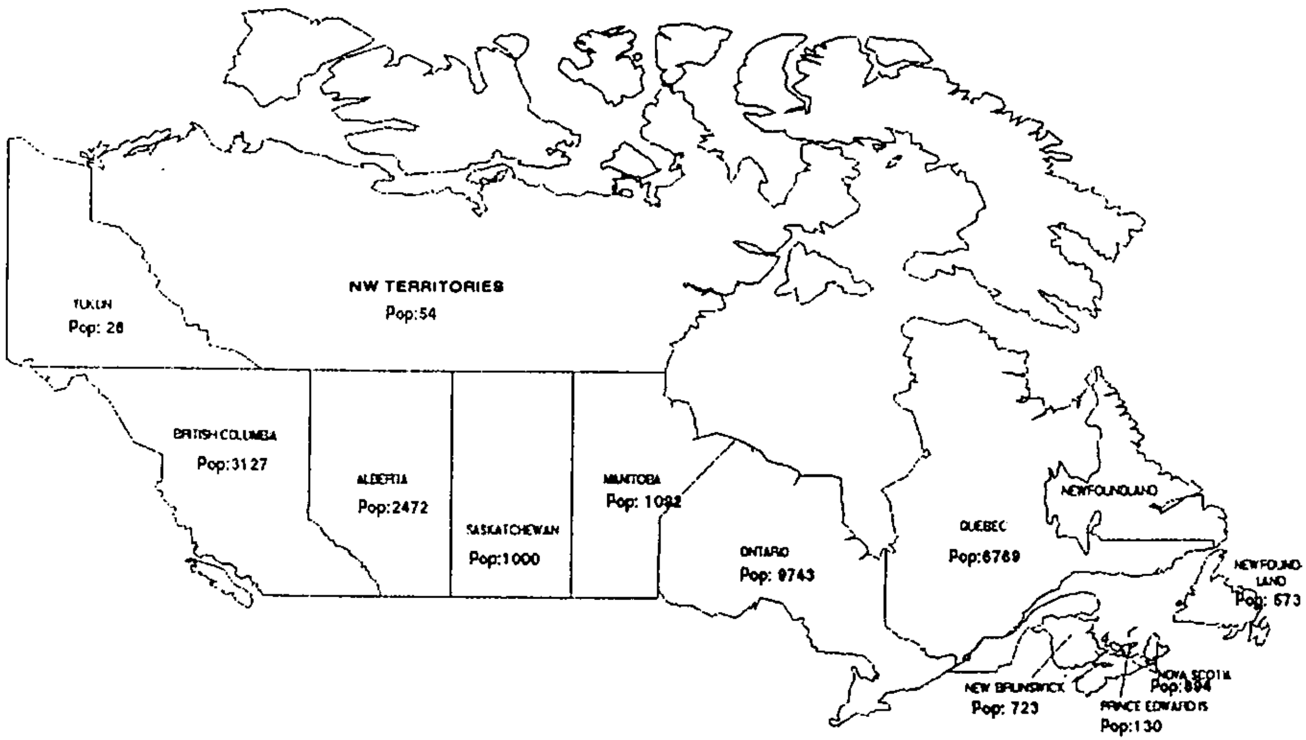


Table 1: *Division of Government Expenditure and Employment 1989-1990*

Level of Government	*Employment*	*Expenditure*
Central	31%	44%
Provincial/Local	69%	56%
Total	100%	100%
Government Employment	1,208,355	
Government Expenditure (% of GDP)		46.5%

Source: Statistics Canada, *Historic Labour Force Statistics* (71-201) and Department of Finance, *Quarterly Economic Review* (1991).

The ten provincial governments are responsible for supplying a broad range of public services, including: roads and highways, the administration of justice, education, health care, tourism, agriculture, natural resource management, industrial development policies, public utilities, and social assistance. In some of these areas responsibility is shared with the national government but in all provincial jurisdiction dominates. The union government in Canada is responsible for national defence, foreign affairs, monetary policy and currency, and a variety of intergovernmental and interpersonal transfer programmes.

Table 2 also presents some general information on Canada and data on the EC for comparisons. It shows that Canada occupies a territory of almost 10 million square kilometres, over four times the size of the EC. But its population is only 26 million, less than 10 per cent of that of the EC and significantly less than many individual EC states. Individual provinces vary significantly in area and population. The smallest, Prince Edward Island, is slightly larger than Luxembourg and has a population of only 125,000. The most populous province, Ontario, has the same population as Belgium.

Tables 3 and 4 present some very general information about the Canadian economy. Table 3 shows that the Canadian union has generated the second highest standard of living in the world (1990, whether measured by GDP per capita or by the United Nations Human Development Index). Canadians also enjoy access to a well developed social welfare system which includes a free and universal health care system, a free and universal primary and secondary education system and comprehensive and relatively generous social security programmes.

Table 2: *Area and Population*

	Area *(000km²)*	*Population* *(millions 1986)*
Newfoundland	405	.568
Prince Edward Island	5	.127
Nova Scotia	55	.873
New Brunswick	73	.710
Quebec	1,540	6.540
Ontario	1,068	9.113
Manitoba	649	1.071
Saskatchewan	652	1.016
Alberta	661	2.375
British Colombia	947	2.889
North West Territories	3,426	.052
Yukon Territory	483	.024
CANADA	*9,970*	*25.3*
Belgium	31	9.9
Denmark	43	5.1
France	549	55.4
West Germany	249	60.9
Greece	132	10.0
Ireland	70	3.6
Italy	301	57.2
Luxembourg	3	0.4
The Netherlands	42	14.6
Portugal	92	10.2
Spain	505	38.5
United Kingdom	244	56.7
EC(12)	*2,261*	*322.5*

Sources: Statistics Canada, *Post Census Annual Estimates; Eurostat*

Table 3: *Measures of Standard of Living, 1990 (World Rankings)*

	Per Capita Real GDP	*United Nations Human Development Index*
United States	1	7
CANADA	2	2
Japan	6	1
Belgium	17	16
Denmark	12	12
France	11	10
West Germany	9	14
Greece	23	22
Ireland	21	21
Italy	15	18
Luxembourg	5	19
The Netherlands	16	8
Portugal	22	23
Spain	20	20
United Kingdom	14	11

Source: Canada (1991) Canadian Federalism and Economic Union.

Table 4: *Economic Performance 1961-1990 (Average Annual Percentage Change)*

	Real GNP or GNP Per Capita	*Employment*
Canada	4.4	2.5
United States	3.1	2.0
Japan	6.5	1.1
Belgium	3.4	0.3
Denmark	2.8	0.6
France	3.7	0.4
West Germany	3.1	0.2
Greece	4.6	0.3
Ireland	3.3	0.2
Italy	3.9	0.2
Luxembourg	3.2	1.2
The Netherlands	3.2	0.6
Portugal	4.6	1.0
Spain	4.6	0.2
United Kingdom	2.5	0.4

Source: Canada (1991) Canadian Federalism and Economic Union.

Other measures of the relative success of the Canadian economy are illustrated in Table 4. Over the past 30 years Canada has enjoyed the seventh highest rate of growth among OECD countries. (Second fastest after Japan among the G-7 countries.) The Canadian economy has also achieved the second fastest rate of employment growth in the OECD over the last 30 years.

Figures 2 and 3 show that the Canadian union has not generated an even pattern of economic development. The four small eastern provinces of Newfoundland, Nova Scotia, Prince Edward Island and New Brunswick are relatively poor and experience the highest levels of unemployment. Ontario and Alberta are relatively rich with low rates of unemployment.

Not surprisingly, the dominate types of economic activities vary significantly as one moves across the country. Newfoundland's economy, once almost completely dependent on the North Atlantic fishery, now includes important natural resource extraction and processing industries. Pulp and paper and fish processing are the main manufacturing industries. Iron ore is most important in the province's substantial mining industry with zinc and asbestos also having some importance. Because of poor soil and an adverse climate agriculture is of minor importance.

On Prince Edward Island agriculture is the most important primary resource industry. Almost 70 per cent of the land is cultivated producing chiefly potatoes with some mixed grains and livestock. Fishing, especially of lobster, is also an important resource industry. Food processing is the chief manufacturing industry.

Nova Scotia's fishery is the largest in the North Atlantic and includes the principal species of lobster, cod, scallop and haddock. About 10 per cent of the land is agricultural which centres on dairy products, livestock and fruit. Coal is the principal mineral produced; gypsum and salt production are also important. Manufacturing is varied and includes food processing, forest products and transport equipment.

In New Brunswick, forest products and food processing are the principal manufacturing industries. Zinc, lead and by-product metals are important in mining. Lobster and crab are the most important species in the provincial fishery. Agriculture is varied, but dairy product and potatoes predominate.

Quebec accounts for about one-quarter of Canadian manufacturing. Textile and clothing industries are most important followed by food processing, pulp and paper, primary metals, chemicals, metal fabricating, wood industries and transportation equipment. Quebec is also a major producer of iron ore, gold and copper and one of the world's leading producers of asbestos. Hydroelectric power exports are extremely important. Dairy products and livestock are the province's most important agricultural products.

Figure 2: Provincial Gross Domestic Product (as % of Canadian Average)

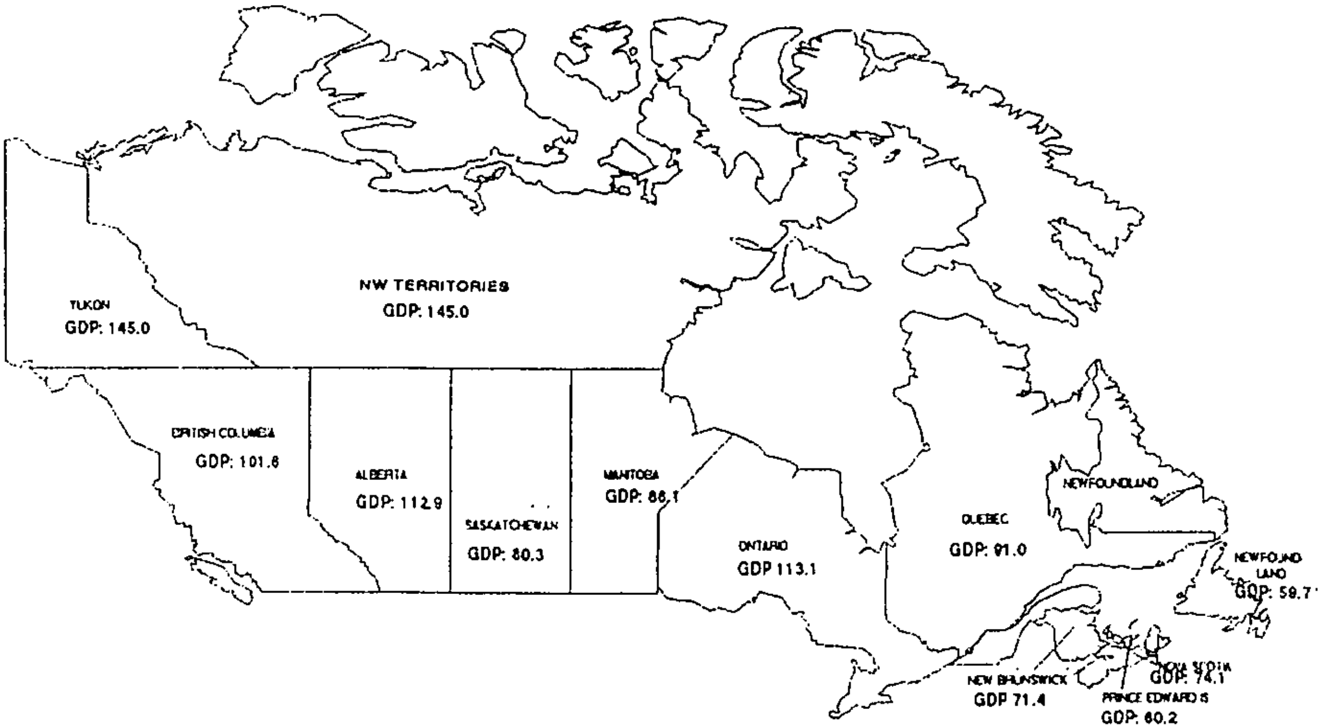
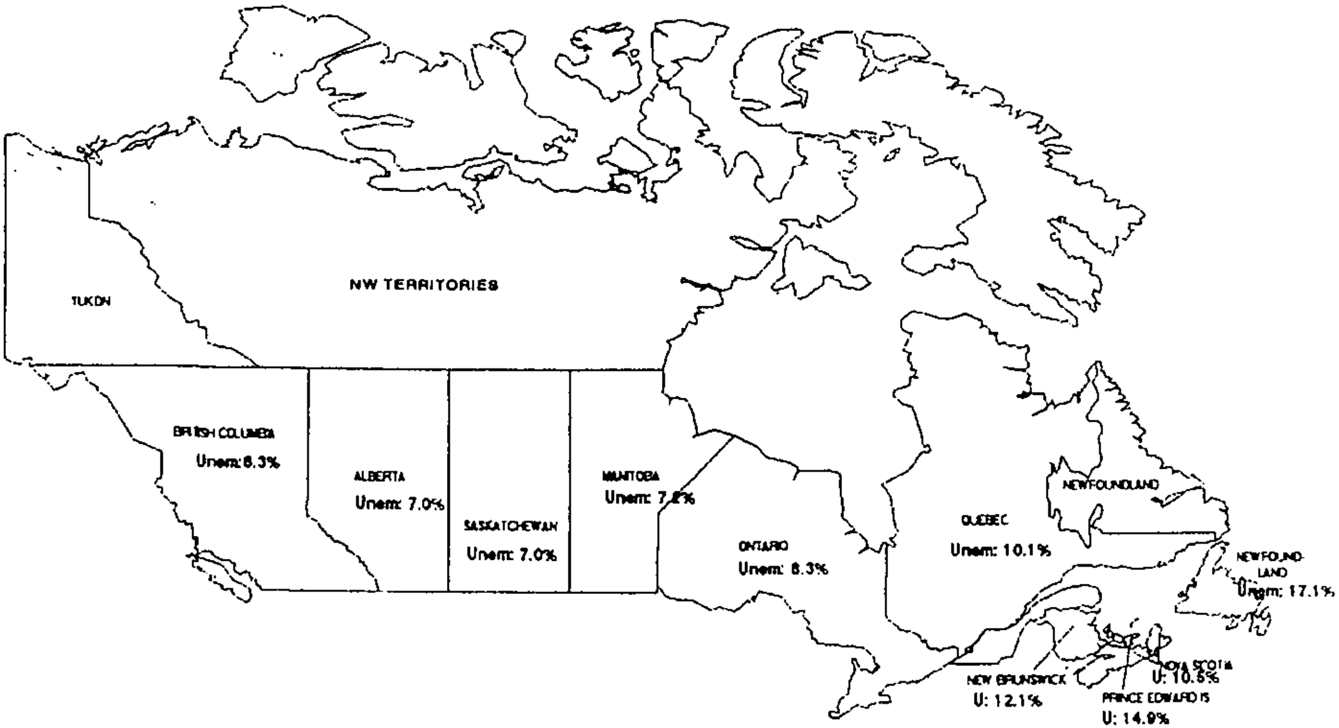


Figure 3: Provincial Unemployment Rates



Ontario accounts for about half of Canadian manufacturing, with transportation equipment being the largest single industry. Other important sectors include food processing, primary metals, metal fabricating, electrical products, chemicals, pulp and paper and printing. Although Ontario ranks second in the value of its total mineral production, it comes first in metals (these include nickel, gold, copper, zinc and uranium). Ontario has the highest agricultural receipts in Canada. Livestock and dairy predominate, but tobacco and vegetables are important cash crops.

Manitoba's economy is built on agriculture. Wheat and other grain crops are most important followed by livestock. The provinces manufacturing is varied, led by food processing and metal fabricating. Mineral production focuses on metals, especially nickel, copper and zinc.

In Saskatchewan agriculture is the leading industry, dominated by wheat and other grains. The important minerals sector includes the non-metals of potash (Saskatchewan is a major world producer) and petroleum and metals (mostly uranium). The varied manufacturing sector is relatively small.

Alberta accounts for about half the value of minerals produced in Canada. Almost all this comes from fuels: oil, natural gas, liquid natural gas and coal. The province also has a strong agricultural sector based on grain and livestock. Alberta has a large and diversified manufacturing sector.

In British Columbia natural resources are the basis of the economy. The forest industry is particularly important both as a primary activity and as the largest component of the provinces manufacturing sector. Lumber is the main forest product, but production of pulp and paper is also important. Food processing and metals are other important manufacturing industries. The provinces extensive minerals sector is dominated by fuels (coal, natural gas and petroleum) and metals (notably copper and molybdenum). Dairy products and cattle are BC's most important agricultural products followed by fruit, vegetables and specialty crops. In the extensive fishery – Canada's largest – salmon makes up over half the landed value. Herring is also important.

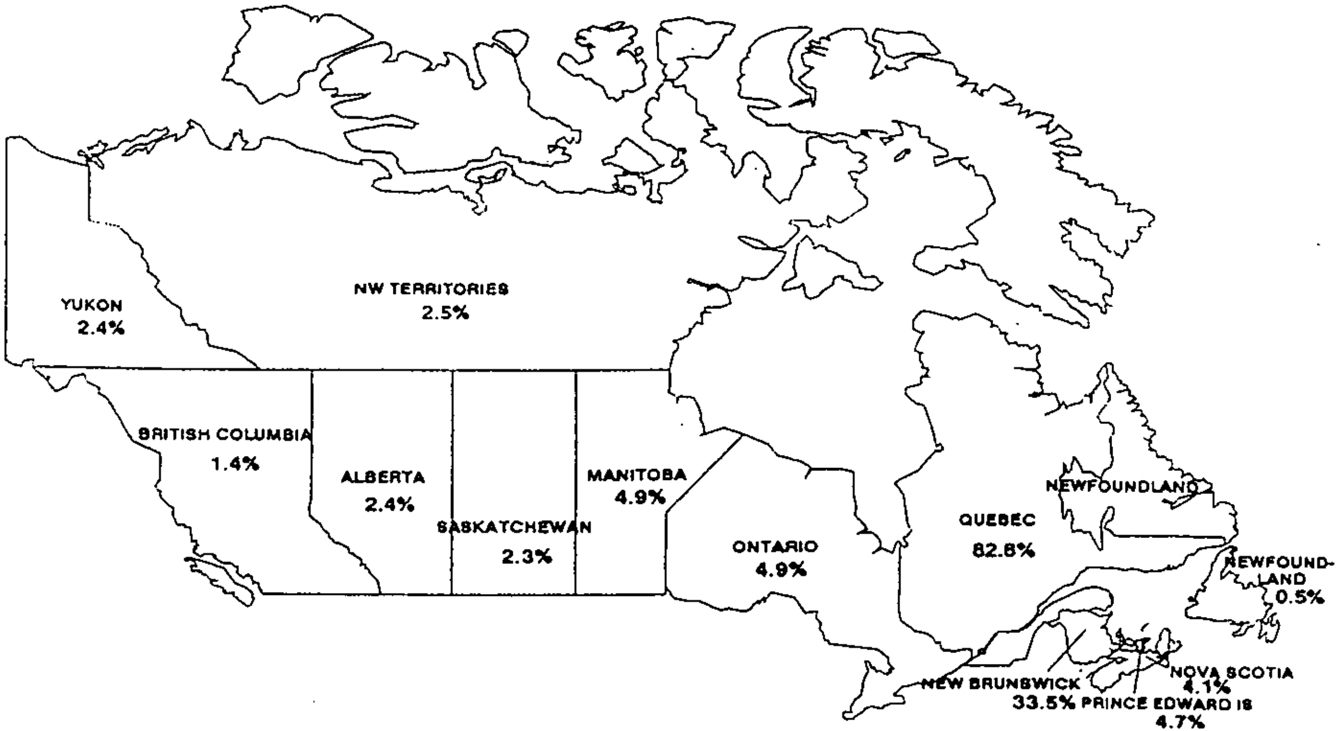
Mining is the chief economic activity in the Yukon with zinc, gold, lead and silver predominating. In the Northwest Territories the mining industry is also large, dominated by zinc, lead and gold. Some oil and gas is also produced. Fur and fishing, mainstays of the native population, are exploited commercially but on a small scale.

