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THE LOGIC OF STATE RESPONSE TO ECONOMIC CHANGE: AN INSTITUTIONAL ANALYSIS OF INDUSTRIAL ADJUSTMENT IN CANADA

by

Prosper M. Bernard, Jr.

A dissertation submitted to the Graduate Faculty in Political Science in partial fulfillment of the requirements for the degree of Doctor of Philosophy, The City University of New York

2003

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Abstract

THE LOGIC OF STATE RESPONSE TO ECONOMIC CHANGE:
AN INSTITUTIONAL ANALYSIS OF INDUSTRIAL ADJUSTMENT
IN CANADA

by

Prosper M. Bernard, Jr.

Sponsor: Professor Howard H. Lentner

This study explores how the Canadian state, from the early 1970s to the mid-1990s, dealt with the problem of industrial adjustment. The growing concern that Canada's international economic position was deteriorating, that its manufacturing sector was facing major structural deficiencies, and that Canada was becoming more vulnerable to shifts in the policies of the United States triggered a sequence of industrial adjustment policy actions. In identifying two industrial adjustment strategies (economic nationalism and economic liberalism), which were used to address the problem of industrial adjustment, this study seeks to explain what caused the shift from one strategy to the other and the variance in the efficacy of each strategy.

The study develops a framework of analysis which combines an institutionalist argument and a modified realist argument. I argue that the sequence of adjustment actions reflects policy actors' efforts to act in the face of domestic and international constraints and incentives. At the international level, I argue that increases in negative externalities stemming from American economic policies and changes in the asymmetry of economic power between Canada and the United States constitute the key obstacles and opportunities for state action. Whereas the deterioration of Canada's economic

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power and increasing exposure to externalities impelled government officials in the 1970s to select economic nationalism, an improvement in Canada's relative power and continued exposure to externalities led Ottawa to shift to economic liberalism in the mid-1980s.

At the domestic level, the path dependence dynamic of institutional politics imposed limits on and enabled government officials as they attempted to effect the necessary institutional adaptation to facilitate the implementation of the two strategies. The increasing returns and the distributional conflict processes that produce path dependent outcomes narrow the parameters within which institutional innovators can act as they seek to set up an institutional framework that is appropriate for the pursuit of an adjustment strategy. This study shows that path dependence shaped how economic nationalism was pursued by creating huge obstacles for government officials as they sought to modify drastically (and deviate from) the prevailing pattern of institutional arrangements. On the other hand, the path dependence dynamic proved to be more amenable to undertaking those institutional modifications that were necessary to pursue economic liberalism because the institutional changes followed the prevailing institutional patterns.

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CHAPTER ONE

CANADA'S INDUSTRIAL ADJUSTMENT PROBLEM AND THE LOGIC OF ECONOMIC ADJUSTMENT

In *Reasons of State*, G. John Ikenberry asks two intriguing questions: "What international and national resources and instruments of power can state officials marshal in the face of international change? How do domestic structures provide opportunities or set limits on the ability of states to achieve official objectives?"[1] In focusing on Canada's quest to manage industrial adjustment, this study poses the same two questions and attempts to answer them. The growing concern that Canada's international economic position was deteriorating, that its manufacturing sector was facing major structural deficiencies, and that Canada was becoming more vulnerable to shifts in the policies of the United States, triggered a sequence of industrial adjustment policy action that began in the early 1970s and continued well into the 1990s. In this study I argue that the most useful framework of analysis to explain what causes *change in and of* industrial adjustment strategies is one that explores how interests, ideas, and international pressures are distorted, refracted, and altered by domestic political institutions.

The survival and standing of states depends on their ability to respond effectively to constant changes in the international system. In contemplating how to respond to new circumstances, states always act in a self-help manner because they cannot expect a supranational entity or another state to guide them toward achieving beneficial economic adjustment or take on the cost of adjustment for them. Also, states behave in this manner because, if they are reluctant to attain redress of adjustment problems, they risk jeopardizing their own survival. As states are forced to respond to the problem of

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[1] G. John Ikenberry, *Reasons of State: Oil Politics and the Capacities of American Government* (Ithaca: Cornell University Press, 1988), p. x.

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adjustment, each will be the ultimate judge of how it decides to cope with this challenge. Because the principle of self-help underpins states' adjustment efforts, it follows to ask what international and domestic capacities can states marshal to ensure adequate adjustment to international changes.

THE NATURE OF CANADA'S INDUSTRIAL ADJUSTMENT PROBLEM

The problem of industrial adjustment that Canada began to respond to in the early 1970s had three aspects. First, tariff protection and the high concentration of American investment in Canada's secondary manufacturing and staples sectors combined to create structural deficiencies in the Canadian economic structure.[2] Second, Canada's economic position in the international economy deteriorated, as illustrated by the decline in Canada's share of world manufacturing. As Britton and Murphy point out, "Compared with other countries Canada's improvement [in the 1950s and 1960s] was a weak response to a world economic environment that was remarkably conducive to economic growth and expanded trade."[3] As a result, Canada's share of world manufacturing dropped from 6 percent in 1965 to 4 percent in 1975. Finally, Canada's increasingly close economic ties with the American economy became a cause for concern because it elevated the risk of becoming vulnerable to the United States and it produced differential levels of economic gains. If these three developments pointed to any particular adjustment goal, it was the need to accelerate the growth of Canada's secondary

---

[2] Secondary manufacturing includes such medium- and high-technology activities as chemicals; man-made fibers; industrial machinery; mechanical handling equipment; agricultural machinery; transportation equipment and vehicles; aircraft and parts; locomotives and rolling stock; communications equipment; heating, refrigeration, and air conditioning equipment; tools; office machinery; pharmaceutical supplies; photographic goods. Resource-based (primary) manufacturing includes such activities as wood products, paper products, primary metal products, non-metallic mineral products, and petroleum and coal products. These definitions are adopted from Britton and Gilmour, *The Weakest Link: A Technological Perspective on Canadian Industrial Underdevelopment* (Ottawa: Science Council of Canada, 1978), pp. 198-9.

[3] Ibid., 1978, p. 41.

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manufacturing sector and improve the degree of domestic control and direction over the development of the country's industrial base.

By the late 1960s, Canada's secondary manufacturing base displayed a number of features that gave strong indication that this sector was not performing well. The symptoms involved inefficient industrial structure, weak export capacity, heavy reliance on imported technology and manufactured goods, and the presence of a small indigenous managerial class. The sources of Canada's industrial adjustment problem were deeply grounded in its historical pattern of economic development. Canadians created the nation's manufacturing base behind a wall of tariff protection and relied heavily on direct foreign investment.[4]

As instruments of industrial modernization, tariff protection and foreign investment helped to develop a domestic market in which to manufacture industrial goods, produce a steady rate of growth that translated into high standards of living, and create competitive advantages in particular international markets. The tariff provision of the 1879 National Policy helped substitute domestic products for imported goods within Canada's expanding home market, which was facilitated by the National Policy's two other goals—promoting western settlement through an active immigration policy and creating a national railway system to connect the country's vast territory. Yet, in one of Canada's greatest historical paradoxes, the policy efforts intended to secure Canada's economic independence and territorial and political integrity resulted in unfavorable economic outcomes. Over time, tariff protection had the effect of creating an inefficient industrial

[4] In 1939, the average level of tariff protection was between 25 and 30 percent, and was among the highest of any industrialized nation. In 1973, Canada's weighted average tariff rate on dutiable industrial products stood at 15 percent and dropped to about 9 percent in 1987, compared to United States' rate which was about 7 to 8 percent in 1979 and between 4 and 5 percent in 1987.

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structure in Canada. The lack of import competition led to the emergence of many inefficient firms in the manufacturing sector that proved unfit to compete in international markets. Moreover, Canada's small domestic market prevented many of these firms from achieving the necessary production runs to lower their production costs.

Import-protection tariffs also spurred an influx of large amounts of American investment into Canada, which over time enabled American-owned Canadian subsidies to gain majority control of key industries and a solid presence in others. The import tariffs and Canada's promising future as an industrial power combined to create a powerful incentive for American investors to jump the tariff wall and establish subsidiaries or branch-plants. Rather than being unnerved by this development, Canadian entrepreneurs and government officials were confident that foreign investors would provide much needed resources to help Canada build its manufacturing capability.

The widespread presence of American foreign investment in Canada has been an important contributing factor to Canada's economic dependence on the United States. The prevalence of American direct investment in Canada by the late 1960s and early 1970s was unequaled by any other country that hosted American investment. Accordingly, if any country was in a position to fear that its economy was falling too deeply under foreign control, it was Canada. As Gilpin points out, "Countries and even all of Western Europe may worry about foreign domination, and particularly American domination, but Canada is the only country where one can say with a considerable degree of truth that American corporations have taken over the economy."[5] Table 1.1 shows that non-residents acquired a solid majority control in the manufacturing, petroleum and natural gas, and mining and smelting industries. In fact, in 1967, the United States

[5] Quoted in Britton and Gilmour, *The Weakest Link*, p. 104.

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obtained majority control of assets in the production of new staples.[6] Although American investors fell short of securing majority control in manufacturing, American participation

Table 1.1. Distribution of Ownership and Control of Canadian Industries, 1954 & 1967
(percentage)

	Canada		United States		Other	
Year	Owned	Controlled	Owned	Controlled	Owned	Controlled
Manufacturing						
1967	48	43	44	45	8	12
1954	53	49	37	41	10	10
Petroleum/Natural Gas						
1967	38	26	51	60	11	14
1954	40	31	57	67	3	2
Mining/Smelting						
1967	39	35	51	56	10	9
1954	44	49	48	49	8	2
Utilities						
1967	81	95	18	5	1	--
1954	86	92	12	7	2	1

Notes: Utilities include air, road, water and urban transportation, telecommunications, and hydro-electric. Manufacturing includes the following industries: food and beverage; tobacco; rubber products; leather products; textile; furniture; printing, publishing and allied; paper and allied products; primary metals; metal fabrication; machinery; transport equipment; electrical products; non-metallic mineral products; chemicals and chemical products; and miscellaneous manufacturing.
Sources: Government of Canada, *Foreign Direct Investment in Canada* (Ottawa: Information Canada, 1972); and Hugh Aitken, *American Capital and Canadian Resources* (Cambridge, MA: Harvard University Press, 1961).

in this sector weighed heavily if measured as a percentage of assets controlled by non-residents.

Within the manufacturing sector, foreign control was high in capital goods and in higher value-added staples-related activities. As Table 1.2 illustrates, of the 17 manufacturing activities, 10 industries were under the majority control of foreigners. Aitken observes that the inflow of American investment into Canada helped accomplish

[6] The term new staples is borrowed from Aitkens and refers to industrial raw materials such metallic minerals, fuels, and newsprint. This is in contrast to old staples, which include fur, timber, and foodstuffs. See H. J. Aitkens, *American Capital and Canadian Resources* (Cambridge: Harvard University Press, 1961), p. 100.

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Canada's developmental objectives, which included assisting Canadians in developing a capacity to exploit the country's resources and diversifying the country's industrial

Table 1.2: Percentage of Foreign control of Assets, by manufacturing industry, in 1974

Industry	%Foreign Control of Assets	Industry	%Foreign Control of Assets
Petroleum and coal products	99.6	Primary Metals*	55.3
Tobacco products*	84.3	Metal Fabricating	42.0
Rubber products	94.1	Machinery	69.2
Leather products*	22.0	Transport Equipment*	86.6
Textile*	39.4	Electrical products	65.3
Wood	28.4	Non-metallic mineral products*	51.5
Furniture	19.7	Chemical and chemical products	78.8
Printing, publishing and allied*	21.0	Mineral fuels	75.4
Paper and allied	44.0		

Note: *1968
Source: Gray Report, 1972, p. 21.

structure.[7] But the presence of foreign investment also generated costs. Because of its sheer volume, American investment shaped the direction and pace of economic growth in Canada. Nowhere was this more evident than in the orientation which the expansion of the secondary manufacturing and new staples activities assumed. Whereas American-owned Canadian subsidiaries in the secondary manufacturing sector employed their control strategically to suppress exports, enhance intra-firm imports, and serve Canada's internal market, their managerial control in new staples industries was used expressly to serve the industrial needs of the United States.

The inward oriented characteristic of Canada's secondary manufacturing and the export-oriented feature of the new staples sector were the consequence of the large presence of American investment in the Canadian economy. While the export performance of the resource-based manufactured sector was strong from the 1950s to the mid-1970s, that of the secondary manufacturing sector was weak. Canada consistently

[7] Hugh G. J. Aitken, *American Capital and Canadian Resources*, 1961.

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maintained a trade surplus in resource-based manufacturing activities, with the United States serving as the key destination for commodities in this group. Moreover, as a percentage of total exports, this group of economic activities constituted the largest share of Canadian exports until the 1970s, as Table 1.3 shows. The trade balance in fully manufactured products experienced a growing trade deficit that reached a little over $10 billion in 1975, marking a three-fold increase from 1970. Moreover, exports of end-products made up only 32.7 percent of total exports in 1968, making Canada the weakest exporter in this category among advanced industrial nations.

This trade pattern was much influenced by the preference of foreign-owned subsidiaries to service the domestic market rather than export what they produced. Often, this practice was facilitated by establishing licensing arrangements which restricted Canadian subsidiaries from exporting the goods they produced. In 1969, the Department of Industry, Trade, and Commerce published a report which concluded that out of about 1000 subsidiaries, 58 percent of American branch plants and 43 percent of other foreign subsidiaries faced export restrictions imposed by their parent companies.[8] In comparing the export practices of Canadian-owned and American-owned companies, Britton and Gilmour note that "clearly foreign-controlled subsidiaries do not direct themselves to making export sales, whereas Canadian-controlled secondary manufacturing firms are the main ones penetrating foreign markets."[9]

In addition to displaying export resistant tendencies, Canada's secondary manufacturing sector became highly dependent on imports of technology and other intermediary goods by the late 1960s and early 1970s. End-products constituted the

[8] Report is cited in Government of Canada, *Foreign Direct Investment in Canada* (1972).
[9] Britton and Gilmour, *The Weakest Link*, p. 110.

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largest group of imported goods and its volume registered the largest increase between 1968 and 1993, as Table 1.3 illustrates.

Table 1.3. Percentage Share of Products in Canada's Merchandise Export and Imports

Products	1963		1968		1973		1978		1983		1988		1993	
	Ex	Im	Ex	Im	Ex	Im	Ex	Im	Ex	Im	Ex	Im	Ex	Im
Agriculture & food	21.5	11.9	12.1	7.4	12.7	8.5	10.1	7.5	11.8	6.6	8.7	5.4	7.8	6.0
Crude materials	21.0	13.7	18.5	9.1	20.2	8.7	16.9	11.7	16.2	9.6	12.9	5.3	12.3	5.3
Semi-manufactures	45.7	--	36.4	19.7	33.1	18.4	36.7	17.5	34.0	18.6	35.9	19.2	32.1	18.8
End-products	11.5	48.4	32.7	61.6	33.8	63.4	36.1	62.5	37.8	63.9	42.0	68.0	46.8	67.4

Source: Department of Foreign Affairs and International Trade, *Canada: Drawers of Water, Hewers of Wood and Dangers of Other Myths.* Trade and Economic Policy Paper, No. 96/07 (December 1996), pp. 9 and 12.

Moreover, imports in four high-technology industries, which together represent key pillars of manufacturing strength, all listed high levels of import dependence, as Table 1.4 demonstrates.

Table 1.4. Percentage of Different Canadian Markets served by Imports (level of import penetration)

Market Category	1964	1975
Consumer Electronics	14	63
Computer and Office Equipment	56	90
General Machinery	65	74
High-technology Manufactures	32	52

Source: Britton and Gilmour 1978, pp. 45-9.

The high concentration of American investment in Canada's capital goods industries had a profound effect on these industries' import proclivity. In a 1974 study by the Industry, Trade and, Commerce Department, it was observed that of 217 foreign-controlled companies operating in Canada in 1969, almost 50 percent of the materials they required were imported and only 30 percent of the goods they produced were exported.[10] Even more significant was that intra-corporate sales ("tied imports") as a

[10] Britton and Murphy, *Weakest Link*, pp. 115-6. This figure combines the secondary manufacturing category (which omits transportation equipment) plus transportation equipment, pulp and paper.

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percentage of total imports in the secondary manufacturing sector was 68.1 percent. This was also echoed in the Gray Report. The Report pointed out that "Foreign-controlled companies tend to import from the country of the parent and indeed from parents and affiliated companies." It also remarked that "imports tend to be high in the sectors where foreign control is high [and that] foreign-controlled companies appear to be more import oriented than Canadian-controlled companies."[11]

Perhaps the most significant effect this development had on Canada's industrial structure at the time was that it impeded the creation of upstream industries that could supply the intermediary products used in downstream industries, that is the end-products sector of the Canadian economy. The underdeveloped side of upstream industries witnessed in the 1960s contributed to the development of the warehouse-assembly processing characteristic of Canada's manufacturing sector in which basic assembly functions were carried out in Canada using imported higher value-added inputs. Moreover, for many of these branch-plants, the bulk of research and development activities were reserved for the parent company and thus impeded the development of an indigenous R&D capacity in Canada. As for its effects on Canada's balance of payments, deficits increased not only in the service accounts due to the repatriation of profits, but also in the merchandise trade account as a result of large imports of machinery, patents, heavy equipment, and tools.

The presence of an 'entrepreneurial gap' was another characteristic of Canada's weak manufacturing sector in the late 1960s and early 1970s. The activities of foreign-controlled companies resulted in reducing the indigenous managerial class which in turn widened the gap between Canada and other industrialized countries. The adverse effect

[11] Gray Report, 1972, p. 183.

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of the entrepreneurial gap on Canada's secondary manufacturing was of some significance. For example, it kept Canada from fully developing its corporate leadership capacity as well as administrative and creative skills. Appendix I illustrates the extent to which foreign managers penetrated Canadian industry in the early 1960s. The data indicate that the number of managers that were Canadian citizens increased as the foreign ownership share in firms grossing more than $25 million decreased. But companies that were 50 percent or more owned by foreigners were less inclined to employ Canadian citizens as directors or presidents. In fact, only 44 percent of directors in those companies were Canadian citizens. The same pattern was repeated with respect to corporate presidents. Of the firms which were 50 percent or more foreign owned, only 45 percent of presidents were Canadian citizens, but the percent was much higher for firms under greater Canadian ownership. In terms of retaining economic autonomy, these figures were alarming because the managerial decisions most closely linked to the pattern of industrial development in Canada were made by foreigners, whose preferences were more likely to be coincident with advancing the interests of their parent company and home economy than those of Canada. As the Gray Report noted, these decisions "often reflect the economic and political industrial objectives of a foreign government or economy which may or may not accord with Canadian objectives and priorities."[12] Furthermore, by placing citizens of the parent company's home country into positions of management, the indigenous managerial class lost out on opportunities to develop its managerial and entrepreneurial capacity.

Political costs such as vulnerability to the policy actions of the United States and diminished freedom of action began to beset Canada more profoundly starting in the

[12] The Gray Report, 1972, p. 42.

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1960s. The problem of extraterritoriality—which arises when foreign companies obey and implement the laws and policies of their home governments in the host country—particularly concerned government officials because Canadian subsidiaries of American companies were forced by the American government to conform to its policies and laws. The 1968 Report of the Task Force on the Structure of Canadian Industry noted the following:

> The most serious cost to Canada of foreign ownership and control results from the tendency of the United States government to regard American-owned subsidiaries as subject to American law and policy with respect to American laws on freedom to export,... anti-trust law and policy, and...balance of payment policy. The intrusion of American law and policy into Canada by the medium of the Canadian subsidiary erodes Canadian sovereignty and diminishes Canadian independence.[13]

Between 1950 and 1971 there were 16 cases of extraterritoriality. Of the 16 cases, 6 provoked strong responses from the Canadian government (see Appendix II). Of the 6 cases, Canada was able to gain a favorable outcome in only 3 cases after investing substantial political resources. The remaining 10 cases were judged to be of low salience for the Canadian government and did not provoke a strong government response. However, from the point of view of costs to Canada's political integrity, half of the 16 cases rendered results that failed to protect the interest of Canadians. Even more striking was that of the cases registered as favorable, Canada found itself on the defensive and in a position of relative weakness when it came to negotiating its way out of an extraterritoriality case.

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[13] Privy Council Office, *Foreign Ownership and the Structure of Canadian Industry: Report of the Task Force on the Structure of Canadian Industry* (Ottawa: Queen's Printer, 1968), pp 360-1. The report is commonly called the Watkins Report, named after its leading author Melville H. Watkins. Accordingly, this study will refer to it as the Watkins Report.

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Of particular importance are the 1965 and 1967 balance-of-payments cases of extraterritoriality. The balance-of-payments form of extraterritoriality to which Canada was exposed resulted from American efforts to shift to its partners some of the cost of adjusting to its growing balance-of-payments deficit. The Voluntary Cooperation Program of December 1965 (1965 guidelines) and the Mandatory Direct Investment Guidelines of January 1968 (1968 guidelines) established specific goals to guide the domestic and foreign activities of American multinational corporations. The Voluntary Cooperation Program established voluntary guidelines which called upon approximately 900 American multinational corporations to lower their net capital outflow by exporting more from the United States, to repatriate foreign earnings, and to raise investment capital abroad. The 1968 measure converted the 1965 voluntary guidelines into mandatory ones and they were to inform the activities of all American multinationals.[14]

Although Canada was granted exemptions in both cases, they were granted with the understanding that Canada would take voluntary measures to assist the United States in rectifying its balance-of-payments problem. On the issue of repatriation of profits, the two governments came to an understanding that American subsidiaries operating in Canada were not expected to carry out significant repatriation of their earnings, an important amendment given that retained earnings were an important source of investment capital for Canada. Although Canada also obtained an exemption from the 1965 guideline that restricted American companies from exporting capital to foreign countries, Canada agreed to lower its reserve ceiling by $100 million as way to lessen

[14] See Watkins Report, 1969, pp. 336-338; Gerald Wright and Maureen Appel Molot, "Capital Movements and Government Control," *International Organizations* (Autumn 1972); and Dave Godfrey and Mel Watkins, "Masters & Gentlemen: A Diary of the US Guidelines Issue," in *Gordon to Watkins to You. Documentary: The Battle for control of our Economy* (Toronto: New Press, 1970).

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pressure on the American dollar. Moreover, in deference to the American government's concern that American multinational corporations, banks, and insurance companies were not complying with these guidelines, the Canadian government undertook certain measures that had the effect of enforcing American guidelines in Canada.[15] As for the 1968 guidelines, Canada obtained an unconditional exemption, but it voluntarily agreed to convert $1 billion of its foreign exchange reserves into American Treasury securities, non-liquid assets. Moreover, the United States managed to gain Canada's commitment to prevent banks, insurance companies, and other private investors from using Canada as a 'pass-through' to transfer American dollars to the Eurodollar market.[16]

The sharp increase in the balance-of-payments deficit plus inflationary pressures compelled American President Richard Nixon in August 1971 to implement an economic strategy that included instituting wage and price controls, which Chrysler and Douglass Aircraft Company enforced through their Canadian subsidiaries; imposing a 10 percent surcharge on imports into the United States, which affected the commercial activities of American-owned Canadian subsidiaries; and closing the gold window in an effort to stem the outflow of gold and restore some national policy autonomy. Unlike the two previous cases of extraterritoriality, Canada was not granted an exemption. The "Nixon Shock," as these measures came to be known, heightened Canada's sense of vulnerability to a level that was unprecedented.

The Nixon shock was a deliberate effort by the Nixon administration to pressure advanced industrial countries to assume greater international responsibility in

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[15] Under domestic criticism for giving into American pressure, the Canadian government issued on March 21, 1966 "Some Guiding Principles of Good Corporate Behavior for Subsidiaries in Canada of Foreign Companies."

[16] Wright and Molot, 1972 and David Leyton-Brown, "Extraterritoriality in Canadian-American relations," *International Journal* 36 (Winter 1980-1).

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maintaining the international economic system. Moreover, it demonstrated that the United States was willing to employ aggressive unilateral measures to gain the acquiescence of its allies. For Canada this did not bode well because it marked the end of the "special relationship," that previous leaders in both countries had evoked in recognition of their mutual interdependence, as a means to steer through the complications of maintaining cooperative bilateral relations. The special relationship also had conferred upon Canada disproportionate commercial and security advantages that few other American allies were privileged to receive. Nixon's call to develop a "mature relationship" in which each country was expected to share more evenly the cost of maintaining an open international economy and be able to pursue "autonomous independent policies" as well as "define the nature of its own interests," created a sense of uncertainty and vulnerability within various circles of the Canadian government.[17]

While this change in the politics of bilateral relations posed no difficulty for the United States to adjust to, for Canada this change exposed the real costs of having a relationship of dependence with the United States. If a mature relationship meant that Canada could no longer rely on the benevolence of the United States, then Canada had to confront the challenge of finding and pursuing a viable alternative without the assurance of success. Then Secretary of State for External Affairs, Mitchell Sharp, remarked that "because of the high concentration of our trade with the United States...Canada was probably more exposed than any other country to the immediate impact of the U.S.

[17] Address of President Nixon to members of the Senate and of the House of Commons in the House of Commons Chamber, Ottawa on Friday, 14th April, 1972.

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measures and had more reason to be concerned about their future implications." He added, "They threw into sharp focus the problem of Canada's vulnerability...."[18]

It could be said that the Nixon measures helped concentrate attention on the problem of industrial adjustment whose existence was recognized by some in previous decades, but failed to provoke any meaningful reaction from government officials.[19] By the early 1970s, Canada's industrial adjustment problem had two dimensions. First, the existing pattern of economic activities between Canada and the United States had shaped Canada's economy in such a way that it seriously undermined its capacity to pursue such economic goals as international competitiveness, technological progress, accumulation of wealth, and the development of an autonomous industrial base. The second dimension to the adjustment problem was that the prevailing pattern of economic interdependence between Canada and the United States produced asymmetrical dependence. For Canada, bilateral interdependence was increasingly inhibiting its freedom of policy action, deepening its vulnerability to changes in American policies, and reducing Canadian leverage over domestic economic development.

NATIONAL ADJUSTMENT TO INTERNATIONAL CHANGE

States constantly adjust to international change. "Of the many international and domestic forces that set states in motion," as Ikenberry points out, "none is more important than the constant pressure for national adjustment to international change

[18] Mitchell Sharp, "Canada-U.S. Relations: Options for the Future," *International Perspectives* (Autumn 1972), pp. 7-8.
[19] For example, The 1951 Royal Commission on the Arts, Letters and Sciences (Massey Report) and the 1956 Royal Commission on Canada's Economic Prospects (the Gordon Report) discussed the potential effects of having large amounts of direct foreign investment in Canada.

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produced by constant differential change between national and international systems."[20] States respond to international change because it affects national wealth and power, as well as states' ability to maintain domestic welfare and political and territorial integrity. Moreover, international economic or political change affects states differently—it creates relative winners and losers. As Gilpin notes:

> Modern nation-states are extremely concerned about the consequences of international economic activities for the distribution of economic gains. Over time, the unequal distribution of gains will inevitably change the international balance of economic power, and will thus affect national security. For this reason, states have always been very sensitive to the effects of the international economy on relative rates of economic growth.[21]

Wealth and power form two sides of the same coin. Because wealth is instrumental in projecting power and influence and because both of these are important to accomplish other state goals, a state will seek to maximize its wealth. Yet, because a state is more concerned about its relative position in the international system, it will naturally assess its material capabilities in relative terms; in other words, a state will be concerned with how economic gains are divided among states. In the event that outcomes of market activities become unfavorable to a state, that state will seek to change this pattern of wealth distribution. It will do so in order to bring about a more favorable distributional outcome that in turn preserves and improves its relative power even though it was gaining hitherto in absolute terms. As Gilpin observes, "Even though two states may be gaining absolutely in wealth, in political terms it is the effect of these

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[20] G. John Ikenberry, "The State and Strategies of International Adjustment," *World Politics* (1986), p. 56.
[21] Robert Gilpin, *Global Political Economy: Understanding The International Economic Order* (Princeton: Princeton University Press, 2001), p. 80.

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gains on relative power positions which is of primary importance."[22] The dual considerations of power and wealth are what motivates state officials to address the problem of industrial adjustment; moreover, the desire to channel market activities so that they work to advance state interests and power is a crucial objective that informs the actions of government officials as they seek to respond to international changes.

A state that fails to respond effectively to international change can face deepening economic dependence. In its most fundamental form, dependence refers to an asymmetric power relationship between two states. When dependence is not countered, a state runs the risk of undermining its ability to maintain the nation's economic independence and political autonomy, as well as its influence in international affairs. Notwithstanding the fact that some states respond more promptly than others, states respond to the problem of dependence always for the same reason—namely, to thwart the threat of vulnerability and external domination.

The purpose of economic adjustment is to maintain or improve a state's material capabilities, particularly those capabilities whose deterioration are the source of a state's vulnerability and fear of domination by more powerful states. Capabilities are to states what utilities are to a house.[23] Like the utilities that make a house operational and habitable, capabilities enable a state to maintain its relative position, plus maintain domestic welfare and national wealth.

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[22] Robert Gilpin, *U.S. Power and the Multinational Corporation: The Political Economy of Foreign Direct Investment* (New York: Basic Books, Inc., Publishers, 1975), p. 34.

[23] My understanding of capabilities is the same as Grieco's, who defines material capabilities as "economic, military, and political resources whose employment permits a state to induce changes it desires in the behavior of other states or to resist what it views as undesirable changes in its own behavior sought by others." See Joseph Grieco, *Cooperation Among Nations: Europe, America, and Non-Tariff Barriers to Trade* (Ithaca: Cornell University Press, 1990), p. 39.

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National adjustment can be undertaken by private actors or state officials. Heightened international competition caused by changes in international market conditions can force firms to rationalize their operations, seek joint-ventures or mergers with local or international firms, engage in selective divestiture, diversify into new lines of production, augment direct foreign investment activities, or perform a combination of the above options. In addition, firms may seek political solutions to deal with international economic change. Threatened industries may receive government support, especially if the government recognizes that the industry is important for the wealth, industrial capacity, and employment level of the nation. Subsidies, bailouts, import protection, export promotion, among other compensatory and stabilization instruments can be employed to shore up industries.[24]

In this study I will explore adjustment measures undertaken by the state. Although private-initiated and state-initiated adjustment may seek to accomplish a common objective, the two sets of actors do not always define the adjustment problem the same way, nor support the same course of action when they are in agreement with respect to the nature of adjustment problem. For example, a high level of foreign participation in a national economy is more likely to provoke concern for state officials than for business because the state is preoccupied not just with the performance of the national economy, but also with the political consequences of a market economy, particularly the prospect of economic vulnerability and the erosion of political independence. At other times, although the private sector and the state are in agreement with the diagnosis of an adjustment problem, the two may be in disagreement over which course of adjustment

[24] See Robert M. Uriu. *Troubled Industries: Confronting Economic Change in Japan.* (Ithaca: Cornell University Press, 1998) for a similar discuss of this topic.

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action to take as a result of their unwillingness to shoulder their share of the costs of economic adjustment.

An industrial adjustment strategy refers to a set of coherent policies that are derived from a common body of economic ideas. Such a strategy is formulated and implemented by central executive officials over a period of time and aims to achieve the necessary national industrial adaptation to deal with adverse external and domestic changes or situations. Adjustment strategies are necessarily steeped in politics. Domestically, such a strategy will discriminate against some sectors of the economy to promote others. Moreover, an adjustment strategy will require government officials to elicit the cooperation of certain societal groups. As Tilly notes, the state will be forced to enter into a "process of bargaining with ordinary people for their acquiescence and their surrender of resources" in order to achieve redress of adjustment problems.[25] Internationally, an adjustment strategy may seek to shift the burden of adjustment to other countries as many powerful states have attempted to do.

An adjustment strategy may also attempt to obtain the cooperation of other countries in order to arrive at a mutually beneficial multilateral solution to the problem of adjustment, as less powerful states have sometimes tried to do. When dealing with an adjustment problem, a state will act strategically within a set of international and domestic constraints and incentives. Adjustment policies are rarely made and executed on the basis of functional efficiency; instead, policymakers address the problem of adjustment by maneuvering within a labyrinth of obstacles, laboring under the weight of

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[25] Charles Tilly, *Big Structures, Large Processes, Huge Comparisons* (New York: Russell Sage Foundation, 1985), p. 9.

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their organizational and instrumental limitations, and often proceeding in accordance to a trial-and-error and bounded rationality process of decision making.

Adjustment strategies generally aim at achieving some combination of absolute and relative gains.[26] Adjustment strategies seek to create absolute gains, that is to generate new wealth through the expansion of a system of economic activity. Adjustment strategies can be designed to promote positive change by exploiting economies of scale and existing comparative advantages, or by creating new ones altogether. The outcome of such a function is that an economy will augment its industrial activities, improve overall productivity, boost economic growth, and create more skilled-intensive employment opportunities. At the international level, the absolute gains function of adjustment strategies can take the form of expanding and deepening patterns of economic activities among countries in order to promote more mutually beneficial gains. The relative gains function of adjustment strategies, on the other hand, concerns the allocation of gains derived from existing patterns of economic activities. It seeks to rectify the adverse distributional effects of market activities. The purpose is not so much to create new wealth as to secure a more favorable division of gains for a dissatisfied state. Importantly, strategies contain elements of both functions; in fact, a successful adjustment strategy is one which can create absolute gains, plus seek to improve the relative achievement of gains by rectifying adverse relative outcomes.[27]

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[26] The terms absolute gains and relative gains are compatible with Ikenberry's offensive and defensive strategies, respectively. Whereas offensive strategies seek to create new rules of the game, promote positive change, and create and exploit an economy's comparative advantages, defensive strategies seek to redistribute existing economic gains without necessarily creating new ones. Here, the purpose of redistribution is to change the existing pattern of economic activities so that more benefits are conferred to the party that is currently disadvantaged. See Ikenberry, *Reasons of State*, 1988.

[27] Lake makes a similar argument to explain why states seek free trade. His theory of international economic structure posits that "a country will be concerned not only with its own absolute gain from trade but also with its relative gain, or the difference between its gain and the gains of others." See David Lake,

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Domestic and international spheres serve as two distinct although interlinked arenas for problem solving. Strategies generally work their effects at both levels, but strategies tend to be designed to take advantage of an arena in which state capacity is most pronounced. The balance between a state's domestic and international capacities figures largely in determining the general orientation of an adjustment strategy. As Krasner points out:

> Weakness stems from the inability to influence unilaterally or to adjust internally to the pressures of global markets. Larger industrialized states are able to influence the international environment and can adjust internally. Smaller industrialized states have little influence over the global pattern of transactions, but their domestic political economies allow them to adjust. Small size and inflexible domestic structures make Third World states vulnerable[28]

In this study, reference to Canada's domestic capacity refers to the federal state's ability to bargain with society for the purpose of directing, mobilizing, and extracting productive resources. It also refers to the ability to engage in the selective innovation of domestic institutions as a means to facilitate the pursuit of the federal state's instrumental goals. The international capacity of the Canadian state refers to its ability to wield influence in international affairs in a way that advances and preserves state interests. Internationally weak states tend to use domestic policies to address the adjustment problem, whereas internationally strong but domestically weak states tend to deal with the adjustment problem using international policies. Nevertheless, even in the arena in which they are relatively weak, states will labor in a trial-and-error manner to find the most suitable course of action to address the adjustment problem.

Power, Protection, and Free Trade: International Sources of U.S. Commercial Strategy, 1887-1939. Ithaca: Cornell University Press, 1988), p. 22.

[28] Stephen Krasner, *Structural Conflict: The Third World Against Global Liberalism* (Berkeley: University of California Press, 1985), p. 11.

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The origin of Canada's economic adjustment problem derives from its differential rate of economic progress relative to the other advanced industrial economies. The prevailing economic conditions, noted above, contributed to lowering Canada's relative standing and prompted concern about the country's ability to advance and protect its national interests. This study focuses on two industrial adjustment strategies: economic nationalism or the Third Option, which was the course of action pursued by Ottawa throughout the 1970s and early 1980s; and economic liberalism or continentalism which has been the prevailing policy orientation since the mid-1980s.[29]

As adjustment strategies, the two have been designed to cope with the industrial adjustment problem with which Canada has been confronted. In particular the problem of adjustment is derived from the challenge of changing the distribution of and augmenting the scale of those economic activities that have a direct impact on economic growth, industrial development, international competitiveness, employment opportunities, and domestic ownership of resources. Although the two strategies have operated simultaneously at the international and domestic levels, the Third Option focused relatively more of its adjustment efforts at the domestic level, whereas continentalism emphasized the international level. The other key points of contrast between the two strategies have to do with the type of policy instruments they employ, the designated objectives of their plans of action, and the institutional framework that each industrial adjustment strategy requires for its implementation.

[29] In this study, I analyze the strategy of continentalism or economic liberalism from the mid-1980s to the mid-1990s.

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The strategy of economic nationalism or the Third Option encompassed three objectives.[30] At the international level, the Third Option dealt with the adjustment problem by diversifying Canada's export markets, as well as by reshaping its terms of trade in an effort to break from the prevailing relations of trade wherein Canada served as a supplier of staples. The second goal related to asserting domestic control over Canada's economic activities. There were two key policies pertaining to this goal, Canadianization and the regulation of foreign investment. Canadianization concerned those government actions aimed at enhancing Canadian control and ownership of domestic industries.[31] Whereas Canadianization sought to reduce Canadian alienation from the process of capital accumulation, foreign investment regulation sought to channel the domestic activities of foreign investors so that they contributed more to attain Canada's developmental objectives. The last policy objective related to the Third Option dealt with the promotion of industrial development. The central aspect of this goal was to change Canada's economic structure so that the manufacturing sector would assume a dominating role in what was up to now a dual economy with a sizeable staples sector.

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[30] Some analysts have argued that the Third Option only contained international level adjustment objectives. But a thorough analysis of the Third Option, such as those offered by von Riekhoff and Mace and Hervouet, reveals that this adjustment strategy combined both international and domestic level adjustment objectives. Mace and Hervouet observe that "many students of the Third Option considered the strategy to imply only commercial diversification, and failed to appreciate its double nature. In fact, the Third Option strategy contained two distinct but related courses of action. On the domestic front, it was designed to deal with a long-term restructuring of the Canadian economy....In the foreign sphere, it was supposed to encourage an overall economic and political diversification of [Canada's] external relations. This dual feature has not been taken into account by most of the previous studies on the subject." See Gordon Mace and Gerard Hervouet, "Canada's Third Option: A Complete Failure?," *Canadian Public Policy* 15 (1989), p.389.; and Harald von Riekhoff, "The Third Option in Canadian Foreign Policy," in Brain Tomlin ed., *Canada's Foreign Policy: Analysis and Trends* (Toronto: Methuen, 1978).

[31] This definition is based on Pratt's, who refers to Canadianization as "incentives and institutional mechanisms whose net impact is to lower the costs of entry by Canadian capital into the most profitable and fastest-growing sector of the economy." Importantly, Pratt notes that Canadianization is distinct from nationalization, which refers to "the coercive expropriation of privately-owned (often foreign-owned) assets by the state in return for financial compensation" (ibid). Nationalization was not a policy instrument employed to pursue the goals of the Third Option; however, some provinces, such as Saskatchewan did employ this instrument, as evidenced by the nationalization of the province's potash industry. See Larry Pratt, "Energy: The Roots of National Policy," *Studies in Political Economy* 7 (Winter 1982), p. 41.

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The last two policy areas of the Third Option should be treated separately for two reasons despite the common tendency among analysts to combine the two under the heading of industrial strategy. First, the purposes of the two policy areas are different. Whereas the goal of asserting domestic control is intended to change the form and scale of Canadian participation in domestic market activities, the second area concerns the need to improve Canada's international competitiveness by expanding its industrial base, particularly its manufacturing sector.[32] The two policy areas are also distinct because of the policy resources each uses. The goal to expand Canadian control was pursued through a foreign investment regulatory regime and other forms of direct government intervention, such as the formation of Crown corporations or the National Energy Program, a dirigiste-inspired plan. On the other hand, the goal of promoting industrial development was pursued using various regional development programs, industry-specific subsidies, and business-government and federal-provincial coordination. Based on the substance of these three policy goals, the Third Option sought to expand the interventionist capacities of the state.

In fact, the enhanced involvement of the state in the economy was manifested through several mutually-reinforcing roles. As an entrepreneur, the federal state created the Canada Development Corporation and used it to invest in high technology and new staples industries and to facilitate the transfer of corporate decision making power from

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[32] On this distinction, Noisi makes the following critical observation regarding what Canadianization has sought to achieve. Canadianization "involves the expanded reproduction of the Canadian indigenous bourgeoisie in its existing and traditional forms: as a mainly financial-commercial and resource-related class. The strategy is *not* intended to alter Canadian technological dependency, to build up our truncated industrial structure, or to make Canada more independent of the American economy" (italics original). Industrial development policy, on the other hand, seeks to enhance Canada's technological base, extricate the national economy from the prevailing arrested-type pattern of industrialization, and increase the size of the secondary manufacturing sector. See Jorge Niosi, "Continental Nationalism: The Strategy of the Canadian Bourgeoisie," in Robert Brym, ed., *The Structure of the Canadian Capitalist Class* (Toronto: Garamond Press, 1985), p. 63.

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foreign interests to domestic interests through an active program of enhancing Canadian participation in the economy. As a gatekeeper, the state sought to regulate the entry of direct foreign investment through the establishment of the Foreign Investment Review Agency (FIRA) so that it could better serve the industrial needs of Canada and reduce the cost that this form type of investment imposes on society as a result of the partial loss of domestic managerial control. Lastly, as an administrator, the state sought to spearhead economic development plans to promote regional development through the system of General Development Agreements with individual provinces and to promote industrial development at the national level through the mega-project proposal it introduced in the late 1970s. Moreover, the state-as-an-administrator was manifested in its efforts to develop the state's transformational capacity through which it could coordinate industrial adjustment with producer groups.[33]

The strategy of economic liberalism or continentalism had two policy objectives. First, this strategy sought economic integration with the United States. The failure of the strategy of economic nationalism and improvements in Canada's international position combined to make this policy option appealing after rejecting it for over a century. Although domestic pressures and the constant exposure to negative externalities—which are those economic and political costs borne by Canada that are generated by the economic policies of the United States—were important factors that motivated government officials to seek a free trade arrangement, it is Canada's perception of being in a position of relative strength that spurred confidence in its ability to arrive at a

[33] I have borrowed this term from Zysman. The state-as-administrator, as defined by Zysman, "executes certain operations based on specific assignment or task, applying particular decision criteria and following set of procedures." See John Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca: Cornell University Press, 1983), p. 75.

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mutually-beneficial political arrangement. Economically, the 1989 bilateral free trade arrangement and 1994 North American Free Trade Agreement were expected to enable Canadian firms to reap economies of scale from the expansion of market opportunities, secure access to the American market, and help rationalize Canada's manufacturing sector. Politically, the free trade agreements were aimed at rendering the economic policies of the United States toward Canada more predictable, transparent, and amenable to some outside influence.

There was another political dimension to the free trade arrangements. Free trade was to provide a solution to the impasse between provinces and the federal state that was instigated beginning in the early 1970s by their interventionist tendencies in jurisdictionally-disputed public policy areas. Free trade was to serve as a kind of political truce under which the two levels of government could mutually withdraw their involvement from their respective economic spheres. Furthermore, this immediate outcome was to serve a catalyst for the promotion of domestic neoliberal reforms. The second objective of this strategy, based on this last point, was to embed market governance in the economy through privatization, deregulation, and elimination of inter-provincial barriers to trade. Compared with the strategy of economic nationalism, continentalism was based on the strategic withdrawal of state involvement from the economy and the establishment of rules and regulations that institutionalized the operation of market governance both at the international and domestic levels.

THE ARGUMENT

I make three central arguments, each representing an important aspect of the institutionalist analysis developed in this study. In normal times, government officials

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come to pursue economic policy objectives that are compatible with their institutional and instrumental capacities. However, when a new adjustment problem arises that requires new solutions, what follows is the unraveling of the existing match between the prevailing set of economic policy goals and state capacities, and the forging of a new one involving revised policy objectives and modification of state capacities. It is during this period that competing interests are most exposed, policy debates most intense, and political support most needed. Politics is what drives the process of economic adjustment; however, how politics evolves is profoundly affected by domestic political structures and the international position of a state.

My first argument is that the adjustment policy choice of a middle power or less powerful state that is deeply dependent economically and militarily on a powerful neighboring state is influenced by shifts in disparities of power relative to the powerful state, as well as by shifts in the level of negative externalities generated by the powerful state's policies. These two systemic causes have an impact on how government officials will cope with an adjustment problem, such as whether to seek redress primarily at the international or domestic level and whether to adopt an international policy that brings the middle power closer to or farther from the powerful neighbor. A modest increment in power capabilities and an increase in exposure to negative externalities will impel a middle power to negotiate a long-term institutional economic arrangement with its neighbor. Moreover, a less powerful state will seek this type of arrangement because it will enable its government officials to "lock in" their country's present positional advantage, secure favorable long-term distributional gains in the context of expanding absolute gains, provide a way to challenge the actions of a powerful neighboring state,

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and obtain compensation through a remedial process in the face of temporary shifts in distributional benefits. I argue that this logic of integration is what motivated Canada to consider favorably and eventually pursue the idea of establishing a free trade arrangement with the United States.

A state will respond differently when its relative capabilities have declined. A less powerful state will be pressured to follow the logic of counterweight internally and externally. Externally, this logic leads a middle power to deepen its economic ties with other trading partners not for the purpose of replacing its ties with the powerful state, but to lessen its dependence and vulnerability caused by the excessive concentration of economic exchanges with the powerful neighbor. Internally, the logic of counterweight impels a less powerful state to mobilize directly and indirectly the resources of society in order to improve its economic power. Although these two systemic logics do not explain why Canada acted in the fashion it did as it sought to redress its industrial adjustment problem, the two logics help us to predict how a state will respond to shifts in systemic constraints and incentives. This logic of counterweight, I argue, is what motivated Canada to attempt to create counterweights so as to mitigate its vulnerability to the United States. Whereas the logic of integration is used by a middle power that is in a position of relative strength, the logic of counterweight is used by a middle power that is in a position of relative weakness.

Second, I argue that fundamental to any state efforts to pursue a strategy of economic adjustment is the concurrent task of undertaking the necessary institutional adaptation or innovation that will facilitate the implementation of an adjustment strategy. For any strategy to be effective, the set of tasks that defines the strategy must be matched

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with a set of domestic political institutions that confer upon government officials the kind of instrumental and organizational capacities needed to implement a particular adjustment strategy.

Since state institutions form an integral part of pursuing an adjustment strategy, having appropriate institutional structures is essential. I argue that the strategy of economic nationalism failed to gain a home in Canada during the 1970s and early 1980s not because there was a lack of interests among state officials and society for it, but because efforts to adapt the existing institutional terrain in order to make it compatible with the organizational requirements of pursuing the strategy of economic nationalism failed. The shallowness of institutional adaptation demonstrated how resistant the preexisting institutional order was to producing optimal institutional change. Unlike the first adjustment strategy, the strategy of continentalism succeeded because government officials were able to achieve the appropriate institutional innovations to pursue the strategy. The institutional obstacles that government officials are up against also shape how they proceed with institutional adaptation. Where the adjustment task is not matched with the requisite domestic political institutions as demonstrated with the Third Option, a sequence of circuitous policy actions will emerge; where the adjustment task is joined with the appropriate institutions as illustrated in the case of the strategy of economic liberalism, a sequence of linear or self-reinforcing policy actions will emerge.

Finally, although I agree with the notion that path dependency shapes the trajectory of institutional development, I contend that institutions are less "sticky" than historical institutionalists have posited but less malleable than rational institutionalists have

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contended.[34] The self-reinforcing process of path dependence allows for some "stretching" of institutional parameters to the extent that government officials experience varying degree of success when they undertake institutional adaptation to facilitate the implementation of different adjustment strategy. Path dependence will prevent actors from profoundly deviating from a current course of institutional trajectory, but it can allow for meaningful "branching off" of the historical pattern of development. Thus, agency and structure are both at play, not one or the other. With human agency playing a key role in the politics of industrial adjustment, I argue that emphasis should be placed on the different political strategies that government officials employ in order to produce the necessary institutional innovations that will support the pursuit of an adjustment strategy. State officials act purposefully and strategically as they select, abandon, and try new political strategies in order to achieve institutional innovation. However, how government officials proceed with institutional modification is largely shaped by the organizational and instrumental capacities at their disposal.

This dissertation uses comparative historical inquiry as its main method of research to account for the actions of the Canadian in the face of the problem of industrial

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[34] The notion that institutions are not easily amenable to change constraining effect of path dependency is one that is generally accepted by historical institutionalists. See Kathleen Thelen, "Historical Institutionalism in Comparative Politics," *Annual Review of Political Science* (1999); Stephen Krasner, "Sovereignty: An Institutional Perspective," *Comparative Political Studies* (21 (April 1988); G. John Ikenberry, "Conclusion: an institutional approach to American foreign economic policy," *International Organization* 42 (Winter 1988); Paul Pierson, "Not Just What, but When: Timing and Sequence in Political Processes," *Studies in American Political Development* 14 (Spring 2000); and Paul Pierson and Theda Skocpol, "Historical Institutionalism in Contemporary Political Science," American Political Science Association Meeting paper (August 30-September 2, 2000). The idea that institutions can successfully adapt—that is, can be easily changed or reformed—in order to deal with the emergence of new cooperation and coordinative problems resulting from transaction costs, information asymmetries, principal-agent problems is one that is accepted by rational choice institutionalists. Among the vast literature, see Terry Moe, "The new economics of organization," *American Journal of Political Science* 28 (1984); Helen Milner, "Rationalizing Politics: The Emerging Synthesis of International, American, and Comparative Politics," *International Organization* 52 (Autumn 1998); Oliver Williamson, *The Economic Institutions of Capitalism* (New York: Free, 1985); Kenneth Shepsle, "Studying institutions: some lessons from the rational choice approach," *Journal of Theoretical Politics* (1989).

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adjustment. A comparative historical analysis is based on three integral notions.[35] First, this method of inquiry seeks to identify the causal configuration that explains industrial adjustment outcome, particularly the sequence of measures within each industrial strategy and the shift from one strategy to the other. This study posits that to explain this dependent variable it is necessary to focus on the structure-agency dynamic. Human agency always matters in politics, but actions take place within a structured context that will shape the capacity of agents to attain their objectives. This study elaborates on those domestic and international structures which had the greatest affect on the actions of policy actors. Moreover, in order to gain an understanding of how actors acted in the face of the enabling and constraining effects of institutional structures, I have relied on official reports, statements of public officials on the House of Commons and in other public forums, and newspaper reporting. These sources provide crucial information that enables one to decipher the intentions, interests, and preferences of policy actors.

Second, comparative historical inquiry, as Mahoney and Rueschemeyer have pointed out, "explicitly analyze[s] historical sequences and take[s] seriously the unfolding of processes over time."[36] This is especially relevant in this study because it posits that the pattern of industrial adjustment witnessed from the early 1970s to the mid-1990s was shaped by the self-reinforcing process of path dependence. In the next

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[35] These three aspects of comparative historical analysis are treated in James Mahoney and Dietrich Rueschemeyer, "Comparative Historical Analysis: Achievements and Agendas," in Mahoney and Rueschemeyer, eds., *Comparative Historical Analysis in the Social Sciences* (New York: Cambridge University Press, 2003).

[36] Mahoney and Rueschemeyer, "Comparative Historical Analysis: Achievements and Agenda," p. 12. This particular aspect of comparative historical inquiry is directly associated with historical institutionalism, from which this study is informed. As Pierson and Skocpol have observed, "Historical institutionalists take time seriously, specifying sequences and tracing transformations and processes of varying scale and temporality." Paul Pierson and Theda Skocpol, "Historical Institutionalism in Contemporary Political Science," in Ira Katznelson and Helen Milner, eds., *Political Science: The State of the Discipline* (New York: W.W. Norton, 2002).

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chapters, emphasis will be placed on tracing this process in the various policy measures policy makers undertook as they attempted to address Canada's problem of industrial adjustment.

Finally, comparative historical analysis is distinct from other methods in the sense that it engages in comparison of similar and different cases. In using this method of inquiry, comparison is achieved, as Skocpol remarks, "with selected slices of national historical trajectories as the units of comparison."[37] This leads one to decide among several options about how to proceed with comparison. The analyst has the option of using John Stuart Mill's method of agreement, method of difference, or a combination of both.[38] Also, the analyst has the option of comparing across a large or small number of countries or to compare using a time-series analysis within a country. Although it is not so common to see such an application in comparative historical analysis, this study contrasts two time periods, each identified by the particular adjustment strategy that was pursued.

Moreover, the use of the method of difference is instructive because it helps to detect variance in the effectiveness of each adjustment strategy. The two time periods are similar to the extent that both were concerned with the problem of industrial adjustment and witnessed purposeful state efforts directed at coping with such a problem. However, whereas the period during which economic liberalism was pursued serves as a positive case, the period during which economic nationalism was pursued illustrates a negative case. This is so because in the negative case we do not find a compatible institutional

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[37] Theda Skocpol, *States and Social Revolutions: A Comparative Analysis of France, Russia, and China* (New York: Cambridge University Press, 1979), pp. 35-36.
[38] See Theda Skocpol and Margaret Somers, "The Uses of Comparative History in Macrosocial Inquiry," *Comparative Studies in Society and History* 22 (1980).

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framework that can confer upon policy makers the required organizational and instrumental capacities necessary for implementing the strategy of economic nationalism.

In the next chapter I will present a literature review that will serve as platform from which this study's analytical framework is built. In Chapter three, I will provide a historical overview of the political development of the Canadian state, focusing on the developmental trajectory of the federal bureaucracy, of provincial-federal relations, and of government-societal relations. Chapter four discusses the foundation of the two industrial adjustment strategies, namely the Third Option and liberal continentalism. The policies of diversification, gatekeeping, and economic planning—all of which were part of the Third Option—are the topics of chapters five, six, and seven respectively. The strategy of liberal continentalism is discussed in Chapter eight and a concluding chapter brings together the findings of this study.

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CHAPTER TWO

EXPLAINING INDUSTRIAL ADJUSTMENT POLICY

A number of approaches have been used to explain state action. In this chapter, I will consider five groups of theoretical explanations: systemic, ideational, state autonomy, interest-based, and historical institutionalism. The goal of this section will be to identify the limitations of the first four lines of analysis and demonstrate why an institutionalist analysis offers a fuller account of the sequence of industrial adjustment actions undertaken by the Canadian state. In particular, I argue that historical institutionalism offers a more convincing explanation of what caused different patterns of programmatic changes within the two adjustment strategies—economic nationalism and economic liberalism. Also, historical institutionalism provides a convincing account of the shift of strategy from nationalism to liberalism in the 1980s.

To strengthen the explanatory power of an analytical framework, it should take into account how international structure and processes affect state actions. No state deals with the problem of economic adjustment without calculating what systemic opportunities and constraints it faces. Hence, it is necessary to develop an analytical framework that combines international and domestic level analyses. This study addresses an important point raised by Moravcsik and others with respect to theoretical efforts aimed at integrating comparative and international politics: the challenge facing theorists today "is not *whether* to combine domestic and international explanations into a theory..., but *how* best to do so."[1] This analysis of Canadian industrial adjustment is based on the premise

[1] Andrew Moravcsik, "Integrating International and Domestic Theories of International Bargaining," in Peter B. Evans, Harold K. Jacobson, and Robert D. Putnam, *Double-Edged Diplomacy: International Bargaining and Domestic Politics* (Berkeley: University of California Press), p. 9, italics original.

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that the two spheres of analysis are not separate, but are interacting and mutually constitutive such that outcomes in one sphere shape those in the other.

SYSTEMIC-LEVEL EXPLANATIONS

Systemic-level approaches focus on those international forces that provide opportunities for and place obstacles to the actions of states. Although systemic approaches do not directly explain why states select one policy option over others, they do inform us about the pressures that the international system places on every state and remind us that states feel impelled to respond to these pressures. This section is broken into two parts. In the first part, I will consider a group of arguments which fall under the general heading of political economic explanations, while in the second part the analysis will focus on realist explanations.

Political Economic Arguments

The political economic literature focuses on the economic relationship between Canada and the United States. Although this body of theory is diverse and sometimes contradictory, there are four key arguments that tie the literature together. First, the high level of American control over Canada's manufacturing base has resulted in a number of adverse effects, such as technological dependency and manipulation of exports of industrial goods. Second, by serving as the United States' supplier of such staples as metallic minerals, fuels, and newsprint, Canada has fallen ever deeper into a 'staples trap.' The staples trap refers to the notion that by focusing on the development of the staples sector in the Canadian economy, a number of adverse economic effects will arise. They include, Canadian vulnerability to price fluctuations in international commodity

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markets; the persistence of Canadian technological backwardness since much of the processing that staples commodities undergo is done in the United States; and lastly, the diversion of scarce financial resources from manufacturing toward the extraction of staple products. The third argument advanced by this line of analysis is that if measures are not taken to overcome the staples trap, the standard of living in Canada will deteriorate. Finally, the political economic literature argues that economic dependence, which is reinforced by Canada's technological dependence and staples exports to the United States, leads to political and cultural dependence.

In *Silent Surrender*, Levitt combines two bodies of ideas: (1) H.A. Innis's idea that the Canadian economy is a staple-producing hinterland and (2) the dependency-structuralist notion that there is a relationship between multinational corporations and the underdevelopment of the hinterland.[2] The Canadian dependency thesis that emerged in the early 1970s was pioneered by Levitt and marked the dawn of the new political economic approach. The dependency thesis, informed by Canada's economic circumstances, can be defined as follows:

> The central thesis of our argument is that the subsidiaries and branch plants of large American-based multinational corporations have replaced the operations of the earlier European-based mercantile venture companies in extracting the staple and organizing the supply of manufactured goods. In the new mercantilism, as in the old, the corporation based in the metropole directly exercises the entrepreneurial function and collects a "venture profit" from its environment. It organizes the collection or extraction of the raw material staple required in the metropolis and supplies the hinterland with manufactured goods, whether produced at home or "on site" in the host country.[3]

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[2] Kari Levitt, *Silent Surrender: the multinational corporation in Canada* (Toronto: Macmillan of Canada, 1970).
[3] Ibid., pp. 24-5.

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American-based multinational corporations have shaped the Canadian economy via their sheer power and influence. By controlling the 'commanding heights' of the Canadian economy, notably manufacturing and the staples sectors, foreign corporations have obtained control of Canada's rate and direction of capital accumulation. The economic activities in which foreign corporations have not moved into, such as banking, transportation, and communications, are those where Canada has been able to preserve the highest degree of economic autonomy. This is the essence of the political nature of multinational corporations or the "new mercantilism": foreign interests assume economic control by virtue of simply extending themselves into certain economic sectors of foreign countries.

Levitt notes that Canada's underdevelopment is a product of foreign interests' domination in the host economy. Although Canada is the "world's richest underdeveloped country," as Levitt points out, underdevelopment has progressed as a result of the presence of a weak indigenous capitalist structure in Canada, a result directly attributed to the presence of foreign corporations in Canada.[4] Multinational corporations have created a branch-plant economy in which vital manufacturing decisions are made by foreign interests, the pace of technological progress is set by foreign needs, the marginal scale of indigenous manufacturing leads to the weakness of local entrepreneurs, and balance-of-payments patterns are distorted as more capital goods are acquired through intra-firm trade with parent companies in home countries.

In taking Levitt's work one step forward, a number of Canadian dependency theorists have incorporated insights gained by Paul Baran's and Andre Gunder Frank's neo-Marxist analyses. Scholars such as Naylor and Clement have posited that the

[4] Ibid., p. 25.

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"development of underdevelopment" in Canada is linked to actions of an alliance involving the capitalist class in the hinterland (peripheral) economy and the metropolis.[5] Naylor's work focuses on the division of investment interests between Canadian and American capitalists. Accordingly, it is argued that Canadian merchants and financiers, who formed the dominant class and instrumentally used the state to advance their interests, stifled the process of industrialization by exclusively focusing on the development of the hinterland's circulatory or nonproductive sector, which includes such activities as transportation, finance, and banking. As a result, Canada's ruling class and state made the historical decision to allow for "industrialization by invitation," a choice which American investors took advantage of by heavily investing in Canada's manufacturing and staples sectors.[6]

Clement's analysis reinforces Naylor's explanation of Canada's postwar pattern of economic development. Clement argues that underdevelopment has been caused by the "compradorization" of the Canadian capitalist class. The elite structure is distorted to the extent that the "comprador class"—the dominant class—in Canada is made up of American corporate managers and directors who make vital economic decisions on behalf of their parent companies that have a significant impact on the pattern of economic development in Canada.

Whereas the analyses of Levitt, Naylor, and Clement locate Canada within the peripheral or intermediary ranks of the international capitalist system, other scholars working within the new political economic framework understand Canada to be within

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[5] R.T. Naylor, "The Rise and Fall of the Third Commercial Empire of the St. Lawrence," in G. Temple, ed., *Capitalism and the National Question in Canada* (Toronto: University of Toronto Press, 1972); Wallace Clement, *Continental Corporate Power: Economic Linkages between Canada and the United States* (Toronto: McClelland and Stewart, 1977).

[6] Naylor, *History of Canadian Business, 1867-1914*, Volume Two (Toronto: Lorimer, 1975), p. 276.

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the sphere that includes metropolitan economies. Williams has contended that what distinguishes Canada from other resource-dependent countries is that historically it has been positioned within the center, first under the British empire and in the better part of twentieth century, under the American sphere of economic influence.[7] "Indeed," as Williams remarks, "when investment, production, and trade are considered, the Canadian economy may...be usefully conceptualized as a geographically large zone within the U.S. economy."[8] Williams posits that Canada's relatively well-positioned place within the international capitalist system has enabled it to exercise more political autonomy than dependency theorists have suggested.

In focusing on the role that historical policy choices had on the pattern of economic development in Canada, the "Canada at the center" argument advances the view that Canada's economic position in the international economic system has been more influenced by its own decisions than by foreign interests. Still, consistent with the new political economic approach, the "Canada at the center" argument maintains that Canada's economic choices have been conditioned by the pressures of the international capitalist system, most notably Canada's role as a supplier of raw materials and semi-manufactured goods to the advanced industrialized economies.

There are a number of important flaws associated with this framework of analysis. First, some of the literature in this school of thought contends that multinational corporations and the economic policies of foreign governments, particularly American multinational corporations and the American government, have manipulated economic activities in Canada in order to advance their interests. What emerges from this line of

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[7] Glen Williams, "On Determining Canada's Location Within the International Political Economy," *Studies in Political Economy* 25 (Spring, 1988).
[8] Williams, 1988, p. 133.

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argument is that the Canadian state is incapable of acting autonomously, let alone defining its own interests. Nossal rebuts this argument by correctly pointing out that what Canada faces is a relation of dependence with the United States not one of dependency.

> Dependence refers to a relationship between two parties in which the costs to one party of altering that relationship grow too high to make alteration acceptable. The use of dependence in this context differs considerably from the usage of *dependencia* theory, where the condition of dependence is in essence forced on one party by the other. In the Canadian context, dependence must be seen as self-generated.... Thus it is not that Canadians—or the state in Canada—are incapable of changing this condition, but that they are constrained from doing so by the high costs of altering their relationship with the United States.[9]

Economic dependence arises from relations of economic interdependence that market forces facilitate. When market forces are left to their own devices, they tend to concentrate rather than spread growth and to create an international division of labor rather than an international system composed of economically self-sufficient states. But, as economic nationalists inform us, such a pattern of economic relationships also generates adverse relations of power. Because participating states reap gains at differential rates over time, some states will become more economically powerful than others. It is this asymmetry in power, produced by the distributive effects of existing patterns of economic activities, that has limited Canada's capacity to lessen its economy's level of dependence on the United States.

Second, the new political economic approach offers contradictory insights about what kind of action Canada is expected to take in order to cope with the economic adjustment problem. Levitt posits that Canada's deteriorating position in the international

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[9] Kim Richard Nossal, "Economic Nationalism and Continental Integration," p. 85.

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capitalist system should prompt government officials to adopt a strategy of economic nationalism as a way to shore up Canada's eroding economic independence and political autonomy. The "Canada at the center" position, on the other hand, asserts that Canada will be pressured to pursue a policy of deeper continentalism, as it responds to the need to "overhaul Canadian branch-plant manufacturing so as to maintain Canada's established regional share within continental manufacturing."[10] Whereas the first line of argument predicts that Canada will seek to preserve and improve its economic independence and political autonomy, the second line of argument predicts that Canada will seek to secure its ability to produce wealth by seeking economic integration with the American economy.

The last shortcoming associated with the political economic approach is that it does not lend sufficient attention to the political underpinnings of Canada's economic relations with the United States. Canada's military relations with the United States have had a significant impact on how it interprets the political-security effects of its economic relations with its neighbor, in particular what it perceives as conditions of vulnerability and threat. Unlike many other states, Canada has tended to be less concerned with the military security implications of economic dependence. As Laxer points out:

> The absence of a real military threat from the Americans [in the twentieth century] coincided with the period when the industrial structure was established in its branch-plant mould. The result was clear: Canada had no strategic logic, no compelling motive to block foreign ownership.... [T]he state discarded the first line of defence against foreign ownership and technological dependence....[11]

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[10] Glen Williams, *Not For Export: The International Competitiveness of Canadian Manufacturing*, Third Edition (Toronto: McClelland and Stewart Limited, 1994), p. 177.
[11] Gordon Laxer, *Open For Business: The Roots of Foreign Ownership in Canada* (Toronto: Oxford University Press, 1989), pp. 150-1.

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Omitted from the political economic approach is the understanding that Canada's political-security circumstances have affected its state action by eliminating a crucial factor that would otherwise undoubtedly prompt Canada to reduce the degree of economic dependence on the United States.

Realist Explanations

Structural realism offers a different interpretation of how states are affected by the international system. Whereas the new political economic approach positions states within the international capitalist system, the structural realist approach places states within the international political structure. Structural realists argue that the structure of the international system disposes states to act similarly and to respond to similar international concerns. In particular, the anarchic structure of the international system compels states to act in a self-help manner. In the absence of a centralized authority governing over states, states act as the ultimate judges of their interests.[12]

Structural realists assert that anarchy is a significant force shaping state actions and that it pressures states to pursue a similar set of international political objectives. First, states seek to maintain territorial integrity and recognize this goal to be first and foremost among all state objectives.[13] In an effort to guarantee their security, states will seek to establish a suitable balance between maintaining sufficient domestic military capability and forming military arrangements with other states.

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[12] Kenneth Waltz, *Theory of International Politics* (Reading, Mass.: Addison-Wesley, 1979). Waltz notes that "To achieve their objectives and maintain their security, units in a condition of anarchy—be they people, corporations, states, or whatever—must rely on the means they can generate and the arrangements they can make for themselves," (p. 111).

[13] In this classic statement, Waltz remarks that "in anarchy, security is the highest end. Only if survival is assured can states safely seek such other goals as tranquility, profits, and power." Waltz, *Theory of International Politics*, p. 126.

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Another concern that states face is the need to preserve or improve their relative position in the international system. When contemplating whether to take part in an international engagement, structural realists contend that states will be more concerned about achieving relative rather than absolute gains.[14] This state preference for relative gains stems from the recognition that if states neglect the distributive consequences of economic exchange over time, vulnerability to the actions of other states and the threat of domination might become proximate problems that states will be forced to confront. Grieco observes that countries located in the medium power category, such as Canada, "may be extremely sensitive to gaps in gains, for they must simultaneously fear the strong and aspire to their status *and* they must worry that they might slip down into ranks of the weak."[15] Lastly, structural realists argue that states are concerned with preserving as much freedom of action and political autonomy as possible. Autonomy and independence enable states to advance their national interests with greater effectiveness and to ward off those external influences that undermine the national interest.

A state's ability effectively to advance its interests is based on state power. States decide how they will attain their goals on the basis of an aggregate assessment of their countries' economic, political, and military resources. For states, power capabilities figure prominently in any decision they make because it conditions what, when, and how state goals should be pursued. Because power is instrumental in achieving state objectives, government officials desire to improve their nation's power position in order

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[14] Waltz observes that "when faced with the possibility of cooperating for mutual gains, states that feel insecure must ask how the gain will be divided. They are compelled to ask not "Will both of us gain?" but "Who will gain more?" If an expected gain is to be divided, say, in the ratio of two to one, one state may use its disproportionate gain to implement a policy intended to damage or destroy the other." See Waltz, *Theory of International Politics*, p. 105.

[15] Joseph Grieco, *Cooperation Among Nations: Europe, America, and Non-Tariff Barriers to Trade* (Ithaca: Cornell University Press, 1990), p. 46.

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to afford them more flexibility with regard to how to act upon their nation's instrumental interests.[16] Accordingly, a shift in the position of a state relative to others is expected to have an impact on the range of foreign policy objectives that the state seeks to attain and on the range of policy instruments at the disposal of government officials.

Although structural realism provides a convincing account of how states are impacted by the international system, there are three important general flaws with this line of analysis. The first drawback concerns structural realism's use of a worst-case/possibilistic logic to depict state behavior in the international system.[17] According to this logic states are always concerned about the possibility of military aggression or domination by stronger states. Mearsheimer observes that

> States in the international system fear each other. They regard each other with suspicion, and they worry that war might be in the offing. Although the level of fear varies across time and space, it can never be reduced to a trivial level. The basis of this fear is that in a world where states have the capability to offend against each other, and might have the motive to do so, any state bent on survival must be at least suspicious of other states and reluctant to trust them.[18]

It is expected that the fear of aggression and domination is more intense among militarily weaker states than militarily more powerful states. Because security is scarce in the international system, states will always assess their interaction with others in terms of what is optimal for improving their relative position. Accordingly, international cooperation rarely lasts over time, for the distributive effects of international

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[16] For a similar understanding of the role of power in the structural realist approach see Stephen Brooks, "Dueling Realism," *International Organization* 51 (Summer 1997).

[17] Brooks notes that structural realists maintain "that the possibility of conflict shapes the actions of states, who are seen as always adopting a worst-case perspective." See Stephen Brooks, "Dueling Realism," *International Organization* 51 (Summer 1997), p. 446.

[18] John Mearsheimer, "The False Promise of International Institutions," *International Security* 19 (1994-95), p. 11.

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engagements are bound to change unfavorably for some states and thus intensify their fear of military conquest or domination.

I argue that this possibilistic logic does not capture the interaction between Canada and the United States as well as it does in other bilateral relations in the world. States are animated more by a probabilistic logic than by a possibilistic one, as Brooks argues. The former logic is based on the premise that the international system generates more security than what structural realists argue and consequently the fear factor that states face as a result of the condition of anarchy figures less prominently in the calculations of state officials. The probability of conflict is determined not just by the condition of anarchy, but also by technology, geography, and international economy conditions.[19] These factors help to determine the probability of military aggression by affecting the cost-benefit balance associated with the use of force by other states. Moreover, states pursue goals other than military security, such as political autonomy, economic independence, peace and justice, and domestic welfare. Accordingly, states will seek power and wealth precisely to advance these objectives, sometimes at the expense of military security.

Another weakness associated with structural realism is its overemphasis on relative gains. It is doubtless that states are concerned about the relative achievement of gains, but it is questionable that states will always reject cooperative arrangements because the distribution of gains substantially benefits partners. The importance that states attach to either relative gains or absolute gains can vary over time; much depends on the circumstances that states are facing. For example, if the possibility of war between two states is absent then absolute gains will take on a greater value than relative gains, but if one of the two states judges that it has become increasingly vulnerable to the actions of

[19] Brooks, "Dualing Realism," p. 456.

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the other, the weaker state will be inclined to place more value on the goal of achieving relative gains.

The third weakness concerns the omission of systemic processes as a causal force of state action. Interactions with states produce benefits, but they can also lead to undesirable effects especially when actors fail to coordinate policies. The more integrated the economies of different states are, the greater the risk of being adversely impacted by a state's uncoordinated policy action. Externalities, as Milner points out, refer to "when through its choice of policies a foreign country generates costs or benefits for another country that are not included in the foreign country's calculation of the optimality of the policy...."[20] As a state becomes more exposed to negative externalities brought about by the policies of another state, with which the former maintains close ties, it will seek either to coordinate bilateral economic policies or reduce its exposure to them by seeking to foster economic ties with other countries.

The systemic level of the two-level approach to explaining state action advanced in this study is based on a modified version of structural realism that incorporates the three points discussed above. The systemic framework I propose encompasses two systemic variables: the degree of power asymmetry between Canada and the United States and the degree of externality. The model identifies four different configurations of systemic situations facing Canada in the context of Canadian-American relations. By combining these two variables, it is possible to define the counterweight and integrative logics, which have been manifested in the strategy of economic nationalism and of economic liberalism, respectively.

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[20] Helen Milner, *Interests, Institutions, and Information* (Princeton: Princeton University Press, 1997), p. 44.

