

# **FEDERALISM AND THE NEW ECONOMIC ORDER: A Citizen and Process Perspective<sup>1</sup>**

**By**

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## **I: INTRODUCTION<sup>i</sup>**

The power and pervasiveness of globalization and the knowledge/information revolution (henceforth referred to as the new economic order, NEO, or the new global order) are such that all nations will have to conform to this new paradigm. However, the federal model is so inherently flexible that it can accommodate the NEO dictates on the one hand and a wide range of domestic political and social values on the other. Substantiating this assertion – that federalism can, consistent with underlying societal values, deliver both economic competitiveness and social cohesion in the new economic order – is the primary purpose of the ensuing analysis.

Toward this end, the first order of business will be to draw on the experience of four successful but politically and institutionally widely different federal systems in order to demonstrate the remarkable ability of the structures and processes of federalism not only to deliver competitiveness and cohesion, but to do so while fully respecting the underlying

social and political cultures of the respective nations. What this means is that, despite the inevitability of the NEO dictates, federal systems do have a rich variety of choices in terms of *how* they will accommodate the NEO.

The second order of business is, of course, to detail the salient features that characterize the transition from the old societal paradigm to the NEO. Included among these will be the implications for governments, citizens, and markets, as well as for the division of powers.

With this overview focus on both the demand side (the nature of the NEO) and the supply side (the range of structures and processes to accommodate the NEO), the remainder of the paper focusses in more detail on selected policy and governance issues within federations themselves and also with reference to their participation in supra-national agreements like NAFTA, the EU and Mercosur. Included among the former are the preconditions for the successive exercise of competitive federalism, approaches to generating hard budget constraints, securing an internal economic union, and preserving and promoting the social union. These relate in large measure either to aspects of intergovernmentalism (horizontal, vertical or both) or, in the case of the social union, to co-determination.

There is, however, a key aspect of federalism that transcends these interrelationships among and between levels of government, namely the relationship between federalism and citizens. While, the literature on intergovernmental transfers does pay appropriate attention to horizontal and vertical equity, a key role of the ensuing analysis is to transcend this socio-economic relationship and address citizens' rights, democratic participation and accountability in federal systems. While this is important in its own right, especially in light of the citizen-enhancing aspects of the WEO, it is doubly important in the federalism context since without features like sub-national accountability to citizens it is highly unlikely that desirable operational characteristics such as hard budget constraints and an internal common market can be achieved.

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The final section of the paper then turns briefly to the relationship between federalism and regional trading blocs. The main message here is that, for federations that have already accommodated themselves to the dictates of the NEO (as outlined earlier in the analysis), the transition to a regional trading block or to “supra-national federalism” should neither be difficult nor unnatural. Nonetheless, some new challenges will arise such as centrifugal pressures relating to provincial-international linkages or to province-to-province associations across national boundaries. And the advent of the euro means that issues relating to currency integration will inevitably surface.

A brief conclusion completes the essay.

## **II: FEDERALISM AS THE EMBODIMENT OF SOCIETAL VALUES: A COMPARATIVE PERSPECTIVE<sup>ii</sup>**

Federations come in many varieties. What they all have in common is a constitution that allocates powers on a self-rule, shared-rule basis and a set of processes to implement this constitutional structure. Given the difficulty of accomplishing constitutional amendment in most federations, this puts a premium on *process* as a means of accommodating change, especially during periods in which societies are in full evolutionary flight. As Friedrich (1968) noted:

Federalism should not be seen only as a static pattern or design, characterized by a particular and precisely fixed division of powers between government levels.

Federalism is also and perhaps primarily the process ... of adopting *joint policies* and making *joint decisions* on *joint problems* (quoted in Bastien 1981:48, emphasis added).

But the process dimension plays a larger role still. Specifically, while the combination of intergovernmental grants, equalization and

intergovernmental arrangements can and does vary widely across federations, it is nonetheless (and perhaps surprisingly) the case that the nature of, and incentives within, these grants is anything but arbitrary across federations. Rather, they tend to embody and indeed to re-enforce the values and norms of the citizen-government and citizen-citizen relationships that underline the societal social/political contract.

To see this, it is instructive to focus on the structure and process dimensions of federal systems in a comparative context, beginning with the Commonwealth of Australia and then dealing in turn with Germany, Canada and the US.

### **A. Australia**

Australia is not only a highly centralized federation, it is also a highly egalitarian nation. For example, welfare payments are designed and delivered from Canberra and, as a result, are identical across the country, in sharp contrast to, say, Canada where responsibility for welfare is provincial and benefits vary widely across provinces. Wage grids are also essentially uniform across the country – university professors are on the same wage grid whether they teach in Perth, Sydney or Launceston. On the tax side, the Australian states do not have effective access to broad-based taxes (income taxes, sales taxes) and the taxes that they do levy are being eroded by a combination of global forces and High Court decisions (Courchene, 1999). Not surprisingly, therefore, the Australian states are highly transfer dependent: “Australia has by far the highest degree of vertical fiscal imbalance among the major federations in the world” (Walsh, 1996, 115).<sup>iii</sup>

More relevant for present purposes, the system of intergovernmental grants fully complements Australia’s centralized/egalitarian society. First, over one-half of the cash transfers to the states are in the form of conditional grants (Specific Purpose Transfers, in the Australian context) which, in turn, enhance both centralization and uniformity.<sup>iv</sup> Second, Australia’s approach to removing horizontal fiscal imbalances – the Financial