The coexistence of strong provincial governments, significant variation in types of economic activities, regional disparities, and ethnic nationalism in Quebec continually challenges the institutions of the Canadian union.

The particular institutions which have evolved in Canada reflect these challenges. Given these challenges also exist in Europe, but in a still stronger form, there is probably much Europeans can learn from the Canadian experience.

Figure 4 provides a final piece of introductory information about Canada: the distribution of population by language.

Figure 4: Distribution of Francophone Canadians (as a % of provincial population)



Chapter 2

INTEGRATION: AN INTRODUCTION TO THE ISSUES

Integration is a complex phenomena and it is possible to identify a wide variety of forces which can potentially generate some form of integration. The approach to integration adopted in this paper is relatively restrictive since our discussion is limited to formal political arrangements consciously chosen to increase integration. It is important, however, to recognise that integration can and does occur without formal treaties or new constitutions. Indeed, a decision not to integrate taken by political leaders rejecting a new treaty does not necessarily halt a movement toward more integrated societies since informal relationships among peoples can be of considerable significance.

None the less, the focus of this paper is on formal relationships among peoples designed to secure integration and our goal in this chapter is to provide a general framework for discussion of these formal arrangements. Two basic premises underlie our discussion of integration. First, integration is not a goal in itself but rather is a means to secure other objectives such as prosperity, peace, liberty, etc. Similarly, sovereignty is not an end in itself but a means to the same ends as integration. Second, the formal integrative arrangements result from a "give and take" negotiation process involving representatives of sovereign peoples trying to act in the interests of the people within the geographically defined region they represent.[2] The representatives will compare the consequences (in terms of prosperity, peace, liberty) of maintaining sovereignty with the consequences of surrendering some sovereignty to a new inclusive level of government. Moreover, the representatives may surrender sovereignty in some areas, even though there are little gains or even loses from doing so, to secure favourable outcomes in other areas.

2 The assumptions adopted here should be controversial. Some people do view sovereignty as an end in itself. Moreover, it is not at all clear that politicians act solely in the interests of the people they represent. They have their own interests which may diverge from those of the broader society. Indeed, it is often argued that local politicians resist political integration because it reduces their role and thus their power and prestige in society.

The fundamental challenge facing representatives of societies considering integration is to identify and assess the costs and benefits associated with different degrees of integration. Rising to this challenge is extremely difficult. In recent years the body of research attempting to identify the costs and benefits associated with different levels of integration has grown dramatically and today our representatives have access to more information about the consequences of integration than ever before. However, much remains unknown. Given the complexity of society and the myriad of ways institutional arrangements governing integration interact with other economic, social, and political phenomena it is almost impossible to predict the consequences of any one institutional arrangement for the evolution of societies over time. Moreover, integration may well involve federal institutions. If so, the local governments will lose some control over the evolution of the union since the new inclusive government institutions will enjoy considerable independence. The future of the union becomes still more unpredictable as a consequence.

The purpose of this section is to review some of the existing research on integration placing special emphasis on the implications of the research findings for relatively small and relatively poor states considering integration issues. The review of the Canadian experience in the following chapter develops the theoretical ideas in the context of a concrete case study and identifies the importance of the unpredictable consequences of the Canadian integration experiment.

Economic Integration

Economic integration can take many forms. The most basic involves the creation of a *free trade area.* This involves the elimination of all import duties and quotas applied to goods from other countries in the free trade area. Each member state is still free to establish its own system of tariffs and quotas to apply on goods from countries outside the union. A *customs union* pushes integration one step further by establishing a common tariff structure for goods from outside the union. Integration is pushed further still in a *common market* where labour and capital can move freely within the union.

It is possible to integrate even more economic functions. Since national policies which regulate market activity can also distort the pattern of trade a union may decide to co-ordinate, or even unify regulatory policies. The result would be *economic union.* If members also decided to adopt common monetary policies and/or a common currency there would be *monetary union.*

As a union moves to higher and higher levels of integration member states must experience a loss of sovereignty. In a free trade area national governments lose their ability to set tariffs and quotas on goods from other countries within the union; in a customs union the nation state can not independently choose its own tariff schedule; etc. With full economic and monetary union the citizens of the individual member states have virtually no room to independently establish their own system of economic policies.

The debates which surrounded the process of European integration between 1957 and 1992 provoked a substantial body of research on the cost and benefits of a common market, economic and monetary union (broadly defined to include the elimination of tariff and non-tariff barriers, harmonisation of regulations, and the introduction of a common currency) and much is now known about the costs and benefits which flow from this type of integration. The results of this research are relatively familiar and little will be added here. (See Bradley, *et. al.*, 1986; Padoa – Schioppa, 1987; NESC, 1989; and Foley and Mulreany, 1990; for reviews which pay particular attention to the costs and benefits of economic and monetary integration for poorer regions and countries.)

In general the research suggests that economic and monetary integration offers significant aggregate gains. Consequently, the lost sovereignty may be a price worth paying. However, the research also concludes that the regional distribution of these aggregate gains is unpredictable a priori. Unfortunately for the poorer, peripheral regions there are strong, but not necessarily insurmountable, forces at work which tend to result in a concentration of economic activity in already successful and affluent regions.[3] Since economic and monetary integration seriously constrains the choice of policy instruments available in the poor peripheral regions to counter these forces there are very real risks associated with integration.

3 There are, at the same time, forces which work in the opposite direction. Low wage rates in the periphery can result in the spread of economic activity rather than concentration. Integrated capital markets can generate lower interest rates in the periphery and increase the level of capital accumulation. The exploitation of potential scale economies, specialisation according to comparative advantage, etc. can provide real gains in the periphery, as can lower prices for imports and the resulting increase in demand for domestic goods (through the higher real incomes which result from lower import prices). Unfortunately, it is impossible to determine theoretically which tendency dominates and reviews of historical experiences provide no basis for unambiguous conclusions.

However, research also shows that many policies traditionally used to protect peripheral economies (tariffs and other trade barriers, expansionary monetary policy (low interest and exchange rates),etc.) have their own costs and benefits. Indeed, the costs of protection for the peripheral countries may be quite high. Moreover, as product diversity increases, as transport and communication costs fall, and as new technologies are adopted in the more affluent core regions the peripheral regions will find it increasingly difficult and costly to use protectionist measures to counter any centralising tendencies inherent in a market economy. Thus, many of the policy instruments surrendered under a formal integration agreement may not be real policy options for small, peripheral regions at all.

The failure of the theoretical work to generate unambiguous conclusions on the benefits and costs of economic and monetary union has left the representatives of the people in small, peripheral states in a position where their decisions about the appropriate degree of integration must be based on a "leap of faith".[4] Whether or not "faith" in a particular belief is justified will only be revealed over time.

Public Goods

Sovereign states can also agree to transfer responsibility for supplying some public goods and services to an inclusive level of government. A large literature has emerged under the general heading of fiscal federalism to deal with this type of integration. This literature notes that some goods and services involve significant economies of scale in consumption (one individual's consumption of the good or service – say the freedom from oppression by other countries provided by the existence of a system of national defence – does not reduce the amount of the good or service available for others to consume) and that centralised provision can generate considerable savings to all. As the number of individuals consuming a given amount of the public good or service rises the cost per person falls. Significantly, the smaller the population of a sovereign state providing a public good the larger the potential gains from integration. Thus, small, peripheral countries may secure significant benefits from political integration.

4 The expression "leap of faith" was widely used in political debate in Canada over a free trade agreement with the United States. Because the consequences of a particular policy choice can not be known with certainty there is always some "leap of faith" required when choosing a policy. The "leaps of faith" made by pro and anti free traders in small countries are particularly large.

However, the fiscal federalism literature also notes that preferences may differ across states and that centralised provision may result in types and levels of public good provision which are not at all attractive to the residents of some regions. Indeed, the reduction in the tax cost per person which results from centralised provision may not offset losses which result because the policy package is no longer tailored to meet the individual preferences of residents of each of the original states but instead is designed as a compromise to satisfy the demands of the inclusive community. Small peripheral regions with distinctive preferences are especially vulnerable to losses since the preferences of the larger states are likely to dominate in the process of policy choice.

Thus, the literature concludes that political integration is desirable in areas where there are economies of scale in consumption or production and preferences in the small peripheral regions are almost identical to those of other members of the new inclusive polity. Moreover, if these conditions are met integration offers large benefits to the small region. If, on the other hand, there are few scale economies and preferences vary, political integration is not attractive.

The fiscal federalism literature also notes that a phenomena known as spill overs or externalities can provide a rationale for integration. If developments in one state (pollution; emerging research on solar energy, health, or some other field; the in-migration of substantial numbers of university educated citizens of other countries; fiscal and regulatory policies; etc.) have significant repercussions for people in another state, the affected non-residents may want to influence those developments. Of course, international negotiations are a possible response to this type of interdependency. However, negotiations may fail to generate an optimal solution and centralised action, if preferences are relatively homogeneous, may be preferred.

Again, the theoretical literature fails to provide unambiguous policy prescriptions. Representatives of the people of small and relatively poor sovereign states must consider each publicly supplied good and service individually. Economies of scale in consumption and/or production must be identified for each good and the degree of homogeneity of preferences, both current and future, must be assessed. Ultimately, the decision on integration to supply public goods and services, like the decision on economic and monetary union, must be based on a degree of "faith".

Social Insurance

The centralised provision of an actuarially fair social insurance scheme – whether insuring against the risk of unemployment, incurring medical expenses, living beyond retirement age, etc. – can generate gains since the cost of risk falls as risk is spread over a larger and larger group. Although the gains are enjoyed by both large and small uniting states the small states enjoy the larger relative gain.

However, social insurance schemes are rarely designed to be actuarially fair. If they were, those most likely to be unemployed, those most likely to need medical treatment, and those most likely to live a long time would pay the highest premiums. But, since these people are also more likely to be poor the typical social insurance schemes abandon actuarial principles and explicitly incorporate some redistribution. Centralisation of insurance schemes may not be attractive to the large, relatively affluent regions in this case since the gains from risk spreading are small and the cost of redistribution could be quite large.

On the other hand, it should be obvious that small and relatively poor countries can gain from centralised social insurance schemes. However, centralisation also involves a reduction in the ability of small and relatively poor states to design insurance to reflect local values and economic conditions. This can be a serious problem if the centralised scheme generates economic outcomes (higher wages, increased seasonal employment, etc.) which inhibit economic growth or offset local development policy.

Redistribution of Income

There are a number of reasons why centralised income redistribution might be considered. The peoples uniting to form a larger community may, through altruism or a commitment to a common set of egalitarian principles, want to create a society which overrides the market distribution of incomes when the market generates too much inequality. The appropriate policies in this case would involve redistribution from rich to poor persons. Place of residence would not be a crucial factor in the policies although redistribution could be effected through a relatively standardised progressive tax system, intergovernmental transfers to member states with populations that are relatively poor, and reasonably harmonised state level income distribution schemes.

However, this case for centralised income redistribution is probably based on unrealistic assumptions about altruism and the level of commitment to egalitarian principles. Why would states uniting to form a federation or the nations uniting in the European Community choose to delegate some responsibility for the pursuit of equity to the central level of government? It is generally agreed that the pursuit of equity has real costs and that these real costs are a major factor in the continued inequity. But if this is true why would richer member states agree to assume more responsibility for equity outside their borders when they already find the pursuit of equity too expensive at home? To be sure, it is possible that egalitarian ideals may be strong and the peoples of the richer states may be willing to make transfers because the beneficiaries of the pursuit of equity are poorer in the poor member states than the poor in the richer member states.[5] However, this possibility simply begs a further question: Why would the richer state not devote resources to improve the standards of living in the very poor countries of Africa and South East Asia rather than assist the much more affluent but relatively poor regions of a federation or the Community? Clearly, equity considerations alone are unlikely to generate agreement to centralise the redistribution function.

Another commonly advanced argument for centralised redistribution is based on the economic theory of migration. If integration involves free mobility within a federation or common market, richer member states may find it impossible to restrict their pursuit of egalitarian objectives to their original citizens. A generous redistribution programme within a rich member state of a federation will induce immigration. Consequently, the individual migration decisions of people outside the richer state will result in the richer state assuming some responsibility for the well-being of people within the inclusive community but originally outside the richer state. In this situation it can be efficient for the central government to assume at least some responsibility for equity.[6] Differences in the net fiscal benefits of government activity[7] and/or congestion costs [8] also give rise to

5 A number of philosophical frameworks often used to discuss equity, such as utilitarianism, Rawl's Theory of Justice, Roman Catholic social teaching, etc., suggest that the poorest of the poor should receive priority.

6 There are a number of papers in the literature which deal with the problem of assigning jurisdiction over redistribution. See for example: Musgrave (1969), Oates (1972) and Wildasin (1990).

7 If people of the poor region see that they can obtain more public services for the same tax bill or the same services for a lower tax bill they may move in response even when their market income is the same in both regions. Under conditions of diminishing marginal productivity this migration results in lower total (both regions) output and lower market incomes in the rich region. See: Boadway and Flatters (1982) for a full treatment.

8 Congestion costs are defined to include the costs associated with increased environmental pollution, increased travel times, reduced attractiveness of public amenities, increased crime, etc. which tend to arise as population grows. The individual migrant does not take into account that his or her decision to move imposes these costs on existing residents in the receiving region. This externality generates the inefficiency.

similar externalities which generate an inefficient allocation of resources under condition of free mobility. Redistributive activity across states is desirable if the cost of bribing people not to move is less than the cost (in higher taxes, lower productivity, congestion, etc.) incurred by residents of the richer state when the migrants move. The appropriate policy is the least cost method of bribing people to remain where they are. If the population is not very mobile across borders (the cost of migration will be an especially important impediment to mobility when there is significant variation in culture and language) or, if there are increasing returns to scale, these efficiency arguments for cross regional distribution lose much of their force.

Regional Development Policy

There are a number of reasons why centralisation of some aspects of regional development policy may be desirable. First, since economic and monetary union imposes serious constraints on the set of policy instruments available to the relatively poor states uniting in an economic and monetary union these states may not be willing to join the union. But this decision can harm the more affluent regions. Consequently, they may consider centralised regional policy a price worth paying to secure the larger union.

There are a variety of costs incurred in the core region when protection in the periphery reduces the market size available to the central, affluent regions. For example, there will be a welfare loss in the centre because of higher prices (some potential economies of scale are unexploited) and less product diversity in the centre than would be the case in an integrated environment. Thus, it may be in the interests of both centre and peripheral regions to establish a union which gives a new inclusive level of government some responsibility for policy intended to protect peripheral regions.

A related argument for centralised regional development policy focuses on the need to harmonise regional development policy in an economic and monetary union. Competition for "foot loose" firms can result in a significant transfer of income from the general public to the owners of these firms without generating significant changes in the choice of location of these firms. Centralised provision, by eliminating this inefficient competition, can generate gains for all. Moreover, because richer states have a large revenue base they are in a better position to gain the advantage in the competition for "foot loose" firms. Thus, the geographical distribution of industry may be distorted in favour of the richer regions and aggregate incomes will be lower as a result.

A third case arises from theory in regional economics. According to some regional economists efficient resource allocation in any economic community requires a relatively harmonious pattern of development across space.[9] According to this view regional development policy is necessary in any community and this policy, "far from redistributing income in favour of retarded regions at the expense of reduced efficiency of the national [Community] economy, can increase the efficiency of both the regional and the national economies" (Higgins,1989). For example, policies aimed at stimulating lagging regions may reduce inflationary pressures by taking pressure off overheated labour markets in rich regions.

None the less, if regional policy involves losses in richer regions (which is possible even when regional policy contributes to overall efficiency) there is likely to be considerable resistance to initiatives aiding poor regions in the more affluent regions. Moreover, this resistance is likely to act as a serious constraint on centralised regional policy initiatives especially during periods when the more affluent regions are experiencing economic problems of their own. Consequently, it is probably dangerous for small, poor regions to allow complete control of regional policy to fall into the hands of a central authority.

Societal Cohesion Policy

Societal cohesion policy is one of the central concerns of this paper. Consequently, it is extremely important to clearly explain how societal cohesion policy is defined in this paper, especially given that the European Community uses the term cohesion in a way very different from the way it is used here. The European Community equates social cohesion and convergence with regional convergence in living standards, employment prospects, and unemployment rates and hence tends to equate cohesion policy and regional development policy. In contrast, in this paper a cohesion policy is defined as any policy designed to counter pressures which threaten the union. To avoid confusion this paper uses the term *societal cohesion* to refer to the problem of keeping a union together.

Unfortunately, societal cohesion has generally been neglected in the research literature even though, as will become evident in our review of the Canadian experience, it is extremely important in any union involving

9 See Boadway and Flatters (1981) and Boadway and Wildasin (1990) for the neo-classical – Paretian welfare economics case for regional policy. An alternative approach – based on a rejection of both neo-classical theory and Paretian welfare economics – is used by Higgins (1989) to build a national efficiency case for regional policy.

distinct national groups. Given the importance of societal cohesion and the absence of any explicit discussion of societal cohesion in the literature a very general theoretical discussion of societal cohesion must be offered here.

Societal cohesion exists when an economic, monetary, and/or political union prevails. This social state does not necessarily arise in a *laissez – faire* world and a set of social institutions and policies initiatives *may be* required to assure this social state prevails.

A social state where societal cohesion prevails can be viewed as a public good. Once societal cohesion exists all can potentially enjoy the benefits without affecting anyone else's enjoyment and no one can be excluded from the benefits. But what are the benefits? First, there is the surplus created by social union, whether economic and/or political. Social cohesion may well be a necessary, but certainly not a sufficient, condition for the realisation of gains from the economic and political union for reasons discussed below. Second, there is the gain, a significant part of which is passed on to future generations, arising because exchange, gifts, and the rule of law govern relationships among regions not war and conflict. Both of these benefits are significant and some investment in societal cohesion is probably warranted.

It is, however, important to recognise the first type of benefit is very different from the second. At first glance the gains from economic, monetary and/or political union do not appear to have the characteristics of a pure public good. There will be winners and losers (at the individual level and probably at the regional level), consequently any gains appear rival and exclusive. However, on closer inspection social cohesion does emerge as a public good.

There are four considerations which underlie the position on cohesion as a public good advanced in this paper. First, realisation of the gains from union which arise from exploiting comparative advantage, economies of scale, reduced transactions costs, etc. requires costly economic restructuring. Freeing trade will change relative prices which in turn will generate a reallocation of resources. Second, the act of union is reversible. Individual states can, if they so choose, leave the union. Third, investment in restructuring will depend on beliefs about the sustainability of the union. Individuals will not be willing to invest in restructuring to produce the potential gains from union if they believe the union is fragile. The more confident individuals are in the future of the union, the greater the investment in restructuring, and the greater the aggregate gains. Fourth, a breakdown of an economic, monetary, or political union will necessarily result in costly restructuring. In combination these considerations suggest that the gains from union are tied to the sustainability of the union. When international economists argue that economic, monetary, and/or political union produces gains they implicitly assume that the union is irreversible. Once allowance is made for reversibility sustainability (cohesion) becomes a critical factor.[10] The so called "gains from trade" are actually gains from politically sustainable union.[11]

Further insight into the problem of sustainability can be gained by thinking about a specific example. Specifically, consider an agreement which establishes free trade between states. Presumably, the treaty is struck because each of the uniting countries believe that their people will gain. However, because gains are realised in the future they do not know if their people will gain with certainty.[12] Given this uncertainty some form of insurance is demanded. Typically insurance is provided in an opt out clause. If things do not turn out as expected the state can withdraw from the union. Clearly, if the agreement was permanently binding there would be no sustainability problem. But, because widely accepted principles of state sovereignty constrain the arrangements incorporated in the treaty, states will always enjoy this form of insurance.