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Each logic advances a particular international policy strategy that a state is expected to follow in the face of a particular set of systemic constraints and opportunities. Accordingly, a shift in the configuration of systemic constraints and opportunities should correspond to a change in Canada's economic strategy. It is important to note, however, that how precise these systemic pressures will affect state behavior depends on how they are translated through the domestic institutions of the state. Still, these systemic constraints and incentives do frame the context of policy making by delineating the parameters of feasible strategies.

Table 2.1: Two Systemic Logics: Integrative and Counterweight Logics

Degree of Power asymmetry	Exposure to Negative Externality: Decrease	Exposure to Negative Externality: Increase
Relatively less	- moderate to high bargaining power - preserve political autonomy and strengthen relative position - weaker state will not be inclined to enter into integration arrangement with powerful state	Integrative Logic (early 1980s-present) - moderate bargaining power is used to conserve relative position - give up some autonomy in exchange for establishing coordinative and regulatory mechanisms with powerful state. - obtain "effective voice opportunities" within the collaborative arrangement with powerful state
Relatively greater	- limited to moderate bargaining power - multilateral form of engagement preferred	Counterweight Logic (1970s-early 1980s) - limited bargaining power is used to improve relative international position - selective diversification of external relations - extend state's domestic capacity for the purpose of generating national wealth and power.

As a causal variable, Canadian exposure to externalities is treated as having gradually increased since the early 1970s. Its causal effect on state behavior is displayed in the form of meaningful changes in the preferences, strategies, or interactions of a state. Like the anarchic structure of the international system, externalities—which are derived from (or an attribute of) the systemic condition of interdependence—do affect state behavior in a way that can be generalized across different states in the international

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system. Emphasis on externalities adds texture to an analysis of bilateral relations by taking into account the nature of interaction between two states. Negative externalities imply costs associated with closeness of relations. Moreover, externalities—such as those generated by American policies—commonly arise when one state seeks to improve its relative terms of exchange and in the process transfers costs to its partner. Rather than inducing economic harmony, Waltz notes that "interdependent states whose relations remain unregulated...raises the prospect of at least occasional conflict."[21] In the face of externalities, an injured state has two options. First, it can attempt to lessen interdependence by forging stronger ties with third parties. This is the course of action that is most likely to be selected by a state that perceives itself to be in a position of relative weakness vis-à-vis its partner whose policy actions are the source of externalities. In the second option, an injured state will attempt to regulate its interdependence after judging that it can arrive at favorable terms of exchange in light of recent improvements in its relative position.

Degree of power asymmetry or disparity refers to the difference in power capabilities between two or more states. Power capabilities include those economic, political, and military resources whose employment enables a state to achieve its instrumental interests.[22] In this study, power disparity is understood to be the principal

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[21] Kenneth Waltz, *Theory of International Politics*, p. 138. See also Arthur Stein, *Why Nations Cooperate: Circumstance and Choice in International Relations* (Ithaca: Cornell University Press, 1990).

[22] Capabilities and power are intricately tied. The more capabilities a state possesses the greater its international power, that is to say, the more able a state is to influence the behavior of other states, to protect and advance its economic independence and political autonomy, and to accumulate national wealth. The concept of power can be further refined by noting that power "permits wider ranges of action, while leaving the outcome of action uncertain," as Waltz points out. See Waltz, 1979, p. 194. Here, Waltz cautions us against understanding power to mean the achievement of a particular outcome; instead power is a means to an end. See Waltz, "Reflections on Theory of International Politics: A Response to My Critics," in Robert Keohane, ed., *Neorealism and Its Critics* (New York: Columbia University Press, 1986), p. 333.

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factor underpinning the pattern of interdependence between Canada and the United States.[23]

Power asymmetry is gauged using three types of measurement. First, power disparity is measured by the degree of Canadian control over the productive resources of the Canadian economy and is conceptualized in terms of Canadianization.[24] Canadian control can be measured by comparing the percentage of the total capital stock controlled by Canada to that of the United States. By increasing Canadian participation in the economy, policies promoting Canadianization help national firms to obtain higher levels of capital accumulation, as well as ensure that domestic interests have a greater impact in shaping the course of industrial progress. In short, Canadianization contributes to improving Canada's position relative to the United States by enhancing the distribution of economic assets held by Canadian owners and strengthening Canadian control over national activities.

The second measurement of power asymmetry refers to the degree of Canadian penetration in the United States. This is conceptualized in terms of greater or lesser mutual dependence between Canada and the United States. Canada's export dependence

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[23] In their seminal work, Keohane and Nye argue that one of the political contexts in which power is manifested is that of interdependence. As the two scholars observe, "It is *asymmetries* in dependence that are most likely to provide sources of influence for actors in their dealings with one another. Less dependent actors can often use the interdependent relationship as a source of power in bargaining over an issue and perhaps to affect other issues" (italics original). To the extent that material capabilities underpin the projection of power, it is assumed that relative capabilities figure largely in determining the asymmetries of interdependence that a state faces. Thus, this study acknowledges the linkage among material capabilities, power projection, and asymmetries of interdependence. In elaborating sensitive and vulnerability interdependence, Keohane and Nye contend that power is best conveyed through the latter dimension of interdependence because power is a function of the availability of policy alternatives at the disposal of a state and opportunity cost associated in pursuing those alternatives. See Robert Keohane and Joseph Nye, *Power and Interdependence*, second edition (New York: Harper Collins Publishers, 1989), pp. 10-11.

[24] Canadianization concerns state efforts to promote greater participation of Canadian capital in the economy. The purpose of Canadianization is highly political, for it seeks to increase Canadian control over national economic resources, in particular, to capture the economic benefits associated with industrial development that would otherwise be retained by foreign interests.

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on the United States stabilized in the 1970s and early 1980s as a result of increased Canadian exports to third party markets, most notably in Europe and Asia. However, by 1990 Canada's export dependence on the United States had increased to 74.9 percent from 64.1 percent in 1980. But concealed in this mixed outlook were two significant developments. Although Canada failed to diversify away from the American market, it was able to diversify the range of its export commodities to the point where a diverse mix of secondary manufactured products accounted for an expanding share of Canadian exports. More important still, these Canadian exports possessed a higher degree of value-added. These two developments produced significant results. For example, although approximately 30 percent of the American softwood lumber market in the 1990s was supplied by Canadian exports, in the event that this market was completely closed to Canadian exports it would amount to an annual loss no greater than a day and half of trade.[25]

Another aspect of Canadian penetration relates to Canadian direct investment in the United States or more generally, Canada's international investment position. The differential rates of two-way investment flows during the 1970s and 1980s resulted in the registering of a 370 percent increase in Canadian investment in the United States compared to the 123 percent increase of American investment in Canada between 1971 and 1981.[26] This was owed to the emergence of a new group of Canadian firms that joined other successful national players on the international scene, in particular in the American market, such as Massey-Ferguson, Seagrams, Polysar, Alcan, Inco, and

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[25] Kim Richard Nossal, "Bilateral Free Trade With the United States: Lessons From Canada," *Policy, Organization & Society* 20 (2001), p. 58.

[26] Jorge Niosi, "Continental Nationalism: The Strategy of the Canadian Bourgeioise," in Robert Brym, ed., *The Structure of the Canadian Capitalist Class* (Toronto: Garamond Press, 1985), p. 61.

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Brascan. Some five hundred Canadian firms acquired an array of assets in the United States by the beginning of the 1980s, their numbers increasing most staggeringly in the second half of the 1970s and early 1980s. Importantly, this flow of Canadian investment into the United States—a development that the Canadian government supported more implicitly than explicitly—had the effect of further entangling the two economies and, from a Canadian point of view, helped balance the degree of dependence between the two neighboring economies.

Finally, power asymmetry is gauged by taking account of shifts in the leverage one actor can bring to bear on another actor. Because of the sheer size of the American domestic market, the ability to induce vulnerability toward other states by threatening market closure, and more generally America's commanding economic position, the United States has constantly wielded relatively greater leverage over Canada than the other way around. But certain policy episodes have created opportunities for Canada to exercise leverage power in a manner that has been rare historically. Although the Third Option failed to accomplish its adjustment objectives, it demonstrated to Americans that Canada was capable of asserting its political and economic independence in the face of criticism from its powerful neighbor.

Moreover, the Third Option illustrated that Canada's pursuit of self-interest did not necessarily coincide with American self-interests and indeed sometimes could undermine them, as the Foreign Investment Review Agency and the National Energy Program explicitly showed. As Doran points out, the policy measures linked to the strategy of economic nationalism "stand as reminders to the United States that unilateral trade and commercial initiatives which ignore Canadian interests are likely to stimulate policies

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having very negative consequences for United States interests as well."[27] Although Canada has generally refrained from employing linkage politics with the United States in order to advance its interest, Canadian governments have tended to be more successful in eliciting the attention of and gaining some desired concessions from its neighbor on issues of significance to Canada when it practiced policies that proved damaging to American interests.

I argue that the adoption of the logic of integration by government officials, beginning in the early 1980s, is owed to an improvement in Canada's material capabilities. The link between the logic of integration and relative material capabilities has been analyzed by Grieco.[28] Grieco's "relative disparity shift" thesis posits that when a weaker power is faced with the option of deepening economic cooperation with a powerful state, shifts in power disparity (which affects potential bargaining leverage) will have a significant influence in determining the policy choice of a weaker state. Grieco asserts that when a weaker state's position relative to a powerful state is deteriorating, the former will be less inclined to support further economic cooperation with a powerful state through regional institutionalization because it fears it will become more vulnerable to the other's shifts in policy and susceptible to the other's domination. When power relations are stable or register a recent improvement, a less powerful state—emboldened by its steady or slightly improved bargaining position—judges favorably the potential for

[27] Charles Doran, "The United States and Canada: intervulnerability and interdependence," *International Journal* 38 (Winter 1982-83), p. 140.
[28] Joseph M. Grieco, "Systemic Sources of Variation in Regional Institutionalization in Western Europe, East Asia, and the Americas," in Edward Mansfield and Helen Milner, eds., *The Political Economy of Regionalism* (New York: Columbia University Press, 1997).

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the creation of future gains through deeper forms of economic cooperation with a more powerful state.[29]

Canada's change of economic adjustment strategy in the early 1980s from the Third Option to continentalism coincides with the registering of favorable gains in the country's relative position over the course of previous years. Although these relative gains signified that Canada's potential bargaining power had improved compared to that of the early 1970s, its bargaining power relative to the United States' remained largely asymmetric. Accordingly, Canada's decision to institutionalize bilateral economic relations would not result in advancing all of the interests of Canadian negotiators. Yet, the fact that Canada's relative capabilities had improved over the 1970s led Canadian officials in the 1980s to recognize that Canada was in a better position to secure mutually beneficial gains with the United State than it had been in the previous decade. Moreover, it was believed that they could negotiate a bilateral political arrangement whose institutional terms of engagement would enable Canada to maintain and improve its relative capabilities over the long term.

The strategy of economic nationalism is based on the logic of counterweight, whereas the strategy of economic liberalism is based on the logic of integration. The integration logic is based on two systemic conditions: relative improvement of international power and high level of externality. Because power determines the ability of a state to secure a more beneficial distributional outcome, a weaker state will hold off on adopting this logic until it recognizes that it now obtains national advantages it previously did not possess.

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[29] Grieco (1997) measures intra-regional shifts in disparities in capabilities using two variables: first, the ratio of a country's gross domestic product to the region's gross domestic product and second, ratio of gross domestic product of the powerful partner to the weaker partner.

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The strategic setting to which the integrative logic is applied is likened to the "battle of the sexes" game. As this game theoretical model demonstrates, states seeking to coordinate policies—because they recognize they share mutual interests in an issue-area of concern—may encounter several possible terms of arrangement, each producing a political outcome that impacts participants differently. Krasner aptly remarks that the challenge facing states after recognizing the need to cooperate is determining "which point along the frontier will be chosen."[30] The more national power a state can project, the greater its ability to secure a distributional outcome that approximates what it desires; hence the imperative in narrowing as much as possible the gap in power disparity between a powerful and less powerful states.

When a less powerful state perceives an improvement in its capacity relative to its powerful ally, it can embolden that state to pursue the integrative logic. Such power enables a less powerful state to secure greater benefits and make the collaborative arrangement worthwhile. Economically, the benefits include increased economies of scale which have positive effects on national productivity and efficiency; secure export access to a partner's markets which is likely to multiply the range and intensity of exported goods; and reduce negative externalities by redrawing property rights. Politically, economic integration imposes new constraints on the exercise of state autonomy, but the institutional apparatus that makes integration possible bestows on a weaker participant influence over the policies of a more powerful state, as well as a capacity to seek redress or remedy of grievances in the event that a less powerful state is dissatisfied with ongoing patterns of engagement. Integration affords a less powerful

[30] Stephen Krasner, "Global Communications and National Power: Life on the Pareto Frontier," *World Politics* 43 (April 1991), p. 340.

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state with what Grieco calls "effective voice opportunities."[31] The institutional rules and procedures embodied within a cooperative arrangement serve as instruments with which a state can exercise influence over the other's behavior, restrain and render more predictable the exercise of power of a powerful state, and provide a dissatisfied state with a mechanism to obtain remedial actions in the event that the division of gains become imbalanced.[32]

Although the logic of integration implies that the position of a weaker state has improved, the fact that it requires the acquiescence of a powerful state in order to address the externalities problem, suggests that a powerful state is in a relatively better position to exercise effective leverage. Thus, the integrative logic should be qualified by noting that although a less powerful state has experienced an improvement in its capabilities, its bargaining power is limited by the fact that it is more likely to have to give up relatively more in order to attain minimal concessions from a more powerful state.

Whereas the logic of integration is premised on the notion that a weaker state's position has improved relative to a more powerful state, the logic of counterweight is based on the opposite. A state that follows the counterweight logic is one that has recently experienced a relative decrease in its power capabilities and has been exposed to an increasing level of negative externalities resulting from its partner's recent change in its economic policies. The counterweight logic differs from the integrative logic to the

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[31] Grieco defines "effective voice opportunities" as "institutional characteristics whereby the views of partners (including relatively weaker partners) are not just expressed but reliably have a material impact on the operations of the collaborative arrangements." See Joseph Grieco, "State Interests and Institutional Rule Trajectories: A Neorealist Interpretation of the Maastricht Treaty and European Economic and Monetary Union," *Security Studies* 5 (Spring 1996), p. 288.

[32] See Grieco, 1996 and G. John Ikenberry, *After Victory: Institutions, Strategic Restraint, and the Rebuilding of Order After Major Wars* (Princeton: Princeton University Press, 2001).

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extent that it seeks strategically to find outlets with which to offset the United States' centripetal economic force.

The counterweight logic should not be mistaken with balancing of power. Balance of power occurs when a state forms an alliance in an effort to defend itself against a belligerent state. Canada's use of the counterweight logic in the 1970s was motivated, contrary to the balance of power logic, by the need to reduce and manage its relationship of dependence with the United States, which had been economically beneficial, but politically harmful. As Dolan points out, "The imagery of the counterweight refers to a foreign policy which combats an overly close and dependent relationship with another country by intensifying the relationship with a third country or...with a regional bloc."[33] Thus, the counterweight logic does not seek to terminate or replace Canada's economic activities with the United States, rather it seeks to develop and intensify Canada's economic interactions with other countries in an effort to balance the political and economic costs associated with being economically dependent on the United States. Multilateralism and minilateralism are this logic's key international instruments to create an effective counterweight.

The counterweight logic is likely to impel state officials not only to diversify strategically toward specific international counterweights, but also to create internal counterweights. As Rose points out, "Over the long term the relative amount of material power resources countries possess will shape the magnitude and ambition...of their foreign policies: as their relative power rises states will seek more influence abroad, and

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[33] Michael Dolan, "Western Europe as a Counterweight: An Analysis of Canadian-European Foreign Policy Behaviour in the Post-War Era," in Brian Tomlin, ed., *Canada's Foreign Policy: Analysis and Trends* (Toronto: Methuen, 1978), p. 28.

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as it falls their actions and ambitions will be scaled back accordingly."[34] Because an internationally weak state is less able to influence and shape international outcomes, such as the ability to shift the burden of economic adjustment to other states, it will be forced to employ domestic adjustment instruments more extensively as a way to achieve adjustment goals.[35]

As an adjustment logic, the logic of counterweight places more emphasis on domestic capacities of a state compared to the logic of integration. A state's limited range of international capacity is offset by its capacity to mobilize and extract the necessary resources to affect the rate and form of the process of wealth accumulation and in the long term improve national power. The integration logic, on the other hand, focuses more on the employment of international means of adjustment than on domestic ones. Accordingly, the efficacy of this logic in achieving its adjustment objectives largely depends on the ability of state officials to marshal those national capabilities that are necessary to extract desired concessions from other states.

> *Hypothesis 1:* The selection of a strategy will reflect two systemic forces: prevailing relations of power, as well as the degree to which a state is exposed to negative externalities. A state will tend to select economic nationalism when its power position has deteriorated and it has become more exposed to negative externalities. A state will tend to select economic liberalism when its power capabilities have improved and it faces a higher level of externalities.

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[34] Gideon Rose, "Neoclassical Realism and Theories of Foreign Policy," *World Politics* 51 (October 1998), p. 152.

[35] Mastanduno, Lake, and Ikenberry argue that a state's international power helps determine which adjustment arena (international or domestic) is selected. "Internationally weak states will emphasize domestic strategies more than will internationally powerful states. Likewise, powerful states will emphasize international strategies more than will weak states." Neoclassical realists also attribute changes in adjustment policies (particularly whether pursued at the international or domestic level) to shifts in relative capabilities. See Michael Mastanduno, David Lake, and G. John Ikenberry, "Toward a Realist Theory of State Action," *International Studies* Quarterly 33 (1989), p. 468.

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DOMESTIC-LEVEL EXPLANATIONS

These two systemic logics offer important insight regarding the impact systemic conditions have on the behavior of states. Systemic approaches inform us about where international constraints on and possibilities for state action come from and how states might respond to them as they seek to achieve national goals. Shifts in relative capabilities and degree of externalities combine to form an international context in which state officials formulate and implement policies. International level explanations posit that systemic changes tend to bring about change in state behavior.

The principal limitation of this approach is that the international pressures do not determine state behavior; instead, systemic forces are more likely to leave their imprint on state action by producing pressures which government officials are most likely to respond to. Holding the degree of externality constant, an increase in the degree of power disparity between the United States and Canada will reduce the range of policy actions Canadian officials can undertake at the international level and create an incentive to use domestic instruments. A decrease in the power asymmetry between the two countries will create new problem-solving opportunities for Canada at the international level and make the domestic level a less attractive problem-solving arena. When state officials decide to act on these opportunities and constraints, how they respond to them are matters that are significantly shaped by domestic politics. Systemic pressures impact state action indirectly to the extent that they traverse through the intervening, distorting, and refracting prism of domestic politics.

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Idea-Oriented Explanations

Ideas play an important role in politics. In the context of this study, there are two sets of ideas that have dominated political discourse and informed two alternative adjustment strategies. The strategy of economic nationalism embodies ideas associated with the ideology of nationalism; the strategy of economic liberalism is informed by the ideology of liberalism.[36] Ideas impact politics by serving as road maps for decision makers as they seek to realize their goals. As Goldstein has observed, ideas are tantamount to "beliefs about the efficacy of particular strategies for attaining... objectives."[37]

Since the late 1960s, Canadian government officials have relied on two sets of economic ideas to help them interpret Canada's objective economic situation and determine which policy actions to take in order to advance their interests with respect to dealing with the problem of industrial adjustment. By objective economic situation, I mean that the features of Canada's industrial adjustment problem—economic vulnerability to shifts in American policies, structural deficiencies of the Canadian manufacturing sector, and the deterioration of Canada's international competitiveness and economic position are widely recognized and backed by strong evidence. The two ideas, however, advance different interpretations of these three features and recommend different problem-solving solutions.

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[36] Robert Gilpin uses a similar conceptualization when he refers to liberalism and nationalism as ideologies. He refers to the two bodies of ideas as ideologies because "each position entails a total belief system concerning the nature of human beings and society." He adds, "Ideologies allege to provide scientific descriptions of how the world *does* work while they also constitute normative positions regarding how the world *should* work." See Robert Gilpin, *The Political Economy of International Relations* (Princeton: Princeton University Press, 1987), p. 26.

[37] Judith Goldstein, *Ideas, Interests, and American Trade Policy* (Ithaca: Cornell University Press, 1993), p. 9.

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The ideology of economic nationalism is based on the premise that unregulated market activities produce political consequences. The distributive effects of international economic activities can have an important impact on political relations among states. Although two states can gain in absolute terms by engaging in mutual economic exchanges, one state may become more dependent and vulnerable on the other because of differential rates of economic growth, of technological progress, and of industrial development. This ideology contends that the key source of Canada's adjustment problem is the existence of a relationship of economic dependence between Canada and the United States. This power relationship, as supporters of this ideology argue, is derived from the failure of the Canadian state to intervene in the economy in order to shape the pace and direction of national wealth accumulation.

Nationalists propose that preserving economic independence, which enhances political autonomy and freedom of action, should figure more prominently in the calculations of state officials as they seek to change the terms of interaction with Canada's trading partners. A strategy informed by this economic ideology would place emphasis on achieving such goals as improving the degree of Canadian economic independence and political autonomy. In extending the interventionist capacity of the state, this ideology calls upon the state to become involved in efforts to enlarge the domestically-controlled share of the Canadian production sector, to facilitate industrial rationalization and further develop Canada's industrial base with the cooperation of business, and foster closer economic ties with third parties to serve as counterweights to Canada's economic reliance on the United States.

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The economic liberal ideology contends that Canada's adjustment predicament has been caused by the use of wrong policies. It is the continuation of the prewar import-substitution tariffs, as well as other forms of market restrictions that has contributed to the weakening of Canada's manufacturing base and rendered the economy reliant on exports of staples.[38] The liberal ideology rejects the nationalist warning that economic exchanges have political significance. In particular, economic liberals are not concerned with the high level of American foreign investment in Canada, for such investments supply Canada with resources that would otherwise have to be produced domestically probably at a higher cost. Although proponents of this ideology are in agreement with nationalists with respect to the adverse effect of extraterritoriality (a component of Canadian vulnerability vis-à-vis the United States), they contend that such a cost is outweighed by the positive effect associated with the import of American technology, the development and training of a managerial class in Canada, and provision of investment capital to develop Canada's vast natural resource capacity. Moreover, proponents of this ideology contend that the country's adjustment problem—in particular the need to foster economies of scale in the manufacturing sector—would best be alleviated by actively pursuing a policy of trade liberalization, which would involve leveling Canada's tariff structure.

Ideas play an important role in policy making because they help decision makers comprehend and interpret a public policy problem and suggest ways to rectify such a problem. However, because ideas themselves do not act and ideas have ideational rivals against which to compete, it is important to take into account the agency of individuals—

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[38] For more on this point see Economic Council of Canada, *Looking Outward: A New Trade Strategy for Canada* (Ottawa: Information Canada, 1975).

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through which ideas take on significance—and the institutional setting—which significantly influences which idea prevails over alternative ideas. For an idea to command any authority over state action it must be sponsored by a politically powerful group of actors, whose organizational and instrumental capacity will ensure the successful implementation of an idea through the aegis of an economic strategy.[39] An idea effectively defeats its ideational rivals when it gains the advocacy of both state officials and well-organized and well-financed societal groups. Accordingly, when such societal groups adopt a new belief—such as abandoning protectionism and endorsing free trade—as a result of changes in their economic situation, but ideational inertia keeps state officials glued to protectionism, it is expected that neither set of ideas will muster sufficient political power to ensure its successful implementation.

Equally important is the receptivity of an institutional setting to the introduction of a new economic idea in political debates. The effectiveness of an idea and the acquiescence it gains from individuals largely depend on how well the idea complements the existing normative order that structures relations among actors. An institutional setting favorably disposed toward market-based solutions will not offer an optimal home for an economic idea prescribing greater state interventionism, just as policies pushing for the extension of market governance will fare poorly in an institutional context favoring state activism.

[39] Judith Goldstein, *Ideas, Interests, and American Trade Policy* (Ithaca: Cornell University Press, 1993), p. 15; Peter Gourevitch, *Politics in Hard Times: Comparative Responses to International Economic Crises* (Ithaca: Cornell University Press, 1986).

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State Autonomy Explanations

The state autonomy argument is based on the premise that state actions are not reducible to the instrumental interests of dominant societal groups. This line of analysis refutes the instrumental Marxist position, which argues that the state functions as the instrument of the capitalist class. It also challenges the pluralist line of analysis, which contends that the state functions as an impartial, unregulated arena in which organized societal groups engage in political competition to determine policy outcomes. The state autonomy argument posits that the state is separate from society, that the policy preferences and strategic goals of a state is derived from its understanding and interpretation of the domestic and international realities it faces, and that states are capable of pursuing autonomous goals in the face of societal resistance. [40]

Two prominent approaches are found in state autonomy line of analysis, statism and structural Marxism. Three points of contrast help to convey the differences between these two approaches. First, structural Marxism posits that the autonomy of the state is related to its relations with the capitalist class, whereas statism contends that the state possesses autonomy relative to society in general. Second, structural Marxism contends

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[40] The literature on the state is vast. The following is a sample of this literature. Peter Evans, Dietrich Rueschemeyer, and Theda Skocpol, eds., *Bringing the State Back In* (Cambridge: Cambridge University Press, 1985); Peter Hall, *Governing the Economy: The Politics of State Intervention in Britain and France* (Cambridge: Polity Press, 1986); Peter Katzenstein, ed., *Between Power and Plenty* (Madison: University of Wisconsin Press, 1978); Eric Nordlinger, *On the Autonomy of the Democratic State* (Cambridge University Press, 1981); Stephen Krasner, "Approches to the State: Alternative Conceptions and Historical Dynamics," *Comparative Politics* 16 (January 1984); Stephen Krasner, *Defending the National Interest: Raw Materials Investments and U.S. Foreign Policy* (Princeton: Princeton University Press, 1978); Howard H. Lentner, "The Concept of the State," *Comparative Politics* 16 (April 1984); John Zysman, *Government, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca: Cornell University Press, 1983); Stephen Skowronek, *Building a New American State* (New York: Cambridge University Press, 1982); Michael Mann, "The Autonomous Power of the State: Its Origins, Mechanisms and Results," *Archives Européenes de Sociologie* 25 (1984); G. John Ikenberry, "Conclusion: an institutional approach to American foreign economic policy," *International Organization* 42 (Winter 1988); and G. John Ikenberry, *Reasons of State: Oil Politics and the Capacities of American Government* (Ithaca: Cornell University Press 1988).

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that state autonomy is necessary to arrange compromises between capitalists and labor as a way to cope with capitalism's tendency to produce economic and political contradictions, while statism argues that state autonomy is instrumental in defining and protecting the national interest. Lastly, whereas structural Marxism contends that the exercise of state autonomy is constrained by the demand to ensure the long-term functioning of the capitalist system, statism argues that the exercise of state autonomy is limited by the imperative of assuring survival in an anarchic international system and opportunities arising from relations of power among states.[41]

The structural Marxist perspective has been used in several Canadian-related works on political economy, in particular in the works of Mahon and Sjolander.[42] Mahon seeks to explain why the Canadian state intervened in the economy in the 1960s and 1970s to avert the deindustrialization of the textile industry even though it was more concerned about creating and maintaining an economic climate conducive to the expansion of staples exports. Building on Poulantzas' concept of hegemonic class domination, Mahon explains this puzzle by arguing that the hegemonic class in Canada—the staples fraction of the capitalist class—has maintained its dominance largely by having the Canadian state accommodate the interests of subordinate socioeconomic groups—the industrial fraction of the capitalist class and workers—which have demanded that the state stem the process of deindustrialization. Mahon argues that it is only the state which has the capacity to make such a strategic economic policy compromise, one which is deemed

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[41] For a comparison of statism and structural Marxism see Stephen Krasner, *Defending The National Interest: Raw Materials Investments and U.S. Foreign Policy* (Princeton: Princeton University Press, 1978). Of the two state autonomy approaches, statism is firmly lodged in the Weberian tradition of the state.

[42] Rianne Mahon, *The Politics of Industrial Restructuring: Canadian Textiles* (Toronto: University of Toronto Press, 1984), and Claire Turenne Sjolander, "Foreign Investment Policy-Making: The Canadian State in the Global Economy," Doctoral Dissertation (Ottawa: Carleton University, 1989).

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necessary to gain the acquiescence of subordinate classes and non-hegemonic groups of capitalists, but which falls short of undermining the material interests of the hegemonic class. According to Mahon the pattern of national economic strategy in the 1970s and early 1980s reflected state efforts to tailor a strategic compromise that advanced the interests of the staple class while at the same time catering to the interests of subordinate classes, whose consent was necessary to assure the continuation of the former's hegemonic position.[43]

The tensions between these two political goals may explain why the strategy of economic nationalism in the 1970s and early 1980s lacked coherence and consistency in the way this strategy was implemented. On the one hand, the nationalist camp demanded that the state intervene in the economy in an effort to increase Canadian participation in the domestic economy, diversify export markets as well as products, and stimulate industrial development. On the other hand, the staples fraction pressured the state to rationalize industries within a continentalist framework, strengthen ties between the Canadian staples class and American industrial class, and promote American investment in Canada.

Mahon points out that the policy preferences of the staples fraction has historically prevailed because an unequal structure of representation has been implanted within the state which has had the effect of reproducing in the state the same imbalance of power

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[43] As Mahon has pointed, "The direction of national economic development will reflect the state's attempt to organize an unequal but positive-sum relationship among the fractions of capital and between them and the subordinate classes. If the state is to maintain an unequal but positive-sum relation among these forces, then it can be the 'instrument' of neither the leading fraction (which must make sacrifices) nor dissident forces." Rianne Mahon, *The Politics of Industrial Restructuring: Canadian Textiles* (Toronto: University of Toronto Press, 1984), pp. 12 and 38.

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relations found in society between social classes and fractions of capitalism. As Mahon points out,

> The establishment of the State's policy must be seen as the result of class contradiction inscribed in the very structure of the State. More specifically, the effect of class conflict on the state apparatuses can be understood as the constitution of the various organs and branches of the state as 'representatives' of the interests of the classes and class fractions present in a social formation. Yet just as the relations among these forces are unequal, so too does the quality and form of their representation within the state vary; the structure of representation is unequal.[44]

On this note, Sjolander contends that as class struggles change the prevailing pattern of social class relations, the unequal structure of representation within the state should change as well. Sjolander argues that Canada's change of policy orientation toward foreign investment in the 1970s and 1980s was a product of changes in the realities of domestic class struggles which in turn were reflected within the federal state structure. In particular, state concern about the adverse effects of branch plant manufacturing in Canada and the supporting effects American investment have in perpetuating this economic condition and the development of the Foreign Investment Agency Review (FIRA) reflected the interest of a rising new middle class in the 1970s and the challenge it posed to the prevailing knowledge and understanding of the state on this issue. But, as Sjolander points out, the central position of the interest of the new middle class that came to be reflected within the state structure was replaced in the mid-1980s by those of Canadian business, from whom a different understanding and interpretation of Canada's economic position emerged and was adopted by the state.

The state autonomy argument tells us that the state, as an actor, is capable of acting autonomously in relation to the capitalist class as it seeks to respond to the demands of

[44] Mahon, p. 39.

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the capitalist system. Yet, there are three problems with this line of analysis. First, this argument does not consider how class struggles are mediated by state institutions. The preferences of competing social classes are not perfectly transmitted and represented within the state because of the "mobilizing bias" of its organizational structure. Institutions shape class struggles within the state in a way that is not experienced outside of it. As Hall points out, "The notion that the state embodies the 'institutionalization of class conflict' or a 'condensation of class forces' must be modified to take into account the fact that the state acts as a distorting mirror to reproduce a highly imperfect reflection of these conflicts and one that imprints its own image on their resolution."[45]

While the state autonomy argument provides some insight into the context in which state officials formulate policy views, a study about state action benefits more by focusing on state capacity. Scholars have become less interested in exploring the question of whether state actors are autonomous and more intrigued by the question of explaining differences in state capacity across issue-areas, among countries, and over time. It is the capacity of states to accomplish what they identify as national goals that warrants greater attention.[46] Focusing on state capacity moves us away from the question of how the state formulates national goals to the questions of what policy instruments are

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[45] Peter Hall, *Governing the Economy: The Politics of State Intervention in Britain and France* (New York: Oxford University Press, 1986), p. 233.

[46] In her study of developmentalism in Brazil and Argentina, Sikkink notes the following: "The state-centric approaches that are more useful for understanding the adoption and implementation of developmentalist policies are those that focus on issues of state capacity and purpose rather than on state autonomy." Similarly, in his efforts to explain variance in the responses of advanced industrial world to the oil shocks of the 1970s, Ikenberry expresses a much greater interest in exploring state capacity and the autonomy of the state. "I do not attempt to demonstrate that the various states in question acted autonomously. Rather, I assume that government elites acted upon preferences.... This assumption moves us beyond the debate on 'relative autonomy' to explore *more interesting questions* about how government elites conceive of an attempt to implement state interests" (Italics added). See Kathryn Sikkink, *Ideas and Institutions: Developmentalism in Brazil and Argentina* (Ithaca: Cornell University Press, 1993), p. 11, and G. John Ikenberry, "The irony of state strength: comparative responses to the oil shocks in the 1970s," *International Organization* 40 (Winter 1986), pp. 104-5.

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appropriate for fulfilling particular state goals, what institutional innovations must accompany a state's efforts to attain a state goal, and why this stage of state action sometimes produces intended and unintended consequences.

Lastly, the state autonomy explanation confuses state strength with a state's ability to act autonomously. Evans and Weiss have argued that a key attribute of state strength is the degree to which state autonomy is embedded in society, not separated from it.[47] The closer the relationship between government and business, the greater the capacity of a state to pursue economic adjustment in coordination with private enterprises. A state's coordination capacity is important because few states have the capacity to accomplish their economic adjustment goals on their own, and the same can be said about private enterprise's ability to achieve their adjustment objectives. The more developed a state's coordination capacity is, the more likely business and the state will come to define their economy's adjustment needs similarly and the more able the two groups of actors will be in jointly attaining their adjustment objectives.[48]

Political Survival Explanations

Political survival arguments explain state action in terms of what politicians do to secure political power. Emphasis is placed on the electoral arena and the choices and policy promises both incumbents and candidates make as they seek reelection or to be elected. Scholars working with this line of analysis have employed two different approaches: the constituency and incumbency approaches. Whereas the constituency approach argues that state actions are the result of the governing political party's

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[47] See Peter Evans, *Embedded Autonomy: States and Industrial Transformation* (Princeton: Princeton University Press, 1995), and Linda Weiss, *The Myth of the Powerless State* (Ithaca: Cornell University Press, 1998)

[48] See Weiss, especially pp. 4-9.

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disposition to act upon the preferences of its electoral constituency, the incumbency approach contends that the policy actions of incumbents are motivated by the desire of the incumbents' political party to consolidate its electoral base more firmly so as to better secure future electoral victory.

In their efforts to explain why Canada sought a free trade arrangement with the United States after a long history of rejecting the idea, Gruber uses the constituency approach while Lusztig employs the incumbency approach.[49] Gruber argues that the 1985 free trade decision was a result of Prime Minister Brian Mulroney's effort to act upon the economic interests of his party's constituency, in particular those of Canadian business who pushed vigorously for a free trade arrangement. Lusztig posits that Mulroney's decision to seek a free trade arrangement was a strategic move aimed at forming a winning electoral coalition for the Tories in future parliamentary elections.

Lusztig contends that after Mulroney became prime minister in 1984, he sought to effect an electoral realignment in an effort to strengthen the Progressive Conservative Party's electoral base. In previous elections, the Tories fared poorly among the electorate in the province of Quebec. However, in the federal elections of 1984, a majority of Quebecers voted for the Tories, who won 58 of the 75 seats allocated to Quebec in the House of Commons. Mulroney engaged in logrolling politics to transform this ephemeral electoral shift into a permanent partisan realignment. According to Lusztig, in order to produce a lasting partisan realignment among the Quebec electorate, Mulroney initiated the Meech Lake talks with the aim of seeking a constitutional settlement that would rectify Quebec's objections to the Constitution Act of 1982 and pave the way for

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[49] Lloyd Gruber, *Ruling the World: Power Politics and the Rise of Supranational Institutions* (Princeton: Princeton University Press, 2000), Michael Lusztig, *Risking Free Trade: The Politics of Trade in Britain, Canada, Mexico, and the United States* (Pittsburgh: University of Pittsburgh Press, 1997), pp. 71-94.

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Quebec's reentry into the constitutional fold. Because the success of the Meech Lake Accord required the acquiescence of all provinces, Mulroney sought to secure the support of western provinces, the Tories' traditional electoral stronghold and the region that was most likely to pose a challenge to Mulroney's proposed constitutional change. The Prime Minister sought to elicit the cooperation of the Prairie provinces by giving them a free trade deal, as well as such side-payments as the termination of the Foreign Investment Review Agency, the deregulation of the energy market, and the establishment of the Western Development Fund to promote regional economic development.

Gruber's constituency approach posits that the policy change toward continentalism coincides with Mulroney's willingness to act upon the economic interests of his government's electoral constituencies, in particular the business community and the Quebec electorate. A long-time supporter of the Tories, the business community staged a remarkable volte-face in the early 1980s, embracing free trade after a history of opposing economic integration with the United States. Spearheaded by the Business Council on National Issues, a pro-free trade consensus emerged among the business community, demonstrating a new sense of confidence in Canada's ability to compete in American markets and growing disenchantment with Prime Minister Pierre Trudeau's policies of economic nationalism. Equally significant was Quebec's endorsement of free trade. As Gruber points out, Quebec's pro-free trade position was intricately linked with the province's efforts to assert its independence relative to the rest of Canada.

The constituency approach has also been used by Clarkson to account for Trudeau's renewal of economic nationalism after the Liberal party gained a majority

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victory in the 1980 federal elections.[50] Clarkson argues that Trudeau's statements in the 1980 throne speech on expanding the scope of the Foreign Investment Review and increasing industrial benefits to Canadian firms reflected the Liberal government's efforts to make good on the electoral promises it had made to the new corporate nationalists, who included some of Canada's most successful corporations. While serving as the official opposition party in parliament between May 1979 and February 1980, the Liberal Party under the leadership of Trudeau became receptive to this group's call to increase the government's contribution to strengthening Canada's export-oriented industries. Despite the Liberal government's retreat starting in 1981 from carrying out the economic nationalistic goals it had enunciated in 1980, Clarkson contends that it is due to Trudeau's decision to appeal to the new corporate nationalists during the months it spent on the opposition side that it pursued an economic nationalistic agenda in the first year the Liberal Party regained power.

These political survival explanations are helpful in understanding state action because they all point to the critical element that the formation and retention of political coalitions are critical tasks that state officials must undertake as they seek to attain national goals. This line of analysis confirms what Gourevitch has observed, namely "that freedom of politicians is circumscribed by their need to construct support coalitions."[51] Its main problem, however, concerns the lack of attention paid to the prevailing policy debates of the day. Both Luztig and Gruber explain Mulroney's actions as if they were detached from the prevailing policy debate regarding adjustment policies,

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[50] Stephen Clarkson, *Canada and the Reagan Challenge* (Toronto: James Lorimer & Company, Publishers, 1982).

[51] Peter Gourevitch, *Politics in Hard Times: Comparative Responses to International Economic Crises* (Ithaca: Cornell University Press, 1986), p. 239.

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which revealed that the strategy of economic nationalism had run its course and that a replacement had to be devised. Mulroney was responding to the political demand for a new course of action to deal with the problem of adjustment.

Moreover, what politicians do to secure political power may have little to no effect on shifts in and of policies, as evidenced by Trudeau's near abandonment of his pre-election promise to launch a more vigorous nationalistic program in 1980 or Mulroney's volte-face in supporting free trade once becoming prime minister in 1984 after announcing during the pre-election period that he did not advocate this economic policy. In effect, what determines the freedom of politicians is the existence of a supporting coalition, plus the structural constraints facing policy entrepreneurs. Mulroney took advantage of the institutional resistance that had undermined efforts to implement the strategy of economic nationalism, and he used to his advantage the facilitating nature of the preexisting institutional order to implement market-based adjustment solutions.[52]

Economic Interest Group Explanations

According to this line of argument, state actions are the result of strategic interaction among social groups or classes, a process driven by utility maximization and ability of social actors to build politically powerful coalitions, which will ensure the advancement of their interests. It is assumed that political institutions have minimal distributional consequences and serve as neutral arenas in which political struggle takes place. Further, it is argued that government officials serve as spectators amid the competition among societal actors, and that government officials eventually take their

[52] This is consistent with Ikenberry's observation that "organizational structures influence the types of policies likely to be generated and successfully implemented...." See G. John Ikenberry, *Reasons of State*, 1986, p. 30.

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policy cue and form political coalitions based on the prevailing configuration of interests determined by the outcome of the political struggle among organized social groups.

This line of argument offers useful explanations about how the economic interests of various societal groups are shaped. Gourevitch has argued that countries respond to international crises differently because of variations in the composition of their ruling domestic political coalitions that link politicians and societal groups which are differently positioned in the international economy.[53] According to this coalition analysis, policy changes are caused when changes in societal group preferences occur as a result of their changing "situation" within the international economy. More specific theories of societal preferences have surfaced as well, many focusing on the issue of distributional consequences of different trade policies.

The Stopler-Samuelson theorem, from which the factoral theory of preferences is based, contends that owners of abundant factors of production tend to support free trade, whereas those of scarce factors support protectionism. Thus, where raw materials are abundant in a capital-poor country, one would expect producers of raw materials to favor free trade, while owners of capital to favor protectionism. The Ricardo-Viner model of trade from which the specific-factors model is derived, argues that factors of production employed by import-competing industries tend to support protectionism, whereas those attached to export-oriented industries tend to favor free trade. Applied to Canada, this model would advance that all factors of production used by the manufacturing industry would favor protectionism, while the opposite would hold for factors associated with the staples industry.

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[53] Peter Gourevitch, *Politics in Hard Time*, 1986.

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Some scholars have sought to explain policy preferences of societal groups by privileging the causal effect of the process of internationalization and proliferation of internationalized firms. Internationalization, which refers to the exogenous reduction in the cost of international transactions and the concurrent rise in the level of international economic transactions relative to domestic transactions, is beneficial for importers, exporters, and consumers of imported goods, but detrimental for import-competing industries, as Frieden and Rogowski have observed.[54] Accordingly, it is expected that tradeable sectors and consumers of tradeable goods will favor policies that promote trade liberalization, whereas nontradeable sectors will advocate protectionist policies.

Focusing on a different aspect of the process of internationalization, Milner contends that "firms more extensively involved in the international economy through exports, multinationality, and intra-firm trade" are more favorably disposed to advocate freer trade even in the face of import competition.[55] On the one hand, internationalized firms advocate greater trade liberalization because that is how they can maximize their profits and market share, and foster economies of scale. On the other hand, they oppose domestic societal groups who advocate protectionism because such a policy orientation may invite protectionism from their trading partners and risk provoking retaliatory measures from them as well. Milner's argument offers a convincing answer to the question of why the Canadian business community began increasingly to advocate freer trade with the United States and the rest of the world toward the end of the 1970s and even more fervently in the 1980s and 1990s. The Canadian business community's turn

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[54] Jeffry A. Frieden and Ronald Rogowski, "The Impact of the International Economy on National Policies: An Analytical Overview," in Robert O. Keohane and Helen V. Milner, eds., *Internationalization and Domestic Politics* (New York: Cambridge University Press, 1996), pp. 25-47.

[55] Helen Milner, "Resisting the Protectionist Temptation: Industry and the Making of Trade Policy in France and the United States during the 1970s," *International Organization* 41 (Autumn 1987), p. 643.

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away from its century-long support of protectionism was spurred by the increasing internationalization of its operations, a transformation that found many Canadian-owned firms maintaining important stakes in the American economy and possessing world production mandates.[56]

Economic interest group explanations help us to identify the economic groups that benefit from particular economic policies. They also offer clues about the configuration of socioeconomic interests that will be expressed in political struggles as governments attempt to change economic policies. This line of analysis, however, fails to take into account how domestic political economic institutions shape the interests and political capabilities of socioeconomic groups, a point Milner acknowledges by integrating institutions into her model. As Hall points out, "The organization of policy-making affects the degree of power that any one set of actors has over the policy outcomes" and the "organizational position also influences an actor's definition of his own interests, by establishing his institutional responsibilities and relationship to other actors."[57] Institutions affect policy outcomes by structuring political struggles among domestic groups, that is they shape relations of power among actors, and by creating mobilization of bias, institutions enable some groups to advance and preserve their interests more effectively than other domestic groups.

That societal actors are drawn into the policy making process because they seek to bring their particularistic interests to bear on policy outcome is an obvious fact of

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[56] The Advisory Committee on Global Product Mandating notes that world product mandate "implies responsibility for all aspects of research and development, including conceptual or basic research; responsibility for manufacturing; and direct responsibility for international marketing for a particular product or set of operations." See Government of Ontario, *The Report of the Advisory Committee on Global Product Mandating* (December 1980), p. 3.

[57] Peter Hall, *Governing the Economy*, p. 9.

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political life. But what is less obvious is why some societal groups in Canada are more successful than others in translating their interests into desirable policy outcomes. Here, Coleman offers some clues by pointing out that the institutional parameters shaping relations between societal groups and the federal state resemble the "policy advocacy" model, which stresses the importance of competition among groups as a way to secure one's position in the policy making process and obtain a desirable policy outcome. This model, as Coleman notes, contrasts with the "policy participation" model, which emphasizes direct involvement of societal groups in the policy making process and consensual decision-making.[58]

As the prevailing institutional mode of interest representation in Canada, the policy advocacy model militates against achieving corporatist forms of societal organizations, and creates an incentive for competing societal groups to organize themselves around specific public policy issues. The competitive nature of interest group politics in Canada may serve occasionally to enhance state autonomy because the problem of collective action prevents societal groups from achieving sufficient organization to be able effectively to pressure the government. This institutional arrangement may also cause the state to become a victim of its own internal divisions in the absence of societal support to facilitate the triumph of one policy option. It is also possible that government officials will take advantage of the fragmented character of the organization of society by selectively putting together a coalition of social groups that will provide legitimacy to government officials as they seek to advance state objectives.

[58] William D. Coleman, "Analysing the associative action of business: policy advocacy and policy participation," *Canadian Public Administration* 28 (Fall 1985).

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A discussion of state-societal relations would be incomplete if the role of federalism were not taken into account. When the federal structure tends to produce competition between the central government and constituent units, societal interests may find it more difficult to influence the behavior of their governments as they are engaged in jurisdictional competition with each other. Fossum observes that in some public policy areas, the focus on state-societal and policy substantive issues have been deflected by jurisdictional concerns.[59] As a structural effect, policy deflection not only undercuts the impact economic interest groups have on policy making, but by intensifying the element of politics, attention to the functionality of policies is also undercut. Consequently, in the face of an economic issue—such as dealing with the problem of industrial adjustment—the actions of federal government officials may be motivated by the desire to gain advantage over provincial governments in a jurisdictional turf battle or to diffuse intergovernmental tensions. In such a case, a government response to an adjustment problem takes on not only an economic dimension, but also a political one.

The purpose of the assessment of alternative explanations has not been to reject them, but rather to identify their weaknesses in explaining state action. Based on this assessment, it can be concluded that ideas, interests, and the state actors are three important causal forces that influence state action. But if this assessment points to any definitive conclusion, it is that the causal impact of these elements is altered, distorted, and structured by the institutional setting with which they are in contact. It is fitting to conclude this section by quoting the words of Thelen and Steinmo with regard to the particular role of institutions in political life:

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[59] John Erik Fossum, *Oil, the State, and Federalism: The Rise and Demise of Petro-Canada as a Statist Impulse* (Toronto: University of Toronto Press, 1997).

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> The emphasis on institutions as patterned relations that lies at the core of an institutional approach does not replace attention to other variables – the players, their interests and strategies, and the distribution of power among them. On the contrary, it puts these factors in context, showing how they relate to one another by drawing attention to the way political situations are structured. Institutions constrain and refract politics...[they] structure interactions and in this way affect political outcomes.[60]

AN INSTITUTIONAL APPROACH TO STATE ACTION

The 'new institutionalist' literature is represented by three schools: sociological, historical, and rational choice.[61] This study's focus on the institutional limitations of institutional innovation, the path dependent trajectory of historical political economic development, and the interaction between macroscopic structures and strategic behavior of individuals places it squarely within the historical institutionalist school.

Historical institutionalism advances three general propositions. First, institutions have structural attributes that pertain to the organization of groups and that contribute to ordering and constraining relationships among these groups. This structural conception of institutions forms the basis of Hall's definition of institutions, for he defines institutions as "formal rules, compliance procedures, and standard operating practices that structure the relationship between individuals in various units of the polity and economy."[62] Because of their structural foundation, institutions are not neutral forces; instead, their existence generates distributive consequences in politics, such as producing

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[60] Kathleen Thelen and Sven Steinmo, "Historical institutionalism in comparative politics," in Sven Steinmo, Kathleen Thelen, and Frank Longstreth, eds., *Structuring Politics* (New York: Cambridge University Press, 1992), pp. 12-3.

[61] For several accounts concerning the theoretical differences among the three 'new institutionalist' schools see Kathleen Thelen, "Historical Institutionalism in Comparative Politics," *Annual Review of Political Science* 2 (1999); Kathleen Thelen and Sven Steinmo, "Historical Institutionalism in Comparative Politics, in Sven Steinmo, Kathleen Thelen, and Frank Longstreth, eds., *Structuring Politics* (Cambridge: Cambridge University Press, 1992); Peter Hall and Rosemary Taylor, "Political Science and the Three New Institutionalisms," *Political Studies* 44 (1996).

[62] Hall, *Governing the Economy*, p. 19.

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a built-in advantage for particular groups engaged in political battles, endowing groups with relatively more organizational and instrumental capacities than others, aggregating and distorting societal preferences, and defining available policy choices by precluding certain policy options and magnifying others.

The second proposition is that politics is conditioned by the weight of past institutional developments. As Ikenberry points out, state action is affected by the "shadow of the past," for "old institutions shape and influence the approach to new problems" which require state attention.[63] Historical institutionalists argue that once institutions are established, it is difficult for political innovators to update or modify them. For a period of time, the stickiness of institutions can contribute to the stability of political life, but once external circumstances and realities change, these institutions may became the cause of dissonance and disorder in politics.

Two factors contribute to the staying power of institutions. First, groups privileged by an institutional arrangement will mobilize in its defense when political innovators seek to adjust the operation of that institution. In addition to the efforts of sponsors to perpetuate an institutional order in the face of institutional renovation, institutional resistance can come from the linkages forged across different institutions. Second, the stickiness of institutions arises from what Pierson and Ikenberry call "increasing returns" to institutions or what Stinchcombe refers to as the "liability of newness."[64] These scholars observe that the cost of engaging in institutional renovation surpasses the costs

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[63] G. John Ikenberry, *Reasons of State*, p. 195.

[64] Paul Pierson, "Increasing Returns, Path Dependence, and the Study of Politics," *American Political Science Review* 94 (June 2000), pp. 251-267; G. John Ikenberry, *After Victory: Institutions, Strategic Restraint, and the Rebuilding of Order After Major Wars* (Princeton: Princeton University Press, 2001); and Arthur Stinchcombe, "Social Structure and Organizations," in James March, ed., *Handbook of Organizations* (Chicago: Rand McNally, 1965).

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of maintaining the existing institutional order. Because of the hidden benefits associated with sunk costs lodged with the old institution, the new institution would have to generate overwhelmingly large short term benefits to convince potential supporters to shift allegiance away from old institutions. The cost of building new institutions is further attributed to the fact that old institutions benefit from economies of learning and have developed intricate links with other institutions.[65] In short, historical institutionalism posits that political actors seeking institutional adaptation will be inhibited by the staying force of existing institutions.

The third proposition advanced by historical institutionalism is that historical processes are path dependent. Path dependency refers to a self-reinforcing process that pushes a country toward a particular direction of historical development. What corrective policy measures are taken in the face of an adjustment problem today depends on the timing and sequence of previous historical developments. Fundamental to the self-reinforcing dynamic of path dependency is that once a political choice is made in response to an event or circumstance, this particular historical juncture will have the effect of taking that country on a distinct track that will be reinforced over time. Shonfield aptly conveys this point when he likens path dependence to "a living tentacle [that] reaches out of past history, loops itself round, and holds fast to a solid block of the present."[66]

In recent years a debate within the historical institutionalist school has emerged on the question of when and how institutional changes occur. This is an important analytical question because actions taken by state officials often require some kind of institutional

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[65] See Ikenberry, *After* Victory, pp. 69-72.
[66] Andrew Shonfield, *Modern Capitalism*, p. 88.

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adaptation. As I argue in this study, Canada's efforts to cope with its economic adjustment problem through the use of two distinct adjustment strategies demanded important institutional innovation in order to provide the necessary organizational and instrumental instruments to facilitate the implementation of each strategy. Such questions as the following warrant exploration: Is institutional change episodic or gradual? Under what circumstances does institutional change occur? and When is institutional change successful?

Widely accepted by institutionalists, the "punctuated equilibrium" model, informed by a set of ideas linked to evolutionary biology, offers a basic understanding about how institutional arrangements give way to change. Introduced in his seminal article, "Approaches to the State: Alternative Conceptions and Historical Dynamics," Krasner argues that institutional changes are episodic and dramatic.[67] The endurance of institutions over long intervals affirms that once institutional arrangements are built they become resistant to most kinds of exogenous changes. As Orren and Skowronek point out, the common understanding about the role of institutions in politics and economics is that "institutions are...the pillars of order in politics" and are regarded "as the structures that lend the polity its integrity, facilitate its routine operation, and produce continuity in the face of potentially destabilizing forces."[68]

Institutions, however, are not impervious to change. As the model points out, institutional stability is periodically disrupted when a crisis situation arises, an event

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[67] Stephen Krasner, "Approaches to the State: Alternative Conceptions and Historical Dynamics," *Comparative Politics* 16 (January 1984).
[68] Karen Orren and Stephen Skowronek, "Beyond the Iconography of Order: Notes for a "New Institutionalism," in Lawrence C. Dodd and Calvin Jillson, eds., *The Dynamics of American Politics: Approaches & Interpretations* (Boulder: Westview Press, 1994), p. 312.

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which creates an opportunity for institutional innovators to bring about institutional change. In times of great turbulence, existing institutional arrangements will give way to new, coherent structures that seek to fulfill the emerging political, economic, or social needs. The establishment of new institutions signifies a critical moment because once built, institutions will generate an order that will once again constrain and condition politics until the next crisis occurs. Consequently, crisis situations coincide with periods of intensive political struggles as actors bring to bear on the political process whatever capacities they possess in order to shape new institutional rules and procedures. In short, the punctuated equilibrium model proposes that institutional change occurs neither gradually nor continuously. Instead, they are rare occurrences and take place within a temporally limited time frame that coincides with a crisis situation.

The 'punctuated equilibrium' model posits that institutional politics is 'politics as usual,' that political actors are spectators during ordinary times and proactive during crises situations, and that the new institutional order emerging from a crisis situation will "fit into a coherent whole." The evidence suggests otherwise on all three accounts. Although it is true that periods of crises can spur profound institutional change as the punctuated equilibrium model points out, North argues that "the overwhelming majority of change is simply incremental and gradual."[69] Institutional adaptation occurs more frequently and in a less climactic fashion.

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[69] Douglass North, "Five Propositions about Institutional Change," in Jack Knight and Itai Sened, eds., *Explaining Social Institutions* (Ann Arbor: University of Michigan Press, 1990), p.19. Elsewhere, North argues that "The single most important point about institutional change...is that institutional change is overwhelmingly incremental." Institutional change takes on the depiction of "a gradual restructuring of [an institutional] framework." See North, *Institutions, Institutional Change and Economic Performance* (New York: Cambridge University Press, 1990), p. 89.

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Moreover, rather than producing a definitive divorce from past institutional orders, incremental change occurs by way of building on, converting, or layering on existing institutional structures. The effect of this type of change on the trajectory of historical development is such that it may produce a 'branching' outcome in which new institutions reflect the underlying logic of the existing institutional order, but the new or altered institutions are structurally and substantively different from previous ones. Structurally, the institutional rearrangement installs new rules, standards, and procedures that shape relationships among actors; substantively, the institutional recombination comprises a new distributive settlement that determines the division of benefits and costs among actors.

If institutional change is gradual and incremental, it suggests that actors are more than spectators waiting for a crisis to arise before they spring into action and proceed with institutional adaptation. As Thelen and Steinmo point out, "Groups and individuals are not merely spectators as conditions change to favor or penalize them in the political balance of power, but rather strategic actors capable of acting on 'openings' provided by such shifting contextual conditions in order to defend or enhance their own conditions."[70] The incremental change model advanced in this study assigns more importance to political actors as agents of institutional change. Therefore, one of the analytical aims of this study's model is to understand what motivates political actors to seek institutional change in non-crisis situations such as the persistent demand to achieve economic adjustment, a question neglected in the punctuated equilibrium model because political actors are assumed to act only in response to external crises of great significance.

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[70] Kathleen Thelen and Sven Steinmo, "Historical institutionalism in comparative politics," in Steinmo, Thelen, and Longstreth, eds., *Structuring Politics* (1992), p. 17.

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In taking into account this line of criticism against the punctuated equilibrium model, Thelen and Steinmo offer an alternative model of institutional change. The "institutional dynamism" model posits that the interaction between institutions and politics is more dynamic than what the punctuated equilibrium model contends.[71] A key contribution to this model is Thelen's "dynamic constraints" argument used to explain Germany's "dual system" of labor relations. The "dynamic constraints" notion advances two arguments. First, institutional parameters undergo change as a result of the strategic maneuvering of political actors within them. The focus is placed on the employment of political strategies at the disposal of these actors, which is largely derived from an individual's position within the institutional configuration. The second argument is that institutional adaptation is caused by the actions of political actors seeking to respond to domestic and international changes. Accordingly, it is these responses to external changes which set in motion strategic maneuvers by political actors as they seek to advance their interests and preserve or enhance their institutional positions.

Although the dynamic constraints model brings historical institutionalism closer to shedding light on the agent-structure problem, there are several ways in which this model could be improved. First, the model could benefit by illustrating how the weight of existing institutions figures on the pattern of institutional adaptation induced by the strategic maneuvering of political actors. A revised model, as the one I advance in this study, should provide insight into how institutions condition the strategic moves of actors by making available varying configurations of organizational resources and policy instruments. As Ikenberry observes, state structure "fixes in place the policy tools and organizational resources that a governmental elite can draw upon." Ikenberry adds,

[71] Ibid., pp. 16-18.

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"Strategy is developed by government officials in the context of state structures, which provide opportunities for and constraints on policy choice."[72]

These sources of state capacity give rise to two different kinds of strategic political behavior, both of which are important for effecting institutional innovation. On the one hand, state officials may attain institutional adaptation by way of changing their institutional position relative to other actors so as to give them greater ability to control political outcomes: on the other hand, executives may accomplish institutional alteration by changing the rules and procedures that govern patterns of interaction and engagement among actors.

Second, the model would benefit by taking into account the possibility that institutional change may produce suboptimal or unwanted political results. Institutional change may fall short of producing a desired political outcome for two reasons. First, institutional change can trigger distributive struggles as potential losers seek to redress the adverse distributional effects contained in the proposed institutional alteration. This feedback effect is contrary to the functional feedback mechanism, which posits that once institutional changes occur actors adapt their strategies accordingly. Changes in institutional parameters may provoke a concurrent round of political struggle, not necessarily aimed at reestablishing a pre-existing institutional status quo, but at achieving more mutually-beneficial terms. The political demand of coordination is what may contribute to a suboptimal outcome. Second, institutional change may affect the existing balance of power among actors and groups and consequently prompt negative or positive

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[72] G. John Ikenberry, "The irony of state strength: comparative responses to the oil shocks in the 1970s," *International Organization* 40 (Winter, 1986), p.120. Krasner echoes this point when he remarks that "the range of options available to policymakers at any given point in time is a function of institutional capabilities that were put in place in at some earlier period" See Stephen Krasner, "Sovereignty: An Institutional Perspective," *Comparative Political Studies* 21 (April, 1988), p. 67.

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reactions, depending on how the power shift has affected actors' abilities to advance and preserve their interests.

The third area of improvement concerns the fact that the model depicts a strategic context that is narrow in scope, that is it does not involve multiple institutional contexts. Not only can political actors employ different strategic behaviors in an effort to attain their objectives, but they can also decide to shift from one institutional setting to another in order to take advantage of perceived institutional advantages. However, as a political actor moves from one institutional context to another, say from intergovernmental relations to state-society relations, it will have to go up against a new set of institutional constraints.

The institutionalist model I propose modifies the dynamic constraint model in two ways. First, it identifies the institutional conditions (structural-contingency) of successful branching off (or bounded deviation) from the path dependency of historical processes; second, it identifies different modes of strategic maneuvering that political actors can employ, with varying consequences, to bring about the required institutional alterations to facilitate the pursuit of different adjustment strategies. At the macroscopic level, the mixed results of the two industrial adjustment strategies were caused by variance in compatibility between the preexisting institutional order and by the institutional requirements of each adjustment strategy. Whereas institutional resistance blocked the efforts of institutional innovators as they sought to effect purposeful changes in the existing institutional context in order to facilitate the implementation of the strategy of economic nationalism, institutional accommodation facilitated those innovation efforts necessary for the implementation of the strategy of economic liberalism. At the

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microscopic level, the mixed results of the two adjustment strategies were caused by differences in the results of different political strategies used by government officials to modify institutions so that they were appropriate for the pursuit of adjustment strategies. At this level, the sequence of adjustment measures is shaped by the strategizing behavior of state officials in the face of structural constraints on their capacity for action.

In this study, the institutionalist explanation of state action advances three propositions. First, it is argued that to explain state action with respect to economic adjustment strategy it is imperative that one understands the preferences and policy choices of state officials. From there, one can consider the structural constraints and limits that state officials are confronted with as they attempt to attain their objectives. Second, state action often takes the form of institutional change. Institutional adaptation is caused by political actors' efforts to respond to changes in their domestic and international environments. State capacity is the ability to bring about appropriate institutional innovations or adaptation that will enable state officials to respond effectively to exogenous changes. Such institutional changes are deemed warranted because changes in domestic and international conditions often "call into question existing rules of the game and the repertories of state action," as Ikenberry observes.[73] A crisis or non-crisis situation heightens attention to an issue area that requires problem solving; but more important still, it raises concerns about the suitability of the institutional structure in which problem-solving measures are embedded. As Zysman

[73] G. John Ikenberry, "Conclusion : an institutional approach to American foreign economic policy," in Ikenberry, David Lake, and Michael Mastanduno, *American Foreign Economic* Policy (Ithaca: Cornell University Press, 1988), p. 234. Cortell and Peterson make a similar argument: "Every environmental trigger – whether a crisis or non-crisis – creates the opportunity for structural change if it discredits existing institutions or raises concerns about the adequacy of current policy-making processes." Andrew P. Cortell and Susan Peterson, "Altered States: Explaining Domestic Institutional Change," *British Journal of Political* Science 29 (1999), p. 183.

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points out, "Because structure constrains strategy, those who pursue new economic goals or try new approaches to policy must often reform or rearrange economic institutions and the links between them and the state."[74] I argue that the task of dealing with an industrial adjustment problem involves more than just the implementation of adjustment policies, it also entails modifying the parameters of those institutions that are fundamental to making such policies work.

Lastly, certain political strategies are employed by state officials to induce the kind of institutional adaptation required to facilitate the implementation of adjustment strategies. These political strategies are strategic in nature. Strategic means that the capacity of policy entrepreneurs to attain their adjustment goals through a political strategy is as much shaped by how other actors—such as bureaucrats, elected representatives, societal groups—respond to this action as it is by the imperative of functional efficiency.[75] In other words, state officials are goal-oriented and act purposefully, yet the context of strategic interaction compels them to switch political strategies as well as maneuver among different adaptation instruments in response to the countervailing or accommodative behavior of other actors.

The chart below illustrates two kinds of political strategies to which state officials can resort with varying degrees of effectiveness in order to bring about institutional innovation. The two strategies are defined by three attributes: type of strategic behavior, location of institutional change, and institutional effect.[76] The first attribute refers to the

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[74] John Zysman, *Governments, Markets, and Growth*, p. 79.

[75] Lake and Powell have noted that "a situation is strategic if an actor's ability to further its ends depends on the actions others take. It is the set of decisions made by the relevant actors that constitutes the strategic *interaction* and produces the observed outcome." See David Lake and Robert Powell, *Strategic Choice and International Relations* (Princeton: Princeton University Press, 1999), p. 8.

[76] I have borrowed the two concepts, relational power and meta-power, from Krasner. The key difference between Krasner's work and mine is that domestic politics is the context in which I apply these two terms,

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political purpose of strategic action, in particular it focuses on changes in the way interaction takes place between the federal state and other actors.[77] Whereas the political

Table 2.2. Types of Political Strategies: Relative Power and Meta-Power Strategies

	Type of Strategic Behavior	Location of Incremental Institutional change	Institutional Effect
Political Strategies	*Relational Power Strategy*: efforts to enhance the federal state's control over policy outcomes by expanding its capacity to act unilaterally	uncoordinated, politico-administrative institutional change at the federal level	depending on the impact of the political strategy on the prevailing balance of power among actors and on their ability to promote their interests, a political strategy may heighten or diffuse struggles among actors
	Meta-Power Strategy: efforts to change the existing rules and modes of engagement that structure relations among actors; it is based on recognition of mutual interest among actors	coordinated, intergovernmental and/or state-societal institutional change	success of strategy in bringing change depends on actors' ability to agree on a new set of institutional arrangements and resolve distributional struggles

strategy of relational power seeks to enhance the federal state's control over political-economic outcomes by extending its capacity to act unilaterally, the meta-power strategy attempts to change the pattern of interaction with other actors as a means to accomplish the federal state's industrial adjustment objective. The second attribute concerns the different locations of institutional alteration. The relational power strategy focuses on changes within the federal state—in particular, reform of the politico-administrative apparatus, building new state structures, or shedding state layers, essentially any alteration of the organizational structure of the federal state aimed at enhancing state

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whereas Krasner applied them in the context of international politics. See Stephen Krasner, *Structural Conflict: The Third World Against Global Liberalism* (Berkeley: University of California Press, 1985).

[77] As two distinct political strategies, relational power and meta-power are consistent with Weiss's "hard state and "transformative state," respectively. With respect to the "hard state," the strength of such a state is derived from its capacity to translate its interests into policy actions in the face of opposition from societal and political actors. Like the relational power strategy, the "hard state" seeks to accomplish its objectives by acting unilaterally and in a self-interested manner, weakening its competitors, and imposing policy action. The "transformative state" exercises a distinct kind of state capacity, one based on coordinative and consultative abilities, from which meta-power behavior takes its cue. According to Weiss, the "transformative state" accomplishes its objective by seeking to "mobilize consent" and "institutionalize cooperation" among societal and political actors. See Linda Weiss, *The Myth of the Powerless State* (Ithaca: Cornell University Press, 1998).

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capacity. On the other hand, the institutional change produced by the meta-power strategy entails changes in the organizational structure that patterns either state-societal relations or provincial-federal (intergovernmental) relations.[78]

Lastly, institutional effect concerns the political struggles provoked by the employment of a political strategy. The use of political strategies tends to provoke varying degrees of political struggles between the institutional innovators and those actors that have benefited from the status quo. Because political strategies are used to achieve institutional innovation and because all institutional orders are "established positions of privilege," when institutional innovators use a particular political strategy it will trigger a political battle between displaced interests and newly empowered interests.[79] Political strategies impact the balance of power in varying degrees between society and the state, within society, and/or within the state itself.

Each type of political strategy generates a distinct institutional effect. Relational power strategy is used by the federal state to alter the balance of political power in its favor so that it can better achieve greater control over policy outcomes and augment its leverage over other actors. Relational power behavior tends to provoke countervailing actions by those actors whose interests are undermined in the face of such strategic maneuvering. The affected actors in question can be societal groups such as business and the financial communities, some or all provinces, or even particular bureaucratic actors within the federal state. Accordingly, it is expected that the institutional change produced

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[78] Cortell and Peterson's use incremental and episodic change are consistent with the institutional changes generated by the relational power strategy and meta-power strategy, respectively. Episodic change, they argue, "reinvents institutional patterns so as to break with prevailing customs and procedures." Incremental change, they point out, "involves a smaller amount of change...[and] may build on existing institutional patterns [or] streamline existing structures, a process that can involve dismantling or integrating institutions." See Andrew P. Cortell and Susan Peterson, "Altered States: Explaining Domestic Institutional Change," *British Journal of Political Science* 29 (January 1999), p. 182.

[79] See Zysman, pp. 78-80.

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by this strategy will fail to become permanent as the affected actors seek institutional redress.

The same political strategy, however, may have the opposite effect, for the federal state's unilateral action may have the effect of diffusing political tensions in a politically-charged issue-area setting. In this case, tensions are diffused because the unilateral action has not negatively impacted the balance of power among actors and interfered in their ability to promote their interests. Such an outcome is the result of the federal state's deliberate effort to depoliticize economic outcomes—that is, delimiting the authority of the state to intervene in the economy. By shrinking the boundaries of state authority and enlarging that of private authority, "the state is removed as an object of judgment."[80]

Meta-power behavior can bring about either positive or negative institutional effects. This strategy calls upon federal institutional innovators to gain the acquiescence of other actors for the purpose of changing the rules, procedures, and standards that constraint and order relationships between them and such actors as provinces or societal groups. The institutional change this strategy produces is more consequential on politics because it reconfigures rules of the game and imposes a new distributional settlement. This type of political strategy induces a different kind of political struggle from that generated by the relational power strategy. The process of settling upon a new distributional outcome, as Elman observes, "will be dependent on whether bargains, pacts

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[80] See G. John Ikenberry, "The International Spread of Privatization Policies: Inducements, Learning, and "Policy Bandwagoning," in Ezra Suleiman and John Waterbury, eds., *The Political Economy of Public Sector Reform and Privatization* (Boulder, Col.: Westview Press, 1990), p. 97. Also see Janice Thomson, "State Sovereignty in International Relations: Bridging the Gap Between Theory and Empirical Research," *International Studies Quarterly* 39 (1995), pp. 213-233.

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and deals can be successfully concluded. Often this will require the amendment of new institutions such that no group will be likely to attain disproportional benefits."[81]

If these two political strategies facilitate the achievement of institutional adaptation which in turn enables state officials to pursue a particular industrial adjustment strategy effectively, what causes state officials to select one political strategy over the other? I argue that three possible factors influence which political strategy is selected. The first factor influencing choice is the institutional capacity of state officials.[82] Institutional capacity is what links officials' ability to act with their position within the organizational structures of state—the organization of federal decision-making authority, institutional arrangement of provincial-federal relations, and organizational structure of state-societal relations. When executive decision-making power is diffused, federalism is depicted by two orders of government that are in positions of relatively equal strength, and the state is penetrated by societal groups, the institutional capacity of government officials seeking to effect institutional innovation is limited. In such a decentralized and fragmented state structure, the number of "veto players" who authoritatively weigh in on political decisions is greater than in a centralized and hierarchically organized state structure.[83] Accordingly, government officials will employ a political strategy that best avoids those "veto players" bent on thwarting the actions of the former; conversely, government officials will employ a political strategy that includes those "veto players" that support the actions of the former.

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[81] Miriam Fendius Elman, "The Foreign Policies of Small States: Challenging Neorealism in It Own Backyard," *British Journal of Political Science* 25 (1995), p. 185.
[82] I have borrowed the term "institutional capacity" from Cortell and Peterson. See Cortell and Peterson, "Altered States: Explaining Domestic Institutional Change," pp. 190-1.
[83] See George Tsebelis, "Decision Making in Political Systems: Veto Players in Presidentialism, Parliamentarism, Multicameralism, and Multipartyism," *British Journal of Political Science* 25 (1995), pp. 289-325.

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The other aspect of institutional capacity refers to the ability of officials to achieve "functional conversion," that is, putting existing institutions in the service of new purposes.[84] The more amenable existing institutions are to functional conversion, the greater the institutional capacity of state officials because existing institutions can be harnessed to fulfill the purposes of a new economic adjustment strategy. Since each political strategy is associated with different domestic political institutions—namely, relational power with the federal state's political-administrative organization and meta-power with intergovernmental relations as well as government-business relations—state officials will be inclined to select the political strategy which they perceive to be most likely to produce "functional conversion" or "branching off" of existing institutions.

The second factor influencing the selection of political strategy has to do with the need to reform those institutional arrangements that are necessary to support an adjustment strategy. Because each political strategy is identified by its particular location of institutional change, state officials will select the political strategy whose components are most appropriate for producing the kind of institutional reform that is necessary to pursue a particular adjustment strategy. Some strategies require that the state be embedded in society, practice a centralized form of federalism, and possess the kind of bureaucratic capacities that confer on state officials the authority to act with discretion, autonomously, and strategically; other strategies require that the state be a "night-watchman," promote decentralized federalism, and substitute market governance for state activism.