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

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

## **B. Germany**

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

federalism” that prevails in, say, Canada where the provinces have wide legislative responsibilities. Not surprisingly, therefore, all major tax rates in Germany are set centrally with no variations allowed at the Länder level (although the Länder “administer” or collect these tax revenues). Apart from a relatively minor range of Länder and municipal taxes, most Länder revenue comes from revenue-sharing arrangements with the centre. The major shared or joint taxes include corporate and personal income taxes, capital taxes and the VAT. Some of this revenue sharing follows the principle of derivation, some is allocated on equal-per-capita terms and some (especially for the new Länder) is based on equalizing principles. Beyond this revenue sharing, there is a second and overarching tier – an inter-Länder, revenue-sharing pool. One should note that “needs” are also taken into account in terms of the operations of the inter-Länder revenue-sharing pool, i.e. the “standardized” revenues for purposes of the pool incorporate expenditure needs to a degree. Other things equal, Länder with large cities and/or high population densities are deemed to require more revenues and vice versa. (This is in sharp contrast to the Australian approach to needs where population sparsity is deemed to require greater expenditures which, in turn, suggests that equalizing for expenditure needs in federal nations remains a very subjective exercise).

The guiding principle underlying intergovernmental transfers in Germany is the constitutional (*Basic Law*) provision ensuring “uniformity of living conditions”. One should note that in the late 1990s three Länd governments (Baden-Württemberg, Bavaria and Hessen) challenged the system of equalization in the German Constitutional Court on grounds that it is excessively redistributive. The resulting decision of the Court limited the degree of per capita equalization to 95% of the national average, down from the previous 99.5%. Spahn (2001) notes that while this decision will trigger a “fundamental review” of the existing equalization law, it might not lead to a corresponding fundamental reworking of the law since “interregional solidarity ...

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

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

### **C. Canada**

In contrast to Germany, the Canadian provinces have no formal role in the operations of the central government: the Senate (upper chamber) is appointed for “life” (up to age 75) by the government of the day and, as a result, is not a “federal” chamber in any meaningful sense. Hence, provincial concerns and issues tend, by default as it were, to be articulated through the provinces and their respective premiers. Indeed, Canada also differs from the typical federation in that the Canadian constitution embodies an extensive listing of exclusive provincial powers. Beyond this, there are other features of the Canadian federation which propel it toward decentralization. The province of Quebec, with one-quarter of Canada’s population, is linguistically, culturally and institutionally (continental civil law rather than English common law) distinct. Not surprisingly, Quebec

has long been a “states’-rights” province which, in turn, has moved Canada not only toward greater decentralization but greater asymmetry as well (e.g. Quebec has its own, separate, personal income tax whereas the rest of the provinces “piggy-back” their tax rates on Ottawa’s personal income tax system).

In any event, the Canadian federation is highly decentralized on both the expenditure and tax fronts. For example, the provinces levy their own tax rates and bracket structures in terms of personal and corporate taxes, levy their own sales taxes, control the natural resources within their borders and on the program expenditure side are responsible for health, welfare, education, and training, among many other areas. Given the thrust of this section, it should not come as a surprise that the Canadian system of intergovernmental transfers is serving to accommodate this decentralization.

Focussing first on Canada’s equalization program, the constitutional principle is much less comprehensive than that in Australia: “Parliament and the government of Canada are committed to making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable tax rates”. This Canada does by providing equalization payments to the poorer provinces in order to bring their per capita revenues up to the so-called “five-province standard” (i.e. close to the national-average standard). Unlike Australia, however, the revenues of rich provinces are not “levelled down” to this five-province average, nor does Canada equalize for needs on the expenditure side. These equalization payments are wholly unconditional.

More interesting, perhaps, is the Canadian approach toward those transfers designed to address vertical imbalance. When introduced in the 1950s and 1960s, these vertical-balance grants were of the shared-cost, conditional variety, linked to various program areas such as welfare, health and education. Over time, as the programs that they were associated with became “established” across the citizenry in the various provinces, the federal

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

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

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

#### **D. The United States**

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

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

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

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

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

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

government. Although critics of competitive federalism argue that it induces “races to the bottom”, especially in business regulation, social welfare, and environmental protection, there is, to date, little evidence of negative downsides.

This mobility also helps to explain a distinctive feature of American federalism, namely, the absence of federal fiscal equalization for the constituent states. Most federations, such as Canada and Germany, engage in fiscal equalization. Given that mobility compels no one to live in a poor state, the U.S. government and wealthy states are not seen as being obligated to supply poor states with revenue to provide services equal to the national average or to a constitutional command for “uniformity of living standards” as in Germany’s Basic Law. (Per capita income ranged from \$38,480 in Connecticut to \$19,012 in Mississippi in 1998.) Although, as a practical matter, some states, especially in the Northeast, have been long-term fiscal donors while some states in the South and West have been immortal vampires, the historic tendency in Congress has been to treat all states roughly equally or in proportion to population with respect to federal largesse. Furthermore, unlike some federations (e.g., Canada and Germany) for which fiscal equalization is a key component of the “social compact,” this has never been relevant in the United States. The key component of the American “social compact” is the ability of the federal

Constitution and federal government to deliver individual liberty, economic opportunity, and social welfare, plus national security. As a result, rather than

The larger message is the following. The pervasiveness of the forces of globalization and the knowledge/information revolution are such that all federations are wrestling with the need to accommodate themselves to the dictates of the NEO. However, what the above comparative

redistribute federal revenues to places via fiscal equalization, revenues are redistributed to persons via welfare programs. Such redistribution is the U.S. government’s single largest function, consuming 55-70% of the federal budget, depending on how one defines redistribution.

However, one comes out on this equalization issue, it is clear that the US approach to intergovernmental grants, and to the processes of federalism generally, accords well with the *laissez-faire* US constitutional rhetoric, “Life, Liberty and the Pursuit of Happiness”.