When is union sustainable? If all individuals entering the union *always* perceive that they are better off as members of the union than they are when they are outside the union then the union is sustainable. But, if the union does result in losers or if some members perceive they are losers

10 Indeed, as Krugman (1987) notes the new trade theory with its emphasis on scale economies and market power suggests that free trade "probably involves less conflict within countries and more conflict between countries than conventional trade" based solely on comparative advantage. Thus, the problem of sustainability is likely to be more serious given the nature of trade in the current era.

11 The emphasis on sustainability in this paper reflects the Canadian experience where cohesion has been a perennial concern. European unity has not been threatened in the way Canadian unity has been. However, as Padoa-Schioppa (1987) notes "the threat of secession, while happily not on the horizon in the Community at the present time cannot be dismissed".

12 Traditional trade theory suggests that all uniting countries gain from freeing trade. However, international economists working with the traditional theory have probably underestimated the importance of the uncertainty associated with the gains from trade. Recent theoretical work – which incorporates imperfect competition and economies of scale – has shown that some countries can emerge as net losers when trade is freed. (See, for example: Krugman, 1987) Moreover, "history is replete with examples of regional conflicts" which emerge as a result of integration . (See Padoa-Schippoa, 1987, pp.21-25.)

then the union *may* not be sustainable. For example, if the losers are concentrated within a particular country a majority in that country may decide that it is in their interest to withdraw from the union. Indeed, there maybe pressures on the union even if a majority in every member country gains from the union. This possibility is suggested in recent work on rent seeking behaviour which predicts that national governments will attempt to protect the losers (perhaps by withdrawing from the union) if there are large number of winners whose winnings are relatively small and a small number of losers whose losses are relatively large. Of course, this is precisely the type of situation one encounters during a move to monetary and economic union. Consumers gain with lower prices thanks to more efficient production, exploitation of economies of scale, and lower transaction costs. But, some workers and capitalists lose their source of livelihood when operations close. If the economic union disintegrates as a result of rent seeking the aggregate gains from union disappear and new adjustment costs will be incurred. Moreover, if individuals within the union are concerned about sustainability investment in restructuring will be lower and the gains from union will be smaller than they otherwise would have been. Thus, concerns about the sustainability of the union can reduce the potential gains from union which in turn can reduce commitment to the union.

Clearly, the type of insurance provided by the opt out clause is unlikely to be efficient. Not only does the opt out clause potentially reduce investment in restructuring to a level below that required to realise all potential gains from union but also an individual state's decision to withdraw from the union will impose costs on other states since some of the original gains from union enjoyed by states remaining will disappear and since additional restructuring costs will have to be incurred. The state that is withdrawing will not take these external costs into account. As a consequence some type of "second best" arrangement may be desirable to assure cohesion.

It is also important to note that the potential threat to union is particularly strong when the union involves groups which define themselves in nationalist terms. Although nationalism can have positive consequences in some areas it is unlikely to make sustaining union easier. Indeed, "nationalist" ideologies typically blame domestic problems on other nations. Consequently, unions involving distinct national groups may be threatened because the union is blamed for domestic problems even though the union was not in any way responsible for those problems.

The purpose of the societal cohesion policies implied by this theoretical framework is to assure, as much as possible, that the economic community of states or nations remains together. A wide variety of policies can potentially contribute to this objective. These can be grouped under three general headings (these groups are not mutually exclusive): (1) the use of institutional arrangements which minimise conflict; (2) citizenship policies designed to foster a sense of citizenship in the inclusive community; [13] and (3) redistributive policies designed to "compensate" the losers. [14] The purpose of each group of policies is to establish a political environment in which discontent does not manifest itself in movements which threaten unity. Moreover, there are a wide variety of policy instruments (including the centralised provision of public goods and services, centralised income redistribution, centralised regional policy, and centralised social insurance schemes) which fall under each of these general categories.

The most important institutional arrangement used to minimise conflict arises from the application of the federal or subsidiarity principle. If a union involves diverse groups with unique preferences the legislative powers of the inclusive level of government should be limited to areas where there is little possibility of conflict. However, it is not possible to have a union without some type of centralised institution which is vulnerable to conflict. The challenge of assignment is to weight the benefits of centralised jurisdiction against the potential for conflict over centralised policies in the particular legislative area being discussed. Moreover, it is necessary to keep in mind that conflict can result in the complete breakdown of the union thereby eliminating all gains from integration not just the gains from centralisation in the legislative area being examined. Unfortunately, we have seen that there are no mechanical rules one can apply to determine the optimal assignment of jurisdiction.[15]

13 Many redistributive policies pursued by the inclusive level of government probably fall within both groups 2 and 3. Policies which are not explicitly redistributive, such as policies encouraging educational and cultural exchanges, new curriculum with more "union content", and the like fall exclusively under group 2.

14 It is important to recognise that a plethora of difficulties arise when considering "compensation". It is well beyond the scope of this paper to discuss the difficulties here. Those interested in these difficulties should consult the extensive literatures dealing with the new welfare economics, the welfare cost of redistribution, and moral hazard.

15 There is a very,very large literature on the assignment of legislative jurisdiction. Breton and Scott (1978) is a very good introduction to the subject.

Citizenship policies involve fostering a sense of citizenship in the inclusive community. Under conventional free trade agreements the people uniting to form the economic community are linked together only through market exchanges. Citizenship policies introduce other social bonds between the uniting peoples and strengthen the individuals identification with the inclusive polity. A wide variety of policies can do this including the introduction of a common set of democratic rights for all members of the inclusive polity, the use of symbols (such as the European community flag), education policies which increase knowledge about other peoples in the union, and cultural exchanges. Citizenship policies might also include the introduction of social rights and an inclusive welfare state.

Compensatory policies, the final category, involve discretionary intervention to compensate the losers to assure unity. Regional policy designed to facilitate adjustment, income transfers designed to insure against losses which result from union, and intergovernmental transfers implemented to assure states can maintain public services are specific examples of compensatory policies. The European Commission currently favours this approach as is evident in the following quotation: "Smaller countries, in particular those having recently joined the Community with relatively protected economic structures, have proportionately the biggest opportunities for gain from market integration. In any case, *instruments exist to provide an insurance policy to help losers recover* (my italics). (The Commission of the European Communities,1988a)."

At present there is no general theory or body of empirical evidence to guide policymakers attempting to choose the best combination of policies to assure cohesion. The review of the Canadian experience in this paper attempts to focus attention on the significance of cohesion by identifying the types of policies implemented to achieve cohesion in Canada and by highlighting some of the Canadian successes and failures.

There is, however, one significant theoretical lesson which emerges from the theoretical framework outlined in this section. If the basic theory of fiscal federalism developed in economics is at all insightful one must conclude that the inclusive level of government has a critical role to play in providing the public good, societal cohesion. The gains from cohesion spill over national boundaries. Indeed, if the arguments about cohesion advanced here are accepted, there is a strong a priori case for a federal system of government, where the inclusive level has the independence to pursue policies which might counter the policies which threaten disintegration even though these were chosen by a sovereign member state. Although the inclusive level of government is also vulnerable to rent seeking, it is relatively certain that the inclusive level of government will not pursue policies which result in the breakdown of the union.

But this said, it is important to recognise a complication. Societal cohesion is not a light house or an army which can be produced by bringing together labour, capital, natural resources, and current technical knowledge. Instead it is a social state where the economic and monetary union is intact and people are solving disputes peacefully. Creating this state of the world through policy is difficult, perhaps even impossible. Moreover, even if policy did create the desired societal cohesion it would be impossible to establish this fact using empirical techniques used by social scientists. As a consequence, it will be impossible to convince those who are sceptical about the prospects for "social engineering" societal cohesion that it is worth talking about. None the less,the history of Canadian federalism illustrates that policies designed to deliver societal cohesion play a critical role in an economic and monetary union involving diverse communities and this paper is based on the premise that much can be learned about the delivery of social cohesion via a study of the Canadian experience.

It is also extremely important to emphasise the precarious balance any successful policy package designed to assure cohesion must achieve. Successful cohesion policies must balance the interests of both winners and losers produced by union; cohesion policies are not just about the losers. The current problems in a number of federal states (Canada, India, Belgium, Nigeria) originate in the richer member states (Alberta, Punjab, Wallonia, Biafra) who feel that they would be better off outside the union due, in part, to relatively high implicit transfers to poorer member states.[16] Actually achieving the balance necessary for a successful cohesive policy is extremely difficult as the following discussion of the Canadian experience indicates.

Taxation

There are many potential gains from harmonising and centralising tax systems, especially in corporate tax area where capital movements are quite sensitive to differences in tax regimes. A centralised tax collection system can reduce administrative costs and improve collection by exploiting economies of scale and supporting more specialised support services. A centralised tax collection system can reduce compliance costs by allowing tax payers to deal with a single tax form and a single bureaucracy no matter where they live. This is especially important for corporations

16 This problem is not restricted to federal states as the recent rise in Scottish nationalism within the UK illustrates.

operating in more than one member state. Economic efficiency may be increased since differences in tax regimes and tax induced distortions in the spatial pattern of economic activity are reduced. Moreover, the centralised tax system can enhance equity if that is a goal.

The centralisation of taxation can take many forms. One model is to assign responsibility for taxation of a specific base to the central authority. In this model the central authority may end up with more or less tax power than needed to finance its assigned responsibilities. A system of intergovernmental transfers which either redistributes some of the collected revenue back to the member states or redistributes funds from the member states to the central authority will be needed if tax powers and expenditure responsibilities are not congruent. Another model simply involves the creation of a centralised tax collection authority which collects taxes and distributes the taxes collected in a member state back to that member state. Still another model involves a harmonised system but with decentralised collection. Moreover, many hybrid approaches also exist. Each offers at least some of the benefits noted above.

On the other hand, centralisation is not without costs. Because local governments lose some control over taxation with centralisation they are unable to design the tax system in response to local needs and values. Tax expenditures are a very important policy instrument, consequently the cost could be quite high.[17] The traditional democratic rule of accountability, which states that the government that spends the funds should be responsible for raising them, can also be violated. However, it is difficult to see why this goal should be interpreted as an inviolable axiom in the design of a good tax system. It is also sometimes argued that decentralised tax systems encourage desirable tax competition. According to this view, governments spend too much and tax competition acts as a constraint on spending growth.

Any evaluation of the costs and benefits of centralised taxation must also take into account the dynamic effect of the assignment of tax power. If the central authority is given access to an income elastic tax base it will undoubtedly face pressure to expand its role in society. This growth of the central authority will result in a redistribution of income from rich to poor regions contributing to the cohesion of the union. But, it may also

17 Many economists question the desirability of tax expenditures. If tax expenditures are primarily hidden redistributive transfers implemented in response to "rent seeking" the average citizen, although not necessarily local politicians, will experience a gain not a loss if centralisation reduces tax expenditures.

generate conflict if member states find that the central authority is encroaching on their areas of responsibility or transferring too much money out of their region.

Protecting Sovereignty in Federal and Integrated Systems

One of the central concerns which emerged in the discussions of the various forms of integration in this paper was the loss of local sovereignty which necessarily results with integration. This concern is particularly acute in the case of small member states where local preferences are distinctive. People in these states often assume that centralisation will involve the tyranny of the majority over the minority.

The institutional arrangement which provides the most protection for member state sovereignty involves a confederal system with member state veto power over all union initiatives. Under a *confederal system* decisions are made by negotiation among member states and any central institutions are funded by contributions from the member states. Confederalism assures no policy is implemented without unanimity. However, this arrangement is very inflexible and potentially divisive. Indeed, the costs of this arrangement are so high few existing unions include provision for unlimited state veto over union policy. Typically, veto power is restricted to a limited set of major constitutional or treaty changes and most policy initiatives are governed by some type of institutional arrangement which gives some role to majority voting or a federal system of government.

The institutional arrangement which offers the least protection for local government sovereignty involves a *federal* political structure. Under a federal constitution legislative responsibilities are clearly divided among the inclusive and state governments. The different governments are completely independent and are free to implement what ever policies they want in their own legislative sphere. All governments have the ability to raise their own revenue. As a consequence, decisions of the central government are not subject to the approval of state legislatures and the population of small states may be subject to the tyranny of the majority over the minority.

However, it is important to recognise that local government sovereignty and simple majority/minority arguments against federalism have little support in democratic theory. Ultimately, democracy is a system of government which gives the individual power to have some influence over the collective decisions which shape the individuals well being. Local government sovereignty does not guarantee that individuals have the power to shape their own destiny. Indeed, local government sovereignty may well reduce the political power of individual citizens, especially if many important decisions are made in a confederal system of state negotiation and individual citizens have little means to directly express their preferences about union policies.

Also, recent theoretical work on public sector decision making suggests that a federal system empowers the average citizen by simultaneously establishing a system of checks and balances and competitive governments. The "checks and balances" and governmental competition protect people residing in small distinctive regions from the tyranny of the majority in the union by empowering local governments to make decisions in the interest of the local population while also protecting minority groups within the region from the tyranny of the majority within that region. The minority within the small state will at least have the ability to "voice" its preferences to two different levels of government and the inclusive government may well protect the interests of the minority group. This "check" on the power of the local majority can be an extremely important and desirable feature of federal institutions. Although the member state government may lose sovereignty under federalism individual citizens of that state (especially minority groups) may actually be empowered by federal institutions.

In addition, even though the central authority is constitutionally autonomous there are a number of practical protections for the interests of residents of small states built into a federal system. First, the residents of small regions will have elected representatives who will advance their interests. These regional representatives may have much more power than their numbers seem to warrant since their influence is exerted at the margin, especially if the governing party holds only a slim majority (or a minority). Second, the citizens of small states will often have similar interests to other constituencies in the broader community and coalitions can emerge which are potentially powerful. Third, all representatives within inclusive level of government will tend to take a more wholistic view of the community than the public at large. In Canada, even the most regionally motivated politicians adopt a national perspective after serving in the central parliament. Fourth, the interests of small states can be advanced through "log-rolling" (securing support for initiatives advantageous to one's own constituents by offering to support legislation in the interests of other groups).

Interests of small states can also be protected through intergovernmental negotiation, challenges to the legality of central actions, and the use of the veto in discussions of constitutional change. Moreover, the existence of a regionally based institution, such as the Senate in the United States, can provide still more protection. As a last resort, the local government can always take policy actions to counter policies of the central authority. To be sure, these safeguards can not guarantee the protection of minority interests.[18] However, they do provide much more protection than typically allowed in many discussions of integration.

18 The concern with the tyranny of the majority over the minority has dominated discussions of federalism since the publication of The Federalist Papers by Madison, Hamilton, and Jay (1770). Recent theoretical work in economics and political science has formalised many of the arguments advanced by Madison, Hamilton, and Jay and adopted in the federal constitution of the United States. (See Ostrum, 1978; and Breton and Scott, 1978.)

Chapter 3

THE CANADIAN EXPERIMENT

The history of the Canadian federal union, which has lasted over 125 years, provides the basis for an interesting case study in integration. Like the history of any community, Canadian history has been shaped by a set of unique factors. These include: a relatively recent settlement by largely European migrants, a legacy of British colonial rule, and a unique combination of cultural, linguistic, and economic diversity. As a consequence, the Canadian experience may seem far removed from the current concerns of Ireland and the European Community. However, much of the Canadian experience has been influenced by factors which are not unique to Canada. Indeed, the two most important challenges to Canadian integration will be familiar to anyone who has seriously thought about the future of the European Community. Moreover, many of the policies adopted to secure integration in Canada have surfaced at some point in academic debate over the future of Europe.

One of the important challenges to Canadian integration can be traced to the regional dimensions of Canada's cultural, linguistic, and economic diversity. The peoples in each of the Canadian states have a remarkably strong sense of regional identity. Indeed, even after 125 years, many Canadians lack a strong sense of national identity. This is particularly true in the Province of Quebec which is the home of most of Canada's French speaking population.

The coexistence of two language groups within the Canadian state is a particularly important aspect of this challenge to unity. The "language question" arises out of a colonial history where Canada was first a colony of France and then, following military conquest, a colony of England. By the time of union the French speaking population was concentrated in the Province of Quebec while English speaking settlers formed a majority elsewhere. Moreover, at the time of union the French speaking population was a minority within Canada and represented a small fraction of the total North American population. Not surprisingly, the people of Quebec were concerned about the survival of their language and culture. Today, the 6.5 million Quebecois people continue to be concerned about their ability to survive in a continent of over 250 million English speakers and they are particularly interested in assuring that they have the sovereignty required to preserve their unique culture .[19]

The second challenge to the federation arises out of the uneven distribution of the benefits of union. Although the Provinces that united to form the federation all believed that they would benefit from the union it quickly became evident that the benefits of union would not be spread evenly. The uneven distribution of benefits has been a contentious issue ever since.

In part, the conflict over the distribution of benefits arises in the five eastern provinces, including the Province of Quebec. The income disparity between rich and poor provinces widened considerably in the period following union and the poor provinces have lagged behind other regions of the country in their levels of economic activity ever since. In part, the conflict over the distribution of benefits arises in the western provinces of Alberta and British Columbia where it is generally believed that the national government's policies, especially policy affecting natural resource industries, have hampered development.