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[84] See Kathleen Thelen, "Timing and Temporality in the Analysis of Institutional Evolution and Change," *Studies in American Political Development* 14 (Spring 2000), pp. 101-108.

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The last factor influencing the selection of a political strategy is institutional feedback. When state officials undertake policy measures that alter the parameters of existing organizational structures, it may lead to unintended consequences—that is, institutional reforms can fall short of producing desired results. As mentioned above, the relational power political strategy can exacerbate political struggles between the affected actors and the initiator because the measures taken by the latter improves its position relative to the other actors. The relational power political strategy can produce political outcomes that are perceived by others as zero-sum. Given the distributive effects of policy measures, it is expected that the affected parties will counter that political measure and consequently produce an unintended consequence. As for meta-power, an unintended consequence may occur when the process of coordination leads to terms of settlement that are not satisfactory to the initiator.

In light of these two scenarios, the selection of a political strategy might be motivated by the desire to avert the repetition of a negative feedback effect brought about by an unintended consequence during a previous round of institutional adaptation. For example, if the relational power strategy contributed to an unintended consequence, the next logical move might be to employ the meta-power strategy, either at the level of intergovernmental relations or business-government relations, wherever a window of opportunity opens.

> *Hypothesis 2*: The success of an adjustment strategy depends on the presence of an appropriate institutional framework. If the present institutional terrain does (does not) provide government officials with the kind of organizational and instrumental capacities that are necessary to pursue a particular adjustment strategy, then the objectives of the strategy will (or will not) be attained.

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Hypothesis 3: The shadow of past institutions will affect the ability of government officials to undertake those institutional innovations that are necessary to pursue a particular industrial adjustment strategy. When the existing institutional terrain already displays some forms of compatibility with an adjustment strategy, efforts to produce a better match between institutions and the tasks of a strategy will be more successful than when the institutional terrain is initially unsuitable for the pursuit of an adjustment strategy.

In the next chapter I will provide a historical account of the development of the Canadian political economic structure, focusing particularly on the organizational structures of the federal bureaucracy, of intergovernmental relations, and of government-societal relations.

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CHAPTER THREE

THE CANADIAN STATE AND INDUSTRIAL POLICIES

A state's ability to pursue an industrial adjustment strategy is chiefly shaped by the existence of an appropriate set of domestic institutions. This chapter attempts to answer two questions tied to this central thesis: What kinds of institutional dynamics have emerged from Canada's particular historical trajectory of political development? and What organizational features of the domestic political structure are appropriate respectively to pursue the two alternative adjustment strategies—the Third Option and continentalism? In answering these two questions, it will become clear which of the two strategies the Canadian domestic structure best accommodates and it will provide an idea about the scope of institutional reform efforts required to pursue either of these adjustment strategies.

In this chapter I seek to show that the organizational structure of the Canadian state has inherent characteristics which suggest a closer affinity to the required institutional framework associated with continentalism. Consequently, based on the institutional theory developed in chapter two, it is expected that institutional adaptation should face fewer obstacles if it is directed at implementing the liberal variant of the National Policy, whereas institutional innovation is expected to encounter more obstacles if it is linked to the Third Option.

ORGANIZATIONAL STRUCTURES OF THE STATE: THE EXECUTIVE

The Weberian perspective of the state posits that the legal and bureaucratic institutions of the state create a sphere that is differentiated, although not necessarily autonomous, from the socioeconomic setting in which it interacts. Fundamental to the

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existence of a state, according to Weber, is the notion that the state makes an exclusive claim to maintain the "monopoly of the legitimate use of physical force within a given territory."[1] Moreover, the Weberian state is one whereby the authority and capacity of the state to perform other functions and pursue other political purposes is based on its ability to assert an authoritative and exclusive claim on the legitimate exercise of force.[2] These other state functions or purposes include preserving internal order, looking after the general welfare of citizens, formulating and implementing laws, resolving domestic conflicts, preserving and enhancing a country's power capabilities, and articulating and promoting the national interest in domestic and international affairs.

Whereas the Weberian view helps to understand why the state needs to be differentiated from society, another group of state theorists interested in state capacity, have attempted to show how different national institutional structures impact the ability of the state to achieve its objectives. Zysman, Gilpin, and Katzenstein among others have argued that the range of organizational and instrumental capacities which government officials can bring to bear on situations requiring problem solving is largely shaped by the institutional framework in which they exist.[3] State structures and institutionally embedded ideas constitute the national political institutional framework. On the one hand, historically-rooted state structures are products of past political struggles between

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[1] Weber affirms this point in the following passage: "Every state is founded on force....If no social institution existed which knew the use of violence, then the concept of 'state' would be eliminated, and a condition would emerge that could be designated as 'anarchy'....Of course, force is certainly not the normal or the only means of the state...but force is a means specific to the state." Quoted in H.H. Gerth and C. Wright Mills, *From Max Weber: Essays in Sociology* (New York: Oxford University Press, 1946), p. 78.
[2] As Ikenberry points out, "The state's monopoly on force is the precondition for the sanctioning of law and property rights and, ultimately, for resolving political conflict." See G. John Ikenberry, *Reasons of State*, (Ithaca: Cornell University Press, 1988), p. 28. See also Samuel Finer, "State-building, State Boudaries and Border Control," *Social Science Information* 13 (1974).
[3] John Zysman, *Governments, Markets, and Growth* (Ithaca: Cornell University Press, 1984); Robert Gilpin, "Economic Evolution of National Systems," *International Studies Quarterly* 40 (1996); Peter Katzenstein, ed., *Between Power and Plenty: Foreign Economic Policies of Advanced Industrial States* (Madison: University of Wisconsin Press, 1978).

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societal groups and the state as well as within the state, and shape future political developments by defining the preferences of government and societal actors and limiting their capacities to act instrumentally. On the other hand, ideas leave their imprint in political life by establishing policy routines, however, not before they gain the advocacy of powerful partisans and find an institutional home.

The federal bureaucratic structure, the federal structure, and state-societal relations constitute the three most central components of the Canadian state and accordingly have the greatest impact on state capacity.[4] To understand Canada's federal bureaucratic structure, it is noteworthy to consider alternative paths of political development. From a comparative view, powerful state bureaucracies have been found in countries where the development of representative institutions succeeded monarchical systems. Absolutist regimes in Europe built powerful bureaucracies to assist in the process of state-building. Bureaucratic staffs were needed to raise taxes, extract and mobilize the resources of society, create and administer the military, and help secure the authority of the Kings in the face of powerful aristocrats.

Unlike this trajectory of political development, the Canadian bureaucracy evolved slowly and under the short-term control of elected representatives. Until the Civil Service Act of 1908, public service fell victim to political patronage. The dispensation of patronage was used first by the Conservative Party under Prime Minister Sir John A. Macdonald (1867-1873; 1878-1891) and later by the Liberal Party under the government of Prime Minister Wilfrid Laurier (1896-1911) specifically as a way to assemble large

[4] See William Chandler and Herman Bakvis, "Federalism and the Strong-State/Weak-State Conundrum: Canadian Economic Policymaking in Comparative Perspective," *Publius: The Journal of Federalism* 19 (Winter 1989); and Michael Atkinson and William Coleman, *The State, Business and Industrial Change in Canada* (Toronto: University of Toronto Press, 1988).

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bases of electoral support which required political parties to cross the cultural divide by appealing to both French and English Canadians.[5] The Act of 1908 introduced the merit rule and created the Civil Service Commission to enforce this rule in the sphere of public service, thus making it more difficult for politicians to continue the practice of using the civil service for political gains. Progress was further achieved when the Civil Service Act of 1918 linked the process of appointment to a system of competitive examination. In short, these two institutional reforms enabled the civil service to achieve some degree of internal integrity and to become non-partisan. These reforms, however, did not enhance the capacity of the bureaucracy to act autonomously relative to their political superiors nor lead to the development of such bureaucratic capacities as long-term planning and the strategic use of bureaucratic discretion to promote state interests.

Within the federal executive, the bureaucratic apparatus has historically demonstrated a reluctance to develop an internally-coherent and autonomous mode of thinking despite the fact that it has attracted highly competent and intelligent people. From the end of the nineteenth century until the Second World War, although the authority of the executive grew relative to that of Parliament, policymaking was largely the preserve of the Cabinet and involved minimally the bureaucracy, aside from performing the task of gathering information which was subsequently processed by politicians.[6] This pattern changed by the Second World War, however, because the increasing demand for and scope of public policy overwhelmed the limited capacity of the Cabinet.

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[5] Keith Archer, Roger Gibbins, Rainer Knopff, and Leslie Pal, *Parameters of Power: Canada's Political Institutions*, Second Edition, (Scarborough, Ontario: International Thomson Publishing, 1999), p. 446.
[6] A. Paul Pross, "Parliamentary Influence and the Diffusion of Power," *Canadian Journal of Political Science* (June 1985).

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The recognition that complexity was becoming an integral part of the policy formulation and implementation processes brought about a key change in the pattern of bureaucratic-political relations. It ushered in the "age of the mandarins" and for the first time, a small group of well experienced civil servants found itself in a position to wield political clout as they were called upon to generate policy ideas and define courses of action. As Granatstein observes, the "Ottawa men" profoundly affected the course of developments in key public policy areas, an element attributed to the political influence they projected upon their political superiors:

> [The mandarins] played a crucial role in centralizing power in Ottawa. They created a Canadian foreign policy that was by their lights nationalist and at the same time internationalist. They provided the ideas and the intellectual rational for the establishment of the Canadian welfare state.[7]

Their relationship with ministers went beyond the mere information-gathering role and simple administrative functions that previous civil servants were called upon to perform. If ideas and information are sources of power, then the mandarins, who provided the intellectual guidance for governments from the Second World War to the late 1950s and early 1960s, wielded much political influence. Mitchell Sharp, a former civil servant and member of the group of mandarins, makes the following observation:

> When I was a civil servant, I think it is fair to say that individual Ministers and the Cabinet as a whole depended more upon the advice of senior civil servants than they do today and they did so deliberately. When a difficult problem arose, the customary response was to refer it...to a committee of senior public servants. There was also a period during the war and in the immediate post-war years when influential public servants...were active promoters of new ideas and approaches that they persuaded their Ministers and the Cabinet to adopt.[8]

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[7] J.L. Granatstein, *The Ottawa Men: The Civil Service Mandarins, 1935-1957* (Toronto: University of Toronto Press, 1998), p. 273.

[8] Mitchell Sharp, "The Role of the Mandarins," *Policy Options* (May/June 1981), pp. 43-4.

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The age of mandarin, however, was short-lived. Beginning with Prime Minister John G. Diefenbaker (1957-1963) and Prime Minister Lester B. Pearson (1963-1968), and even more so with the governments of Pierre Elliot Trudeau (1968-1979, 1980-1984), senior civil servants came under increasing criticism for wielding too much influence in the policy making process.[9] This is ironic given the fact that the mandarins were neither seeking self-aggrandizement nor attempting to usurp political power from the elected representatives they served, but rather sought to place their resources fully in the service of their political leaders. Pross observes that, although they provided valuable guidance to ministers "they did not allow themselves to usurp the authority of the prime minister and his colleagues."[10] It is clear that this brief window of opportunity was not used by the bureaucracy to enhance its relative autonomy from the political executives and enhance its political authority relative to the political executive. Moreover, this brief period of bureaucratic ascendancy failed to inculcate common modes of thinking specific to different public policy areas.

The influence of bureaucrats was markedly delimited in the wake of Trudeau's organizational change of the machinery of government. The objective behind the reform of executive institutions was to promote 'rational management,' a paradigm of executive leadership that Trudeau strongly advocated.[11] The bureaucratic structure that existed at the time was not appropriate to aggregate public power so as to facilitate policy

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[9] Granatstein remarks that some ministers in Diefenbaker's government were more willing to accept the advice and ideas of senior civil servants than others. Diefenbaker was among those who grew suspicious of the motives of civil servants and failed to make use of their abilities.

[10] Pross, "Parliamentary Influence and the Diffusion of Power," p. 244. Similarly, Granatstein remarks that the Ottawa men "felt deeply that it was the duty of the bureaucracy to serve the government of the day to the best of its ability, to provide ideas, advice, and the competent administration of policies that the government passed into law." Granatstein, *The Ottawa Men*, p. 277.

[11] Peter Aucoin, "Organizational Change in the Machinery of Canadian Government: From Rational Management to Brokerage Politics," *Canadian Journal of Political Science* (March 1986).

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coordination. Since the end of the Second World War, bureaucratic entities had grown in size and were becoming increasingly differentiated and operated in isolation from each other. While this organizational development was a product of the expansion of public responsibilities over a host of public policy areas, this institutional change occurred without undertaking simultaneous institutional reforms designed to establish horizontal coordinative linkages. Rational management introduced an element of coordination to a policymaking structure inclined to bring about inconsistencies, decentralization, and dispersion of functions.

Under rational management, attention shifted to the cabinet committees and central agencies. By the early 1980s, in comparison to the British and American governments, Canada had "the most institutionalized system of cabinet committees...[and] the most highly differentiated central agencies support[ing] ministers' efforts toward collective decision-making," as Campbell observes.[12] Ministerial autonomy was replaced by cabinet-level decision-making, informed by the principle of collegiality and joint responsibility. By shifting decision-making from individual ministers to cabinet committees, it was expected that line department bureaucrats would not be able to influence individual ministers as much as they used to, and that this new institutional location would facilitate policy coordination, planning, and innovation.[13] Bureaucratic influence at the agency and departmental levels was further curbed because the increasing

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[12] Colin Campbell, *Governments under stress: Political executives and key bureaucrats in Washington, London, and Ottawa* (Toronto: University of Toronto Press, 1983), p. 351.

[13] Peter Aucoin, "Organizational Change in the Machinery of Canadian Government: From Rational Management to Brokerage Politics," *Canadian Journal of Political Science* (March 1986). In conveying Trudeau's disapproval of bureaucratic influence, French noted that the "Prime Minister often expressed conviction that cabinet is less easily captured by the bureaucracy than are ministers operating independently." See Richard French, "The Privy Council Office: Support for Cabinet Decision-Making," in Richard Schultz, Orest Kruhlak, and John Terry, eds., *The Canadian Political Process*, Second Edition (Toronto: Holt, Rinehart and Winston, 1979).

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number of bureaucrats working within the central agencies that served the cabinet and the prime minister created a counterbalance against line department bureaucrats.[14]

Trudeau's institutional reforms caused a number of significant changes. First, department and agency-level bureaucrats lost some of their influence over their ministers, who were now engaged at the cabinet committee level and assisted by central agencies, and constrained in their ability to promote the particularistic interests of the departments they headed. Second, the proliferation of differentiated central agencies, with the addition of the Ministry of State for Social Development, the Ministry of State for Economic and Regional Development, and the reorganized Department of External Affairs in addition to the Privy Council Office, the Prime Minister's Office, the Treasury Board, and the Department of Finance worsened the problem of organizational fragmentation in the executive and ended up undermining the policy-integrative function these central agencies were intended to perform in the first place.[15] In fact, the problem of bureaucratic pluralism which already existed at the departmental level, was reproduced at the central agency and cabinet committee levels. Lastly, too much confidence was placed on the norm of collegiality and too little emphasis was placed on prime ministerial leadership. Collective decisionmaking only worked when the prime minister took interest in its operation. Absent prime ministerial leadership, ministers were reluctant to

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[14] Aucoin, "Organizational Change in the Machinery of Canadian Government: From Rational Management to Brokerage Politics," p. 8.

[15] Aucoin, ibid., p. 16; and Campbell, *Governments under stress*. It should be noted that the Privy Council Office, the Prime Minister's Office, the Treasury Board, and the Department of Finance make up the so-called exclusive club of central agencies because their actions are guided by a statutory obligation to support the prime minister and ministry. Of these four central agencies, the first three are without individual programs, whereas Finance is responsible for the fiscal framework of the government, which places Finance in a position to wield significant influence over the making of a government's budget.

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adhere to the norm of collegiality; instead, they tended to be more committed to pursuing the objectives of their departments and to defending their individual prerogatives.[16]

While it is clear that Trudeau's organizational changes resulted in shifting power away from line departments and individual ministers, his successors were no less involved in reshaping the balance of power within the executive. As Savoie observes, "Power in the federal government has shifted away from line ministers and their departments towards the center, and also, within the centre itself, power has shifted to the prime minister and his senior advisers at both the political and public service levels and away from Cabinet and Cabinet committees."[17]

Beginning with Prime Minister Brian Mulroney (1984-1993), and continuing with Prime Minister Kim Campbell (1993) and most recently with Prime Minister Jean Chrétien (1993-present), the gravitational force within the center of government has moved to the prime minister, which central agencies have come chiefly to serve.[18] Unlike the narrowly-defined, functionally-oriented responsibilities of bureaucrats in line departments, the bureaucrats in these central agencies weigh in on the actions of the government by virtue of their broad and generalist fields of responsibility. Their ubiquitous nature stems largely, as Savoie has observed, from their role in "maintaining the integrity of the government policy and decision-making process, of overseeing the

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[16] Aucoin, ibid.

[17] Donald Savoie, *Governing from the Centre: The Concentration of Power in Canadian Politics* (Toronto: University of Toronto Press, 2000), p. 7.

[18] The relationship between the prime minister and central agencies is an important one. Central agencies increasingly are at the service of the prime minister, and this relationship informs the actions of central agencies in their dealings with the cabinet and cabinet committees. One central agency official has remarked that "central agencies instinctively think first of the prime minister, second, again of the prime minister, and third, of the Cabinet process, as their 'clients.'" Quoted in Savoie, ibid., p. 7.

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management of the latest political or governmental crisis, of acting as goalkeepers, preventing silly things from happening, and 'corralling bouncing politicians.'"[19]

The effect this organizational change has had on the pattern of governance in the center of government is significant. First, cabinet dynamics have changed insofar as rendering the prime minister the most powerful politician at the center and the figure upon whom all eyes are fixed. Not only have these organizational changes rendered the role of cabinet as the main decision-making body less important, but the prime minister is no longer considered *primus inter pares*, given the vast range of bureaucratic resources placed at his disposal. Furthermore, the bureaucratic structure has become top-heavy, with bureaucrats in central agencies wielding relatively greater political clout than those at the department level. In fact, once they receive the prime minister's consent on a particular policy issue, line departments have been forced to fall in line with the designated course of policy formulation.

This sketch of the organizational structure of the government offers two key insights about general institutional dynamics of Canada's federal executive. First, the conditions of institutional disorder and dissonance have been inherent features of the federal executive, and have been manifested in the forms of perpetual reorganization and constant wrestling with the need to bring about greater coordination in the policymaking process. Over the course of half a century, the center of government has witnessed three different institutional reforms, each putting forth a particular organizational solution to the problems of disorder and dissonance and each resulting in the relocation of political authority within the executive. Perhaps the most important effect such changes have had on the capacity of the state to act is, as Atkinson and Colemen point out, "No

[19] Savoie, ibid., p. 8.

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organizational home exists in the executive institutions of Canadian government...from which consistent political and bureaucratic instructions can be expected to flow."[20]

The other insight concerns the nature of the Canadian bureaucracy. With the rare and qualified exception of the "Ottawa Men," department-level bureaucrats have not enjoyed the kind of relative autonomy from politicians that is required to engage in long-term planning, foster a common mode of collective thinking within the economic bureaucratic apparatus, and exercise statutory discretion with respect to the allocation of resources in society. Instead, constrained by the short-term political control of elected representatives, bureaucrats have used their limited authority and capacity to serve their political masters.

THE FEDERAL STRUCTURE

The evolution of Canadian federalism has been anything but a smooth one. Circuitous, rather than linear, is the pattern of evolution most fitting to describe the changes in Canadian federalism. The path of evolution has taken Canada through periods marked by oscillations between centralist and decentralist tendencies, between intergovernmental cooperation and competition, and between security and insecurity of jurisdictional authority.

Contrary to unitary states, federal states divide political authority and responsibilities between constituent units and the central government and provide for the representation of regional interests in the central government. The purpose of federalism is to accommodate regional differences and enable regional interests to promote their particularistic values within their territorial space while simultaneously working to

[20] Michael Atkinson and William Coleman, *The State, Business, and Industrial Change in Canada*, 1989, pp. 64-5.

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preserve the integrity of the nation-state. Canadian federalism recognizes that territorial differentiation—in other words, regionalism—has been a permanent feature of the Canadian political landscape since the beginning of Confederation when the new nation-state came into existence by piecing together the previously separate British colonies and integrating two distinct cultural groups—the French-Canadians and English-Canadians.[21]

Since Confederation, regionalism has also taken on a spatial character as depicted by the breakdown of Canadian regions into hinterlands and the center. Such a formulation has been used to feature the asymmetric economic and political relations among differentiated regions of Canada.[22] Significantly, regionalism has been a key source of political conflict between the federal and provincial governments chiefly because of the challenge posed by the task of reconciling and accommodating regionally specific and conflicting interests, but also because of the inevitability of the spatial impact of federal policies. In fact, the resource-based hinterland provinces have faulted the federal government for placing them in an economically disadvantaged position relative to Ontario and Quebec, which have served as Canada's industrial center.[23] According to Smiley, regionalism has worked its effect on the political system by creating a "bias in favour of mobilizing of interests which are territorially based and

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[21] Today, Canadian historians, political scientists; commentators among others are in agreement that a discussion of Canada's founding cultures would have to include a third founding culture, the natives.
[22] Two general schools of thought have emerged to explain economic differences across regions of Canada. Whereas one school posits that economic disparities have been caused by variations of resource endowment across regions, the other school contends that disparities have been caused by the economic policies of the federal government, particularly the first and second National Policy. See James Bickerton, "Regionalism in Canada," James Bickerton and Alain-G. Gagnon, eds., *Canadian Politics* (Peterborough, Ont.: Broadview Press, 1999).
[23] For more on federalism as a cause and effect, see James Bickerton, "Regionalism in Canada,"; Cairns (1977); Donald V. Smiley, "Territorialism and Canadian Political Institutions," *Canadian Public Policy* 111 (1977).

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frustrating the political expression of interests and attitudes which are largely non-territorial."[24]

Unlike the German federal system in which functional federalism is a key mode governing intergovernmental relations, the dominant mode in Canada is jurisdictional federalism.[25] Whereas functional federalism links the division of power to the logic of division of labor, jurisdictional federalism handles power in accordance to the logic of division of jurisdiction.[26] In the German federal system, functional federalism is such that policy is initiated, formulated, and decided on in the central government, while the Länder—Germany's constituent units—are involved in the implementation and administration of these laws.[27] This functional division of authority facilitates intergovernmental relations because it creates a condition of interdependence between the two levels of government. Accordingly, countries that employ this type of federal arrangement tend to have institutionalized coordinative mechanisms to ensure a smooth operation of the functional breakdown of the policymaking process between the two orders of government.

In Canada, although all residual powers belong to the federal government and thus contribute to the federal government's vast range of constitutional powers and responsibilities, the Canadian constitution also endows provinces with powers and responsibilities which enable them to have a commanding role in such areas as provincial economic development and management of natural resources, as well as in the provision

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[24] Smiley, "Territorialism and Canadian Political Institutions," p. 450.
[25] German federalism combines both functional and jurisdictional federalism. The Basic Law, Germany's constitution, gives certain powers to the Länder as well as the central government.
[26] William Chandler, "Federalism and Political Parties," in Herman Bakvis and William Chandler, eds., *Federalism and the Role of the State* (Toronto: University of Toronto Press, 1987).
[27] Martin Painter, "Intergovernmental Relations in Canada: An Institutional Analysis," *Canadian Journal of Political Science* (June 1991); Hans Michelmann, "Federalism and international relations in Canada and the Federal Republic of Germany," *International Journal* (Summer 1986).

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of welfare and education. In essence, Canadian federalism was designed to make the two levels of government operate as independently as possible and put them in positions of relative strength vis-à-vis each other. However, in several public policy areas, most notably industrial adjustment, the constitution does not allocate exclusive responsibility to either level. Consequently, when the two levels of government are involved in overlapping jurisdictions, jurisdictional federalism has tended to heighten intergovernmental wrangling as each level seeks to assert its independence and defend its particularistic objectives. Just as this particular feature of interdependence can easily frustrate the policy goals of either level, so too can it compel the two levels of government to mobilize consensus for devising a plan of coordinated action. This political reality is what led Dicey to assert that federalism leads to a weak central government.

> The distribution of all the powers of the state among co-ordinate authorities necessarily leads to the result that no one authority can wield the same amount of power as under a unitarian constitution is possessed by the sovereign. A scheme again of checks and balances in which the strength of the common government is...pitted against that of the state governments leads, on the face of it, to a certain waste of energy. A federation therefore will always be at a disadvantage in a contest with unitarian states of equal resources.[28]

A brief overview of the evolution of Canadian federalism should suffice to demonstrate how the logic of jurisdictional federalism has played an integral part in the transformation of the federal structure. The period from 1883 to the 1910s witnessed the ascendancy of provincial power and adherence to the "watertight compartments"

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[28] A.V. Dicey, *Introduction to the Study of the Law of the Constitution*, Eight Edition, (Toronto: Macmillan & Co, Limited, 1915), pp. 167-8.

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interpretation of the constitution.[29] Described as the period of "dual federalism," the provinces benefited from various pro-provincial rulings of the Judicial Committee of the British Privy Council—Canada's final court of appeal at the time, located in Britain—which had the effect of consolidating the distribution of powers. By broadly interpreting provincial powers, the court established interpretations of the constitution which limited the breadth of the federal government's supremacy clause and residual powers.[30]

The dismal performance of the post-Confederation economy also contributed to the assertion of provincial powers. It was thought that the Confederation scheme would accelerate national economic growth and bring about improvements in socioeconomic conditions across Canada, the combination of which, it was believed, would impel Canadians to shift their allegiances to Ottawa and thus enhance its legitimacy at a time when Canadians felt more attached to their provincial governments. Unfortunately, the economic depression which soon followed the creation of the Confederation—and lasted until the late 1890s when the wheat boom arrived and spurred an economic recovery—eroded the legitimacy of the central government that the founding fathers of Canada had hoped would be quickly gained.[31]

This stage of evolution came to end, however, when centralist forces gained momentum starting at the time of First World War and lasted until the 1960s. Periods of crises, such as the two world wars, and conditions that provoke intense national social concerns, such as the Great Depression, have thrust the federal government to the

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[29] Howard Cody, "The Evolution of Federal-Provincial Relations in Canada: Some Reflections," *The American Review of Canadian Studies* (Spring 1977).
[30] Between 1880 and 1896, the JCPC ruled in favor of the provinces 15 out of the 18 cases involving overlapping jurisdiction cases. See Archer, Gibbins, Knopf, and Pal, *Parameters of Power*, 1999, p.149.
[31] Edwin Black and Alan Cairns, "A Different Perspective on Canadian Federalism," *Canadian Public Administration* (March 1966).

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forefront of political life in Canada.[32] The world wars had the effect of temporarily enabling the Canadian state—by capitalizing on its emergency powers—to govern as a unitary state as it built and directed the war economy. But two other important developments helped spur the centralist trend in Canadian federalism. First, the Judicial Committee of the Privy Council was abolished and replaced in 1949 by the Supreme Court. The Supreme Court's orientation toward the adjudication of jurisdictional disputes proved to be more in favor of centralism. It should be noted, however, that before the JCPC was abolished the court had taken a more conciliatory position by allowing the federal government to employ a broad definition of federal powers during the two world wars.

The second factor that facilitated the centralist trend in Canadian federalism had to do with the fact that provinces were becoming more dependent on federal transfers to help them carry out their responsibilities in such areas as education, welfare, and health. Because the provinces could only raise revenue through the means of direct taxation, the provincial revenue base became insufficient to meet the growing expenditures associated with provincial constitutional responsibilities, a condition made worse as the Great Depression caused an increase in the unemployment level and in the demand for other welfare provisions. This latter development, particularly, ushered in a period of "cooperative federalism," in which civil servants from the two levels of government created fiscal arrangements and engaged in policy coordination.

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[32] This centralist trend in Canadian federalism gained energy particularly during and after the Second World War, after a slow and precarious start. During the Depression, Prime Minister R.B. Bennett's 'New Deal' legislation—which included the Employment and Social Insurance Act of 1935, legislation providing for unemployment insurance and health care—was struck down by the Judicial Committee of the Privy Council in 1937 because it went beyond the constitutional powers of the federal government. Furthermore, it did not help that King's Liberal government, which defeated Bennett's Conservative government in 1935 was lukewarm about pursuing a centralist attack against decentralizing forces. See Archer et. al., 1999.

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The practice of 'cooperative federalism' produced some notable intergovernmental arrangements, such as the tax-rental and tax-sharing arrangements whereby provinces agreed to transfer their taxation powers to the federal government in exchange for compensatory federal payments. Significantly, in receiving such payments and conditional grants—that helped provinces provide health and welfare services—from the federal government, provinces also had to accept greater federal involvement in provincial affairs. In sum, the period of 'cooperative federalism' witnessed not only a centralist trend in the federal structure, but also a higher degree of provincial acquiescence to federal terms in the face of limited alternatives.[33]

The 1960s saw a major change in the way federalism worked. The pendulum swung back toward decentralized federalism. The key impetus driving this change was the emergence of province-building.[34] As Black and Cairns point out, this shift toward decentralization was to be expected once the conjuncture of forces which prompted the federal state to extend its capacity in the first place began to abate.[35] But Black and Cairns observe that other factors contributed to this stage of decentralized federalism. They included,

> A mid-century decline in the importance of the powers constitutionally assigned to Ottawa and a corresponding magnification in social importance of the provincial powers [, and] a relatively great increase in the competence and confidence of provincial administrations and a consequent growth in elites who identified their prospects with the fortunes and favours of the provincial governments.[36]

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[33] Cody, "The Evolution of Federal-Provincial Relations in Canada," 1977.
[34] For more on province-building, see R.A. Young, Philippe Faucher, and André Blais, "The Concept of Province-Building: A Critique, *Canadian Journal of Political Science* 9 (1966); and Marsha Chandler and William Chandler, "Public Administration in the Provinces," *Canadian Public Administration* 25 (1982). The term province-building was coined by Black and Cairns in their article "A Different Perspective on Canadian Federalism" (1966).
[35] Black and Cairns, "A Different Perspective on Canadian Federalism."
[36] Ibid., p. 89.

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These administrative and organizational changes that provincial governments were facing emboldened them to assert control over such "growth areas of government" as education, health, and natural resources, as well to embark on the restructuring of their provincial economies through the agency of an increasingly capable provincial apparatus. In effect, the emergence of province-building was spurred by the expansion of the bureaucratic and planning capacity, as well as the financial resources of the provincial state; an increasing willingness on the part of provincial governments to intervene in the economic affairs of the province for the purpose of accelerating industrial development; and the conviction to resist federal intrusions into provincial spheres of jurisdictional responsibilities.

The two periods in which federal decentralism gained currency have coincided with an increase in the level of intergovernmental conflicts. In the first decentralist phase witnessed in the last decades of the nineteenth century and early twentieth century, intergovernmental conflict was linked to the provinces' efforts to secure their authority claims within provincially demarcated spheres, which for the most part meant using the adjudicative mechanism of the JCPC to scale back the expansive interpretation of federal powers in the formative years of the Confederation. The more recent decentralist phase provoked intense intergovernmental conflicts between the two levels of government partly as a result of provincial efforts to regain exclusive claims to those provincial spheres of authority that they temporarily transferred to or voluntarily allowed for infringement by the federal government. In addition, intergovernmental conflict was caused by the competitive drive of the two orders of government to occupy those public policy fields, such as industrial adjustment, over which the constitution gave neither order of government exclusive jurisdictional authority. As Cairns observes, "The security and

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certainty of jurisdictional responsibilities that cannot be gained by reference to the constitution are sought by the exercise of sheer power, the staking of claims for popular support by the manufacture of constituencies of allegiance tied...to a government seeking to maintain its position."[37]

Since the 1960s, many have depicted the two levels of government as being two interdependent centers of roughly equal strength. This has been attributed to the manifestation of province-building, but also to changes in the practice of fiscal federalism. In 1960, the combined gross revenue of provincial governments was a little over $3.1 billion, while that of the federal government was slightly more than $6.25 billion. By 1970, provincial revenues had increased to approximately $15 billion and federal revenues stood at a little under $16.7 billion; but more amazingly, by 1980, these figures had multiplied, reaching over $62 billion for provinces and approximately $58.4 for the federal government.[38] The increase in the revenue base of provinces and the beneficial effect this had on their capacity to advance provincial interests came about as a result of the federal government's willingness to grant more "tax room" to provinces, that is, enabling them to take a larger share of personal and corporate income taxes.[39] Also important was that conditional transfers were replaced by unconditional transfers which did not impose federal standards on provinces, in addition to the growth in revenue some

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[37] Alan Cairns, "The Other Crisis of Canadian Federalism," in Douglass Williams, ed., *Constitution, Government, and Society in Canada* (Toronto: McClelland and Stewart, 1988), p. 185.
[38] R.A. Young, Philippe Faucher, and Andre Blais, "The Concept of Province-Building: A Critique," *Canadian Journal of Political Science* (December 1984), p. 791. Provincial figures do not include the revenue of municipal governments.
[39] Robert Jackson and Doreen Jackson, *Politics in Canada: Culture, Institutions, Behaviour and Public Policy* (Toronto: Prentice-Hall, 2001), pp. 209-212.

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provinces obtained from the sale of oil and gas as a result of an increase in the demand of these commodities during the energy crisis of the 1970s.[40]

The reality of federalism since the 1960s has been profoundly shaped by the rise in the spending power and ambitions of provinces. Provinces have regarded their "tasks as positive and managerial" and have developed "visions commensurate with their enlarged responsibilities."[41] Indeed, the "other crisis of Canadian federalism" which Cairns addresses, refers to the provinces' ability effectively to compete against the central government to move into, occupy, and shape those public policy areas which neither level of government can claim exclusively for themselves. Provincialism has emerged to counter the force of nationalism, both of which have competed in shaping the Canadian society and economy in ways that have been guided by competing objectives.

This brief sketch illustrates that the federal system has fragmented authority and responsibility over the economy and, worse, has created a dynamic where intergovernmental conflicts occur regularly and where coordinative solutions are difficult to maintain. Moreover, the pendulum swing between centralized and decentralized federalism has prevented the institutionalization of a permanent location in which to engage in nation-wide long-term planning, orchestrate the aggregation of public resources in order to create a coherent front, and launch a collective effort to implement the common interests of both levels of government on the issue of industrial adjustment.

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[40] The increase in provincial spending power has not been blanket phenomenon across all provinces. Newfoundland, New Brunswick, Prince Edward Island, and Nova Scotia have fared less well than other provinces.

[41] Alan Cairns, "The Other Crisis of Canadian Federalism," p. 176.

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THE ORGANIZATIONAL STRUCTURE OF ECONOMIC GROUPS

In his seminal historical comparative analysis of industrialized nations, Gerschenkron discerns a relationship between the timing of industrialization (early or late industrializing nations) on the one hand and patterns of relations among business, banks, and government and role of the government in the economy on the other.[42] Early industrializers, such as Britain, undertook economic development with limited government intervention in the economy and with limited reliance on bank credits to help private entrepreneurs move into new industries. For late industrializers, such as Germany, the process of economic development required more state intervention and greater reliance on bank credits to facilitate the development of new industries. According to Gerschenkron, two economic variables explain these differences between early and late industrializers. First, whereas the leading industrial sector which early industrializers sought to develop, such as textiles, was less capital intensive, the primary industrial sector which late industrializers sought to develop, steel, was capital intensive and its viability rested on achieving large-scale production. Thus, the cost of launching industrial development for late industrializers, in terms of capital requirements and scale of production, was relatively higher than the cost with which early industrializers had been confronted.

The second variable concerns the level of competition that industrializing nations faced in the initial stages of economic development. Competition was greater for late industrializers than it was for early ones because the former group had to go head-to-head with earlier industrializers that had already moved into the very industries that later

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[42] Alexander Gerschenkron, "Economic Backwardness in Historical Perspective," in *Economic Backwardness in Historical Perspectives: A Book of Essays* (Cambridge: Harvard University Press).

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industrializers sought to develop. To be internationally competitive in leading industrial sectors, therefore, late industrializers were required to expedite their entry into new industries and to have available all of the resources amenable to achieve a competitive edge in a short period of time. Because of its capacity to extract and mobilize the resources of society, the state joined by banks—which provided much need industrial capital to industrialists—were the two primary driving forces of industrialization in late industrializing nations and contributed to the development of particular institutionalized linkages among the three actors. However, the economic role of the state has varied across late industrializers. State involvement has been more direct when the banking system was weak and undeveloped as in the case of Russia, while the role of the state centered largely on infrastructural development when the financial system was strong and effective in supplying capital to industrialists, as in the case of Germany.[43]

Although a late industrializer, Canada did not develop the bank-business relations nor imitate, for the most part, the developmental practices of states in other late industrializers. Like its American counterpart, the Canadian business community evolved autonomously from financial institutions and from the government. The existence of capital markets—in which stocks and bonds are the main sources of long-term industrial funds—in Canada at the time of Confederation and its continuing growth thereafter, pre-empted the development of a credit-based financial system, a type of financial system in which the relationship between industries and banks is much closer and the market power of the state is enhanced.[44] Moreover, the financial system that

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[43] Ibid., pp. 16-21.

[44] Zysman discusses three types of financial systems. The capital market-based system "places banks, firms, and governments in distinct spheres from which they venture forth to meet as autonomous bargaining partners." The other two types of financial systems are based on the credit-based model, in

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existed at the time of Confederation was biased in favor of underwriting the expansion of those activities relating to the sphere of circulation, which involved such activities as merchant shipping, exchange of commodities, transportation, and utilities.

When manufacturing activities began to rival commercial ones, the financial community regarded investing in manufacturing as being a far riskier venture than the well-established activities that defined Canada's sphere of circulation. Consequently, Canadian banks kept their involvement in the development of manufacturing activities at a minimum, and in turn enhanced the role of capital market actors—most notably American investors—in industrial development. As Atkinson and Coleman point out, Canada's financial system was marked by the "unwillingness of banks and other financial intermediaries to undertake long-term and equity investment in industrial firms." Instead, "The chartered banks devoted themselves primarily to short-term personal and corporate lending, while long-term capital [was] raised by industrial corporations in securities markets."[45] The dominance of the capital-based financial system—and by implication the relative autonomy of industrialists from banks and the state—eliminated a key channel through which financial institutions and the Canadian government could have influenced the allocation of investment capital for the purpose of achieving long-term strategic developmental goals.

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which industrial credit (bank lending) is the key source of long-term industrial funds. One variant of this model is the credit-based system "in which market interrelations are dominated by government-administered prices," and the second variant is a credit-based system "in which a limited number of financial institutions dominate the system without themselves being dependent on state assistance." The market power of the state in the first variant of the credit-based system is much greater than it is in the second variant, however, state influence over the allocation of industrial credit under the latter system can be bolstered if banks act as allies for the state, in which case banks will follow the state's policy guidelines to allocate industrial credits. *Governments, Markets, and Growth*, pp. 69-75.

[45] Atkinson and Coleman, *The State, Business, and Industrial Change in Canada*, p. 39.

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If reliance on this market arrangement helped secure Canadian business's autonomy from banks and the government at an early start, then it is the organizational weakness of labor and farmers that enabled business to dominate economic group politics and consequently gain the favor of government more readily. The prevailing balance of influence among these three societal groups in the twentieth century was determined early on after the Confederation was established and pivoted on the issue of trade protection. Until the early 1900s, business was polarized between supporters of tariff protection—primarily manufacturers—and of free trade—namely export-dependent firms involved in timber, dairy, and mining activities and those dependent on imported manufactured items. While free traders were organizationally weak as well as regionally and functionally differentiated, supporters of protectionism were regionally concentrated and functionally undifferentiated. Consequently, manufacturing interests were relatively more successful at organizing collective action, as exemplified by the creation in 1874 of the Ontario Manufacturers' Association which subsequently became the Canadian Manufacturers' Association (CMA).

Party politics formed another front on which free traders and protectionists competed. This came to a head in the 1878 election, as the Conservative Party rode to victory with the backing of protectionists. The free traders were dealt a major blow when their party of preference, the Liberal Party, was defeated, a development which eventually led free trade supporters to accept tariff protection and eliminate the key source of division within Canadian business.[46] Bliss remarks that by 1911 "business comment on the trade question was overwhelmingly weighted in favour of protection, so

[46] Ben Forster, *A Conjunction of Interests: Business, Politics, and Tariffs, 1825-1879* (Toronto: University of Toronto Press, 1986), pp. 110-126.

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much so that there was no real debate among businessman on the question. The National Policy [of which tariff protectionism was a key component] was national business policy."[47]

Labor and farmers did not experience the same fortune as that of business. The position of the Trade and Labour Congress of Canada (TLC) on the issue of trade protection was divided as soon as the issue had gained salience. Workers supported protection because restrictions on imports created jobs in import-substitution economic activities. Still, labor opposed it because protection benefited business relatively more than labor.[48] In effect, this internal division not only undermined labor's ability to act as an effective counterbalancing force to business's demands, but also demonstrated the TLC's inability to arrive at a compromise in the face of internal division. Divided from within, the TLC failed to even articulate a position in the 1911 election in which the free trade issue once again became the subject of intense debate.[49]

Farmers suffered a fate similar to labor's. Farmers opposed tariff protection because it kept the price of manufactured goods in Canada relatively high and pushed up the cost of farming. The Patrons of Industry, an association representing anglophone farmers in Ontario, Quebec, Manitoba, and the Maritimes that sought to evolve into a pan-Canadian movement, was beset by the growing salience of ethno-national and religious divisions between Catholic French-Canadians and Protestant English-Canadian.[50]

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[47] Michael Bliss, *A Living Profit* (Toronto: McClelland and Stewart, 1974), p. 96.
[48] Paul Craven and Tom Traves, "The Class Politics of the National Policy, 1872-1933," *Journal of Canadian Studies* 14 (1979), p. 15.
[49] Paul Craven, *'An Impartial Umpire': Industrial Relations and the Canadian State, 1900-1911* (Toronto: University of Toronto Press, 1980), p. 122.
[50] Gordon Laxer, *Open For Business: The Roots of Foreign Ownership in Canada* (Toronto: Oxford University Press, 1989), pp. 122-151.

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Central to preventing the Patrons of Industry from gaining the support of French-Canadian farmers was that many farmers in Ontario supported the farmer association as well as the Protestant Protective Association (PPA), a fervent anti-Catholic organization that boycotted Catholic-owned enterprises and sought to remove Catholics from political office. Although the Patrons of Industry attempted to steer clear of ethno-national and religious issues, it could not convince French-Canadians that it did not support the activities of the PPA. Farmers did experience a bout of success in party politics, but without the involvement of French-Canadian farmers. In the 1921 elections, the National Progressive Party, formed by a loose coalition of provincial United Farmers, managed to win 65 seats in the House of Commons and placed the party in a position to become the official opposition, which it declined.[51] In the face of such victory, Prime Minister Mackenzie King sought to lure Progressives into the Liberal party by conceding tariff reductions on a number of goods and by reducing the freight rates of grain shipments. Gradually, the strength of business's closest rival waned, thus enabling business to maintain its dominance in economic interest group politics. Moreover, business dominance was reinforced by party politics to the extent that the two major political parties co-opted rising third parties that posed a challenge to business interests.

Canadian business's unchallenged dominance stemmed from the absence of equally powerful rivals, not because of its unusual organizational strength and unity of interests. The organizational structure of Canadian business has never been hierarchically organized and centrally guided by one or a few peak associations. Absent major interest group rivals, which would create an incentive to institutionalize collective

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[51] Robert J. Jackson and Doreen Jackson, *Politics in Canada: Culture, Institutions, Behaviour and Public Policy* (Toronto: Prentice Hall, 2001), pp. 396-7.

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action, Canadian business has remained fragmented and loosely organized. Over the course of the twentieth century, Canadian business was splintered into three groups—the staples fraction, the branch-plant manufacturing fraction, and corporate nationalist fraction.[52]

Historically, the staples fraction—led by an alliance among finance, transportation, and resource capital interests—was the most dominant, with roots going back to pre-Confederation times. Initially, its activities were predominantly linked to the sphere of circulation, but over time they spread into the sphere of production, as illustrated by its entry into resource-related manufacturing such as steel, pulp and paper, food and beverages, and construction. With its roots in finance, new staples-based manufacturing, and consumer goods, this fraction combined both international and national firms.[53] In 1976, the Business Council on National Issues (BCNI) was launched by this business alliance in an effort to gain greater influence over central policy makers at a time when state interventionism was increasing and the organizational changes in the executive that Trudeau undertook in the 1970s appeared to give economic policy makers more autonomy from economic interest groups.[54]

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[52] See Atkinson and Coleman, pp. 48-52. Wallace Clement uses a different set of terms: dominant indigenous fraction, dominant comprador fraction, and middle-range indigenous fraction instead of the terms that appear above, respectively. See Wallace Clement, *Continental Corporate Power: Economic Linkages between Canada and the United States* (Toronto: McClelland and Stewart, 1977), p.25.

[53] Clement points out that activities in the sphere of circulation—transportation, utilities, and finance—tend to be controlled by Canadian-owned companies, whereas activities in the sphere of production—which includes production of new staples such as oil, minerals, pulp and wood—tend to be controlled by American-owned Canadian subsidies. See Clement, p. 24.

[54] James Gillies observes that "The development of the BCNI was a tacit recognition that the days of the strong inter-relationship between senior ministers and businessmen and senior mandarins and businessmen are over...because the system of decision-making in Ottawa has changed so the one-to-one relationship is no longer as effective as it once was. Indeed, it is much less easy for the businessman...to identify the players with power, and when they can be identified they are not easily approached...[and may not share our philosophy based on] greater reliance on the private sector for the operation of the economy...." Gillies, *Why Business Fails: Business Government Relations at the Federal Level in Canada* (Montreal, 1981), p. 72.

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The branch-plant manufacturing fraction has included Canadian subsidiaries of American firms, whose main goal has historically been to occupy and service the domestic market. Represented by the Canadian Manufacturers' Association, this business group has supported the continuation of an import-substitution strategy, first implemented through the National Policy. However, in a surprising volte-face in the early 1980s, the Business Council on National Issues, followed by the Canadian Manufacturers' Association, abandoned their pro-import-substitution strategy position and embraced free trade with the United States. Indeed, in the face of salient public issues and complementary interests, these two business alliances have found it politically expedient to create ad hoc organizations during different periods in Canadian history. For example, the staples and branch-plant manufacturing fractions created the Canadian Home Market Association during the 1911 elections to compete against free traders and the Liberal Party, and established the Canadian Reconstruction Association after the First World War to drive home the point that protectionism was in Canada's best interest. In 1987, the Canadian Alliance for Trade and Job Opportunities was created by corporations from both fractions in order to promote a "fair and workable" free trade agreement between Canada and the United States as well multilateral trade liberalization.[55]

The nationalist coalition of businesses, before it unraveled by the early 1980s, was composed of Canadian-owned firms, whose interests converged on the goal of pursuing a strategy of "continental nationalism."[56] In pushing for Canadianization and international

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[55] David Langille, "The Business Council on National Issues and the Canadian State," *Studies in Political Economy* 24 (Autumn 1987), p. 69.
[56] Jorge Niosi, "Continental Nationalism: The Strategy of the Canadian Bourgeoisie," in Robert Brym, ed., *The Structure of the Canadian Capitalist Class* (Garamond Press, 1985).

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expansion of Canadian firms, the two key objectives of continental nationalism, these firms relied on the assistance of provincial and federal governments and pushed for the rationalization of Canadian industries in order to enhance Canada's international competitiveness. Importantly, this business alliance did not seek directly to reverse Canada's technological dependency or develop new strategic, non-resource sectors. Rather this coalition sought to reduce the level of absentee ownership of Canadian industry by domestic entrepreneurs, move into higher forms of resource processing activities, and heighten Canadian firms' international presence, particularly, in the American market. The firms that came to represent this coalition were from an array of industries ranging from energy, mining (coal, potash, and asbestos), telecommunications, real estate, and media.[57] This coalition fared well in the end of the 1970s and early 1980s when its ideas were picked up by the Liberal Party and incorporated into its new economic nationalistic programs which it vowed to implement once it regained control of the government. Its new-found fame quickly faded, however, when the Liberal Party's economic programs encountered stiff opposition and after some of its members abandoned the coalition.

In sum, the decentralized and fragmented institutional features one finds in the executive and federal system is also found in the organizational order of societal groups. Moreover, such institutional features as well as the arm's-length mode of relations between business and the state—partly attributable to the dominance of the capital

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[57] Ibid., pp. 60-63. See also Atkinson and Coleman, pp. 49-50. A number of Canadian companies represented this nationalist coalition: Lavalin in the construction industry; Bombardier in the transportation equipment (trains, snowmobile, and airplane) industry; Agropur in the food processing industry; Northern Telecom and Mitel in the telecommunications industry; Olympia and York, Cadillac Fairview, Trizec, and Campeau in the real estate industry; Petro-Canada and Hydro Quebec in the energy industry; and the "Big Five" chartered banks as well as Quebec's Mouvement Desjardin and La Laurentienne in finance.

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market-based financial system—have created a major structural obstacle for the state as it seeks to mobilize societal consensus on such matters as industrial adjustment.

THE HISTORICAL ROLE OF THE STATE IN THE ECONOMY

As Zysman observes, there are different forms which state involvement can assume in an economy.[58] In the state-led model, which has been followed in Japan and France, the state assumes a guiding role in the economy. The state's interventionist capacity enables it selectively to intervene in the economy in order to shape the course of economic progress, as exemplified by the use of state discretion to promote the development of particular industries. In the company-led model, found in the United States and Britain for example, the path of economic development is largely determined by the decisions of the private sector and features a state that is relegated to facilitating—through the employment of pro-market regulations and non-intrusive policy instruments—market actors' maximization of self-interests. Lastly, in the tripartite-negotiated model of development, which small European states have used, the focus is placed on maintaining a collaborative arrangement among industry, labor, and the government, setting the stage for a social compromise in which producers are able to follow the logic of markets in exchange for the provision of social compensation to labor.[59]

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[58] John Zysman, *Governments, Markets, and Growth* (Ithaca: Cornell University Press, 1983).

[59] Peter Katzenstein has discerned three models of industrial change—statist, liberal, and flexible models of industrial adjustment—which coincide with Zysman's in the order they appear above. Other categorizations have been used as well. For example, Streeck uses the term "nonliberal capitalism" to define the political economies of Japan and Germany, and "liberal capitalism" is used in reference to the American political economy. The primary difference between the two models of capitalism pivots on the degree to which market forces are institutionally or socially embedded. Whereas liberal capitalism fixes a minimum level of embeddedness in market forces, nonliberal capitalism restricts market forces by imposing a higher degree of institutional embeddedness. See Wolfgang Streeck, "Introduction: Explorations into the Origins of Nonliberal Capitalism in Germany and Japan," in Wolfgang Streeck and

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Business-government relations in Canada have been unique in the sense that none of these models captures the realities found in Canada. Instead, the pattern of business-government relations in Canada has been defined by the coexistence of two historically-rooted political economic developments: the "firm-centered culture" as argued by Atkinson and Coleman and the "public enterprise culture" as maintained by Hardin.[60] The firm-centered culture has recognized the importance of upholding market-based outcomes and protecting the autonomy of the private sector from those state initiatives that are too restrictive and intrusive on the free play of market forces. As Atkinson and Coleman point out,

> For Canadian business, the principle of competitive markets is enshrined to the point that the internal decisions of firms are not considered legitimate targets of political action. Under these circumstances, the prospect of a concertative relationship, in which business and government collaborate in making longer-term investment decisions, is greeted with hostility.[61]

Although the market logic is an integral feature of the relationship between the Canadian state and business, another equally significant, and largely ignored, historical legacy has figured largely on Canada's course of economic development. The public enterprise culture that Hardin identifies provides the clearest clue regarding the proper task and scope of government intervention in the economy. Hardin and Aitken observe

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Kozo Yamamura, eds., *The Origins of Nonliberal Capitalism: Germany and Japan in Comparison* (Ithaca: Cornell University Press, 2001).

[60] Atkinson and Coleman, *The State, Business, and Industrial Change in Canada*, and Hershel Hardin, *A Nation Unaware: The Canadian Economic Culture* (Vancourver: J.J. Douglass Ltd., 1974)

[61] Ibid, p. 42. In his characterization of the American business-state pattern of relationships, one which is consistent with the firm-centered culture expounded by Atkinson and Coleman, Andrew Shonfield notes that "there is a general commitment to the view...of the natural predominance of private enterprise in the economic sphere and of the subordinate role of public initiative in any other than a manifest national emergency." Andrew Shonfield, *Modern Capitalism* (New York: Oxford University Press, 1969), p. 298.

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that throughout Canadian history state interventionism has been guided by a geopolitical purpose.[62] As Aitken observes,

> No one familiar with Canadian politics...can question that defense against the economic and political dominance of the United States is today among the over-riding concerns of the Canadian federal government, no matter which of the two major parties is in power. Resistance to the threat of absorption by the United States made such assistance vital, and, indeed, thrust on the government...a continuously active strategic role in directing Canadian economic development.[63]

Central to this "defensive expansionist" thesis depicting the historical pattern of relations between business and the state in the economy is that business has accepted and rendered legitimate the type of state involvement that has been of defensive nature, that is aimed at strengthening Canada's political independence and economic capabilities. Integral to the geopolitical purpose of state intervention has been the belief that government officials should harness domestic capabilities so as to develop the nation's industrial sectors, build an integrated domestic market, and foster national confidence and a sense self-identity in Canada. From an historical perspective, it is this geopolitical purpose that has guided state involvement in the economy, and it is this task for which the instrumental and organizational capacities at the disposal of the federal state have been developed and employed.

Throughout Canadian history, state interventionism has coexisted with free market enterprise. The geopolitical task of the state did not menace market players; the exercise

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[62] As Hardin notes, "Public enterprise in Canada is the direct issue...of the dilemma of Canadians with their small domestic market immediately next door to the Americans with their large market and manifest power. We did not choose public enterprise freely. It was forced on us by American expansion. See Hershel Hardin, *A Nation Unaware: The Canadian Economic Culture*, p. 55. Interestingly, Hardin notes that this is a durable historical legacy that many Canadians have failed to recognize, an omission he attributes to Canada's weak sense of self-identity and belief that Canadians are more like Americans.

[63] Hugh G. J. Aitken, "Government and Business in Canada: An Interpretation," *Business History Review*; Alexander Brady, "The State and Economic Life in Canada," in K.J. Rea and J.T. McLeod, *Business and Government in Canada* (Toronto: Methuen, 1976), pp. 7-8.

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of state capacity in the economy helped create an environment in which business could expand freely, profit abundantly, and make corporate decisions on the basis of market signals. The arm's-length pattern of business-government relations enabled the former to maintain its autonomy and impelled the state to build capacities that were limited in scope, but that were appropriate to fulfill its geopolitical task. The Canadian state was not a "player state" insofar as pursuing a strategy of selective industrial development supported by discretionary allocation of capital: rather the kind of authority the Canadian state has historically employed in the economy is consistent with the government-as-an-economic administrator, to which the role of an economic regulator was added by the 1940s.[64]

Integral to these two types of interventionist capacities, has been the employment of various policy instruments, such as infrastructure-building state-owned enterprises, regulations, tax incentives, government spending, and tariff protection.[65] These instruments have proven neither to be too intrusive on business autonomy nor tied to a dirigiste plan of economic development. Until Canadian nationalism underwent a significant transformation beginning in the late 1960s, the staying power of this brand of Canadian nationalism was responsible for defeating the idea of pursuing a policy of economic integration with the United States, which after the abrogation in 1866 of the reciprocity treaty of 1854 had resurfaced during the 1891 and 1911 elections and during the 1947-8 free trade discussion. Although a number of commercial arrangements have

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[64] I have borrowed these three terms from Zysman in *Governments, Markets, and Growth*, pp. 75-87. Zysman defines the state as an economic regulator as "an umpire refereeing the behavior of others in the hope that if they follow a particular set of rules, a certain set of outcomes will occur" (p. 75). The administrative state is one that "executes certain operations based on a specific assignment or task, applying particular decision criteria and following set procedures" (p. 75). The player state "specif[ies] the objectives it seeks and assemble[s] bits of policy to press toward it goals" (p. 86).

[65] See G. John Ikenberry, "The irony of state strength: comparative responses to the oil shocks in the 1970s,' *International Organization* 40 (Winter, 1986) for an elaboration of these policy instruments.

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had the effect of bringing about freer trade between Canada and the United States, such as the trade agreements of 1935 and 1938 trade agreements, the Hyde Park Agreement of 1941, and the Auto Pact of 1965, all were sector specific and posed no challenge to Canada's ability to strengthen its political and economic autonomy.

Canadian scholars have divided the period from Confederation to the 1960s into two distinct periods or commonly referred to as "national policies."[66] In promoting the geopolitical purpose of the Canadian state, these national policies have served as policy paradigms in which national priorities—that have responded to emerging economic, social and political concerns—are delineated, policy instruments are selected to attain these public policy objectives, and institutional rearrangement is undertaken to facilitate the implementation of such plans of action. The timing and sequence of national policies, therefore, have reflected changes in historical conditions with which Canada has been confronted. National policies have reflected a particular balance between the role of the state and market and have advanced a particular solution to the dual consideration of promoting wealth accumulation and preserving Canada's relative power position, which have had implications with respect to state actions at the domestic and international levels. Finally, national policies have been products of political struggles, during which a set of interests and ideas has managed to gain ascendance over its rivals and has secured its position over time given the overwhelming support it receives. Consequently, national policies are likely to undergo programmatic changes as some of their content is

[66] See for example, Lorraine Eden and Maureen Appel Molot, "Canada's National Policies: Reflections on 125 Years," *Canadian Public Policy* 19 (1993); Donald V. Smiley, "Canada and the Quest for a National Policy," *Canadian Journal of Political Science* 8 (March, 1975); Michael Bliss, *The Evolution of Industrial Policies in Canada: An Historical Survey* (Ottawa: Economic Council of Canada, June 1982).

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discredited because of operational difficulties or erosion of political support.[67]

The First National Policy, 1879-1920s

> "...The time has arrived when we are to decide whether we will be simply hewers of wood and drawers of water [or will] make this a great and prosperous country, as we all desire and hope it will be."[68]

Canadian business established its dominance soon after Confederation, and the state, motivated by geopolitical concerns, found an ally in business, for both were in agreement with respect to the course of policy action that needed to be taken in order for the two to attain their objectives. The First National Policy of 1878 was a product of an alliance between the federal government and business, represented by financial, industrial, and transportation interests. For the Canadian business community, the First National Policy's three-pronged policy program of tariff protection, building a national railway system, and recruitment and settlement of immigrants was instrumental in developing industrial sectors, in achieving capital accumulation, and facilitating the creation and servicing of a home market. Although the First National Policy was an explicit display of the Canadian state's strategic exercise of political power, it nonetheless purposefully incorporated the market logic to the extent that these policies enabled business to exploit the maximum available resources in Canada with minimal state interference.

For the federal government, the First National Policy was a way to secure the nascent nation-state's geopolitical integrity against the expanding influence of the United

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[67] For an excellent discussion of national policies see Neil Bradford, *Commissioning Ideas: Canadian National Policy Innovation in Comparative Perspective* (Toronto: Oxford University Press, 1998).
[68] Sir Samuel Tilley was the Minister of Finance in 1879 made this statement at the time Sir John A MacDonald enacted the National Policy tariffs.

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States. The political logic incorporated in the First National Policy directed the state to work rapidly to construct a national political and economic union of hitherto loosely linked regions.[69] The national policy thrust upon the state the function of engendering a sense of nationalism, creating a political community, and building Canada's economic power so that the country could stand on its own. In effect, the political logic of the First National Policy was essentially an extension of the logic underpinning the decision to seek Confederation in 1867. As Dubuc points out, Confederation "had as its goal the creation of adequate institutions for the pursuit of a centralized policy of long-term economic development."[70]

As policy instruments, public ownership, state credit, and tariffs were the centerpiece of the First National Policy. In using the first two types of instruments, the state promoted national integration by building a national railway system and helped build a national electric power grid to supply electricity across the country. In using tariff protection, the state spurred import-substitution industrialization, which business undertook with minimum state guidance. Moreover, the increased domestic orientation of Canada's manufacturing sector meant that the bulk of Canada's export revenue came from its exports of natural resources.

The construction of the Canadian railroad system in the late 1800s and early 1900s was owed in large part to state subsidies. A railroad system was necessary to connect the western and eastern regions of the country to central Canada. In 1876, after much debate

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[69] Anthony Westell argues that from the time of Confederation to the 1980s, Canada's "desire to escape from US influence, the desire to put distance between Canada and the United States, arises in large measure from fear of absorption by the US and from jealousy of US wealth, power and vitality." See Westell, "Economic integration with the USA," *International Perspective* (November/December, 1984), p. 22.
[70] Alfred Dubuc, "The Decline of Confederation and the New Nationalism," in Peter Russell, ed., *Nationalism in Canada* (Toronto: McGraw-Hill, 1966), p. 117.

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about whether to go through Maine, the government completed the high-cost, roundabout construction of the Intercolonial Railway, joining Halifax with Quebec and Montreal. In seeking to link western and central Canada, both federal and provincial governments underwrote the construction of several transcontinental railroads undertaken by such private companies as Canadian Pacific Railway (CPR), the Canadian Northern Railway, and the Grand Trunk Railway through the provision of land-grants, cash subsidies, and bond guaranties. These efforts doubled the railroad mileage, led to the discovery of new mineral deposits due to the excavation that preceded railroad work, and created numerous all-Canadian routes.

The rapid expansion of the Canadian railroad system, however, created a problem of overcapacity and consequently threatened the survival of many of these high-cost operations. Faced with the excess capacity and the precarious financial situations of many of these companies, between 1918 and 1923, the government set up the Canadian National Railways (CNR) and brought under its ownership and control existing railroad companies, except CPR whose financial state was sounder. Notwithstanding the high-cost structure associated with maintaining the Canadian railroad system and unprofitability of its activities, Brady notes that the Canadian National Railways, from its inception, has been "an instrument of nation-building, drawing together widely-scattered communities and making possible the exploitation of natural resources remote from the industrial heart of Canada."[71]

The tariff protection instituted by the First National Policy became a permanent feature of Canadian economic policy until the 1970s. Tariffs became an important policy instrument used to induce industrial development and it was a means of enhancing

[71] Alexander Brady, "The State and Economic Life in Canada," p. 31.

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Canadian economic power. In defense of the National Policy tariff, Prime Minister John A. Macdonald observed, "There are national considerations...that rise far higher than the mere accumulation of wealth, than the mere question of trade advantage, there is prestige, national status, national dominion and no great nation has ever risen whose policy was free trade."[72]

Ironically, efforts to secure Canada's independence were coupled with an increase in the economy's dependence on the American market, capital, and technology. Canada's promising future as an industrial power plus the import-protection tariffs combined to attract American investors to set operations in Canada and to establish branch-plants or acquire those Canadian companies with which they had entered into licensing arrangements. As Bliss points out, "From the perspective of the late 1960s [the First National Policy] now appears to have been a peculiarly self-defeating kind of economic nationalism. The funny thing about our tariff was that we always wanted the enemy to jump over them. Some Walls!"[73] By the early 1920s American investment exceeded the level of British investment in Canada, and by the mid-1950s direct investment surpassed portfolio investment as the main form of American investment flowing into Canada.

American investment also entered Canada because in the late 1800s and early 1900s the country's economic prospects were particularly good. Canada's manufacturing

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[72] Quoted in Donald S. Macdonald, "Leap of Faith," in L. Ian Macdonald, *Free Trade: Risks and Rewards* (Montreal: McGill-Queen's University Press, 2000), p. 51. Goldwin Smith, a critic of the National Policy and a supporter of free trade with the United States in the 1880s and 1890s, argued that Canada was "rich by nature, poor by policy," in other words, the National Policy strategy had made Canada worse off and in its place Canada should have opted for a strategy that exploited the untapped potential of the country's resource wealth and deepen its commercial ties with the United States, the export market most attractive for Canada's abundant natural resources.

[73] Michael Bliss, "Canadianizing American Business: The Roots of the Branch Plant," in Ian Lumsden, ed., *Close the 49th Parallel, Etc: The Americanization of Canada* (Toronto: University of Toronto, 1970), p. 32.

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base compared favorably to those of other "late-follower" industrializing countries such as Sweden, Italy, the Netherlands, and Japan. Throughout the nineteenth century, the quality of Canadian iron matched those of the United States, Great Britain, and Sweden.[74] Agricultural implements—such as harvesters, mowers, and ploughs—competed effectively in the markets of England, Germany, and France. Estimates show that in 1870, Canada was the eighth largest industrial country in the world, and in seventh position in 1900.[75] Within the group of late-follower industrializing countries, Canadian exports of finished goods in 1899 totaled $12 million compared to Sweden's $13 million, Italy's $23 million, and Japan's $10 million.[76] Moreover, in 1901, 33 percent of Canada's labor force was engaged in industrial activities compared to Italy's 35 percent, Sweden's 28 percent, the Netherlands' 36 percent, and Japan's 20 percent.[77] In short, Canada had a promising beginning as a country seeking to diversify its manufacturing strength.

Canadian governments and manufacturers alike were not oblivious to the tariff-jumping logic that emboldened American companies to invest in Canada. In fact, the prevailing understanding among them was that without the tariff, Canada would have at its disposal many fewer technologies and less investment capital to develop Canada's economic potential. Although nationalistic in their dispositions neither the government nor the indigenous manufacturing class concerned themselves with the extent to which American investors were gaining influence over the form and rate of industrial development in Canada. Canadian manufacturers focused almost exclusively on "occupying the home market," rather than also seeking out export opportunities and

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[74] Gordon Laxer, *Open For Business: The Roots of Foreign Ownership in Canada*, p. 11.
[75] Ibid.
[76] Laxer, p. 46.
[77] Simon Kuznets, *Modern Economic Growth: Rate, Structure, and Spread* (New Haven: Yale University Press, 1966), pp. 106-7.

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reducing their dependence on foreign technology and capital.[78] The true colors of Canadian nationalism remained up to the 1960s a peculiar mix, for in seeking to secure its political and economic survival in the shadow of an increasingly powerful neighbor, it invited its neighbor's industrialists to take part in Canada's process of industrialization, thus giving them a sizeable slice of Canada's growing economic wealth.

Two important economic structural developments were witnessed during the First National Policy period. First, the policies of this national policy created a hinterland-center pattern of economic exchanges whereby the peripheral regions of Canada, namely the Western and Maritime provinces, focused almost exclusively on the production and extraction of resources which were shipped via the railway system to Canada's industrial center, Ontario and Quebec, where processing and manufacturing would take place. The hinterland's undeveloped industrial capacity was further reinforced because Ontario and Quebec supplied the rest of Canada with the capital goods and other manufactured products their regional economies needed. The second structural change concerned the creation of a north-south axis of economic relationship, a development owed to the shift in the pattern of foreign investment in which the United State overtook Britain as Canada's largest supplier of investment capital. Although such a linkage was weak at the time, it established the conditions for its future development.

The Second National Policy, 1920s-1960s

By the 1920s, the Canadian state had demonstrated a willingness to use public enterprises to produce desired changes in the economy. State capacity, however, had not extended into the regulatory domain. The lack of the state's regulatory capacity was

[78] See Glen Williams, *Not For Export*, 1993.

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partly due to the lack of information the government was able to obtain about business activities and partly attributed to the notion that regulations should not interfere with the process of nation-building. As Ostry points out, "Canadian competition policy has always reflected a good deal of ambivalence; our approach was in a sense to say, 'Competition is desirable as long as it does not impede the industrialization and development of this large and relatively sparsely populated country.'"[79]

Consistent with a path-dependent evolutionary process, state involvement in the Second National Policy preserved arm's-length business-government relations and invoked the 'public enterprise culture.' However, as the state's organizational and administrative capacities increased, it began to marshal those resources required to administer economic regulations, devise tax-incentive programs, and undertake government-sponsored research and development. Lastly, the Second National Policy proved to be more outward-oriented than the previous development strategy, for it advocated a push toward trade liberalization.

The Second National Policy differed from the first one in important ways. Whereas the First National Policy focused primarily on the exigency of nation-building, the Second National Policy was based on a trilogy of challenges facing Canada—the cultural and social implications of the growing economic influence of the United States in Canada, Canada's war obligations in the two world wars, and the need to promote macroeconomic stability in the postwar period. Although the first two challenges forced the Canadian state to take notable measures, it was the last concern of the state, in particular, which figured largely in defining the legacy of the Second National Policy.

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[79] Sylvia Ostry, "Government Intervention: Canada and the United States compared," *Policy Options* (March, 1980), p. 27.

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Whereas the logic of "defensive expansionism" had primary importance in the First National Policy, the logic of "defensive pragmatism" was what guided the Second National Policy, which came to signify the triumph of economic stabilization and wealth accumulation over such concerns as strengthening the nation's independence and autonomy.[80]

It was the logic of "defensive expansionism" that moved the Canadian government in 1932 to create the Canadian Radio Broadcasting Commission—later named Canadian Broadcasting Corporation (CBC)—and in 1937 Trans-Canada Airlines—renamed Air Canada in 1964. According to the Privy Council Office, the creation of the Canadian Broadcasting Corporation was needed in order to prevent Canadian broadcasting from becoming dominated by broadcasts originating from the United States.[81] Similarly, the political justification supporting the Trans-Canada Air Lines Act was to prevent "American airlines, which were already carrying Canadian travelers and airmail [from becoming] the effective transcontinental carriers for Canadians."[82]

However, coupled with these measures were a number of "defensive pragmatist" measures, as Knubler argues, which took government in new directions with respect to its involvement in the economy. In response to fluctuations in the price of wheat as well as surplus production, the Bennett government created the Canadian Wheat Board in 1935, which was given a mandate to purchase and sell grains. The government also created a central banking system, headed by the Bank of Canada. Lastly, in 1936, the National Harbours Board was created to manage the largest harbors in Canada. By 1939, fifteen

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[80] I have borrowed this term from Knubley, *The Origins of Government Enterprise in Canada* (Ottawa: Economic Council of Canada, 1987).
[81] Privy Council Office, *Crown Corporations: Direction, Control, and Accountability* (Ottawa, 1977), p.11.
[82] John Knubley, *The Origins of Government Enterprise in Canada*, p. 60.

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state-owned enterprises (also called Crown corporations) existed and were involved in such activities as transportation, communications, harbor management, and commodity marketing.

The demands for war supplies and munitions during the Second World War forced the Canadian government to resort to the use of public enterprise. From 1939 to 1945, 33 Crown corporations were established specifically to assist in the war effort.[83] Importantly, the organizational structure found in these wartime Crown corporations was designed to make them operate like a private company and were often headed by businessmen. Indeed, this model of public corporation was adopted by many Crown corporations created in the postwar period. By the end of the war, the Canadian government had become a major economic actor, owning $200 million worth of war production plants.

Immediately following the war, the government initiated a plan designed to bring about conversion to peacetime production while maintaining industrial growth and preventing a drop in the employment level.[84] To facilitate peacetime conversion and promote macroeconomic stability, the government offered accelerated depreciation rates to private firms that purchased publicly owned plants, a transaction further made attractive given that such facilities were sold at reduced prices. The combination of tax incentives and discounted sale price appealed to American investors, who ended up purchasing many of the government-owned assets. As Laux and Molot point out, because of the concern with steering the Canadian economy clear of a postwar economic slowdown, C.D. Howe, an influential Cabinet minister who served as Minister of

[83] Privy Council Office, *Crown Corporations: Direction, Control, Accountability* (Ottawa, 1977), p. 12.
[84] David Wolfe, "Economic Growth and Foreign Investment: A Perspective on Canadian Economic Policy, 1945-1957," *Journal of Canadian Studies* (Spring 1978).

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Munitions and Supply, Reconstruction, and then Trade and Commerce between 1940 and 1957 and the King government "encouraged American capital to participate in the Canadian economy with a variety of taxation and investment incentives."[85] These spending instruments were also employed to promote resource exploration and development. Again, American investors proved to be more taken by these incentives than Canadians, as the sharp increase in foreign ownership of Canadian resources starting in the late 1940s would suggest.

In addition to the challenge posed by the country's conversion to a peacetime economy, the immediate postwar economic period also announced the arrival of another challenge for the Canadian government. By 1946, Canada was facing a growing balance-of-payments deficit caused by the rapid increase in imports of American capital goods, which the appreciation of the Canadian dollar relative to the American dollar had fueled. Canada's balance-of-payments problem was fundamentally caused by the warehouse-assembly processing character of Canada's manufacturing sector, whose growth during and immediately after the war period necessarily demanded an increase in imports of machinery, patents, heavy equipment, and tools from the United States.[86] In 1948 Canada became the world's leading importer of equipment, machinery, and tools, a volume that exceeded the volume of American and British imports of these goods combined.[87]

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[85] Jeanne Kirk Laux and Maureen Appel Molot, *State Capitalism: Public Enterprise in Canada* (Cornell University Press, 1988), p. 53.