### **E. Recapitulation**

The conclusion to be drawn from this brief review of the role of intergovernmental transfers in the four developed federal systems is that intergovernmental transfer arrangements are anything but arbitrary. Indeed, the opposite appears to be the case – they complement the existing tax and expenditure allocations in a manner that integrates overall fiscal federalism in directions consistent with the implicit or explicit underlying values and norms of the respective federal systems. In this sense they are, in effect, part and parcel of the constitutional/institutional machinery that reflects and embodies the deeper societal values of the federation.

To be sure, the causation may go both ways. If intergovernmental grants are unconditional, this will tilt the balance of power toward sub-national governments. But already decentralized federations may dictate that future grants continue to be unconditional. Nonetheless, this potential symbiosis does not undermine the observation that the manner in which federal systems operate resonates closely with the underlying values of the federation.

analysis demonstrates is that federations can be both economically successful and faithful to their societal compacts under a very wide range of federal structures and processes. In turn, this implies that federations can be accommodative to

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

But what are these “dictates” of the NEO. To this I now turn.

### **III: THE IMPLICATIONS OF THE NEW ECONOMIC ORDER ON FEDERAL SYSTEMS**

In *A State of Minds: Toward a Human Capital Future for Canadians* (2001), I have outlined the variety of ways in which globalization and the information era have transformed the roles of citizens, markets and governments and the interrelationships among them. For present purposes, the focus is on a narrower set of implications, beginning with the implications of the NEO for what Castells (1989) refers to as the “space of places” and the “space of flows”. The former reference is to the integration of geo-economic space and the latter is to the (inherently-non-territorial) information-revolution-driven networking relationships among economic and political agents.

#### **A. Integrating Economic Geography: The Sub-National/International Interface**

At the highest level of generality, “nothing is ‘overseas’ any longer” (Ohmae, 1990, vii). Alternatively, everything is! Ohmae (1993,98) further observes, “On the global economic map, the lines that now matter are those defining what might be called “region states”. Indeed, in *From Heartland to North American Region State: The Social, Fiscal and Federal Evolution of Ontario* (1998) Colin Telmer and I designated the Canadian province of Ontario as having donned the mantle of a North American region state. Part of the rationale for this was trade related: from a position in 1981 when Ontario’s exports to the rest of Canada (interprovincial exports) and its exports to the rest of the world (international exports) were both running at or near C\$40 billion, Ontario’s international exports are now in the C\$200 billion range, fully three times larger than its interprovincial

exports. Given that the value of international exports is equivalent to roughly 55% of Ontario GDP and given, also, that over 90% of these exports are destined for US markets, it should be evident to one and all that Ontario’s economic future lies in USA/NAFTA economic space. Part, also, of the rationale for the North American region state label reflects the policy approach of the government of Ontario: Effectively, the province is legislating with an eye to privileging Ontario and Ontarians in this emerging NAFTA economic space, consistent with the “creation-of-untraded-interdependencies” requirement of region states (Storper, 1995,211).

Canada is probably the most extreme example of the interplay among globalization, economic geography and sub-national jurisdictions. All but one of Canada’s ten provinces are now more integrated, trade-wise, with the rest of the world (essentially the US) than with the rest of Canada.<sup>v</sup> In this sense, virtually all provinces are also in the process of embarking on region-state status.<sup>vi</sup> This leads to several observations that, although specifically related to Canada, are likely to have important implications for federations elsewhere. The first is that Canada is progressively less and less a single east-west, national economy and more and more a series of north-south, cross-border economies. A second implication is that since these cross-border economies are quite different from each other, the net result will not only be more decentralization but more asymmetry across provinces: the manner in which British Columbia integrates with the US northwest and the Pacific Rim is likely to be quite different from the way in which Ontario integrates with the New York-Chicago axis. Thus, the resulting challenge on both counts is how to mount an east-west (or internal) social/political union over an increasingly north-south (external) trading union. The traditional nation-to-nation interface in terms of international economic relations is progressively giving way to a series of “regional-international interfaces” (or sub-national/international interfaces). Federal systems must be flexible in order to accommodate these centrifugal forces.

While the above focus has been on Canada, it is clear that the upper tier of Mexican states is also progressively integrating into NAFTA economic space, e.g., one can also view Nuevo Leon as a North American region state, and as well one can view key aspects of its legislation as being directed toward privileging its citizens within a progressively integrating North America. And as Rezende and Afonso (2002, 34) note, some Brazilian regions are also becoming more integrated externally and in the process reducing their former dependence on domestic inputs and markets.

Since these region states are more likely to arise in the context of regional free-trade arrangements, it is convenient to direct attention to them.

#### **regional integration (Mercosur, NAFTA, EU)**

To this point the discussion of integrating geo-economic space has essentially dealt with a federation operating within a WTO framework. I now turn to the implications for federations that are part of regional (or supra-national) economic/trading unions.

Regional free trade agreements (RFTAs) provide both opportunities and challenges. Intriguingly, they may make it easier, politically, for a federation to create an *internal* economic union either because the RFTA would incorporate operating provisions like “national treatment” which would be binding on both federal and provincial governments, or because of the “directives” or harmonization agendas that flow from the RFTA. In Canada’s case, the “demonstration effect” of the Canada-US FTA and of NAFTA turned out to be a powerful catalyst for freeing up *internal* markets. In effect, Canadians said to themselves, “if we can negotiate international free trade, then surely it must be possible to negotiate free trade across provincial boundaries,” with the result that Canada’s *Agreement on Internal Trade* (AIT)

was signed by Ottawa and all provinces in 1994 and came into effect in 1995. As an aside, note that the Canada-US Free Trade Agreement became effective in 1989 and, as noted above, provided an important catalyst for CLAIT.