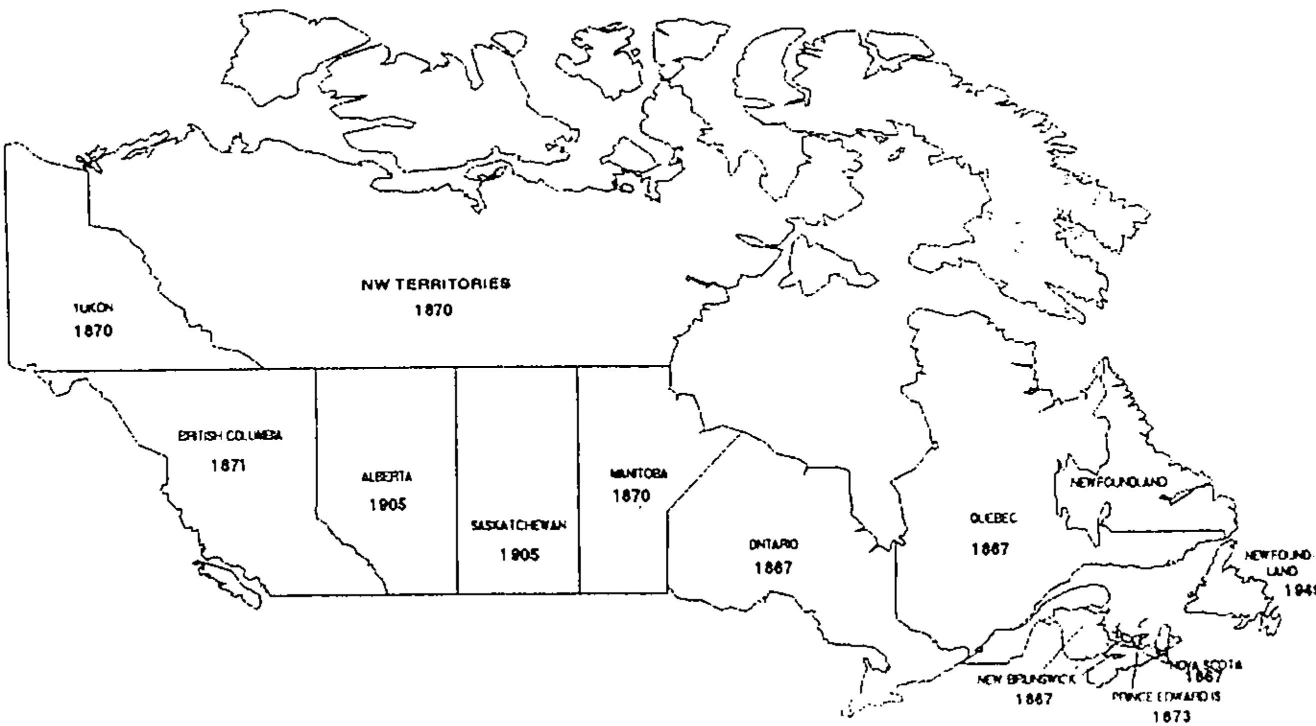
The Canadian Union

The British North America Act, which established the Canadian federation, united four English colonies in 1867. Over time membership expanded reaching a total of 10 in 1949 when the country of Newfoundland voted to join the Canadian union. (See the map presented as Figure 5 for

19 The challenge presented by the coexistence of two large cultural-linguistic groups within the Canadian union has been exacerbated by two additional historical considerations. First, the Quebec people do not always view themselves as equal partners in the Canadian federation. Although the decision of Quebec to enter the Canadian federation was voluntary the people of Quebec still believe that their participation in the Canadian federation was influenced by underlying coercive forces. Specifically, the eighteenth century colonial battles between England and France and the victory of the English in Quebec still influence the way the Quebecois people view English speaking Canada. The Quebecois view English speaking Canada as the conquerors and themselves as the conquered. Consequently, the goal of independence has special historical significance.

Second, the English speaking minority within the Province of Quebec have traditionally dominated commercial activity in that province and, as a consequence, have enjoyed higher incomes than the French speaking majority. Overt discrimination against French speaking Quebecois is also an extremely important feature of Quebec economic history. These facts have also influenced Quebecois attitudes toward the English speaking parts of the country and attitudes towards the goal of independence. (It is important to note that French speaking Canadians now control the Quebec business community, that there is currently no evidence of discrimination , and that there is virtually no difference between the average incomes of francophone and anglophone Quebecers.)

Figure 5: Date of Entry to Canadian Union



dates on which various provinces joined the union.) The original agreement which united the four English colonies was motivated by a number of factors. First, the uniting provinces all believed that they would gain from internal free trade. Prior to 1844 these British colonies had enjoyed a privileged position in the British imperial system. However, as England moved to a policy of free trade this privileged position was undermined and the colonies were forced to look elsewhere for markets. These were found in the United States and from 1851 to 1865 free trade between the colonies and the US prevailed. In 1865 the US dramatically increased duties on produce from the English colonies and the colonies were forced to look inward. The result was the creation of a common market within Canada.

Second, the uniting provinces believed they would gain from a common military policy. In part, concern with national defence was a result of US policy. The English colonies in North America had already experienced a war with the United States (in 1812) and a repeat appeared increasingly likely.[20] In part, this was a response to British policy. The British wanted to reduce their military expenditures and the colonies were not sure if they could rely on the British government to come to their defence if there was a war.[21] The uniting provinces believed that a common response would be cheaper and more effective.

Third, the uniting colonies believed they would gain because the larger country could borrow on capital markets on better terms then any of the individual provinces could attain. At the time of union the individual states uniting to form Canada needed to borrow heavily to finance infrastructure required to exploit the resources in the western half of North America. Collective action seemed to offer potential gains to all.

Although economics was the dominant factor in union the importance of societal cohesion was also recognised. The British North America (BNA) Act of 1867 established a federal system with two independent, democratically elected, orders or levels of government.The uniting states divided legislative powers between these two levels of government in a way which the signatories had hoped would assure cohesion. The states uniting to form the federation maintained legislative powers over areas where

20 The United States was just emerging from a civil war. During the war the British had supported the South and there was, very legitimate, concern that the victorious Union Army would move north into what is now Canada in a campaign of "liberation".

21 The British position is best interpreted using the theory of public goods. The British government believed the colonies were "free riders" and wanted the people residing in the colonies to assume a larger share of the cost of defence.

centralised control was likely to generate conflict due to differences in language, religion, and basic values. Education, health, and social welfare were areas considered especially vulnerable to conflict and these important fields were left to the provinces. The inclusive government, on the other hand, was given responsibility for economic affairs: navigation and shipping, the postal service, currency and coinage, weights and measures, banking, and the regulation of trade and commerce. The inclusive government was also given responsibility for the military and the criminal code.

The BNA Act also established two areas of shared jurisdiction: agriculture and the fishery. In addition, the constitution included provisions to protect the minority English speaking population in the Province of Quebec and the minority French speaking population in the other provinces.

The assignment of jurisdiction over taxation in the British North America Act was also extraordinarily important. The most important revenue source for governments at that time (approximately 85 per cent) was customs duties. As part of the move to a new Canadian common market, which by definition involves a centralised system of tariffs, this revenue source was assigned to the inclusive government. Indeed, the British North America Act, 1867, gave the inclusive government unlimited tax powers while restricting the provinces to direct taxation. This would have important consequences for the future of the union.

In agreeing to give up the right to levy indirect taxes the uniting states lost their most important revenue source. However, because the new central government assumed responsibility for all accumulated provincial debts expenditure demands were also reduced. None the less, the governments of the uniting states retained significant legislative responsibilities and they still required revenue. As a consequence, the British North America Act included provisions for a fixed per capita transfer from the new inclusive government to the state governments to enable the provinces to discharge their legislative responsibilities.

The division of legislative powers embodied in the British North America Act reflects the basic principles which emerged later from work on the theory of fiscal federalism. Legislative powers which potentially impinged upon the free movement of goods were assigned to the inclusive government. In theory this is desirable since policies "that interfere with the free movement of goods, services, and factors of production in an economy induce nationwide externalities" (Van Rompuy, Abraham, and Heremans, 1991). On the other hand, areas where preferences were likely to differ and where economies of scale in production and consumption were small, were assigned to the provincial governments.

The assignment of tax powers in the British North America Act generated what public finance economists call a fiscal gap. One level of government had access to more revenue than they needed to finance their constitutionally assigned expenditure responsibilities and the other level of government lacked the tax power to finance spending in their policy areas. Many public finance economists now believe that this fiscal gap is desirable since it gives the inclusive government the power to maintain the internal market by encouraging societal cohesion, assuring the tax structure is harmonised, and correcting externalities (See Norrie, Boadway, and Osberg, 1991.)

The redistribution of some revenue (approximately 25 per cent of total revenue) to the member states using a per capita formula introduced an element of equalisation. Because there were not serious disparities across the uniting states at the time of union, and because the role of government in the economy was relatively limited, it was not expected that this provision would generate significant redistribution across states. None the less, the provision for some equalisation did provide a mechanism to redress disparities and assure cohesion, provide insurance against random shocks, and limit inefficient fiscally induced migrations (see below for a more detailed discussion of the economics of equalisation.)

Thus, the British North America Act established a union with many features now considered desirable by economists. Moreover, in many respects, the British North America Act is close to the ideal sometimes advocated in Ireland (see NESC 1989, Chapter 13) for Europe.[22] Also, the new central level of government's expenditure (net of transfers to the provinces) amounted to only 4 per cent of total GNP in 1870. It is, therefore, interesting to see how the Canadian union evolved under this institutional arrangement.

Regional Disparities, Regional Discontent, and Cohesion in Canada: 1867-1939

The division of legislative power embodied in the British North America Act and the limited role assumed by the new inclusive government pre-empted much of the conflict potentially arising out of the fierce regional loyalties which are characteristic of Canada. Even in the

22 The assignment of expenditure responsibilities assured considerable local autonomy while the assignment of tax bases provided the central authority with the revenue sources required to redistribute income from rich to poor and to encourage regional development.

Province of Quebec most intellectuals and political leaders believed that the confederation arrangement provided more protection for their culture than the alternative: full sovereignty. Specifically, they felt that their concerns would not only be reflected in political decisions made by their provincial government but also in decisions made by the new national government since national governments would have to depend on Quebecois votes to secure political office. None the less, a few intellectuals and political leaders in Quebec did argue that the English speaking majority would eventually use national policies against the interests of the Quebecois people. However, even those opposed to the union recognised that the division of powers offered them significant protection. They were most concerned that the union would evolve in a way which eroded this advantage.

On the other hand, the distribution of economic benefits from the union agreement generated problems very early in the country's history. Indeed the union was seriously threatened when the people of the Province of Nova Scotia (1869) elected a government committed to withdrawal from the union. The inclusive governments policies to promote economic development, it was argued, were favouring the central, more populated regions. The smaller provinces were not enjoying the gains they believed would accrue as a result of union. It is likely that the union would have fallen apart at this point had not the British Government refused to restore Nova Scotia's colonial status.

The inclusive government, faced with a very unhappy member of the union, established a system of special intergovernmental transfers to placate the Nova Scotians. Although these transfers did not completely satisfy the aggrieved provinces they did help the Nova Scotians swallow a very bitter pill. There was no opposition to the transfers in the other provinces. Most importantly, the use of intergovernmental transfers to respond to the threat of disintegration established an important precedent in Canada.

The transfers introduced to placate the people in the slow growing regions did not have a significant impact on the emerging disparities. The eastern provinces, which enjoyed incomes marginally below those in Ontario in 1867, fell further and further behind. By the 1890s the economies of the Maritime Provinces of Nova Scotia, New Brunswick, and Prince Edward Island were in serious trouble. Many manufacturing industries which emerged in the period after 1850 went out of business leading to de-industrialisation,. Immigration virtually ceased. Emigration rose to unprecedented levels. In many areas population declined significantly. This experience, so familiar to the Irish, was unique in North America.

The explanation for this relative decline advanced by economic historians is of significant interest. In the first half of the nineteenth century the colonial economies of British North America relied heavily on resource exports and imported manufactured goods. Economic progress was, as a consequence, largely determined by the demand for a region's exports and the relatively strong performance of the economies of the Maritime Provinces in the period prior to 1860 can be attributed to the rapid growth in demand for their resource exports.[23] Between 1850 and 1870 domestic manufacturing employment became increasingly important. Initially, local markets for manufactured products enjoyed relatively high rates of natural protection due to transport costs. But, with the introduction of transcontinental rail links and a general move to new manufacturing techniques with significant scale economies in the late 1870s and early 1880s this natural protection was reduced significantly. As trade within the Canadian common market increased local entrepreneurs in the Maritime provinces responded by investing wealth accumulated in earlier years in new manufacturing establishments. During the 1880s output of state of the art manufacturing establishments in the iron, steel, metal working, textiles, and food products grew as rapidly in the Maritime Provinces as in the nation as a whole (Acheson, 1971,1977). The development of the manufacturing sector simultaneously encouraged the development of the regions coal and iron mining industries. But during the recession of the 1990s these new manufacturing industries came under increasing competitive pressure from those located in the emerging metropolises of Montreal and Toronto and many folded or contracted.[24]

23 Wood and fish were the most important exports of the region. The economy developed around these two principal exports giving rise to important shipbuilding, wood and fish processing, and shipping industries as well as a relatively well developed financial sector providing the banking and insurance services required to sustain the export activity. At the time of union the shipping fleet owned and operating out of Nova Scotia ports was the fourth largest in the world (only the fleets of Great Britain, the United States, and Holland were larger) and the shipbuilding industry rivalled that of the United States. As a consequence, considerable wealth was accumulated in the shipping and staple trades. Moreover, local coal and iron deposits were also attracting interest and the first heavy metal industries in Canada were established in Nova Scotia in the period of union.

24 The most frequently advanced explanation for this suggests that the larger and more rapidly expanding market in Ontario enabled firms there to better exploit economies of scale (Keirstead, 1948). The argument has been recently formalised in work by Krugman (1990).

Although the "normal" operation of market forces in an economy with increasing returns to scale and an unevenly distributed population played an extremely important role in the process of economic decline it must be noted that the policies of the inclusive government undoubtedly exacerbated the problems. On balance inclusive government commercial policy was less favourable to these provinces than to the central provinces, the eastern provinces did not enjoy any significant return on their share of investment to open up the west of the country, and these provinces were relatively disadvantaged when land given to the inclusive government by the British Crown was transferred to Quebec, Ontario, and the new western provinces of Manitoba, Saskatchewan, Alberta, and British Columbia (Alexander, 1978).

This experience, not surprisingly, generated considerable discontent in the Maritime Provinces. However, by the 1890s the people of these provinces did not see any viable alternative to remaining in the union and channelled their energies into securing a "better deal" rather than separation. They did not get it. No new special programmes were introduced to help nor were policies favouring the central regions eliminated.

Although the inclusive policies of governments in this period did not promote cohesion the market response to regional disparities, labour mobility, did. The residents of the English speaking eastern provinces increasingly responded to the disparities by moving to the more affluent province of Ontario. This established important family ties across the country which acted as a unifying force. However, language limited the mobility of the Quebecois people. As a consequence the people of Quebec did not have the same opportunity to share in the gains from union (by moving to the centres of economic activity) as the people of the English speaking eastern provinces. The limited labour mobility which results because of language plays a particularly important role in Canadian policy on cohesion in later years.

The next major threat to the Canadian economic and political union emerged with the First World War. The inclusive government, which had been given responsibility for the military, chose to participate in the conflict despite significant opposition to participation in the Province of Quebec. In the English speaking part of the country participation resulted in a powerful sense of national citizenship. But, in Quebec, the policy revealed the dangers of uniting in even a loose federation when the interests of a minority diverge from those of the majority. Thus, the same policy simultaneously created social cohesion and undermined it.

The Canadian experience between 1914 and 1918 clearly indicates one of the dangers of political union. The public finance literature generally uses the military as the classic example of a public good. All can gain from political union to produce this good since the cost per person of providing any level of military expenditure declines as membership in a collectivity increases. However, if preferences are not similar minority groups may not be able to appropriate the gains which arise due to economies of scale in consumption. Indeed, they may find themselves worse off in the union than they would be outside where they have more control over the way the public good is delivered. In the early public finance literature this problem was assumed away. (It was assumed that preference functions were known and that individual tax bills could be assigned to equate marginal benefits and marginal tax cost.) The literature today focuses specifically on this problem and the absence of a practical solution is now the strongest basis for the principle of subsidiarity.

The experiences of World War I had two effects which influenced the evolution of the Canadian union in the post war period. First, it placed the language question on the agenda thereby increasing interest in societal cohesion. Second, it united Canadians, especially English speaking Canadians, establishing a sense of Canadian identity and increasing the importance of the inclusive level of government in the every day lives of the citizens.

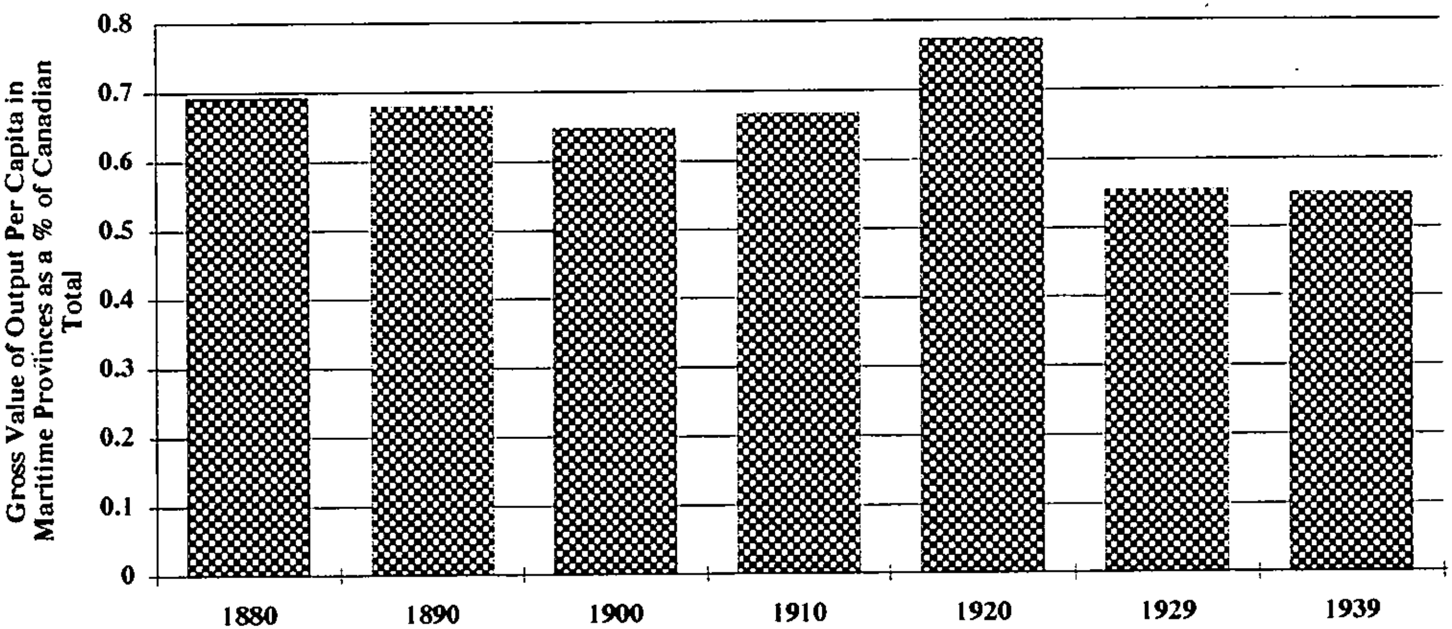
Initially, activity relating to societal cohesion was limited to inclusive government commissions studying the problems of Quebec and of the lagging Maritime provinces of New Brunswick, Nova Scotia, and Prince Edward Island. These inquiries were usually highly specific – the problems of the coal industry, the fishing industry, fiscal problems, etc. – which suggests the difficulties were not thought to be irrevocable. Because the economic problems were especially severe in the 1920s and 1930s as the poor regions fell further and further behind the rest of the country, protest movements became increasingly vocal. None the less, only one concrete policy initiative to deal with the problems was initiated in this period.[25]

The important features of the regional evolution of the Canadian economy in the first 75 years just described are summarised in Figures 6 and 7. Clearly, union did not generate convergence nor were the benefits of union spread evenly across space. As Figure 6 illustrates income disparities across regions actually grew through much of the period.This picture is reinforced by Figure 7 which compares the actual population

25 The Maritime Freight Rates Act (1927) provided a small subsidy to shippers to offset some of the locational disadvantages which emerged over the period following union.