[86] This characterization of Canada's manufacturing sector is made by Williams (1994). In addition to using this term, the term "assembly nature of Canadian production" is used in his study as well. This trait of Canada's manufacturing sector is coincident with the underdeveloped upstream industries, whose purpose is to supply downstream manufacturing processing activities. The upstream industries in question concern machinery, precision tools, electronics, heavy equipment, for example.

[87] Glen Williams, *Not For Export*, 1994, p. 114.

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Canada dealt with its balance-of-payments problem by pursuing a two-sided strategy. The Emergency Exchange Conservation Act of 1947 imposed import controls which established restrictions and quotas on imports of consumer goods, as well demanded the licensing of imported capital goods[88] Prior to the Liberal government's decision to take this measure, Alex Skelton, Howe's principal adviser, studied Canada's balance of payment problems and had come to the conclusion that major policy changes were needed. In particular, he suggested that pressure be applied on branch plants to engage in more complicated functions of production such as product development and research, rely more heavily on Canadian producers to supply needed production inputs, and step up their efforts to develop lines of production tailored to service the American market. However, Howe and the Liberal government chose to follow the policy routine of promoting import-substitution.

The import control policy augmented American control of the Canadian economy, for this policy measure created an incentive for American producers to manufacture through their branch-plants in Canada the consumer goods they previously exported to Canada. As Wolf points out, "The import control policy...represented the most direct attempt by the government to induce foreign manufacturers to locate in Canada."[89] Ironically, and more important, this measure worsened the deficit in the merchandise account as branch-plants—facing a relatively small Canadian-based capital goods market that lacked the capacity to supply branch plants in the immediate term with required production components, parts, and capital equipment—were forced to import even greater amounts of these goods in order to set up their new production lines in Canada.

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[88] Wolf, "Economic Growth and Foreign Investment."
[89] Wolf, ibid., p. 7.

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The government also pushed for trade liberalization as a way to deal with Canada's balance-of-payments problems. In the 1947 trade negotiations of the General Agreement on Tariffs and Trade, Canadian negotiators fought hard for tariff reductions and obtained a concession from the American government that led to the lowering of quotas on Canadian resource goods entering the United States. For Howe, it was better for Canada to secure market access to the United States in the area of natural resources because, as Howe saw it, "As the mineral reserves of the United States are diminishing, it was logical that attention will turn increasingly to Canadian mineral and associated hydro power resources."[90] This trend toward the increased resource content of Canadian exports was reinforced in July 1952 when the Truman administration came out with the Paley Report which concluded that Canada could become a significant foreign supplier of ten out of the twenty-two "key materials" that the United States, according to the report, needed to stockpile in order to ensure the country's national security and to sustain United States' industrial progress.

In retrospect, the Second National Policy helped further strengthen east-west links with the creation of CBC and Trans-Canada Airlines; but its lasting legacy was that it strengthened the south-north link. In 1939, Americans invested $4,151 million in Canada, of which $2,270 million (54.6 percent) was in the form of portfolio investment. By 1955, the figure grew almost two-and-half fold, reaching a total of $10,295 million of which $6,513 million (63.2 percent) was in direct investment.

More important still, was the change in the balance between portfolio and direct investment. As direct investment outpaced portfolio investment, more of Canada's

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[90] Quoted in David Wolf, "The Rise and Demise of the Keynesian Era in Canada: Economic Policy, 1930-1982," in Michael Cross and Gregory Kealey, eds., *Modern Canada, 1930-1980's* (Toronto: McClelland and Stewart, 1984), p. 60.

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economic assets fell under foreign managerial control. Specifically, Canada's consumer goods industry witnessed an increasing level of American investment, and, emboldened by the Paley Report, numerous American firms acquired in Canada major stakes in lead, zinc, asbestos, iron ore, petroleum, nickel, and copper production. For example, in 1957, Americans owned a 75 percent share of Canada's mining and smelting production compared to 38 percent in 1946. Further spurring this inexorable continental pull was the completion of a major infrastructure project, the St. Lawrence Seaway, which connected the St. Lawrence River to the Great Lakes. Once a major waterway enabling Canada to trade with Europe, by the late 1950s the St. Lawrence River was becoming an important artery, which among its many uses, served to transport Labrador's iron ore to both Canadian and American steel mills of the Great Lakes region.[91]

If Howe had any lasting impact on the evolution of the Second National Policy and after, it is that his policies firmly embedded the free market enterprise idea using the government as its main catalyst. The influence of free market enterprise even affected the "public enterprise culture," for it became increasingly guided by the market logic. For example, the Financial Administration Act of 1951—which addressed the question of financial direction, control, and accountability—created three categories of Crown corporations. A schedule B corporation—known as a departmental corporation—was defined as "a servant or agent of Her Majesty in right of Canada and is responsible for administrative, supervisory or regulatory services of a governmental nature." A schedule C corporation—also referred to as an agency corporation—was "responsible for the

[91] See Melissa Clark-Jones, *A Staple State: Canadian industrial resources in Cold War* (Toronto: University of Toronto Press, 1987).

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management of trading or service operations on a quasi-commercial basis, or for the management of procurement construction or disposal activities...."

Finally, a schedule D corporation—called a proprietary corporation—was responsible for "the management of lending or financial operations, or for the management of commercial and industrial operations involving the production of or dealing in goods and the supplying of services to the public." In terms of degree of freedom from parliamentary scrutiny, proprietary corporations were granted the most independence, whereas departmental corporations were most exposed to parliament's policy direction and control.[92] Moreover, proprietary corporations were expected to generate profits and to compete against private corporations, while Crown corporations falling under the first two categories were expected to promote non-commercial goals. The Public Accounts of Canada (1974-75) reported that of the 54 Crown corporations that existed at the time, 23 were proprietary corporations, 19 were agency corporations, and 12 departmental corporations.[93]

The Second National Policy fared no better than its predecessor in reducing regional disparities. Perhaps most important about the persistent problem of uneven economic development was that economic linkages between Canada and the United States were beginning to have a significant spatial impact across Canadian regions. For example, whereas Americans channeled the bulk of their investment capital going to the Western provinces into the region's abundant energy industries, their investment activities in Ontario and Quebec focused on establishing warehouse-assembly branch-

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[92] See Don Gracey, "Public Enterprise in Canada," in André Gélinas, *Public Enterprise and the Public Interest: Proceedings of an International Seminar* (Toronto: The Institute of Public Administration of Canada, 1978).

[93] Canada, Privy Council Office, *Crown Corporations: Direction, Control, and Accountability. Government of Canada's Proposals*, 1977, p. 14.

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plants to take advantage of the shorter distances separating them from their parent companies in the United States. Within this division of labor, the Atlantic provinces were largely marginalized. In sum, regional specialization—energy production in the west, manufacturing in the center—was no longer a mere result of historical accident, it was purposefully promoted by both Canadian and American capital.

In the next chapter I will discuss the Third National Policy, which began in the early 1970s. Canada's political economy became particularly focused on the problem of industrial adjustment. It is in this context that two strategies of adjustment emerged—the Third Option and continentalism.

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CHAPTER FOUR

THE THIRD NATIONAL POLICY: THE FOUNDATIONS OF THE TWO INDUSTRIAL ADJUSTMENT STRATEGIES

The realities facing Canada by the late 1960s were mixed. On the one hand, the country had achieved a high standard of living; a respectable international reputation founded on an outstanding peacekeeping record and contribution to the American-led Western alliance; a highly educated population, some of whom had immigrated to Canada in search of a better life; and strong economic performance as illustrated by sustained economic growth, industrial development, and the presence of a few successful Canadian multinational corporations. On the other hand, the realities showed a country with an excessively large presence of American investment in Canada, a pattern of exports that was concentrated on the commerce of new staples, and a reliance on imports of capital goods, technologies, and managerial know-how to meet a large percentage of domestic needs. The Third National Policy responded to two general concerns. First, it offered a response to the concern that if the current pattern of economic exchanges with the United States was left unchanged Canada risked becoming increasingly vulnerable to American pressures. It became increasingly apparent that the existing terms of economic exchange between Canada and the United States had contributed to the erosion of Canada's relative capabilities and margin of autonomy. The second concern to which the Third National Policy responded had to do with need to increase the level of diversification and sophistication of Canada's industrial structure.

The disposition of the Canadian state during the Third National Policy was fundamentally different from the previous national policy. Rather than settling for a reactive role as it had done in previous decades, the federal state played a proactive role

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during the Third National Policy. Two proactive state dispositions were apparent: the statist variant, which was informed by economic nationalism and the liberal variant by market liberalism. Each face of the proactive state featured a particular form of state capacity. Whereas the statist-based form of state pro-activism relied on the instrumental use and expansion of those organizational and policy resources appropriate for inserting greater state guidance in economic activities, the market-based form employed those state capacities suitable to impose market governance on economic activities.

Most of the political and economic concerns addressed in the Third National Policy had been raised by the Royal Commission on Canada's Economic Prospect launched in 1955. As the chairman of the commission, Walter Gordon remarked that the purpose of the commission was to explore "the question of selling control of our business enterprises to foreigners and the effect this could have on Canada's independence."[1] The Final Report of the Royal Commission (1957) acknowledged the benefits derived from United States investments in Canada. In particular, the Report argued that "the increase in...investment in Canada, accompanied as it has been by new technology and managerial skills, has clearly resulted in a faster rate of economic growth than would otherwise have been possible."[2] But the report threw caution to the wind by pointing out that Canadian interests were not necessarily advanced by or coincident with foreign interests; in fact, the presence of foreign investment could in the future produce negative effects on Canada's pattern of economic development. As the report observed,

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[1] Quoted in Stephen Azzi, *Walter Gordon & the Rise of Canadian Nationalism* (Montreal & Kingston: McGill-Queen's University Press, 1999), p. 37. In an outline of the task that were to occupy the Commission, Gordon formulated a number of questions which inquired into the effects of foreign investment on Canada's ability to advance its interests. The questions he posed were: "should we do more processing of our natural resources at home? How far is Canadian enterprise likely to be owned and controlled by the United States and what are the implications? What measures might be taken to reduce the dependence of Canadian industry on United States research facilities?" Quoted in Azzi, ibid., pp. 40-1.
[2] Gordon Commission, p. 41.

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> Despite the tremendous contributions which foreign capital—and the management and technological skills and the access to markets that has come with it—has made and will continue to make to the development of our country, we do not believe Canadians will cease to be concerned about this matter unless something is done to make Canadian voices more strongly and effectively heard in some vitally important sectors of our economy in which non-residents exercise a large measure of control.... To do nothing would be to acquiesce in seeing an increasing measure of control of the Canadian economy pass into the hands of non-residents and to run the risk that at some time in the future a disregard for Canadian aspirations will create demands for action of an extreme nature.[3]

Although the Gordon Report received mixed reactions from government officials, the press, and professional economists, it had an important impact on economic policy discourse, particularly in the late 1960s and 1970s. The report helped sound an alarm about the possibility that Canada's economic prospects could be jeopardized if the country continued heavily to rely on foreign investment and if industrial sectors continued to be dominated by branch-plant manufacturing which tended to suppress innovation and technological advancement. Moreover, the Gordon Commission challenged postwar economic policy thought by introducing a rival set of economic ideas, interventionist nationalism, which called for a level of state involvement in the economy which went much farther than what was witnessed during the Second National Policy. Rather than the occasional macroeconomic fine-tuning, interventionist nationalism proposed that the federal state use its capacity to help increase the level of independence and strength of the Canadian secondary manufacturing sector. In effect, the Commission helped define the points of contention in the national debate—which were thoroughly

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[3] Gordon Report, p. 399.

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explored by the four key government reports—on the issue of industrial adjustment that began in the late 1960s and early 1970s.[4]

As I argued in the last chapters, for a strategy to succeed it must be grounded in a compatible institutional terrain, that is the tasks which a particular strategy sets out to undertake must be accomplished by an appropriate institutional framework which provides the necessary organizational and instrumental capacities required to carry out those tasks. The ideas underpinning the Third National Policy marked a significant departure from the previous set of political economic ideas that informed the first two national policies. From the late 1880s to the 1960s, four ideas guided the beliefs and policy actions of government officials with respect to state involvement in the economy and Canada's relations with the United States. First, Canada needed foreign investment if it was to exploit the maximum potential of its national resources. Second, the overriding concerns of the federal state were to promote national growth, improve domestic welfare, and secure national integration. Third, Canada's technological needs could be met by relying on technology imports at a minimum cost to the country's economic autonomy. Last, Canada's economic strategy was guided by the belief that neither Canada's export opportunities nor economic progress was undermined by the prevailing practice of branch-plant manufacturing in the economy.

By the beginning of the 1970s a new set of ideas had replaced the old set. Informed by the findings of government reports, the Third National Policy advanced the

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[4] The four reports in question are: Privy Council Office, *Foreign Ownership and the Structure of Canadian Industry: Report of the Task Force on the Structure of Canadian Industry* (Ottawa: Queen's Printer, 1968), also called the Watkins Report; Government of Canada, *Eleventh Report of the Standing Committee on External Affairs and National Defence Respecting Canada-U.S. Relations*, 2nd Session, 28th Parliament (Ottawa: Queen's Printer, 1970), also called the Wahn Report; *Government* of Canada, *Foreign Direction Investment in Canada* (Ottawa: Information Canada, 1972, referred to as the Gray Report; and Michell Sharp, "Canada-U.S. Relations: Options for the Future," *International Perspectives* (autumn 1972, pp. 1-24, referred to as the Third Option Paper.

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following set of ideas. First, although Canada benefited from foreign investment, foreign investors needed to be held to stricter standards with respect to what they contributed to Canada's process of industrial development. At no point from the early 1970s to the 1990s did the Third National Policy seek to thwart or restrict foreign investment from entering Canada. Instead, the goal was to continue to attract foreign capital, while seeking to make investors better partners with domestic firms in the quest to develop Canada's industrial capacity. Second, the state was to be more concerned about the relative achievement of economic gains, in particular the distribution of those economic activities that enabled Canada to develop a sophisticated and diversified industrial structure, accumulate national wealth, maintain and improve domestic welfare, strengthen its national autonomy and political independence. This last concern was echoed by the Secretary of State for External Affairs, Mitchell Sharp, when he remarked that "there is no reason why [Canada] should not aim, in the context of an expanding economy and expanding trade prospects, to achieve relative shifts that, over time, could make a difference in reducing Canada's dependence...and, by extension, the vulnerability of Canada's economy...."[5]

In addition to these two ideas, the need for Canada to develop an indigenous technological base to reduce its reliance on imports of capital goods defined the Third National Policy. As the Science Council of Canada urged, Canada was to work to achieve "technological sovereignty," which it defined as the "ability to *develop* and *control* the technological capability necessary to ensure its economic, and hence its

[5] Mitchell Sharp, "Canada-U.S. Relations: Options for the Future", p. 23.

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political, self-determination."[6] The last idea held that Canada could only go so far to reduce its reliance on the American market, which meant that it needed effectively to manage the bilateral relations in order to lessen its vulnerability to shifts in American policies.

THE STATIST AND LIBERAL VARIANTS OF THE THIRD NATIONAL POLICY

As a general set of industrial adjustment ideas, the Third National Policy was not pursued in a uniform manner. On the contrary, I identify two variants associated with it: the Third Option and continentalism. Although each variant was guided by the same set of ideas, the two diverged sharply in terms of the policy orientation they advanced, as Table 4.1, illustrates and the institutional framework they required, as Table 4.2 depicts.

The Statist Variant (The Third Option)

The statist variant or the Third Option accorded more weight to the instrumental goals of the federal state than did the liberal variant or continentalism, and was designed to attain those objectives by expanding the interventionist capacity of the state. Under the statist variant, the nature and scope of state involvement in the economy differed from previous decades to the extent that there was an increased use of public enterprises to pursue the developmental goals of the state and that the state broadened its entrepreneurial role, both as a producer and investor. Importantly this variant was more engaged at the domestic than the international level, the arena from which the federal state sought to redress industrial adjustment problems.

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[6] Science Council of Canada, "Technological Sovereignty: A Strategy for Canada," *Eleventh Annual Report*, 1976-77, p. 26.

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The limited opportunities available for problem solving at the international level reflected Canada's relatively weak international position. One of the underlying goals of this variant was to harness domestic capabilities in order to strengthen Canada's international position. Indeed, Pentland remarks that "the options paper recognized the organic linkage between the domestic and external dimensions of economic policy [but the] linkage was expected...to transmit the positive effects of domestic change outward to foreign policy—especially relations with the United States...."[7] Accordingly, the Third Option focused especially on expanding the entrepreneurial role of the state in the economy, employing such policy designs as foreign investment regulation and economic planning, and forging stronger ties with Canadian business community as a way to

Table 4.1. Third National Policy

Components of Policy	Statist Variant	Liberal Variant
A more balanced concern about attaining absolute and relative gains	emphasis is on achieving relative gains in the short term as a way to improve national wealth and power	emphasis is on securing relative gains in the long term so as to conserve and enhance national position
Reduce and manage Canada's vulnerability dependence resulting from heavy reliance on American market	diversification of export production base and of export market	establish a rules-based regime with the U.S. in order to secure market access and enhance trade opportunities
Channel the dynamic forces of economic development in Canada's direction	greater use of political interventionism (state-led initiatives)	use of market governance (more reliance on market efficiency and rationality)
Problem-solving arena: balance of opportunities for and constraints on state action at the international and domestic levels	weakened international power and few options at that level leads to greater reliance on domestic capacities of the state	improvement in relative position enhances freedom and range of action at the international level and is amenable to favorable problem-solving options

[7] C.C. Pentland, "Domestic and External Dimensions of Economic Policy: Canada's Third Option," in Wolfram Hanrieder, ed., *Economic Issues and The Atlantic Community* (New York: Praeger Publishers, 1982).

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coordinate industrial change. The international undertakings associated with this strand were intended to lessen Canada's reliance on the United States markets by developing strategic counterweights that were expected to balance Canada's overall export performance.

Only an appropriate set of political institutions was amenable to attaining the objectives set out by the Third Option. Below I will discuss the ideal institutional order that is most conducive to the successful pursuit of this strategy. This adjustment strategy requires coordination between business and government and the centralization of decision-making authority in a small, highly-competent group of state officials, who benefit from partial insulation from political interference, but are accountable to representative bodies. Moreover, this variant of the Third National Policy requires a bureaucratic apparatus that is internally cohesive, capable of engaging in long-term economic planning, and is given authority to exercise discretion over the allocation of state resources for the purpose of pursuing state goals. Shonfield aptly indicates what institutional requirements are necessary to make such a strategy successful

> ...Planning in a capitalist context...is a matter of tightening the hierarchical structure of government, compelling all departments to put all the decisions which have significant long-term consequences into a single intellectual framework, determined at the highest level of administration. New lines of authority are established, and at each level of power there is a more precise definition of the area in which choice and local initiative are allowed. Planning thus requires a high degree of explicitness in the relations between the different departments of government and a clear division of responsibilities.[8]

The political-administrative organization that the statist variant of the Third National Policy requires has been found in postwar France and Japan until the 1980s.

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[8] Andrew Shonfield, *Modern Capitalism: The Changing Balance of Public and Private Power*, p. 316.

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France's Planning Commission and Japan's Ministry of International Trade and Industry—the two central economic planning bureaucracies that have been credited for orchestrating their country's postwar economic progress—evolved into internally cohesive and competent bureaucratic entities, and were given the exclusive mandate to plan and guide their respective countries' process of industrial development.

Equally important for the success of the Third Option as well as French and Japanese economic planners is the repertoire of policy instruments at the disposal of the state. The state's ability to extract wealth and allocate it selectively to specific sectors of the economy is an important aspect of state capacity. According to Sharp, the Third Option strategy need to be "deliberate," "involve some degree of planning, indicative or otherwise," and constitute at "least a modicum of consistency in applying it." In further elaborating on the required domestic capacity of the federal state, Sharp adds, "One implication of the conception of deliberateness is that the strategy may have to entail a somewhat greater measure of government involvement than has been the case in the past."

The state's relationship to society is another important institutional aspect of the statist variant. Once again, France and Japan are instructive cases to consider. The development of state-societal networks in France and Japan has traditionally brought state officials in close contact with particular groups of firms, and through the practice of "administrative guidance" in the case of Japan or "indicative planning" in the case of France, state officials have been able to gain the acquiescence of the private sector—by offering incentives and disincentives—for the purpose of coordinating industrial change.[9]

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[9] In Japan, the state's relationship to society has been defined by the practice of "administrative guidance." Johnson refers to administrative guidance as "the authority of the government...to issue directives,

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This coordinative capacity of the state, as Weiss argues, is a crucial component of state capacity and is instrumental in producing industrial adjustment.[10] More important still, the attention paid to a state's coordinative capacity signifies that state strength is not solely based on insularity from particularistic interests, but is also derived from its ability to elicit the consensus of the private sector.

For the statist variant of the Third National Policy to be effective in a federal state, the existence of an institutionalized pattern of intergovernmental cooperation is necessary. To avoid the emergence of competing industrial adjustment strategies between the two levels of government, functional federalism is required. Simeon informs us about the difficulty in devising a coherent plan of action when intergovernmental relations are devoid of coordination and division of labor:

> We have a clash at two levels. At the level of the substance of industrial strategy, the questions are: Where development will take place; what sectors will be emphasized; and how the conflict between the desire for regional growth can be reconciled with the desire to promote redistribution and maximization of aggregate growth across the whole country. At the level of procedures there is the question of how such a reconciliation might be brought about, and who is the make industrial policy. Is it Ottawa alone, the provinces acting independently, or some combination.[11]

Under functional federalism, the central government formulates and decides on a national strategy of industrial adjustment, while the implementation and administration of

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requests, warnings, suggestions, and encouragements to the enterprises or clients within a particular ministry's jurisdiction." In France, the state has traditionally shaped the economy through the practice of "indicative planning," which is not dissimilar to administrative guidance. Shonfield defines indicative planning as "a system which relies on pointing out desirable ends rather than on giving orders to achieve them...[and works well] in a situation where there is a central core of important enterprises which are more responsive to the desires of the state than the ordinary private firm." See Chalmers Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975* (Stanford: Stanford University Press, 1982); and Shonfield, *Modern Capitalism*, p. 84.

[10] Linda Weiss, *The Myth of the Powerless State* (Ithaca: Cornell University Press, 1998).

[11] Richard Simeon, "Federalism and the Politics of a National Strategy," in *The Politics of an Industrial Strategy: A Seminar* (Ottawa: Science Council of Canada, March 1979), pp. 22-3.

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the strategy would take place in coordination with the provinces. Moreover, to facilitate consensus-building between the two levels of government on what goals a national adjustment strategy should pursue, the practice of cooperative federalism—widely used

Table 4.2. Institutional Structures (institutional characteristics that best fit each industrial adjustment strategy)

	Variants of Third National Policy	
Institutional arrangements	Statist	Liberal
Degree of centralization of decision-making power within the central government: coherence of bureaucracy; political executive-bureaucratic relations; bureaucratic discretion; dispersion of power	moderate to high degree: high degree of bureaucratic coherence; semiautonomous bureaucracy; strong, informal political executive-bureaucratic alliance; bureaucratic discretion; concentration of power in the executive	Low to moderate degree: medium degree of bureaucratic coherence; non-autonomous bureaucracy; shifting, delimited political executive-bureaucratic relations; limited bureaucratic discretion; diffusion of power in the executive.
Federal structure: relations between the central and provincial governments	functional federalism and cooperative federalism: emphasis on intergovernmental coordination	competitive federalism and lack of permanent channels to promote intergovernmental cooperation
Pattern of business-government relations	semi-autonomous bureaucracy is embedded in society so as to facilitate coordination of economic adjustment	arm's-length mode of interaction: business desires to retain its ability to make its own economic choices and laissez-faire tradition keeps the state largely disengaged
Organizational and instrumental capacities of state	state has the capacity to extract and mobilize economic resources to effect desirable industrial change; emphasis on capacity to mobilize consent	strategic extrication of the state from the economy and imposition of market governance; centrality of deregulation, liberalization, market allocation

in the post-1945 period to the late 1960s—must be renewed. Ideally, such an institutional forum should involve a small body of civil servants and political executives from each province and central government and provide the context in which they act upon the recognition of opportunities for the attainment of mutual interests. Such a structure

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should dispose officials from the orders of government to think in terms of what is in the best interest of the nation and what the economic purpose of the state should be, and subsequently undertake the task of drawing up a national strategy to improve the economic capabilities of the sum of constituent units, rather than sub-national economies.

This overview of the institutional requirements of the statist variant gives us an understanding of the extent and scope of the institutional innovations that the federal state had to undertake to match Canada's political structure with the tasks set out by the Third Option. At the end of the 1960s, few of these institutional features existed. The challenge in pursuing this adjustment strategy came in the form of institution building, particularly achieving institutional innovation in an existing institutional order whose logic fundamentally conflicted with that of the Third Option. As Chapters Five, Six and Seven show, although the federal state employed the relational power and meta-power political strategies to bring about the kinds of institutional changes required for pursuing this strategy, these institutional adaptations proved to be suboptimal because of the intractability of existing institutions as they were pushed to adapt to new ideas and tasks which were dissonant with existing ones.

The Liberal Variant (Continentalism)

The liberal variant of the Third National Policy or continentalism tackled the industrial adjustment problems by seeking to embed a system of market governance in society. Accordingly, the state interventionism of the Third Option was to be replaced by pro-market policy measures, such as deregulation, privatization, and liberalization. Unlike the statist variant, this strategy was more engaged at the international level. The use of the international arena to deal with the adjustment problems corresponded with the

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limited opportunities for problem solving at the domestic level; plus it signified that Canada's relative position in the North American continent had improved compared to the 1970s. In particular, as a solution to the adjustment problem, free trade gained support because the possibilities of generating both absolute and relative gains were more in Canada's favor than they had been before. It was recognized that with Canada's relative improvement in its position, it would be able to negotiate a political agreement with the United States which set up the kinds of coordinating and regulatory mechanisms that would ensure the preservation of Canada's distributional gains in the long run.

The liberal variant was based on the premise that the free trade solution was a means for solving Canada's externality problem, strengthen its autonomy and independence, and promote manufacturing activities and technological independence.[12] The liberal variant rebuffed the critics who argued that a bilateral free trade would inevitably undermine Canada's ability to assert its political independence and long-term national power. As Johnson notes, "Growing wealth gives both an increasing capacity for individual self- fulfillment and the resources necessary for the achievements of national objectives."[13] Similarly, Nossal summarizes the logic supporting the argument that free trade allows Canada to attain its political goals:

> A wealthier Canada would be better able to assert its independence and sovereignty. With a more rationalized, competitive and productive manufacturing sector, and an

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[12] A number of international relations theorists have noted that a state's interest in entering into a free trade arrangement is consistent with the conventional understanding that states define their interests in terms of power and wealth. For example, as Gilpin has remarked, "As the world economy has become more closely integrated, regional groupings of states have increased their cooperation in order to strengthen their autonomy, increase their bargaining position in disputes about distributive issues, and promote other political and economic objectives. Regionalization is a means to extend national concerns and ambitions...." See Robert Gilpin, *Global Political Economy: Understanding the International Economic Order* (Princeton: Princeton University Press, 2001), p. 357.

[13] Quoted in Kim Richard Nossal, "Economic Nationalism and Continental Integration: Assumptions, Arguments, and Advocacies," p. 80.

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> ever-increasing real income, the Canadian people and their government could...better 'afford' the measures required for the maintenance of the nation's independence and sovereignty.[14]

This logic held that with an improvement in its international position, Canada would be effective in securing a more balanced distribution of those gains affecting Canada's ability to attain its political and economic goals. Canada's bargaining leverage could be used to establish institutional rules and modes of interaction that secured a balanced division of positive gains derived from the free trade arrangement; compensate for the loss of independence by establishing procedures that gave Canada the opportunity to exercise political influence within the regional political framework; and redress those grievances arising from adverse shifts in the division of gains, in which case Canada could mount a challenge by employing the regional body's institutionalized remedial process.

As a market solution this strategy used to its advantage the thrust of the existing institutional order. In fact, the established political structure in Canada was more suitable to accommodate the institutional demands of this adjustment strategy. Ikenberry and Katzenstein argue that different types of state structure—such as decentralized or centralized political-administrative organization and the embedded autonomy or detachment of the state in relation to society—will have a profound effect on the type of policy instruments that will ultimately be selected by policymakers.[15] In particular, a state whose political-administrative structure is fragmented and decentralized, whose

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[14] Kim Richard Nossal, ibid., p 77.

[15] Ikenberry, *Reasons of State* and Peter Katzenstein, "Conclusion: Domestic Structures and Strategies of Foreign Economic Policy," in Katzenstein, ed., *Between Power and Plenty: Foreign Economic Policies of Advanced Industrial States* (Madison: University of Wisconsin Press, 1978).

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federal structure lacks channels to foster intergovernmental coordination, and whose relations with business is detached or 'unembedded,' will encounter huge obstacles as it seeks to expand its interventionist capacity in order to deal with the adjustment problem. But, the same state will be at an advantage if it seeks to extricate itself from the economy because it does not face network linkages that keep it entangled with societal groups; it can harness to greater effectiveness the already existing commitment of the state to market liberalism; and it can apply the market principle to the federal system, that is induce a coordinated process of competitive pro-market reforms among subnational governments and between the two levels of government.

The liberal variant of the Third National Policy was effective in harnessing the forces of competitive federalism to accomplish the objectives of this strategy. As an important institutional dynamic in the Canadian political order, competitive federalism was one of the principal institutional forces that had undermined the Third Option because it had impelled both levels of government to assume a proactive role in the economy without an appropriate intergovernmental framework to aggregate state capacities and create a coherent coalition of public power with which to effect economic change. Instead, the two levels of government pursued conflicting goals and intensified intergovernmental wrangling in a domain in which the constitution does not give either level exclusive jurisdiction and responsibility.

Under the strategy of continentalism, competitive federalism created an appropriate institutional setting in which to elicit consensus between central and provincial governments in regard to a coordinated withdrawal from their respective spheres of the economy. The liberal variant offered a way for both levels of government mutually to

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delimit their economic role under an international political arrangement such as a regional free trade agreement.[16] Also, the binding nature of such an institutional arrangement helped the two levels of government to overcome the problem of collective action, for both affirmed their commitment to such engagement from the beginning of the negotiations thus alleviating concerns about the possibility of cheating one's way out of mutual obligations. According to Simeon, the free trade arrangement put forth a political framework that facilitated coordinated withdrawal between provinces and the federal government from the economy.

> Any such treaty may well have the long-term effect not of strengthening either Ottawa or the provinces, but rather of constraining and limiting both, since the quid pro quo for the security of access we seek in the United States will undoubtedly be strong limitations on Canadian industrial and regional development policies, both federally and provincially.[17]

By exposing federalism to the institutional demands of the market it was expected that "market-preserving federalism" would emerge, whereby governments at both levels would compete against each other not by building their interventionist capacity as was experienced under the Third Option, but by offering the most attractive pro-market incentives.[18] In effect, market-preserving federalism was expected to provide a solution to the lack of institutionalized channels of intergovernmental cooperation since the mode of interaction would now be governed by a logic that placed a premium on the reciprocity

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[16] Ronald L. Watts, "The Macdonald Commission Report and Canadian Federalism," *Publius: The Journal of Federalism* 16 (Summer 1986), p. 185.
[17] Richard Simeon, "Considerations on Centralization and Decentralization," *Canadian Public Administration* (Fall, 1986), p. 458.
[18] Barry Weingast, "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development," *Journal of Law, Economic, and Organization* (1995).

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of government moves and incrementally lead them to withdraw from the economy where they once pursued competing policies.

The ideas and tasks of the liberal variant or continentalism proved to be more consistent with the existing organizational features of business-government relations and political-administrative relations. The analysis of the first two national policies in the previous chapter demonstrates that free market enterprise was well embedded within these two institutional structures. For example, the historical development of the business-government relationship in Canada since the late 1800s was marked by a path-dependent process, where the prevailing notion of free market enterprise fixed in place an arm's-length pattern of relationship between the two sets of actors after which a process of positive reinforcement between these structural realities and agency of policy makers has occurred. Although state control over the economy expanded throughout the 1900s, the institutionally-embedded free market enterprise idea set limits on the ability of the state to redefine its role in the economy beyond the accepted scope of maintaining the autonomy of the private sector.

Moreover, the decision of the federal state to formulate policies in accordance with the guidelines of market economics throughout the 1900s created a policy legacy that was much more appropriate for pursuing the goals of the strategy of continentalism. It can be argued that the fragmented organization and delimited authority of the federal state resulted from the ideational injunction about the purpose and form which state intervention should take in the economy. A minimal role called for limited interventionist capacity and obviated the need to build a centralized and coordinated economic decision-making apparatus. In many respects, the liberal variant of the Third

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National Policy tapped into this institutional logic thus making the existing institutional order much more appropriate for pursuing continentalism. At this point, it would be useful to put together the components of the two industrial adjustment strategies, as elaborated on in this chapter and the last section of chapter one. As table 4.3 illustrates, the two strategies have two dimensions: (1) an affiliation with a particular variant of the Third National Policy and (2) the location of adjustment actions. This gives rise to four types of adjustment action plans.

Table 4.3. Adjustment Strategies

	Domestic	International
Third Option (Statist Variant)	Gatekeeping (FIRA & NEP) Economic Planning	Diversification
Continentalism (Liberal Variant)	Market deregulation Privatization	Continental Free Trade (CUFTA and NAFTA)

In the following chapters I seek to analyze the differences in the institutional situations that emerged when the federal state pursued the Third Option and continentalism. The first institutional situation corresponding with the Third Option depicts a set of institutional dynamics that is resistant to institutional adaptation while the other situation, created by the implementation of continentalism, illustrates a set of dynamics that is receptive to adaptation. I maintain that the first institutional situation—institutional resistance—is denoted by three characteristics. The first characteristic of institutional resistance is the circuitous pattern in which the implementation of an economic adjustment strategy is pursued. Rather than a self-reinforcing, linear pattern of

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implementation, institutional resistance causes government officials to resort to a series of discontinuous policy actions.

Second, institutional resistance arises from the opposition of institutional actors as they seek to preserve their advantages derived from the existing institutional order. Lastly, and linked to the first two characteristics, institutional resistance is illustrated by the erosion of initial policy objectives and the tendency to settle on the lowest-common denominator solution. Importantly, the trajectory of the three programs of the Third Option have culminated in outcomes that have tended to pave the way for the adoption of the strategy of continentalism.

I argue that institutional receptiveness is demonstrated by the occurrence of the following three characteristics. First, the problem of adjustment is dealt with in accordance to a course of action that is self-reinforcing and linear. This is reflective of the institutionalization or consolidation of policy changes, a process that failed to occur when the Third Option was implemented. Second, institutional receptiveness is represented by a shift in the behavior of important institutional actors, namely from being opponents to advocates. Such a behavioral change is caused when actors recognize that the distributional consequences of proposed institutional innovation are Pareto optimal. Finally, institutional receptiveness is illustrated when state actors are not forced to water down initial policy objectives; instead they encounter an institutional home that facilitates the fulfillment of original policy goals.

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CHAPTER FIVE

THE LIMITS OF DIVERSIFICATION

Diversification was the Third Option's foreign policy idea of addressing Canada's adjustment problem. Although diversification shares some similarities with multilateralism, diversification is different to the extent that it seeks to reduce a country's vulnerability to the actions of a country with which it is deeply linked economically and or politically. When President Nixon announced in 1971 that the United States would seek to advance its national interests more overtly, Canada feared that relations with its neighbor would change for the worse. This forced Canada to create counterweights in order to balance out the country's heavy reliance on the United States. Europe and Japan, in particular, became the focus of Canada's diversification policy.

In this chapter I will explore the efforts of the Canadian government to pursue diversification, explain why diversification failed to create effective counterweights, and explain why renewed multilateralism, as an approach to redress the adjustment problem, succeeded and paved the way for the shift to continentalism in the 1980s. Despite the fact that Canada was a state with modest power capabilities and limited leverage, it was able to secure favorable terms in the collaborative arrangements it negotiated with the European Community and Japan.

In this chapter, I argue that the limits of diversification arose from one major source. The federal state was unable to gain the support of the business community on the policy of diversification. The arm's-length business-government relationship and the limited export promotion capacity of the federal state combined to limit the ability of the state to influence the export habits of the Canadian business community in a way that

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attained the goal of diversification. Ottawa was unable to achieve the kind of institutional adaptation required to pursue the diversification policy, in particular establishing a consultative mechanism through which to mobilize business consensus and coordinate a plan by which to undertake an export drive. This posed a major obstacle to the diversification policy because its success depended on the collaboration of the private sector. Ottawa's efforts to compensate for its lack of organizational capacity proved unsuccessful to accommodate the task set out in the diversification policy. Moreover, Canada's ability to effect a significant change in the country's pattern of trade and investment was beset by such market costs as transaction costs, information asymmetries, and late market entry. Given the limited export promotion capacity of the state, private sector actors were unable to receive the kind of export assistance to overcome these market costs.

The turn toward multilateralism reflected Ottawa's recognition that it could not overcome domestic opposition to the policy of diversification. However, domestic interest in seeking greater multilateral trade liberalization led Ottawa to renew its efforts to seek a favorable multilateral agreement in the Tokyo Round of the General Agreement on Tariffs and Trade that began in 1973. Realizing that Canada's interests would be better served by entering into a dialogue with the business community and the provinces, Ottawa established a consultative and coordinative framework that provided direction for Ottawa during the Tokyo Round of the General Agreements on Tariffs and Trade and helped secure domestic support for the new international policy. Furthermore, the shift toward renewed multilateralism signified that Canada's efforts to minimize its economic dependence on the United States would be better served not by creating counterweights

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but by subscribing to the principle of 'safety in numbers,' a formula whereby "power matters less, rules matter more, and supportive coalitions can be engineered."[1] Canada's confidence in the success of this strategy also stemmed from the fact that Ottawa had experience in the art of multilateral trade negotiations.

THE THRUST TOWARD DIVERSIFICATION

Canada had never been too vulnerable to American actions until President Nixon announced in 1971 a series of economic measures that threatened to put the bilateral economic relationship on a path where it would no longer be certain that Canada could maintain the benefits it had gained from its economic ties with the United States. The concern with the tendency of letting go unchecked Canada's economic dependence on the United States had been addressed in *Foreign Policy for Canadians*, a white paper published in 1970 which discussed the results of a special review of Canada's foreign policy that was launched in May of 1968 by Prime Minister Trudeau. The White Paper summed up Canada's international situation as follows:

> ...Canada's particular situation [the fact that it is in the shadow of United States' economic and political influence] requires a certain degree of self-reliance and self-expression if this country is to thrive as an independent state.... The key to Canada's continuing freedom to develop according to its own perceptions will be the judicious use of Canadian sovereignty whenever Canada's aims and interests are placed in jeopardy....[2]

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[1] Denis Stairs, "Change in the Management of Canada-United States Relations in the Post-War Era," in Donald Barry, ed., *Toward a North American Community?: Canada, the United States, and Mexico* (Boulder: Westview Press, 1995), p. 54.

[2] Canada, Secretary of State for External Affairs, *Foreign Policy for Canadians* (Ottawa: Queen's Printer, 1970), pp. 38-39. In an insightful assessment of the 1970 White Paper, von Riekhoff summarizes the document's primary objectives addressed as follows: First, "the desire to adjust foreign policy objectives to a more modest and pragmatic scale and to attune them to domestic political needs;" second, "to strengthen national independence by broadening Canadian contacts with other regions;" third, to assert Canadian sovereignty; and finally, "to meet the challenges which face industrial societies through adaptive behavior." See Harald von Riekhoff, "The Recent Evolution of Canadian Foreign Policy: Adopt, Adapt and Improve," *The Round Table* 245 (January 1972), p. 71.

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No major foreign policy changes, however, were made in response to the White Paper. The import tax surcharge that the United States imposed in August 1971 followed by United States' unwillingness to grant Canada an exemption after a series of diplomatic attempts by the Canadian government, provoked strong reactions in Canada.[3] The 'Nixon shock' demonstrated how risky it was for Canada to depend on the goodwill of the United States, especially when the American market took in about 65 percent of Canada's exports at the time. As the Principal Secretary to Prime Minister Trudeau Thomas Axworthy pointed out, Canada's perception of increasing vulnerability had to do with the fact that "most of the trade eggs were in one large basket."[4]

Officials in Canada were firmly of the view that Canada had least contributed to the problems the United States was seeking to resolve and therefore that Canada should be excluded from the Nixon measures.[5] In responding to the American suggestion that Canada should limit itself to exporting natural resources to the United States, External Affairs Minister Sharp forcefully stated,

> Canada...has built a balanced and successful industrial and trading economy. I can assure you that Canada is determined to continue on the course it has set for itself. Suggestions from responsible authorities in the United States that Canada should reduce its secondary manufacturing industry and concentrate on the exploitation and processing of natural resources are insensitive as they

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[3] During these bilateral exchanges, the Canadian government, not knowing what the impact of United States' economic measures would be on the Canadian economy, tactically used inflated figures to try to soften the Americans into granting Canada an exemption. In the end, Nixon's measures did not inflict severe costs on the Canadian economy and eventually accommodations were made between the two governments.

[4] Thomas Axworthy, "To Stand Not So High Perhaps but Always Alone: The Foreign Policy of Pierre Elliot Trudeau," in Axworthy and Pierre Trudeau, eds., *Toward A Just Society* (Toronto: Penguin Books, 2000), p. 79.

[5] A day after Nixon announced his economic program, Sharp noted that if the measures "are supposed...to induce countries to change their unfair exchange rates or to remove discriminatory restrictions against American imports...we're not guilty on either count." Quoted in Peter Dobell, *Canada in World Affairs, Volume XVII, 1971-1973* (Toronto: Canadian Institute of International Affairs, 1985), p. 15.

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are uninformed.[6]

Having recognized that Canada would not receive an exemption, the Canadian cabinet toward the end of August 1971 requested that the Secretary of State for External Affairs Mitchell Sharp assess the state of the bilateral relationship and explore the feasibility of alternative policy options. Toward the end of September, Sharp submitted a memorandum to the cabinet, in which three options were identified as possible strategies to direct Canada's policy toward the United States. The three options were: first, "to maintain more or less our present relationship with the United States;" second, "move deliberately toward closer integration with the United States;" and third, "pursue a comprehensive, long-term strategy to develop and strengthen the Canadian economy and other aspects of our national life and in the process to reduce the present Canadian vulnerability."[7] After assessing each option, the cabinet chose the third option.[8] The first and second options were rejected on the grounds that each risked pushing Canada closer into the American orbit and did not offer political solutions to the problem of vulnerability. Moreover, while the options paper made clear that the first two options made economic sense, they were rejected on the grounds that Canada lacked the necessary power leverage to change the pattern of bilateral economic ties in Canada's favor.

The Third Option proposed that a policy of diversification was Canada's best

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[6] Quoted in Peter Dobell, *Canada in World Affairs*, p. 19.
[7] Mitchell Sharp, "Canada-U.S. Relations: Options for the Future," *International Perspectives* (Autumn 1972), p. 13.
[8] The options paper authored by Sharp never assumed the status of a government white paper. Instead, released in the 1972 autumn issue of the journal *International Perspective*, published by the Department of External Affairs, the paper served more as a think-piece among government officials and the public, and the paper's endorsement of the third option reflected the intellectual climate of Trudeau's Liberal government. Accordingly, a number of Trudeau's policy initiatives were consistent with the third option.

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foreign policy option to deal with its adjustment problems. Two factors shaped Ottawa's views on diversification. First, diversification was not understood to be a panacea for Canada's economic dependence on the United States. Diversification was recommended not because Canada could not achieve the volume of economic gains it desired through the relationship of economic dependence with the United States but rather because of the concern among government officials that the current state of the relationship risked undermining Canada's ability to assert its political independence and strengthen its economic autonomy. As Sharp pointed out in 1972 before the Chamber of Commerce in Buffalo, New York:

> For Canada, there is not, and will not be, any substitute for the market this country represents. Canadian prosperity depends on access to the American market. But I think that, if there is one thing Canadians and Americans agree about, it is that Canada should remain free, sovereign, and independent. Diversification of relations does not imply disengagement from our community of interest with the United States."[9]

Diversification was motivated more by political calculations than by economic ones. To the extent that Canada pursued a policy of diversification, it was not so much designed to disentangle the two countries as to balance out the asymmetry of bilateral interdependence by creating counterweights. Europe and Japan were singled out as strategic markets that would enable Canada to diversify its patterns of trade and investment.

The second factor guiding the thinking of policy makers on diversification concerned the need to pursue this policy systematically and over a long period of time.

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[9] Department of External Affairs, *An Address by the Secretary of State for External Affairs, the Honourable Mitchell Sharp, to the Buffalo Area Chamber of Commerce, Buffalo, New York*, Statements and Speeches, May 9, 1972.

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Diversification, as Stairs observes, was an "act of will, in defiance of fate."[10] Indeed, previous attempts to diversify Canada's economic ties had produced meager results. For example, little came of Prime Minister John Diefenbaker's national development policy of 1958 in which he proposed to increase exports of manufactured products and lessen Canada's reliance on the American market as the major destination for Canadian exports and foreign supplier of investment capital in Canada. Diefenbaker's plan to divert 15 percent of Canada's trade from the United States to Great Britain and to increase trade with the Commonwealth never materialized.[11]

If anything the trend toward trade deepening with the United States continued unabated. In 1970, 64.4 percent of Canadian exports went to the United States, up from the 55.8 percent in 1960. Exports to Western Europe reached 16.5 percent in 1970, down from 25.8 percent in 1960. A similar trend appeared with respect to imports. In 1960, 67.3 percent of Canadian imports came from the United States compared to the 16.1 percent from Western Europe; in 1970, the figures were 71.3 percent and 11.2 percent, respectively.[12] If past trends offered any advice to policymakers involved in the implementation of the diversification policy it was that creating counterweights for the purpose of generating countervailing influences to the strong American economic embrace would "take time to materialize," require "a conscious and deliberate effort" in

[10] Bothwell refers to the policy of diversification and more generally to the Third Option as "an attempt to secure the triumph of politics over geography." Robert Bothwell, "The Canadian Connection: Canada and Europe," in Norman Hillmer and Garth Stevenson, *Foremost Nation: Canadian Foreign Policy and a Changing World* (Toronto: McClelland and Stewart, 1977), p. 35.
[11] Michael Hart, *A Trading Nation: Canadian Trade Policy from Colonialism to Globalization* (Vancouver: University of British Columbia Press, 2002).
[12] Michael Howlett, Alex Netherton, and M. Ramesh, *The Political Economy of Canada: An Introduction* (Don Mill, Ontario: Oxford University Press, 1999), p. 112.

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the application of statecraft in order to "put and maintain the Canadian economy on such a course."[13]

'Linking Up' With Europe and Japan

As an idea, Atlanticism has always had an influence in shaping Canadian foreign policy since the late 1800s. For some, the Atlantic idea refers to the notion that Canada and Europe share historical ties and common values; for others, it alludes to the triangular relationship linking Canada, Europe, and the United States through which they have pursued their common interests; for others still, Atlanticism refers to Canada's quest to project its influence and secure its relative position within those institutions that bind states on both sides of the Atlantic.[14] In short, although Canada has been drawn ever more deeply into the American orbit over the course of the twentieth century, Europe has always figured prominently in Canadian foreign policy.

It came as no surprise therefore when the White Paper homed in on Europe as a market Canada could turn to in order to balance its relations with the United States. As a basis for deepening their economic ties, Canada attempted to draw a parallel between the concerns of Europe and Canada resulting from the vulnerability both were facing because of the lopsided relationship they maintained with the United States. According to the White Paper, "The maintenance of an adequate measure of economic and political independence in the face of American power and influence is a problem Canada shares

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[13] Sharp, "Canada-U.S. Relations: Options for the Future," p. 17. It is interesting to note that although the Third Option paper makes a strong case for diversification, it is quite short on how to go about diversifying Canada's trade relations. In fact, it does not mention Europe and Japan as likely counterweights. Instead, it is the 1970 White Paper which sheds light on this issue, in particular, making the case concerning why Europe and Japan should become the focus of Canada's policy of diversification.

[14] Kim Richard Nossal, "Un pay européen? L'histoire de l'atlantisme au Canada," in John English and Norman Hillmer, eds., *Making a Difference? Canada's Foreign Policy in a Changing World Order* (Toronto: Lester Publisher Limited, 1992).

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with the European nations, and in dealing with this problem there is at once an identity of interest and an opportunity for fruitful cooperation."[15] But there was another factor that pushed Canada to strengthen its economic relations with Europe. Britain's entry into the European Community in 1973 was of concern because it would doubtless affect Canadian relations with its European partner. After studying the impact of British entry into the European Community, the Senate Standing Committee on Foreign Affairs reported that such a move "would throw a greater burden of adjustment on Canada than on any other country outside the enlarged EC."[16] It was estimated that over $600 million (approximately 4 percent) of Canadian exports to Britain would be affected by changes in the terms of market access.

During the five years it took to arrive at the 'Framework Agreement for Commercial and Economic Cooperation" with the European Community in July 1976, Canada insisted on attaining three key objectives. First, Canada sought to create an institutional framework which would facilitate closer economic ties with the European Community. However, there was much vagueness about the substance of the agreement Canada was seeking, a factor that contributed to Europe's lack of interest and polite indifference to Canada's diplomatic initiative. Absent a 'big idea' to catch the attention of Europe, Canada made several unsuccessful diplomatic overtures until it finally arrived at a design that gained the support of the European Community.[17]

The second objective was to obtain a collaborative arrangement which enhanced

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[15] Secretary of State for External Affairs, *Foreign Policy for Canadians: Europe*, p. 14.
[16] The Standing Senate Committee on Foreign Affairs, *Canadian Relations with the European Community* (Ottawa: Queen's Printer for Canada, 1973), p. 2.
[17] E.E. Mahant, "Canada and the European Community: The First Twenty Years," *Journal of European Integration* 4 (1981), p. 272.

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Canadian opportunities to increase exports of secondary manufactured goods and increase industrial cooperation with Europeans. Fundamental to this goal was the desire to dispel the view among European governments that Canada should serve as Europe's supplier of natural resources. Ottawa sought an arrangement that did more than produce mutually positive gains; it sought to secure those provisions that would directly assist in domestic efforts to strengthen Canadian manufacturing capacity.

Lastly, Canadian negotiators insisted that Europeans recognize Canada as having a set of interests which was distinct from that of the United States. Sharp noted,

> Outside this country, I have sometimes found an assumption that that Canada should fall naturally and inevitably into the U.S. orbit. this is perhaps understandable, but it is unacceptable to Canadians. It is contrary to the Canadian Government's basic policy of a relationship "distinct from but in harmony with" the United States. Canada's relationship with Europe is not the same as the United States' relationship with Europe. Perhaps, in relative terms, our relationship is more important to us than the United States' relationship with Europe is to the Americans.[18]

To Ottawa this was important for the obvious reason that there were real differences of interests between the United States and Canada, but more so because Ottawa wished to avoid finding itself in an embarrassing situation where the European Community felt it needed to consult with the United States before it agreed to enter into a cooperative arrangement with the Canada. For Canadian negotiators, it was important to make clear to the Europeans that how Canada conducted its foreign economic policy was the concern of none other than Canadians.

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[18] *Statement by External Affairs Minister Mitchell Sharp to the Conference on Canada and the European Community in Ottawa* (November 2, 1973).

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Negotiations started off slowly. In April of 1971, Sharp visited Brussels to explore with the European Community ways to achieve the 1970 White Paper's recommendation that Canada establish "appropriate consultative arrangements which will take account of mutual Canada-EEC interests." By December of that year, it was agreed by both sides that bilateral consultations would take place twice a year. The negotiations progressed at a very slow pace, however, even with this recent diplomatic breakthrough.

As a petitioner, Canada faced two initial obstacles in its efforts to gain the interest of Europeans in strengthening bilateral ties. First, although trade between the two was of some significance, the Europeans needed the United States more than they needed Canada. Consequently, while Europeans came to the realization after the Nixon shock of August 1971 that Canada should be differentiated from the United States, they were concerned about what effect a bilateral agreement with Canada would have on their relations with the United States. This concern came to a head when reports surfaced indicating that the United States was pressuring some European governments to block Canadian proposals. Second, Trudeau's 1969 decision to cut the number of Canadian troops stationed in Europe under the umbrella of the North Atlantic Treaty Organization was not well received by the Europeans, for it was interpreted as an attempt on Canada's part to place its self-interest above the common security interests of NATO. Moreover, the Europeans were perplexed about Canadian intentions for Ottawa was announcing it wanted militarily to withdraw from the continent but at the same time it sought to deepen economic ties. The view across European capitals was, if Europe was a Canadian foreign policy priority then Ottawa had to devote a full range of national

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resources to back this claim, which meant being militarily and politically engaged in the continent.

An opening occurred in November 1973 when the European Community requested that Canada make its intentions known on the nature of closer economic ties. In April 1974, the Canadian government delivered a proposal calling for the initiation of negotiations "with the appropriate Community institutions with a view to concluding a trade agreement [that would] effectively underpin the contractual relationship with the Community which is currently based on common adherence to the General Agreement on Tariffs and Trade."[19]

The proposal received a cool reception by Europeans. Two factors contributed to this outcome. First, the Europeans regarded Ottawa's proposal to be too vague for their taste and feared that the proposal would undermine the General Agreement on Tariffs and Trade framework even though Canada underlined that the contractual relationship would comply with the rules and principles of the multilateral trade regime. Second, in the face of the energy crisis of 1973, the Europeans were more interested in exploring ways to make the goal of stabilizing the supply of energy the basis for pursuing closer bilateral economic relations.

Ottawa was not prepared to give Europeans access to Canadian natural resources. Conveying this point after a visit to Europe in 1974, Trudeau remarked that "we are telling the Europeans bilaterally and as a community: you may think you are going to be able to take all our raw materials out, but you aren't."[20] Nevertheless the Prime Minister

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[19] Quoted in J.L. Granatstein and Robert Bothwell, *Pirouette: Pierre Trudeau and Canadian Foreign Policy* (Toronto: University of Toronto Press, 1990), p. 164.
[20] Leo Ryan, "Resources are Trudeau's lever for trade agreement with EEC," *Globe and Mail* (October 26, 1974), p. B2.

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was willing to employ resources as a bargaining chip to gain the acquiescence of reluctant Europeans. "We are defining our energy and natural resources policies and if you want to get in there, you'd better embark on this process of negotiations," Trudeau pointed out.[21] Moreover, to strengthen their case, Canadian negotiators were not shy about making clear what would be the consequences of a failure to deepen economic ties. As Kinsman put it, "The alternative to the success of Canada's third option could be a North American economic bloc dominated by the U.S. economy that would...reduce the possibilities of EEC access to Canadian industrial markets and energy resources in conditions of increasing scarcity."[22] If anything good came of these diplomatic exchanges it was that the Europeans were beginning to take Canada more seriously. Aside from the effective pressure tactics, Ottawa's renewed interest in NATO by 1973 certainly figured in Europe's change of view toward the diversification policy of Canada.

In March 1975, Trudeau delivered a proposal with which the Europeans were more content or at least willing seriously to consider. Up to now, although there was recognition of opportunities for achieving common interests, differences over how to translate them into an agreement prevented the two sides from making headway. Almost a year after the Europeans had rejected the Canadian proposal to enter into a bilateral trade agreement, Trudeau spent over two weeks visiting different European capitals attempting to gain support for his proposal to develop a "contractual link." Trudeau laid out the logic underpinning his decision to proceed with this plan as follows:

> [It is] the desire of Canada to enter into a contractual relationship with the Community—one that would ensure that both the Community and Canada would keep the other informed, would engage regularly

[21] Ibid.
[22] Jeremy Kinsman, "Pursuing the realistic goal of closer Canada-EEC links," *International Perspective* (January/February 1973).

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> and effectively in consultation, would not consciously act to injure the other, would seek to co-operate in trading and any other activities in which the Community might engage. Because we do not know... how far or how fast [Europe's] experiment in integration will take it, or what form it will assume on arrival, no overall agreement can be laid in place at this time. But what can be done is to create a mechanism that will provide the means (i.e., the "link") and the obligation (i.e., "contractual") to consult and confer, and to do so with materials sufficiently pliable and elastic to permit the mechanism to adapt in future years....[23]

On June 25, 1975, in a unanimous decision, the Council of Ministers gave a mandate to community officials to negotiate a framework agreement with Canada. However, the Community did not form a common front, for Britain and France—both of which were concerned about preserving their prerogative to maintain and deepen their individual economic ties with Canada—were less enthusiastic than Belgium and Germany were about entering into negotiations.[24] By October, however, Britain and France had come around and notwithstanding Denmark's request that Canada give Europe equal access to its energy resources—which it eventually withdrew—the negotiations were brought to a successful conclusion in early June and culminated on July 6, 1976 to the signing of the Framework Agreement for Commercial and Economic Cooperation.

The Agreement was the product of Canadian efforts to institutionalize a consultative mechanism to facilitate economic cooperation with the European Community. The Joint Co-operation Committee (JCC), established under Article IV of the Framework was given the mandate "to promote and keep under review the various

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[23] Canada, Department of External Affairs, "The Contractual Link—A Canadian Contribution to the Vocabulary of Co-operation," Remarks by Prime Minister Pierre Elliot Trudeau at the Mansion House, London, England, *Statements and Speeches*, No. 75/6 (March 13, 1975), pp. 4-5.

[24] In response to their concern, Article III (4) of the Framework Agreement for Commercial and Economic Cooperation states that "the present Agreement and any action taken thereupon shall in no way affect the powers of the Members States of the Communities to undertake bilateral activities with Canada in the field of economic co-operation and to conclude, where appropriate, new economic co-operation agreements with Canada."

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commercial and economic co-operation activities envisaged between the Communities and Canada." Allan MacEachen, then Secretary of State for External Affairs, remarked during the signing of the Framework that the JCC would be in charge of infusing the agreement with life. In particular, the JCC was to play an important role in helping the business communities of Europe and Canada achieve broader interfirm links, such as joint ventures; greater involvement in the industrial development; higher levels of mutually beneficial investment; and exchange of technology and scientific knowledge. Moreover, the Framework represented a collaborative arrangement which ensured a balanced division of mutually positive gains between the European Community and Canada, one which enabled Canada to export a full range of products, from primary and secondary manufactured. Cadieux remarked that a mutual understanding with the Europeans underpinned the bilateral agreement, which affirmed that Canada had "reached the stage where [it wished to] export semi-finished or fully-finished material" and that "classical nineteenth-century deals involving the mere export of unprocessed raw materials are behind us."[25]

Canada's "contractual link" with Japan resembled the one struck with the European Community. Just as the Canada-EC agreement was owed to Canadian diplomacy and Trudeau's personal involvement, so was the agreement between Canada and Japan. Its in diplomatic efforts, however, Canada did not have to resort to linkage politics as it had done in order to secure an agreement with the European Community. Nevertheless, it took sustained efforts to persuade Japan to purchase more Canadian manufactured goods

[25] Department of External Affairs, "The Contractual Link: why and How?," Address by Mr. Marcel Cadieux Ambassador of Canada to the European Communities, to the Canadian Institute of International Affairs, Toronto, November 24, 1976. *Statements and Speeches* No. 76/33.

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and to undertake more capital-intensive investments in Canada. During the Pacific Basic Economic Cooperation Council meeting in Vancouver in May 1971, the Minister of Industry, Trade, and Commerce Jean-Luc Pépin called upon the Japanese government to ease access to Japanese markets for Canadian manufacturing as well as to encourage Japanese businesses to increase their participation in processing and manufacturing activities in Canada. Again, the same message was communicated by the new Minister of DITC, Alastair Gillespic during a visit to Tokyo in September 1973. Gillespie "called for the purchase of Canadian fully manufactured and high technology goods...[and] also called for Japanese investment in Canada using Canadian management, labour, equity participation, and local supplies and equipment to upgrade Canadian resources."[26]

In 1975, the Japanese government accepted a Canadian offer to enter into a "partnership" in joint ventures for the purpose of processing Canadian natural resources with the objective of encouraging the "relocation of Japanese industries abroad, and thus ensure supply for Japan and assured access for Canadian processed and fabricated goods in Japan."[27] With the breakthrough in EC-Canadian negotiations in 1976, Secretary of State for External Affairs Allan MacEachen sought to accomplish a similar arrangement with Japan. MacEachen suggested to Prime Minister Trudeau that he deliver a proposal calling for the negotiation of a framework agreement similar to the one signed with the Europeans during his scheduled visit to Japan in October. On October 21, 1976, the two sides signed the Framework for Economic Cooperation. A Joint Economic Committee, headed by the foreign ministers in both countries, was created and given the mandate to

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[26] Frank Langdon, "Problems of Canada-Japan Economic Diplomacy in the 1960s and 1970s: The Third Option," in Keith Hay, ed., *Canadian Perspectives on Economic Relations with Japan* (Montreal: the Institute for Research on Public Policy, 1980), p. 81.
[27] Ibid., p. 79.

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expand bilateral trade, increase investment, and encourage technological and scientific exchanges.[28]

Act of Will, But Not in Defiance of Fate

Political will coupled with effective statecraft are what enabled Canada eventually to establish framework agreements with Europe and Japan despite the initial odds working against Canada; domestic institutional resistance as well as the obstacles created by market failures and geography combined to prevent the development of two effective counterweights over time.

From the beginning, Canadian officials recognized that the success of the diversification policy would depend on Ottawa's ability to get the business community aboard. The institutional hurdles with which Ottawa was confronted were influential in shaping the negotiator's decision to devote few resources to and delay the process of business-government consultation. The optimal political strategy would have been to build and harness the federal state's adjustment capacity and to strengthen its export promotion capacity. With such capacities, the federal state would have launched consultations with the Canadian business community at the outset of the negotiations with Europe and Japan as a way to mobilize consensus among business interests and to coordinate an export strategy that would have the effect of spurring an export drive to the two markets. The success of a coordinated export strategy would rest on the abundant provision of export promotion incentives which the federal state would administer selectively to achieve the state's diversification objective.

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[28] J.L. Granatstein and Robert Bothwell, *Pirouette: Pierre Trudeau and Canadian Foreign Policy* (Toronto: University of Toronto, 1990), p. 174.

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This type of institutional transformation and expansion of federal state capacity, however, reached in excess of what the existing institutional framework could accommodate. The arm's-length pattern of business-government relations, the decentralized structure of business, the limited resources that Ottawa could bring to bear on export promotion, and the high market costs that Canadian business faced by expanding to Europe and Japan were part of the institutional and structural obstacles that prevented Ottawa from undertaking the optimal course of institutional adaptation and consequently contributed to the failure of the diversification policy. As Axworthy notes, "To change the individual decisions of thousands of exporters [was] beyond the [government's] power. [T]he ability of government to redraw trading patterns was too limited to turn the diversification goals of the Third Option into a reality."[29]

The lack of consultative and coordinative efforts between Ottawa and the business community reflected the institutional realities between the two actors, that is the existence of arm's-length relations where business autonomy was reinforced by limited government interference in business affairs. The few consultative measures that took place occurred in an ad hoc fashion. The view in Ottawa, however, was that if negotiators produced a favorable bilateral agreement then Canadian entrepreneurs would automatically use its provisions to expand their business to Europe and Japan. A few months after signing the Framework Agreement with the European Community, Cadieux remarked that having laid down an economic framework "it will be up to the entrepreneurs, the investors, the financiers, the bankers to see what can be done to

[29] Thomas Axworthy, "To Stand Not So High Perhaps but Always Alone: The Foreign Policy of Pierre Elliott Trudeau," p. 80.

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develop our relations with Europe...."[30]

However, Ottawa did take certain measures designed to create positive inducements. For example, Article III (3) of the framework agreement negotiated between Canada and the European Community was designed to induce Canadian business to increase trade with Europe by facilitating the exchange of information regarding commercial opportunities and encouraging such economic activities as joint ventures, direct investment, exchange of expertise and technological information with their European counterparts. But it became clear that this provision had a minimum effect on the export patterns of Canadian firms, which forced Ottawa to make some headway in establishing a consultative mechanism through which it could influence the business community. The Department of Industry, Trade, and Commerce arranged a series of seminars under the title "Perspective on Western Europe" which were offered in conjunction with Enterprise Canada 77, a consultative initiative aimed at achieving a closer relationship between the private sector and the government.[31] In the final analysis, these efforts failed to change the export habits of the private sector.

It was also clear that both the decentralized structure of business and the market logic which guided their decisions combined to dissuade Canadian entrepreneurs from exploiting the opportunities offered in the Framework Agreements. Even before the Framework Agreement was signed with Japan, it was clear that Canadian business lacked the organizational capacity to mount a strategy to sell Canadian products to Japan. Langdon, for example, has observed that during a trade mission in January 1972 led by

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[30] Marcel Cadieux, "The Contractual Link: Why and How?," p. 5.
[31] Government of Canada, Department of Industry, Trade, and Commerce, *Annual Report, 1977-1978* (Ottawa: Supply and Services Canada, 1978), pp. 4-5 and 15-17.

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Pépin, in which the objective was to sell nuclear reactors and aircraft, "the businessmen ...were not...organized and prepared for the sort of high-powered approach being urged on them by the Cabinet minister."[32] As a result, both the Canadian government and the Japanese businessmen undertook the initiatives to complete the transaction.

Perhaps more important was the high market costs that the Canadian business community faced by seeking to expand into Europe and Japan. The interaction between Canadian and American firms, dating back to the early 1900s, had the effect of creating similarities in business practices, from marketing to production methods to technology use to management systems. Fundamentally, decades of cross-border business contacts and bilateral economic ties had contributed to the development of two national systems of economic institutions that were highly compatible with one another which in turn had contributed to lowering transaction costs and solving the problem of information asymmetries that any firm faces when engaging in international trade. As the Economic Council of Canada pointed out in a 1975 report, "Canadians are better able to develop systems of business operations in the United States than in Europe, because they are more attuned to U.S. institutions, practices, and even habits of thought."[33] The difficulty in overcoming market failures and in penetrating a group of markets in which the level of competition was high proved too much for most Canadian businesses to accept. As one Canadian businessman noted, not only were Europeans not interested in importing Canadian manufactured goods, but the transaction costs facing a Canadian exporter were

[32] Frank Langdon, "Problems of Canada-Japan Economic Diplomacy in the 1960s and 1970s: The Third Option," p. 79.
[33] Economic Council of Canada, *Looking Outward: A New Trade Strategy for Canada* (Ottawa 1975), p. 97.

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higher than what many of them cared to incur just to gain a foothold in a foreign market without a guarantee of success.[34]

The lack of export promotion capacity of the federal state also contributed to the reluctance of the Canadian business community to take advantage of the two Framework Agreements. Granatstein and Bothwell remark that "corporations had waited for Ottawa to offer incentives to encourage their efforts in Europe and Japan, but there were no tax breaks, no export incentives, and no subsidies to encourage research and development aimed at world markets."[35] Indeed, this message was echoed in the Final Report of the Export Promotion Review Committee.

The 17 member committee, all of whom came from the private sector, was established in December 1978 by the Minister of Industry, Trade, and Commerce and given the task of assessing the effectiveness of the government's current export promotion programs.[36] In its report, the committee remarked that such government services as export marketing and promotion, export financing and insurance, the trade-foreign aid interface, and export taxation policy were inadequate to the extent that the programs did not provide sufficient resources to assist the private sector in its efforts to diversify exports. As the Hatch Report pointed out, "Relative to other leading nations, not only is business-government coordination deficient, but also coordination between the various federal agencies that represent Canada abroad and between federal and

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[34] Conversion with Giovanni Di Sclafani, President of the Bureau D'Affaires Internationales Inc., Montreal, Quebec., December 29, 2001.
[35] J.L. Granatstein and Robert Bothwell, *Pirouette: Pierre Trudeau and Canadian Foreign Policy* (Toronto: University of Toronto Press, 1990), p. 176.
[36] Final Report of the Export Promotion Review Committee, *Strengthening Canada Abroad*, November 30, 1978. This report is commonly referred to as the Hatch Report, named after the chairman of the committee, Robert E. Hatch, President of Canpotex Ltd..

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provincial governments."[37] With respect to the Export Development Corporation, which was established in 1969 to provide finance and insurance to assist Canadian export trade, the report made the following observation:

> At the heart of the [export promotion] problem is the fact that the [Export Development Corporation] does not, cannot and will not subsidize exports. It simply is not set up for it. Of greater importance are criticisms about the lack of international competitiveness in medium-term financing, the absence of short-term financing for small exporters, the lack of involvement of the commercial bank.... If Canada is to move aggressively to increase her exports, it is essential that we realize how the competitive game is played by other nations.[38]

The decentralized and fragmented structure of the government-business relationship and the delimited scope of the government's instrumental capacity with respect to export promotion were significant obstacles that prevented the implementation of the diversification schemes. In addition, internal bureaucratic struggles undermined the policy of diversification. At issue was the clash of interests between the Department of External Affairs on the one hand and the Departments of Finance and Industry, Trade, and Commerce on the other. The 1970 White Paper had emboldened the Department of External Affairs to expand its field of interest into Canadian foreign economic policy, a policy field that had traditionally been led by Finance, the Bank of Canada, and the Department of Trade and Commerce (until it was merged with the Department of Industry in 1969 to create the Department of Industry, Trade and Commerce).

Furthermore, External Affairs aspired to put foreign economic policy fully behind the department's efforts to strengthen national independence and enhance Canada's

[37] Hatch Report, p. 13.
[38] Hatch Report, p. 28.

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international position. The diversification policy focused on pursuing these possession goals more selectively and deliberately than had the foreign trade policies of previous Canadian governments. The expansionist ambitions of External Affairs provoked a strong response by officials in Finance and Industry, Trade, and Commerce. As Keenes notes, the two departments "opposed the [diversification policy of the] Third Option because it provided External Affairs with the justification for a greater role in economic and domestic policy-making."[39] More important, they opposed the logic that guided the creation of counterweights because it went against their dominant economic ideology, free market enterprise. They criticized, particularly Finance officials, the diversification policy for being too dirigiste in its design, that is, intruding in business affairs by pushing on them a politically motivated design; for shifting attention away from the more important concern of enhancing Canadian international competitiveness; and for deviating from the traditional multilateralist track which had been credited for bringing about postwar economic growth and industrial development. Without the full support of Finance and DITC, External Affairs was constrained in its ability to boost Ottawa's export promotion capacity since the two departments had at their disposal important promotional instruments.

In sum, the failure of the diversification policy to have a consequential effect on the Canadian pattern of economic ties resulted from Ottawa's weak infrastructure capacity—that is, its inability to influence the export behavior of the business community in a way that advanced the goal of creating counterweights. Equally important was that such a political goal lacked powerful bureaucratic partisans within the federal state,

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[39] Ernie Keenes, "Rearranging the deck chairs: A political economy approach to foreign policy management in Canada," *Canadian Public Administration* (Autumn 1992), p. 395.

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which certainly constrained the policy's main advocate, External Affairs, from marshalling the available instrumental capacity accessible from within the federal state under a condition of broader bureaucratic support.

TOWARD RENEWED MULTILATERALISM: THE TOKYO ROUND

Multilateralism has had a longer following in Canada than has diversification. Unlike diversification, which has been used primarily to achieve possession goals such as enhancing Canada's margin of independence and increasing its level of capabilities particularly in the arena of the international economy, multilateralism has been used to pursue both milieu and possession goals in the arenas of the international economy and international politics.[40] In the context of the Canadian relationship with the United States, multilateralism and diversification have promoted Canadian goals by deflecting American influence and managing Canadian vulnerability. As former Prime Minister Lester Pearson has pointed out, Canada's involvement in multilateral settings has "helped us escape the dangers of a too exclusively continental relationship with our neighbor without forfeiting the political and economic advantages of that inevitable and vitally important association."[41]

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[40] Some analysts of Canadian foreign policy have argued that multilateralism is a guiding principle always employed by middle powers—such as Canada, Sweden, Australia, for example—and have suggested that such middle powers employ multilateralism only to pursue milieu goals such as international peace and security, international economic order, protection of human rights, promotion of humanitarianism, and pursuit international justice and equalitarianism. While it is true that middle powers use multilateralism frequently to promote milieu goals, it is equally true that the commitment of middle powers to those guiding principles has varied as their individual domestic and international situations have change and that multilateralism has been used to advance their self-interest even if that has meant undermining the very milieu goals they have championed. For a good discussion of this subject see A. Claire Cutler and Mark W. Zacher, eds., *Canadian Foreign Policy and International Economic Regimes* (Vancouver: University of British Colombia Press, 1992) and Tom Keating, *Canada and World Order: The Multilateralist Tradition in Canadian Foreign Policy* (Toronto: McClelland & Stewart Inc., 1993).

[41] Tom Keating, *Canada and World Order: the Multilateralist Tradition in Canadian Foreign Policy* (Toronto: McClelland & Stewart Inc., 1993), p. 20.