Rezende and Afonso (2002, section 5) provide an excellent overview of many of the challenges facing federations as members of a regional trading bloc. For example, they proceed to sketch out what tax reform in an integrated geo-economic space ought to achieve – common tax bases, both levels of government able to set tax rates, effective audits, etc. However, as I will argue later, these are increasingly also the requirements of the NEO, whether or not one is part of a regional trade block. Indeed, under the heightened mobility of capital (physical, financial and human), the top marginal tax rates for mobile factors must be in line with those of one’s major trading partners. More generally, short of the creation of some sort of global tax on capital, taxation has to shift from away taxing income and toward taxing consumption, where the ideal form of the latter is an export and import neutral VAT.

Of more concern is that regional integration could lead to unequal growth prospects or to provincial economic disparities within federations. While one cannot deny this possibility, Canadian experience has been instructive. The Atlantic Provinces (Newfoundland, Prince Edward Island, Nova Scotia and New Brunswick), long dependent on the federal government for income support of various sorts, have in the context of the FTA and NAFTA been able to begin to wean themselves off of decades of federal largesse and to attempt to pursue a more independent way within NAFTA economic space. Rezende and Afonso (2002) suggest that this might also hold for the poor northeast region of Brazil.

#### **B. Integrating Networks (The Space of Flows)**

One of the ways in which the information revolution manifests itself is that the *network* is becoming the dominant and pervasive organizational form of the information age. Not

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

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

These (essentially non-territorial) networks of power range both horizontally (among and between nation states) and vertically (up, down and across the hierarchy of cities, regions, nations, and supra-national institutions). Thus, governance and power are being distributed across these networks and more generally across society, economy and polity. Paquet (1997,30) notes that these relationships can shift from being hierarchical to being heterarchical, very similar to the common game of paper, rock and scissors, where paper covers rock, rock crushes scissors, and scissors cuts paper. Thus, “any sector may at times have dominion over the others: indeed, the three sectors [society, economy, polity] co-evolve.” (*loc. cit.*).

The interaction between the changing nature of the space of places and the space of flows has obvious implications for the division of powers, to which I now turn.

### C. Subsidiarity and the Division of Powers

It is by now commonplace to recognize that in the NEO powers are being transferred both upwards and downwards from central governments of nation states, a process that I have referred to as *glocalization* (1995). The upward transfer is straightforward: economic space is transcending political space with the result that countries are, in countervail fashion, transferring powers to supranational structures and regulatory bodies (NAFTA, EU, European Central Bank). The downward transfer is to markets (privatization, contracting out, deregulation), to lower levels of government (e.g. the devolution in Canada of powers relating to forestry, mining, tourism, training, etc.), and to citizens (via the democratization of access to information technology). Indeed, one aspect of this downward transfer of powers is that governments have lost their erstwhile monopoly or control over information which has, in turn, resulted in a redrawing of the boundaries between what ought to be public or private, or federal or provincial.

The process of *glocalization* can also find a rationale in terms of the operation of the “principle of subsidiarity”. In its most general version, the principle of subsidiarity states that the locus of decision-making and delivery should be as close to the people affected as is feasible. Clearly, the information revolution component of the new societal order (especially the dramatic fall in communication and computation costs) is decentralizing in that it makes more feasible the downward transfer of many more programs/policies. However, there is a corollary to subsidiarity that states that if there are spillovers or externalities associated with locating service delivery at a given level or jurisdiction, then these externalities should be “internalized” by transferring the activity up the jurisdictional ladder. Since one of the key determinants of spillovers or externalities is the inherent *mobility* of the good or service in question, and since one of the frequently used definitions for globalization is “ultra-mobility,” it is clear that globalization component

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

Intriguingly, one can also make a case that part of the rationale for the upward or supra-national transfer of powers is to strengthen *national autonomy*. The argument runs roughly as follows. Global forces, including the ultra-mobility of capital, are progressively impinging on the ability of nation states to control key policy areas *within their own borders*. Hence, the resort to supra-national fora for oversight and regulation occurs in part in order to regain and/or re-assert some *domestic* control over these policy areas. For example, one of the reasons for the success of the EU is that “the European Union does not supplant the existing nation-states but, on the contrary, is a fundamental instrument for their survival on the condition of conceding shares of sovereignty in exchange for a greater say, in world, *and domestic*, affairs in the age of globalization” (Castells, 1998,330, emphasis added). Hence, “nationalism not federalism, is the concomitant development of European integration” (*Ibid*, 327).

This line of reasoning can be carried beyond the European Union. Arguably, an important part of the rationale for nation states participating in supra-national arrangements is roughly similar, namely to allow nations a role in formulating multilateral principles and procedures that will hopefully provide an enhanced degree of order and certainty to the international system and, at the same time, will also generate increased degrees of freedom for them to manoeuvre on the domestic front.

To round out the discussion of issues relating to governance and powers, one needs to address the emergence of global city regions.

#### **D. Global City Regions**

The interplay among globalization, the emergence of region states, the information era and the principle of subsidiarity have conspired, as it were, to catapult “global city regions” into the role of dynamic motors of the NEO. For example, without Toronto and the Greater Toronto Area (GTA) as an economic engine with an international reach, Ontario could not be a meaningful North American region state. Presumably the same would apply to Monterrey and Nuevo Leon. Beyond this, there is a growing recognition that large urban agglomerations are driving much of what falls under the umbrella of globalization. In a recent book, Scott *et al* (2001,18) note that “global city regions come to function increasingly as the regional nodes of the global economy, that is, as dynamic local networks of economic relationships caught up in the more extended worldwide webs of interregional competition and exchange.” Ohmae (2001,33) takes an even more sweeping view: “the world, economically and in management terms, has become a network of prosperous regions, prosperous city-regions.”