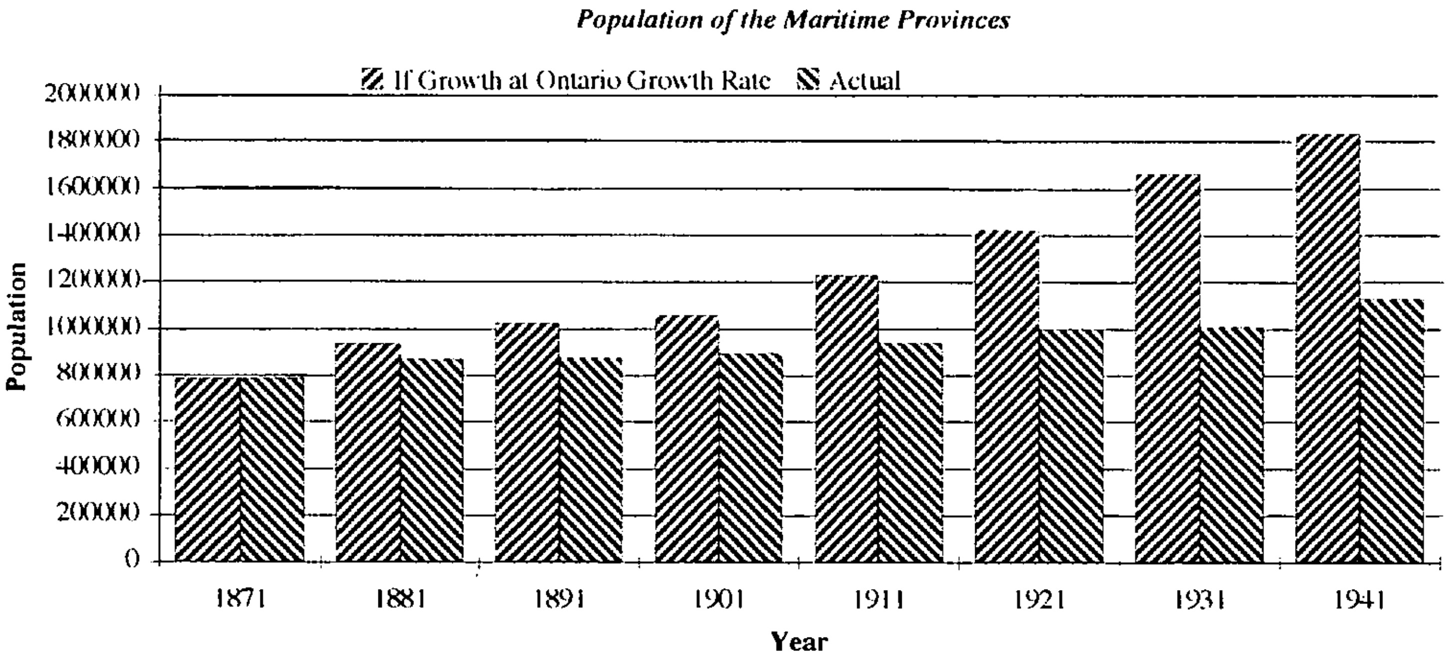
Figure 6:

Regional Disparities in Canada:1880-1939



Note: Alexander (1978)

Figure 7:


Population of the Maritime Provinces
If Growth at Ontario Growth Rate
Actual
2000000
1800000
1600000
1400000
1200000
1000000
800000
600000
400000
200000
0
Population
1871
1881
1891
1901
1911
1921
1931
1941
Year

growth in the Maritime Provinces with that which would have occurred had population grown at the same rate as it did in Ontario. Between 1880 and 1940 over 400,000 people left these eastern provinces to seek employment elsewhere including many who went on to become leading commercial figures.

It is especially important to note that, despite the existence of a strong democratically elected inclusive government with access to a significant tax base and a feeling of solidarity established during the war of 1914-1918 little action was undertaken to secure cohesion or balanced regional development. Indeed, the national government Commissions studying regional problems in the 1920s and 30s unanimously agreed that national government policies, on balance, harmed rather than helped the lagging Maritime Provinces. This experience should give rise to second thoughts among those who believe that a union will necessarily generate convergence, that political homogeneity and solidarity will increase sufficiently over time to motivate action on regional disparities, or that the existence of a strong democratically elected inclusive government will necessarily result in policies favouring lagging regions.

The almost exclusive reliance upon a division of legislative powers to secure cohesion in Canada prior to 1939 was about to change. Three factors were especially important: (1) the growth of government which occurred with the emergence of Keynsian economic ideas and the philosophy of the welfare state; (2) troubles with the Canadian tax system; and (3) political changes in the province of Quebec. The last of these factors is considered in the following section. The first two, which are closely linked, are considered here since the problems first arose in the 1920s and 1930s.

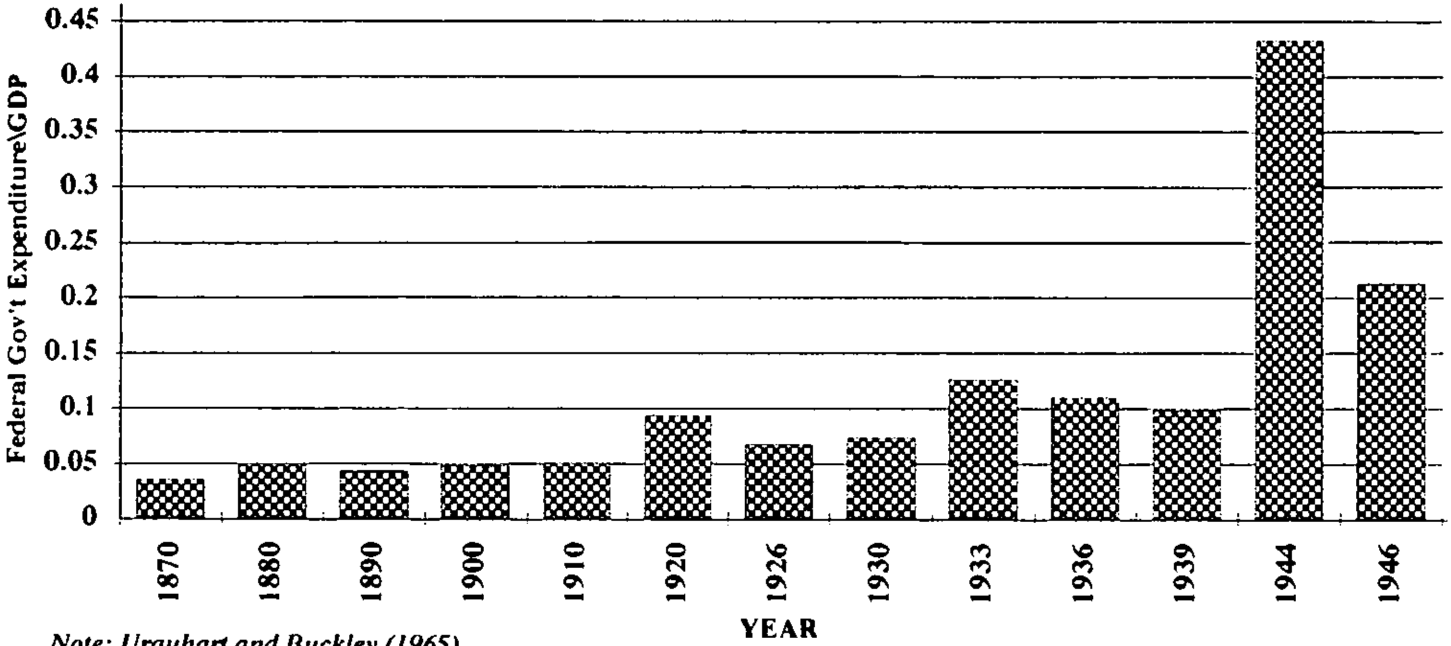
In comparison with today, the role of government in Canadian society in the 1867-1939 period was relatively limited. As illustrated in Figure 8 total expenditure of the inclusive government was generally 5 or 6 per cent of GNP. Although slightly higher in some years, low GNP rather than high government expenditure explains the size of the ratio in these periods.[26]

Provincial and municipal governments were more significant in the every day lives of Canadians during this period than the national government. Consequently, when citizens began to demand more and more government services the provincial governments, who were also

26 Canada was at war between 1914 and 1918, a severe recession occurred in 1920, and the depression of the 1930s was especially severe in Canada (output fell by over 25 per cent between 1929 and 1933).

Figure 8:

Inclusive Government Expenditure as a Share of GDP



Note: Urquhart and Buckley (1965)

constitutionally responsible for welfare state policies, were forced to turn to new revenue sources. Because they were limited to direct taxation the income tax became the base of choice. The national government did not enter the income tax field until 1919 (it claimed that this was a temporary measure to finance debt accumulated during the war). The national government quickly became the major player. Unfortunately, the coexistence of 11 different tax systems (10 provincial/1 central) generated a "tax jungle" which impeded the operation of the Canadian internal market.

The emerging welfare state policies and the "tax jungle" created a political crisis in Canada during the 1930s. In part, this crisis was due to the fact that the depression did not have an equal impact on all provinces and the governments in the provinces hardest hit faced bankruptcy. In part, it was due to the distribution of tax bases and the legacy of the war of 1914-1918. Canadians, especially those in the predominantly English speaking parts of the country, looked to the central government for solutions to their economic problems. In 1937, the national government responded to the crises by initiating a critical examination of the institutions of Canadian federalism. The Report of the Royal Commission on Dominion Provincial Relations was released in 1939 and the principles advocated in that report had a profound influence on the evolution of the Canadian federal system over the following 40 years.

The Commission recognised that provincial autonomy in areas under provincial jurisdiction was a prerequisite for national unity and argued that this autonomy must be protected unless there were extremely compelling reasons for change. But, the Commission also recognised that provincial autonomy was meaningless if the provincial governments lacked the financial resources to act in areas of their jurisdiction. Indeed, the Commission believed that the union could not be sustained if serious disparities in resources persisted. Specifically, the Commission noted: "[There is] danger to national unity if the citizens of distressed provinces come to feel that their interests are completely disregarded by their more prosperous neighbours, and that those who have been full partners in better times now tell them they must get along as best they can and accept inferior educational and social services." (p.79) and "[It is] the Commission's conviction that provincial autonomy in these areas must be strengthened and respected, and that the only true independence is financial security" (p.125) (Royal Commission on Dominion Provincial Relations, 1939).

The Commission recommended the introduction of a system of "National Adjustment Grants" to assure provincial autonomy and financial security. The National Adjustment Grants involved a transfer from the inclusive government to the poorer states to assure all Canadians, regardless of province of residence, would have access to reasonably comparable standards of public services at reasonably comparable tax rates.

The Royal Commission did not, however, accept that the existing division of legislative responsibility, imposed by the British North America Act, was sacred. Indeed, the Commission argued that the provinces should turn over all income tax fields to the inclusive government and that inclusive level of government should have responsibility for unemployment insurance. In 1941 an amendment to the British North America Act enabled the national government to implement an unemployment insurance programme. Also in 1941 the tax problem was at least temporarily resolved by the introduction of a tax rental system (discussed below).

Much of the philosophy of the Commission, particularly its stress on the importance of intergovernmental transfers to enable provincial governments to provide reasonably comparable standards of public services to all Canadians regardless of province of residence, was ultimately embodied in the Canadian federal system. Although this outcome was, in part, a consequence of accident and compromise rather than design as the following section of the paper makes clear all subsequent governments recognised the importance of the feeling of "national citizenship" highlighted in the Commission's Report.

Regional Disparities, Regional Discontent, and Cohesion in Canada: 1939 - 1967

The Second World War helped clear up the inefficient tax system that had evolved in the 1920s and 1930s. As part of a programme of wartime finance the inclusive level of government struck agreements with the provinces to "rent" the three major provincial tax bases : the personal income tax, the corporate income tax, and succession duties. The provinces received a fixed per capita transfer in exchange. The revenue net of payments to the provinces went to finance the war. The rental agreements were especially significant in that they incorporated an element of equalisation, all provinces received the same revenue per capita regardless of the size of their tax base thus each province was given the ability to provide the same standard of public service at approximately the same rates of taxation as any other province. Thus the tax rental agreement reflected the philosophy of the Royal Commission on Dominion – Provincial Relations.

At the end of the war the national government wanted to retain the highly centralised tax system implicit in the tax rental agreements and devote the difference between revenue and payments to the provinces to national programmes in health, education, and welfare. The emerging Keynsian ideas strongly influenced the central governments position since it wanted to have the tools to control the level of aggregate demand. Moreover, in the aftermath of the war many Canadians were looking to the national government to solve the problems of peacetime. A rise of Quebecois nationalism also convinced national government leaders that a cohesion problem existed and that the equalisation implicit in the tax rental agreements and advocated by the Royal Commission on Dominion Provincial Relations should be continued in the interests of national unity.

However, there was also significant opposition to expansion of the role of the central government. Economists in the central government Department of Finance, although strong advocates of some type of demand management, did not want to see new policies which might interfere with market adjustment. The economists were particularly opposed to policies which might impede labour mobility across regions or across jobs. The influence of the Department of Finance economists was most evident in the Canadian White Paper on Employment which announced the introduction of Keynsian type policy in 1945. Although generally modelled on the Beveridge proposals of England, the Canadian version failed to include specific mention of regional disparities as a policy concern. The expansion of the inclusive level of government was also opposed by the richer provinces and Quebec. These provinces rejected the national government proposal to expand activity in the areas of health and welfare arguing that only provincial governments had the constitutional authority to act in these areas.

The rise of a strong Quebecois nationalism following the war played a particularly important role in the evolution of the Canadian union in the post 1945 period. The rise of Quebecois nationalism was a consequence of at least three factors. First, the rural, Catholic, francophone population of Quebec were strongly influenced by the Catholic Church and Catholic social teaching and rejected the liberal capitalist values which held sway in much of the rest of the country. Second, the war of 1939-1945 had the same effect as the previous war in Europe. The introduction of conscription despite significant opposition within Quebec again revealed the dangers of a powerful central government for a minority population. When a serious conflict in values or interests emerged the majority view would carry the day. Third, the national government bureaucracy was dominated by anglophone Canadians and there were virtually no opportunities for francophone Quebecois to participate in this bureaucracy, especially in the higher circles, in their own language. The provincial government, on the other hand, was dominated by francophone Quebecois.

The people of Quebec elected (and re-elected) a provincial government led by Maurice Duplessis from 1944 to 1959 on a strong provincial autonomy platform. The Duplessis' Government contended that the survival of francophone culture and Canada's inter-ethnic harmony depended on continued adherence to the decentralised pattern of power sanctioned by the Confederation pact (Freidman and Forest, 1988). The national governments desire to expand its sphere of influence and the autonomy demands for Quebec were bound to conflict and they did.

The conflict began when Quebec decided to establish its own personal and corporate tax systems. This simultaneously threatened tax harmonisation and undermined the inclusive governments strategy to achieve social cohesion by fostering a sense of national citizenship using conditional grant programmes and implicit equalisation.

The national government responded to the failure of its own initiatives and the Quebec tax proposals by entering into negotiations with the provinces. The outcome of these negotiations was a tax system in Quebec quite similar to that developed by the inclusive government and a set of agreements with the other provinces to share taxes collected by the inclusive government from tax base defined by the national government. Under the tax sharing agreements the participating governments received a share of the total tax collected equal to the share actually collected in the province. A formal scheme of revenue equalisation which provided transfers to all provinces, including the Province of Quebec, whose personal and corporate income tax bases were unable to yield as much revenue per capita as the richest provinces was introduced as part of the package. The Equalisation transfer was unconditional and financed from the inclusive governments revenues. The Equalisation programme in Canada is a concrete manifestation of the Royal "Commission National Adjustment Grant" philosophy discussed above. The inclusive government also decided to proceed with cost shared programmes.

The federal provincial agreements covering tax sharing, equalisation, and the major cost shared programmes became an extremely important feature of Canadian federalism. Although the Equalisation and cost shared programmes were governed by national government legislation and the provincial governments had no legal rights to influence the development of these programmes, these programmes were closely linked to tax sharing and Quebec/Canada tax harmonisation which required provincial government approval. Consequently, the entire package was subject to intergovernmental negotiations and the provinces were given some leverage to influence the final outcome. Because the agreements only covered a period of five years the Canadian fiscal system was the subject of regular intergovernmental meetings and conferences.

The revenue equalisation scheme contributed significantly to social cohesion in Canada while at the same time keeping the independent corporate and personal income tax systems in Quebec in harmony with the rest of the country. Indeed, the revenue equalisation programme has been called "the glue that holds the country together". In 1957 the programme was restricted to the tax bases subject to the federal tax collection agreements. But over time, eligibility was extended to all tax bases available to the provinces (over 30 in all) to provide a very general system of revenue equalisation. Then, in 1982, the equalisation principle was formally entrenched in the Canadian constitution. Undoubtedly, part of the reason for this is that redistribution is not of the simple zero sum type and people in all provinces, not just the people in the poor provinces derive some benefit. (This is discussed in more detail below.)

Not surprisingly, the major national government conditional grant programmes in health, welfare, and higher education introduced in the 1950s were strongly opposed by Quebec on constitutional grounds. However, the national government successfully argued that these transfers did not represent an intrusion in provincial jurisdiction even though they forced the provinces to change their policies to qualify but instead represented "gifts" from the national government. The legal right of the national government to make "gifts" was eventually established but the Quebec government refused to accept the "gifts" despite the fact that the Quebec people were ultimately financing at least part of these gifts through their tax payments to the national government. This situation could not persist long without threatening the union.

The conditional grant programmes were not especially attractive in the poorer provinces either. Because these transfers were conditional the poor provinces adjusted their spending to qualify. It is likely that local development programmes suffered as a result. Also, the poor provinces had to impose higher tax rates to finance their share of expenditures (their tax base was smaller) than their richer neighbours. None the less, the transfers did increase government revenue and these provinces accepted the funds without much complaint.

Thus, the national government was forced to adjust its policy to meet the concerns of Quebec. The compromise eventually reached involved increasing the weight given to provincial concerns in the federal – provincial negotiations and "opting out". Under "opting out" the Quebec government or any other provincial government could decide not to participate in a national cost shared programme and instead receive an equalised tax transfer provided they introduced a programme which met the general conditions required of the national shared cost programmes. (The inclusive level of government would reduce its tax rates within the province while the provincial government increased their rates to keep total tax collection unchanged. This provided additional provincial revenue equal to what the province would have received had it accepted the conditional transfer.)

In the 1962 renegotiation, the tax sharing agreements were replaced by tax collection agreements. Under the tax collection agreements the inclusive level of government offered to continue collecting personal and corporate income taxes on behalf of the provincial governments while at the same time offering more provincial flexibility in the choice of tax rates in exchange for continued federal control over the base. The revenue equalisation scheme was expanded to "equalise" tax collections from provincial tax bases not covered by the tax collection agreements. In subsequent negotiations the equalisation formula was extended to cover all tax bases used by the provincial governments thereby assuring each province received revenue equal to what they would have received had they applied the national average tax rates to the national average tax bases.

During the 1960s the inclusive government also continued to expand its programmes in health, education, and welfare. By the late 1960s a unique federal welfare state had evolved to the point where all Canadians, regardless of province of residence, could expect reasonably comparable levels of these public services while paying reasonably comparable levels of tax. This undoubtedly contributed significantly to a feeling of "national citizenship". None the less, serious regional disparities and the "language problem" remained. Table 5 contrasts the Canadian and US experience with regional disparities over the period from 1920 to 1965. Despite the emergence of a national welfare state in Canada with significant regional redistribution, disparities in personal income changed very little. In contrast, in the United States, where there is no truly national welfare state, the reduction in regional disparities was significant.

There is no simple explanation for the differences in the experience of these two large North American federations. The United States federation did generate significant redistribution across regions. Indeed, Bayoumi and Masson (1992) estimate that the US "federal fiscal system reduces differentials by 22 cents out of every dollar" even though redistributive effort was only half that of Canada. It is possible that heavier reliance on market adjustment accounts for the greater success in the US. But, the obvious alternative hypothesis, that the poor Canadian regions are more peripheral with respect to North American markets than any US region and thus face severe handicaps in a competitive market environment, is equally plausible. At present, there is no empirical research available to use in an assessment of these alternative positions.