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The main difference between the two policy thrusts rests on the mechanism each employs to attain national goals. Multilateralism has been based on the formula of safety in numbers which is exemplified by the structure of international organizations such as the General Agreement on Tariffs and Trade (now the World Trade Organization), the North Atlantic Treaty Organization, Organization for Economic Cooperation and Development, the United Nations and its affiliated international organizations, whereas diversification has been based on the selective forging of counterweights.[42]

As a rules-based multilateral trade regime, the General Agreement on Tariffs and Trade has well served Canadian interests. For one, the regime's push for greater trade liberalization has created export opportunities for Canadian producers. In the postwar period, the continuation of multilateral reductions of tariffs became imperative for Canada because an increasing share of its gross domestic product was generated by exports. Another advantage that Canada enjoyed from the multilateral trade regime concerned the regime's set of international rules and decision-making procedures. The international rules embodied within the regime in many ways constrained and shaped the commercial policies of its member states, most notably imposing restrictions on the practice of tariff protection. Moreover, the regime's decision-making procedures ensured that Canadian officials would have opportunities to voice their interests and concerns and have some material impact on the results of multilateral trade negotiations.

Finally, Canada has benefited from the GATT's dispute settlement mechanism. Despite its flaws, the multilateral dispute settlement process has given member states a

[42] For a similar formulation, see Denis Stairs, "Choosing Multilateralism: Canada's Experience After World War II and Canada in the New International Environment," *CANCAPS Papier* No. 4 (July 1994), p. 1.

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mechanism through which they can seek redress of economic disadvantages resulting from the protectionist measures and unfair trade practices of trading partners. Initially the Third Option did not consider the Tokyo round of multilateral trade negotiations launched in 1973 as a vehicle for advancing the goals of the Third National Policy, but as it dawned on government officials that the diversification policy would fall short of meeting their expectations Ottawa renewed its focus on the multilateralist track, zeroing in on the Tokyo round.

Despite the inopportune circumstances surrounding the launching of the Tokyo round of multilateral trade negotiations—the 1973 oil crisis, the increasingly aggressive economic policy of the United States, the international economic slowdown, and European regionalism—by its conclusion in 1979, trading nations had achieved some major breakthroughs and Canada had agreed to make some substantial cuts in its tariff levels. Until the Tokyo round, Canada had been one of the few industrialized nations—Australia and New Zealand were the other two—to have reduced its tariffs on dutiable imports at a much slower rate than other industrialized nations. Tariff protection was a key instrument of economic policy in Canada dating back to the National Policy in 1879. Serving as an import-substitution tariff, the National Policy tariffs were designed to help build Canada's manufacturing capability by protecting domestic entrepreneurs from international competition. Originally championed by the Conservative party and the business community in central Canada and opposed by the natural resource-based economies of the western and eastern provinces as well as the Liberal party, by the 1940s tariff protection had become a way of life which was endorsed by both the Conservatives and Liberals and defended by the federal bureaucracy and Canadian manufacturers.

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In the Kennedy Round, Canada opposed using the proposed 'linear' or across-the-board tariff cuts formula calling for the reduction of tariffs on dutiable industrial products by 40 percent. Instead, it opted to use an item-by-item approach to tariff reduction with individual trading partners. This decision was based on the observation that under the linear formula Canada would obtain an unequal distribution of gains. Because Canada was an importer of manufactured goods and maintained relatively high domestic tariffs in this linc of goods and because it was primarily an exporter of primary manufactured goods currently facing low international tariff levels, the proposed reduction in tariff levels on dutiable manufactured goods would have increased import competition in a group of goods where Canada faced a comparative disadvantage without offering offsetting international tariff cuts in a category of goods where it maintained a comparative advantage. As Sharp has pointed out,

> We argued that because of the nature of our trade—the high proportion of foodstuffs and raw materials in our exports and of manufactured goods in our imports—other countries gained much more valuable access to our market for manufactured goods than we gained from an equal percentage cut in the already low tariffs on foodstuffs and raw materials in countries to which we exported.[43]

In the end, the Kennedy Round delivered some notable gains to Canada. As Evans observes: "Canadian negotiators managed a remarkable 'tour de force'.... Over three billion in Canadian exports stand to benefit...while Canada has agreed to reduce on some two and a half billion of imports...[which means that] nearly half [of] Canada's present dutiable imports remained untouched."[44]

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[43] Michell Sharp, "The Trading Revolution," O.D. Skelton Memorial Lecture, Sponsored by the Department of Foreign Affairs and International Trade (Calgary, Alberta, February 7, 1995), p. 3.
[44] John Evans, *The Kennedy Round and American Trade Policy* (Cambridge: Harvard University Press, 1971).

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What factors explain Canada's decision to reverse its policy of maintaining high import tariffs during the Tokyo Round, which was further reinforced in the 1980s? The unwillingness of major economic powers to extend to Canada during this round of negotiations the same concessions they had agreed to in previous rounds, was certainly an important factor contributing to this policy change. But three other factors stand out as well. First, although the policy of diversification and multilateralism were pursued simultaneously in the 1970s, Ottawa's inability to overcome domestic obstacles associated with the former ruled out hopes by 1977 that the policy could produce some significant change in the realities of the bilateral relationship. Still determined to use the international trade system to counterbalance its ties with the United States, Ottawa renewed its interest in multilateralism, proposing a draconian change in its commercial policy. As Winham observes,

> Given what Canada wants from the international system, and given that Canada's wants are interdependent with the wants of other nations, there was little real choice about whether Canada would become committed to the formula procedures of the [Tokyo Round which meant substantial tariff reductions for Canada][45]

If the goal of the Third Option was to prevent further Canadian export dependence on the United States, then the policy of diversification was clearly the optimal policy, for it sought deliberately to establish supplementary markets in order to diversify Canada's exports away from the United States. Canada's renewed interest in multilateralism, however, was a second-best choice because in addition to promoting international liberalization (and increasing market access abroad), the results of past multilateral trade negotiations had drawn Canada closer to the United States. Stone notes that Ottawa

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[45] Gilbert Winham, "Bureaucratic politics and Canadian trade negotiation" *International Journal* 35 (Winter 1978-9), p. 84.

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defended its position, arguing that diversification would fail without the multilateralism of GATT. "In discussing the Third Option concept, Mr. Sharp dismissed any suggestion that the liberal world-trade system was responsible for the imbalance in Canada's trade relationship with the United States; indeed, he expressed the view that a less liberal world-trade system would have led to even stronger links between the U.S. and the Canadian markets."[46] The post-Dillon Round of the GATT (1960-1) trade statistics, however, showed that the share of Canadian exports destined for the United States had increased from 60 percent in 1961 to 70 percent in 1969. The pull of geography was the same after the Kennedy Round as Canada saw its proportion of American-bound exports increase from 70 percent in 1970 to 80 percent in the early 1980s. Thus, although Ottawa was firmly of the view that diversification could be achieved through multilateralism, the realities clearly showed that after the conclusion of trade reduction negotiations, Canada grew more trade dependent on the United States.

Second, and related to the first, Ottawa began seriously to question the merits of tariff protection, especially in the face of pressures to attain economic adjustment. In fact, Keating notes that by the end of the Tokyo Round of negotiations, "the government once and for all reject[ed] the national policy that had influenced Canadian trade policy for nearly a century."[47] Canada had experimented with freer trade in the 1960s and the results were positive. The 1965 Canada-United States Automobile Products Trade Agreement put in place institutional terms allowing for duty-free trade in cars, trucks, buses, parts, and automobile-related accessories. Moreover, the Auto Pact devised

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[46] Frank Stone, *Canada, The GATT and the International Trade System* (Ottawa: The Institute for Research on Public Policy, 1984), p. 179.
[47] Tom Keating, *Canada and World Order*, p. 189.

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provisions which served as incentives for automakers to increase their manufacturing activities in Canada.

With the Auto Pact in place, Canada witnessed not only an increase in the production of automobiles—as a result of rationalization, regional specialization, and productivity improvements—but also a change in the composition of Canadian exports, for automobiles and related products began to make up a larger share of export commodities. Finlayson and Bertasi observe that as a share of merchandise exports bound for the United States, manufactured goods increased from 15 percent in 1965 to 30 percent in 1970, a substantial increase owed to the surge in exports of automobile and parts. The positive results of this sector-specific free trade experiment set off a riveting debate in the 1970s which attacked the conventional wisdom that Canada needed tariff protection in order to build and preserve its manufacturing capability.[48]

Finally, the policy change was coincident with the change in Canada's trade profile. Starting in the mid-1960s, manufactured commodities began to figure more prominently in Canada's trade profile, partly due to the Auto Pact and partly because of exports in other categories of end-products. In their review of Canada's trade position in the international economy, officials at the Department of External Affairs remarked that by the 1970s "Canada had developed a diversified industrialized base capable of exporting a wide variety of products to markets all over the world."[49] As a result of this change, Canadian negotiators could no longer make a credible argument that Canada warranted preferential treatment by being exempted from the tariff cutting schedules that

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[48] Jock A. Finlayson and Stefano Bertasi, "Evolution of Canadian Postwar International Trade Policy," in Cutler and Zacker, *Canadian Foreign Policy and International Economic Regimes*, p. 25.
[49] Department of External Affairs, *A Review of Canadian Trade Policy: A Background Document to Canadian Trade Policy for the 1980s* (Ottawa: Supply and Services Canada, 1983), p. 7.

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guided other major trading states because it had a weak manufacturing base and its economy was primarily resource-based. Canada had to abandon the practice of riding free on others' tariff cuts and demonstrate its commitment by equally contributing to multilateral tariff reduction. Thus, given the international and domestic constraints and incentives facing Canada it became clear that Canada's interests would be better served by jumping on the bandwagon leading toward deeper tariff cuts.

As the policy of diversification illustrated, political will does not assure effective policy implementation; therefore, it is important to consider what conditions contributed to the success of renewed multilateralism. Importantly, at this juncture of international economic adjustment, the political strategies Ottawa used did facilitate the implementation of renewed multilateralism. Whereas Ottawa was constrained in its ability to mobilize societal and bureaucratic consensus behind diversification, such was not the case with renewed multilateralism. In fact, Ottawa went beyond the range of institutional innovation attempts associated with the previous adjustment effort, since this time it skillfully marshaled intergovernmental capacity, that is Ottawa actively pursued consensus-building and coordinative activities with the provinces. Below I will explain this variance in the institutional adaptation capacity of the state.

Canada entered the Tokyo Round with several objectives. They included reducing the levels of foreign tariffs that Canadian exporters faced and expanding access to foreign markets, reducing non-tariff barriers and restricting the arbitrary use of these instruments by foreign governments against Canadian exports, establishing specific terms that would spur progress in the development of more sophisticated forms of Canadian processing of primary and secondary manufactured goods; and increasing the international

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competitiveness of Canadian industries by lowering Canadian tariff levels, while limiting tariff concessions in employment sensitive industries and allowing for orderly adjustment by private actors.[50]

A major preoccupation of Canadian negotiators once the Tokyo Round was inaugurated in 1973 concerned the formula that members would use in order to coordinate this round of tariff reductions. From the outset, Canada favored using a sector approach, one which held the greatest hopes of securing Canadian objectives. The sector approach, as Winham points out, was "originally proposed by Canada...for negotiating all tariff and nontariff barriers in selected commodity areas, and particularly including goods at different levels of processing."[51] Although this formula was preferred by resource producing nations, it failed to gain the support of major economic powers because they believed that the sector approach did not generate the kind of reciprocity they were hoping to receive. It was not until late 1977 that the major economic powers—the United States, Japan, and the European Community—settled on a tariff-cutting formula referred to as the Swiss formula.

Unlike the sector approach, the Swiss formula called for a 30 to 40 percent cut in tariff levels across industries and proposed deeper cuts for countries with higher tariffs than those with lower tariffs. In January 1978, Ottawa announced that it would accept this formula and abandon the sector approach it had initially advocated. With the conclusion of the multilateral trade negotiations, the depth of cuts for all industrial

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[50] Jacques Roy, "The Tokyo Round: Canadian Perspectives," in Lee H. Radebaugh and Earl H. Fry, eds., *Canada/U.S. Trade Relations* (Utah: Brigham Young University, 1984); and External Affairs, *A Review of Canadian Trade Policy*, p. 7.

[51] Gilbert Winham, *International Trade and the Tokyo Round Negotiation* (Princeton: Princeton University Press, 1986), pp. 237-238.

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products that Canada agreed to was 38 percent, more than the 31 percent and 29 percent agreed to by United States and the European Community respectively, but less than Japan's 49 percent.[52]

This important shift in Canada's commercial policy was facilitated by the particular political strategies Ottawa effectively used during this phase of economic adjustment. However, there were two broader, macro-institutional factors that rendered this bout of innovation successful. This second attempt at international economic adjustment benefited from the fact that, unlike diversification, the policy of multilateralism was well established and had carved a political legacy for itself within the federal state. It had become consequential enough to defeat rival policies (including diversification) and to be able to marshal a full range of federal resources to serve this policy orientation. Moreover, although multilateralism at this juncture was to a certain extent motivated by the ideas of the statist variant, the fact that it was consistent with the free market enterprise ideology and devoid of a dirigiste design made this policy all the more acceptable to the bureaucracy, the provinces, and the business community.

The government employed three institutional innovations that were central to the success of renewed multilateralism: rational management within the federal state, government-business consultation, and federal-provincial consultation. Created in 1973, the Canadian Trade and Tariffs Committee (CTTC) provided an organizational framework with which "to meet the government's wish to have an appropriate mechanism to receive the views of and to maintain liaison with all interested parties in

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[52] Frank Stone, *Canada, the GATT and the International Trade System*, p. 182.

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Canada with respect to Canada's participation in the [multilateral trade negotiations]."[53] Led by a senior bureaucrat at the deputy minister level and assisted by a small secretariat, the CTTC functioned as a clearing-house where the private sector and the provinces could submit briefs, which were subsequently distributed to the Departments of Finance; Industry, Trade, and Commerce; and External Affairs for review and gathering of information. In an effort to foster administrative coherence and coordination within the federal state, an interdepartmental Trade Negotiations Coordinating Committee (TNCC) at the level of deputy minister was established in the months following the inauguration of the Tokyo Round and given the task of preparing "recommendations to Cabinet with respect to Canada's objectives in the Tokyo Round, and to convey Canada's instructions to the trade delegation in Geneva."[54]

By 1977 pressure had mounted to undertake more optimal forms of institutional adaptation. Two sets of pressures had arisen. The first came from the need to improve intergovernmental coordination. The need to have provinces weigh in more on the process of international trade policymaking was spurred by the increased recognition in Ottawa that jurisdictional interdependence prevented it from proceeding without gaining the acquiescence of provinces.

Although international trade negotiations and the administration of tariffs are two responsibilities that fall under the authority of the federal state, the constitution equips the provinces with two important sources of trade authority. First, provinces have the means to employ non-tariff instruments—such as regulations, subsidies, restrictive standards,

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[53] Review of Developments in the GATT Multilateral Trade Negotiations in Geneva (Ottawa, August 1977), p. 1.
[54] Quoted in Winham, "Bureaucratic politics and Canadian trade negotiations," p. 77.

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and government procurement—and consequently can impede interprovincial and international trade. Moreover, the federal government is limited in its ability to implement treaties whose subject matters fall within provincial jurisdiction.[55] When it cannot assert its international competence because of jurisdictional incompatibility, the federal government must gain the approval of the provinces to ratify a treaty. Accordingly, if Ottawa wanted to tackle the issue of non-tariff barriers in the Tokyo Round it needed to bring the provinces into the negotiation process; by the same token, if provinces, particularly western provinces, wanted to bring about further trade liberalization in Canada, they needed greater access to decision makers in Ottawa.

The second source of pressure arose from the need to increase further coordination within the federal state—in particular, within the federal bureaucracy, between the bureaucracy and cabinet, and between the negotiating team in Geneva and Ottawa. The TNCC fell into disuse soon after it was created because it became apparent early on that its organizational features matched poorly with the task it was intended to fulfill. As Winham points out, "the TNCC was too oriented to the external negotiation and unable to generate the domestic political and preparatory work needed to support the Canadian position at the Tokyo Round."[56] Ottawa needed to centralize its negotiation authority while establishing consultative and informational linkages that mobilized bureaucratic consensus and coordinated their actions.

In response to these pressures, the position of Canadian Coordinator for Trade Negotiations (CCTN) was created in August 1977. Upon receiving the appointment to

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[55] Stephen de Boer, "Canadian Provinces, US States and North American Integration: Bench Warmers or Key Players," *Choices* (November 2002).
[56] Winham, ibid., p. 87.

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head the Office of the Coordinator, Jake H. Warren discussed the tasks with which he was entrusted:

> I am to be the key link between Canadian negotiators and Geneva and the cabinet and departments in Ottawa.... I am to liaise with the provincial governments and with interested organizations in the private sector during the whole course of the trade negotiations, and I am responsible for coordinating for cabinet the preparation of the Canadian positions for all of the various elements of the negotiations.[57]

The process and structure relating to Canada's undertaking in the multilateral negotiations pivoted on the Office of Coordinator. The coordinator became a secretariat for the ad hoc Cabinet Committee on the MTN, where authority in formulating Canada's MTN position formally resided; assumed the chair of the Federal-Provincial Committee which oversaw intergovernmental coordination activities; and co-chaired the Interdepartmental Committee on Trade and Industrial Policy, a newly created committee in charge of addressing the problem of economic adjustment derived from the post-Tokyo Round tariff reductions.

The CCTN structure created a propitious environment in which tough decisions could be made, such as the one to accept the Swiss formula in the face of initial opposition from the Canadian business community. Above all, the CCTN helped centralize channels of communication within the federal state and resulted in the easing of decision-making and offering clear direction to the negotiating team in Geneva. Moreover, the CCTN helped significantly to improve federal-provincial relations in a manner unseen before in multilateral negotiations. As Winham observes, "When the MTN began, the federal government treated the provinces as constituents [however, by]

[57] Quoted in Winham, "Bureaucratic politics and Canadian trade negotiations," p. 79.

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the time major decisions had been made, the provinces has been advanced to the role of joint policy-makers, and on some matters they appeared to be as influential as the major federal departments."[58]

In sum, the diversification policy effort illustrated how futile an adjustment measure can be when the political strategies used by the state are insufficient to undertake the necessary complementary institutional adaptations. When the state was able to marshal appropriate adaptation capacities, as was demonstrated with renewed multilateralism, implementation proved more successful. The variance in policy performance was attributed to the consequences of positive reinforcement between the existing institutional structure and agency. The institutionally embedded belief in preserving the autonomy of market players embedded in the domestic political institutions and the structural obstacles preventing the aggregation of state power and use of state discretion to pursue a collective objective offered an institutional terrain that was much more amenable to the pursuit of renewed multilateralism than of diversification policy which consequently facilitated Ottawa's institutional innovation efforts directed at the promotion of renewed multilateralism.

FROM RENEWED MULTILATERALISM TOWARD CONTINENTALISM

The increasing prominence of continentalism in the 1980s as Ottawa's external response to Canada's adjustment problem was spurred in part by the failure of the diversification policy in the 1970s and the success of renewed multilateralism. As I have argued above, it was the inability of policy makers to match the institutional demands of diversification with a corresponding set of institutions that rendered the diversification

[58] Winham, ibid., p. 87.

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strategy unworkable. Consequently, Ottawa was forced to pursue the Third Option using renewed multilateralism, a second-best option.

Renewed multilateralism, as it turned out, paved the way for the shift to continentalism by locking in two key economic forces. First, renewed multilateralism reinforced Canadian reliance on trade. In 1980, exports accounted for 25.6 percent of Canada's gross domestic product, up from 19.5 percent in 1970.[59] As Canada became more integrated in the international economy, Ottawa was pressured to change the way in which it addressed the national power consequences of its economic activities. Because an increasing proportion of Canadian national wealth was derived from international trade, there were higher stakes facing Canada for seeking a more open and rules-based international trade regime as well as obtaining better terms of access to the markets with which Canada traded the most. Moreover, in the 1970s the share of Canada's total exports destined for the United States reached unprecedented levels, fluctuating between 63 percent in 1980 and 70 percent in 1978.[60] If the post-Kennedy Round effect of intensifying Canada's export market concentration was repeated after the Tokyo Round, as many believed would happen, an even higher level of Canadian exports would be destined for the American market in the 1980s, thus deepening the level of trade dependence on the United States. Canada's trade was becoming increasingly bilateral; consequently if such a pattern persisted in the future, a bilateral rather than a multilateral political framework would be required to redress Canada's adjustment problem. In fact,

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[59] Department of External Affairs, *A Review of Canadian Trade Policy*, p. 20. The ratio of merchandise exports to gross domestic product of Canada was the highest among the Group of Seven countries. In 1980, Germany's was 23.6 percent, Britain's stood at 22 percent, and the United States' was 8.4 percent, the lowest in the group.

[60] Department of External Affairs, *A Review of Canadian Trade Policy*. p. 204.

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Ottawa realized that despite the virtues of multilateralism, it could not address one overriding concern with which bilateralism could potentially deal: ensuring security of access to the one market upon which Canada's national wealth was most deeply reliant.

Finally, by the beginning of the 1980s, Canada had eliminated approximately 80 percent of its tariff barriers, the bulk of which occurred as a result of the tariff cuts of the Kennedy and Tokyo rounds.[61] The trade liberalization to which Canada subjected itself in the 1960s and 1970s spurred the private sector to undertake important structural adjustments. It is firm-level adjustments which caused a significant change in Canadian businesses' perspective on their capacity to compete without the support of tariff protection and other forms of state involvement. In particular, by the early 1980s the private sector began exploring opportunities to compete against their American counterparts in a tariff-free continent-wide market.[62] Moreover, Canadian exports became increasingly diversified, as illustrated by the rise in exports of fully finished goods. Table 5.1 indicates that in chemical related products, electrical products, and machinery industries the proportion of production bound for external markets, in

Table 5.1. Export Orientation of Some Manufacturing Sectors in Canada, 1966-1981 (percent of production exported)

	1966-73	1981
Chemical and chemical products	15.3	29.0
Electrical products industries	13.0	24.4
Machinery industries	37.8	54.4
Transportation equipment industries	60.4	68.4
Paper and allied industries	50.7	59.9

Source: Department of External Affairs, *A Review of Canadian Trade Policy: A Background Document to Canadian Trade Policy for the 1990s* (Ottawa: Supply and Services Canada, 1983), p. 30.

[61] Richard G. Lipsey, "The Canada-U.S. FTA: Real Results Versus Unreal Expectations," in L. Ian Macdonald, ed., *Free Trade: Risks & Rewards* (Montreal: McGill-Queen's University Press, 2000).
[62] Ibid., p.100.

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particular the American market, saw a notable increase.

Exposure to increasing international competition (the market solution) rather than forced market diversification (statist solution) proved more effective in bringing a solution to economic adjustment in Canada. By the early 1980s, the policy momentum was not in favor of pursuing diversification; rather it stressed the need to enhance trade and secure access to those markets upon which Canada most relied. The liberal variant of the Third National Policy offered the most suitable framework within which to act on this policy dynamic. But such systemic pressures proved to be part of the equation which ultimately contributed to the shift from the Third Option to continentalism starting in the mid-1980s. The next two chapters analyze the sequence of domestic adjustment policy changes, whose underlying policy momentum eventually converged with and reinforced the one that prevailed at the international level and, in effect, combined to effect a shift of adjustment strategy.

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CHAPTER SIX

LIMITS OF GATEKEEPING

In elaborating the purpose of the federal state's gatekeeping function as envisioned in the Third Option, Secretary of State for External Affairs Mitchell Sharp stated in 1972 that it was the goal of the Trudeau government to encourage the "emergence of strong Canadian-controlled firms...by provid[ing] a climate conducive to the expansion of Canadian entrepreneurial activity [and which would seek particularly] to foster the development of large, efficient multinationally-operating Canadian firms that could effectively compete in world markets...[and] meet a higher proportion of the domestic requirement for goods and services."[1] The gatekeeper function which the Third Option envisioned for the state called for the development of new state capacities designed to channel the benefits of foreign investment more in Canada's direction and to enhance Canadian participation in economic activities. Importantly, as an industrial adjustment policy measure, the gatekeeper function was not based on the premise that foreign capital was detrimental to Canada, thus requiring the use of defensive regulatory measures. Instead, through different courses of action, the state's gatekeeper function was intended to augment the level of domestic control relative to that of foreign control and create incentives for foreign investors to contribute more in the development of Canada's manufacturing strength.

This chapter analyzes three policy measures that were designed to help increase domestic control of national economic activities. Established in 1971, the Canadian Development Corporation (CDC), a state holding company operating as a public and

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[1] Mitchell Sharp, "Canada-U.S. Relations: Options for the Future," *International Perspectives* (Autumn 1972), p. 11.

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private stock company, was given a mandate to enhance Canadian ownership and promote Canadian developmental ambitions by serving as a supplementary source of Canadian equity investment. Two years later, the Foreign Investment Agency Review (FIRA) was created to screen foreign investment in order to assess the extent to which Canada benefits from acquisitions and new investment proposals. Lastly, the National Energy Program of 1980 sought to Canadianize the domestic oil industry by augmenting the Canadian-controlled share of the industry to 50 percent by 1990. These three policy measures signified an important shift away from the postwar policy of accepting the high degree of foreign control of economic assets in Canada as a cost of promoting sustained economic growth during the period.

These three programs, however, never functioned the way they were originally conceived. This chapter will explain why that was the case. Whereas these programs demanded the agency of a powerful interventionist state apparatus, the existing institutional terrain impeded the development of those organizational capacities necessary to carry out such gatekeeper function. The FIRA, CDC, and NEP all represented federal policy thrusts that encountered strong provincial, societal, and bureaucratic opposition. This affected the way in which Ottawa proceeded with establishing those programs, particularly the organizational structure to support them. In the case of FIRA and the CDC, Ottawa dealt with the political battle by creating two organizational structures that proved inadequate to fulfill their gatekeeping task. In particular, those structures were intentionally designed to limit the kind of state intervention necessary to enhance Canadian control of national economic assets. As for the NEP, a thrust and riposte dynamic emerged between Ottawa and the provinces, particularly with Alberta. Ottawa's

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interference in the energy sector amounted to an intrusion into provincial jurisdiction since the provinces are responsible for natural resources. In the end, all three programs failed because Ottawa lacked the adjustment capacity to effect appropriate institutional changes to support each program.

CANADIAN DEVELOPMENT CORPORATION

Although the idea of creating the Canadian Development Corporation dates back to the 1957 Report of the Royal Commission on Canada's Economic Prospects, it was not until the 1960s that the idea caught on in the government. Over the course of eight years, beginning in 1963, a public policy debate centering on two competing viewpoints emerged on the issue of CDC. The debate ended in 1971 when Minister of Finance Edgar Benson introduced Bill C-219, the legislation to create the CDC, in the House of Commons and it subsequently received Royal Assent in June.

From the outset, two schools of thought framed the public policy debate over the CDC. Developed by Walter Gordon, a prominent Liberal Party member who served as Finance minister under Prime Minister Lester Pearson's Liberal governments, the nationalist school emphasized that the government needed to create an investment corporation, whose chief goal would be to 'buy back Canada.' The Canada Development Corporation would assist Canadians in gaining greater leverage over domestic economic decisions in the face of high levels of foreign control of Canadian assets. As Gordon argued in 1965,

> ...The vast majority of Canadians want our country to remain free and independent. But if we lose our economic freedom—and an excessive absentee ownership of our businesses and resources means some loss of economic freedom—then sooner or later we shall lose our political freedom also. Many things must be done to prevent this.

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> One of these is to secure in Canadian hands a greater measure of control of future economic developments. The Canada Development Corporation will help use to do this....[2]

It was Gordon's concern about the adverse effects of having too much foreign investment in Canada that persuaded him to propose in his 1963 budget the ill-fated takeover tax for new foreign purchases of Canadian firms. However, Gordon was forced to abandon this proposal after facing strong opposition from his own party and the business community.

By providing industrial venture capital, the CDC was expected to help fix the "capital gap" which was the key cause of the high absentee ownership of Canadian industry. According to Gordon, foreign investors ended up being the suppliers of investment capital in lucrative commercial projects in Canada because there was a lack of available domestic equity capital. The new investment corporation was expected to serve as a vehicle that would attract private capital and channel venture capital into risky but potentially profitable developmental projects while simultaneously working toward taking back Canadian industry.[3] This approach was met with strong resistance from the business and financial communities in Canada. On the one hand, they were at odds with Gordon on the issue of the existence of a "capital gap," which they claimed was not adequately supported by the evidence. As the authors of the Report of the Royal Commission on Banking and Finance noted, "We do not regard the sometimes heavy foreign borrowing by Canadian business in the postwar period as resulting primarily from deficiencies in the domestic financial markets."[4] On the other hand, the Canadian

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[2] Quoted in E.P. Neufeld, "Some Qualifying Thoughts on the CDC," *The Canadian Banker* Vol. 73 (Summer 1966), p. 30.

[3] The elements of the nationalist approach have also been discussed in two of Gordon's books: *Troubled Canada: The Need for New Domestic Policies* (Toronto: McClelland and Stewart, 1961) and *A Choice for Canada: Independence or Colonial Status* (Toronto: McClelland and Stewart, 1966).

[4] Quoted in E.P. Neufeld, "Some Qualifying Thoughts on the CDC," *The Canadian Banker* (Summer 1966), p. 31.

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business and financial communities were hostile toward Gordon's approach because it signified the expansion of the federal state's interventionist capacity, which threatened to interfere with private entrepreneurship by enhancing the role of state judgment with respect to making investment decisions.

Gordon also had a difficult time persuading members of his own political party to support his CDC plan. In his Throne Speech in 1963, Prime Minister Pearson stated that his government was committed to creating a corporation designed specifically to increase Canadian participation in domestic economic activities. As the point man for the promulgation of the CDC, Gordon worked out the details of his CDC plan and submitted a resolution to the House of Commons calling for the creation of the CDC shortly before his budget speech. Initially the resolution did not provoke opposition; however, in the wake of Gordon's budget speech in which he proposed a takeover tax as a way to make it more difficult for foreign companies to acquire Canadian companies, the resolution was viewed as part of a nationalist design focused on thwarting foreign participation in the Canadian economy. As Liberal members attempted to shoot down Gordon's takeover tax proposal, the CDC resolution was caught in the line of fire and Gordon was forced to drop both plans.

The CDC issue was purposefully left out of Gordon's 1964 budget as well as Pearson's February Throne Speech. As Kent observes, "Action was inhibited in 1964 by the government's induced caution about anything that smacked of economic nationalism."[5] Although the CDC plan resurfaced in 1965, both in Pearson's Throne speech and in Gordon's budget speech, no policy initiative emerged. However, if there

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[5] Tom Kent, *A Public Purpose: An Experience of Liberal Opposition and Canadian Government* (Montreal & Kingston: McGill-Queen's University Press, 1988), p. 346.

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was one thing that Gordon learned from his experience as being the lone voice of economic nationalism in Pearson's government, it was that the CDC would have to be equally concerned about making profits and basing its activities on sound business decisions. To that extent, the CDC would have a dual role, one involving the pursuit of commercial objectives, the other a nationalist objective—namely enhancing Canadian participation.

The other school of thought, the developmental approach, was advanced by the new Finance Minister, Mitchell Sharp, when Gordon stepped down in November 1965. According to Sharp, the main objective of the Canada Development Corporation would be to promote Canadian industrialization, create employment, and generate profits for its shareholders. The CDC was to make sound investment decisions based on expected future earnings and opportunities for growth. According to Dimma, Sharp believed that the role of the CDC

> would be chiefly to grow large and profitable through direct investment in viable Canadian enterprise and developments. Canadian economic independence would be promoted only to the extent that the CDC—which would be owned and controlled by Canadians—prospered through its role in industrial development and growth.[6]

Thus, Sharp's developmental approach placed much more emphasis on the CDC's commercial component because it was a means to attaining a stronger Canadian presence in the economy and he viewed the CDC more as a market-oriented entity.

Moreover, Sharp's position did not draw a connection between the high degree of foreign investment and Canada's inability to secure its independence, as Gordon did. Sharp did recognize that Canada's sense of independence would be enhanced if Canadian

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[6] William Dimma, "The Canada Development Corporation," (Ph.D. dissertation, Harvard University, 1974), p. 360.

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invested more in the economy. Accordingly, Sharp stressed that the CDC should function as an investment vehicle designed to attract private savings and invest in profitable projects that otherwise would be financed with foreign capital. Finally, the Sharp approach maintained that it was important for the CDC to operate as independently of government involvement as possible. The CDC's ability to mobilize private saving and to make sound investment decisions depended on the assurance of non-interference by the government.

When Gordon rejoined Pearson's cabinet in 1966, support was building for Sharp's developmental approach to the CDC.[7] Sensing that there was now adequate attention being paid to the issue of Canadian control and foreign investment, Gordon persuaded Pearson to create a task force to study the effects of foreign investment in Canada. In its report *Foreign Ownership and the Structure of Canadian Industry*, the Task Force on the Structure of Canadian Industry advocated the Sharp approach.

The Task Force's eight members—all of whom were economists—agreed that the CDC could be used "to enhance the capacity of the Canadian economy to grow with relatively less foreign direction investment."[8] Specifically, the Task Force envisioned the CDC playing an active role in innovative projects in the areas of resource development as well as contributing to the rationalization of industry. These views were repeated in the Eleventh Report of the Standing Committee on External Affairs and National Defence (Wahn Report) completed in June 1970. The Wahn Report noted the following:

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[7] It should be noted that by the time he left the government in 1965, Gordon had moved closer to the developmental approach. In fact, in the April 26 1965 Budget Speech, Gordon stated that "the Corporation would be expected to invest in projects and enterprises which are likely to contribute to the sound economic development of Canada and to be profitable in the long-run."

[8] Government of Canada, *Foreign Ownership and the Structure of Canadian Industry: Report of the Task Force on the Structure of Canadian Industry* (Ottawa: Queen's Printer, 1968), p. 361.

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> Its main purpose should not be to buy back Canadian businesses now owned by Americans or other foreign citizens. Nevertheless, in exceptional circumstances it would be permitted to make investments to retain or establish a Canadian presence in a vital industry where it would serve as a pacemaker or a goad for foreign owned corporations. The Canada Development Corporation should not be...concerned with trying to outbid American businesses each time they try to buy Canadian concerns. Rather, the Canada Development Corporation...could arrange mergers among smaller Canadian companies which needed a large scale financial and administrative base and it might become an investor in such enterprises.[9]

The two governmental reports agreed that the mixed corporation should seek to increase Canadian participation in the economy without restricting the ability of foreign investors to do business in Canada. With this working premise, as a holding company in which Canadians and government invested, the CDC could become an active player in the economy as it sought to move into different industrial sectors for the purpose of contributing to the growth of the nation's industrial strength and, in the long term, expanding the share of industrial assets under the control and ownership of Canadians.

When it was finally introduced by the Trudeau government in January 1971, Bill C-219 assigned two principal objectives to the CDC. As Section 2 of the Bill pointed out, "The purpose of this Act is to establish a corporation that will help develop and maintain strong Canadian controlled and managed corporations in the private sector of the economy and will give Canadians greater opportunities to invest and participate in the economic development of Canada." Central to the legislation was the commitment not to use the CDC in a way that impeded the inflow of foreign investment, but rather to ensure that the CDC was proactive enough to identify and secure profitable investment projects

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[9] Government of Canada, *Eleventh Report of the Standing Committee on External Affairs and National Defence Respecting Canada-U.S. Relations*, Second Session, 28th Parliament (Ottawa: Queen's Printer, 1970), p. 33:94.

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before foreign investors seized such opportunities. Thus, the CDC was given a dual mandate: on the one hand, it was to pursue commercial objectives such as being profitable, making sound investment decisions, and diversifying its activities across various sectors of the economy; on the other hand, it was required to ensure that its activities directly enhanced Canadian participation in the economy.

Not long after the CDC Act was passed, the *Globe and Mail*, which had echoed the opinions of the business and financial communities in previous years on the CDC issue, was less than enthusiastic about the creation of the CDC. In particular, there were doubts about how the CDC would manage to balance its two mandates, which were not necessarily compatible.

> What it comes down to is that the Government is trying to be half government and half entrepreneur. Neither one nor the other, only a maladroit mix, that will set the cast of the entire corporation. Its motives will be forever suspect; its personality forever split; its decisiveness forever impaired. It will be afraid to take risks because of political repercussions and afraid to play safe because of business repercussions. Canadians may sympathize with its fervently proclaimed wish to protect Canadian economic independence. But they will fear its deformities and what those deformities can produce. Poor beast. It should be put to sleep rather than be unchained.[10]

The Institutional Parameters of the Canada Development Corporation's Divided Mandate

As a mixed corporation, the CDC was expected to operate like a private enterprise and to mobilize private savings by promising strong returns on money invested in the holding company. To accomplish this it was necessary for the CDC to have freedom from state control. To assure its relative autonomy, the CDC, unlike other Canadian Crown corporations, was not subject to the provisions of the Financial Administrative Act.

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[10] "The beast is loose," *Globe and Mail* (December 1, 1971).

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Under this Act, Crown corporations were accountable to Parliament for their operation via the particular Minister responsible for their oversight. Because the CDC was exempted from Crown agency status, it did not have to seek budgetary approval from the Parliament nor meet financial reporting requirements, thus shielding the organization from parliamentary scrutiny and supervision.

The decision to lodge the CDC within the Department of Finance was also intended to give the CDC the necessary flexibility to act in accordance to the profit motive. The Finance Department had a reputation for being the department least in favor of expanding state involvement in the economy and would be the best candidate to ensure that the CDC upheld its commercial mandate with the least government interference. Had the CDC been placed in the Department of Industry, Trade, and Commerce or the Department of Regional Economic Expansion, there was the risk that the CDC would become implicated in the politics of industrial policy and of regional development to the detriment of profit maximization.

With these organizational measures in place to guarantee its freedom against political interference, the CDC was still expected to fulfill particular public objectives, such as increasing Canadian participation in the economy and diversifying Canada's industrial base through a selective corporate strategy. When Bill C-219 was introduced, Benson noted that "able and experienced entrepreneurs will direct the corporation's operations to areas of critical importance in economic development—to high technology industry, to resource utilization, to northern-oriented companies and to industries where Canada has a special competitive advantage."[11] Similarly, the CDC's 1980 annual report,

[11] Quoted in Stephen Brooks, "The State as Entrepreneur: from CDC to CDIC," *Canadian Public Administration* (1983), p. 529.

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pointed out that its objective was "to develop companies that can become world-scale and develop sales in foreign markets to gain the size needed for full operating economies and efficiencies."[12]

Several institutional parameters were fixed in place to ensure that its operations advanced these rather broadly defined political objectives with minimum hindrance to its profit motive. For example, in its first three years the CDC was completely state-owned, after which the corporation could begin engaging in public offering of shares. However, a 10 percent baseline was established which ensured that the government would always exercise some influence over the CDC. Moreover, such measures as the three percent limit on the share of stocks a shareholder could own, the rule that all directors of the board had to be Canadian citizens and that the majority of them reside in Canada, and the requirement that all shareholders had to be Canadian residents or citizens, all helped make the CDC a policy instrument with which the government could advance the public interest.

The Performance of the Canada Development Corporation

In assessing the performance of the CDC, three questions should be taken into account: (1) How well did the CDC fulfill its developmental objectives?, (2) How well did the private corporate model upon which the CDC was based lure private capital and placate concerns about government interference?; and (3) How well did the federal state restrain itself from interfering with the operations of the CDC? The CDC did exceptionally well in inserting itself in the energy sector; however, the same could not be

[12] Canada Development Corporation, *Annual Report*, 1980, p. 3.

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said with respect to moving into a range of industries in order to promote industrial diversification.

Table 6.1 shows that more than 80 percent of CDC's investments went into the energy and mining sectors throughout the 1970s and early 1980s. Of importance were the petrochemical and oil and gas industries. The CDC's acquisition of all the shares of the state-owned Polymer Limited (later renamed Polysar) in 1972 and its investment in Petrosar—a company Polysar helped create and fund jointly with Dow Jones of Canada and Dupont of Canada—starting in 1974 made petrochemicals the sector that received the most investment capital from the CDC until 1981. From 1981 to 1982, the oil and gas sector received the largest share of CDC's investment capital, after it acquired Aquitaine Company of Canada Limited from its French parent company and the oil, gas, and sulphur assets of Texasgulf, both in 1981.

Table 6.1. Canada Development Corporation – Percentage of Total Assets by Industry Group, 1973-82

	1973	1975	1977	1979	1981	1982
Oil & Gas		10.6	9.1	8.0	37.2	38.8
Mining	39.4	25.4	17.8	16.2	23.3	18.8
Petrochemicals	48.7	47.2	63.6	61.9	31.6	30.2
Information Processing				6.5	3.3	9.2
Life Science	9.9	7.0	5.3	5.6	2.2	1.4
Fishing					0.4	0.3
Industrial Automation					0.6	0.5
Venture & Expansion Capital	1.5	1.0	0.6	0.7	0.4	0.5
Miscellaneous	0.5	8.8	3.6	1.1	0.4	0.3

Note: Life Science refers to health care sector.
Source: Canada Development Corporation, *Annual Reports*, various reports from 1973-82.

There were additional corporate moves that the CDC undertook in other industrial sectors. They include, for example, the CDC Data Systems' purchase of majority interests in AES Data Ltd., Wordplex Corporations, and Ventek Limited in mid-1978 and the CDC's acquisition of a 57 percent interest in the American photocopier maker Savin

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Corporation in 1982. These acquisitions contributed to making the information processing category the fourth largest sector to receive CDC investment. Still, the attention given to those industries paled in comparison to the CDC's interest in the energy sector.

Founded on the private corporate model, the Canada Development Corporation was designed to operate much like a private company and appeal to private investors by promising competitive returns. As Brooks notes, the CDC "would constitute 'people's capitalism,' providing ordinary citizens with an opportunity to invest directly in Canada's economic development."[13] To achieve this goal, the CDC could begin issuing shares to the public three years after it was created, thus reducing the percentage of shares owned by government over a period of time. Although the government's holdings declined from 100 percent in 1974 to 68 percent in 1978 to 48.6 percent in 1981, the level of government ownership remained above the expected target. Disappointed at the lower than expected percentage of privately-owned shares, the government sought to encourage more private investors to channel funds into the CDC by "writing a letter of understanding to the Board of Directors and by refraining from exercising its right to vote in favor of the option to nominate 4 members to the 18-to-21 member board" as Laux and Molot point out.[14] Private investors were reluctant to invest in the CDC in part because they discounted the government's reassurance that it would not interfere in the corporation's affairs.

The other factor which contributed to low private sector involvement related to the lack of confidence among its investors about the CDC's ability to be perceived as

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[13] Brooks, *The State as Entrepreneur*, p. 532.
[14] Jeanne Kirk Laux and Maureen Appel Molot, *State Capitalism*, p. 96.

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maintaining a balance between its two mandates. A survey of shareholders' perceptions of the CDC taken in 1976 concluded that private investors believed that the nationalist objective weighed more significantly in decisions of the CDC than the commercial mandate.[15] As such, the sentiment among its investors was that the CDC did not always base its investment decisions solely on the criterion of profitability but rather on a formula that included profitability and expanding Canadian control of particular key sectors of the Canadian economy.

If private actors felt that the institutional devices intended to protect the CDC from government interference were weak, they were proven correct in the wake of the Liberal Party's return to power in 1980 after a brief Conservative interregnum. Emboldened by a renewed interest in the ideology of economic nationalism which took root during the few months it had served as the official opposition party in Parliament, the Liberal government unveiled an economic agenda that promised more government involvement in the economy. In particular, the new Minister of Industry, Trade, and Commerce Herb Gray suggested that the government exert more influence over the management of the CDC so that it could "take a stronger role in the manufacturing sector [which was] underrepresented in CDC's portfolio."[16]

The willingness on the part of government to use the CDC as an instrument of policy was displayed in two cases. In late 1980, the Department of Industry, Trade, and Commerce attempted to persuade the CDC to invest in Massey Ferguson, a Canadian multinational corporation, at a time when the corporation was seeking to refinance its operations. When the CDC opposed the plan to bail out the Canadian firm, the

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[15] R. F. Kelly, *Shareholder Survey* (1976).
[16] Financial Times, "Herb Gray's plea to cabinet," 16 (September 16 1980), p. 2. See also Globe and Mail, (May 29, 1980), p. B1.

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government pressured members of the corporation's Board of Directors to replace the current chairman, Frederick Sellers, with Maurice Strong whose views on the CDC were closer to those of the government's. Such interference embittered relations with CDC management, who strongly resisted this move by the government. The case illustrated that the Liberals were seeking a more tractable entity that would adhere to government objectives.[17]

Before a solution could be found to this impasse, the government further undercut the CDC with a plan to subsume the entity under a new holding company called the Canada Development Investment Corporation. The economic recession that gripped Canada in the early 1980s coupled with the revelation that an increased number of Crown corporations were facing financial and managerial problems caused the government to look into ways of rationalizing publicly owned assets and to increase the profitability of commercially oriented public companies such as Teleglobe Canada, Eldorado Nuclear, and Canadair among others. The new entity would be responsible for implementing plans to shore up those state-owned companies that remained economically viable and divest out of those companies no longer profitable.

The combination of these two circumstances served as a catalyst for the creation of the Canada Development Investment Corporation (CDIC) in 1982. As an investment holding company with a Crown corporation status, the CDIC was given the mandate to "manage in a commercial manner enterprises and investments assigned to it by the government and to divest those enterprises and investments on commercial terms when

[17] See Peter Foster, "Ottawa's Man: The Interventionist Politics of Maurice Strong," *Saturday Night* (August 1983).

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the opportunity arises."[18] The CDIC became the holding company for the government's 48 percent shares of the CDC; for such Crown corporations as Canadair, De Havilland Aircraft, Eldorado Nuclear, and Teleglobe Canada; and for the government's $125 million equity in Massey-Ferguson.[19] The CDIC was also designed to be a more tractable instrument of public policy. As Brooks points out, "The origins of the CDIC cannot be considered apart from the inability of the government to exercise even a minimal level of control over the investment activities of the CDC. If the commercial success of the CDC was achieved...at the cost of its failure as a governing instrument, the reverse is a likely prognosis for the CDIC."[20] To avoid a repetition of the political feud between the CDC and the government, an institutional choice was made to subject the CDIC to political accountability. In particular, the order-in-council (a cabinet decision) that created the CDIC established that "the Corporation shall comply with any specific direction in writing that may be given to it by the Governor-in-Council [the cabinet] in furtherance of any policy or policies of the Government of Canada."[21]

The CDIC practiced a 'businesslike' style of management, focusing the bulk of its resources on managing the rationalization of public assets. As Laux and Molot point out, the CDIC "served principally to rationalize state-owned enterprises in crisis to avert their financial collapse and divert political pressures..."[22] If there is one accomplishment the CDIC could take credit for it was that it proved to be an effective transitional agent from the Third Option to the strategy of economic liberalism. Although the Trudeau

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[18] CDIC, Annual Report, p. 2.
[19] CDIC, Annual Report, 1983.
[20] Brooks, "The State as entrepreneur: from CDC to CDIC," p. 537.
[21] Quoted in Laux and Molot, *State Capitalism*, p. 134. The CDIC was incorporated under the Canada Business Corporations Act, a legislative track which does not require formal parliamentary approval.
[22] Laux and Molot, *State Capitalism*, p. 135.

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government did not undertake privatization in its last two years in office, a few privatization plans that were being formulated by the Liberals were quickly implemented when Prime Minister Mulroney's Progressive Conservative Party took power in late 1984.

The case of the CDC illustrates the difficulty Ottawa encountered when it sought to employ a well-established policy instrument, the creation of a public enterprise, to perform a task that had never been undertaken before. Although previous national governments had created public enterprises, what distinguished the CDC case from others was the fact that the CDC went beyond the normal scope of government involvement in the economy. Rather than the activity-specific functions of other Crown corporations, such as the involvement of Canadair in the transportation sector, Teleglobe Canada in the telecommunications sector, de Havilland in the aerospace sector, the CDC was designed to move into as many sectors as possible. While undertaking this, the CDC was required to balance two mandates that were not necessarily compatible. On the one hand, the commercial mandate forced the CDC to identify those sectors of the economy where there were opportunities for growth and profit making. Canada's abundant energy resources made this sector one of the very few sectors in which the CDC could accomplish this objective. On the other hand, the nationalist mandate required the CDC to assist in expanding Canadian participation across all sectors of the economy, a task which demanded that the CDC diversify its activities into sectors that did not necessarily promise opportunities for sustained growth or profit making.

The effectiveness of the CDC in performing the gatekeeping function was also undermined as a result of the arm's-length pattern of government-societal relations,

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which constrained the government's ability to mobilize private savings. Whereas other Crown corporations did not depend on the consent of the private sector to attain their objectives, the CDC demanded it.

THE REGULATION OF FOREIGN INVESTMENT: FOREIGN INVESTMENT REVIEW AGENCY AND THE NATIONAL ENERGY PROGRAM

As a general rule, a government tends to be concerned with the level of foreign ownership and control of the productive assets of its economy and interested in the performance of national firms abroad. A government is concerned about foreign involvement because as the ratio of foreign to domestic ownership increases the less domestic interests are reflected in the economy's process of economic development. Moreover, a government takes particular interest in the international performance of its national firms because the economies of scale they obtain by expanding their international activities will translate into more robust economic growth and strengthen the industrial capacity of the national economy. Historically, the Canadian state has paid attention to foreign participation in the economy; however, the issue gained particular importance starting in the late 1960s and early 1970s in Canada as it did in other countries. Canada's heightened concern with foreign investment was illustrated when the Trudeau government created the Foreign Investment Review Agency (FIRA) in 1974. This section will discuss past policy efforts with respect to regulating foreign investment and it will explore how the political structure shaped the creation of FIRA. Finally, this section will explain why the Trudeau administration's efforts to toughen FIRA and to engage in the Canadianization of the energy sector through the National Energy Program failed.

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Historical Antecedents

Since 1867, some sectors of the Canadian economy have been subject to foreign investment regulations. For instance, from the beginning of the 1900s to the late 1960s, a number of laws limited the level of foreign participation in the banking, transportation, and broadcasting industries.[23] In the 1960s, the regulatory power of the federal state spread to the energy sector, as Ottawa implemented such laws as the Canada Mining Regulations, the Canada Oil and Gas Regulations, and the Northern Mineral Exploration Assistance Regulations, all of which were aimed at increasing the level of Canadian participation in a sector largely dominated by American companies.[24]

The passage of the Corporations and Labour Unions Returns Act (CALURA) in 1962 amounted to an expansion of the government's ability to monitor the activities of foreign companies. The Act required all Canadian companies with assets and revenues that exceeded a minimum level to file detailed annual reports revealing their operations, corporate assets, and composition of ownership structure. Finally, in response to the growing presence of foreign investors in Canada, Prime Minister Pearson's Liberal government in 1966 introduced "Guidelines of Good Corporate Citizenship," a set of non-compulsory rules intended to influence the practices of foreign corporations (see Appendix III). In assembling a list of guidelines, Trade Minister Robert Winters hoped that "this statement of the basic essentials of good corporate citizenship will contribute to a better understanding of the role of subsidiaries ...in our economy and will encourage

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[23] Richard Schultz, Frank Swedlove, and Katherine Swinton, *The Cabinet as a Regulatory Body: The Case of the Foreign Investment Review Act*, Working Paper no. 6 (Ottawa: Economic Council of Canada, 1987).
[24] Thomas Franck and K. Scott Gudgeon, "Canada's Foreign Investment Control Experiment: The Law, the Context, and the Practice," *New York University Law Review* (April 1975), p. 96.

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and facilitate their full participation in our growth and development in line with Canada's trade, economic, and social needs."[25]

In addition to the sectoral approach to foreign investment regulation and creation of CALURA, the immediate years preceding the creation of the FIRA saw the publication of three important reports that specifically studied the issue of the political and economic effects of foreign investment in Canada. The reports included the *Foreign Ownership and the Structure of Canadian Industry* (Watkins Report, 1968), the *Report of the Standing Committee on External Affairs and National Defence* (Wahn Report, 1970), and the *Foreign Direct Investment in Canada* (Gray Report, 1972).

The most important conclusion of the Watkins Report was that the practice of extraterritoriality—where foreign corporations obeyed and implemented the laws and policies of their home governments in the host country, amounted to the severest effect associated with hosting a large number of foreign firms. As the Report noted, "From the viewpoint of the host country, the extraterritorial extension of law is an undeniable cost of foreign direct investment. Overlapping legal jurisdiction threatens the national sovereignty of the host country...[and] if the content of the law conflicts with the policy of the host country, the situation simply becomes more tense."[26]

The Watkins Report also concluded that the threat of extraterritoriality would increase as the level of foreign ownership and control increased, a trend the authors of the Report attributed to the fact that foreign investors viewed Canada as an attractive market

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[25] "Masters & Gentlemen: A Diary of the US Guidelines Issue," in Dave Godfrey with Mel Watkins, eds., *Gordon to Watkins to You. Documentary: The Battle for Control of our Economy* (Toronto: New Press, 1970), p. 52.

[26] Government of Canada, Privy Council Office, *Foreign Ownership and the Structure of Canadian Industry: Report of the Task Force on the Structure of Canadian Industry* (Watkins Report) (Ottawa: Queen's Printer, 1968), p. 49.

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in which to do business. To enhance the benefits derived from the activities of multinational corporations operating in Canada without undermining Canada's reputation as a lucrative investment location, the Watkins Report recommended the creation of a special agency which would survey and monitor the activities of multinational corporations in Canada and seek to gain the consent of multinational corporations with respect to fulfilling the 1966 Guidelines.[27]

The report submitted by the House of Commons Standing Committee on External Affairs and National Defence marked the first time members of Parliament had addressed the implications of foreign investment in Canada. Unique in this respect, it was also unique in the recommendation it put forth:

> The Committee recognizes that as a general rule it is desirable that Canadians should control Canadian companies by owning at least 51% of their voting shares, particularly in the important sectors of the economy where American control is now most highly concentrated, and that we should move toward this goal as rapidly as capital requirements and other relevant circumstances permit.[28]

According to the Wahn Committee, the current level of foreign investment in Canada had reached a high enough level to warrant such a radical "buy-back" policy. Interestingly, the Committee did not consider how much of an expansion of state intervention it would require to achieve such a vast repatriation of foreign-owned economic assets. However, the Committee did recommend that the government create a Canadian Ownership and Control Bureau which would carry out functions similar to those of the agency outlined in the Watkins Report. The Wahn Committee envisioned the Bureau as being actively

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[27] Watkins Report, pp. 395-6.
[28] Government of Canada, *Eleventh Report of the Standing Committee on External Affairs and national Defence Respecting Canada-U.S. Relations*, Second Session, 28th Parliament (Wahn Report) (Ottawa: Queen's Printer, 1970), p. 138.

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involved in the screening of foreign takeovers of Canadian business, scrutinizing all applications for new foreign investment in Canada, and assessing the activities of those multinational corporations where the practice of extraterritoriality was alleged.[29]

Armed with these two reports the government began to develop and assemble the pieces of the organizational apparatus that would eventually give rise to the FIRA. But the period from 1970 to 1973 also witnessed some important changes which helped keep the issue of foreign investment regulation at the forefront of the government agenda. For instance, public perception of foreign investment shifted in favor of foreign regulation. When respondents were asked in 1970 whether there was enough or would like to see more American investment in Canada, 62 percent of Canadians stated that there was enough while 25 percent of respondents wanted to see more investment. In 1975, 71 percent of respondents noted that there was enough United States investment in Canada, while 16 percent wanted to see more.[30] Equally significant were the responses to the question of whether Canadians would support a policy initiative to buy back a majority control of American companies in Canada even if it meant having to accept a reduction in their standard of living. In 1970, 46 percent of Canadians supported a policy that promoted the repatriation of economic assets, while 32 percent disapproved. In 1975, the approval rate had increased to 58 percent, while 26 percent rejected such an economic plan.[31]

This period also saw the emergence of two influential societal groups which focused their efforts on pressuring the government to regulate the inflow of American

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[29] Wahn Report, pp. 140-142.
[30] Maureen Appel Molot and Glen Wiliams, "The Political Economy of Continentalism," in Michael Whittington and Glen Williams, eds., *Canadian Politics in the 1980s* (Toronto: Methuen Publications, 1984), p. 93.
[31] Ibid., p. 93.

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investment in Canada. Founded in 1969, the Waffle entered the political scene by forming an alliance with the worker-based New Democratic Party (NDP).[32] The Wafflers contended that "the major threat to Canadian survival [was] American control of the Canadian economy." To that extent, they argued that "the major issue of our times [was] not national unity but national survival, and the fundamental threat [was] external not internal."[33] To counter this external threat, the Wafflers and the NDP proposed a plan to drastically increase the role of the state in the economy to the point of nationalizing various sectors of the economy.

As a centrist organization, the Committee for an Independent Canada (CIC) was created in September 1970 to offer a more moderate alternative to the radicalism of Waffle. The CIC urged Ottawa to "adopt legislative policies that will significantly diminish the influence...exerted by outside powers...on Canadian life." Drawing upon the conclusions and recommendations of the Watkins and Wahn Reports, the CIC suggested that Canada could strengthen its economic autonomy if the government established an agency to "supervise the conduct of foreign-controlled operations in Canada, and in particular any new takeovers."[34] Although it claimed to have non-partisan ties, the CIC maintained ties to the Liberal Party. The former Liberal finance minister Walter Gordon served as its honorary chairman and Liberal Party members such as Herb Gray and Alastair Gillespie, both of whom were instrumental in defining the

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[32] Among the members of the Waffle, the most notable were Melville Watkins, James Laxer, and Cy Gonick.
[33] Quoted in Janine Brodie and Jane Jenson, *Crisis, Challenge and Change: Party and Class in Canada* (Ottawa: Carleton University Press, 1988), p. 273.
[34] Quoted in Stephen Azzi, *Walter Gordon & the Rise of Canadian Nationalism* (Montreal: McGill-Queen's University Press, 1999), p. 178.

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statist variant of the Third National Policy, were supporters of the CIC.[35] Thus on the eve of the publication of the Gray Report, a wave of economic nationalism had swept through Canada, spurred by an emboldened and more dominant middle class.

When the Gray Report came out in 1972, it was the most comprehensive analysis of foreign investment in Canada ever undertaken by a government-sponsored commission. Unlike the Watkins and Wahn Reports, the Cabinet had called on Herb Gray in 1970, who at the time was Minister Without Portfolio, to bring "forward proposals on foreign investment policy for the consideration of the government."[36] Although the Report included a caveat that "it is not a statement of government policy nor should it be assumed that the government endorses all aspects of the analysis contained in it," the Report had a defining impact on subsequent public debates on the issue of foreign investment restrictions.

The Gray Report put forth two groundbreaking conclusions. First, it concluded that the effects of foreign-controlled Canadian assets went beyond extraterritoriality, which the Watkins and Wahn Reports had underlined. The Gray Report contended that the high level of foreign penetration contributed to the "truncation" of Canadian manufacturing. The Report defined the problem as follows:

> Truncation means potentially less *decision making* and *activity* in in Canada—fewer opportunities, fewer supporting services, less training of local personnel in various skills, less specialized product development aimed at Canadian needs or tastes and less spill-over economic activity. It ties the subsidiary to the parent in a relationship of dependence... (italics added).[37]

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[35] Other notable members of the CIC included Mel Hurtig, Maurice Lamontagne, Lloyd Axworthy, Adrienne Clarkson, Kenneth McNaught, Denis Smith, Peter Newman, and Claude Ryan.
[36] Government of Canada, *Foreign Investment in Canada* (Gray Report) (Ottawa: Information Canada, 1972), p. v.
[37] Gray Report, pp. 42-43.

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Although the Report acknowledged that the Canadian economy had benefited from foreign investment, it also argued that Canadian subsidiaries of American companies purposefully limited their range of activities, thus slowing the pace of industrial development in Canada. In light of this, the report proposed the establishment of an agency to assess the contributions of foreign investment on the basis of what "significant benefits" they provide to the Canadian economy.

The second conclusion of the Gray Report related to the need to enhance the Canadian government's bargaining leverage vis-à-vis foreign investors in order to obtain from them greater commitment to diversify their activities. What is significant about this conclusion is the fact that it was based on the belief that Canada could be "selective in determining what type of foreign capital will be allowed to enter" and avert regulation because Canada was host to many foreign subsidiaries that could not quickly exit upon introducing some restrictions and conditions on their activities.[38] With this goal, the Report considered three approaches—the "key sector," the "fixed rule," and the investment screening approaches. Whereas the "key sector" approach proposed restricting foreign involvement in certain "commanding heights" of the economy, the "fixed rules" approach suggested setting a mandatory minimum level of Canadian equity ownership in American-owned companies.[39] Rejecting these two approaches, the Gray Report advocated the investment screening approach. It envisioned a screening agency with the capacity to scrutinize all foreign takeovers of companies operating in Canada, all

[38] See Gray Report, p. 84 and pp. 479-80. This point is also addressed by Sjolander, *Foreign Investment Policy-Making*, p. 288 and by Franck and Gudgeon, 1975, pp. 103-4.
[39] For a discussion of these two approaches, see the Gray Report, pp. 493-517.

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new foreign investment entering Canada, and all expansions into unrelated activities of foreign-owned companies already established in Canada.[40]

The Creation of FIRA: The Politics of Institutional Innovation

The politics surrounding the creation of the institutional machinery of FIRA were profoundly shaped by provincial and bureaucratic forces. The nature of the public policy issue—restricting foreign investment—inevitably involved the provinces because of jurisdictional overlapping. To make matters more complicated, the Liberal government of Trudeau was divided over foreign investment regulation as was the federal bureaucracy. Moreover, the political battle took on added significance because the proposal to restrict foreign investment would mean expanding the interventionist capacity of the federal state beyond any level previously experienced.

On May 4, 1972, two days after the Gray Report was released to the public, the Trudeau government introduced the Foreign Takeovers Review Act (Bill C-201) in the House of Commons. The Takeovers Bill did not adopt in full the recommendations that the Gray Report had made with respect to reviewing foreign investment in Canada. In fact, Bill C-201 proposed to review only foreign takeovers of existing Canadian businesses, thus leaving unscreened all existing foreign investments and all new foreign investment projects in Canada.

The reluctance of the Trudeau government to broaden the scope of foreign investment screening was owed to three factors.[41] First, the absence of prior policy

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[40] Gray Report, pp. 462-469.

[41] See Franck and Gudgeon, 1975, pp. 105-6. The authors note that the Trudeau government was also concerned about the possibility that the United States would retaliate if Canada began to set conditions on American investment in Canada. Of the factors addressed by the authors this one appears to have had least lasting impact. While Americans become increasingly irritated with FIRA as the 1970s drew to a close and

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experience in performing this task produced a mood of caution among policy makers who were uncertain about how to deal with the administrative and managerial complexity of engaging in foreign investment review. Second, over the course of the postwar period, the Liberal Party had let Canada become more tied economically with the United States. This silent integration had been propelled by the idea of foreign investment liberalism which was embedded in various segments of the federal bureaucracy and especially advocated by the Canadian business community. Finally, foreign investment was viewed differently across the provinces, for foreign investment tended to serve the interests of some provinces better than others. The lack of consensus among the provinces led Ottawa to settle for minimal foreign investment screening as a way to stave off widespread provincial opposition.

The lifespan of Bill C-201 was cut short, however, when Parliament was dissolved in September of 1972 in preparation for the October elections. After a couple of months out of the political limelight, the foreign investment review issue reemerged when the minority Liberal government of Trudeau introduced the Foreign Investment Review Act (Bill C-132) on January 24, 1973.

Compared to the previous foreign investment regulation legislation, Bill C-132 and the Gray Report had more in common. It is without a doubt that the new electoral landscape had weighed heavily in shaping the Review Act. To appease the New Democratic Party, which held the balance of power in the House of Commons, the Trudeau government had included a few of the recommendations that the NDP had requested when Bill C-201 was introduced in House of Commons. But there were other

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particularly in the first half of the 1980s, American opposition tended to be modest in the beginning of the 1970s. See Stephen Clarkson, *Canada and the Reagan Challenge: Crisis in the Canadian-American Relationship* (Toronto: James Lorimer & Company, Publishers, 1982), pp. 86-8.

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factors that helped define Bill C-132. Trudeau's decision to appoint Alastair Gillespie as Minister of Industry, Trade and Commerce, a position that would make him the point man in the political battle to pass the Review Bill, proved to be a clever one given Gillespie's advocacy of economic nationalism. Moreover, the Review Bill was introduced as part of a broader plan of action to enhance Canadian control over the national economy. According to Gillespie, Bill C-132 was just one of the means to accomplish the following:

> Foreign ownership policy is not an end in itself. Together with other measures, this bill will help...to support the development of strong, Canadian-held business enterprises; two, to ensure that future foreign takeovers and the establishment of new foreign-held businesses will be of significant benefit to Canada; three, to help arrest and reverse the increasing degree of foreign control of our economy; four, to contribute to the development of a distinctive Canadian identity.[42]

The Foreign Investment Review Act received Royal Assent on December 12 1973, and its first phase came into force on April 19, 1974, while the second phase began in October 15, 1975. Despite the notable differences between the Foreign Investment Review Agency (FIRA) and its aborted predecessor, FIRA received poor marks throughout the 1970s and 1980s. According to Molot and Williams, "the agency was more an exercise in symbolic politics than a genuine effort to regulate foreign investment coming into Canada."[43] Similarly, Jenkins refers to FIRA as a rubber-stamping agency proving unwilling to challenge the postwar trend toward increased foreign investment in

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[42] House of Commons, *Commons Debates* (March 30, 1973), p. 2777.
[43] Maureen Appel Molot and Glen Williams, "The Political Economy of Continentalism," in Michael Whittington and Glen Williams, eds., *Canadian Politics in the 1980s*, Second edition (Toronto: Methuen, 1984), p. 89.

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Canada.[44] And, as Franck and Gudgeon note, "It is evident that the Government consistently sought to strike a balance between prohibition or roll-back of foreign investment on the one hand and traditional laissez-faire on the other."[45] Why did FIRA fare poorly in the 1970s? The answer can be divided into two parts: (1) its dismal performance reflected what it was programmed to do, (2) its performance also reflected FIRA's decision-making structure.

One of the sources of FIRA's weakness stemmed from what it was programmed to do. FIRA's scope of authority was restricted and ambiguously defined. FIRA was given the authority to review three types of foreign investment: first, review most acquisitions of Canadian corporations by non-Canadian investors; second, review the establishment of new Canadian corporations by foreigners who were not already present in Canada; and third, review new investment into an unrelated line of business by non-Canadians already operating in Canada.

Omitted from FIRA's scope of authority was the ability to review the operations of existing foreign companies in Canada, particularly their expansion and investment into "related" production activities. This was an important omission given that 80 percent of foreign investment in Canada was accounted for by this form of investment activity.[46] In a brief submitted to the House of Common's Standing Committee on Finance, Trade and Economic Affairs, the Committee for an Independent Canada noted that FIRA "assumes that takeovers and new foreign investment may or may not be of significant benefit to Canada, but it refuses to apply this same assumption to existing foreign enterprises which

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[44] Barbara Jenkins, *The Paradox of Continental Production: National Investment Policies in North America* (Ithaca: Cornell University Press, 1993), p. 110.
[45] Franck and Gudgeon, 1975, p. 109.
[46] "Brief Submitted to The Standing Committee on Finance, Trade and Economic Affairs of the House of Commons by the Committee for an Independent Canada concerning Bill C-132," (Ottawa, June 21, 1973).

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represent the bulk of our problem of controlling the Canadian economy in the interest of Canadians. It establishes a 'grandfather' clause to legitimize all existing foreign investment, whether good or bad."[47]

FIRA's authority was further undercut because the criteria used to review foreign investment were ambiguously defined. FIRA assessed foreign investment on the basis of whether it contributed "significant benefits" to Canada. Without specific benchmarks, there was no way to measure the significance of foreign investment contribution, thus leaving FIRA little reason for rejecting foreign investment applications. However, to the critics of FIRA, this particular flaw was not without its disadvantages. As the Canadian business community saw it, a general set of criteria would invite "discretionary governmental intrusion into the economic processes."[48] But, in justifying the decision to go forward with a general set of criteria, Minister of Industry, Trade and Commerce Gillespie stated during committee hearings on Bill C-132 that "at this stage, precise standards for measuring acceptability cannot be spelled out. Ability to spell these out will depend upon experience with specific cases; particular decisions will lead to a body of guidelines [which] I would hope then, it may eventually be possible to publish."[49] In the meantime, five general criteria were established:

> (a) the effect on the level and nature of economic activity in Canada, including the effect on employment, on resource processing, on the utilization of Canadian parts, components and services, and on exports;
> (b) the degree and significance of participation by Canadians in the business enterprise and in the industry sector to which the

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[47] Ibid., p. 269.
[48] Executive Council of the Canadian Chamber of Commerce, "Submission on Foreign Investment in the Context of a Canadian Industry Strategy to the Honourable A.W. Gillespie, Minister of Industry, Trade and Commerce (April, 1973), p. 322. Reproduced in Appendix Q of Hearing of the Standing Committee on Finance, Trade and Economic Affairs of the House of Commons (July 19, 1973).
[49] Alastair Gillespie, "Statement before the Standing Committee on Finance, Trade and Economic Affairs of the House of Commons, (June 5, 1973), p. 7.

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enterprise belongs;
(c) the effect on productivity, industrial efficiency, technological development, innovation and product variety;
(d) the effect on competition within any industry or industries in Canada;
(e) compatibility with national industrial and economic policies.[50]

As the 1970s wore on, the FIRA gained expertise and managed to elaborate more specifically certain objective conditions by which to evaluate foreign investment. Perhaps the most important development was the announcement of "New Principles of International Business Conduct" by ITC Minister Gillespie (see Appendix IV). Like the Winters Guidelines announced in the 1966, the Gillespie Guidelines were informed by economic nationalism. The new guidelines sought to shape the behavior of foreign companies operating in Canada in ways that helped Canada accomplish its economic development objectives as well as political objectives such as enhancing the country's economic and political independence. Moreover, when Gillespie introduced these guidelines in the House of Commons, he intended them to further clarify the set of criteria which FIRA employed as measurement of "significant benefits." However, they were not compulsory guidelines which foreign companies were forced to satisfy, nor were these guidelines embedded in the institutional machinery of the FIRA.

These two factors accounted for FIRA's liberal record of foreign investment applications reviews. Contrary to the Canadian business community's assertion that the FIRA was biased against foreign investment, the agency was more inclined to approve rather than disallow applications of foreign investment as Table 6.2 shows. The data collected by FIRA revealed other interesting facts. The data show that the share of rejected applications gradually declined over the course of the 1970s, reaching a low of

[50] Foreign Investment Review Agency, *Foreign Investment Review Agency: Annual Report, 1975-76* (Ottawa: Supply and Services, 1976), p. 11.

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5.01 percent in 1977, and relative lows of 8.11 percent in 1978 and 7.31 percent in 1979.[51] Moreover, in its five year review, the FIRA observed that of the 2,089 reviewed

Table 6.2. Foreign Investment Agency Review Activities, 1974-1985

	Outcome of Resolved Acquisition Percentage of Industry Sector Total			Outcome of Resolved New Business Percentage of Industry Sector Total		
	Allowed	Disallowed	Withdrawn	Allowed	Disallowed	Withdrawn
1974-75						
Resources	81.8	9.1	9.1	--	--	--
Manufacturing	60.0	17.8	22.2	--	--	--
Services	79.4	8.8	17.6	--	--	--
1975-76						
Resources	68.2	13.6	18.2	--	--	--
Manufacturing	75.8	16.7	7.5	--	--	--
Services	69.2	12.3	18.5	--	--	--
1976-77						
Resources	64.3	21.4	14.3	80.0	--	20.0
Manufacturing	84.7	6.7	8.6	84.7	4.2	11.1
Services	76.4	12.5	11.1	77.6	8.8	13.6
1977-78						
Resources	82.6	4.4	13.0	88.5	3.8	7.7
Manufacturing	93.2	2.6	4.2	93.0	1.0	6.0
Services	90.3	5.7	4.0	87.2	5.7	7.1
1978-79						
Resources	91.7	--	8.3	81.0	--	19.0
Manufacturing	87.1	6.8	6.1	94.6	3.2	2.2
Services	88.0	9.6	2.4	85.4	7.3	7.3
1979-80						
Resources	72.4	20.7	6.9	87.0	8.7	4.3
Manufacturing	86.7	5.2	8.1	92.7	2.7	4.6
Services	86.5	7.6	5.9	84.5	8.7	6.8
1980-81						
Resources	43.8	31.2	25.0	57.9	5.3	36.8
Manufacturing	80.4	9.8	9.8	95.3	1.9	2.8
Services	70.4	12.4	17.2	72.0	14.3	13.7
1981-82						
Resources	35.7	50.0	14.3	66.7	11.1	22.2
Manufacturing	88.0	6.8	5.2	83.1	4.8	12.1
Services	75.4	12.0	12.6	56.3	14.3	29.4
1982-83						
Resources	67.9	17.8	14.3	94.4	--	5.6
Manufacturing	92.7	--	7.3	91.0	2.2	6.8
Services	91.2	2.7	6.1	77.3	10.7	12.0
1983-84						
Resources	94.1	--	5.9	85.0	--	15.0
Manufacturing	95.9	--	4.1	93.3	3.0	3.7
Services	88.6	2.0	9.4	84.4	5.3	10.3
1984-85						
Resources	92.6	--	7.4	87.6	6.2	6.2
Manufacturing	95.6	1.5	2.9	95.2	0.8	4.0
Services	92.8	0.4	6.8	93.2	1.1	5.7

Source: Foreign Investment Review Agency, *Foreign Investment Review Act: Annual Report* (Ottawa: Supply and Services, various years).