The emergence of global city regions poses a structural or process problem for some federations where cities are in effect “constitutionless.” Consider the Canadian federation, where cities/municipalities are not mentioned in the constitution and are the creatures of the provinces. Hence, they find themselves without an independent fiscal base and have no direct relationship to the federal government, unlike comparable US cities which can, via accepted convention, access Washington’s infrastructure monies. In Toronto’s case, this has led the city to promulgate a “Charter” which seeks to bring the city more fully and more formally into the intergovernmental operations of Canadian federation. The larger message for all federations is that the economic and, therefore, the political star of global city regions is rising in the NEO and, one

way or another, this reality has to be accommodated.

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

### **E. Citizens and the NEO**

Citizens have emerged as the principal beneficiaries of the information revolution. In their role as consumers, they are clearly in the driver's seat, so much so that in *The Borderless World* Kenichi Ohmae (1990) actually defines globalization as "consumer sovereignty." Moreover, like-minded citizens, networking within and among countries, are emerging as increasingly important players in domestic and global governance. Information empowerment and the democratization of technology will make this so. As Lawrence Grossman, former President of NBC News remarked:

Printing made us all readers.  
Xeroxing made us all publishers.  
Television made us all viewers.  
Digitization makes us all broadcasters."  
(cited in

Friedman, 1999,45).

For example, of the 25,000 INGOs listed in the Union of the International Organizations, fully 20,000 of them did not exist a decade ago. Phrased differently, INGOs are the product of the Internet. Not only are these institutions of civil society playing a significant role internationally (e.g., helping derail the Multilateral Agreement on Investment and stalling the WTO process), they are also serving to "internationalize" citizenship in terms, for example, of trans-national goals and rights agendas and in the process are also serving to

undermine the nation state "from below," as it were.

Undoubtedly, the most significant aspect of this interaction between citizens and the NEO is that the knowledge/information revolution is privileging skills and human capital in much the same way as the Industrial Revolution privileged physical capital. Among the implications that flow from this are:

- The absolute and relative returns to human capital are rising, with the result that market incomes are polarizing;
- All nations must guard against Dani Rodrik's (1997,2) concern, namely "ensuring that international economic integration does not lead to domestic social disintegration";
- The good news here is that with knowledge at the cutting edge of competitiveness, social policy in its human capital development aspects is essentially identical to economic policy;
- Relatedly, and assuming that we can surmount the "digital divide" associated with the information revolution, human capital is likely to be distributed much more equally than access to physical and/or financial capital, with significant implications for developing nations and the north-south divide.

The obvious policy response is to increase the equality of opportunity for all citizens to develop their human capital. That this may create special challenges for federations is now highlighted.

### **F. More on the NEO and the Division of Powers**

Consistent with the thrust of the above analysis that the NEO will catapult citizens and human capital into the economic policy limelight, it appears that the political marketplace is evolving along similar lines. In Canada, at least, the electoral currency of the old paradigm – resource-based economic development – is no longer the stuff of nation building. This being the case, one may as well devolve some of these areas to the provinces,

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

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

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

emphasizing the importance of "federalism as process."

### **G. Recapitulation and Transition**

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

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

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

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

among other goals, would guarantee non-interruption of essential social services to citizens as they move from province to province. A third feature might be a “citizens’ rights charter” which would guarantee certain rights of citizenship no matter where citizens choose to live, e.g., the right to move anywhere in the country, the right to have one’s credentials/qualifications recognized throughout the country, and the right to appeal treatment under the various agreements falling under the covenant. Beyond the obvious, namely that an internal economic union will enhance competitiveness, the rationale for the remaining two agreements is that developing a social union for services and human capital is important for both competitiveness and cohesion, while a citizens’ rights charter will enhance participation and democracy and also serve as a reminder that federal systems are intended to benefit citizens, not just governments. Moreover, this is consistent with the earlier observation that the balance between citizens and governments under the NEO is now tilting in the direction of favouring citizens.

The fifth final component would be some version of a federal-provincial commission on fiscal federalism. Australia’s CGC is an example of a formal approach to this intergovernmental body, but less formal versions also exist.

By way of elaborating on the rationale for intergovernmental transfers, as they relate to this implicit model, my preference is to view them in terms of a constitutional/federal rationale and a citizenship rationale (Courchene, 1998). The former is straightforward. If the federal principle is to be effective, then the sub-national levels of government must have revenues sufficient to exercise the powers assigned to them under the constitution. The citizenship, or nationhood, rationale begins with the premise that wherever citizens live in the county they ought to have access to certain key economic and social rights – rights that ought to attend citizenship, as it were. If these basic rights fall under provincial

jurisdiction, then the provinces must have revenues sufficient to deliver them. Note that these citizenship rights are also important in terms of economic development and competitiveness now that human capital is emerging as a key element of the NEO. One can of course continue to rationalize these transfers in terms of the traditional concepts of fiscal equity and fiscal efficiency.

With NEO-compatible or globalization-compatible federalism thus defined to embrace both economic competitiveness and social cohesion, the remainder of the paper addresses a range of principles, policies, instruments and institutions intended to “ensure that globalization works for people, not just for profits (United Nations Development Programme, 1999). Specifically, the analysis will focus in turn on competitive federalism, achieving hard budget constraints, securing the economic and social unions and, finally, issues related to democracy and accountability. By and large, the formal structure and division of powers will be taken as given in what follows and emphasis will be directed largely to the process dimensions of federalism.