Table 5: *Comparison of Convergence in USA and Canada, Personal Income Per Capita*

USA (Avg.=100)	1920	1926	1930	1940	1950	1960	1965
Northeast	124		129	121	106	109	108
Mid Atlantic	134		140	124	116	116	114
Mid West	108		111	112	112	107	108
West North Central	87		82	84	94	93	95
South	59		56	69	74	77	81
East South Central	52		48	55	63	67	71
West South Central	42		61	70	81	83	83
Mountain	100		83	92	96	95	90
Pacific	135		130	138	121	118	115
Disparity Gap (Highest/Lowest)	3.21		2.91	2.51	1.95	1.76	1.62
Coefficient of Variation	0.381		0.376	0.301	0.208	0.186	0.16
CANADA (Avg.=100)							
Newfoundland		na	na	na	51	55	59
Prince Edward Island		56	52	53	55	56	62
Nova Scotia		67	74	78	75	76	73
New Brunswick		64	65	65	70	68	68
Quebec		84	92	86	86	87	90
Ontario		114	124	126	122	118	117
Manitoba		108	99	92	101	99	93
Saskatchewan		101	61	71	83	89	89
Alberta		113	90	91	101	100	96
British Colombia		122	127	123	122	115	113
Disparity Gap (Highest/Lowest)		2.17	2.41	2.37	2.40	2.12	1.99
Coefficient of Variation		0.268	0.304	0.281	0.289	0.257	0.234

Source: Statistics Canada, *Historical Statistics of Canada*, US Department of Commerce, *Historical Statistics of the United States*.

The continued existence of regional disparities and the language problem did not go unrecognised in Canada in this period. Indeed, as so often happens in Canada, these problems were addressed by government appointed Commissions. The Gordon Commission reported in 1957 arguing that a "bold and comprehensive and coordinated approach" was needed to resolve the underlying problems of the Atlantic region (Savoie, 1986). The national government responded in 1960 with its first regional development programme and by 1967 eight regional development programmes were in place. For the first time in Canada there was interest in regional problems. The Royal Commission on Bilingualism and Biculturalism (1965) tackled the language question directly advocating a policy of official bilingualism which would assure francophones could enter the highest circles of the inclusive government civil service and guarantee francophones throughout the country access to national government services in their own language. In addition the Commission concluded "We believe the notion of equal partnership connotes a vast enlargement of the opportunities for francophones in both private and public sectors of the economy". Thus, resolution of the language question also required policies to deal with regional disparities since the Province of Quebec was relatively disadvantaged.

By 1967, Canada's centennial year, the national governments policy of stimulating the development of a national and federal welfare state via intergovernmental transfers had achieved much. Although the citizens of the poorer provinces continued to face low incomes and poor employment prospects disparities in the quality of health, education, and welfare services had been reduced significantly. This not only reduced inequalities in comprehensive incomes but it also had a significant impact on "equality of opportunity" in the national labour market. Young adults from Newfoundland could now enter the labour market with the same general skills and training as young adults from Ontario and Alberta. While young Newfoundlanders may have had to move to secure employment they at least could compete on equal terms with other job applicants from other parts of the country. The remaining income and employment problems would be addressed in the following decades.

Regional Disparities, Regional Discontent, and Cohesion in Canada: 1968–Present

In 1968 Pierre Elliot Trudeau was elected as Canadian Prime Minister. He made national unity his central preoccupation and described it as the single motivating force for his involvement in public life. Trudeau's political activity was a reaction to developments in his home province of Quebec. Between 1960 and 1965 Quebec experienced what is often called

" the Quiet Revolution". The "Quiet Revolution" in Quebec involved four convergent phenomena: " (1) the capture of state power and the exercise of social hegemony by an urban based, technocratic, and pro-union francophone elite; (2) the secularisation of civil society; (3) the modernisation of the provincial state apparatus and a marked shift toward state intervention in economic life; and (4) the formulation of an aggressive nationalism which involved a redefinition of francophone collective, territorial identity"(Friedman and Forest, 1989). Demands for increased provincial autonomy and even independence in Quebec increased and political debate within the province was dominated by Trudeau, who argued that Canadian federalism could, with some important changes, provide the basis for a society which would be the envy of the world, and Rene Levesque, who argued that the interests of Quebecois people would be better served by a new politically independent Quebec.

Trudeau, a strong opponent of ethnic nationalism and a consummate federalist, strongly believed that the existing constitutional structure in Canada provided the best base on which to build a better society for both anglophone and francophone Canadians. What was needed, according to Trudeau, was a new emphasis on language rights, individual rights including what might be called, following Marshall (1964), welfare state rights, a division of constitutional powers which reflected the realities of the late twentieth century, and a policy of official bilingualism. In addition, Trudeau strongly believed that a balanced pattern of regional development was both necessary and desirable. Indeed, Trudeau argued that: "Economic equality ... [is] just as important as equality of language rights ... If the underdevelopment of the Atlantic provinces is not corrected, not by charity or subsidy, but by helping them become areas of economic growth, then the unity of the country is almost as surely destroyed as it would be by the French – English confrontation."(Quoted in Phidd and Doern, 1978). Shortly, after assuming his role as leader of the governing Liberal Party, Trudeau called a general election. His policy proposals proved very popular and he was returned to office with a massive majority.

Thus, for the first time in Canadian history, there was a central government in Canada with a very strong desire and mandate to tackle the problem of regional disparities. The government moved quickly and established the Department of Regional Economic Expansion (DREE). Jean Marchand, a close and highly respected friend of Trudeau, was appointed Minister of the Department, guaranteeing that regional development issues would occupy an important role within the Cabinet. Moreover, all parties supported this initiative.

The new Department adopted the "growth pole" approach to development advocated by Perroux (1950) and Boudeville(1966) and proceeded to implement two related programmes: the special areas programme, which provided support for infrastructure improvements in a small number of designated areas, and the regional development incentives programme, which provided incentive grants to encourage firms to locate in lagging regions. Once these programmes were in place Canada enjoyed one of the most comprehensive development schemes in the world. Not only was DREE supporting development directly, but also, cost shared programmes in health, income maintenance, and post secondary education were assuring national standards across the country and the general Equalisation programme was enabling the provincial governments in poor regions to provide a comprehensive range of services and programmes (including their own regional development programmes) without forcing their residents to incur relatively high tax burdens.

The Trudeau government remained in power for most of the following twelve years and national unity remained its central preoccupation. After a series of attempts Trudeau finally managed to secure constitutional change in 1981. Unfortunately, the government of the Province of Quebec, led by Rene Levesque, refused to sign the new Constitution. Although still legally binding in Quebec (unanimity was not required) the absence of Quebec's signature was a major weakness. Importantly, the new constitution explicitly included a section declaring that all governments in Canada were committed to reducing regional disparities and that the inclusive government was responsible for an Equalisation programme which would allow all provinces to provide "comparable standards of public services at comparable rates of taxation".

The inclusive governments redistributive and regional development programmes have generated a substantial redistribution of resources from the richer to poorer provinces including the province of Quebec. Table 6 provides a general picture of the inclusive governments fiscal activity in the Atlantic Canadian provinces of Newfoundland, Prince Edward Island, Nova Scotia, and New Brunswick. The data are converted to US$ per capita at purchasing power parity to allow a comparison with the EC expenditure in Ireland. In the poorest provinces the net inflow of funds from the national government (expenditures in the province minus taxes collected in the province) currently exceeds 30 per cent of GDP. In these same provinces almost 50 per cent of provincial government revenue comes directly from the national government via intergovernmental transfers. Given this level of transfer one would expect to see some convergence and considerable cohesion.

Table 6: *Canadian Government Fiscal Activity in the Atlantic Provinces and EC Activity in Ireland (Per Capita in US$, Purchasing Power Parity)*

		Federal Government Expenditures (by Category) and Taxes in Atlantic Canada				
Year	*EC Expenditure in Ireland*	*Expenditure on Goods and Services*	*Transfers to Persons*	*Transfers to Business*	*Transfers to Government*	*Taxes Collected*
1961	–	168	126	23	103	163
1966	–	192	142	40	160	214
1971	–	310	261	36	367	436
1976	66	648	700	313	708	926
1981	231	892	905	740	990	1,360
1986	433	1,123	1,326	322	1,153	1,607

Sources: Statistics Canada (1989), NESC (1989), OECD (1989).

The outcomes of Canadian policy in the post 1968 period fall far short of what one might expect. The regional development and redistributive programmes undoubtedly played an important role when the people of Quebec rejected the independence option in a referendum in 1980. Thus, in one sense, the policies did contribute to cohesion. However, the threat of Quebec independence remains the dominant issue in Canadian politics and another independence referendum is planned for the fall of 1992. The policies have also resulted in some convergence in living standards, especially if incomes are defined comprehensively to include the benefits flowing from publicly provided goods and services. None the less, as illustrated in Tables 6, 7, 8, and 9 traditional disparities, whether measured in terms of GDP per person, personal income, earned income, or unemployment rates proved to be remarkably persistent.

Table 7: *Provincial Gross Domestic Product Per Capita at Market Prices, by Province, Selected Years 1961-1986: Relationship to National Average (Canada = 100)*

Province	*1961*	*1966*	*1971*	*1976*	*1981*	*1986*
Newfoundland	50.0	52.1	56.2	53.6	52.0	60.0
Prince Edward Is.	49.4	48.4	52.3	52.2	50.5	59.5
Nova Scotia	65.3	63.0	67.9	66.0	61.3	75.1
New Brunswick	60.5	61.3	63.7	63.8	63.1	71.4
Quebec	91.1	89.9	88.9	88.1	86.0	90.3
Ontario	119.9	117.4	117.3	109.4	106.5	119.9
Manitoba	90.4	87.1	90.7	91.4	88.1	86.5
Saskatchewan	77.3	99.6	86.9	101.2	108.8	85.4
Alberta	108.8	109.3	110.8	137.1	146.0	121.4
British Colombia	111.1	109.2	106.8	108.6	109.4	99.8
Disparity Gap (Highest/Lowest)	2.42	2.42	2.24	2.62	2.89	2.04
Coefficient of Variation	0.314	0.306	0.277	0.320	0.355	0.240

Source: Savoie (1986), Statistics Canada, *Provincial Economic Accounts.*

Table 8: *Personal Income Per Capita at Market Prices, by Province, Selected Years 1961-1986: Relationship to National Average (Canada = 100)*

Province	*1961*	*1966*	*1971*	*1976*	*1981*	*1986*
Newfoundland	58.2	59.9	63.8	68.1	64.9	69.6
Prince Edward Is.	58.8	60.1	63.7	68.2	67.4	74.6
Nova Scotia	77.8	74.8	77.5	78.4	77.9	83.6
New Brunswick	68.0	68.9	72.3	75.3	71.3	77.5
Quebec	90.1	89.2	88.7	93.2	93.3	93.6
Ontario	118.4	116.4	117.0	109.6	107.7	110.4
Manitoba	94.3	91.9	94.1	93.2	93.0	90.3
Saskatchewan	71.0	93.1	80.3	98.8	99.5	89.1
Alberta	100.3	100.1	99.0	102.4	110.2	105.3
British Colombia	114.9	111.6	109.0	108.8	101.7	100.3
Disparity Gap (Highest/Lowest)	2.03	1.94	1.83	1.60	1.69	1.58
Coefficient of Variation	0.274	0.249	0.223	0.195	0.193	0.15

Source: Savoie (1986), Statistics Canada, *Provincial Economic Accounts.*

Table 9: *Earned Income Per Capita at Market Prices, by Province, Selected Years 1961-1986: Relationship to National Average (Canada = 100)*

Province	*1961*	*1966*	*1971*	*1976*	*1981*	*1986*
Newfoundland	53.2	52.5	54.8	56.1	53.4	57.6
Prince Edward Is.	53.5	53.6	57.0	60.2	59.0	66.5
Nova Scotia	75.0	71.5	74.2	74.2	73.4	79.9
New Brunswick	64.1	65.1	68.1	69.0	64.9	71.7
Quebec	89.5	89.2	87.8	90.4	89.9	91.3
Ontario	121.5	118.3	119.2	112.5	110.6	115.4
Manitoba	93.5	91.0	93.7	93.9	92.9	90.1
Saskatchewan	67.2	92.3	78.7	99.5	98.9	87.5
Alberta	100.3	99.0	98.6	105.0	114.4	107.2
British Colombia	103.1	111.0	109.5	109.5	109.7	100.8
Disparity Gap (Highest/Lowest)	2.27	2.25	2.17	2.00	2.1	2.0
Coefficient of Variation	0.280	0.271	0.256	0.238	0.261	0.210

Source: Savoie (1986), Statistics Canada, *Provincial Economic Accounts.*

Table 10: *Provincial Unemployment Rates, Selected Years 1961-1986: Relationship to National Average (Canada = 100)*

Province	*1961*	*1966*	*1971*	*1976*	*1981*	*1986*
Newfoundland	275	171	135	189	186	219
Prince Edward Is.	-	-	-	135	150	151
Nova Scotia	114	138	113	134	134	138
New Brunswick	148	156	98	155	154	151
Quebec	130	125	118	123	137	126
Ontario	77	76	87	87	87	77
Manitoba	70	82	92	66	79	81
Saskatchewan	58	44	56	55	61	81
Alberta	66	74	92	56	50	103
British Colombia	120	135	116	121	88	131
Canadian Rate (%)	3.8	3.4	6.2	7.1	7.5	9.5
Disparity Gap (Highest/Lowest)	4.74	3.88	2.41	3.43	3.72	2.84
Coefficient of Variation	0.571	0.390	0.228	0.400	0.403	0.346

Source: Savoie (1986), *Canada Finance, Quarterly Economic Review, June 1991.*

Given the current state of knowledge about regional disparities it is impossible to provide a satisfactory explanation for the remarkable persistence of Canadian regional disparities [27]. It appears that the economic forces that initially generated the disparities are extremely strong and that countervailing forces would have to be very strong indeed.

It is, however, possible to identify a number of factors which weakened the impact of the Canadian attack on regional disparities. First, the first OPEC oil crises in 1973 dramatically changed the terms of trade within the Canadian common market. The oil rich western provinces, especially Alberta, experienced a dramatic surge in growth while Ontario and the Montreal region in Quebec, the manufacturing heartland of the country, stagnated. The dramatic growth in Alberta directly increased measured disparities thus masking some progress. Meanwhile, the difficulties of southern Ontario and Montreal simultaneously weakened political support for regional policy (especially for regional incentive grants), provoked national policy to deal with the Montreal/southern Ontario problems (decreasing the attractiveness of regional incentive grants), and resulted in changes in the designated areas making regional development incentive grants available to firms locating in some relatively developed areas of the country, including Montreal and Windsor, Ontario (one of the centres of the Canadian automobile industry). In the Montreal area alone 1,241 incentive grants were approved over a five year period generating an estimated 36,000 jobs. It took the Atlantic provinces 12 years to achieve 421 approved grants and an estimated 20,000 jobs. Second, the discovery of large oil reserves on the Continental shelf off the coast of the Atlantic provinces in the early 1970s reduced concern about these regions and provoked a change in regional policy so the focus was now on exploitation of these resources (Most of the subsidies to business in the late 1970s and early 1980s were energy related). The manufacturing heartland of the country benefitted significantly from the heavy investment in infrastructure. Unfortunately for the Atlantic provinces these oil fields are not in production and if current oil prices persist there is little hope that they will ever come on stream. Third, the extension of the national unemployment insurance programme in 1971 to include all labour force participants with at least eight weeks of employment may have had adverse consequences (see below for a discussion).

27 It is, however, clear that continued disparities are not a consequence of a complete failure of incentive type policies. Fewer than 10 per cent of approved projects under DREE programmes were discontinued or were not in commercial production within three years after the initial grant was payable (Savoie, 1976).

The relative failure of the Canadian approach to regional disparities can also be seen by comparing Atlantic Canada and the Republic of Ireland. Table 11 and Figures 9 and 10 present pictures of the progress made during the period discussed in this section. Although the focus on GDP per capita and unemployment rates, is incomplete at best , the pictures do give the general impression that large scale redistributive transfers to the economies of the Atlantic Provinces of Newfoundland, Prince Edward Island, Nova Scotia, and New Brunswick were unable to stimulate significant gains relative to Ireland over the period. Indeed, it appears the Irish economy may have preformed slightly better than that of Atlantic Canada.

A comparison of the performances of the two economies raises a number of questions. Is Atlantic Canada better off having relatively high incomes, excellent public services, and an economic structure heavily based on transfers from outside than Ireland with its large public sector debt, and dependence on the EC? Probably. But will Atlantic Canada still be better off if the Canadian union changes dramatically over the next few years as many observers believe it will? Significant declines in the standards of living enjoyed by the residents of Atlantic Canada as well as significant as out-migration would have to be expected. Indeed, the scale of adjustment that would be necessary seems to dwarf anything that could be contemplated in Ireland in even a worst case scenario for that country. Unfortunately for Atlantic Canada its worse case scenario is not that improbable.