[51] Barbara Jenkins, *The Paradox of Continental Production*, 1992, p. 116.

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applications, 61.5 percent came from American investors and 31.7 percent from Western European investors. Whereas the services sector was the main target of new-business applications with 62.3 percent compared to manufacturing's 30.5 percent, the manufacturing sectors faced more acquisition applications with 46.4 percent compared to services' 44.4 percent. In the manufacturing sector, the United States accounted for 49 percent of the acquisition cases compared to Europe's 42 percent.[52] As for the distribution of applications by provinces, 1,147 applications were destined for Ontario, 495 for the Western provinces, 361 for Quebec, and 86 for the Atlantic provinces.[53]

FIRA's dismal performance also resulted from the decision making structure it was given. Ideally, FIRA's institutional position within the executive administrative apparatus should have given it an ability to make decisions based on the application of an internally derived standard of application evaluation which was consistent with the promotion of state goals. Moreover, the ideal institutional home would have given the agency some autonomy from political influence as well as an ability to consult with societal groups as a way to exchange information vital to accomplishing the government's goals of developing a stronger Canadian presence in the economy and ensuring that incoming foreign investment contributed to strengthening Canada's industrial capacity.

When the Gray Report recommended the establishment of a review agency, it argued against endowing the agency with independent decision-making capacity. According to the authors of the Report, granting the agency an independent tribunal status "would require the government to delegate a substantial measure of responsibility

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[52] This data can be found Foreign Investment Review Agency, *Foreign Investment Review Agency: Annual Report, 1978-79* (Ottawa: Supply and Services, 1979), pp. 19-26.
[53] Ibid., p. 22.

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for decisions which would have great importance to its overall industrial and commercial policies to an independent body."[54] In keeping with the Report's position, Bill C-132 created an agency not in the institutional image of an independent body, rather as a non-departmental, advisory body.

The Cabinet was the designated entity that possessed regulatory authority. Accordingly, all applications were scrutinized to determine whether they were reviewable and included all the information the Compliance Branch of FIRA required to process an application. Once an application passed this stage, it was sent to the Assessment Branch where it was analyzed on the basis of the "significant benefit" criteria and documented. From there, the document prepared by the Assessment Branch was considered by the Minister responsible for the FIRA—the Minister of Industry, Trade and Commerce—who arrived at a particular recommendation. The general rule was that the Agency's advice was compatible with the Minister's recommendation. Finally, the Minister's recommendation was sent to the Governor in Council (the Cabinet) where it approved or disapproved the Minister's recommendation. In most cases, the Cabinet's decisions reflected the Minister's recommendation. In sum, FIRA did not exercise any decision-making authority and its recommendations were subject to two political veto players, the Minister in charge of FIRA and the Cabinet.

FIRA's decision-making structure was also shaped by two additional factors relating to the executive administrative apparatus. First, the organizational structure of the federal state offered an institutional backdrop that was not amenable to placing FIRA in a departmental structure and endowing it with independent decision-making capacity. On the question of departmental location, no department offered an appropriate home

[54] The Gray Report, p. 480.

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within which to operate. As Schultz, Swedlove, and Swinton point out, the most likely "departmental candidates for administering the screening process were rejected as being too biased in favour of foreign investment."[55] The Department of Finance, for example, contended that restricting foreign investment would produce balance of payments problems. As for the Department of Industry, Trade and Commerce (ITC), the other departmental candidate, the policy legacy of C.D. Howe weighed on present thinking to the extent that ITC bureaucrats continued to believe that the task of developing Canada's industrial base required foreign investment, even though there was evidence suggesting that foreign investment had the effect of truncating domestic manufacturing, worsening foreign technology dependence, and weakening exports of manufactured goods. The economic policy ideas that FIRA advocated, as Williams notes, were "just too unpalatable to ingest for many senior bureaucrats" of both departments since they advocated silent integration with the United States and foreign investment liberalization.[56] Adding to the difficulty of identifying a departmental home for FIRA was the recognition that the exercise of the agency's mandate would inevitably affect the activities of at least 17 departments.

Although horizontal politics among departments played an important role in the institutional politics revolving around FIRA, vertical politics between departments and central agencies also played a notable role. In the 1970s, Trudeau sought to centralize power and harness the machinery of government by giving central agencies more responsibilities and influence over policy formulation. On the one hand, the

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[55] Richard Schultz, Frank Swedlove, and Katherine Swinton, *The Cabinet as a Regulatory Body: the Case of the Foreign Investment Review Act* (Ottawa: Economic Council of Canada), p. 19.
[56] Glen Williams, *Not For Export: Toward a Political Economy of Canada's Arrested Industrialization* (Toronto: McClelland and Stewart, 1983), p. 166.

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administrative reform was intended to introduce greater coherence in the decision-making process; on the other hand, the reform was designed to increase the prime minister's influence and control of the bureaucracy. As such, central agencies, such as the Privy Council Office and the Prime Minister's Office, were to assume greater responsibility in managing policy making.

The decision to give FIRA a non-departmental status was influenced by the concurrent process of centralizing decision-making authority within the executive administrative apparatus. It was believed that just as other policy initiatives had been undermined by bureaucratic struggles so too would this dynamic interfere in the operations of FIRA if the agency was placed within a departmental structure. Also, the non-departmental status of FIRA would at least give central agencies greater access to the agency than if it were lodged within a department. As Schultz, Swedlove, and Swinton note, "A non-departmental status for the agency, especially given its limited size and its concomitant inability to call on the resources of a 'parent' department would be a means whereby central agencies could attempt to ensure that they would maintain control of the process."[57]

Finally, FIRA's organizational structure was a perfect institutional compromise between the need to draw attention toward the federal government when FIRA received positive endorsements and to divert criticism away from government when FIRA made controversial decisions. The non-departmental status of FIRA afforded the government the needed political distance to avert being directly embroiled in the event the agency made a controversial decision to struck down an application. In sum, the decision-making structure of FIRA reflected key features of the executive apparatus at the time it

[57] Schultz, Swedlove, and Swinton, *The Cabinet as a Regulatory Body*, p. 20.

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was conceived, which explains why FIRA appeared to be pulled in different directions and at the same time appeared to be isolated. The growing importance of central agencies only added to the bureaucratic pluralism inherent in the federal executive structure. Consequently, FIRA was not only exposed to the influences of the Cabinet and various departmental officials, but also central agencies. Moreover, the absence of an appropriate departmental home, the lack of unanimity within the bureaucratic apparatus on the issue of foreign investment regulation, and the unwillingness to accept responsibility for controversial FIRA decisions contributed to placing the agency outside of the regular bureaucratic apparatus.

In addition to the executive administrative structure, Canada's federal structure shaped the decision-making structure of FIRA. In light of the realities of a federal system in which both levels of government share overlapping jurisdictions such as economic regulation, the ideal institutional form of FIRA would have included an intergovernmental component that sought to foster consensus on the goals that FIRA should fulfill and gave a voice to the provinces in the agency's review process.

Although the actual institutional design of FIRA had a provincial-federal consultative mechanism which allowed provinces to weigh in on the review of foreign investment applications, FIRA was not guided by a set of economic objectives jointly conceived. Section 2(2)(e) of the Act that created FIRA stated that as the Agency reviewed applications, it was required to consider "the compatibility of the acquisition or establishment with national industrial and economic policy objectives enunciated by the government or legislature of any province likely to be significantly affected by the acquisition or establishment." Section 9(d) added that when the Minister of Industry,

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Trade and Commerce and the Cabinet reviewed applications they needed to consider "any representations submitted...by a province that is likely to be significantly affected by the proposed or actual investment." While these two sections contributed to instituting mandatory consultations with provinces, no procedures were established to facilitate the articulation of a common set of economic objectives which earned the approval of the provinces and Ottawa and that would be used to assess the significant benefits foreign investment applications brought to Canada. Instead, by recognizing "enunciated provincial policies," the particularistic economic interests of provinces were allowed to prevail over a common set of objectives. What explains the mandatory consultations with provinces and the inability to link the activities of FIRA to a common set of objectives? Two factors can shed light.

The Canadian constitution obscures rather than clarifies the issue of economic regulation in Canada. This was particularly the case with FIRA, a federal agency responsible for regulating foreign investment. As Franck and Gudgeon point out:

> Under the provisions of the British North American Act of 1867..., the provincial government has jurisdiction over "property...in the province" and "the incorporation of companies with provincial objects," while the federal government controls "trade and commerce".... This leaves open to question the exclusivity, supremacy or even permissibility of federal regulation of...the expansion of a foreign-controlled but provincially incorporated and regulated business operating wholly within one province.[58]

Indeed, this was a major concern raised in the briefs that the provinces submitted to the Standing Committee on Finance, Trade and Economic Affairs concerning Bill C-132. For example, Quebec argued that "any bill [restricting foreign investment] should

[58] Franck and Gudgeon, p. 136.

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explicitly...respect provincial jurisdictions."[59] Similarly, Ontario remarked that "it is a serious concern to Ontario that there be clarification of the manner in which the federal government proposes to ascertain the nature and status of provincial policy objectives for the purposes of the review process. In this regard, Ontario stresses that the provinces should alone be responsible for articulating their policy positions to the federal government."[60] Similarly, Saskatchewan welcomed Section 2(2)(e) because by creating FIRA Ottawa was in essence "assuming primacy of jurisdiction in this area of economic development involving corporate behaviour."[61] But, in seeking to safeguard its jurisdictional authority on this matter, the Saskatchewan government "was interested in obtaining some clarification from the federal government of what control measures or policy initiatives might be undertaken by the provinces as part of a national effort to regain control of the Canadian economy." In sum, the consultative mechanism of FIRA, which allowed provinces to influence the review process, was a product of constitutional necessity, for FIRA was engaged in a public policy domain over which neither the federal nor provincial authorities had exclusive jurisdiction.

The difficulty in formulating a common set of goals between the provinces and Ottawa had to do with inter-provincial differences in views toward foreign investment. In Central Canada, where foreign investment and manufacturing were most pronounced, FIRA's powers could have potentially positive effects as the Agency sought to extract favorable concessions from applicants. But in the Maritime region, where foreign

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[59] Government of Quebec, "Brief Submitted to the Standing Committee on Finance, Trade and Economic Affairs of the House of Commons, Concerning Bill C-132," Québec, Thursday, July 19, 1973.
[60] Government of Ontario, "Brief Presented to the Parliamentary Committee on Finance, Trade and Economic Affairs Re bill C-132: The Foreign Investment Review bill," July 19, 1973.
[61] Honourable Elwood Cowley, Minister of Finance, Government of Saskatchewan, "Brief Represented by the Government of Saskatchewan to the House of Commons Standing Committee on Finance, Trade and Economic Affairs Concerning Bill C-132, the Foreign Investment Review Act," June 19, 1973.

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investment and manufacturing industries were lacking, FIRA's efforts could potentially have negative effects, for foreign capital was regarded as the region's best chance of developing its industrial base. These regional differences are captured in Table 6.3, which measures public opinion on the issue of foreign investment. Canadians living in the Atlantic region and Prairies did not view foreign investment as posing as serious a problem as did Canadians in other parts of Canada. Interestingly, there was little difference of views among Canadians across different regions with respect to the problem posed by foreign investment in the future. Slightly more than one-quarter of the respondents agreed that foreign investment might be a problem in the future. This corroborates with the results of another public opinion poll, which indicated that approximately one-third of Canadians supported some kind of investment regulation in 1974 and 1976, as Table 6.4 illustrates. Significantly, when investment regulation and support for the CDC are added, slightly more than half of the respondents advocated the gatekeeping functions of the Liberal government in 1974.

Regional differences with respect to foreign investment, however, came out clearer when provincial governments debated Bill C-132. For the Ontario government, FIRA's

Table 6.3. Regional Views of Foreign Investment: Is Foreign Investment a Serious Problem (1974-1975)

		Atlantic	Quebec	Ontario	Prairies	British Columbia
Yes, a serious problem	(1975)	35.5%	43.1	38.6	34.3	40.1
	(1974)	32.2	43.3	38.5	41.5	51.0
Might be in the future	(1975)	26.3	28.7	24.9	27.2	29.0
	(1974)	29.2	26.4	26.7	27.9	24.3
No, not a problem	(1975)	24.7	20.9	26.4	26.5	23.2
	(1974)	25.9	22.0	24.7	19.9	18.7
No opinion	(1975)	13.1	7.4	10.1	11.9	7.7
	(1974)	12.6	8.3	10.1	10.7	6.0

Source: Terence Keenleyside, Lawrence LeDuc, and J. Alex Murray, "Public Opinion and Canada-United States Economic Relations," *Behind the Headlines* 35, No. 4 (1976), p. 18.

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Table 6.4. Proposed Solutions to the Foreign Investment Problem

	1979	1976	1974
More support for Canadian Business	35%	34%	33
Government regulation	24	31	32
Canada Development Corporation	18	17	22
Selected industry controls	13	14	12
Investment from many countries	9	7	7
All other	2	2	1
No opinion	2	2	1

Source: Lawrence LeDuc and J. Alex Murray, "A Resurgence of Canadian Nationalism: Attitudes and Policy in the 1980s," In Allan Kornberg and Harold Clarke, eds., *Political Support In Canada: The Crisis Years* (Duke University Press, 1983), p. 283.

instruments were to be brought to bear on those ongoing efforts to create a more integrated national economy, which naturally would work to preserve the current regional economic divisions. As the Government of Ontario noted, "We believe the primary objective of the proposed review process should not be to restrict foreign investment per se but to ensure that future investments by foreign corporations make an effective contribution to the achievement of national economic and social objectives." Although Ontario recognized that it was necessary for FIRA to "be sensitive to diverse provincial viewpoints," the province argued that "the wider interventionist role which will be available to the federal government should not be used as an instrument of regional development policy."[62] Clearly, the position of the Ontario government was that FIRA's screening capacity (and by extension its ability to extract favorable concessions from foreign investors) should not be employed to undermine the province's comparative advantage in manufacturing by persuading foreigners to invest in another province when the original plan was to invest in Ontario.

The government of Saskatchewan had a different position than Ontario, for it suggested that FIRA should be put in the service of a development policy intended to

[62] Government of Ontario, July 19, 1973.

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alleviate regional disparities caused by regionalized economic specialization. As Saskatchewan's Minister of Finance Elwood Cowley pointed out, one of the consequences of the current liberal approach toward foreign investment in Canada has been that "foreign ownership increases regional disparities and thus has hurt a province like Saskatchewan." Foreign investors, according to the Minister, reinforced the hinterland-center pattern of economic development within Canada by locating the bulk of their operations in Central Canada. Therefore, FIRA's screening powers should be employed in a manner which seeks to "ensure that investment is allocated across Canada by province and region such that the total package will contribute to a lessening of regional disparities."[63]

But perhaps the harshest indictment of FIRA came from Stephen Weymen, President of the Atlantic Provinces Economic Council. In conveying the view of Atlantic provinces, Weymen made the following remark: "It seems as if certain segments of opinion in Central Canada, having achieved the benefits of industrialization for themselves, now wish the Atlantic Provinces to forego the industrialization they never had in the interests of maintaining an ill-defined Canadian economic independence."[64] Sharing the same sentiment as Mr. Weymen, the Premier of New Brunswick, Richard Hatfield, remarked:

> The Government of New Brunswick's opinion on the proposed legislation [to create FIRA] is a simple and straight-forward one—we see no need for it in our region of Canada and we believe that it would prove to be harmful to our attempts to attract and to accelerate industrial development. The Maritime region has

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[63] "Brief Presented by the Government of Saskatchewan to the House of Commons Standing Committee on Finance, Trade and Economic Affairs concerning Bill C-132, the Foreign Investment Review Act," June 19, 1973.

[64] Stephen Weymen, "Statement before the Standing Committee on Finance, Trade and Economic Affairs of the House of Commons, 28th Parliament of Canada, June 13, 1972.

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> enough difficulty now in attracting industrial development. We are dependent to a large degree on foreign-controlled enterprises in our efforts to attract new industry....This Bill will tend to have a disproportionate impact on an area like New Brunswick because foreign-controlled firms are often the only one which can be interested in our area.[65]

Given these divergent provincial views, it is no wonder that FIRA was unable to be guided by a set of economic objectives on which both the provinces and Ottawa could agree. FIRA was forced to straddle between two competing imperatives: the imperative of being sensitive toward provincial efforts to attain industrial development and the imperative of rationalizing and integrating the national industrial structure. The latter meant employing FIRA's regulatory authority for the purpose of enhancing the economic specialization of each region, thus preserving the regionally-differentiated economic structure in which Central Canada served as the industrial center and Western Canada and the Atlantic region served as resource producers. In contrast, the former imperative meant employing FIRA's regulatory power to reduce regional disparities or, from the perspective of the Maritime region, FIRA should not meddle with foreign investment.

The Force of Canadianization: The Quest to Strengthen FIRA and the National Energy Program

In 1980, Ottawa announced two economic policy changes, both of which were derived from the Trudeau government's conviction to pursue an aggressive, centralist economic strategy. However, these policy changes provoked the provinces, and even triggered a thrust-and-riposte dynamic between Alberta and Ottawa. In addition, the

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[65] Government of New Brunswick, "Statement of the Honourable Richard Hatfield Before the Standing Committee on Finance, Trade and Economic Affairs Concerning Bill C-132 Foreign Investment Review Act, June 12, 1973; and "Remarks by Honourable Richard Hatfield, First Ministers Conference," May 23-25, 1973.

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announcement of these two policy thrusts encountered strong resistance from the Canadian business community and the American government.

In announcing the first policy change, Trudeau said that "my ministers believe that the stake of Canadians in their own economic destiny must be strengthened." Accordingly, "The Foreign Investment Review Act will be amended to provide for performance reviews of how large foreign firms are meeting the test of bringing substantial benefits to Canada...[and] amendments will be introduced to ensure that major acquisition proposals by foreign companies will be publicized prior to a government decision on their acceptability." The intent of this new policy was to create a first-move advantage for potential Canadian investors interested in purchasing assets of companies operating in Canada. By publicizing foreign investment proposals, Canadian investors would be made aware of an acquisition opportunity which they otherwise would not have known about. Furthermore, Ottawa sought to spur this activity by promising that the government would "assist Canadian business wishing to repatriate assets or to bid for ownership or control of companies subject to takeover offers by non-Canadians."[66]

The other major policy change was the creation of the National Energy Program (NEP) in 1980. The NEP had three policy objectives. First, it sought to promote Canadian self-sufficiency in energy supply by speeding up the exploration and development of high-risk sources of energy in Canada, such as those located in the Arctic, the offshore region of the Maritime provinces, and Western Canada where there was an abundance of heavy oils and tar sands. Second, the NEP sought to promote Canadianization by increasing the level of public ownership, increasing the number of Canadian-controlled firms, and enabling Canada to control 50 percent of the oil and gas

[66] "Speech from the Throne," *Commons Debate* (April 14, 1980), p 6.

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industry by 1990. Canadianization was to be promoted by three policy instruments. First, the goal of Canadianization was to be achieved by lowering the cost of entry into the oil and gas industry for Canadians, which at the time was the most profitable and fast-growing industry in Canada and dominated by foreign concerns, mostly American. For example, the share of the industry's revenue controlled by foreigners increased substantially in the 1970s, jumping from $1.7 billion in 1972 to $11 billion in 1980.[67]

Moreover, the goal of increasing Canadian involvement in this industry was to be promoted by requiring that a 25 percent buy-in option be given to the federal government on any leases on federal-owned Canada Lands.[68] As table 6.5 illustrates, the National Energy Program enabled Canadian-controlled companies to increase their activities and consequently changed the pecking order of the largest oil and gas companies. Canadian ownership in the oil and gas industry rose from 28 percent in 1980 to 34.7 percent in mid-1981, while Canadian control climbed from 22.3 percent to 33.1 percent.[69] Lastly, Canadianization was to be achieved by exercising FIRA's screening authority in a way that advanced this goal. FIRA "will also continue to play a key role in ensuring the Government's Canadianization goals" and it will be used specifically to achieve the government's goal of preventing foreign-controlled firms from buying already-discovered oil and gas reserves.[70] Thus, as Table 6.2 shows, FIRA disallowed more foreign investment applications associated with the energy sector than it had in previous years.

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[67] John Erik Fossum, *Oil, the State, and Federalism* (Toronto: University of Toronto Press, 1997), p. 122.
[68] Canada Lands cover an area twice as large as the 10 provinces combined. These federal-owned lands include the Yukon and Northwest Territories, the area off the coast of Canada, and small patches of land scattered throughout Canada. The 25 percent buy-in option was designed to give Petro-Canada, a federal Crown corporation active in the energy sector, an opportunity to increase its presence if it chose the option.
[69] The Minister of Energy, Mines and Resources Canada, *The National Energy Program: Update 1982* (Ottawa: Minister of Supply and Services Canada, 1982), p. 46.
[70] Ibid., p. 50.

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Table 6.5. The Largest Oil and Gas Producing Companies, 1981

Rank	Foreign Controlled	Canadian Controlled
1	Imperial	
2	Gulf	
3	Texaco	
4		Petro-Canada (7th place in 1979)
5	Shell	
6	Amoco	
7		Dome (12th place in 1979)
8	Mobil	
9	Suncor	
10	Chevron Standard	
11		Pan Canadian (11th place in 1979)
12		Canterra (14th place in 1979)
13	Canadian Superior	
14	Canada Cities	
15		Norcen (15th place in 1979)

Source: Minister of Energy, Mines and Resources Canada, *The National Energy Program: Update 1982* (Ottawa: Minister of Supply and Services Canada, 1982), p. 49.

The final objective of the NEP was to promote fairness in the way in which oil and gas revenues were shared between producers and consumers and between the provinces and the federal government.[71] The NEP sought to protect consumers by imposing a domestic price regime that helped keep oil prices below those of other industrialized countries. For example, from 1981 to 1982, gasoline prices in the United States were 3 percent higher than in Canada, Great Britain's prices were 108 percent higher, and Italy's prices were 137 percent higher.[72]

The NEP's objective of promoting fairness between the two levels of government was motivated by Ottawa's desire to redistribute energy revenues more equally between Alberta and other emerging energy-producing provinces—whose coffers had grown

[71] As Pratt notes, "increased share of rents skimmed from the development of existing Western Canadian oil and gas reserves [were] appropriated by energy users, via low prices, and the federal government, via new taxes, while the share of rents accruing to producers and the producing provinces [was] substantially cut." See Larry Pratt, "Energy: The Roots of National Policy," *Studies in Political Economy* (Winter 1982), p. 55.

[72] Energy, Mines and Resources Canada, *The National Energy Program: Update 1982*, p. 90. See also the pioneering document, Energy, Mines and Resources Canada, *The National Energy Program, 1980* (Ottawa: Minister of Supply and Service Canada, 1980).

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substantially in the 1970s as a result of the hike in the world price of oil—and Ottawa which was seeking to augment its fiscal capacity.[73]

Table 6.6. Revenue Shares of Industry and Governments (in percentages)

	1979	1980	1981	1982
Industry	41.2	45.4	39.7	40.3
Provinces	45.7	42.4	37.3	32.3
Ottawa	13.1	12.2	23.0	27.4

Source: David Milne, *Tug of War: Ottawa and The Provinces Under Trudeau and Mulroney* (Toronto: James Lorimer & Company, Publishers, 1986), p. 85.

By imposing new taxes on oil and gas, the federal government managed to increase its share of revenues from 12 percent in 1980 to 27 percent in 1982 while provincial shares dropped from 42 percent to 32 percent, as Table 6.6 illustrates. In many respects, the NEP amounted to a potent political instrument which enabled Ottawa to reassert federal primacy relative to energy-producing provinces; it also demonstrated Ottawa's interest in sharpening its centralist economic capacity. In sum, the stringency of FIRA and the creation of NEP were two policy programs that proved to be interventionist, nationalistic, and centralist. It is precisely those features that provoked the provinces, the Canadian business community, and the United States government because Ottawa's policy move threatened to undermine their interests.

The NEP came under heavy criticism from many provinces. Leading the pack was Alberta, Canada's largest energy-producing province. Since 1930, when the Prairie provinces were granted the right to own the public lands located within their provinces, this region of Canada has greatly benefited from the increasing world demand for oil. When Joe Clark's Conservative government came to power in 1979, he proposed a set of

[73] Stephen Clarkson, *Canada and the Reagan Challenge* (Toronto: James Lorimer & Company, Publishers, 1982), p. 66.

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energy policies which promised to improve the energy revenue of Alberta, in particular. Clark planned gradually to increase the domestic price of oil to about 85 percent of world prices, privatize Petro-Canada, and to increase the federal government's tax base by seeking a revenue-sharing regime to which the provinces could agree.[74] However, Ontario, Canada's largest energy-consuming province, staunchly opposed Clark's energy policy, for it meant that Ontario's economy would have to shoulder higher energy costs while Alberta enriched itself.

The political landscape changed when the Liberal Party returned to power in 1980, as Ontario and New Brunswick sided with Ottawa's energy program and the other eight provinces formed an alliance opposing the NEP. The fundamental cause of provincial opposition to NEP was that the program amounted to a direct intrusion into provincial jurisdiction and threatened to undermine the provinces' capacity to pursue their economic development strategies. As I will discuss in the next chapter, energy development was the main engine of economic growth and industrialization for these provinces. The intrusive and controlling nature of NEP interfered with the provinces' ability to fulfill their economic objectives.

Ottawa was forced to amend the NEP in 1981 after its relations with Alberta soured into bitter confrontation. In May 1980, Alberta's Energy Minister Merv Leitch proposed a bill that would enable Alberta to reduce oil supplies to the rest of Canada, a move that threatened to lead to oil shortages throughout Canada and increase the burden on consumers and industry. In response, Ottawa proposed to impose a tax on exports of natural gas, a measure that would particularly injure Alberta since it was a leading natural gas-exporting province. This pattern of thrust and riposte came to an end in September

[74] Larry Pratt, "Energy: The Roots of National Policy," pp. 33-34.

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1981 when Ottawa and Alberta reached a mutually beneficial five-year agreement in which both agreed to a schedule of energy price increases and a new revenue-sharing regime.[75] In the following months, intergovernmental tensions were further defused as Ottawa entered into similar arrangements with British Colombia and Saskatchewan. In the end, these intergovernmental arrangements significantly softened the centralist and unilateralist aspects of NEP.

Opposition to Ottawa's aggressive, unilateral policy changes also came from the Canadian business community. The Business Council on National Issues (BCNI), a business association which represented the interests of big business, used its political influence to pressure Ottawa to back down from its policy initiatives. The concern of the BCNI with regard to a tougher FIRA was that it would undermine Canada's reputation as a favorable investment location.[76] But the most fundamental problem the BCNI had with FIRA was that foreign investment regulations conflicted with the free enterprise tradition of the Canadian business community. The business community argued that "investment decisions should be made by the firm, not by the government."[77] This too was the source of the BCNI's opposition to the NEP. The BCNI maintained "that the rigidity of the National Energy Program be eased, that the Canadianization rules be relaxed, that curbs on foreign-owned companies by softened."[78]

Ottawa's political interventionism of the early 1980s also drew fire from the American government. Whereas American officials tolerated FIRA in the 1970s, that was not the case after Trudeau announced changes to the Agency in 1980. Despite initial

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[75] For a discussion of the specifics of this bilateral arrangement, see Pratt, "Energy: The Roots of National Policy"; and Fossum, *Oil, the State, and Federalism.*
[76] See Arpad Abonyi, "Government Participation in Investment Development."
[77] Barbara Jenkins, *The Paradox of Continental Production*, p. 134.
[78] Stephen Clarkson, *Canada and the Reagan Challenge*, p. 81.

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concerns about the FIRA when it first appeared in the early 1970s, the review process of FIRA demonstrated that the Agency was neither biased against foreign investment nor an instrument of Canadianization, as some American observers alleged it would be. As American Ambassador to Canada, Thomas Enders noted in a conciliatory tone, "It was feared that FIRA might act as a barrier to new incoming investment in Canada. But rather it has applied its mandate—to assure benefit to Canada in investment proposals. I can understand how Canada relying as heavily as it does on outside investment feels the need for having such a mechanism to insure that its interests are identified and met."[79] In fact, throughout the 1970s, the United States government focused most of its criticism on the foreign investment regulations of other countries because they were more arbitrary and discriminatory than Canada's.

However, the Reagan administration did not well receive Trudeau's plan to toughen FIRA. Fundamental to the emerging Canada-United States economic discord was that, as Reagan was seeking to put market liberalism at the center of the United States' economic alliance with allies, Canada was moving in the opposite direction by introducing greater interventionist regulations. This point was well communicated by Raymond Waldmann, the Assistant Secretary of the Finance Department for International Economic Policy:

> Canada's growing reliance on government intervention to direct and control national trade and investment patterns conflicts with this Administration's advocacy of free market oriented policies. We believe that the methods used by Canada to enforce economic nationalism pose a threat to the international trading system by erecting barriers to cross-border flows of trade and capital.[80]

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[79] Quoted in Clarkson, *Canada and the Reagan Challenge*, p. 87.
[80] Statement of Raymond Waldmann before U.S. Senate, Committee on Foreign Relations, *U.S. Economic Relations with Canada*, 97th Congress, March 10, 1982, pp. 1-2.

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In reaction to the tough wording of the new FIRA, the American government considered a number of retaliatory measures. First, the American Congress—having held several hearings on FIRA—proposed two bills that would have imposed tougher standards on Canadian investment in the United States. Second, the Reagan administration considered invoking the Section 301 clause of the Trade Act of 1974, which is a retaliatory instrument directed at those unfair trade practices of foreign countries that restrict American commerce. Finally, the American government requested that the General Agreement on Tariffs and Trade (GATT) examine and render a judgment on FIRA. Although Canada demonstrated an ability to stay the course despite American criticism, it was the constant pressure from the American government combined with those of the business community and provinces which compelled the Trudeau government to retreat from its pledge to toughen FIRA.

Whereas American pressure played an important role in changing Trudeau's behavior on FIRA, the same cannot be said about the role of American pressure in diluting the NEP. Behind United States' opposition to the NEP was the fact that the energy policy conflicted with America's efforts to secure the dominance of market liberalism within its economic alliance; opposition also stemmed from the concern that contagion would arise through the "NEP-ing" of other Canadian industries.[81] Emboldened by the strong public support for the NEP, Ottawa defied American pressures. But the greatest impediment facing the American government as it sought to persuade the Trudeau government to soften the nationalistic edges of NEP was the political deflection caused by the jurisdictional disputes and subsequent bargaining

[81] G. Bruce Doern, "Liberal Economic Development Statement: To Scheme Virtuously," *The Canadian Business Review* (Spring 1982).

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between the provinces and Ottawa.[82] The battle between Western Canada and Ottawa consumed most of the latter's attention. Furthermore, the American government could not count on Alberta and other provinces to fight Ottawa on its behalf. When Ottawa and the energy-producing provinces found a settlement to the jurisdictional dispute, the bilateral arrangements preserved the Canadianization force of the original NEP and allowed for the collection of more revenue for both levels of government. This was an outcome that fell short of what the United States desired.

By the end of 1981, it became clear that the implementation of Ottawa's 1980 policy agenda had stopped in its tracks. Talks of enhancing the stringency of FIRA abruptly ended after the Canadian government announced in its 1981 budget paper that it would not pursue this policy goal, acknowledging that the existing apparatus was sufficient to accomplish the goals of the government.[83] It also added that "the special measures being employed to achieve more Canadian ownership and control of the oil and gas industry are not...appropriate for other sectors," thus assuaging concerns about the "NEP-ing" of other sectors in the Canadian economy.[84] From 1981 to 1984, the regulatory component of FIRA was gradually liberalized, paving the way for the neoliberal economic policies of Mulroney. For example, FIRA raised the ceiling for the review of applications that fall under the scope of the "abbreviated small business procedures" from $2 million in gross assets and 100 employees to $5 million and fewer

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[82] Clarkson, p. 79.
[83] Government of Canada, *Economic Development for Canada in the 1980s*, (Ottawa, November 1981).
[84] Ibid, p.12. The BNCI partly credited its lobbying efforts to the change in the policy direction of the Trudeau government. As Thomas d'Aquino, President of the BNCI noted, the November Budget paper "was a good demonstration of what we'd like to see. We'd like to think we helped shape it..it reflects a lot of the concerns we'd expressed...." Quoted in David Langille, "The Business Council on National Isuses and the Canadian State," *Studies in Political Economy* (Autumn 1987), p. 58.

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than 200 employees.[85] Moreover, FIRA was no longer used to support NEP's Canadianization goal. As Table 6.2 illustrates, approval of foreign investment applications increased in the resource sector between 1982 and 1985.

Like the Third Option's first objective, the promotion of diversification, the government's gatekeeping goals could not find an appropriate institutional home to ensure their implementation in a way that it was originally intended. Constrained by a divided federal bureaucracy, a federal system that both placed the provinces in a position of strength relative to the federal government and represented divergent regional views, and the business community's opposition to Ottawa's efforts to strengthen its regulatory power all contributed to undermining FIRA and the NEP. However, Ottawa's gatekeeping efforts were not totally in vain. The policy of Canadianization did enhance Canadian participation in the national economy, particularly in such "commanding heights" as the oil and gas industry. Moreover, at the end of the 1970s and early 1980s, as a result of changes in global production patterns as well as the exigency of Canada's gatekeeping efforts, more American multinational corporations had broadened the range of production activities in their Canadian operations.

[85] Abonyi, "Government Participation in Investment Development," p. 168.

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CHAPTER SEVEN

THE LIMITS OF ECONOMIC DEVELOPMENT PLANNING

Two species of economic planning emerged in Canada in the 1970s and early 1980s. Whereas regional economic development figured prominently among federal planners until the late 1970s, national industrial development gained primacy in the last years of the 1970s and into the 1980s.[1] Politics is at the core of economic planning, for planning entails the formulation and implementation of a policy program intended to produce specific changes in the national economy which are desired by the state. Planning is also steeped in politics because it entails making choices about what economic goals to pursue and what programmatic approach to select in the face of rival designs. For example, should policy makers focus more on regional development or national development and what set of instruments ought to be employed to attain state goals? Moreover, planning is highly political because it often requires the state to expand its interventionist capacity in the face of institutional constraints.

Economic planning gained much attention starting in the late 1960s. At issue was the desire to restructure the Canadian economy, that is, accelerate the pace and broaden the scope of industrial development so that the economy could produce more internationally competitive and high valued-added manufactured goods. The other goal of economic planning was to foster an increasingly sophisticated and diversified industrial structure by relying on indigenous technology and entrepreneurial capacity, and on domestic capital investment. Indeed, Smiley points out that economic nationalism

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[1] In this chapter, the emphasis is on relative importance attached to the two forms of economic planning. Although efforts were undertaken to pursue national industrial development planning in the 1970s, these efforts were eclipsed by regional economic development planning which was in the political forefront at the time. The opposite occurred from the late 1970s to the mid-1980s.

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constituted an integral component of economic planning. "The master-prescription of the emergent national policy is for a Canadian economy with a highly developed capacity for indigenous innovation [which] comes about through indigenous action rather than outside influences."[2]

From the early 1970s to the mid-1980s, two economic planning approaches were employed to accomplish these economic goals. As a decentralized approach to restructuring the Canadian economy, the regional economic development policy design considered the political interventionism of provinces as the main driving force to fulfill the objectives of economic planning. Central to this approach was the planning apparatus of the Federal Department of Regional Economic Expansion (DREE), which placed a premium on a federal-provincial coordination mechanism through which the problem of spatial development of industry or regional division of economic activity was to be confronted. DREE sought to spread the development of industrial manufacturing from Central Canada, where such activities were most concentrated, to the Western and Atlantic provinces, where resource production was the main form of economic activity. In short, the approach sought to transform the existing pattern of regional economic specialization so that all regions had a similar industrial structure.

The second economic planning approach was the national industrial development policy design. As a centralized approach, the national industrial development policy emphasized the importance of federal political interventionism as the primary driving

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[2] Smiley adds that the economic planners also sought "the rationalization of the secondary manufacturing sector to increase the relative importance of this sector in the economy and make it internationally competitive," and "to the extent that the national economy continues to rely on the export of natural resources, these resources should be exported in a state more nearly finished than is now the case." Donald Smiley, "Canada and the Quest for a National Policy," *Canadian Journal of Political Science* (March 1975), pp. 56-7 and 58.

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force of industrial development. It sought to promote the interdependence of the different regions of Canada by building upon existing regional specialization. Regional interdependence was to be fostered by introducing high-technology and specialized innovation to the existing division of economic activities between the manufacturing-oriented Central Canada and the resource-producing Western and Maritime regions.

In this chapter, I seek to explain why the exercise in economic planning failed. In particular, I attempt to account for the rise and fall of the two economic planning approaches. I argue that the competitive nature of provincial-federal relations, the arm's-length pattern of business-government relations, and the internally-divided bureaucratic apparatus affected the practice of economic planning during this period. More specifically, Canadian federalism and the federal executive administrative apparatus profoundly shaped the evolution of regional development policy planning. Regional development planning gained the support of the provinces because it was designed to help them accomplish their developmental goals.

Unexpectedly, the approach helped set in motion the forces of economic provincialism, which had the potential to fragment the national economy if it was not countered. The decision to shift to national industrial development planning was partly attributed to the federal government's efforts to reverse the trend toward economic decentralization. Also important in explaining the shift in planning designs toward the end of the 1970s was the internal division within the federal bureaucracy. Bureaucratic conflict emerged between the DREE and the Departments of Finance and Industry, Trade and Commerce (DITC) over the efficacy of regional development planning. As economic-oriented departments, Finance and DITC challenged the decentralized

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approach because it jeopardized the division of economic activities, which was the basis for Canada's international competitiveness and of national efficiency.

A different set of institutional dynamics contributed to the failure of national industrial development planning. The centralization of economic planning required the development of an appropriate set of coordinative mechanisms that linked the provinces and business to the federal state and that centralized decision-making within the state. Although the federal government achieved some notable institutional innovations, such as forging consultative channels with business and labor and with the provinces, they failed to become institutionalized and replace previous patterns of societal and intergovernmental relations. In fact, rather than replacing the arm's-length pattern of societal-government relations and provincial-Ottawa relations, the institutional modifications preserved them.

REGIONAL ECONOMIC DEVELOPMENT PLANNING: THE MAKING OF THE DEPARTMENT OF REGIONAL ECONOMIC EXPANSION

Until 1973 when the Department of Regional Economic Expansion (DREE) launched the General Development Agreement (GDA), Ottawa's regional economic development policy instruments were not designed to attain the developmental objectives of the Third Option, namely, increasing the sophistication and diversification of Canada's industrial structure, developing indigenous technology, and expanding domestic entrepreneurial capacity. The DREE's GDA programs were premised on a notion which held that the promotion of regional growth necessarily contributed to the overall industrial strength and dynamism of the national economy.

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From Confederation to the late 1950s, the federal government had no specific regional policy. The dominant view during this period was that if Ottawa put its development capacity fully behind the development and integration of the national economy, Canada's regions would all benefit. As DREE pointed out, "Federal economic policy was directed towards the development of the national economy, with the underlying assumption being that a strong national economy...would result in all regions sharing in Canada's growth and prosperity virtually automatically."[3] Although the federal government did provide assistance to regions during this period, such as assistance to provinces with weak fiscal capacities, it was not concerned about the distribution of economic gains across regions.

The release of two Royal Commission reports, however, did eventually effect important changes in Ottawa's approach to regional development.[4] In the face of gross provincial fiscal shortcomings during the Great Depression, the 1940 Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission) called for the reform of the Canadian fiscal system so that it could better promote equality of fiscal resources among the provinces. The goal was to allow each province to provide an acceptable standard of services at comparable tax costs to those of other provinces. Whereas the Rowell-Sirois Commission focused on the fiscal deficiencies of provinces, the 1957 Royal Commission on Canada's Economic Prospects (the Gordon Commission) focused on the relative economic weakness of the Atlantic region and called into question the widely accepted belief that national progress necessarily resulted in regional progress.

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[3] Government of Canada, Regional Economic Expansion, *DREE Departmental Profile* (Ottawa: November 1979), p. 7.

[4] N. Harvey Lithwick, "Regional Policy: The Embodiment of Contradictions," in G. Bruce Doern, ed., *How Ottawa Spends Your Tax Dollars* (Toronto: James Lorminer & Co., 1982).

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Twenty years after the Rowell-Sirois Commission, the federal government launched a fiscal equalization program to rectify the imbalances in the fiscal capacity of provinces. The problem of regional disparities that the Gordon Commission brought to light led the federal government to launch a number of programs in the 1960s specifically to assist slow-growth regions.[5]

The Conservative government of John Diefenbaker undertook key policy initiatives to deal with regional disparities. In 1961, Parliament passed the Agriculture Rehabilitation and Development Act (ARDA), marking the federal government's first regional development program. As a program designed to induce development in depressed rural areas, the ARDA involved the federal and provincial governments in a shared-cost program to boost agricultural development. In particular, the program sought to promote alternative land uses for small-scale farmers, build natural resource industries, such as fisheries, and develop water and soil resources. The program's principal goal was to increase the output and productivity of farmers and create employment opportunities.

Based on the recommendations of the Gordon Commission, Prime Minister Diefenbaker also established the Atlantic Development Board (ADB) in 1962 and gave it a mandate to administer an Atlantic Development Fund of $186 million to be used to improve the basic economic infrastructure of the Atlantic provinces. More than half of the fund was spent on highway construction and water and sewerage systems

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[5] According to Brodie, 1957 was a major turning point in regional policy because it ushered in two particular types of policy instruments. The work of the Rowell-Sirois Commission and follow-up studies contributed to the launching of compensatory policies which involve "measures that compensate a given region for the situation in which the market or public policy has left it." The second type of policies, derived from the work of the Gordon Commission and follow-up studies, are developmental policies which seek "to alter the underlying forces that allegedly 'cause' uneven development. See Janine Brodie, *The Political Economy of Canadian Regionalism* (1990), pp. 164-175.

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improvement. Although the mandate of the ADB was renewed under the Pearson government, which opted to allocate more funds to the program, some groups criticized it. In particular, the Atlantic Provinces Economic Council, a non-governmental research agency established in 1954, criticized the program for not offering direct subsidies to industry to entice new companies to the region. The ADB countered by arguing that infrastructure development was the best means of attracting new firms in the region.

Unlike the two previous regional economic programs the Area Development Agency (ADA), established in 1963, turned to the private sector to stimulate the economy in slow-growth regions. Tax concessions and capital grants were employed to lure companies into designated areas facing high unemployment. The last major regional development program to be established before the creation of the DREE was the Fund for Rural Economic Development (FRED). Like the ARDA, the FRED had a rural focus; but instead of the non-geographical focus of the ARDA, FRED's activities focused on five designated regions facing low income and major adjustment problems.[6] Extensive research was to be conducted in each region for the purpose of developing and implementing a comprehensive development plan in each region.[7]

The 1960s saw the establishment of a number of redistributive programs which contributed to the consolidation of Canada's welfare state. Between 1965 and 1967, the Canada Pension Plan, the Medical Care Act, and the Canada Assistance Plan were established. Moreover, the fiscal equalization program was also established, which sought to equalize the ability of provinces to provide social services at acceptable standards. In sum, this decade witnessed the development of new instruments designed

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[6] The five regions in question were the Interlake region of Manitoba, the Gaspé (Québec), the Mactaquac, northeastern New Brunswick, and Prince Edward Island.
[7] See Brodie, pp. 170-175.

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to tackle the problem of regional economic disparity. But the proliferation of issue-specific developmental programs, headed by different departments, resulted in an uncoordinated and unfocused federal regional policy. Another element that prompted Ottawa to reassess this policy arena was the 1967 report of the Royal Commission on Bilingualism and Biculturalism. The Commission Report concluded that it was imperative for the federal government to step up its efforts to foster national unity as well as closer French-English relations. In emphasizing the need to reverse the trend toward the economic and cultural disadvantages of French Canadians, the Royal Commission noted that "we believe the notion of equal partnership connotes a vast enlargement of the opportunities for francophones in both private and public sectors of the economy."

When Pierre Trudeau became leader of the Liberal Party in 1968, regional development became one of Trudeau's top policy priorities, for it stood as a key component of his idea of a "just society."[8] As Trudeau put it, "If the underdevelopment of the Atlantic Provinces is not corrected...by helping them become areas of economic growth then the unity of the country is almost as surely destroyed as it would be by the French-English confrontation."[9] According to Trudeau, a coherent approach to combat regional disparities and foster regional development was required. Under this approach, policy programs were to be delivered through an appropriate national-level administrative

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[8] Perhaps one of the best elucidations of what Trudeau's "just society" means is his comparison of just society to alternative modes of social organization. "A just society is motivated by the supreme importance we attach to the dignity and rights of the individual human being; ethnic nationalism [as it is promoted by French-Canadians] promotes the groups. A just society promotes equal life chances for all [that is, equal opportunity]; laissez-faire economics lets the market chips fall where they may. A just society is prepared to use the federal government to promote a minimum standard of citizenship everywhere in Canada; a confederacy of provinces reduces to insignificance the instrument of national will." See Thomas Axworthy and Pierre Elliot Trudeau, *Towards A Just Society: The Trudeau Years*, Second Edition (Toronto: Penguin Books, 2000), p. 10.

[9] Quoted in Richard Phidd and G. Bruce Doern, *The Politics and Management of Canadian Economic Policy* (Toronto: Macmillan Company of Canada Limited, 1978), p. 324.

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framework which would be headed by a single bureaucratic entity and make full use of federal-provincial coordination.

The creation of the Department of Regional Economic Expansion (DREE) in 1969 provided the institutional solution to the organizational quagmire that the uncoordinated proliferation of regional development programs had produced earlier in the decade. In addition, the DREE was Ottawa's response to the growing threat of disunity resulting from Quebec nationalism. Trudeau's interest in these two problems was evidenced in his choice of individuals to head the new department. The department's first minister was Jean Marchand, a well-respected Liberal Party official who served as the party's trouble-shooter in Quebec; Tom Kent, an influential and able administrator who had served as principal secretary to Prime Minister Pearson, became DREE's deputy minister.

The new department incorporated the ARDA and ADA and other regional programs, but terminated the ADB and FRED. The decision to drop the last two programs reflected the new thinking regarding regional development. Focus shifted from assisting rural slow-growth regions to helping build the industrial structure of urban areas. Although regional disparity remained a concern of Ottawa's regional policy, DREE deployed its instruments to promote industrial development in all regions of Canada, particularly in areas with the greatest potential for economic growth and development. This new thinking was based on the growth-pole approach, which held that "the strategic location of a propulsive industry will promote spread effects and further development throughout a depressed area."[10]

To achieve these growth-poles, the DREE launched two programs. The Special Areas Program was designed to attract industry into designated regional growth centers

[10] Janine Brodie, p. 173.

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by providing finance to infrastructure development projects. The SAP identified 23 of these areas across Canada, many of which were located in Quebec and the Atlantic provinces, that received federal monies for highway construction, water and sewage system improvement, and industrial park development projects, among other infrastructure projects. The Regional Development Incentives Program, on the other hand, provided development grants of up to $6 million to manufacturing and processing companies that moved to designated regions across Canada and/or agreed to expand and modernize their plants.[11] By 1973, the DREE had spent approximately 29 percent of its budget on rural development, 41 percent on infrastructure assistance, and 24 percent on the RDIA program.[12]

After three years into its existence, the initial upbeat mood surrounding the creation of DREE had vanished almost entirely. Having received praise for its efforts to coordinate and rationalize the federal government's regional development policy, by the early 1970s a growing tide of criticism was building against the relatively new department. First, DREE's programs failed to produce notable changes in the geographical pattern of economic activities across Canada. Despite efforts by DREE to spread more evenly and accelerate the growth of more sophisticated industrial activities in Canada by promoting growth-poles, Central Canada continued to account for 80 percent of manufacturing activities, as Table 7.1 shows. In the first couple of years of their existence, neither the SAP nor RDIA seemed to have had any meaningful positive impact on economic development through their attempts to relocate industries in designated areas.

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[11] See Donald Savoie, *Regional Economic Development: Canada's search for solutions* (Toronto: University of Toronto Press, 1986).
[12] N. H. Lithwick, "Regional Policy: The Embodiment of Contradictions," p. 133.

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Table 7.1. Share of Value Added in the Goods-Producing Industries, by Province, 1970-73

	Agri-culture	Forestry	Fishing	Mining	Manu-facturing	Construc-tion
Newfoundland	-	3	16	4	1	3
Prince Edward Island	1	-	5	-	-	-
Nova Scotia	1	2	27	1	2	3
New Brunswick	1	2	8	1	1	2
Quebec	13	20	5	11	27	22
Ontario	26	14	3	20	54	36
Manitoba	10	1	1	5	2	4
Saskatchewan	24	1	1	8	1	3
Alberta	20	2	-	40	3	12
British Columbia	4	52	34	10	9	14
Atlantic Region	3	10	56	6	4	8
Prairie Region	54	4	2	53	6	19

Source: Economic Council of Canada, *Living Together: A Study of Regional Disparities* (Ottawa 1977), p. 65.

Criticism of DREE's activities also came from the provinces. Provincial criticism was not so much based on their rejection of what the department was seeking to accomplish; instead, they argued that Ottawa was not doing enough to reverse the trend toward increased regional specialization of industrial activities. The perception among the provinces was that some federal programs—particularly those of the Department of Industry, Trade, and Commerce—were working at cross-purposes with those of the DREE to the extent those other programs were biased in favor of continuing Ontario's manufacturing dominance over the other regions of Canada. As Tupper notes, "DREE's initiatives...were said to be offset by larger IT&C expenditures which strengthened central Canada's hegemony." In fact, the provinces resented Ottawa's tendency to use its spending and regulatory power in ways that undermined their developmental objectives. The root cause of the problem was that federal economic policies tended to have territorial implications given Canada's regionally specialized economy. Outcomes often took a zero-sum appearance as federal support for a particular industrial activity, such as

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the expansion of manufacturing, was viewed as support given exclusively to the region in which this activity was mostly concentrated.

Provincial disenchantment with DREE also stemmed from its top-down method of administering regional development programs. Initially, it was Trudeau's goal to make full use of provincial-federal cooperation to ensure the efficacy of programs. As it turned out, however, DREE was reluctant to work with the provinces. As Careless points out, DREE "was a great deal more unilateral and single-minded than the agencies it replaced. The new pre-packaged, pre-financed approach of Ottawa meant that the provinces became increasingly recipients of rather than partners in federal expenditure decisions."[13]

The 1972-73 policy review that was launched by DREE offered a solution to the "obsession with industrial location" and the recurring concern with the regional incidence of federal policies.[14] DREE's decision to launch the General Development Agreements (GDAs) coincided with the federal government's desire to resolve federal-provincial wrangling. As an instrument designed to ameliorate intergovernmental tensions, this program initiative "acknowledged interdependence, recognized the sanctity of provincial priorities, and reflected the need for policy coordination."[15] The GDAs also reflected Ottawa's desire to introduce the method of planning to the management of regional development policy and, as such, became an integral component of Ottawa's Third Option.

The GDAs were based on three fundamental and innovative ideas. First, the growth-pole approach to regional development was replaced by an approach which

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[13] Anthony Careless, *Initiative and Response: the Adaptation of Canadian Federalism to Regional Development* (Montreal: McGill-Queen's University Press, 1977), p. 89.
[14] Tupper, "Federalism and the Politics of Industry Policy," p. 304.
[15] Allan Tupper, *Public Money in the Private Sector: Industrial Assistance Policy and Canadian Federalism* (The Institute of International Relations), p. 42.

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sought to realize the "developmental opportunities" of each province. Don Jamieson, the Minister of DREE in 1973 remarked the following:

> I have become increasingly impressed by the range of opportunities for economic development that exist in most parts of this country and by the large number of public policies and programs that bear or could be brought to bear upon a concentrated effort to realize some of these opportunities. This is what has led me to speak...about the possibilities inherent in...an approach that could call for the identification and pursuit of major developmental opportunities by means of the coordinated application of public policies and program....[16]

This new idea held that each province faced particular circumstances which could give rise to developmental and growth opportunities if exploited effectively. For instance, the processing of renewable and nonrenewable resources was identified as a promising area of development for Western provinces, whereas Quebec's opportunities for development rested on its efforts to move out of slow-growth manufacturing activities and move into fast-growing and more capital-intensive ones. Although it was acknowledged that economically the Atlantic provinces were behind other provinces, the policy review noted that the region's best opportunities for industrial growth lay in the development of the tourist, fishing, mining, forestry, and agricultural industries. As for Ontario, the policy review noted that southern Ontario fared relatively better than the northern part of province and recommended that more developmental projects be undertaken in the north.

The GDAs that the federal government negotiated with each province, with the exception of Prince Edward Island, were general planning statements elucidating the broad developmental objectives of each province which the federal and provincial authorities pledged to pursue in a coordinated manner. Each GDA was accompanied by several subsidiary agreements of a duration of 10 years. These subsidiary agreements

[16] Quoted in Phidd and Doern, p. 340.

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described in more specific detail the different industrial, infrastructure, and economic diversification projects which would be undertaken to attain the broad goals outlined in a GDA.

Among the three types of developmental projects, economic diversification was the most technical in terms of the degree of planning involved. Economic diversification projects were conceived by provincial and DREE officials for the purpose of creating upstream and downstream linkages to the dominant industries in a province. The cost of implementing these subsidiary agreements was divided between the federal and provincial governments, but the federal share varied by provinces as Table 7.2 shows. The federal government shouldered 90 percent of the costs of subsidiary agreements in Newfoundland; 80 percent in Nova Scotia and New Brunswick; 60 percent in Quebec, Manitoba, and Saskatchewan; and 50 percent in Ontario, Alberta, and British Columbia.

Coinciding with the GDAs was the decentralization of DREE operations, a measure that was intended to foster closer federal-provincial relations. In an

Table 7.2. Subsidiary Agreements by Provinces, 1974-1979

	Number	Total ($)	Federal Share
Newfoundland	18	456.3	394.0
Nova Scotia	11	348.1	245.0
New Brunswick	17	460.3	346.7
Quebec	13	2,058.5	908.5
Ontario	9	361.3	155.9
Manitoba	7	292.8	187.3
Saskatchewan	12	474.0	213.8
Alberta	6	146.8	73.2
British Columbia	10	332.8	149.5
Yukon	1	6.6	4.5
Northwest Territories	1	3.8	2.5
Total	105	4,941.2	2,680.9

Source: Government of Canada, Regional Economic Expansion, *DREE Departmental Profile* (November 1979), p. 15.

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unprecedented move, DREE shifted the majority of its staff from its head office to the 24 field or provincial offices it created. Prior to the decentralization plan, 30 percent of DREE's staff worked in field offices, by 1978 70 percent of the department's staff was located at the field level.[17]

With this massive transfer of personnel came the delegation of decision-making authority to provincial offices, to the point where they gained full responsibility for the formulation, implementation, and evaluation of subsidiary agreements in the context of the GDAs each province had signed with the department. This represented a genuine effort on the part of the federal government to achieve greater coordination of developmental efforts with each provincial government as well as a desire to accommodate provincial developmental priorities.

This joint decision-making structure was a significant departure from the top-down structure that was embodied in previous DREE programs. Significantly, although the delegation of authority did augment provincial influence over the federal government's regional development activities and become the principal economic planning unit, this institutional innovation conferred a political advantage on the federal government which it did not have before. By handling each province separately through the medium of the GDAs, the federal government reduced the risk of having to confront a coordinated political attack by a coalition of provinces, which appeared to be in the making in the pre-GDA period, and gained a margin of flexibility concerning how best to deal with each province's grievances. Careless points out that as a bilateral instrument in

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[17] Donald Savoie, *Regional Economic Development*, p. 50.

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intergovernmental relations, the GDAs served as a kind of "divide and conquer" tactic that worked to the advantage of Ottawa because it "fragmented collective action" by the provinces "and left only Ottawa in a position to establish broad national objective."[18]

Finally, the GDAs represented an effort on the part of the federal government to improve interdepartmental coordination of activities relating to economic development. This proved to be a challenging task because DREE was never given the necessary authority to wield dominant influence over this policy arena. As a less optimal solution, whenever DREE field offices were devising new initiatives, other relevant federal departments were involved in the formulation process. In addition, DREE agreed to hold annual interdepartmental meetings with federal departments to assess and review GDAs.[19] Moreover, this rational management effort was intended to facilitate the reconciliation of the two modes of thinking about economic development, which had nested in two groups of departments—decentralized development approach in DREE and the centralized development approach in DITC.

THE CENTRALIST COUNTERATTACK AND TRUDEAU'S EFFORTS TO REBALANCE FEDERALISM

By the end of the 1970s, decentralized economic planning was out of favor in Ottawa, and focus shifted toward centralized, national economic planning. The institutional innovation which DREE's GDAs represented failed to produce the developmental outcome that the federal state sought to attain. While it was never the intention of the federal state to lessen its role in economic development by working

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[18] Anthony Careless, *Initiative and Response: The Adaptation of Canadian Federalism to Regional Economic Development* (Montreal: McGill-Queen's University Press, 1977), p. 196.
[19] Donald Savoie, *Regional Economic Development: Canada's search for solutions* (Toronto: University of Toronto Press, 1986), p. 52.

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closely with the provinces, this economic planning effort unexpectedly led to this outcome. In fact, the decentralized approach to economic development of DREE complemented and facilitated economic provincialism, a political dynamic which by the end of the 1970s threatened to fragment the national economy. Moreover, regional economic planning never gained the advocacy of the two key economic departments, Finance and the DITC. In fact, throughout the 1970s, the positions of DREE and of Finance and DITC only grew further apart, thus making consensus-building efforts ineffective. While their opposing positions were owed to the distinct body of economic ideas that informed their respective actions, the emergence of an alternative planning design also contributed to this divergence. In this section, I argue that the shift from the regional development planning to national development planning was the result of two factors: (1) the ascendancy of economic provincialism, and (2) the shift in thinking within the federal state about how best to promote economic development.

Ascendancy of Economic Provincialism

In many respects, the regional economic development planning exercise that was carried out in the 1970s complemented economic provincialism. The rise of economic provincialism was a direct outgrowth of efforts to increase the productive output of provincial economies by expanding the interventionist capacity of provincial authorities. DREE's GDA's aided the provinces to accomplish this goal by offering them financial support for particular capital projects. Aside from the GDAs, there were two other factors that enabled provinces to pursue economic provincialism in a way they were unable to do before. First, provinces witnessed an expansion of their administrative machinery and acquired public managerial expertise as a result of the growth of the

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welfare state in Canada and reform of fiscal federalism in the 1950s. The presence of a more complex bureaucratic structure and a pool of experienced public managers facilitated the move to seek a more activist role in the economy.

Second, the provinces became bolder in their use of policy instruments. Although the provinces do not have macroeconomic policy instruments at their disposal as the federal state does, they are able to wield more direct influence over the decisions of firms than the federal government can. As Jenkins observes, "Provincial industrial-policy instruments resemble those of other advanced industrialized countries more than they do federal policy instruments, mainly because of their emphasis on directly influencing individual firms."[20] Provinces have attempted to restructure their economies by bringing firm-specific policy instruments, such as selective allocation of credits and use of other discretionary financial tools, to bear on companies located within provinces.

The provinces pursued economic provincialism in the 1970s in two different ways. British Columbia, Alberta, Saskatchewan, and Newfoundland adopted a strategy of economic diversification, in which the goal was to increase the level of processing of natural resources, develop forward linkages which were technology-intensive, and maximize rents from resources in order to help underwrite these resource-based capital projects. This strategy was largely conceived with the express purpose of reversing the subordinate position of hinterland economies to central Canada, a condition to which previous National Policies had contributed.[21] Quebec, Ontario, Manitoba, and Nova Scotia sought to enhance their manufacturing capacity through rationalization,

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[20] Michael Jenkins, *The Challenge of Diversity: Industrial Policy in the Canadian Federation* (Ottawa: Science Council of Canada-Minister of Supply and Services, 1983), p. 86.

[21] I will discuss Alberta's strategy of diversification in the next pages. It is important to note that the four provinces pursued this strategy quite differently. British Colombia emphasized the importance of

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technology infusion, and moving into more sophisticated and competitive manufacturing activities.

Within the first group of provinces, Alberta was the province that took economic planning the farthest. In a 1974 internal government memorandum, the Alberta government remarked that the provincial economy was witnessing a shift "from a primarily extractive economy, where our resources are exported for processing to other parts of Canada and the rest of the world, to an industrialized economy which will see further processing of our raw materials, increased manufacturing and...satisfying employment opportunities for Albertans."[22]

To ensure that this transition came to fruition, the government of Peter Lougheed stressed three key factors. First, the development strategy emphasized the need to reduce Alberta's reliance on outside government and private involvement. Achieving a degree of self-sufficiency, that is enabling Albertans to have greater control over the development of provincial potential, was a desired goal. Second, focus was placed on the development of an indigenous industrial-technological base by encouraging the involvement of local and private sources of capital. Finally, the role of the public sector was to be limited to functions which the private sector proved unwilling to undertake, and

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expanding the province's export opportunities and of limiting government involvement to the development of an adequate infrastructure to facilitate the expansion of the province's nature resource sector. Also it sought to enhance its capacity in mining extraction, ocean engineering, and production of forest products. Unlike the other three provinces that pursued this strategy, British Columbia was not so much concerned about enhancing local control of provincial productive assets. Saskatchewan pursued economic diversification by applying a much heavier dose of government intervention than British Columbia, Alberta, and Newfoundland. The goals of achieving higher levels of resource processing and enhancing provincial control of productive assets were largely attained using state-owned enterprises. For example, the state-owned Potash Corporation of Saskatchewan accounted for approximately 50 percent of potash production in the province by the mid-1970s after acquiring several private companies. Newfoundland has followed an aggressive policy to augment provincial control of local resources, refusing to renew a cooperative arrangement with Quebec to develop the hydroelectric power potential in Newfoundland and seeking unconditional payments from the federal government to guarantee maximum flexibility.

[22] Alberta, Department of Industry and Commerce, "Management of Growth," (May 29, 1974).

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state intervention was to take place selectively and using such arrangements as joint ventures and mixed corporations.[23]

The Alberta government employed several instruments to help shape the restructuring of the economy. For example, the Alberta Heritage Savings Trust Fund (AHSTF), created in 1976, received 30 percent of the province's oil and gas royalties. The AHSTF functioned as an investment reserve trust fund to protect the Albertan economy against the depletion of its non-renewable resources and eventual decline in the price of oil and gas.[24] By the beginning of the 1980s, 53 percent of AHSTF's funds were used to finance capital projects that contributed to strengthening and diversifying the provincial economy. For instance, a number of these projects involved the recovery of oil from non-conventional sources such as deposits of tar sands and heavy oils.

Equally important were Alberta's efforts to promote technological development. The Alberta Research Council was created in the 1970s in an attempt to pool private and public technological know-how and expertise for the purpose of assisting in building the province's industrial sector. Among its key initiatives was the Council's effort to expand the biotechnology industry by developing specialized crops that could be harvested to suit Alberta's short growing season. Moreover, the Alberta Oil Sands Technology and Research Authority (AOSTRA) developed technologies for the recovery of bitumen oil sands, at an estimated cost of $100 million between 1976-80.[25] Importantly, the AOSTRA had the authority to be selective in the allocation of research funds, preferring to hire provincial and Canadian expertise.

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[23] Premier of Alberta, Peter Lougheed, "Alberta's Industrial Strategy," Speech to the Calgary Chamber of Commerce (September 6, 1974).
[24] Janine Brodie, *The Political Economy of Canadian Regionalism*, pp. 197-198; and Michael Jenkins, *The Challenge of Diversity*, pp. 55-56.
[25] Michael Jenkins, *The Challenge of Diversity*, pp. 56-57.

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Another crucial component of Alberta's industry strategy was its use of joint-venture arrangements. In addition to forging joint ventures with companies involved in the petrochemicals, steel production, electric generation, and pipeline industries, the government created in 1973 the Alberta Energy Company, a company that was half government owned and half privately owned, to participate in the Syncrude oil sands venture and the Suffield natural gas fields.[26] The province's ties to NOVA were also noteworthy. Although NOVA was a privately owned company, some of its directors were considered "government representatives" because of the close working relationship the company maintained with the provincial government. Owing its success to the provincial government's favorable treatment, NOVA reciprocated by insisting on making Alberta the home base for its vast operations.[27]

In Quebec, the ascendancy of economic provincialism corresponded with the Quiet Revolution that started in the 1960s. The Quiet Revolution marked the end of the conservative political era of Premier Maurice Duplessis, during which the government pursued a minimalist, laissez-faire approach to managing the economy and advocated the heavy presence of the Catholic church in society, particularly in education and social welfare. The victory of the Liberal government of Jean Lesage in 1960 launched an era of statism, which was supported by the increasing influence of secularism and of a technocratic mode of thinking. The industrial strategy that emerged from the Quiet Revolution focused on two key objectives. First, Quebec sought to effect a change in its manufacturing structure, from its emphasis on light manufacturing activities to technology-intensive and high value-added activities associated with aerospace,

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[26] John Richards and Larry Pratt, *Prairie Capitalism: Power and Influence in the New West* (Toronto: McClelland and Stewart, 1981), p. 242.
[27] Michael Jenkins, *The Challenge of Diversity*, p. 54.

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chemicals, and electrical equipment.[28] Second, the industrial strategy sought to enhance the presence of Francophones in the commanding heights of the provincial economy and increase the managerial capacity of French-Canadians.

To help accomplish these objectives, the Quebec government created several public corporations on a scale unparalleled in other provinces. To assist in the development and processing of Quebec's natural resources, a number of Provincial Crown corporations were created: the Société québécoise d'initiatives agro-alimentaires (SOQUIA) was established in the agro-food industry in 1975; the Société québécoise d'exploration minière (SOQUEM) was created in the mining industry in 1965; the Société québécoise d'initiatives pétrolières (SOQUIP) was established in the gas and oil industry in 1969, Hydro-Quebec was established in electric generation sector in 1964, and SIDBEC was created in the iron and steel industry in 1964.[29]

Moreover, the Quebec state established a number of public corporations that were instrumental in providing the necessary investment capital to undertake industrial development and reduce Quebec's dependence on outside finance. In 1962 the Société générale de financement (SGF), a state-owned industrial holding company, was created to provide investment capital in priority sectors of the Quebec economy. The establishment of the Caisse de dépôt et de placement du Québec, an entity formed in 1965 to manage the funds generated through public pension and insurance plans, has used its funds to finance capital projects, most notably the huge James Bay hydro-electric development project and the Quebec-based Provigo, which became one of Canada's

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[28] Alan Tupper, *Public Money in the Private Sector*, p, 28.

[29] Report of the Committee on the Privatization of Crown Corporations, *From the Quiet Revolution...to the Twenty-First Century* (June 1986). See also Gouvernement du Québec, *Bâtir le Québec: un énoncé de politique économique* (Quebéc: Ministère de l'industrie et du commerce, 1979).

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largest food retailers. Also, the Société de développement industriel du Québec was established in 1971 to provide finance to projects which promoted the rationalization and modernization of manufacturing activities.[30]

Although economic provincialism and GDAs both worked to foster industrial growth in the provinces, it was the repercussions of the former which particularly alarmed Ottawa. Economic provincialism was inherently protectionist and designed to channel more economic gains in the direction of one province at the expense of others, just as economic nationalism is a strategy that a country employs to produce more equitable achievements of gains from its interstate exchanges. Moreover, economic provincialism often brought the provinces and Ottawa on a collision course because it emboldened the provinces to assert themselves vis-à-vis the federal government. As Jenkins points out, "In the attempt to implement their economic policies, provincial governments increasingly tr[ied] to insulate their economies from negative national developments, while seeking to capture all the benefits of a particular opportunity."[31] Although regional development planning had not contributed to this, promoters of economic provincialism did seize the opening that it created to pursue their respective provinces' economic self-interest. Consequently, the experiences of the economic planning exercise in the 1970s had the unexpected effect of unleashing divisive forces in the federal system which came to the fore by way of intensifying intergovernmental tensions, fragmenting the common market within Canada, and undermining the federal government's efforts to maintain its visibility.

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[30] Ibid.; and Allan Tupper, *Public Money in the Private Sector*, pp. 27-31.
[31] Jenkins, p. 230.

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As the two levels of government took on a more activist interventionist role in the economy, the more frequent intergovernmental conflicts became as they were more likely to find themselves interfering with each other's economic objectives. This was the message that came out of the 1979 "Intrusions Paper" published by the Western Premiers' Task Force on Constitutional Trends. The report identified 57 intrusion incidences in which western provinces complained that their economic goals were undermined by the way in which the federal government exercised its powers. For its part, the federal government complained that provincial policies undermined the common market principle, a concern that came to the political forefront at the end of the 1970s.

The concern over the fragmentation of the national economy was caused by the increasing use of discriminatory instruments by the provinces. The concern was severe enough for the Ontario Minister of Industry and Tourism to argue that "despite the magnitude of our economic interdependence it appears as though we have chosen to frustrate what could be a strong national economic system. In fact, Canada's ambassador to the European Community has stated 'that there are now fewer barriers to trade among the countries of Europe than among the provinces of Canada.'"[32] The pursuit of provincial industrial strategies often involved the use of discriminatory policy instruments that sought to create exclusive advantages for intra-provincial producers. First, their constitutional authority over management of natural resources enabled provinces to regulate the pace of exploitation and supply of natural resources, and often used their constitutional leverage to impose more stringent resource processing standards within their provinces. Second, by the end of the 1970s, most provincial governments

[32] Ontario, Minister of Industry and Tourism, *Interprovincial Econoimc Cooperation: Towards the Development of a Canadian Common Market* (January 1981), p. 6.

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used procurement policies that discriminated against bidders from other provinces, as Table 7.3 illustrates.

Although studies have shown that these policy instruments have not been as harmful as expected, what remained undisputable was that provincial governments were inclined more than ever to advance their own self-interests even if it meant undermining the integrity of the national economy. As Tupper notes, "The very existence of beggar-

Table 7.3. Some Examples of Provincially-biased Policies, late 1970s-1981

Newfoundland
- Offered a preference of up to 15 percent for locally produced goods and services.

Quebec
- In 1976, Quebec extended to all government departments the procedure followed by Hydro-Quebec since the late 1960s, buying approximately 70 percent of what they need from Quebec-based suppliers. Unless the lowest bid by a Quebec firm is substantially higher than the lowest bid from non-Quebec firms, the province will source locally.

Maritime Provinces (New Brunswick, Nova Scotia, and Prince Edward Island)
- In 1980, these governments announced a new Maritime purchasing policy designed to improve Maritime manufacturing: "Province first, Maritimes second, and Canada third."

Alberta
- Bidders on certain major projects (e.g., tar sands, pipelines) were required to specify how much local employment will be created and intra-provincial buying it plans to undertake.
- Only companies licensed to do business in Alberta were given permission to engage in exploration and extraction of natural resource exploration.

British Columbia
- Applied a 10 percent preference to local suppliers and could take into account regional or sectoral unemployment as well as general economic state of an industry before awarding contracts.

Ontario
- 10 percent price premium to Canadian suppliers
- preference to Ontario-based firms only when bids are competitive

Sources: Michael Jenkins, *The Challenge of Diversity*, pp. 93-94; Ontario, Minister of Industry and Tourism, *Interprovincial Economic Cooperation: Towards the Development of a Canadian Common Market* (January 1981), pp. 7, 8, and 17.

thy-neighbour policies contributes to distrust in intergovernmental relations, because they symbolize the intentions of individual governments to pursue their own courses and to insulate their economies from external forces."[33]

[33] Allan Tupper, "Federalism and the Politics of Industrial Policy," p. 368.

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The decentralized approach also lost support by the end of the 1970s because it had undermined federal visibility. Ottawa's heightened concern about visibility stemmed initially from the rise of Quebec separatist forces in the 1960s and, by the early 1970s, from the growing provincial discontent with the way in which the federal government was employing its federal spending power.[34] One of the principal purposes supporting the initiation of DREE's GDA was to enhance the visibility of federal government in activities that affected Canadians. The GDAs, federal-provincial cost-sharing agreements, were expected to earn political credits for Ottawa by contributing federal money to programs designed to help provinces attain their "developmental opportunities."