#### **IV: TOWARD NEO-COMPATIBLE FEDERALISM**

##### **A. Competitive Federalism**

The hallmark of the economic theory of federalism is that it is welfare-enhancing because jurisdictions are able to cater the provision of public goods and services to the preferences of their citizens, and citizens for their part are free to choose their preferred jurisdiction. This ability of jurisdictions to experiment with alternative approaches to the design and delivery of policies and services, typically referred to as “competitive federalism,” becomes especially important in times of paradigm shifts. While the operations of governments are not (and should not be) characterized by the creative-destruction processes of the private sector, federations do have the distinct advantage that their sub-national governments can and will experiment with creative approaches to emerging challenges on the social or

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

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

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

The first two principles guarantee "hard budget constraints" at the sub-national level, while the third ensures that provinces cannot inhibit the free mobility of goods and factors. Within this

environment, the exercise of competitive federalism (or "unrestricted public choice," to use McKinnon's phraseology) will enhance, rather than be potentially destructive of, both welfare and efficiency.

Competitive federalism has played an extremely important role in Canada. Our medicare system was the result of creative experimentation in the province of Saskatchewan, which was eventually parlayed into a national system. Not surprisingly, the provinces are now reacting to the NEO with a flurry of creative approaches across a broad range of policy fronts. There is some concern among Canadians that this experimentation may go too far, i.e., it may run afoul of some cherished ideals on the social policy front. Phrased differently, the McKinnon formulation is referred to as "market-preserving federalism" for good reason: it is driven by efficiency concerns with no guarantees that the result will also be "cohesion-preserving federalism."

Intriguingly, in the 1999 social union framework agreement (SUFA) which was signed by all governments except Quebec, these social or cohesion concerns were addressed by way of a set of agreed-upon principles that would guide social policy reform and implementation. Moreover, SUFA also allowed the federal government to exercise its spending power in areas of provincial jurisdiction, while simultaneously allowing the provinces a significant role in designing and implementing these federal initiatives. As an important aside, this is a welcome initiative since, as Breton has convincingly argued, it is inappropriate to exclude the federal government from playing the competitive federalism game, i.e., competitive federalism needs to be both vertical and horizontal. This caveat aside, were one to marry these social union principles to the principles of market-preserving federalism, the result would then be a framework for the exercise of competitive federalism that would be both market- and society-preserving. And now is the time for these frameworks to be in place since flexibility and encouragement to experiment creatively across the

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

### **B. Generating Hard Budget Constraints**

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

Tommasi (2002) documents similar problems with province-bank linkages in the Argentine federation. He then goes on to describe provincial initiatives that serve to breach monetary separation in a creative, albeit inherently destructive, manner. The issue relates to the *bonos provinciales*, or low- denomination provincial bonds that a few provinces (e.g., Cordoba in the mid-to-late 1990s) introduced to help finance their government spending, e.g. the payroll for public sector workers. Canadians would view these *bonos* as a type of “scrip.” Since these bonds do not pay interest, one would assume that they would immediately trade at a discount. However, what makes them generally accepted as substitutes for Argentine pesos is that they are accepted for payment of provincial taxes owing to the issuing province(s). As Tommasi notes, these issuing provinces are effectively appropriating the right of seigniorage of the central-government/central-bank. He also notes this practice has become rather widespread in the wake of the collapse of the Argentine currency board. As an instructive aside, in the context of market-preserving federalism, this

breaching of monetary separation via the issue of the *bonos provinciales* is an obvious case where the exercise of competitive federalism will almost surely trigger the proverbial “race to the bottom.”

In general, however, the lack of fiscal separation between the two (or three) levels of government tends to be a far more pervasive problem across federations than the lack of monetary separation. Serra and Afonso (1999,9) highlight this in the Brazilian context:

[Unlike] what occurs in federations like the United States, the Brazilian federal government has always played the role of lender of last resort for states and municipalities threatened with insolvency. And this is an attitude that generates more permissive fiscal behaviour.

Tommasi (2002,19) also lists “bailouts” as one of the major deficiencies of the Argentinian fiscal system.

The challenge, therefore, is to generate hard-budget constraints. There are no doubt a goodly number of ways to do this. One is to rely on outside pressures arising, say, in the context of a regional integration agreement. For example, one of the reasons why the citizens of the so-called Club Med groups of countries (Italy, Spain, among others) were so much in favour of the euro was that the *external* discipline of the Maastricht Guidelines would (and did) exert a degree of control over their fiscal authorities that was too difficult to accomplish via domestic politics. Another is to put in place some preconditions for successful *internal* discipline. One version of this would run as follows. Assuming that the provinces/states have access to NEO-consistent tax bases, they should then be allowed tax autonomy such that, at the margin, they can control their tax revenues. This will serve two purposes. First, it will make provinces/states masters of their own fiscal fortunes, unlike the status quo in many federal systems where they are overly dependent on transfers from the federal government. Second, and

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

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

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

### **C. Securing the Internal Economic Union**

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

For some federations, this is not an inherently difficult task. For example, it is not overstatement to assert that the US secures its internal market by virtue of the “trade and commerce power,” which the courts have interpreted in a very expansive manner. Similarly, the Australian High Court has also played a major role in delivering the Australian internal common market. However, this is not the case for Canada, where the courts have interpreted the federal trade and commerce power quite narrowly, no doubt in part because the Canadian constitution (unlike the US and Australian constitutions) has a long list of *exclusive* provincial powers. Hence, Canada has had to be creative to preserve and promote its economic union. One part of this is the set of fiscal arrangements, whereby Ottawa will collect the provinces’ taxes free of charge provided they levy their income tax rates on a common definition for the taxable income and refrain from using their taxing powers to fragment the economic union. Relatedly, the provinces have agreed to a formula for allocating corporate profits across provinces thus avoiding both zero and double taxation. But the major initiative for securing the internal economic union market is, as