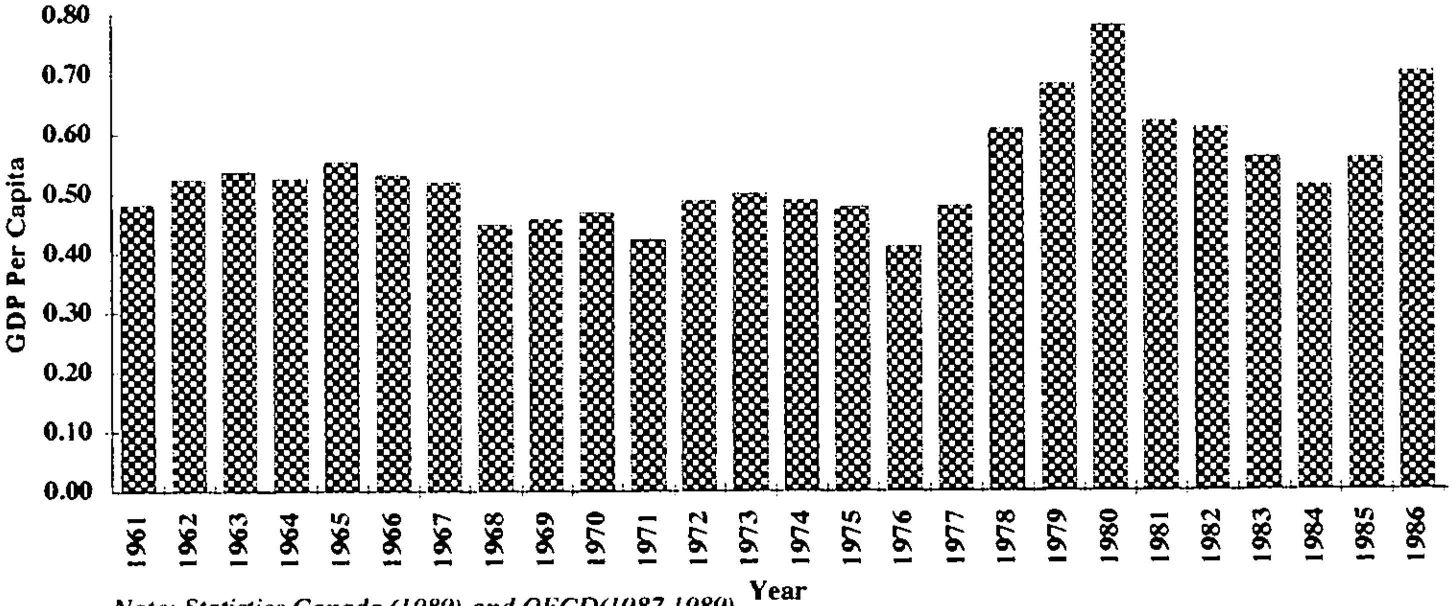
Table 11: *Comparison of Unemployment Rate in Ireland and Atlantic Canada*

Period	*Ireland*	*Atlantic Canada*
1966-69	5.0	5.6
1970-76	6.4	8.8
1977-81	8.4	11.9
1982-86	16.1	14.8

Sources: Statistics Canada, *Labour Force Statistics*, OECD (1988)

Figure 9:

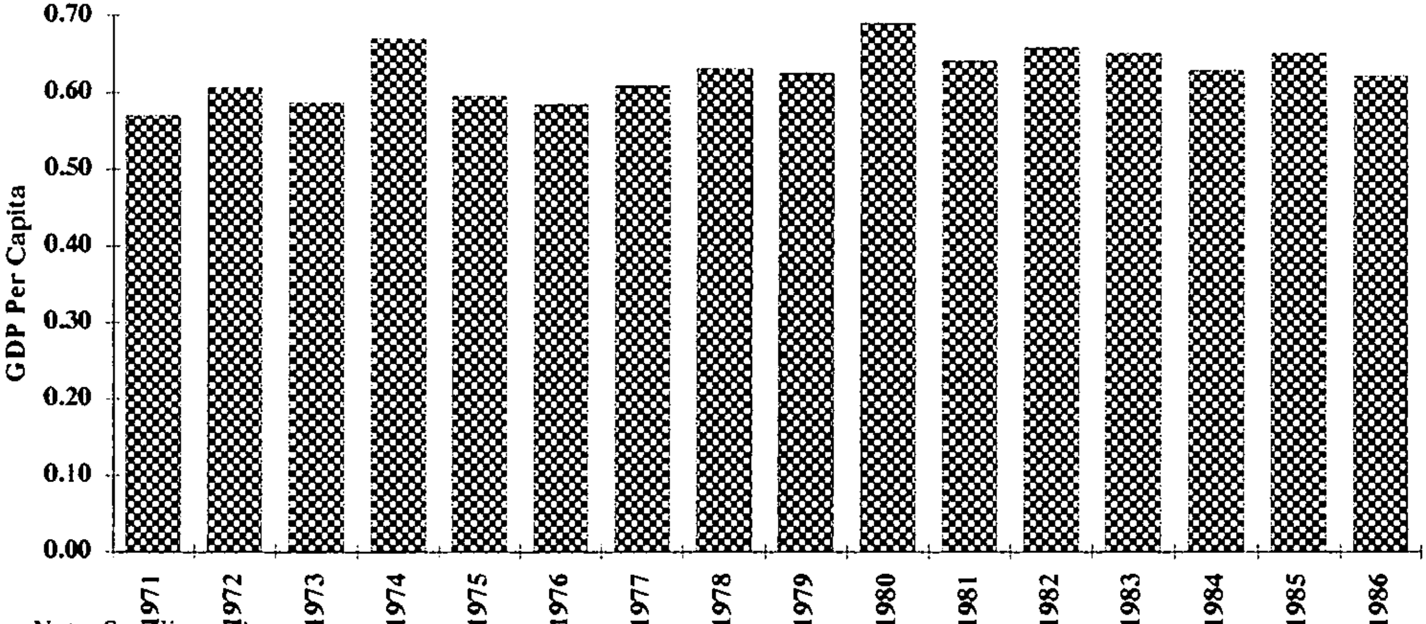
GDP Per Capita: Ireland as a proportion of Atlantic Canada (in US$,Current Exchange Rates)



Note: Statistics Canada (1989) and OECD(1987,1989)

Figure 10:

GDP Per Capita: Ireland as a Proportion of Atlantic Canada (US$, Purchasing Power Parity)



Note: See Figure 9.

Since 1984, when a Conservative government was elected under Brian Mulroney, the Canadian government has been slowly reducing its transfers to provincial governments. The conditional grant programmes will be phased out by the turn of the century and caps have been placed on the revenue equalisation plan (which will allow disparities in public services to grow over time). A free trade agreement signed with the United States is likely to result in an elimination of regional development programmes which are seen as unfair subsidies by the US. The unemployment insurance programme has been reformed to increase the qualifying period (which most strongly affects the poor regions where employment is highly seasonal) and further reforms are being considered which, if implemented, will reduce regional redistribution still more.

An attempt to revise the Constitution in a way which would secure Quebec's signature failed in 1990. The Government of Quebec, now led by a federalist, Robert Bourassa, issued an ultimatum: either dramatically revise the constitution to assure most power is vested with the provinces or the Government will join the independence party, the Parti Quebecois, in support of independence in a referendum scheduled for November 1992.

The dependence of the Atlantic Canadian regions on transfers and the very real possibility that these transfers may be dramatically reduced in the near future highlights another important dimension of the cohesion problem. Small and relatively poor regions in a union can become very vulnerable if a union which involves significant transfers becomes unsustainable.

Summarising the Canadian Experience

Three features of the constitutional arrangement which established the Canadian union in 1867 have dominated the history of that country. First, the constitution created a federal system of government with autonomous inclusive government institutions. Second, the Constitution established a division of expenditure responsibilities which left responsibility for most of the important functions of the modern state in the hands of the provincial level of government. Third, the Constitution gave the inclusive government unlimited powers of taxation. This constitutional framework is particularly advantageous to small and relatively poor states since it simultaneously enables the inclusive level of government to use its tax power to redistribute resources from rich to poor regions while protecting local sovereignty.

The first 75 years of the Canadian federation illustrate that poor regions do not necessarily gain from even this potentially favourable constitutional structure. Indeed, the inclusive government only began to use its potential power to redistribute income in the post 1945 period as a response to a unique combination of factors: the depression of the 1930s and the bankruptcy of some state governments; the Second World War which increased the importance of the inclusive government in the everyday lives of Canadians, increased the "national consciousness" of national government politicians, and increased solidarity among English speaking Canadians; the maturing of Keynsian and welfare state philosophies and the consequent belief that governments can solve social problems; and real threats to national cohesion. The threat to cohesion played a particularly important role in sustaining regional redistribution in Canada over the post 1945 period.

The national equalisation, conditional grant, unemployment insurance, social security, and regional development policies pursued in post 1945 period have resulted in greatly improved standards of public services in the poorer regions of the country. As well, personal incomes grew steadily over the period and there was actually some convergence. This stands in contrast to the experience of the previous period when disparities widened. As a consequence, the people of the relatively poor provinces of Atlantic Canada are relatively happy with the national government policy. Although they continue to be a relatively poor region they generally believe that they would be worse off if the current policies were eliminated. The quality of life for most is very high and living standards are probably superior to those enjoyed by residents of northern New England. None the less, there are still deep grievances. In particular, the people of this region recognise that their standard of living is based precariously on the inflow of transfer payments from outside and would prefer to be self- supporting.

Given the current political environment with its emphasis on reduced state spending, free trade, deregulation, etc. and the risk of a break up of the Canadian union the people of the Atlantic Canadian provinces feel especially vulnerable. Despite (or, perhaps, because of) the massive inflow of money from outside the region the economic structure of the region is quite weak and a reduction in the flow of transfers for any reason would create much hardship. Moreover, continued uncertainty about the future of transfer payments is having a negative impact on current investment levels in the region.

In Quebec there is still more discontent. Indeed, Quebec is currently considering another referendum on independence and support for the independence option in Quebec is at an all time high. Although Quebecois nationalism was traditionally based on rural Catholicism, the nationalism of the 1980s is secular (over a period of just 30 years Quebec moved from the jurisdiction with the highest church attendance in North America to become the jurisdiction with the lowest church attendance) and entrepreneurial (for example,traditionally Quebecois education was dominated by philosophy, religion, and training for the public service; today most students study commerce and engineering.). The Quebecois people now believe that they can succeed in free trading world economy and that they can afford to pursue the longstanding goal of independence. However, it is important to note that the vast majority of Quebecois would vote to remain in Canada if all member states would agree to place serious limits on the ability of the national government to intrude into areas of provincial jurisdiction and give Quebec special legislative powers as the home of most of Canada's French speaking population.

Even the richer provinces are unhappy with the current state of affairs. A growing deficit at the national level has led many to question whether they can afford the expensive system of transfers designed to assure cohesion. The continued discontent in Quebec despite the concerted attempts to secure cohesion via financial transfers has also provoked reaction from Canadians in richer parts of the country. Indeed, many believe that the Quebec government is using the threat of independence as a strategy to secure concessions from the rest of the country. This feeling is so strong that support for Quebec independence is at an all time high outside Quebec.

Current Constitutional Debate in Canada

The widespread discontent in Canada and the threat of a sovereignty referendum in Quebec in November of 1992 have stimulated a critical re-examination of Canadian federalism and a series of reform proposals. Both intellectuals and politicians have been heavily involved in this debate and many of the country's leading economic and political theorists have been forced to leave the rarified air of the academy to advance ideas in a "high stakes" real world. This debate has direct relevance in Europe.

One of the most interesting features of the Canadian debate, especially from the perspective of Europeans, is that the Government of Quebec and many Quebecios intellectuals advocate a new Canada which closely resembles the European Community. Indeed, the Quebec Prime Minister, Robert Bourassa has explicitly advocated the EC model for Canada.

Quebec intellectuals view what they see as the EC model as the way for the future not only of Canada but of the world. A report of the governing Quebec Liberal Party's Constitutional Committee succinctly summarises the Quebec view of the EC model:

> In Western Europe, the countries of the European Community are building a new model of concerted political action and are achieving economic integration without compromising their national political sovereignty. They are proving that economic frontiers literally transcend political borders.
>
> The separation of the political from the economic is relatively recent. It stems from the growing international move to freer trade. This phenomena makes possible the emergence of local sovereignties. On the one hand, new nations, regardless of their size retain access to a vast market. On the other, the redrawn political borders give rise to more uniform entities more conducive to social cohesion and management of the public finances (Quebec Liberal Party Constitutional Committee, 1991, p. 53).

The Quebec position reduces to two critical components. First, trade between provinces of Canada should be as free as possible. Quebec politicians realise that the gains from trade are significant and favour economic and monetary union. Second, Canada should be a union in which the legislative powers are clearly divided in a way which preserves as much local sovereignty as possible. The Government of Quebec should have exclusive authority in most areas including social affairs, income security, social insurance, health, education, agriculture, the environment, research and development, industry, and regional development while the central government should only be responsible for defence, customs and tariffs, and currency. As a corollary, the central government should not be able to influence any policy areas within Quebec's exclusive jurisdiction.

Not surprisingly, Quebec's EC model has been extensively criticised, especially by English Canadian intellectuals. One argument suggests that the Quebec's EC model bears no resemblance to the EC at all. This is obvious to anyone who has seriously studied EC institutions. EC countries have not achieved economic and monetary union without significant reductions in local sovereignty in many areas, including many areas Quebec has targeted for exclusive jurisdiction. Moreover, Europeans are committed to further political integration in the future.

Critics of the Quebec model argue that there is a clear lesson in the EC experience for Canada but it is not the lesson drawn by politicians in Quebec. Instead the EC experience suggests that the Quebec model is unworkable since economic and monetary union is impossible without some form of political union. In the words of political scientist, Peter Leslie, " economic integration can not proceed far unless member states share quite a broad range of powers by allocating decision making authority to supranational institutions in which they may be outvoted from time to time, or unless – as in a federal system – decision making power in key economic areas is constitutionally vested in an order of government that encompasses the whole territory"(1992,vii).

Although critics have dismissed the Quebec EC model as unworkable the suggestion that the EC can be a model for Canada has been taken very seriously. One feature of the EC which has attracted considerable interest is the EC decision making process. Unlike the Quebec EC model which is based on a federal system with clearly divided powers (where, in the words of legal scholar , Kenneth Wheare, governments are co-ordinate and independent) the actual EC involves co-responsibility and co-decision. Local governments have significant input into decisions affecting the entire Community (co-decision) and Community decisions involve directives or conditional transfers which national governments adopt in their own country (co-responsibility). Federalism, in the classical sense, has proven unworkable in Canada. In today's complex society responsibilities can not be neatly divided into separate parcels for central and local governments. The EC system of co-decision and co-responsibility recognises this explicitly. The federal model, which all but prohibits joint decision making, does not.

Many Canadian scholars have used the actual EC model to advocate a renewed federalism in which many legislative areas are shared by the two orders of government. They argue that a classical federal model must be abandoned and new flexible and practical joint decision making methods, like those used in Europe, must be implemented. However, few constitutional scholars have been willing to advocate the entire EC model. Peter Leslie argues that the EC model would be regarded by Canadians as undemocratic; it would lack the capacity to redistribute the benefits of having an integrated market in a way Canadians would consider fair; and it would sharply reduce the capacity of the federal government to defend economic interests internationally, especially *vis-à-vis* the United States. As a consequence he argues that an EC type union in Canada would be politically unacceptable.

Canadians have had some experience with an EC style political model and Leslie's view that the EC political model would be considered undemocratic is based on that experience. In the 1960's the interdependence of all social and economic problems resulted in the growth of federal – provincial conferences involving senior bureaucrats, cabinet ministers, and government leaders. Over time more and more critical decisions were made by "committees of eleven government representatives" at the federal – provincial conferences. This style of government, which became known as *executive federalism*, diminished the role of the central government parliament and the provincial legislatures in the policy process. The resulting concentration of decision making power in the hands of a very tiny political élite was widely viewed as undemocratic.

Although some have argued that the government representatives at the intergovernmental conferences continued to feel a responsibility to their home governments, even these analysts had to admit that this responsibility was not direct. Moreover, members of opposition parties were completely locked out of the process. Deliberations were not generally public and thus not subject to public scrutiny. Even final decisions were presented as a *fait d'acompli*. The extreme version of executive policy making found in Europe would not receive any support in Canada.

Leslie also argues that the EC model for taxation would be politically unacceptable to Canadians because of the severe limits it places on redistribution across persons and regions. Specifically, he notes that redistributive schemes may be necessary in the union as a quid pro quo demanded by the fiscally weaker states and to achieve the equity objectives of Canadians.

Finally, he feels the weakening of Canada's national status would weaken Canadian influence internationally. Canadians value their independence from the US highly and any weakening of Canada's position *vis-à vis* its large southern neighbour would be viewed with concern.

Thus most Canadians, especially Canadian intellectuals, are advocating a renewed federalism which looks much like the existing version. In particular, most Canadian intellectuals would like to see a central government which is democratic, which has the capacity to assure a strong economic and monetary union and to redistribute the gains from union across individuals and regions, and which can represent Canadian interests abroad. Canadian intellectuals would, however, like to see governments closest to the people (the provincial governments) with more power. Given the practical difficulties associated with a classical federal structure with an extremely decentralised division of power, many of these intellectuals favour an approach which involves joint responsibility with local paramouncy. Under local paramouncy central decisions would be limited to the enunciation of principles or objectives, keeping detailed regulations to a minimum. The local governments would be responsible for implementing the directive.

The support for decentralisation among the country's intellectuals is tied to the presence of an equalisation programme which will continue to act as a cohesive force by allowing all provinces to provide comparable levels of public services at comparable tax rates. Even the proposal of the Quebec Government for decentralisation includes a provision for a Canada-wide equalisation programme. There is also significant support for the continuation of a fiscal gap where the national government collects more tax revenue than required to meet its expenditure responsibilities.

The intellectual rationale for the continuation of the fiscal gap and the equalisation programme should be of particular interest to Europeans. Many Canadian economists favour the fiscal gap because it helps assure a harmonised tax system within the Canadian common market.[28] They believe that a return to the tax jungle of the 1920s and 1930s would be a step backwards and that the best way to secure harmonisation is through a strong national government presence in the personal and corporate tax fields. Moreover, they believe that constitutional constraints on the national governments expenditure possibilities can provide a check on the growth of government spending.[29]

The equalisation programme receives support for two reasons. First, the programme contributes to cohesion and thus provides benefits in both rich and poor regions. As Tom Courchene (1984, p.406), one of the strongest advocates of decentralisation in Canada, has noted: "it is probably not an overstatement to assert that equalisation has become an *essential* part of the glue that binds us together as a nation" (my emphasis) Second, of all programmes aimed at cohesion, equalisation is one of the best . The reason for this is that transfers from rich to poor regions via an equalisation programme offers a variety of benefits to a rich region not associated with other cohesion policies. These additional benefits include:

(1) There are potential gains in long run productivity within the union. By enabling all governments to provide comparable quality health and education systems a greater number of "gifted" individuals will be in a position to contribute to the larger community. Entrepreneurship and scientific/technological contributions are often traced to "gifted" individuals. It is in the interest of the entire community to have an education system which will identify and nurture these "gifted" individuals and thereby assure they contribute to the full. (Otherwise the "gifted individuals might end up in occupations where their true talents are wasted.);

28 See Norrie, Boadway, and Osberg (1991) for a strong statement of this position.

29 The division of legislative powers, not a constitutionally entrenched balanced budget rule, plays this role.

(2) The literature on migration shows that education increases mobility thereby improving resource allocation. Moreover, improved education services in the poorer region may well promote indigenous development;

(3) If people migrate in response to differences in government activity the population will be inefficiently distributed. (This is because both labour and capital will respond, in part, to differences in what the literature calls net fiscal benefits when choosing location rather than solely to differences in productivity.) A transfer system which equalises net fiscal benefits will not, as a consequence, harm the donor region at all.[30] (In the absence of the equalisation programme citizens in the donor region will experience a decline in comprehensive income because in-migrants increase labour supply and push down productivity and wage rates.); and

(4) the transfers can also be viewed as a partial insurance scheme. The potential for this insurance role arises from the fact that regional business cycles are likely to differ. For example, a shift in the terms of trade in favour of primary products will stimulate resource based economies and dampen manufacturing based economies that use raw materials as inputs. Left alone, markets will react to this disturbance by altering the volume and composition of trade flows, and by inducing capital and labour to relocate from lower to higher renumeration areas. If the shift in relative prices is transitory, this adjustment may be socially inefficient; the process will be repeated in reverse once the terms of trade shift back. A revenue equalisation scheme can prevent this inefficiency by transferring funds from the primary product producing region to the manufacturing region.[31]

30 See: Boadway and Flatters (1982) for a full treatment of this position.

31 See: Eichengreen (1990) and Sachs and Sala-i-Martin (1991) for a full treatment of this effect.

The constitutional debate has also stimulated a critical examination of the specific programmes used in Canada to redistribute the gains from union. One of the central concerns in this debate has been the possibility that the elaborate system of redistributive fiscal policies designed to establish a sense of national citizenship has resulted in regional dependency. This concern is based on a belief that the regional transfer system inhibits the operation of market forces which would normally result in real convergence.

If the regional redistribution system does inhibit real convergence (convergence in market incomes) the convergence in welfare levels arising from the transfer system will be precariously (and permanently) based on the inflow of funds from outside the poor region. In other words, the regional redistribution system can give rise to a state of permanent dependence on the system itself. Moreover, the donor regions will be faced with a permanent drain on their resources.

The convergence in personal income and the absence of significant convergence in market incomes in Canada suggests a dependency problem. The most significant outcome of the Canadian debate is recognition of the fact that different policy instruments embody different incentive and disincentive effects. General statements about the redistributive transfer system as a whole are simply not sustainable.