By the second half of the 1970s, however, two elements undercut federal visibility. First, it became apparent that the joint delivery mechanism of the GDAs and the fact that they were administered at the provincial level gave Ottawa less visibility than anticipated. Many Canadians were unaware of the extent of the federal government's financial contribution to these cost-sharing agreements.[35] Second, as intergovernmental relations soured during the 1970s on the issue of economic development, the provinces intensified their efforts to discredit the federal government. In sum, the shift away from the decentralized to a centralized approach to economic development was partly motivated by the desire of Trudeau's administration to counteract the decentralizing trend in Canadian federalism which threatened to fragment the internal market and frustrate federal objectives.

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[34] Kenneth McRoberts, "Unilateralism, Bilateralism and Multilateralism: Approaches to Canadian Federalism,"; and Anthony Careless, *Initiative and Response: The Adaptation of Canadian Federalism to Regional Economic Development*, 1977, p. 177.
[35] Savoie, *Regional Economic Development: Canada's search for solutions*, 1986, p. 14.

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Changes In the Views of the Federal State on Economic Development

The second factor that contributed to the shift away from regional economic planning related to the increased focus on the need to develop a national industrial development policy, a policy orientation which called for the centralization of development planning and for sectoral development. There were two related forces driving this policy reorientation within the federal state. First, during the 1970s two competing national development models emerged on the policy scene, which called into question the efficacy of regional economic planning. The second factor that contributed to the change in policy discourse had to do with the emerging dialogue between two planning systems. [36]

Two competing national economic development ideas emerged, one advanced by the Science Council of Canada the other by the Economic Council of Canada, by the second half of the 1970s that directly rivaled regional planning. Regional development had become the dominant mode of economic development planning during the better part of the 1970s largely because of the absence of effective alternative planning schemes. Whereas the Science Council of Canada advocated an economic nationalist-inspired national strategy called "technological sovereignty," the Economic Council of Canada supported a strategy that pushed for free trade.[37]

Notwithstanding their differences, the two models were in agreement on two key factors. First, both focused on the development of the national economy rather than of

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[36] The term "planning system" has been developed by French. It refers to the particular position of each system's principal bureaucratic sponsor on the issue of economic planning and the planning instruments a system requires to achieve planning. French identifies a third planning system, revolving around the Treasury Board; however, this last one was not as relevant in this debate as the first two planning systems. See Richard French, *How Ottawa Decides*, pp. 25-58.

[37] The Science Council of Canada, established in 1966, and the Economic Council of Canada, created in 1963, are two federal policy advisory councils.

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regional economies, and emphasized the objective of improving the international competitiveness of the secondary manufacturing sector. Second, the two strategies were based on the idea that the manufacturing sector could only achieve economies of scale by fortifying the internal common market, in addition to gaining access to foreign markets.

The technological sovereignty strategy blamed the weakness of Canadian secondary manufacturing on the high presence of foreign investment in the country and to the truncated branch-plants that foreign investors established in Canada. According to this national strategy, the key to inducing industrial development was to improve the technological capability of Canadian manufacturers. But the kind of industrial development this strategy envisioned was one that would have to be self-generating, and domestically-controlled. Technological sovereignty, as the Science Council of Canada noted, would be

> a policy which seeks to influence the selective development and use of technology in the industrial system so that the maximum benefits of economic activity in Canada are realized for Canadians. Only by increasing our ability to influence the direction and use of technological change in the economy can Canadians ensure that the adaptation to shifting international economic circumstances is accomplished in a manner consistent with maximizing the advantages to our domestic economy.[38]

To accomplish these objectives, this strategy maintained that it was necessary to increase the demand for Canadian technology, enhance the capacity to develop and absorb new technology, and regulate technology imports. In recognizing the need for the private sector to undertake these measures, the Science Council also maintained that government intervention would be necessary in order to create the kinds of conditions that would be conducive to spur private initiatives. Perhaps more controversial than the

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[38] Science Council of Canada, *Forging the Links: A Technology Policy for Canada* (Ottawa: Ministry of Supply and Services Canada, 1979), p. 14.

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prospect of government intervention was that this strategy was regionally biased in favor of central Canada, where secondary manufacturing was most concentrated and for which the technological drive would be most beneficial.[39]

Unlike the technology sovereignty strategy, the free trade strategy faulted relatively high tariff protection for Canada's weak manufacturing capacity. The Economic Council of Canada observed that "one of the basic causes of our poor productivity performance is the type and organization of manufacturing fostered by the commercial policies adopted by Canada."[40] But the Economic Council was also aware of the small market size constraint that Canadian manufacturers were facing, a condition which made it difficult for them to achieve the level of economies of scale necessary to be efficient and internationally competitive. While free trade was singled out as the key catalyst for the rationalization of Canada's industrial structure and achieving longer production runs, the Economic Council noted that "Canadians could in the end be confronted with the necessity of considering a bilateral arrangement with the United States alone—not as a matter of first choice, but as the only option available that would [in the medium-term] provide opportunities commensurate with the vast requirements for restructuring Canadian industry."[41] It was expected that, like the intra-industry specialization in the automobile industry that resulted from the 1965 Auto Pact, a broader bilateral free trade agreement would produce similar results across a range of industries.

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[39] K. H. Norrie, "Regional Economic Conflicts in Canada: Their Significance for An Industrial Strategy," in *The Politics of an Industrial Strategy: A Seminar* (Ottawa: Ministry of Supply and Services, 1979), p. 72.
[40] Economic Council of Canada, *Looking Outward: A New Trade Strategy for Canada* (Ottawa: Information Canada, 1975), p. 3.
[41] Ibid., p. 108.

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The emergence of these two alternative national development strategies helped shift attention away from regional development to national development as the primary focus of economic planning. Moreover, they placed emphasis on sectoral development. However, without strong supporters, neither idea immediately gained prominence. But, as regional planning was increasingly called into question by bureaucratic actors, attention began to shift to these two emerging views, which provided fresh ideas concerning how to apply economic planning at the national level.

Bureaucratic struggles undercut the support for the continuation of decentralized approach to economic development planning and helped bring to the political forefront the issue of national industrial development. At issue was the divergence of two planning systems, one revolving around the Department of Finance and the other around the Cabinet Planning System, both of which operated simultaneously within the central decision making apparatus throughout the 1970s. The clash between the two systems frustrated efforts to promote intra-state coordination with regard to economic development and pitched the debate on economic development in the direction of national industrial strategy. Caught between the two competing planning systems, the Department of Industry, Trade and Commerce emerged as the key departmental actor to head this new policy undertaking, thus displacing DREE as the lead department in the area of economic development.

From the start, Finance viewed the added attention directed toward regional development as misguided, for it contended that Canada's economic policies should be more concerned with improving the international competitiveness of secondary manufacturing. According to Simon Reisman, deputy minister of Finance in the 1970s,

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"Canada should promote the basic momentum of industrial strength in the Montreal-Windsor corridor, raising the peripheral regions up behind the center."[42] Moreover, Reisman among others in the department viewed regional development as no more than social policy designed to correct the uneven diffusion of growth. Accordingly, the application of the method of planning to this policy arena appeared to be an odd choice. Fundamentally, Finance opposed the use of political interventionism and planning designs to achieve the objectives of the Third Option. As an advocate of silent integration but not of free trade, the department sought to preserve market governance as it had evolved in the postwar period by using discretely macroeconomic stabilization instruments. Indeed, its economic philosophy rested on the belief that the role of government in the economy should be confined to the "fine tuning" of the economy as a way to deal with the business cycle. Consequently, Finance rejected any economic planning efforts—particularly the technology sovereignty plan and the DREE's GDA program—because such an undertaking interfered with the operation of the market.

As a creation of the Privy Council Office (PCO), the Cabinet Planning System emerged on the decision making scene in 1968 as a counterbalancing force to the hitherto unchallenged primacy of Finance. The Cabinet Planning System played an important role in Trudeau's efforts to bring about greater coordination and collective decision making within the political-bureaucratic framework and facilitate the pursuit of a coherent set of explicitly defined policy goals. As French observes, in seeking to imitate the administrative practices of Japan and France, "the Cabinet Planning System emphasized a more proactive approach [to policy making], involving the forecasting of future problems and opportunities, and the design of policies to protect the public interest

[42] Quoted in Richard French, *How Ottawa Decides*, p. 114.

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by anticipating such developments."[43] The issue of industrial development planning gained increasing salience within the Cabinet Planning System starting in the late 1960s. The increased interest of the agents of this planning system toward this issue stemmed in part from their disapproval of the passive and hands-off approach that Finance followed and in part from the lack of serious thinking about industrial planning within the federal state.

Two developments helped propel this issue to the political forefront. First, the PCO designated the issue of industrial development a priority problem by 1971, a status which the central agency had also assigned to tax reform, technology policy, and foreign investment policy. Moreover, having designated industrial development a priority problem, the issue was handed over to the Priorities and Planning Committee (an important agent within the Cabinet Planning System) which undertook the task of defining more explicitly the goals that would guide this policy area, of bringing a long-term perspective to this issue area, and of rendering more coherent and complementary regional development and industrial development policies.

By 1972-73, the Cabinet Planning System had formulated an industrial development plan that called for more proactive state intervention in the economy. In particular, the Cabinet Planning System's plan included a technology policy pushing for more indigenous technology, policies to enhance domestic control of economy and regional development, and policies to promote domestic entrepreneurship and exports. The Cabinet Planning System's efforts to devise and implement a comprehensive industrial development plan brought the Department of Industry, Trade, and Commerce under the Priorities and Planning Committee's direct influence.

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[43] French, p. 43.

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Much younger than the Department of Finance, the Department of Industry, Trade and Commerce (DITC) was formed in 1969 when the Department of Industry and the Department of Trade and Commerce were merged. When Prime Minister Pearson created the Department of Industry in 1963, he assigned to the new department the task of fulfilling Canada's "special need...to create and expand the more sophisticated, the more complicated...kinds of industry producing goods which we both need ourselves and which we can sell to other countries."[44]

Like Finance, the DITC maintained an affinity to the notion of preserving free market enterprise and regarded economic planning as a policy effort that rivaled this prevailing set of policy habits. However, the picture was more complicated than was the case for Finance. The amalgamation of the Department of Industry with Department of Commerce and Trade brought together two distinct ideas on industrial policy. For the Department of Industry, an industrial policy required the state to be involved (as indirectly and passively as possible) in industrial development by assisting different industry sectors as evenly as possible, whereas for the Commerce and Trade, the expansion of trade opportunities was as close to an industrial policy as the state could achieve. The incorporation of these two views led DITC to reject the practice of discriminating in favor of a particular set of industrial sectors, to ignore the regional impact of its activities and consequently to preserve the existing concentration of industry in central Canada and deepening Canada's commercial ties with the United States and other markets.

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[44] Right Honourable Lester Pearson, "Provision for Establishment of Department of Industry," *House of Commons*, June 7 1963, pp. 801-804.

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Moreover, as with Finance, DITC was not equipped with dirigiste instruments, notably the capacity to engage in the selective allocation of capital as a way to advance the developmental goals of the state. Instead, the department's Trade-Industry Program consisted of a set of promotional, regulatory, and incentives programs that targeted product development, industrial rationalization and adjustment, and export market promotion whose resources were largely apportioned on the basis of requests and applications for program assistance by individual firms. Because of the regional location of industrial sectors in Ontario and Quebec, DITC programs came to the aid of firms located in this region. As Jenkins points out, between 1975 and 1980, from 72 to 83 percent of DITC's Trade-Industry Program expenditure went to central Canada.[45]

Thus when the Cabinet Planning System singled out the DITC to be the lead administrative body to carry out its industrial development plan, the department neither possessed the necessary instruments and organizational capacities nor subscribed to the planning ideas of the Cabinet Planning System. In effect, there was much resistance and ambivalence coming from department officials. However, while there was support to defy the PCO and the Priorities and Planning Committee, the department had to remain receptive given that Prime Minister Trudeau supported the Cabinet Planning System's efforts. As French observes, "IT&C found itself wedged uncomfortably between two planning systems [and] although on balance IT&C shared the Finance Planning System's rejection of the Cabinet Planning System's approach to industrial development policy, it could not afford to alienate the PCO."[46] What emerged was a compromise approach that involved changes on three fronts—(1) defining the broad outlines of an industrial

[45] Jenkins, p. 154.
[46] French, *How Ottawa Decides*, p. 112.

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development policy; (2) developing a mechanism to facilitate closer business-government consultations; (3) enhancing interdepartmental and intergovernmental coordination.

Throughout the 1970s, the DITC explored two alternative industrial strategy designs. Under Minister Jean-Luc Pépin, DITC took a bold initiative in 1972 by proposing to implement a comprehensive industrial strategy. As Pépin pointed out, the DITC was prepared to undertake "the proper planning by government for the optimum coordination of policies and decisions, on the use of all productive resources, in order to achieve defined (and accepted) social and economic goals [and] the strategy must embrace all sectors of economic activity from resources to services but must emphasize manufacturing and processing."[47]

Whereas Pépin advanced a comprehensive, one-size-fits-all plan, his successor, Alastair Gillespie, proposed a set of sector-specific strategies which were sensitive to the circumstances of each industry. In addressing the same audience as Pepin had spoken to a year earlier, Gillespie stated that "rather than an industrial strategy, we believe that the most practical approach to industrial development is to identify the problems and opportunities on an industry by industry basis."[48] Before leaving his post in 1975, Gillespie delivered the same message to the Parliament: "I have steadfastly resisted the temptation to announce one master plan for industrial strategy development in Canada. I think we need more than one industrial strategy—and I have mentioned 18 [or] 19 industrial strategies that we are working on at the present time—because each industry

[47] "Notes for a Speech by the Honourable Jean-Luc Pepin, Minister of Industry, Trade and Commerce to the Annual General Meeting of the Canadian Manufacturers' Association," June 5, 1972, pp. 3-4.
[48] "Notes for a Speech by the Honourable Alastair Gillespie, Minister of Industry, Trade and Commerce to the Annual Meeting of the Canadian Manufacturers' Association, June 5, 1973.

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has a unique set of problems, opportunities and constraints...."[49] Although the comprehensive design was closer to the PCO's preference, Gillespie's design gained much more support within the DITC and became the department's answer to the Cabinet Planning System's call for the development of a national industrial development policy.

The compromise plan also featured an increased effort to establish closer government relations with labor and business. This policy measure was largely facilitated as a result of the institutional groundwork laid down in the wake of the Anti-Inflation Board which Trudeau created in 1975 to enforce mandatory wage and price controls in order to suppress growing inflation.[50] These controls were met with opposition from labor, which culminated in the withdrawal of the Canadian Labour Congress (CLC) and the Confederation of National Trade Unions from federal advisory agencies such as the Canada Labour Relations Council and the Economic Council of Canada.

In a move intended to avert further hostilities between labor and the government, the CLC announced in 1976 that it supported the development of a tripartite mechanism that would give labor and business the opportunity to influence decision-making with regard to those policies designed to guide the economy out of the 'control' period. With the strong support for tripartite consultation from the three sides, a group of ten deputy ministers from the key economic departments (DM-10), which was given the mandate to chart post-control economic policies, joined by business and labor began discussing in the mid-1976 the state of the economy and the process of "decontrols."

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[49] Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs, May 5, 1975, pp. 15-16.

[50] In addition to setting price and wage controls, the Bank of Canada with the support of the Department of Finance pursued a highly restrictive monetary policy.

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In the fall of 1976, the federal government released *The Way Ahead*, in which it argued that the government needed to develop closer consultative ties with labor, business, and the provinces in order to generate new policy ideas, attain consensus on how to redress Canada's problems of industrial adjustment, and improve the efficacy of economic policy implementation. As Stewart observes, the government "sought to consult with the labour and business communities and with the provinces in order to discuss the conditions for the exit from wage and price controls and to seek greater agreement on appropriate structures of economic policy."[51]

Although the issue of national industrial development policy was not the focus of these tripartite meetings at this time, this phase established working relationships among the federal government, labor, and business which became crucial as Ottawa undertook a more concerted effort to chart a national industrial development policy in subsequent years. In effect, the Interdepartmental Committee on Trade and Industrial Policy (ICTIP) was able to launch Enterprise 77 in 1977—an undertaking involving government-led interviews of some 5500 firms across Canada in order to gain an understanding of business grievances of existing public policies—by using the consultative relations that the post-controls state-societal tripartite dialogue helped set up.[52]

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[51] Ian Stewart, "Global Transformation and Economic Policy," in Thomas Axworthy and Pierre Elliott Trudeau, eds., *Towards a Just Society: The Trudeau Years* (Toronto: Penguin Books, 2000), pp. 161-62. It is important to note that post-controls tripartite consultations continued until July 1977, when the process broke down because of labor's rejection of the Finance Department's proposal to undertake phased decontrol, which labor argued had been proposed as a 'take it or leave it' plan. Business representatives also had reservations about Finance's plan for decontrol. No serious efforts were undertaken to reinitiate tripartite consultations; consequently the DM-10 committee receded from the political scene.

[52] Particularly noteworthy about the Enterprise 77 initiative was that although the interviews with business leaders were conducted by senior officials mostly from the DITC, officials from other departments as well as from the provinces were involved in the process. They were given access to the information, engaged in deliberations, and drew up some common conclusions about what goals policy makers strive to attain.

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Lastly, the move toward a national industrial development policy was facilitated by advancements in interdepartmental and intergovernmental coordination. Interdepartmental coordination benefited from the exigency of combating effectively Canada's inflation problem in the mid-1970s, as was demonstrated by the creation of the DM-10 committee, which played an important role in the transition to the post-control period.

As the DM-10 committee's role diminished, however, the Interdepartmental Committee on Trade and Industrial Policy inherited a similar interdepartmental consultative function as that of the DM-10 committee. Composed of deputies from all economic departments, the ICTIP took on the task of putting together the pieces of the government's national industrial planning design. Enhanced provincial-federal coordination contributed to the reduction of inflation from 10.6 percent in 1975 to 6.2 percent in 1976, but it also drew their attention to a national problem requiring the mobilizing of consensus between the two levels of government.[53] As one federal official noted, "the AIB [Anti-Inflation Board] had provided a concrete example of how cooperation was necessary to deal with [national] economic problems, and, at the same time, had impressed upon participants the enormity of the constitutional/ jurisdictional complications raised by any unilateral attempt to address such problems."[54]

In sum, by the second half of the 1970s momentum toward the development of a national economic planning design was beginning to build. On the one hand, the ascendancy of economic provincialism, and the concern that it could fragment the internal common market if not counteracted, prompted Ottawa to begin considering

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[53] Douglass Brown and Julia Eastman, *The Limits of Consultation: A Debate Among Ottawa, the Provinces and the Private Sector on an Industrial Strategy* (Ottawa: Science Council of Canada, 1981).
[54] Douglass Brown and Julia Eastman, p. 27.

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economic planning efforts at the national level. On the other hand, the momentum also derived from the emergence of a compromise solution between the Cabinet Planning System's call for national economic planning and the Finance System's rejection of economic planning in general. Building upon the institutional innovations that Ottawa undertook the in wake of wage and price controls, this compromise solution helped delineate the broad outlines of a national economic plan and build the institutional framework that would be necessary to carry out such a plan.

TOWARD A NATIONAL INDUSTRIAL DEVELOPMENT POLICY

The federal government's approach to economic development shifted decisively in 1978. The view from Ottawa was that "provincial economic development was seen to be directly at odds with national economic development. Increasingly, economic development concerns were given a sectoral focus (e.g., energy), with regional considerations at best secondary."[55] Ottawa attempted to effect this change in planning orientation by undertaking several federal initiatives that took place during the remainder of the 1970s and beginning of the 1980s. As Table 7.4 illustrates, these initiatives included the two First Ministers Conferences on the Economy, the establishment of the Tier I and Tier II committees as part of the government's attempt to foster closer working relationships with business and labor representatives, and the creation of the Board of Economic Development Ministers in order to enhance inter-departmental coordination.

Despite the notable institutional innovations which were undertaken to facilitate the task of formulating and implementing a national industrial development plan, by the end

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[55] N. Harvey Lithwick, "Federal Government Regional Economic Development Policies: An Evaluative Survey," in Kenneth Norrie, ed., *Disparities and Interregional Adjustment* (Toronto: University of Toronto Press & Ottawa: Minister of Supply and Services Canada, 1986), p. 133.

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of the first half of the 1980s, these efforts could not take credit for any major accomplishments. In fact, institutional adaptation failed to fix in place a new, permanent institutional framework to facilitate coordination among political and economic actors. Moreover, the national industrial development plan that emerged fell far short of a coordinated, manufacturing-oriented plan of action. As remarkable as these institutional innovations were, I argue that they were not profound enough to dislodge the underlying institutional dynamic inherent Canada's political structure—federal system tending toward competitive relations between the levels of government, arm's-length pattern of government-societal relations, and bureaucratic fragmentation.

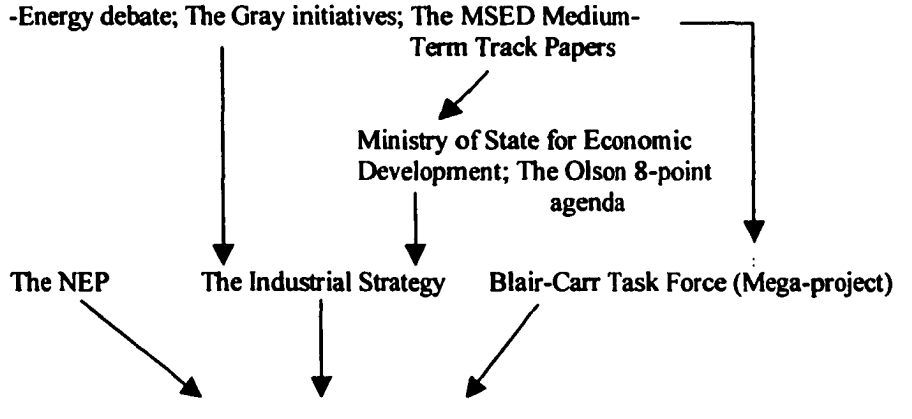
Table 7.4. The Policy Road and Institutional Evolution to the 1981 Statement on Economic Development

1970-74 -The ITC search for an industrial strategy
-Science Council's technological sovereignty arguments
-Economic Council's freer trade approach

1975-77 -The call to restructure the economy in the post-controls period
-DM 10; ICTIP; Enterprise 77

1978 - 23 sector task forces (Tier I and Tier II committees)
- 2 First Ministers Conferences on the Economy (FMC)
- Board of Economic Development Ministers (BEDM)

1979-81 -Energy debate; The Gray initiatives; The MSED Medium-Term Track Papers



1981 The Statement on Economic Development

Adapted from G. Bruce Doern, "The mega-project episode and the formulation of Canadian Economic development policy," *Canadian Public Administration* 26 (1983).

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The Federal-Provincial First Ministers Conferences on the Economy

The First Ministers' Meetings on the economy that took place in February and November of 1978 were the most significant intergovernmental efforts to attain some coordination of economic policies. Prime Minister Trudeau floated the idea of such a meeting in the fall of 1977 during a tour of the provinces. Although provincial governments supported the prime minister's plan, the fact that the meetings would take place prior to an expected general election in late 1978 or 1979 led the provinces to suspect that this initiative was launched as a way to boost the Liberal government's visibility. Nevertheless, government leaders deliberated for three days on two sets of issues. First, provincial and federal leaders discussed macroeconomic economic issues, such as the labor market, commercial policy, government spending, and price stabilization. The other set of issues addressed specific sectors of the economy such as manufacturing, mining, fisheries, and wood and pulp.

Intergovernmental consensus was more forthcoming on what kinds of medium-term macroeconomic objectives should be achieved than on sector-specific issues. Provincial and federal leaders agreed to maintain the growth of government spending below that of the gross domestic product, to support the Bank of Canada's restrictive monetary policy, and to restrain government intervention in order to restore investor confidence. Moreover, Ottawa promised that provincial involvement in Canadian negotiations in the Tokyo Round of the GATT would continue and leaders agreed to launch the 23-sector Task Forces consultations. Deliberations on sector-related issues produced pledges that lacked real substance. Leaders were in agreement about the need to put in place policies that encouraged the private sector to adapt to changes in

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international competitive situations and to eliminate those policies that inhibited market-led adjustments. Aside from that, political leaders could not come to an agreement on which sectors should be given priority over others. At issue were the regional implications of making such a planning decision. The prioritization of some sectors would appear to be biased in favor of those provinces where these sectors were most developed.

In fact, provincial leaders intentionally averted making any commitments about placing more focus on any particular set of sectors out of the concern that such a decision would be disadvantagous to them. Thus, the provinces were inclined to use this conference as well as the other in November to make public what their specific interests and concerns were, hoping to influence other provinces and especially Ottawa. This was evident in the position of the Atlantic provinces. "Lacking the bureaucratic numbers and the economic and political clout of the larger provinces," the Atlantic provinces viewed the conference as an opportunity "to put forward requests for federal assistance on a small number of issues of immediate benefit to their provinces."[56] The Quebec Premier, Rene Lévesque, sought, above all, to protect the province's jurisdiction from Ottawa's intrusions by ensuring "that federal activities in the province would be in line with provincial priorities."[57] Reflecting the deepening rift between Alberta and Ottawa, Premier Peter Lougheed "refused to commit [himself] to many new initiatives so that Trudeau could not realize political gains from the conference."[58]

The November meeting was beset by the rise in intergovernmental conflicts witnessed during the intervening months following the first conference. Not only did

[56] Brown and Eastman, p. 55.
[57] Brown and Eastman, p. 56.
[58] Brown and Eastman, p. 59.

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some provinces seek more stubbornly to defend their economic interests, but the provinces in general were more prone openly to criticize the federal government's economic policies because of Ottawa's recent attempts to introduce more centralization in the manner with which it promoted economic development. Moreover, the pre-election environment, the fact that these forums were televised, and the frequent clashes between the Prime Minister and Premier René Lévesque, emboldened the two leaders to use this public forum to win political points at the expense of each other.

In the face of such a politically-charged atmosphere, the consultations led to few agreements. On the issue of regional development, the first ministers "stressed that regional development should be based on viable economic opportunities resulting from natural strengths." This was largely directed at those provinces pursuing industrial policies that were designed to diversify their economies using provincially-biased instruments and which, according to Ontario and British Columbia, hindered inter-provincial trade.[59]

Moreover, as they had done in the first meeting, the first ministers agreed to reduce the kind of state intervention that thwarted market-based adjustment and to uphold free market enterprise as the principal driving force to achieve industrial growth. However, no plan of action was announced to facilitate the kind of policy coordination that would lead to coordinated government withdrawal from market-impeding policies. Interestingly, the emphasis placed on market-based adjustment introduced an element of contradiction in Ottawa's efforts to design a national industrial development plan. Whereas economic planning required deliberate and selective government decisions on what specific sectors to promote, the message emerging from these two conferences was

[59] Quoted in Brown and Eastman, p. 49.

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that no planning was the best plan. To that extent, the two conferences failed to give Ottawa any kind of guidance concerning the key sectors on which both levels of government should bring their policy instruments to bear. Short of producing an overall outline of where their governments should go from here, leaders acknowledged the need to "continue to discuss and coordinate federal and provincial approaches to Canada's economic problems through an improved federal-provincial framework for consultation, discussions and concerned decisions."[60]

Tier I and Tier II Committees

Another notable institutional innovation that occurred in 1978 was the development of a consultative framework linking the government and labor and business representatives in an effort to generate policy ideas about how to improve the performance of the manufacturing industries in Canada. After receiving the endorsement of government leaders during the First Ministers' Meeting on the Economy in February, the DITC established 23 industry sector task forces (called Tier 1 committees).[61]

As the DITC noted, the principal objective of these task forces was to come up with plans of action "to restore the sectors to a high degree of economic dynamism by encouraging the development of new investment opportunities, improving the efficiency of operations and facilitating the adjustment out of uncompetitive activities into more viable ones."[62] Each sectoral task force had a secretariat composed of DITC officials,

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[60] Quoted in Brown and Eastman, p. 50.

[61] There were 22 manufacturing sectors: aerospace, automobile, cement and concrete, commercial printing, electrical, electronics, fertilizer, food and beverage, footwear, forest products, processed fruit and vegetables, furniture, primary iron and steel, machinery, non-ferrous metals, ocean, petrochemicals, plastics processing, shipbuilding and repair, textile and clothing, and urban transportation. In addition construction and tourism were added.

[62] Department of Industry, Trade and Commerce, *Briefing Notes for Consultative Task Forces* (Ottawa, 1978), p. 1.

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included business and labor representatives, and each invited federal and provincial representatives either as observers, members, or participants or some combination depending on specific task force arrangements.[63] Between the months of April and July, the task forces meet about four times and by late July each task force submitted its report to the DITC. The reports reviewed and revised, if needed, the sector profile each had received at the outset from the DITC and made, in total, over 800 recommendations.[64]

In possession of the 23 individual task force reports and the 800 and some recommendations, the government faced the challenge of sifting through a large amount of information in order to find common points which the government could pursue. Thus in July 1978, an overview committee called the Tier 2 committee was established specifically to accomplish this goal. As Minister of ITC Jack Horner noted, the mandate of the Tier 2 committee was "to work directly from the task Force reports and attachments to identify and make recommendations about factors and policies that cut across sector lines." He added, it would "pull together the common threads running through the reports to make recommendations on broad economic policy based on issues important generally to manufacturing and tourism."[65]

Upon the insistence of the Canadian Labour Congress (CLC), it was agreed that the CLC and the business community would each have five members in the committee, in addition to an academic and a chairperson drawn from the business community. In its report submitted to the government in late October, the Tier 2 committee underlined nine

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[63] 305 firms and 27 unions participated in these task forces. It should be noted that one academic (from 18 universities) assisted in the deliberations of each task force. See Government of Canada, *Action for Industrial Growth: A First Response* (Ottawa, November 1978), p. 1.

[64] Government of Canada, *Industry, Trade and Commerce: Annual Report, 1978-1979* (Ottawa: Ministry of Supply and Services Canada, 1979), p. 22.

[65] Government of Canada, *A Report by the Second Tier Committee on Policies to Improve Canadian Competitiveness* (Ottawa, October 1978), p. 2.

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public policy areas which could promote industrial development: trade and multilateral trade negotiations, manpower and labor relations, taxation, research and development, energy, transportation costs, regional development, government purchasing policies, and rationalization.[66]

Noteworthy among these recommendations were the following. With respect to the recommendation dealing with research and development, the committee noted that "Canada should aim at self-sufficiency in technology; that is, to balance exports against imports of technology."[67] On the issue of regional development, the committee expressed concern with provincial programs that have resulted "in the fragmentation of existing industries" and recommended that "programs encourage industries that are complementary to rather than in competition with existing industry."[68]

Moreover, on government purchasing policies, the committee recognized that Canadian firms often competed against foreign firms whose competitive strength derived from their ability to receive lucrative government contracts from their governments at home. Consequently, it was recommended that "governments in Canada should use federal and provincial purchasing power to equivalent purpose."[69] Finally, with respect to rationalization, the committee acknowledged that in order to spur further productivity gains it was necessary to adjust the size of production runs. The committee argued that one of the most important contributing factors to "Canada's relatively low productivity in some areas of manufacturing [was] the phenomenon of multi-products runs...[that is,]

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[66] Government of Canada, *A Report by the Second Tier Committee on Policies to Improve Canadian Competitiveness.*
[67] Ibid., p. 21.
[68] Ibid., p. 27.
[69] Ibid., p. 28.

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Canadian operations are too often characterized by [the] production of several products geared to the small domestic market."[70]

Although these consultations generated much information about the market conditions different industrial sectors were facing and the public policy needs these sectors required, three drawbacks were particularly evident. First, the fragmented character of the organizational structure of both business and labor significantly impaired their capacity to articulate and convey to the DITC their long-term, cross-sectoral, inter-regional views with respect to the future course of Canadian industrial development. Instead what occurred resembled a bottom-up process whereby private actors flooded the government with an uncoordinated stream of recommendations which avoided the hard decisions associated with priority setting and strategic selection.[71] Moreover, both societal groups were reluctant to assume greater responsibility in attaining collective or public objectives, a position which was consistent with their inclination to place their self-interest above collective goals and, especially in the case of business representatives, to favor a limited sphere of public authority.

The second drawback concerned the fragmentation of the federal state's decision making structure, in which this stream of private sector industrial development proposals was flowing. Missing in this organizational structure of the federal state were the delineation of clear lines of authority, a mechanism with which to aggregate policy resources, and an internal apparatus to facilitate the task of determining industrial development policy priorities and translating them into a coherent, focused course of policy actions. Although the government had began developing some of these

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[70] Ibid., p. 30.
[71] Brown and Eastman, p. 177.

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organizational capacities (as I will discuss in the next section), their absence in the meantime led the government to respond passively, which would not have been the case had such organizational structure existed.

Finally, there was no effort by government officials to influence the behavior of business and labor representatives; rather influence flowed in the other direction, from business and labor to the government. The absence of societal mobilization by the government suggests that the government had weak consensus-building capacity and, more probably, failed to have any clearly defined industrial development goals whose implementation would require mobilizing the support of business and labor representatives.

The Creation of the Board of Economic Development Ministers

The last institutional innovation to take place in the series of institutional changes that began with the Enterprise 77 initiative was the organizational alteration of the federal bureaucracy in November 1978. The goal of this reorganization was to enhance Ottawa's capacity to coordinate and integrate the various aspects of formulating and implementing an economic development plan.

The catalyst for this organizational change was linked to three factors. First, as had been the case since the early 1970s, the economic development policy arena was one best characterized by its highly differentiated structure. This policy arena was occupied by a number of bureaucratic entities—such as the DITC; DREE; Finance; the Department of Energy, Mines, and Resources; the Department of Employment and Immigration; the Department of Science and Technology; and the Department of Labour—which were guided by competing departmental agendas and not amenable to policy coordination

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despite the PCO's efforts. Second, the federal government stood divided and fragmented as it sought to forge stronger ties with societal groups. Indeed, Tier 1 and Tier 2 noted that "business [and labor were] unhappy both at the fragmentation of federal policy and at the multiple points of access to government which this fragmentation required of the private sector."[72] From the viewpoint of labor and business representatives involved in consultations with the government on the issue of economic development policy, the government failed to articulate and communicate ideas which they could discuss and scrutinize. Finally, in August 1978, Prime Minister Trudeau undertook significant budget cuts in federal spending, but also announced that Ottawa would shift funds toward economic development programs to underscore the priority status Ottawa was assigning to this policy area. However, without a centralized mechanism to dispense the new discretionary funds it was expected that interdepartmental competition would intensify as each department fought to secure its share.

The Prime Minister responded to these pressures by establishing the Board of Economic Development Ministers (BEDM) in late November 1978.[73] The president of the BEDM and the new cabinet committee were supported by the Ministry of State for Economic Development (MSED), a central agency secretariat designed to serve the Board. The BEDM and MSED comprised the principal organizational apparatus that would oversee the process of charting and implementing an industrial development

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[72] French, *How Ottawa Decides*, p. 123.

[73] The Board of Economic Development Ministers was composed of the Deputy Prime Minister; the Minister of Finance and the President of the Treasury Board as ex-officio members; and the Ministers of Energy, Mines and Resources, of Science and Technology, of Labour, of Regional Economic Expansion, of Employment and Immigration, of National Revenue and Small Business, and of Industry, Trade and Commerce. See H.G. Thorburn, *Planning and the Economy: Building Federal-Provincial Consensus* (Toronto: James Lorimer & Company, Publishers, 1984); and Government of Canada, Board of Economic Development Ministers, *Action for Industrial Growth: Continuing the Dialogue* (February 1979), p. 1.

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policy. As the Order in Council that gave rise to the BEDM mentioned, the President of the Board was given the mandate to "formulate and develop policies with respect to:"

> (a) The most appropriate means by which to Government of Canada may...have a beneficial influence on the development of industries and regional economies of Canada,
> (b) The integration of programs and activities providing direct support to industry including their coordination with other policies and programs of the Government of Canada,
> (c) The fostering of cooperative relationships with respect to industrial development with the provinces, with business and labour, and with other public and private organizations.[74]

The new cabinet committee and central agency were innovative in terms of the functions they were asked to perform and powers they were given. First, the Board was given the dual responsibilities of formulating an economic development policy and allocating expenditure resources, the latter being a function that was hitherto performed by the Treasury Board. In addition to integrating policy and expenditure decision-making, the new structure assigned central agency functions to be performed in the economic development policy realm to the MSED, tasks once performed by the PCO.[75] More important still, the MSED had a relatively larger secretariat than PCO's and it could also exclusively devote its resources to support the BEDM. As a result, in addition to the president, the ministers of the Board were also briefed by the MSED regarding the

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[74] Quoted in French, p.124.

[75] The Order in Council that established the Ministry of State for Economic Development on December 19, 1978, assigned the new ministry the following central agency responsibilities: (1) formulate, develop, evaluate and coordinate new and comprehensive policies in relation to the programs and activities of the Government that directly support Canadian economic development; (2) promote cooperative relationships with provinces, business, and labor and other public and private organizations for the development of the economy; (3) advise on the allocation of financial, personnel and other resources to federal programs that directly support economic development; and (4) develop mechanisms to improve and to integrate the delivery of economic programs at the local or regional level. See Government of Canada, Ministry of State for Economic Development, *Annual Report, 1979-1980* (Ottawa: Supply and Services Canada, 1980), p. 1.

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implications of departmental policy proposals they were addressing, which the PCO would not have been able to do.[76]

The first item on the Board's agenda was the formulation of a response to the Second Tier Committee Report. In its written response, the Board accepted and endorsed the focus the Tier 2 committee placed on trade and multilateral trade negotiations, manpower and labor relations, taxation, research and development, energy, transportation, regional development, government purchasing policies, and rationalization. It also added that "the recommendations of the Committee and the government's response to them [did] not provide an industrial policy for Canada" but represented "a part of the broad range of measures the federal government [was] now or [was] presently developing to use in supporting the development of competitive Canadian industries."[77] However, before the Board could translate these generalities into concrete policy measures, the Liberal government was defeated by the Progressive Conservatives under Joe Clark in June 1979.

A New Federal Development Strategy

At the time Prime Minister Trudeau announced in his April 14, 1980, speech from the throne that the Liberal government would "promote a national development policy," the Cabinet was grappling with two competing development strategies. One strategy, advanced by Minister of Industry, Trade and Commerce Herb Gray, borrowed many ideas put forth in the Science Council of Canada's technological sovereignty plan and

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[76] During the Clark interregnum (June 4, 1979-March 3, 1980), the Board of Economic Development Ministers became the Cabinet Committee on Economic Development; however, its functions and powers remained unchanged for the most part.

[77] Government of Canada, Board of Economic Ministers, *Action for Industrial Growth: Continuing the Dialogue* (February 1979), p. 10.

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focused heavily on inducing growth in the manufacturing sector of the economy. The other strategy, articulated by Ministry of State for Economic Development Bud Olson, was informed by the market notion of comparative advantage and had a resource-based focus.

Gray's proposed industrial strategy called for the allocation of $2.75 billion over the next four years to programs designed to strengthen Canada's manufacturing and processing capacity as well as to boost exports of higher value-added products. The Gray proposal, which was presented on July 2, 1980, as a Cabinet discussion paper titled "Implementing the New National Industrial Policy," was conceived on the assumption that foreign-owned subsidiaries imposed significant costs on the Canadian economy because their branch-plant activities became obstacles to achieving efficiency gains and progressing toward more sophisticated and diversified industrial activities. As Gray noted,

> The very high level of foreign involvement in our economy has serious adverse effects for the country's ability to fulfill national and regional development goals. [These effects include] inefficient, low-volume scale of many Canadian manufacturers, a low-level of R&D expenditure, a high propensity to import manufactured goods, difficulties associated with the export of manufacturers, and an inability to exploit for our advantage the potential linkages between natural resource wealth and the development of a healthy secondary manufacturing sector.[78]

To overcome these structural deficiencies derived from the branch-plant manufacturing sector, Gray called for the employment of greater state discretion in the economy as a way to channel greater economic gains in Canada's direction. Thus, the strategy sought to promote, through state incentives, such high-technology industries as

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[78] The Honourable Herb Gray, "Economic Nationalism and Industrial Strategies," Notes for an address to the Annual Symposium, École des Hautes Études Commerciales, June 3, 1980.

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aerospace, transportation equipment, and electronics and to increase the state's export-financing efforts to boost exports. It also offered assistance to Canadian firms seeking to repatriate foreign-owned assets and to gain maximum economic benefits from branch-plant subsidiaries by toughening foreign investment regulations which forced them to undertake more sophisticated production-related activities in Canada. The strategy proposed to empower the Canadian Development Corporation to assume a more active role in the manufacturing sector and enact an 'industrial benefits' legislation that would enable Canadian companies to serve as suppliers and subcontractors in major energy projects worth more than $100 million. Finally, the strategy called for the rationalization of troubled industries such as clothing, textiles, and footwear, a measure that would facilitate the transfer of capital from uncompetitive sectors to those manufacturing sectors with better prospects for growth.[79]

The second strategy was explicated in MSED's Medium Term Track (MTT) document which began to circulate in May 1981. The Minister of MSED Bud Olson stressed the importance of having Canada exploit its comparative advantage in resource production as a means of developing backward and forward industrial linkages. As the MTT pointed out,

> A fundamental and essentially permanent shift has taken place during the 1970s, one that strengthens Canada's traditional comparative advantage in the production of basic commodities, related manufacturing products, and high productivity, high technology manufactured goods on the one hand, and increases the comparative disadvantage of many standard manufactured end products on the other. The shifts in the terms of trade toward basic materials can be expected at least to be maintained in the

[79] Les Whittington, "Herb Gray's plea to cabinet," *Financial Times of Canada*, Vol. 69, No. 16, September 15, 1980, pp. 1-2.

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medium term, and perhaps event to strengthen.[80]

This strategy had two advantages over Gray's proposal. First, its strategic focus was broader to the extent that it focused on the development of both the resource and manufacturing sides of the Canadian economy. Indeed, this was consistent with Olson's eight-point agenda announced in 1980, which listed factors conducive to economic development in general rather than to sectoral development. Second, the MTT document proposed a design that proved sensitive to the regional division of economic activities. By linking the development of manufacturing industries directly to that of resource industries, central Canada and the western and Atlantic provinces respectively were promised to benefit equally from government programs.

The MSED strategy received an important endorsement with the release of the Blair-Carr Task Force's report *Major Canadian Projects: Major Canadian Opportunities*, in June 1981.[81] Created in November 1978 by the Federal-Provincial Ministers of Industry Conference, the Task Force was a business-labor consultative body of approximately 80 senior Canadian business and labor representatives, co-chaired by Robert Blair, president of Nova, and Shirley Carr, executive vice-president of the Canadian Labour Congress. The report put together a list of megaprojects with an estimated total value of about $400 billion by the year 2000. Megaprojects were major resource development projects each with an initial capital investment cost exceeding

[80] Quoted in G. Bruce Doern, "The mega-project episode and he formulation of Canadian economic development policy," *Canadian Public Administration* 26 (1983), pp. 230-231. The basic commodities that the MTT document identified as having improved terms of trade included energy commodities, food stuffs, forest products, and minerals.

[81] The full name of the Blair-Carr Task Force is the Major Projects Task Force on Major Capital Projects in Canada to the Year 2000.

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$100 million and intended to have positive effects on the Canadian technological and industrial base.

As the MSED had envisioned in its plan, the megaprojects proposal was designed to create synergies between resource and industrial development, primarily by capitalizing on Canada's comparative advantage in energy resources. As table 7.5 illustrates, the Task Force estimated that about 87 percent of the $400 billion spent on major projects would be in such sectors as electric power generation and transmission, conventional hydrocarbon exploration and development, heavy oil development, pipelines, and hydrocarbon processing and petrochemicals. Moreover, in terms of the geographical distribution of these major projects expenditures, the Atlantic region was expected to receive a little over 10 percent, central Canada 39 percent, western Canada 25 percent; and British Columbia, Yukon, and the Northwest Territory 25 percent.

The report indicated that the benefits of pursuing megaprojects would be manifested throughout the economy. In terms of opportunities for the labor market, megaprojects were expected to create a demand in such high skilled occupations as draftsmen, technologists, technicians, engineers, and managers. In terms of technology development, the report pointed out that megaprojects would have the effect of creating a sufficiently large market for the development of specific, domestic-made technologies that otherwise would not be developed.

Associated with this latter benefit was that megaprojects would create demands for a number of technology-intensive manufactured goods. As the report noted, "about one half of the investment in energy projects [would go toward such] manufactured products as basic steel, pressure vessels, mining equipment, electrical cable and switch gear,

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offshore platforms and support vessels, instrumentation, and power generation and transmission" just to name a few.[82] However, the report revealed that labor and business representatives were at odds with respect to the form of state participation that would be most appropriate in pursuing these megaprojects. Labor representatives favored a direct form of state intervention, involving the use of public ownership and direct grant assistance, whereas business representatives favored an indirect form of state participation, one in which the state would employ an indirect tax forgiveness approach that offered tax credits and accelerated write-offs, among other things.

The government responded to the report by establishing in August 1981 the Office of Industrial and Regional Benefits within DITC. The principal goal of the office was to

Table 7.5. Summary of Inventory of Major Projects to the Year 2000 (Millions of dollars)

Sector	Multi-provincial or undetermined	Atlan.	Que.	Ont.	Man.	Sask.	Alta.	BC.	Yukon/ NWT
Conventional Hydrocardon Exploration & Development	2,500	11,500					700	250	63,200
Heavy Oil Development						1,750	40,985		
Pipelines	27,090	1,185						890	2,475
Processing & Petrochemicals		500	3,100	985		1,300	12,205	10,415	
Electrical generation transmission	620	29,870	66,335	38,435	10,375	3,160	20,250	29,710	100
Forest Products		310	1,210	1,665			1,200	3,325	
Mining		1,010		4,100	500	3,965	3,230	5,625	1,505
Primary Metals Products			1,025	1,300	1,410	500			2,000
Transportation		420	2,315	450			955	1,885	330
Manufacturing	8,575	400	175	4,080			150		
Defence	4,825	280							
TOTAL	43,610	46,500	74,435	51,125	11,375	10,175	79,675	54,100	67,610
% OF TOTAL EXPENDITURES	9.9	10.6	17.0	11.7	2.6	2.3	18.2	12.3	15.4

Source: Report of the Major Projects Task Force, *Major Canadian Projects: Major Canadian Opportunities* (Ottawa: Supply and Services Canada, 1981), p. 27.

[82] Consultative Task Force on Industrial and Regional Benefits from Major Canadian Projects, *Major Canadian Projects, Major Canadian Opportunities* (Ottawa, June 1981), p. 43.

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ensure that Canadian companies and workers would be given opportunities to participate in all aspects of major projects development and to gain maximum benefits from developing Canada's resource strengths.[83]

The *Statement on Economic Development for Canada in the 1980s*, a White Paper tabled with Finance Minister Allan MacEachen's November budget, adopted the approach advanced by the MSED and the Blair-Carr Task Force. As such, the White Paper revealed the government's stance on the internal debate between Gray's strategy and MSED's. The principal argument of the White Paper was the following:

> The leading opportunity [for the Canadian economy] lies in the development of Canada's rich bounty of natural resources. There is increasing world demand for Canada's major resources, such as petrochemicals, and further expansion of agriculture, forest-based industries and mining. Linked to this growth dynamic...is manufacturing activity, both to supply machinery, equipment and materials needed for resource development and to extend the further processing of resource products beyond the primary stage. The third direction of growth...linked to resources [is] built upon our technological infrastructure. This class of opportunities includes adaptations of Canadian and foreign technology and the provision of high technology services such as project management, engineering, industrial design and computer applications.[84]

The White Paper had an important effect on the direction of the Canada's economic development policy. First, although the thrust of the new national development policy seemed to be grounded in sound economic reasoning, the fact that it was based on the assumption that resource prices would remain relatively high made the economic plan

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[83] Among the objectives pursued by the Office were (1) "increased sourcing of equipment and services in Canada with an emphasis on those offering a substantial degree of technology innovation in Canada"; (2) "the enhancement of research and development activity in Canada and increased world product mandating by foreign-owned firms operating in Canada"; (3) "maximum participation by, and the development of, Canadian labour and management skills in all aspect of major project development"; (4) "greater participation in major projects by firms owned and controlled by Canadians." Honourable Herb Gray, "Canadian National Energy Forum: Energy and Industrial Development in Canada," Canadian National Committee World Energy Conference, (Ottawa, November 9-10, 1981), p. 9.

[84] Government of Canada, *Economic Development for Canada in the 1980s* (November 1981), pp. 2-3.

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vulnerable to shifts in international market conditions. Indeed, that is precisely what occurred within months of announcing the new economic planning design. The sharp decline in world oil prices and the lowered projections of future oil prices rendered some megaprojects unfeasible and postponed others. Second, although the new national plan would involve a certain level of state intervention, the government heeded the business community's call to make the private sector (foreign and domestic players) the primary driving force of major project development. On the one hand, this required minimizing the Canadianization component of the economic plan, which Ottawa satisfied by announcing that it would neither toughen FIRA nor extend the Canadianization component of the National Energy Program to other sectors of the economy. On the other hand, the Trudeau government promised to engage in market deregulation and to enhance the national common market by reducing barriers which impeded the mobility of labor and business, a demand underlined in the report of the Blair-Carr Task Force.

Finally, the new national development policy offered a solution to the regional bias which federal economic policies often assumed. By exploiting Canada's comparative advantage in resources while simultaneously developing backward and forward linkages with the resource sector, both central and peripheral regions of Canada would benefit. As Leslie points out, the new federal economic development policy was a "strategy of regional complementarity" for the "development of centre and periphery would be mutually reinforcing."[85] The promotion of resource-based megaprojects offered a way to integrate regional and sectoral development as well as bolster federal visibility to a degree that was previously hard to achieve. These factors figured prominently in Trudeau's decision to merge the regional industrial side of DREE with the industry, small

[85] Peter Leslie, *Federal State, National Economy* (Toronto: University of Toronto Press, 1987), p. 20.

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business, and tourism programs of the DITC to form a new department, the Department of Regional Industrial Expansion (DRIE) in January 1982.[86] The reorganization left regional development without a departmental home, while DRIE focused on national industrial concerns and commercial development. Regional development considerations were to be addressed by the individual departments constituting the Cabinet Committee on Economic and Regional Development (formerly named the Cabinet Committee on Economic Development), which was assisted by the new Ministry of State for Economic and Regional Development (formerly the MSED).[87]

This chapter has demonstrated how the existing institutional framework shaped the evolution of economic development planning. More specifically, it shows how the decentralized and competitive features of intergovernmental relations, the arm's-length pattern of societal-government relations, and the fragmented character of the national bureaucracy combined throughout the 1970s and early 1980s to make economic planning a difficult task to undertake in Canada. Although the decentralized approach to economic development promised to foster regional industrial growth while contributing to the overall strength of the national economy, economic provincialism—facilitated by decentralized federalism—dashed such expectations as provincial governments sought to place their provinces' economic interests above those of the nation. Moreover, the decentralized approach foundered as a result of bureaucratic conflicts. The lack of a centralized decision-making structure in the economic development policy arena, plus the

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[86] In addition to the integration of the DREE and DITC to form the DRIE, the government's reorganization plan announced by Trudeau also entailed placing the DITC's trade component in the Department of External Affairs as a way to strengthen Canada's export promotion capacity, shifting DREE's resource-related programs to resource departments, and moving DREE's regional infrastructure responsibilities to the Department of Transport and Communications. See N. Harvey Lithwick, "Federal Government Regional Economic Development Policies," 1986, pp. 134-137.

[87] Lithwick, pp. 136-137.

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involvement of bureaucratic actors informed by competing economic ideas, created an unsuitable institutional home in which to build support for this kind of economic development planning.

The centralized approach to economic development that emerged toward the end of the 1970s fared no better despite the more rigorous efforts to effect appropriate institutional changes. This was illustrated at the level of government-societal relations, federal-provincial relations, and bureaucratic relations within the federal state. In terms of government-societal relations, the consultations that took place in the First and Second Tier Committees and in the Blair-Carr Task Force lacked the tripartite-corporatist features that would have been necessary to orchestrate a coordinative effort. For one, the weak organizational structure of business and labor and the lack of prior experience in sharing information and working together made it difficult for them to articulate a coherent, selective set of policy ideas, which reflected a thorough consideration of alternatives and of strategic trade-offs.

Equally important was the fact that neither business nor labor representatives were willing to compromise with each other and with government representatives on such issues as the purpose of government involvement in the economy, the degree and form of state intervention, and the degree of private sector involvement in policy making. Had there been prior experience at non-market coordination between Canadian industry and labor, supported by more hierarchically-organized labor and business representation, it seems that the government would not have created 23 task forces in the first place. In fact, consultations among business, labor, and the government would have been much

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more centralized, strategic in orientation, and more amenable to effective coordination of desired changes in the economy.

With respect to federal-provincial relations, consensus on what should be included in the emerging national industrial development plan never flowed from the 1978 consultations or those that followed. Notwithstanding the policy commitments both levels of government made on certain macroeconomic policies and their common interest in encouraging further government-societal consultations, the provinces often made "non-negotiable statements of self-interest [that] overwhelmed any exploration of the common ground on which pragmatic discussion might have proceeded on new policy goals and the modalities of implementation."[88] Although the federal state strove to centralize decision-making and assign to key players the authority to wield greater influence in the economic development policy arena, such efforts were overshadowed and negated by the repeated reorganizations going on in the federal bureaucracy. In the end, the decision to pursue energy-based megaprojects was one that entailed the least amount of planning on the part of the government and of coordination among the business community, labor, and the government.

[88] Neil Bradford, *Commissioning Ideas: Canadian National Policy Innovation in Comparative Perspective* (Toronto: Oxford University Press, 1998), p. 105.

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CHAPTER EIGHT

THE MARKET AS A POLITICAL ECONOMIC SOLUTION

Economic liberalism rose to prominence during the 1980s because of a convergence of particular systemic conditions and domestic forces. In dealing with Canada's industrial adjustment problem—weak domestic manufacturing base, economic vulnerability to American policies, and declining share of the world's manufacturing trade—Ottawa grew more favorable to the view that market governance proved to be a superior mechanism of resource allocation than state interventionism and would produce better adjustment results. Central to the strategy of continentalism was the notion that free trade with the United States would create the appropriate domestic incentives for the federal and provincial governments to replace political discretion by market-enforcing regulations as the principal guiding force in the economy and for the private sector to proceed with industrial adjustment on its own terms. In essence, by stressing the importance of pursuing free trade, the emerging adjustment strategy sought to redress the industrial adjustment problem by being engaged at the international level with the expectation that external forces would bring about favorable domestic adjustment.

In the last three chapters I have demonstrated how institutional constraints prevented government officials from pursuing successfully interventionist-nationalist policy measures and limited their ability to consolidate the institutional alterations they undertook in order to facilitate these policies. Moreover, I have shown that the existing domestic structures have proven more amenable to accommodating policy solutions that seek to protect market governance. In this chapter, I will explain why economic liberalism encountered greater success, measured in terms of policy implementation and

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consolidation of the appropriate institutional reforms. In doing so, I will focus on those systemic and domestic factors that converged in support of this strategy. At the international level, Canadian exposure to increasing American protectionist policies and Canada's partial and qualified improvements in its relative position in the international system and vis-à-vis the United States created powerful incentives to consider favorably the logic of integration, particularly the option of entering into a free trade arrangement with the United States, whose rules and terms of engagement would enable Canada to manage its relations of interdependence.

At the domestic level, two mutually-reinforcing factors converged to build support for embedding market governance. Economic liberalism and its free trade prescription was supported because it served economic purposes, namely it would enhance competition which in turn would inevitably induce industrial rationalization and specialization, help achieve economies of scale and improve productivity, and secure access to the American market. In many respects, free trade would serve as an industrial policy and ensure long-term economic growth.

The strategy also served a political purpose. The business community favored free trade because it would restrain governments in their ability to intervene in the economy. The constraining effects of freer markets on governments was welcomed by Canadian business after having experienced years of ill-devised, market-distorting political interventions. For the federal and provincial governments, free trade and market-based coordination served as the only acceptable neutral referee to guide both levels of government in their efforts to withdraw from their respective economic spheres after a decade of experiencing intergovernmental conflicts caused by the thrust and riposte

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dynamic that propelled them to engage in competitive market intervention. Prime Minister Mulroney's desire to seek reconciliation with the provinces was to be achieved by orchestrating the withdrawal of the state from the economy, which the federal government was willing to initiate unilaterally.

THE SYSTEMIC LOGIC OF MARKET LIBERALISM

The shift away from the logic of counterweight to that of integration was gradual, and it was based on Ottawa's calculation of the changing external realities it was facing. More important still, the shift in favor of free trade amounted to nothing less than a watershed in the evolution of the commercial policy of Canada. In this section, I will focus on systemic-level factors, namely exposure to externalities and Canada's relative international position, that shaped the preferences of government officials in favor of the free trade option. The debate on free trade particularly focused on the systemic conditions facing Canada, gauging whether such conditions were working in favor of or against Canada. As such, the debate considered whether Canada could preserve its political independence, retain a reasonable degree of policy autonomy, maintain its distinct national identity, and in general, whether it would be able to resist American domination when its economy was integrated that of the United States. In addition to these political concerns, the debate weighed the likelihood that a free trade arrangement would enable Canada to attain such economic goals as achieving industrial rationalization, enhancing national productivity and efficiency, and increasing economic growth, employment, and exports of manufactured goods.

The critics of free trade tended to view free trade as a costly arrangement, arguing that it would impose on Canada significant political and cultural costs that would

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outweigh any economic benefits derived from trade liberalization. One concern was that Canada would be forced to place common interests above its own with no guarantee that those mutual goals would always produce equal benefits for Canada. As Barry notes, "Too much bilateral intimacy encourages [Canada] to subordinate legitimate industrial interests to common concerns" with the potential to inflame "anxiety about US dominance."[1]

Other critics argued that a free trade arrangement would relegate Canadians to the role of "hewers of wood and drawers of water," face rapid deindustrialization as American-owned branch plants withdraw from Canada given the removal of border-jumping incentives, and that the Canadian economy would become the dependent-periphery serving the American industrial heartland.[2] Still, others viewed Canada's bid to create a free trade arrangement as an act of desperation, a policy initiative to which Canada was drawn for no other reason than to minimize its losses in the future. As Williams notes, "In the face of pressing 1980s' threats to Canada's economic stability posed by intermittent recession, high unemployment, international trade challenges from Japan, Europe and the newly industrialized countries, and the rise of protectionist forces in the United States, the free trade talks are essentially an attempt to adjust the balance point in the continental relationship so that the already existing network of commercial associations can be safeguarded."[3]

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[1] Donald Barry, "The US and Canada: the right balance," *Baltimore Sun* (September 21, 1984).
[2] Maude Barlow, *Parcel of Rogues: How Free Trade is Failing Canada* (Toronto: Key Porter Books, 1990), Mel Hurtig, *The Betrayal of Canada* (Toronto: Stoddart, 1991).
[3] Glen Williams, "Canadian Sovereignty and the Free Trade Debate," in Allan Maslove and Stanley Winer, *Knocking on the Back Door: Canadian Perspectives on he Political Economy of Freer Trade with the United States* (Montreal: Institute for Research on Public Policy, 1987), p. 109.

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In supporting free trade, the federal government and the business community recognized Canada's respectable international position and believed that it would translate into a capacity to achieve favorable gains through a free trade arrangement. Moreover, they believed that they could secure a bilateral arrangement that would enable Canada to protect itself against increasing exposure to American protectionism. Canada's desire to seek a free trade arrangement stemmed from its confidence in employing its capabilities to accomplish Canada's goals by engaging the United States directly as the Prime Minister Mulroney pointed out in December 1984. Canada, he argued, viewed its "status as a North American nation [as] a source of strength." Canadians were now "mature enough as a nation and confident enough in ourselves to recognize this reality and to take pride in an amicable relationship with a neighbour as powerful as the United States."[4] Similarly, Secretary of State for External Affairs Joe Clark noted that "closer economic relations with the United States, if played right, can enhance our voice and influence in international affairs. Canada possesses a new maturity as a nation [and] the modern purpose of Canadian nationalism is to express ourselves, not protect ourselves."[5]

The logic of integration was premised upon a number of notions and reflected new realities in Canada's external environment. First, it was believed that free trade or economic integration would bolster national economic development and maintain and enhance national power. In rebutting critics of free trade, some have observed that with free trade countries can enhance their national wealth and power by taking advantage of new trade opportunities, by enhancing national productivity and efficiency, and by

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[4] Prime Minister Brian Mulroney, Notes for a Speech to the Members of the Economic Club of New York, December 10, 1984.

[5] Joe Clark, Speech to the Strategic Planning Forum, Ottawa, October 25, 1984, p. 5.

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achieving industrial specialization. Second, although free trade would require the surrendering of some policy autonomy, Canada could channel its increasing national wealth toward efforts to maintain its political independence and maintain its national identity. As Johnson points out, "Growing wealth gives both an increasing capacity for individual self-fulfillment and the resources necessary for the achievement of national objectives."[6] Similarly, the Royal Commission on the Economic Union and Development Prospects for Canada (the Macdonald Commission) asserted that "in the modern era, one of the crucial components of satisfying Canadian identity is to be found in our economic capacity to perform at a high level in a competitive world" which free trade will facilitate.[7]

The logic of integration was also premised on the notion that free trade would neither reduce Canadian autonomy in other spheres of domestic affairs nor lead to political integration. Indeed, Canada sought a free trade arrangement rather than deeper forms of economic integration such as customs union and common market precisely because the former maximized Canada's freedom of action and political autonomy while still benefiting from economic integration with the United States. Lastly, the integration logic held that the political institutional arrangement guiding free trade was particularly beneficial for a weaker or secondary state if the arrangement affords it opportunities to have a material impact on the pattern of economic exchange and render such a pattern more predictable in the long term. A collaborative arrangement designed to foster deeper

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[6] Quoted in Kim Richard Nossal, "Economic Nationalism and Continental Integration," in Denis Stairs and Gilbert Winham, eds., *The Politics of Canada's Economic Relationship with the United States* (Toronto: University of Toronto Press, 1985), p. 80.

[7] Government of Canada, Royal Commission on the Economic Union and Development Prospects for Canada (Macdonald Commission), *Report of the Royal Commission on the Economic Union and Development Prospects for Canada*, (Ottawa: Minister of Supply and Services, 1985), vol. 1, p. 62.

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economic ties could lead to a favorable distribution of gains by establishing a legally binding regulatory and coordinating framework that minimizes the risk of unilateral and harmful actions by the United States, secures Canadian access to American markets, and substitutes rules for power as the main principal mechanism governing relations of interdependence.

Although systemic forces do not explain policy decisions, they do shape state preferences by imposing constraints on and creating opportunities for state actions. The logic of integration reflects a particular conjuncture of systemic constraints and opportunities associated with the degree of exposure to negative externalities and the relative position of a state. The shift from the logic of counterweight to integration coincided with Canada's increasing exposure to negative externalities resulting from American policies and the slight improvements in Canada's capabilities relative to the United States. These systemic factors combined to create part of the incentive structure that encouraged rather than discouraged government officials to initiate free trade negotiations with the United States.[8]

As I indicated in the preceding chapters, the logic of counterweight was closely followed throughout the 1970s and reflected the deterioration in Canada's relative position in the world and vis-à-vis the United States as well as an increase in its vulnerability to American policy changes. Defensive in nature and more tilted toward domestic efforts, this logic impelled Canada to intensify its trade relations with Europe, Japan, and Third World countries and fall back on renewed multilateralism in order to balance out its heavy dependence on the American market. Domestically, this logic

[8] See Gilbert Winham and Elizabeth DeBoer-Ashworth, "Asymmetry in Negotiating the Canada-US Free Trade Agreement, 1985-1987," in William Zartman and Jeffrey Rubin, eds., *Power and Negotiation* (Ann Arbor: The University of Michigan Press, 2000).

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pushed the government to assert greater domestic control over the economy and take a more active role in directing national economic development.

One of the emerging systemic realities the logic of integration came to reflect was the positive development in Canada's relative capabilities. Although asymmetries in power capabilities between Canada and the United States have been large, the confidence Canada demonstrated on the eve of announcing its decision to opt for free trade stemmed in part from the stability in some and moderate improvements in other dimensions of Canada's relative economic capabilities. A number of important indicators demonstrate such a positive change in the standing of Canada by the first half of the 1980s. Table 8.1

Table 8.1. Changes in Canada's Overall Economic Capabilities

Year	Canadian GDP/Regional GDP* (%)	Canadian share of world trade (%)
1974	10.71	
1977	10.37	
1980	11.21	3.8**
1983	11.11	4.2
1984	11.87	4.7
1985	12.40	4.6
1987	11.88	

*To determine regional GDP, I have combined the GDP of the United States and Canada.
**This is figure for 1981.
Sources: OECD, *Economic Survey: Canada*, various years; Statistics Canada, *Summary of Canadian International Trade* (Ottawa: Statistics Canada, various years).

indicates the modest yet significant gain in Canada's share of the regional gross domestic product witnessed beginning in the last years of the 1970s to the end of the first half of the 1980s. In addition, the early 1980s saw an improvement in Canada's share of world trade, inching up to 4.6 percent in 1985 from 3.8 percent in 1981.

Another factor that contributed to the positive trend in relative capabilities in the early 1980s was the decline in the share of foreign ownership of Canadian assets. Table 8.2 illustrates that Canadian ownership of national assets in the manufacturing, mining

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and manufacturing, and oil and natural gas sectors increased in the 1970s and first half of the 1980s. This reflected the increase in Canada's ability to assert through state and private efforts greater control over national economic activities. This was particularly the case in the oil and natural gas sector where the Canadian share more than doubled from 1975 to 1984.

Equally significant was the large amount of Canadian investment pouring into the United States. Canada's international investment position improved remarkably, as the total amount of direct investment more than tripled in size from 16.4 billion in 1978 to 54.1 billion in 1985.[9] Moreover, by the end of 1984, approximately three-quarters of Canada's direct investment abroad went to the United States compared with the 53 percent it received from Canada in 1977, and was largely concentrated in the manufacturing and petroleum and natural gas industries.[10]

Table 8.2. Percentage of capital under Canadian and foreign control, 1954-1984

	1954	1962	1970	1975	1980	1984
Manufacturing						
Canadian	49	40	39	45	49	51
American	41	45	47	42	40	38
Mining and Manufacturing						
Canadian	49	42	30	40	59	62
American	49	52	59	46	29	27
Oil and Natural Gas						
Canadian	31	26	24	26	50	56
American	67	63	61	38	35	35

Source: François Houle, "L'état canadien et le capitalisme mondial: Stratégies d'insertion," *Canadian Journal of Political Science* 20 (September, 1987), p. 486.

The emerging international investment position of Canada translated into an important power asset. The combination of increasing Canadian investment in the United

[9] Statistics Canada, *Canada's International Investment Position, 1988-1990* (Ottawa: Ministry of Supply and Services Canada, 1991), pp. 42-43.
[10] Statistics Canada, *Canada's International Investment Position, 1981-1984* (Ottawa: Ministry of Supply and Services Canada, 1986), p. 14.

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States and the decline in American ownership of Canadian assets, helped reduce to some extent the wide asymmetries in the relations of interdependence between the two countries that existed up to now. As Doran points out, "Canadian firms had increasing control of assets abroad that could be regarded as a counterweight to foreign ownership and control in Canada." Significantly, the more Canadian investors acquired assets in the United States the more concerned they became about protecting their investment against American protectionist threats and in securing market access to the American market.

The early 1980s witnessed a spurt in Canadian exports to the United States, ending the steady rate of exports during the 1970s, as Table 8.3 shows. Against this backdrop, however, Canada saw an increase in the manufactured end-products content of its exports. Exports of manufactured end-products, as Table 8.4 illustrates, jumped to 42.1 percent of total Canadian exports in 1984 from 29.4 percent in 1980. If these indicators

Table 8.3. Distribution of Canadian exports by trading areas, 1960-84 (%)

	1960	1970	1980	1983	1984
United States	55.8	64.4	63.2	72.9	75.6
United Kingdom	17.4	9.0	4.3	2.8	2.2
Other Western Europe	11.3	9.8	10.6	5.8	5.0
Japan	3.4	4.9	5.9	5.3	5.1
Other	12.1	11.9	16.0	13.2	12.1

Source: Richard Lipsey and Murray Smith, *Taking the Initiative: Canada's Trade Options in a Turbulent World* (Toronto: C.D. Howe Institute, 1985), p. 15.

Table 8.4. Commodity composition of Canadian exports, 1960-1984 (%)

	1960	1970	1980	1983	1984
Food and Agriculture	18.8	11.4	11.1	11.6	9.7
Crude materials	21.2	18.8	19.8	15.9	15.8
Fabricated materials	51.9	35.8	39.8	33.3	32.0
Manufactured end-Products	7.8	33.8	29.4	38.9	42.1

Source: Richard Lipsey and Murray Smith, *Taking the Initiative: Canada's Options in a Turbulent World* (Toronto: C.D. Howe Institute, 1985), p. 47.

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reveal anything of importance it is that Canada's improvement in its relative standing stemmed from the remarkable expansion of the capacity of Canadian business.

Equally noteworthy is the fact that by the mid-1980s Canadian businesses had been increasingly exposed to international competition as a result of the reduction in Canadian tariff protection. The C.D. Howe Institute estimates that by 1985, Canada had eliminated close to 80 percent of trade barriers that had existed in 1934, much of which occurred after the Kennedy and Tokyo rounds of the General Agreement on Tariffs and Trade.[11] The removal of tariff protection in turn had forced Canadian companies to undertake market adjustments to ensure their future success. By the early 1980s, business had become internationally oriented and interested in pursuing an international strategy that promoted foreign direct investment and high value-added exports.

In sum, the confidence Canada exhibited on the eve of the free trade decision was a combination of Ottawa's recognition of increments in Canada's aggregate economic capability and of the business community's recognition of its expanding international capacity, particularly its expansion into American markets. As Doran observes, the most recent "change in the bilateral relationship has increased Canadian influence relative to the United States, although marginally and slowly."[12] It is these changes, in addition to others which I discuss in other sections of this chapter, that shaped Ottawa's preference to follow the logic of integration and in particular to come to the judgment that this logic's ideas would be a better policy framework through which Canada could pursue its industrial adjustment objectives. Canada entered free trade negotiations with the

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[11] Richard Lipsey, "The Canada-U.S. FTA: Real Results versus Unreal Expectations," in L. Ian MacDonald, ed., *Free Trade: Risks & Rewards* (Montreal & Kingston: McGill-Queen's University Press, 2000).

[12] Charles Doran, "The United States and Canada: intervulnerability and interdependence," *International Journal* 38 (Winter 1982/83), p. 133.

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confidence that its bargaining power would be sufficient to advance its instrumental interests, that closer ties would not make the United States a more domineering partner, and that a collaborative arrangement would conserve and enhance Canada's national power in the long term.

The other systemic change that the logic of integration came to reflect concerned the increasing cost to Canada of United States' commercial policy choices. Against the backdrop of the modest improvements in Canada's relative standing was the inescapable reality that as Canadian economic ties to the United States were deepening and expanding, insecurity and uncertainty beset such relations of interdependence. At issue was the increasing use of American trade remedy measures—such as the resort to escape clause, anti-dumping, and countervailing duties—in response to national complaints about the unfair trading practices of other countries and the resulting negative externalities to which Canada was exposed.

Although such trade remedy measures had been used against Canada in the 1970s, the new American trade legislation in 1979—which not only exposed the trade remedy process to greater congressional pressures demanding contingency protection, but also lowered the injury test that determined the eligibility of petitioners for receiving countervailing duty support—led to an increase in the number of cases targeting Canada. As Doern and Tomlin point out, American trade remedies were used 51 times against Canada between 1980 and 1986, marking a significant increase compared to the 1970s. From these cases, more than 75 percent of the preliminary rulings by the U.S. International Trade Commission were against Canada.[13] What was particularly troubling

[13] G. Bruce Doern and Brian Tomlin, *Faith and Fear: The Free Trade Story* (Toronto: Stoddart, 1991), p. 68.

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for Canada was the fact that the American trade remedy or contingency protection mechanism was becoming increasingly politicized and susceptible to the whims of protectionist forces brewing in the United States. As Canada's chief free trade negotiator Simon Reisman points out, "The problem was how [Americans] interpreted [their trade remedy laws], and what they did with it, and how responsive they were to the protectionists, and how arbitrary the handling of that legislation was."[14]

The potential material cost to Canada associated with the use of American trade remedies profoundly concerned Ottawa and Canadian exporters. As Mulroney's Progressive Conservative government pointed out in 1986,

> Last year protectionist threats and measures (quotas, anti-dumping and countervailing duties, surcharges) affect[ed] virtually all regions of Canada. Almost $6 billion of Canadian exports to the U.S. or 6 % of the total were involved. The industries concerned provided some 146,000 jobs, a significant proportion of which were at risk.[15]

The insecurity that Canada faced as a result of American protectionist forces also had implications for Canada's emerging strategy of economic liberalism. The Progressive Conservative government was counting on increased access to the American market to induce domestic industrial rationalization, realize those economies of scale that would improve Canada's international competitiveness in manufacturing, and to improve national productivity and efficiency. In fact, Canada's efforts to redress its industrial adjustment problem through this strategy rested heavily on the security of Canadian access to the American market.