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

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

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

But equalizing the ability of sub-national governments to mount comparable social programs is only part of the story. These separate provincial programs must be linked together to form a “national” system by virtue of introducing principles such as portability of benefits, prohibition of residence requirements for program access, mutual recognition of occupational qualifications across provinces, and the like. One obvious way to “police” the social union is to make the citizenship transfers conditional on provinces preserving the social union. But beyond this, provinces have to work together to ensure that their increasingly complex social subsystems (for health and welfare, for example) can accommodate migrants from other provinces without benefit interruption. Whether these transition costs are born by the origin or destination province (or,

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

#### **D. Preserving and Promoting the Social Union**

By virtue of citizenship, individuals merit equality of access to those public goods and services essential for success in the new economic order. If these essential public goods – education, health, welfare, training, etc. – fall under provincial jurisdiction, as they do in Canada for example, then issues relating to vertical and horizontal fiscal balance come to the fore. As already noted, this calls for some combination of unconditional equalization and conditional “citizenship” transfers. And unless supported by demonstrably objective criteria, these conditional transfers relating to specific policy areas should be equal per capita, with preferential provincial per capita transfers contained within the equalization or fiscal equity component. Widely varying per capita transfers to provinces that are not based on revenue-means or expenditure-needs criteria will not only undermine the societal commitment to redistribution but will, as well, tend to trigger provincial rent-seeking to convert these fiscal excesses into entitlements.

preferably, by the central government in order to facilitate mobility and adjustment) is not as important as ensuring that coverage of migrants’ benefits is seamless.

One of the more creative approaches to “positive integration” or promoting the internal socio-economic union is Australia’s *Mutual Recognition Agreement* (MRA) which, among other provisions, guaranteed mobility of credentials and qualifications across state borders. Initial attempts at getting the six states and two territories to agree on a mutually acceptable text were not successful. This led New South Wales, Victoria and Queensland to design the MRA framework and to “offer” it to the rest of the sub-national governments. Intriguingly, what happened was that citizens of the other states did not want to be left out of what was, in part at least, a “citizens’ rights

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

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

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

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

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

### **E. Co-Determination as Institutional Architecture**

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

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

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

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

### **reciprocal federalism**

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

### **G. Citizen-Based Federalism**

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

There are countless ways to integrate citizens more fully and more formally into the institutions and processes of federalism. Earlier in the analysis, the importance of having sub-national governments accountable to their citizens was deemed essential not only for sustaining hard budget constraints, but also and relatedly to give effect to the process of competitive federalism. The Australian experience relating to its Mutual Recognition Agreement demonstrates that appeals to citizens can bring recalcitrant states on side. Along similar lines, it is easy to find examples where the policies and processes of federalism can be improved by introducing more citizen participation and involvement. Consider the following Canadian example. While I have heralded SUFA and the AIT as important new instruments for creating an east-west social and economic union consistent with the exigencies of the new economic order, they have one critical defect. Specifically, SUFA and AIT are agreements among and between governments and, as such, neither agreement allows firms or citizens to trigger the appeal processes – for mobility barriers under the AIT or credential recognition under SUFA’s mutual recognition provisions. Yet the reason these agreements exist is to serve

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

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

On second thought, this is likely to occur in any event, since the NEO, and particularly the information revolution, is dramatically altering the balance of power between governments and their citizens. Individuals are becoming much better informed, are able to network with like-minded citizens anywhere and everywhere, and are able to mobilize special-interest groups to pursue their collective will. In the heyday of Westphalian order, states effectively "created" nations and citizenship. In the NEO, where power and information are no longer monopolized by governments, progressively citizens will create nations. So it will be for federalism as well.

## **V: FEDERALISM AND REGIONAL INTEGRATION**

Federal states have much in common with regional trading areas,<sup>ix</sup> i.e. many of the economic and social issues related to the EU have their counterparts at a federal level. Specifically, harmonizing tax bases, securing economic and social unions, issues related to hard-budget constraints and monetary and fiscal separation, mobility of people and credentials across boundaries, intergovernmentalism/co-determination and managing interdependencies, etc., are at the same time both federal and regional issues. Indeed, McKinnon's version of market-preserving federalism was meant to be applicable both to federations (specifically the US) and to Euroland. And since the foregoing analysis focussed on federal policies, instruments and process in the context of globalization and the knowledge/information revolution, the parallel is much closer than it would otherwise be. Phrased differently, much of the harmonization, coordination, freeing up of markets and the like that are typically associated with regional economic integration has already been addressed in the context of generating NEO-compatible federalism.

Admittedly, membership in a regional FTA may *force* federations to align their internal markets and policies in accordance with the principles of,

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

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

#### **A. Cascading Federalism**

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

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

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

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

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

countries more or less free to design their own policies, subject to non-discrimination between their own citizens/private-sector agents on the one hand and those of their NAFTA partners on the other.

Indeed, in many areas, national treatment under NAFTA really becomes “provincial treatment.” Thus, Ontario can still design many policies in its own likeness and image, provided that in application the province does not favour Ontarians relative to Mexicans and Americans doing business in Ontario. Intriguingly, it is probably not contrary to NAFTA for Ontario to discriminate in favour of Ontarians vis-à-vis Albertans or Quebecers. That this anomaly might arise was one of the motivating reasons that led to Canada’s *Agreement on Internal Trade* (AIT) which, among many other provisions, embraces “provincial treatment” as the operating principle in domestic or interprovincial commerce.