As discussed above two approaches have been used to explicitly redistribute income via the central government in Canada: intergovernmental transfers and insurance schemes. Of these the national unemployment insurance scheme seems to give rise to the strongest disincentives for a variety of reasons. Most importantly it inhibits long term adjustment by reducing labour mobility and perpetuating seasonal employment. There is certainly evidence to suggest that it increases overall unemployment rates. The rise in unemployment rates is due, in part, to factors suggested in the neo-classical theories of labour supply, moral hazard, search, migration, and the reservation wage. However, neo-classical theory does not tell the whole story. In the poor regions of Canada there are often few choices available to workers since there are insufficient jobs available locally. Indeed, it has been argued that the aggregate demand effect of the inflow of UI funds actually results in net increases in employment. A complete account of why the UI programme can cause regional problems requires the abandonment of the standard neo-classical assumption of exogenously given preferences and allowing tastes to be endogenously determined. Such an account would recognise that an unemployment insurance programme has a long-term impact on attitudes within the region which in turn have implications for the unemployment rate. Sociologists in Canada have investigated this aspect of the UI programme and they have identified the rise of what has been called the UI culture. Specifically, people develop "new notions of happiness". Because a significant portion of the population in the poorer regions draw on the national UI programme at some point during the year there is no "stigma" attached to the receipt of UI payments. Thus, there are no social incentives to migrate, accept low wage employment, or attempt to establish new commercial enterprises. Tastes are also affected and the acquisition of material goods is less important within the society. Over time the wage rate required to induce the population to move or accept permanent employment grows. A self-selection process also results in a growing proportion of the population with tastes which imply a high reservation wage. (This is the most important *regional* affect of the programme.) The change in tastes is also passed on from generation to generation which, by affecting aspirations and life goals, influences educational attainment. In sum, the emergence of a UI culture within a poor, high unemployment region with access to a relatively generous UI programme can contribute to serious dependency in the long run.

The incentive effects of the UI programme are not restricted to market behaviour. The national UI programme in Canada also interacts with programmes offered by local governments. For example, local governments in Canada are responsible for 50 per cent of the cost of means tested welfare programmes. Many local governments have found it worthwhile to create short-term employment for individuals on the welfare rolls so they could qualify for the national unemployment insurance programme rather than concentrating on initiatives which would create sustainable long term employment in their region.

The Canadian experience with national unemployment insurance is not a happy one. Even the poorer regions acknowledge that it has had unfortunate consequences. The Canadian programme provides an excellent example of how not to design a UI programme. In Canada, unemployment insurance covers all workers with at least 14 weeks employment. It is not experience rated and has a relatively low benefit ceiling. As a consequence the programme does not provide insurance against the risk of unemployment but instead acts as an income support programme for workers who experience regular bouts of unemployment. Incentives to move, retrain, and/or move into steady employment are impaired. If an insurance programme at the Community level is seriously considered (as advocated by MacDougall, *et. al* (1977), van der Ploeg (1991), and Wyplosz (1991)) the Canadian experience should be carefully examined. The structure of the programme in Canada reflects a simple reality: it is difficult to implement an unemployment insurance programme that levies the highest premiums on those who have the highest risk of becoming unemployed since this group also tends to be among the poorest in a society. But if premiums are not based on actuarial principles the programme is likely to impede structural change and counteract programmes designed to encourage indigenous development.

Shared cost and other conditional grant programmes embodied a different approach to explicit regional redistribution. Such programmes can be used to finance a wide variety of local initiatives. Consequently, the incentive affects will vary with the type of initiative financed. In general these transfers enable local governments to provide better infrastructure without tax increases. This makes the region more attractive. Although this might limit out migration and thus inhibit adjustment it might also increase factor productivity and encourages adjustment. No general conclusions are possible without detailed examination of the individual initiative supported. Shared cost and conditional grant programmes also distort recipient government budgetary allocations. The most efficient methods of achieving a given objective may not be pursued because they do not qualify under the terms of cost sharing. Other, more valuable, programmes might be abandoned to free up resources to pursue the programme, receiving outside support. Also, these types of programmes can generate considerable transactions costs.

It is worth noting in passing that a complex transfer system in Canada has induced recipient governments to make decisions which are not in their long-term economic interests. The following is an example:

> Until recently, the province of Quebec had the highest minimum wage rate on the continent, let alone Canada. This does not make economic sense (given Quebec's high unemployment rate), but a large part of the reason for it is that Quebec does not bear the full economic and financial costs of its decision. The resulting unemployment increase in Quebec is offset, in part by the larger flow of UI benefits and federal contributions to welfare, as well as equalization payments (Courchene, 1981).

The relative expansion of the state made possible by the transfers (government expenditure as a proportion of GDP will be higher in poor regions than in rich regions) may also encourage the population to devote more of their energy to rent seeking than they would otherwise.

In sum, regional redistribution systems can generate dependency but this is not necessarily the case.

Summary

At this point it is not clear if Canada will survive the current constitutional crisis. The people of Quebec may well decided to pursue the long standing goal of independence or the residents in the English speaking part of the country may choose to support a stronger national government even if this implies a Canada without Quebec. But, regardless of the eventual outcome, there is much to be learned from the Canadian experience and Canadian debate and Europeans would do well to take this experience seriously.

Chapter 4

LESSONS FOR EUROPE

There are a number of critical lessons the Irish and Europeans generally can draw from the Canadian experience as they consider closer union within the European Community.

Lesson 1: Societal cohesion should be considered in any evaluation of changes to the European Community

In Canada, commentators frequently liken union to marriage. The analogy is striking for a number of reasons. First union, like marriage, involves a relationship between people and this relationship almost inevitably gives rise to occasional conflicts. As a consequence, union, like marriage, will require continuous adjustment and compromise lest the union breakdown in divorce. Second, a union, like marriage, is easier to sustain when potential points of conflict are minimised. Unions involving diverse ethnic communities, like cross cultural marriages, pose significant challenges. Nationalism will always be a threat to the European Community. Third, disintegration of a union, like marriage breakdown, typically involves significant personal and financial costs.

However, unlike marriage, a union does not involve a strong bond – love – which helps sustain the relationship when conflicts arise. Consequently a union is especially difficult to sustain and all aspects of a union agreement must be carefully scrutinised to assure potential conflict is minimised.

Lesson 2: The division of responsibility is central to any discussion of integration and societal cohesion should be given significant weight when evaluating alternative divisions of responsibility

Because union involves the transfer of some decision making authority from national governments to supranational institutions the division of responsibility between the two orders of government is typically at the centre of discussions of integration. A large technical literature on the economics of integration and fiscal federalism has provided a basis for assessments of alternative allocations of authority. This literature does not, however, provide unambiguous policy prescriptions. As a consequence, decision makers must use judgement and maintain a significant degree of "faith".

The Canadian experience with union suggests that any division of powers has the potential to generate conflict. Points of potential conflict, present and future, associated with any allocation of authority should be identified and assessed as part of any general evaluation of the division of legislative powers.The principle of subsidiarity, which has dominated debate about political integration in Europe, should be applied in many cases to minimise conflict. However, centralisation does not necessarily generate conflict. If it does not, the principle of subsidiarity should not be blindly applied since centralisation may contribute to societal cohesion.

Lesson 3: The de jure *and* de facto *division of legislative powers may differ in any system of multilevel government*

In Canada the central government became increasingly active in fields exclusively assigned to the provinces under the Canadian Constitution. There are at least four factors which account for the intrusion of one level of government into the exclusive affairs of another. First, politicians find it impossible not to respond to demands of their constituents.[32] Thus central government politicians inevitably devote some energy to problems in areas beyond their jurisdiction. Second, as anyone familiar with tax avoidance realises, it is often possible to work around any set of rules. Politicians in Canada certainly have found ways of getting around the formal division of powers to pursue objectives one would think, in principle, beyond their jurisdiction. Third, the inclusive government in Canada has access to all important revenue bases and therefore, has the financial resources to assume a role in provincial areas. Finally, and perhaps most importantly, a unique set of conditions existed in the period immediately following World War Two which facilitated the expansion of the inclusive government in Canada.[33]

32 One need only look at the topics debated in the European parliament to see how irrelevant the assignment of jurisdiction is to the concerns of politicians.

33 These conditions, which included a threat to unity, the "centralizing" influence of the war, and a faith in the power of governments to actually solve problems were mentioned earlier in this paper. The world today stands in stark contrast to the world of the post war period. It is unlikely the expansion of the inclusive government observed in the post war period would be observed in Canada today.

Lesson 4: The central level of government or the supranational institution is best situated to secure societal cohesion and redistributive policies have a role in securing this objective. However, redistributive policies implemented to foster a sense of community citizenship will not guarantee societal cohesion

Given threats to unity are typically initiated by member states and given all remaining states will be adversely affected by the diminution of the community the central authority is best situated to secure unity. The central government in Canada has played a critical role in maintaining unity in that country by establishing inclusive institutions and a sense of national citizenship through redistributive transfers.

However, even though the central Canadian government was able to implement a very generous system of redistributive transfers unity remains a central concern. Thus, redistributive transfers are not, in themselves, sufficient to assure unity.

Lesson 5: Some redistributive policies contribute more to unity than others

Canada has experimented with a wide variety of redistributive policies to secure societal cohesion. Some have worked well, others have not.

Two aspects of redistributive policies can give rise to conflict thus counteracting their value as an instrument to achieve cohesion. First, because redistributive policies generally involve losses for the donors and gains for the recipients they also involve potential conflict. Second, because redistributive policies often involve cost sharing or some other type of restriction they can become a source of conflict if the priorities of national and supranational governments diverge. In Canada shared cost programmes and other conditional transfers designed to foster a sense of national citizenship by encouraging provincial governments to implement programmes with national standards have often been divisive. The Province of Quebec, in particular, vigorously opposed these programmes and the history of federal intrusion into local affairs accounts, in part, for support for independence in that province. Europe currently relies heavily on conditional transfer programmes. The dangers inherent in this approach should be recognised. Fortunately, there are other redistributive instruments which do not generate much conflict.

Lesson 6: The unconditional transfer from central to local governments, especially equalisation type programmes, is probably the best instrument to achieve cohesion

The formal revenue equalisation programme has emerged as the instrument of choice to foster a sense of national citizenship in Canada. The programme has many merits including: respect for state sovereignty, providing insurance against the possibility of losses, contributing to equality of opportunity, and fostering a sense of "fair sharing" of the gains from union. Moreover, theoretical work suggests that it is not a simple zero sum redistributive programme since the donors can receive significant benefits. Although the Spanish proposal for an equalisation scheme was rejected at Maastrict it would be folly to dismiss this proposal permanently.

Lesson 7: Regional disparities are remarkably persistent

The total package of policies implemented to redistribute income across regions and encourage regional development in Canada is one of the most comprehensive in the world. Although the package has reduced disparities significant disparities remain. Indeed, provinces that were relatively poor at the turn of the century are still relatively poor today.

Economists do not fully understand why the comprehensive programme failed to generate significant convergence. It is clear, however, that the market forces which generate disparities are very strong and that policies designed to override these market forces would have to be extremely generous if the objective of regional equality in economic development is to be achieved. Still, it is also clear that the policies have generated some significant successes. In particular the standard of living in poor regions of Canada are not that different from those experienced in the richer regions. Thus, there has been significant convergence in the indicator most important to individual citizens. Also, the economies of rich and poor provinces have grown at approximately the same rate. Thus, the comprehensive policies have assured that any additional growth stimulated by union was shared by all union members.

None the less, the Canadian experience also points to a number of potential problems which can arise with specific policies. Central government redistributive policy, especially centralised programmes directly affecting the labour market – unemployment insurance,for example – *may* exacerbate the economic problems of poorer regions. Programmes must be carefully designed to minimise adverse incentives and inefficiencies.

Lesson 8: Local governments can not rely exclusively on central governments to deal with regional disparities

If regional policy is essentially zero – sum (the gains in the poor regions just equal losses in the rich regions) richer regions will resist the introduction of policies likely to be most effective since these involve the largest losses in the richer regions. Consequently, centralised regional policy is likely to reflect important compromises and it is unlikely that the most effective regional policy instruments, from the point of view of the poor region, will be chosen. In Canada, the central government has heavily supported unemployment insurance and off-shore oil development incentives because much of what is spent ends up back in the richer regions. Programmes designed to redistribute firms across space have received very little support since they involve obvious losses in the richer regions.

Because centralised regional policy is constrained by the richer regions it is often in the interests of local governments to push for unconditional transfers since the funds can be used in a way which reflects the interests of the people of the poor region.

Lesson 9: Poor regions should beware of programmes which generate dependency

The current situation in Atlantic Canada, where the people of this dependent region possibly face a dramatic reduction in transfer payments from outside, illustrates the importance of policies designed to build the economic basis of the region. Given cohesion can not be guaranteed poor regions must make special effort to assure both Community and national policies are designed in a way which minimises the cost of adjustment should the union breakdown. Also, if the living standards in poor regions are sensitive to redistributive policies initiated by the central level of government it is in the interests of the poor region to assure union institutions are designed in a way which assures cohesion, even if these institutions result in less redistribution in the short run.

Lesson 10: It is possible to have a centralised tax collection system in a union with a very decentralised distribution of expenditure responsibilities

The Canadian experience shows that it is possible to have a centralised tax collection system in a union with very decentralised distribution of expenditure responsibilities. The Canadian tax collection system provides an interesting model should European countries decide that tax harmonisation offers significant efficiency gains. The critical features of the Canadian system are that all member states have adopted a common tax base and that the tax is collected by the central government. Individual states are free to chose their own tax rates. The Canadian version of a tax collection system includes a formal revenue equalisation programme but a centralised tax collection system does not have to include this innovation.

Chapter 5

CONCLUSION

The purpose of this paper was to make a contribution to debate over economic and political integration within the European Community. The intent was not, however, to offer a detailed blue print for a new Europe or even strong recommendations for specific changes in European institutions. Instead, the paper pursued the more modest goal of providing background information on the experience of one union to identify some of the contentious issues which can arise in the life of a union and assess the impact of policy measures adopted to maintain unity.

The opening section of the paper provided a rationale for this modest approach by surveying the theoretical literature on economic and political integration. The survey showed that the theoretical literature can not produce a definitive blueprint for European integration. In part, this is because the literature is still underdeveloped and too much remains unknown. But more important, it is because there will always be too much uncertainty about the consequences of specific integrative arrangements.

Uncertainty about the ultimate impact of a treaty, constitution or policy pervades all political debate and, as a consequence, every policy choice involves a "leap of faith".[34] None the less, the required "leap of faith" can be reduced significantly if policy options are subject to rigorous logical scrutiny (theoretical criticism) and if they are assessed in light of past experiences (empirical analysis). It is hoped that the review of the Canadian experience offered in this paper will help Europeans reduce their "leap of faith" as they weigh their options and make choices on future integration.

Two characteristics of the Canadian union were emphasised because they have special relevance to the Irish and European debate over integration. The first highlighted characteristic is that most Canadians , like most Europeans, primarily identify with their local community (in

34 The term "leap of faith" was widely used in the intense debate in Canada over the Free Trade Agreement (FTA) struck with the United States in 1979.

Canada, their province; in Europe, their nation) and their local state. The strong local allegiances and ethnic nationalism have generated continuous tension in the Canadian union. In Europe, where local allegiances and ethnic nationalism are even stronger than in Canada, tension and conflict is almost inevitable.

The second feature of the Canadian union emphasised in this paper was the existence of persistent regional disparities. Like the strong local allegiances and ethnic nationalism, regional disparities in income and employment opportunities generate tension and conflict in a union.

The Canadian union has helped Canadians achieve one of the highest standards of living in the world. Canadians have long recognised the substantial benefits which flow from union and considerable effort has been devoted to sustaining the Canadian union.There are important lessons from the Canadian experience in dealing with strong local allegiances, ethnic nationalism, and regional disparities for Europe.

During the 1980s and early 1990s – the years of "Europhoria" – the problem of sustaining a union did not receive significant attention in Europe. Recent events, including the rejection of the Maastrict treaty by the Danes and the heated debate elsewhere, will almost guarantee more interest in this important problem. It seems particularly important for the European Community to give more weight to the problem of sustaining union as it contemplates broadening membership. Broadening membership may generate gains but it will also inevitably increase tensions and make societal cohesion more challenging.

The Canadian union adopted a broad range of measures to secure "societal cohesion" (to keep the union together). Legislative powers were divided in a way that assured local governments retained responsibility for most expenditure functions where preference diversity and ethnic differences could threaten conflict. Regional development programmes were introduced to encourage even development of the private sector. Intergovernmental transfers were used to encourage even development of the decentralised public sector. Central government transfer programmes to persons were used to simultaneously pursue equity and cohesion objectives.

In general, the policies which simultaneously respected local sovereignty and distributed the gains from union in a way which all members of union considered "fair" worked best. Policies which did not simultaneously respect local sovereignty and "fairly" distribute gains generated tension. For example, when the market was allowed to distribute the gains from union some provinces lost ground. This generated tension despite respecting local sovereignty. When the central government used conditional transfers to encourage the development of comparable health care systems tension arose because some provinces felt that the model for health care chosen by the central government was inappropriate in their jurisdiction. Unconditional transfers from central to local governments simultaneously satisfied both criteria.

The Canadian experience with regional development policies has particular relevance for Ireland and other relatively poor states in Europe. Centralised policies designed to improve infrastructure and influence the location of private sector firms have not always been successful. Richer regions often opposed the introduction of policies likely to be most effective since these involved the largest losses in the richer regions. Moreover, when potentially effective regional policies were implemented richer regions effectively lobbied for other industrial policies which rendered regional policy ineffective. The combination of centralised regional policy and centralised industrial policies is not necessarily in the interests of poorer regions.

In contrast, the Canadian Equalisation programme has been a particularly effective regional policy instrument. The Equalisation programme allows local government in Canada to set their own priorities while at the same time assuring that all local governments have access to a similar revenue base. Under this programme one local government could implement a comprehensive industrial development plan (subject to trade rules on subsidies) if it believed implementation of this programme was the best use of resources in its locality, and another local government could implement a programme to improve health, education , and training if that government believed its policies offered the greatest gain. Because the Equalisation programme equalises opportunity (all local governments can potentially implement the same policies) it contributes to a sense of "fair sharing" in the union. Because it respects local sovereignty it limits conflict. Moreover, the diversity of policies which result provides policy analysts with information on the success and failure of alternative development approaches. This in turn can improve policy effectiveness.

European discussion of equalisation and fiscal federalism has focused almost exclusively on spillovers, inefficient migration, and the need for insurance against random shocks under a common currency or fixed exchange rate regime. Little weight has been given to societal cohesion and regional development in discussions of fiscal federalism and the appropriate roles for supranational institutions. This is most evident in the technical background papers to *One Market/One Money*. The Van Rompuy, Abraham, and Heremans (1991) contribution on fiscal federalism notes in passing that "one of the striking features of federal systems is that interregional solidarity mechanisms form an essential part of the "federal contract" ." However, the authors do not seem to recognise that union necessarily involves some tension (and the threat of breakdown) or that interregional solidarity mechanisms have a critical role to play in reducing tension and keeping the union intact.[35] Consequently, their discussion of fiscal federalism does not include a discussion of policies designed to secure societal cohesion. Given the Canadian experience more work on the relationship between societal cohesion, regional development policy, and fiscal federalism is needed in the EC.

Perhaps the most important lesson to be drawn from this review of the Canadian experience is that a union is a continuously changing entity. The nature of a union is not established by the words of a treaty or constitution but instead by an extremely complex process in which the law and the evolving political, social and economic systems interact. The complexity of this process makes preserving union a challenging task. But the peace and prosperity which result from union make it worth everyone's while to rise to the challenge.

35 The Van Rompuy, Abraham and Heremans contribution is based on the theoretical economics literature on fiscal federalism. This literature also neglects societal cohesion. It is difficult to understand why this important concern is neglected. Perhaps economists are too wedded to their individualistic concept of society, and their particular model of individual rationality. There is little room in the standard model for ethnic nationalism. Indeed, most economists find ethnic nationalism incomprehensible (and often irrational).See Breton (1964) for one of the few economic studies of nationalism. Yet ethnic nationalism exists and people sacrifice their lives to preserve it.

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