## **B. Region States**

A much more important challenge arising from regional FTAs is the emergence of increasingly integrated cross-national-border clusters, one version of which was discussed above under North American region states. This is happening in Europe, Canada, Mexico and, as Rezende and Afonso (2002) intimate, it is also in process in Brazil. Indeed, Ontario and Michigan have recently embarked on discussions to facilitate the movement of skilled labour across the border as well as to upgrade road and rail infrastructures to ease border congestion. Arguably, this is a variant of the growing sub-national/international interfaces alluded to earlier in this analysis. And the incentives for these arrangements clearly exist elsewhere in the Americas. The powers that Nuevo Leon needs in order to succeed in NAFTA economic space bear little relation to the powers that the poorer southern Mexican states need or want. The same will be true for Rio Grande Do Sul on the one hand and the northeast Brazilian states on the other. While these pressures will also arise in the

context of the new economic order, a regional integration agreement with free flows of goods and factors will clearly intensify any such pressure.

To the extent that sub-national governments in these cross-border clusters achieve reciprocal understandings, let alone succeed in negotiating agreements, to advance their mutual economic interests, the result will not only be greater decentralization but as well greater asymmetry within each federation. A related complication is that any such asymmetry at the sub-national level will likely carry over to the design and implementation of *federal* policies. Consider again the Mexican example. The northern tier of Mexican states want greater tax autonomy whereas the poorer southern states would prefer additional transfers. One approach to this is to allow Canadian-style tax decentralization replete with an equalization program. Moreover, in order to enhance their position in NAFTA economic space the northern-tier states will also want to provide various public goods and services that the poorer states either do not want to provide or do not as yet have the administrative capacity to provide (Courchene, Diaz-Cayeros and Webb, 2002). In situations like this it will be hard to avoid double-tracking, or opting in, or “two-speed federalism,” or whatever one wants to call the resulting asymmetry in federal policies as they relate to sub-national governments. It is important to note that asymmetry is well established in the Canadian federation. Not only does Quebec have its own provincial income tax and collection system, but Quebecers pay less tax to the federation than other Canadians (and receive correspondingly less in cash transfers). While these asymmetries bother some Canadians, the key message for present purposes is that asymmetry or opting out is more in the nature of a *solution*, not a problem and it will become more relied upon as cross-border economic integrations becomes more important. One might add that an “opting in” approach to asymmetry may be the preferable route to follow. An example would be to allow states greater tax autonomy or greater expenditure responsibility once they have the technical and managerial expertise in place. In

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

### C. Exchange Rates and Regional Integration

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

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

## VI: CONCLUSION

Globalization and the knowledge/information revolution have ushered in a new economic order. Highlighting the salient features of this NEO in relation to citizens, markets and governments and, therefore, highlighting the challenges for 21<sup>st</sup> century governance constituted the necessary backdrop to this essay. Under the assumption that economic competitiveness and social cohesion have priority as policy goals, the core of the analysis was directed to the manner in which these NEO dictates are interacting with the structures and processes of federalism. Emphasis focussed inter alia, on political implications (subsidiarity, allocation of powers, intergovernmentalism and co-determination, citizen and federal rationale for transfers), on economic requisites (hard budget constraints, competitive federalism, internal economic unions) and on social/citizen agendas (securing a social union, human capital mobility and participation/democracy challenges). In the final substantive section the focus shifted to the implications for federalism arising from the advent of regional trading blocs like Mercosur. Here attention was directed in turn to cascading federalism, region states, and the implications of the euro and currency consolidation for both regional trading blocs and federalism.

Underpinning the analysis are three sub-themes. The first is that the federal model is incredibly flexible. Experience from four developed federations reveals that achieving economic competitiveness and social cohesion is compatible with a wide range of underlying societal values and norms. In effect, this means that complying with the powerful and pervasive forces emanating from the NEO is effectively an exercise in redesigning instruments, not rethinking overall societal goals.

The second theme is related: Accommodating the dictates of the NEO primarily involves rethinking and reworking "federalism as process," not "federalism as structure." Phrased differently, making federalism NEO-compatible is not inherently a division-of-powers or constitutional

issue as much as it is a political, institutional and infrastructure issue.

The final and presumably the most controversial underlying theme relates to the role of citizens in the above analysis. Not only are citizens the principal beneficiaries of the NEO but the balance between citizens and government is shifting in their direction. Hence, enhancing democracy, participation and accountability are now the orders of the day. Beyond this, however, incorporating citizens more formally and more fully into the operational structures and processes of federalism not only endows citizens with the respect they merit, but as well it enhances the efficiency and accountability of federalism.

#### **Endnotes**

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1. Following Canadian usage, “provinces” or “provincial” will refer to the sub-national level of government (cantons/Länder, states, provinces) while “federal” will refer to the central government level. I shall also try to use “regional” as a level above the national, even though Canadians apply it in a sub-national context, often in terms of groups of provinces. While the sub-title of this paper is “A Citizen and Process Perspective,” in perhaps too many places it will also be a Canadian perspective. *Mea culpa*.
2. This section draws heavily from the Appendix to Courchene, Martinez-Vasquez, McLure and Webb (2002).
3. The introduction of the Australian value-added tax, the proceeds of which flow to the states, may increase or decrease vertical fiscal balances depending on how one defines “own-source revenues.” But even if it is viewed as ameliorating vertical imbalance, the operations of the Commonwealth Grants Commission takes the distribution of the value-added tax in account.

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

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

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

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

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

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