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[14] Simon Reisman, "The Negotiation and Approval of the FTA," in L. Ian MacDonald, ed., *Free Trade: Risks & Rewards* (Montreal & Kingston: McGill-Queen's University Press, 2000), p. 91.
[15] External Affairs Canada, *Canadian Trade Negotiations: Introduction, Selected Documents, Further Reading* (Ottawa: Supply and Services, Canada, 1986), p. 1.

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The above analysis of the two systemic forces sheds light on what external pressures and opportunities were at play as Ottawa changed industrial adjustment strategies in the first half of the 1980s. On the one hand, the strategy of continentalism reflected the newfound confidence Canadians were increasingly manifesting regarding their ability to engage directly with the United States. On the other hand, support for the strategy stemmed from the element of necessity, for the rise in American protectionism threatened to disrupt the flow of Canadian exports, which figured largely in Canada's plan to redress its industrial adjustment problem.

The conjunction of the two external forces helped to generate support for a free trade arrangement. As Lipsey observes, defensive and offensive reasons underpinned the free trade option. "The defensive reason was that the best defense against rising U.S. protectionism was to act bilaterally to eliminate all tariffs and to contain the use of non-tariff barriers." The offensive reasons for a free trade arrangement "were that the Canadian economy had matured and was ready to compete openly in world competition."[16]

EXPLAINING ECONOMIC LIBERALISM AT THE DOMESTIC LEVEL

Although systemic constraints and opportunities shape state preferences in a general direction, such an analysis only offers a partial explanation of actual state behavior. The adoption and eventual consolidation of economic liberalism was a product of the convergence of societal and governmental (both provincial and federal) preference on market outcomes and the intervening effect of institutions. Although Conservatives were historically less supportive of trade liberalization than were Liberals, for it was the

[16] Richard Lipsey, "The Canada-U.S. FTA: Real Results versus Unreal Expectations," p. 102.

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Conservative Party that introduced the nationalist-inspired First National Policy, the Conservatives under the leadership of Joe Clark and Brian Mulroney were ideologically sympathetic to free market economics. As such, they advocated policies that promoted deregulation, privatization, and free market entrepreneurship.

With their 1984 landmark electoral victory, the Conservatives used the apparatus of the state to achieve these goals. But support for free trade was not wholly secured until 1985. Launched by Prime Minister Trudeau in 1982 and chaired by Donald Macdonald, a former Liberal minister in Trudeau's Cabinet, the Royal Commission on the Economic Union and Development Prospect for Canada (Macdonald Commission) provided the intellectual and logical guidance that prompted Mulroney's Progressive Conservative government to abandon the party's historical position on trade liberalization and come down in favor of free trade with the United States. One of the key recommendations made by the bipartisan Macdonald Commission was the need to seek a free trade arrangement with the United States. In recalling the key factors that influenced Mulroney's decision to initiate free trade negotiations, former Chief of Staff to Prime Minister Mulroney Derek Burney noted that "there can be not doubt...that the thorough analysis and virtually unanimous recommendations by Mr. Macdonald and his associates proved to be a major catalyst for the negotiation and a bedrock of faith for the political will in Canada...."[17]

Historically, the Canadian business community has advocated free market entrepreneurship, but until the early 1980s it opposed free trade with the United States. The business community's shift to support of free trade was fuelled by the 1981-82 recession, its apprehension about the intensification of economic nationalism in the

[17] Derek Burney, "Where There's the Will...," in L. Ian MacDonald, ed., *Free Trade*, p. 61.

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Trudeau government, and the concern with American protectionism. At the forefront of this development were the Business Council on National Issues (BCNI) and the Canadian Manufacturers' Association (CMA). In 1981, the BCNI created a trade policy committee to examine Canada's commercial policy. By late 1982, the review led the BCNI to support the idea of negotiating a comprehensive trade agreement with the United States.[18] For its part, the CMA became more attracted to the idea of a comprehensive trade enhancing agreement in 1983 after its members had been hit hard by the recession, witnessed an increase in their export activities, and recognized the need to improve their international competitiveness. By early 1985 these two business groups were joined by the Canadian Chamber of Commerce and the Canadian Federation of Independent Business in supporting a comprehensive bilateral trade agreement that would remove tariffs and nontariff barriers. Central to their position was the need to secure market access to the American market and to roll back government involvement in the economy on both sides of the border.[19]

Provincial governments constituted the third group of actors in the emerging coalition supporting the free market idea. By the mid-1980s most premiers, with the exception of Ontario's Liberal Premier David Peterson, supported a free trade arrangement with the United States. The four Western provinces—British Colombia, Alberta, Saskatchewan, and Manitoba—were early supporters of free trade. British Colombia Premier Bill Bennett and Alberta Premier Peter Lougheed were the strongest

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[18] Doern and Tomlin, *Faith and Fear*, pp. 46-50.
[19] Michael Hart, *Decision at Midnight: Inside the Canada-US Free-Trade Negotiations* (Vancouver: University of British Columbia, 1994), pp. 76-78, and David Leyton-Brown, "Canada-U.S. Relations: Towards a Closer Relationship," in Maureen Appel Molot and Brian Tomlin, *Canada Among Nations, 1985: The Conservative Agenda* (Toronto: James Lorimer, 1986).

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supporters, whereas New Democratic Party premier Howard Pawley of Manitoba joined the other premiers after being initially reticent on the issue.

While western premiers favored free trade because it would secure access to the American market for their provinces' goods, their support also stemmed from another motive. Having been adversely affected by Trudeau's National Energy Program, Lougheed and his successor Donald Getty sought to use free trade to guarantee against any future attempts by the federal government to intrude in the energy sector. The four Maritime provinces—Nova Scotia, Newfoundland, Prince Edward Island, and New Brunswick—were generally supportive of a trade free arrangement. During negotiations, the four coordinated their efforts on issues that were particularly important to them, such as ensuring that the funds they received and depended on from regional development programs would not be subject to countervailing actions under the free trade accord.

Whereas Quebec moved cautiously and slowly in favor of free trade under the pro-sovereignty Parti Québécois led by premiers René Lévesque (1976-1984) and Pierre-Marc Johnson (1984-1985), Liberal Premier Robert Bourassa strongly supported free trade after winning the December 1985 elections. Since, both political parties have advocated free trade and, in general, increasing international economic interdependence. Starting with Lévesque, Quebec governments became increasingly committed to the free trade idea as the Quebec business community grew more confident in its ability to compete internationally. Although there were a number of inefficient industries in Quebec, a growing number of Quebec firms, such Bombardier, Cascades, Teleglobe, Vidéotron, and SNC, excelled in international markets. Security of access to the American market would allow other Quebec firms to achieve the economies of scale

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necessary to develop competitive advantages; in addition, added competition resulting from the reduction of tariffs would force Quebec's industries to rationalize and specialize and thus improve their productivity and efficiency.

Quebec's support of free trade also reflected the province's increasingly export-oriented economy. In reflecting on Quebec's decision to support Mulroney's effort to secure a free trade arrangement with the United States, a Parti Quebecois official noted,

> Protectionism is not an option when we export more than 50 percent of our GDP. We are a population of 7 and a half million, our domestic market is small, and what we produce must be exported through vigorous efforts. Could Bombardier survive by simply relying on Quebec's internal market? It's absurd to even think about it.[20]

In addition to this economic rationale, a political logic underpinned free trade. As Meadwell and Martin point out, the two main political parties in Quebec have supported free trade as a way "to increase the relative autonomy of Quebec economic agents vis-à-vis the central government."[21] Significantly, the Parti Québécois has considered free trade to hold an even greater strategic value, for the deepening of economic ties between Quebec and the United States "would help in easing the transition to independence and ensuring the economic viability of a sovereign Quebec."[22]

Ontario was reluctant to join the other provinces in supporting a free trade arrangement. Ontario Premier David Peterson preferred maintaining the way things were, fearing that free trade would produce not enough gains to outweigh the high adjustment costs which would mean plant closures and a rise in unemployment. Still, there were other reasons explaining Ontario's reservation. Stairs notes that Ontario was

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[20] Confidential interview with a Parti Quebecois official, Montreal, Quebec, April 8, 2002.
[21] Hudson Meadwell and Pierre Martin, "Economic integration and the politics of independence," *Nations and Nationalism* 2 (1996), p. 77.
[22] Ibid., p. 77.

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holding back in order to gain more favorable concessions from federal negotiators in exchange for the province's support.[23] Also contributing to Ontario's intransigence was the fact that the provincial government felt that free trade was a strategy that Mulroney was using not so much because of its compelling economic logic but rather to consolidate his party's electoral base in Quebec and Western Canada by giving them what they wanted.[24]

The strategy of continentalism sought to accomplish three integral objectives. First, Prime Minister Mulroney committed his government to achieving national reconciliation after years during which federal-provincial relations had soured in frequent rivalries. In his speech from the throne delivered in November 1984, Mulroney announced that the Progressive Conservative government sought to restore a spirit of cooperation and renew intergovernmental coordination with the provinces. "My government's management of federal-provincial relations will pursue three basic objectives: to harmonize policies of our two orders of government, to ensure respect for their jurisdictions, and to end unnecessary and costly duplication."[25]

The Tory government committed itself to averting the repeat of policy evolution via the thrust and riposte dynamic that characterized the Trudeau era, to abandoning the formulation of centralist, interventionist economic plans, and to ending aggressive federal unilateralism, all of which were the principal sources of intergovernmental rivalry. To

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[23] Denis Stairs, "Canada's Trade Relations with the United States: The Non-Economic Implications of an Economic Issue," in Earl Fry and Lee Radebaugh, eds., *Canada/U.S. Free Trade Agreement* (Provo, Utah: Brigham Young University, 1986), p. 60.
[24] Doern and Tomlin, *Faith and Fear*, pp. 144-5.
[25] "Speech from the throne," November 5, 1984. Mulroney had placed much emphasis on this issue during his campaign leading to the September 1984 parliamentary elections. "Our first task is to breathe a new spirit into federalism. The serious deterioration of federal-provincial relations is not exclusively the result of constitutional deficiencies. Centralistic and negative attitudes are much more to blame....Let us replace the bias of confrontation with the bias of agreement." Quoted in Richard Simeon and Ian Robinson, *State, Society, and the Development of Canadian Federalism* (Toronto: University of Toronto Press), pp. 301-2.

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alleviate the bitter feelings between the provinces and the federal state, the expansion of market governance and simultaneous roll-back of state involvement in the economy was proposed as a way to reduce conflict points. Indeed, tensions had peaked between Ottawa and Quebec, largely because of the constitutional dispute relating to the enactment of the Canada Act of 1982 which was rejected by Quebec, at the time Trudeau was planning to leave the government, but also because Trudeau's economic policies had failed to assist Quebec in achieving its economic objectives. As one Quebec official put it, "Under Trudeau, Quebec was poorly served by the central government."[26]

In particular, market liberalism would improve intergovernmental relations and strengthen the internal economic union by removing those regulatory and commercial policies that had been the source of grievances between western and eastern Canada. To that extent, both Ottawa and the provinces found it in their interest to proceed with this economic adjustment strategy. In addition, intergovernmental relations would also be improved by harnessing the positive aspects of competitive federalism, which market liberalism would facilitate.

In a federal system where the two orders of government exercise authority within distinct jurisdictions and policy responsibilities on the one hand, and have shared and overlapping powers on the other hand, market-embedded competitive federalism proved to be the best intergovernmental formula to advance the interests of both levels of government and to improve the quality of policies. The promotion of cooperative

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[26] Confidential interview, Montreal, Quebec, April 8, 2002. The same sentiment was expressed to me in another confidential interview with a former Quebec official, whose political affiliation differed from that of the latter interviewee. Confidential interview, Quebec City, Quebec, December 27, 2001. Both agreed that Prime Minister Mulroney accommodated Quebec much better than did Trudeau, particularly with respect to pursuing economic policies that had the effect of advancing the interest of Quebec, as the free trade deal did.

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federalism under Trudeau often proved to be insensitive to regional differences, to be associated with Ottawa's centralist, interventionist agenda, and to be burdened by the time it took to achieve minimum consensus and by the uncertainty of its continuation. Under Canada's federal structure, the federal state did not have the capacity to achieve coordination among the provinces on a centralist and dirigist economic plan. As the Macdonald Commission observed, "Federalism seems to be the enemy of policy that is planned, comprehensive, coherent, uniform and consistent." It added, "In a country as diverse as Canada, centralization would be a recipe for paralysis," as was demonstrated during in the strategy of economic nationalism.[27]

It was believed that market-embedded competitive federalism would maximize freedom of action for both levels of government, that is, allow them to act autonomously or cooperate with each other in economic policy fields, depending on what they deemed to be in their interest. For instance, a provincial government could emulate the neoliberal economic policy actions taken by other governments if they produced a desired market outcome. If sufficient interest converged on an issue that required mutual collaboration, short-term intergovernmental cooperation could be resorted to. Moreover, at a time when governments were increasingly relying on market forces, competition in shared policy fields would have a desirable effect on policy outcomes, particularly in responding to the market needs of the private sector and generating capital accumulation. As the Macdonald Commission pointed out,

> It [competitive federalism] offers the opportunity to tailor economic policies to the specific needs and concerns of citizens in different parts of the country. In a world of uncertainty and rapidly shifting economic challenges where there is little understanding of what is likely to work best, it provides the opportunity for experiment and

[27] Macdonald Commission, vol. 3, p. 147.

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> learning, for flexibility and inventiveness. It enhances sensibility to different viewpoints and permits canvassing of multiple sources of information and intelligence in different settings.[28]

Second, economic liberalism was to be pursued in order to effect a transformation of the branch-plant manufacturing sector into an internationally competitive, innovation-based one. Market allocation was judged to be superior to state-led allocation to accomplish this objective since markets were understood to produce greater productivity and efficiency gains and to facilitate industrial specialization, all of which were integral to enhancing international competitiveness. As the Macdonald Commission observed, years of state intervention had stifled industrial adjustment by creating "a number of market-distorting, growth-suppressing policies which redistribute income to protected and privileged enclaves in the economy, reduce economic efficiency, and inhibit flexibility."[29] Central to the strategy of economic liberalism was the notion that opening the Canadian economy to international market forces would generate the kind of incentives that would direct the government to put in place market-enforcing policies as well as induce the private sector to undertake the necessary adjustments to ensure its survival.

The last objective of continentalism was to manage Canada's increased bilateral pattern of trade with the United States. Bilateral tensions came to a head in the early 1980s at a time when the United States was becoming more protectionist and Canada more engaged in nationalist interventionism. Canada's National Energy Program and Foreign Investment Review Agency emerged as regulatory irritants to the United States, while the increasingly politicized American trade remedies were trade irritants to Canada.

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[28] Macdonald Commission, vol. 3, p. 148.
[29] Macdonald Commission, Vol. 1, p. 66.

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As bilateral tensions mounted in the first half of the 1980s, Canada—as the weaker country in the bilateral relations of interdependence—became increasingly alarmed about the threat of market closure in the United States. As the Macdonald Commission pointed out, Canada suffered "from interdependence without security in a context wherein our dependence on the U.S. market is not reciprocated by an equivalent American dependence on the Canadian market."[30] The need 'to get things right' with the United States entailed facilitating the mutual withdrawal of both governments from their respective economies and securing market access to the American market.

EMBEDDING MARKET GOVERNANCE

Central to this strategy was the aim of substituting market governance for state discretion as the principal guiding force in the national economy. This strategy sought to roll back state involvement in the economy and promote market-based allocation of resources. In setting the beat to which Mulroney's government would march, Minister of Finance Michael Wilson promised to shrink the size of the state after years in which the Liberals expanded the scope of state activities with deleterious effects. "A major reason for our poor performance has been the failure of the Government of Canada to deal with the real problems. Through excessive regulation and intervention, it has substituted the judgments of politicians and regulators for the judgments of those in the marketplace."[31] To facilitate the withdrawal of the state from the economy, the federal and provincial governments employed such market instruments as privatization, deregulation, and free trade.

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[30] Macdonald Commission, Vol. 1, p. 59.
[31] Department of Finance, "A New Direction for Canada: An Agenda for Economic Renewal," (November 8, 1984), pp. 1-2.

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Deregulation: The Dismantling of the NEP

The objectives of the National Energy Program (NEP) in 1980 were to achieve security of oil supply, expansion of Canadian participation in the national oil and gas industry, and fairness in the division of energy benefits. A product of federal unilateralism, the NEP contributed to the expansion of federal involvement in the oil and gas industry by imposing strict regulations and a revenue-sharing scheme on energy producing provinces. Outraged by such a display of aggressive unilateralism, Alberta retaliated against Ottawa. Under significant domestic pressures, Ottawa relaxed some of NEP's programs in late 1981 as it struck bilateral agreements with Alberta, British Columbia, and Saskatchewan that were intended to assuage provincial resentment. When Mulroney was the leader of the opposition in the Parliament in the early 1980s, he appointed Pat Carney to serve as opposition energy critic. Carney was assigned the task of developing the Conservative energy policy, whose main goal became to dismantle the NEP and develop an alternative plan which would take greater account of the interests of the provinces and the energy industry.[32] When the Tories assumed power, one of their first policy measures was to dismantle the NEP.

The dismantling of the NEP occurred in a piecemeal fashion through a series of federal-provincial agreements between 1985 and 1988. The Conservative energy policy was based on two ideas. First, the energy sector was to be governed as much as possible by the operation of the marketplace. And second, the Conservatives were less interested in securing the federal government's ability to retain its authority over the energy sector than they were in securing intergovernmental arrangements which protected provincial

[32] Tammy Nemeth, "Continental Drift: Energy Policy and Canadian-American Relations," in Nelson Michaud and Kim Richard Nossal, eds., *Diplomatic Departures: The Conservative Era in Canadian Foreign Policy, 1984-93* (Vancouver: University of British Columbia Press, 2001).

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interests. In 1985 three agreements were reached: in February 1985, the Tory government signed the Atlantic Accord with Newfoundland; in March 1985 the Western Accord was signed with Alberta, Saskatchewan, and Manitoba; and in October 1985, the natural gas agreement was signed. In August 1986, the Canada-Nova Scotia Offshore Petroleum Resources Accord was approved, and in September 1988, the Northern Accord was signed with the two territorial governments—Northwest Territories and Yukon. The Atlantic Accord gave Newfoundland the resource-ownership rights that Trudeau had forcefully withheld, which meant that the province would have the right to manage off-shore energy development and the power to tax off-shore resources.

The Western Accord eliminated several federal taxes or special charges on petroleum which Carney described as "cruel and arbitrary discrimination" against western Canada and agreed to decontrol crude oil prices.[33] The deal amounted to a loss of federal revenue, to greater relative autonomy for the provinces, and to an increase in industry profits. Similar to the Atlantic Accord, the agreements involving Nova Scotia and territorial governments also devolved the functions of managing and taxing oil and gas resources. In sum, these individual energy-related bilateral arrangements between the federal government and provincial and territorial authorities terminated the national energy policy that Trudeau had unilaterally imposed on the provinces in 1980. Importantly, the decentralized approach to handling the energy issue implied that the Tory government "largely accepted a system of regionalized—meaning provincialist—systems of oil and gas management" and was aware of the fact that such a system would

[33] Quoted in "Carney sees energy prices falling," *Globe and Mail* (March 29, 1985).

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"became increasingly oriented along the North-South rather than the East-West axis."[34]

Economic and political factors pushed the Tory government to dismantle the NEP. As far as economic factors were concerned, changes in the international oil market conditions in the course of the past five years obviated the need for a national policy on energy. Although energy resources have always been strategic assets for those countries possessing abundant supplies, the rise in energy prices in the 1970s significantly elevated the strategic value of these resources and became valuable commodities for producing countries. The NEP together with the energy-related megaprojects were designed specifically to harness Canada's potential energy capacity and make the country a major international energy producer. All of this changed, however, when energy prices began to drop in 1980. Not only did this change create a disincentive to engage in large capital investments to develop megaprojects, but it also reduced the need to ensure self-sufficiency and security of supply. Also, governments began to withdraw from their domestic energy sectors as the element of urgency associated with the oil crisis, which had forced them actively to intervene in their domestic energy markets by imposing regulations and creating state-owned enterprises, diminished.

The Conservative energy policy also reflected Mulroney's desire to achieve national reconciliation. The bilateral arrangements were in part intended to defuse tensions between the two levels of government resulting from the expansionist and unilateralist orientation of the past Liberal governments. They did so by curtailing federal capacity to intervene in provincial jurisdiction, rendering the energy sector more

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[34] John Erik Jossum, *Oil, the State, and Federalism: The Rise and Demise of Petro-Canada as a Statist Impulse* (Toronto: University of Toronto Press, 1997), p. 199.

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amenable to the agency of marketplace, and respecting the interests of energy-producing provinces. As Milne observes,

> It was in the field of energy policy that the Mulroney government made its ideas about the mutually supporting goals of cooperative federalism and economic renewal most clear. It did so with dramatic new initiatives that reversed the direction of federal-provincial policies in this sector, diminished intergovernmental rivalry and competition, and cleared the way for private sector reinvestment.[35]

If these bilateral arrangements initially ameliorated intergovernmental relations on the issue of energy by establishing new terms of engagement which enhanced the role of the private sector and curtailed federal incursions into the provincial energy arena, the energy provisions in Chapter 9 of the 1988 Canada-United States Free Trade Agreement (CUFTA) institutionalized this pattern of relations. As Doern and Tomlin point out, "For Alberta and other producer provinces in Western Canada, the FTA's energy provisions were seen as an insurance policy, not only against future U.S. protectionist actions, but even more against any more federal interference in provincial energy affairs. To them, the FTA offered an opportunity to forge an energy producers' charter of rights."[36] Before FTA was incorporated into the North American Free Trade Agreement the provisions prevented Ottawa and Washington from imposing price controls on exports and imports of energy products or discriminatory taxes. For example, neither country could export energy products at prices higher than what it sold them for in the domestic market. If an export tax was imposed on exports of energy products, then the tax also had to apply to domestic energy consumers. Moreover, a proportionality clause was included to ensure that whatever regulatory measures were taken by either government in the future, such as

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[35] David Milne, *Tug of War: Ottawa and the Provinces Under Trudeau and Mulroney* (Toronto: James Lorimer & Company, Publishers, 1986), p. 99.
[36] Doern and Tomlin, *Faith and Fear*, p. 80.

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energy conservation, did not reduce the percentage of exports, unless domestic consumption was also cut. Also noteworthy about Chapter 9 of CUFTA was the provision that allowed governments to continue the existing incentive programs for energy exploration and development and to maintain ownership requirements.

In sum, the energy provisions of the FTA catered to the interests of both the oil and gas industry and the energy-producing provinces by creating a set of rules that precluded the Canadian federal government from launching another national energy policy that encompassed the discriminatory policies of the NEP. Moreover, the FTA helped create a continental energy arrangement that would integrate the two energy markets to the benefit of Canadian producers.

From 'Border Guard' to 'Genial Host': The Deregulation of Foreign Investment

A couple of weeks after the Progressive Conservatives assumed power, Prime Minister Mulroney paid a visit to the United States, during which he announced that FIRA would be replaced by a policy intended to attract more foreign investment. In his 'Open for Business' speech before the Economic Club of New York on December 10, 1984, Mulroney discussed his government's plan to abolish the Foreign Investment Review Agency (FIRA) and establish Investment Canada, which would foster foreign investment:

> The message to prospective foreign investors in Canada is [that] we want an environment conducive to dynamic growth in trade, investment and development on a global basis. One immediate contribution to the creation of this climate is to...close down the old agency [FIRA] and to put in place a new body called Investment Canada, whose mandate will be to encourage and facilitate investment in Canada. Our message is clear: Canada is open for business again. The government of Canada is there to assist—and not harass—the private sector in creating the new

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wealth and new jobs that Canada needs.[37]

Back home the Investment Canada Act, tabled in the House of Commons by Industry Minister Sinclair Stevens on December 7, was supported by provincial governments, the business community, and Canadians in general. The creation of Investment Canada on June 30, 1985, put an end to the highly-controversial FIRA and contributed to a policy framework which promoted foreign investment and constrained state interference in this area. As Senior Vice-President of the Canadian Chamber of Commerce Roger Stanion observed, "The government has replaced FIRA, the border guard, with Investment Canada, the genial host to responsible visitors."[38]

Investment Canada marked a significant departure from the path of FIRA. First, rather than seeking to limit the costs associated with foreign investment as FIRA had done, the new agency was premised on the notion that foreign investment was beneficial to Canada for it helped strengthen Canada's technological capabilities, created new employment opportunities, and spurred economic growth. Accordingly, Investment Canada was given the mandate to promote foreign investment. Its objectives included ensuring "that Canada's environment for investment is attractive compared with the many formidable competitors," pursuing a "sustained campaign, supported by all levels of government and the private sector, to increase investment in Canada by Canadians and non-Canadians," and supporting "the promotion of initiatives of the provinces, territories and the private sector."[39]

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[37] "New Climate for Investment in Canada." Notes for a Speech by the Right Honourable Brian Mulroney, Prime Minister, to the members of the Economic Club of New York, New York, December 10, 1984. Reprinted in External Affairs, *Statements and Speeches* No. 84/18.
[38] "Business likes Investment Canada," *Globe and Mail* (December 8, 1984), p. B6.
[39] Government of Canada, *Investment Canada, 1987-1988 Estimates Part III* (Ottawa: Minister of Supply and Services Canada, 1987), p. 10.

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Initially, Investment Canada reported to the Department of Regional Industrial Expansion (DRIE), whose minister was responsible for making a final decision with respect to review approval.[40] However, in 1987 the agency was subsumed under the Department of Industry, Science and Technology Canada (ISTC), which was formed out of a merger between the DRIE and the Ministry of State for Science and Technology (MOSST). Mulroney considered the ISTC to be the government's "flagship" department to oversee microeconomic policy, and envisioned Investment Canada as playing a facilitating role in this policy arena. As such, the department unveiled three "cornerstone programs:" (1) the strategic technologies program sought to develop information technology, biotechnology, and advanced materials such as metals, alloys, ceramics, polymer, and composites; (2) the sector competitiveness initiatives were designed to improve the international competitiveness of sectors; and (3) the provision of business information and development services.[41] Along with other departmental instruments, the organizational resources of Investment Canada were expected to advance these goals.

The foreign investment review mechanism of Investment Canada differed from that of FIRA. Investment proposals were evaluated on the basis of "net benefits," rather than FIRA's elusive "significant benefit." Under this new criterion incoming foreign investments were approved so long as it brought some kind of benefit regardless of the significance of such a benefit. As Jenkins notes, "If there is one iota of benefit in an investment, it must be approved."[42] Moreover, Investment Canada's scope of review was

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[40] Under FIRA, the final decision was made by the Governor in Council, the Cabinet.
[41] G. Bruce Doern, "The Department of Industry, Science and Technology: Is There Industrial Policy After Free Trade," in Katherine Graham, ed., *How Ottawa Spends, 1990-1991* (Ottawa: Carleton University Press, 1990).
[42] Barbara Jenkins, *The Paradox of Continental Production: National Investment Policies in North America* (Ithaca: Cornell University Press, 1992), p. 119.

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much narrower. Unlike FIRA, the establishment of new businesses by non-Canadians was not subject to review. However, reviews were required in cases when non-Canadians acquired direct control of Canadian businesses with assets worth $5 million or more. Reviews also applied to cases when non-Canadians acquired indirect control of Canadian businesses with assets worth $50 million or more as a result of merger arrangement or the acquisition abroad of the parent company of a Canadian subsidiary. In short, these and other provisions made Investment Canada a promoter of foreign investment and an agent intended to limit state discretion over investment decisions in the private sector. Furthermore, the agency and the Industry, Science and Technology Canada were central in promoting the Tory government's firm-specific industrial policy which stressed market-based incentives to improve productivity and competitiveness.

A number of factors contributed to the abolishment of the FIRA. First, societal preferences shifted more decisively in favor of foreign investment than ever before.

Table 8.5. Canadian Attitudes Towards Extent of US Investment, 1961-1985 (%)

	1961	1970	1975	1978	1980	1982	1984	1985
Enough now	52	62	71	69	64	56	50	51
Want more	32	25	16	23	20	36	35	36
Don't know	16	13	13	9	17	8	14	13

Note: Respondents were asked: "Now thinking about US capital in Canada, do you Think there is enough now or would you like to see more US capital invested in the Country?"
Source: Sylvia Bashevkin, *True Patriot Love: the Politics of Canadian Nationalism* (Toronto: University of Toronto Press, 1991), p. 96.

As Table 8.5 shows Canadians in general had a more favorable and stable outlook on American investment in the first half of the 1980s than in previous periods. Moreover, as LeDuc and Murray point out, such a positive outlook tended to be manifested relatively equally across Canada, with Quebec registering the greatest support for foreign

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investment and the Atlantic region expressing the least support.[43] The preference of the Canadian business community on the issue of foreign investment by the 1980s was firmly in support of the liberalization of the foreign investment regulations. For example, the 1979 Hatch Report submitted to the government recommended that Canada needed to practice "a more liberal policy towards direct investment in Canada." The Report noted that "some subsidiaries have...developed unique products in Canada through which they have earned worldwide or regional marketing rights within their firms. This is a pattern which should be encouraged since it enables subsidiaries to contribute...to Canada's export effort...and it would be difficult to achieve the needed increase in exports if foreign-owned firms were excluded from the challenge."[44]

Indeed, if there was a common theme expressed by the business community with respect to foreign investment it was that Canada was beginning to exhibit fewer structural deficiencies attributed to a branch-plant economy, which had served as the justification for imposing foreign investment regulations in the first place. In the hearings on the Investment Canada Act, Robert Blair of NOVA Corporation stated: "In the NOVA company group, which is Canadian owned, we exist daily in competition around the world with some of the toughest international business rivals in several of the world's most competitive sectors."[45] Thomas D'Aquino, President of the Business Council on National Issues, remarked that the realities of the early 1980s hardly resembled the "long

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[43] Lawrence LeDuc and J. Alex Murray, "Open for Business? Foreign Investment and Trade Issues in Canada," in Harold Clarke, Marianne Stewart, and Gary Zuk, eds., *Economic Decline and Political Change* (Pittsburgh: University of Pittsburgh Press, 1989), p. 134.
[44] Final Report of the Export Promotion Review Committee, *Strengthening Canada Abroad* (November 30, 1979), p. 17.
[45] Testimony of Robert Blair in *Minutes of Proceedings and Evidence of the Standing Committee on Regional Development*, February 27, (Ottawa: Government of Canada, 1985), p. 8:5.

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history of branch plant development in this country."[46] The prevailing view within the business community was that foreign investment neither hindered industrial development nor reduced economic growth, but rather had the opposite effect on both. In addition, more Canadian subsidiaries were exporting thus signifying an important departure from their once dominant import-oriented and domestic market-oriented practices.

The Canadian business community was also concerned with the possibility of an American effort to reciprocate the activities of FIRA by employing similar discriminatory measures against Canadian investments in the United States. At a time when Canadian firms were investing more in the United States, the specter of American foreign investment regulations led the Canadian business community to pressure the government to eliminate regulations and establish a level playing field in which foreign investment would be subject to the same treatment as national firms.

Another factor contributing to the creation of Investment Canada was the need to improve Canada's image as a favorable market in order to compete for foreign investment. In its annual meeting in1984, the World Economic Forum ranked Canada the least hospitable market for foreign investors out of 22 advanced industrialized economies. Although the National Energy Program had contributed to such a poor ranking, it was believed that FIRA was equally to blame. Also significant was the heightened competition among governments to attract foreign investment in light of the increasingly accepted notion that the accumulation of investment brought significant benefits to the economies in which it settled. As one Investment Canada official noted, "Whereas in the 1970s, Canada had little trouble attracting investment, by 1980 the

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[46] Testimony of Thomas D'Aquino in *Minutes of Proceedings and Evidence of the Standing Committee on Regional Development*, March 5, (Ottawa: Government of Canada, 1985), p. 11:28.

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situation had changed. Canada had to compete for investment."[47] Investment Canada helped improve Canada's image by significantly narrowing the scope of reviews of foreign investment proposals and substituting the judgment of the private sector for that of the state with respect to investment decisions. Furthermore, Investment Canada became an instrument with which the government could actively participate in developing investment opportunities for both foreign and domestic investors.

Finally, Investment Canada was designed to encourage more Canadian subsidiaries of foreign companies to develop world product mandates. As the Hatch Report pointed out, more foreign-owned subsidiaries operating in Canada in the late 1970s were implementing a global product mandating strategy in which their parent companies granted them nearly exclusive responsibility for the development, manufacturing, and marketing of particular products on a world-wide basis.

The implementation of a product mandating strategy can confer upon a host economy vast benefits. Such benefits range from an increase in research and development activities, employment of skilled labor, enhanced productivity and efficiency given longer production runs stemming from access to international markets which their parent companies facilitate, increased contracting of local suppliers, and improvement in the managerial and technical talent of the domestic labor market.[48] In view of these benefits, the Ontario Advisory Committee on Global Product Mandating, consisting of senior executives from Canadian multinational affiliates, noted that "governments can influence more multinationals to evolve to specialized missions in

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[47] Quoted in Claire Turenne Sjolander, "Foreign Investment Policy-Making: The Canadian State in the Global Economy" (Ph.D. diss., Carleton University, 1989), p. 417.

[48] See Michael Atkinson, "If You Can't Beat Them: World Product Mandating and Canadian Industrial Policy," in Duncan Cameron and François Houle, eds., *Canada and the New International Division of Labour* (Ottawa: University of Ottawa Press, 1985).

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their Canadian operations. The most effective way to achieve these objectives is to emphasize performance rather than ownership of the multinational affiliate."[49] In particular, the Advisory Committee advanced that the most effective way to attract this type of foreign investment was to improve the investment climate by minimizing government obstruction caused by intrusive regulations and by strengthening market governance to the extent of making the private sector the principal determinant of investment decisions in Canada. Investment Canada was intended to end the market interventionism of FIRA and create an investment climate that would appeal to foreign investors through deregulation and provision of business-oriented services and assistance aimed at encouraging foreign and domestic investment in Canada.

Like the deregulation of the energy sector, the deregulation of the foreign investment regime in Canada was further institutionalized with the inclusion of an investment chapter in the Canada-United States Free Trade Agreement. Although Canada was reluctant to discuss the investment issue in the bilateral trade negotiations simply because it did it not recognize additional benefits in deregulating beyond the scope designated by Investment Canada, by 1987 Ottawa and Washington agreed to extend the principle of national treatment to each other's investors seeking to establish new businesses in either country. Moreover, Chapter 16 of CUFTA established that Canadian provinces and American states were subject to provisions on investment. Under the CUFTA, Investment Canada was to increase gradually the review threshold for direct acquisitions from $25 million in 1989 to $150 million by 1993 as well as for indirect acquisitions from $100 million in 1989 to $500 million in 1991 and in 1992 end

[49] Ontario Ministry of Industry and Tourism, *The Report of the Advisory Committee on Global Product Mandating* (December 1980), p. 4.

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such reviews. Canada, however, did retain the right to review American investments in Canada's cultural industries and to establish restrictions with respect to the sale of Crown corporations.

The deregulation efforts of the Mulroney government in the energy sector and investment area found success chiefly because the existing institutional structure proved amenable to such economic adjustment policy undertaking. For one thing, deregulation coincided with the prevailing arm's-length pattern of relations between business and the state by reducing the scope of state control and consequently securing the autonomy of the private sector. Deregulation also fit the current pattern of intergovernmental relations by facilitating the withdrawal of the federal state from a policy area in which federal involvement had been challenged by the provinces. Lastly, the process of deregulation eased the administrative and managerial burden on a bureaucracy that proved ineffective in attaining coordination from within.

Privatization: Dismantling or Rationalizing the Public Sector?

The Tory government's record of privatization efforts by the 1990s was mixed. Although privatization was an important economic adjustment policy of Mulroney as suggested by the various policy pronouncements, the outcome fell short of what was anticipated. After becoming leader of the Progressive Conservative Party in 1983, the official opposition party at the time, Brian Mulroney established a task force to look into how the federal government could divest itself of Crown corporations. Like the task force headed by Pat Carney that was set up to study the deregulation of the energy sector, the privatization task force was given the mandate to formulate a policy guideline that the Tories would pursue in the event the party won the upcoming national elections in

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September 1984. Significantly, although the Tories were exploring the issue of privatization while in opposition, the electoral campaign did not witness any major discussion or debate on this issue. In fact, when the Tories won the national elections, Prime Minister Mulroney waited until early November before he disclosed the task force report to his cabinet, a few days after Industry Minister Sinclair Stevens had launched the government's privatization program by announcing that Ottawa was planning to sell five Crown corporations.[50]

Between late 1984 to May 1987, as Ottawa sold Crown corporations, the Mulroney government made a number of policy statements that helped define the rationale for proceeding with privatization. In doing so, the Tories worked hard to win the hearts and minds of citizens after public opinion had soured when the Clark government had attempted to divest itself of such Crown corporations as Petro-Canada, de Havilland, Canadair, and Eldorado. Mulroney's efforts to make a case in favor of privatization gained valuable support from the business community and from an increasing segment of society that was disenchanted with the way in which the expansion of the inteventionist capacity of the state under Trudeau had played out.

In emphasizing the virtue of the marketplace, Industry Minister Sinclair Stevens remarked while overseeing the privatization of several Crown corporations that the "discipline and vitality of the marketplace will replace the often suffocating effect of government ownership."[51] Not as bold as Stevens's approach, Finance Minister Michael Wilson stated in his 1985 budget speech that "Crown corporations with a commercial

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[50] See W.T. Stanbury, "Privatization and the Mulroney Government, 1984-1988," in Andrew Gollner and Daniel Salée, eds., *Canada Under Mulroney* (Montreal: Véhicle Press, 1988).
[51] Quoted in Jeanne Kirk Laux and Maureen Appel Molot, *State Capitalism: Public Enterprise in Canada* (Ithaca: Cornell University Press, 1988), p. 191.

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value but no ongoing public policy purpose will be sold."[52] Privatization was an integral component of the minister's plan to achieve economic renewal, which called for an end to the "expansive, intrusive government" under Trudeau. In June 1985, Robert de Cotret, President of the Treasury Board echoed Wilson's logic, but also elaborated on the benefits of selling those holdings that belonged to the private sector:

> It will reduce the size of governments in the economy and make room for private sector initiatives; it will improve market efficiency and the allocation of resources; it will improve firm efficiency through market discipline and by reducing political and bureaucratic impediments; and it will encourage... investment by Canadians through the direct participation in the ownership of major national corporations which they have supported as taxpayers.[53]

In May 1985, in an effort to give structure and substance to the government's privatization policy, Mulroney created a task force that included the cabinet ministers from the Treasury Board, Industry, Energy, and Ministry of State for Finance. Given the authority to bypass the Treasury Board, which normally was required to approve any policy measures that are intended to affect government finances, the task force was given the mandate to report directly to the prime minister on proposed privatization plans. In seeking to give privatization greater public visibility and to devise a privatization strategy, in summer 1986 Mulroney refined the bureaucratic apparatus overseeing the government's privatization programs by naming Barbara McDougall the first Minister of State for Privatization and Regulatory Affairs and adding the Privatization and Regulatory Affairs committee to the cabinet committee structure.

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[52] Department of Finance, "The Budget Speech," (May 23, 1985), p. 10.
[53] President of the Treasury Board, *Annual Report to Parliament on Crown Corporations and other Corporate Interests of Canada, 1983-1984* (Ottawa: Supply and Services Canada, June 1985).

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In 1987, the Office of the Minister of State (Privatization) expounded the purposes of privatization. [54] First, the government argued that it was necessary to privatize those Crown corporations whose "public policy goals [were] no longer legitimate" and whose "original objectives [were] no longer valid." Second, the private sector, it was argued, provided services more efficiently to customers than public sector actors. Third, in the face of fiscal constraints, the federal government was unable to continue to operate existing Crown corporations or channel additional federal funds into existing Crown corporations to help them survive. Fourth, subsidized Crown corporations created unfair competitive situations for the private sector which contradicted the government's efforts to embed market governance. Finally, the government argued that Crown corporations were slow to adapt to external changes and were risk-averse, two behavioral conditions that undermined their ability effectively to compete and succeed.

In outlining the government's logic for undertaking privatization, the Tories made clear that privatization was a means to achieving efficiency gains and relieving the federal state of the financial burden of ensuring the viability of Crown corporations. More fundamental, however, was the attempt on the part of the Mulroney government to effect "systemic privatization." As Feigenbaum, Henig, and Hamnett point out, systemic privatization "involves a nontransient change in the values, culture, and expectations of the active public, resulting in a broadening of the sphere of activities regarded as personal and private and a shrinking of the sphere of activities considered to constitute legitimate areas for public scrutiny and intervention."[55]

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[54] See Office of the Minister of State (Privatization), "Excerpts from Statements made by the Honourable Barbara McDougall on the Reasons for Privatization," (May 1, 1987).

[55] Harvey Feigenbaum, Jeffrey Henig, and Chris Hamnett, *Shrinking the State: The Political Underpinnings of Privatization* (Cambridge, U.K.: Cambridge University Press, 1998), p. 51.

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In effect, the Mulroney government was seeking to change the prevailing normative order, the public enterprise culture, that rendered legitimate the employment of state-owned enterprises to accomplish political-economic goals. As McDougall noted, "We are mindful of the fact that many of our national Crown corporations have earned the respect of Canadians for the key roles they played in the industrial and regional development of our great country." However, "Today, Canada has a developed and maturing social and economic infrastructure;" rather than relying on the galvanizing force of the state, "the private sector is recognized as being more appropriately the principal stimulant of economic growth and renewal."[56] Indeed, like deregulation, privatization was a symbol of Ottawa's determination to substitute market governance for state discretion and to institutionalize market relations in order to ensure that they would remain the principal mechanism of resource allocation in the future and the basis for coordination.

In 1984 the federal government owned 67 parent Crown corporations which owned 128 wholly-owned subsidiaries. The bulk of these state-owned enterprises operated as commercial corporations, engaged in the production and sale of goods and services. The *Financial Post 500* indicated that 19 federal Crown corporations were among Canada's 500 largest non-financial enterprises in 1985. According to the Economic Council, provinces owned 203 parent Crown corporations which in turn owned 187 subsidiaries. The *Financial Post 500* in 1985 listed 16 provincial Crown corporations among the top 500 industrial companies in Canada. Between 1984 and 1988, the Mulroney government

[56] Office of the Minister of State (Privatization), ibid.

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undertook 13 privatizations.[57] Among the privatizations completed in the 1990s by the Tories and Liberals, five stand out for having generated relatively large sale proceeds. In fact, as Table 8.6 illustrates, of all the privatization plans executed between 1985 and 1996, the three largest of such plans occurred in the 1990s. Particularly noteworthy is that the Liberal government of Prime Minister Jean Chrétien oversaw the largest privatization plan ever when it sold the Canadian National Railway in 1995.

The Tory government's privatization strategy, however, did not always conform to its policy declarations. In fact, privatization did not necessarily contribute to greater

Table 8.6. Federal Privatization Completed by Federal Government (1984-1996)

Crown Corporation	Year of Privatization	Sector	Sale Proceeds (C$ millions)
(1) Northern Transportation	1985	Transportation	27
(2) de Havilland Inc.	1986	Aircraft Manufacturing	155
(3) Pecheries Canada	1986	Fish Processing	5
(4) Canadian Arsenals	1986	Ammunition Manufacturing	92
(5) Nanisivik Mines (18%)	1986	Lead and Zinc Mining	6
(6) CN Route	1986	Trucking & Distribution Services	29
(7) Canadair	1986	Aircraft Manufacturing	205
(8) Teleglobe Canada	1987	Telecommunications	488 (a)
(9) Fisheries Products International (62.6%)	1987	Fish/Seafood Processing	104
(10) Canada Development Corporation (48.2%)	1987	Financial	377
(11) Northern Canada Power	1987/88	Electrical Power Generation	20 (b)
(12) CN Hotels	1988	Tourism, Hotels, Restaurants	264
(13) Air Canada	1988	Transportation	474
(14) Petro-Canada	1991	Oil and Gas	1,747
(15) Nordion International	1991	Manufacturing	161
(16) Telesat Canada	1992	Telecommunications	155
(17) Canadian National Railway	1995	Transportation	2,079
(18) Nav Canada	1996	Transportation	1,500

(a) plus $17 million redeemable preferred shares
(b) plus notes worth $56 million
Sources: Mylève Levac and Philip Wooldridge, "The fiscal impact of privatiziation in Canada," *Bank of Canada Review* (Summer 1997) and W.T. Stanbury, "Privatization and the Mulroney Government, 1984-1988, in Gollner and Salée, *Canada Under Mulroney*, p. 127.

[57] In addition to privatization, the Mulroney government dissolved or terminated 8 federal Crown corporations: Canadian Sports Pool Corp., Lotto Canada Inc., Canagrex, Uranium Canada, Crown Assets Disposal Corp., Societa San Sebastine, St. Anthony Fisheries, and CN (West Indies) Steamships. See President of the Treasury Board, *Annual Report to Parliament on Crown Corporations and Other Corporate Interests of Canada, 1983-1984*, pp. 6-7.

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market competition, withdrawal of the state, and strengthening of the private sector. In two particular cases the federal government engaged in lateral transfers by selling its corporate holdings to provincial governments. Ottawa sold the assets of Northern Canada Power Commission to the territorial governments of Yukon and of the Northwest Territories in 1987 and 1988, respectively. The Mulroney government resorted to a similar lateral transfer in 1988 when it sought to offload Eldorado Nuclear Limited, the largest uranium producer in North America. Absent a private buyer, a deal was negotiated with the Saskatchewan government in which the provincial Crown corporation, Saskatchewan Mining Development Corporation, would buy the federal Crown corporation. A new company, Cameco, was created out of the merger of Saskatchewan Mining Development Corporation and Eldorado Nuclear Limited. It was agreed that Cameco would be gradually privatized; however, after a share offering to the public in 1993 the government found itself still owning 42 percent of the provincial Crown corporation.[58] In addition, in the years following its creation, Cameco undertook various successful rationalization measures and development plans to ensure its financial viability.

In other cases, the divestment of federal state assets resulted in the concentration of market players in particular industries. This was the case when the Mulroney government sold de Havilland Inc. to the American giant, the Boeing Company, which resulted in increased concentration in the Canadian and international aircraft manufacturing markets because de Havilland's market share of the world's regional commuter aircraft was transferred to the world's largest aircraft manufacturer.[59] The

[58] Jeanne Kirk Laux, "How Private is Privatization?," *Canadian Public Policy* (1993), p. 409.
[59] Ibid.

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Quebec-based transportation equipment manufacturer, Bombardier, also augmented its market power in a series of purchases of Crown corporations. In 1986, Bombardier purchased Canadair, and when Boeing opted to sell the former Crown corporation de Havilland in 1991, the Quebec-based giant became the new majority owner of the company.[60] The company grew even more when it bought from the Ontario government UTDC, a mass transit company.[61]

Bell Canada Enterprises—which ranked in second place in the *Financial Post 500* in 1988—benefited from the federal government's sale of Teleglobe Canada in 1987. Although Teleglobe Canada was sold to the Montreal-based Memotec Data Inc., Bell Canada Enterprises indirectly gained because it owned 27 percent of the Montreal firm. By being the largest shareholder Bell exercised a respectable degree of control over the operations of Memotec Data Inc.[62] This particular trend in Canada's privatization process has undoubtedly been attributed to the fact that the federal government as been willing to sell its corporate holdings to single buyers.[63]

As the evidence suggests, the outcome of a privatization plan did not always amount to the complete elimination of state influence over the operations of the private sector. In many cases, foreign ownership restrictions were attached to privatization plans, especially after Ottawa faced criticism for selling de Havilland to Boeing. For example, the privatization of Teleglobe Canada included terms which prohibited foreign telecommunications companies from purchasing shares in Teleglobe and prevented non-

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[60] "Deal Moves Bombardier into Aerospace Elite," *Globe and Mail*, November 24, 1992, p. B5.
[61] "Bombardier acquires UTDC in Subsidy Deal with Ontario," *Globe and Mail*, December5, 1991, p. 1.
[62] Richard Schultz, "Teleglobe Canada," in Allan Tupper and G. Bruce Doern, eds., *Privatization, Public Policy and Public Corporations in Canada* (Halifax: Institute for Research on Public Policy, 1988).
[63] See W.T. Stanbury, "Privatization and the Mulroney Government, 1984-1988," in *Canada Under Mulroney*, pp. 128 and 147. There are some notable exceptions, however. For example, the federal government sold Air Canada and Canadian National Railways through public share offerings, thus diversifying the ownership structure of both companies.

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residents from collectively owning more than 20 percent of the telecommunications company. Similarly, when Air Canada was privatized in 1988, a provision was added which prevented non-residents from collectively owning more than 25 percent of the company. As the deal securing the merger of Eldorado Nuclear Ltd. and Saskatchewan Mining Development Corporation was being completed, it was agreed that the aggregate share of the new company Cameco held by non-residents could not exceed 20 percent.[64] In a few cases, the government demonstrated favoritism toward private sector buyers of Crown corporations. For example, after Teleglobe was privatized, its new private sector owner secured a deal which enabled it to maintain Teleglobe's monopoly position on the provision of telecommunications services by satellite between Canada and countries overseas for five years.[65] Shortly after Bombardier acquired Canadair, Ottawa awarded the Montreal-based company a lucrative contract to overhaul its CF-18 fighter aircraft despite receiving a lower bid by the more experienced Bristol Aerospace, based in Manitoba.[66]

Privatization has also taken place at the provincial level. Just as efficiency, fiscal, and political (systemic privatization, in particular) rationales underpinned the privatization of federal Crown corporations, so too have they formed the bases for the privatization of provincial Crown corporations. However, provincial governments have also demonstrated an interest in holding on to Crown corporations and forcing them to be more "businesslike." Molot points out that provincial governments have faced obstacles which have delayed, slowed, and limited privatization that have not been witnessed at the federal level.

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[64] See Jeanne Kirk Laux, "How Private is Privatization?"
[65] Stanbury, ibid., p. 125.
[66] Laux, ibid.

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> These [obstacles] include the economic realities of resource-based provincial economies, the relatively fewer number of economic levers available to provincial governments than to Ottawa which has resulted in their greater reliance on more direct instruments of intervention, continuing public support for Crown corporations,... and the problems of finding interested (and appropriate) buyers.[67]

Nevertheless, provinces have proceeded with privatization. Between 1983 and 1988, seven provinces (British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, and Newfoundland) privatized 24 Crown corporations. Quebec accounted for one-third (8) of the 24 privatizations while British Columbia accounted for 7.[68] Although all ten provinces engaged in privatization in the 1990s, the pace of privatization varied. Alberta actively proceeded to shed its state holdings and accounted for the largest privatizations in 1990s with the sale of Alberta Government Telephones, Alberta Energy Company, Syncrude Canada, Vencap Equities Alberta, and Edmonton Telephone. Ontario's privatization program moved slowly and has demonstrated an interest in seeking opportunities for contracting and entering into public-private partnerships as ways to downsize the province's public sector. Moreover, contrary to Quebec's sweeping privatization efforts in 1986 and 1987, subsequent Liberal and Parti Québecois governments opted to proceed more slowly with privatization.

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[67] Maureen Appel Molot, "The Provinces and Privatization: Are the Provinces Really Getting Out of Business?, in Allan Tupper and G. Bruce Doern, eds., *Privatization, Public Policy and Public Cooperation in Canada* (Halifax: The Institute for Research on Public Policy, 1988), pp. 415 and 417.

[68] In 1986, Pierre Fortier, Minister responsible for Privatization in the Bourassa government published a report that recommended that Quebec privatize those "strategic enterprises" created since the early 1960s, whose principal functions were to accelerate economic development and strengthen the managerial capacity of Francophones. In addition to arguing that privatization was necessary in order to improve economic efficiency and cut government losses, the report pointed out these strategic enterprises had outlived their usefulness because of the emergence of numerous Francophone enterprises that were capable of developing and leading the Quebec economy on their own. "The Committee notes that the growth of the Québec private sector, particularly its Francophone component, calls for a questioning of the government presence in the commercial and industrial sectors of the economy. The major reasons which dictated the institution of Crown corporations working in these sectors are now a thing of the past." Minister Responsible for Privatization, Report of the Committee on the Privatization of Crown Corporations, *From the Quiet Revolution...To The Twenty-First Century* (Quebec City, June 1986), p. 10.

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Like deregulation, privatization was a policy action that demonstrated the Canadian state's desire to strengthen the market while limiting the scope of state involvement in the economy. Unlike deregulation, however, privatization was not subject to same kind of external exigency stemming from continental integration, which led both levels of government to deregulate jointly in the same economic sectors and in a similar degree. If anything, the process of privatization in Canada has been marked by its inconsistency and variance among provinces and Ottawa. Moreover, although there were important economic and political reasons for pursuing privatization, this course of action, unlike deregulation, did not contribute directly to ameliorate intergovernmental relations.

CONTINENTAL INTEGRATION: SYSTEMIC EFFECTS AND THE ROLE OF PROVINCIAL-FEDERAL CONSULTATIONS

The policy shift that led Canada to enter into a free trade arrangement with the United States began in 1983 with the release of a report by a task force in the Department of External Affairs that was in charge of assessing Canada's trade policy.[69] The consultations that the task force conducted with representatives of the business community and provincial governments in 1982 revealed that there was a growing concern about the state of Canadian-American trade relations. At a time when Canada's external trade was becoming more bilateral in nature and the economy more dependent on trade, the threat of American market closure was increasing. Although the report emphasized the importance of improving the international trade regime under the General Agreement on Tariffs and Trade, it also raised the option of pursuing sectoral free trade with the United States, as Canada had done in the automobile industry, defense materials,

[69] Department of External Affairs, *Canadian Trade Policy for the 1980s: A Discussion Paper* (Ottawa, August, 1983).

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and agricultural machinery in previous decades. In June 1984, Trudeau opted to proceed with the bilateral sectoral free trade option and appointed Tony Halliday to negotiate sectoral trade agreements with his American counterpart, William Brooks, the United States Trade Representative. Given the lack of interest in the United States for such an arrangement, the bilateral talks failed to produce any deals.

In late January 1985, barely four months after taking office, the Tory government released a discussion paper which argued that Canada should find a way to enhance and secure commercial access to the United States.[70] International Trade Minister James Kelleher proposed four options to serve as the basis of discussion and debate: (1) to support the status quo; (2) to negotiate sectoral or functional arrangement (for example, in government procurement and in contingency protection); (3) to negotiate a comprehensive bilateral trade arrangement; or (4) based on the recommendation of the Business Council on National Issues, to negotiate a framework agreement that would improve and expand trade relations and establish an institutional mechanism to address trade issues and resolve disputes.[71]

The drafting of the report did not go smoothly. Whereas Kelleher and External Affairs Assistant Deputy Minister for the United States Derek Burney favored the free trade option, others within the Department of External Affairs opposed this initiative fearing that free trade would undermine Canada's political autonomy and its reputation as a supporter of the GATT. Opposition also came from officials in the Department of Regional Industrial Expansion who were concerned with the ability of Canadian industries to compete against their American counterparts under a free trade arrangement.

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[70] Department of External Affairs, *How To Secure and Enhance Canadian Access to Export Markets* (Ottawa, January 1985).
[71] Ibid., pp. 24-28.

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In the end, Burney, who was in charge of drafting the report, muscled through the barrage of bureaucratic opposition and made the option of a comprehensive free trade a key component of the discussion paper. The report dismissed the first two options, for neither would take the bilateral relation in a direction that would serve the interests of Canada, particularly in securing and enhancing market access. Between the last two options, the report sided with the option of negotiating a comprehensive bilateral trade arrangement, arguing that the fourth option would be "essentially declaratory and non-contractual in nature."[72]

The momentum toward entering into a bilateral free trade arrangement with the United States intensified when Prime Minister Mulroney and U.S. President Ronald Reagan held a summit meeting in Quebec City in March 1985. In a joint declaration, the two leaders made known their commitment to establishing "a climate of greater predictability and confidence for Canadians and Americans alike to plan, invest, grow and compete more effectively with one another...."[73] In working toward this goal, the two leaders agreed to find ways to lower barriers to trade and resolve trade-related disputes. On the former issue, a bilateral mechanism, led by Kelleher and U.S. Trade Representative Brock, was established to outline ways to lower and eliminate existing trade barriers and to report with its recommendations in six months. On the latter issue, the two leaders set in motion a process designed to resolve impediments to trade in 8 specific areas. Of great importance for the Mulroney government was that the Quebec

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[72] Ibid., p. 28.

[73] Declaration by the Prime Minister of Canada and the President of the United States of America Regarding Trade in Goods and Services, reproduced in Department of External Affairs, *Canadian Trade Negotiations: Introduction, Selected Documents, Further Reading*, pp. 13-14.

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City Summit revealed that the United States was interested in negotiating a deal with Canada to deepen trade relations.

Released on September 5, 1985, the Macdonald Commission report had an important effect in converting Mulroney, who had advance knowledge of the report in August, to an advocate of free trade. As Burney points out, "There can be no doubt...that the thorough analysis and virtually unanimous recommendation by Mr. Macdonald and his associates proved to be a major catalyst for the negotiation and a bedrock of faith for the political will in Canada that drove those negotiations to conclusion."[74] The Report articulated a convincing argument that held that free trade would not only redress the industrial adjustment problems that Canada faced but would also offer a way to ameliorate intergovernmental relations. Moreover, the Commission's report was released at a time when provincial governments and the Canadian business community favored a free trade arrangement, which only emboldened Mulroney's free trade decision. This was the message communicated to the Prime Minister by Kelleher who, since February 1985, had been conducting cross-country consultations on his discussion paper with representatives of the Canadian business community and labor. This was also the message heard from provincial leaders during the Regina first ministers' conference in February.

The Prime Minister announced in the House of Commons on September 9 that the government would pursue the comprehensive free trade option. On September 26, the Prime Minister informed the House of Commons that he had called President Reagan to commence trade negotiations. In a formal letter sent to Reagan on October 1, the Prime

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[74] Derek Burney, "Where There's The Will...," in L. Ian MacDonald, ed., *Free Trade: Risks & Rewards* (Montreal & Kingston: McGill-Queen's University Press, 2000), p. 61.

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Minister wrote that the "two governments pursue a new trade agreement involving the broadest possible package of mutually beneficial reductions in barriers to trade in goods and services" and that "such an agreement secure and enhance access to each other's markets...and result in a better and more predictable set of rules whereby [bilateral] trade is conducted."[75]

When the trade negotiations began, Canadian negotiators had three broad objectives. The first objective was to secure Canada's market access by seeking an agreement that would limit the ability of the American government to affect Canadian exports going to the United States by employing arbitrarily and unpredictably trade remedy laws. This goal was underscored on several occasions by Prime Minister Mulroney and the negotiating team. "Our highest priority is to have an agreement that ends the threat to Canadian industry from U.S. protectionists who harass and restrict our exports through the misuse of trade remedy laws. Let me leave no doubt that first, a new regime on trade remedy laws must be part of the agreement."[76] Second, Ottawa sought to enhance Canada's market access by deepening and broadening trade liberalization. The goal was to further reduce tariffs and quotas in sectors that the two countries had previously lowered and began opening up sectors that were previously protected. Finally, Canadian trade negotiators sought to establish specific rules and procedures designed to adjudicate in a predictable, consistent, and fair manner disputes relating to trade

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[75] "Text of letter from Prime Minister Mulroney to President Reagan," reproduced in *Canadian Trade Negotiations*, p. 77.

[76] Quoted in David Leyton-Brown, "Canada-U.S. Trade Disputes and the Free Trade Deal," in Maureen Appel Molot and Brian Tomlin, eds., *Canada Among Nations 1987* (Toronto: James Lorimer and Company, 1988), p. 168. Similarly, the Minister for International Trade, James Kelleher, argued that Canada was seeking an agreement "that exempts [Canada's] exports from U.S. protectionist measures aimed at reducing the imports of other countries," that limits "the severity and duration of any measures aimed specifically at Canada," and that constrains "the ability of the United States unilaterally to determine the terms of cross-border trade." See External Affairs Canada, *Canadian Trade Negotiations: Introduction, Selected Document, Further Reading* (Ottawa: Ministry of Supply and Services Canada), p. 1.

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practices. The goal was to develop "a strong dispute settlement mechanism to reduce the disparities in size and power and to provide fair, expeditious and conclusive solutions to differences of view and practice."[77]

The Canada-United States Free Trade Agreement that came into effect in 1989 was a beneficial deal for Canada to the extent that it satisfied most of the objectives Ottawa was seeking to attain. Canada's relative success in the negotiations was largely owed to the negotiating team's ability to command enough political and bureaucratic resources to make up for the country's disadvantage resulting from its relatively weaker aggregate power capabilities. Also, Canada exhibited a relatively higher level of focused attention in the negotiations which in turn allowed for quick decision making and systematic pursuit of specific goals. Such an attribute was linked to the fact that free trade proved to be a much more significant policy matter than it was treated in the United States. As Clayton Yeutter, U.S. Trade Representative under Reagan from 1985 to 1988, notes, "Although this was a big deal in both countries, it was a really big deal in Canada..., whereas in the U.S. we had a lot of other [foreign policy matters, both political and economic in nature] on our table at the time."[78]

The trade liberalization component of the bilateral agreement has enhanced Canadian access to the American market, as illustrated by the increase in volume of trade in liberalized sectors. Enhanced access has created additional positive effects. For example, the free trade arrangement has induced greater specialization and rationalization in continental business activities, a process that has led to increased intra-industry trade

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[77] External Affairs Canada, Minister for International Trade, *Canadian Trade Negotiations: Introduction, Selected Documents, Further Reading* (Ottawa: Ministry of Supply and Services Canada), pp. 3-4.
[78] Clayton Yeutter, "The Negotiation and Approval of the FTA," in L. Ian MacDonald, ed., *Free Trade*, pp. 75-76.

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and intra-firm trade. Moreover, liberalized sectors have been a major source of growth in the economy. As Burney points out, "Enhanced access to the U.S. has fuelled much of the growth that there has been in the Canadian economy over the past decade."[79]

The free trade negotiations did address the issues of American trade remedy and dispute settlement. However, Canada had to settle for a compromise deal on trade remedy, but it was one that still fulfilled the Canadian objective of securing market access. Canada's chief objective in the negotiations was to constrain the ability of the United States to employ its contingency protection laws, namely countervailing duties and antidumping. In fact, the Canadian negotiation team made it clear that even if the negotiations produced a free trade deal in which the distribution of gains from trade liberalization were in Canada's favor, a free trade arrangement would not be worthwhile if it did not include an institutional mechanism that allowed Canada to challenge American trade remedy practices. As the Canadian chief negotiator Simon Reisman points out, "What's the point of entering into an agreement when as soon as you are successful, some protectionists—and in the U.S. you'll get lots—are going to be able to prevail on the Administration...and get things done that interfere with our trade."[80] To achieve this, the Canadian negotiating team sought to establish bilateral rules that clearly defined what constituted dumping, countervailance, and subsidies, which in turn would substitute the application of U.S. trade remedy laws to Canada. Moreover, in the event that problems of interpretation of these rules arose, redress would be achieved through impartial, binding arbitration. In the end, the United States proved unwilling to substitute a common set of rules on fair and unfair trade practices for its own trade remedy laws.

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[79] Derek Burney, "Where There's the Will...", p. 68.
[80] Simon Reisman, "The Negotiation and Approval of the FTA," in *Free Trade: Risks and Rewards*, p. 91.

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The compromise deal led to the development of a dispute settlement institutional framework embodied in Chapters 18 and 19 of the Canada-United States free trade agreement. Chapter 19 created a unique institutional mechanism for resolving disputes over countervailing duties and antidumping. The two countries agreed to employ their respective trade remedy laws, but also agreed to replace domestic judicial review of countervailing duties and antidumping decisions by a binational review panel. Composed of two panelists from each country and one panelist chosen jointly, the binational review panel was given the mandate to review and reverse a domestic decision if it was determined that a particular trade remedy action was based on an improper application of existing trade laws in the country where the case originated. Chapter 19 also included a provision requiring that Canada be specifically named in any changes made to the American antidumping and countervailing duty laws if they are to apply to Canada. Finally, changes to existing American trade remedy laws which named Canada were subject to the review of a binational panel to determine whether the legislative changes conform with the American obligation in the General Agreement on Tariffs and Trade and rules of the bilateral free trade agreement.

Modeled after the dispute settlement process of the GATT, Chapter 18 of the free trade agreement established a mechanism to resolve disputes concerning rights and obligations of the two countries under the FTA, with the exception of disputes linked to antidumping, countervailing duties, and financial services. If a dispute was not resolved through information sharing and direct consultations, the matter could be referred to the Canada-United States Trade Commission. In the event the Commission was unsuccessful in resolving a dispute, the case, among three possible procedures, could be referred to an

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ad hoc panel whose recommendations were given to and acted upon by the Commission. The institutionalized arbitrative mechanisms that Chapters 18 and 19 embodied amounted to a significant change in how the two countries would manage their bilateral trade relations the future. As Stanley and Blank point out, "The most substantial gains from the FTA [for Canada] may well turn out to have been in trade jurisprudence. Getting a trade partner as important as the United States to accept the principle that its own trade-remedy judgments should be 'internationalized' in a binding mechanism made up of experts from each country was extremely significant."[81]

Provincial-Federal Consultations During the Free Trade Negotiations

The Canadian federal structure played an important intervening role between Ottawa's pursuit of its instrumental goals in the free trade negotiations and the substantive outcome of the negotiations. The authority to negotiate and sign an international trading arrangement has always rested with Ottawa. However, the national government's freedom of action in this jurisdictional area has been limited, for this authority does not translate into an ability to implement those provisions of international agreements which fall within provincial jurisdiction. As such, if Ottawa sought a free trade agreement that dealt with such issues as investment, financial and professional services, government procurement, deregulation of liquor monopolies, or subsidies, for example, Ottawa would have to collaborate with the provinces in order to secure their support and compliance. In recognizing the jurisdictional limitations that Ottawa would be facing if it decided to initiate free trade negotiations, the Macdonald Report recommended "close consultations about provincial, as well as federal, objectives" before

[81] Guy Stanley and Stephen Blank, "Big Gains for Canada," *The Gazette* (April 17, 1999).

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negotiations were launched and "binding commitments to achieve them" during the negotiations, which was to be underpinned by "sustained and continuous consultations by federal and provincial Ministers."[82]

The issue of provincial involvement was addressed during the Annual First Ministers' Conference in Halifax in late November 1985. Alberta's Federal and Intergovernmental Affairs Minister Wayne Clifford summed up the position of the provinces on the need to be engaged in consultations with Ottawa. "There has been an increasing realization by all provinces of the impact of changes in the world economy... on provincial economies and the realization that provincial areas of jurisdiction fall increasingly within the scope of trade negotiations....What all of this has brought us to realize is that we have to work together, and that we need...consultation procedures."[83] For Ottawa, provincial-federal consultations served several purposes. Provincial support was necessary in order effectively to implement any free trade deal. Also, Ottawa's interest in these consultations stemmed from Mulroney's desire to renew federalism; in particular, to reduce the sentiment of alienation felt by western provinces and avert the return of sovereigntists in Quebec. The consultations would be one way in which the provinces could voice their preferences and have an impact on Ottawa's course of action. Finally, by securing the support of provinces through consultations, Ottawa would be able to count on the provinces to mount a campaign to sell the free trade agreement to the Canadian people.

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[82] Macdonald Report, Vol. 1, pp. 368-373; Vol. 3, pp. 151-156.
[83] Wayne Clifford, "An Alberta Perspective," in Douglas Brown and Murray Smith, eds., *Canadian Federalism: Meeting Global Economic Challenges* (Kingston: Institute of Intergovernmental Relations, 1991), p. 130.

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Without getting into too much detail about the specific consultative arrangement that would operate alongside the bilateral negotiations, the Premiers and the Prime Minister issued a statement, at the conclusion of their November meeting in Halifax, affirming their commitment to the "principle of full provincial participation in the forthcoming trade negotiations."[84] For the next 6 months, wrangling replaced the initial show of consensus between Ottawa and the provinces. As outlined in a letter from Donald Getty, Premier of Alberta sent to Mulroney in March 1986, the provinces had come to interpret full provincial participation to mean that provincial representatives would be directly involved in the negotiations, that the chief negotiator would receive his orders from provincial and federal governments, and that provinces would have a veto on issues pertaining to provincial jurisdiction.

Appointed to head the Canadian negotiating team in early November, Simon Reisman countered this provincial position, stating that the provinces would not be present at the negotiating table and that Ottawa alone would issue instructions for the negotiating team. However, Reisman was not against the concept of consulting with the provinces on issues that fell within provincial jurisdiction. He recognized that to ensure full implementation and compliance of a free trade agreement, it was necessary to gain the consent of provinces prior to signing an agreement. With this in mind, Reisman began chairing monthly meetings in January 1986 with provincial advisors, which became known as the Continuing Committee on Trade Negotiations (CCTN). As a prenegotiation forum, the meetings were used to exchange views and gain an

[84] Quoted in David Barrows and Mark Boudreau, "The Evolving Role of the Provinces in International Trade Negotiations," in Allan Maslove and Stanley Winer, eds., *Knocking on the Back Door* (Halifax: Institute for Research on Public Policy, 1987), p. 140.

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understanding of each other's expectations and concerns. But this initiative did nothing to solve the impasse about what role would provinces play during the negotiations.

A resolution came out of the First Minister's meeting in Ottawa in June 1986. The resolution entailed a number of key points. First, Chief Negotiator Reisman would be accountable to the federal cabinet, the Trade Negotiations Office (TNO) would be supervised by Reisman, and no provincial representatives would be in the TNO or at the negotiating table. Second, in consultation with the provinces, Ottawa would formulate the mandate of the Chief Negotiator. Finally, in addition to having a First Minister's meeting every three months for the duration of the negotiation process for the purpose of reviewing progress in the negotiations, provincial trade representatives and Reisman would meet regularly through the CCTN to exchange information and views.[85] Thus, the provinces would be fully consulted and briefed regularly on the progress of negotiations, but they would not share negotiating authority with the federal government.

From the start, Western provinces took full advantage of this intergovernmental apparatus, as did Quebec. Ontario's involvement was less than enthusiastic. Unable to prevent free trade negotiations from going ahead, Ontario acted more as a spoiler than a constructive shaper in the series of intergovernmental consultations. Interestingly, as Ontario became more removed, Quebec's role and influence in the consultations increased, much to the satisfaction of the Bourassa government. The general feeling among most provinces after a free trade deal emerged was that the consultations that ran alongside the actual negotiations proved to be a major milestone in the way in which the two orders of government worked with each other in international negotiations.

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[85] See Douglas Brown, "The Federal-Provincial Consultation Process," in P.M. Leslie and R.C. Watts, eds., *Canada: The State of the Federation, 1987-88* (Kingston: Institute of Intergovernmental Relations, Queen's University, 1988), p. 83. The Committee also had observers from the Yukon and Northwest Territories.

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Aside from the interruption of the regular provincial-federal consultations toward the end of the negotiations, the consultations were successful to the extent of keeping the provinces informed and involved. From September 24 to October 4, 1984, formal intergovernmental consultations did not take place as the bilateral trade negotiations entered into a period of brinkmanship in which Canada threatened to walk out of the negotiations if no agreement prevailed on the issue of trade remedy. When the *Elements of the Agreement* was released on October 4, outlining the broad strokes of what would become the free trade agreement, the provinces did not encounter any new issues that interfered in their jurisdiction. Overall, the free trade deal intruded less into provincial jurisdiction than was first anticipated by the provinces. As it turned out, provincial procurement, provincial technical standards, and financial services were not affected and only future provincial investment laws would be affected.[86]

When the final legal text of the free trade agreement came out in December, Ontario, Manitoba, and Prince Edward Island opposed the agreement. For the Mulroney government, what was important to ensure the approval of the agreement was that it satisfy the general constitutional amending formula requiring parliamentary approval and the support of at least seven provinces with a combined population of more than 50 percent. With respect to the latter, Mulroney could rely on the seven provinces that approved the free trade deal, among which Alberta and Quebec were its most enthusiastic supporters. As for the former criterion, Mulroney faced a more challenging task. When the Tory government tabled Bill C-130, An Act to Implement the Free Trade Agreement between Canada and the United States of America, in the House of Commons in June

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[86] Douglas Brown, "The Federal-Provincial Consultation Process," *Canada: The State of the Federation, 1987-88.*

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1988, the Liberal Party and the New Democratic Party, assisted by the Pro Canada Network, mounted a massive campaign to defeat the free trade deal.[87]

In an attempt to stop the legislation in its tracks, the Liberal Party used its majority in the Senate to force Bill C-130 to go through the Liberal-dominated Foreign Affairs Committee and subject it to an extensive series of hearings. At the same time, Allan MacEachen, the Liberal leader in the Senate, declared that the Senate would not approve the legislation unless Mulroney turned the issue over to a national vote. Faced with the intransigence of Liberal Senators, the Prime Minister dissolved Parliament and called a national election to be held in November 1988. Although the Tories tried to shift the focus to other issues during the campaign, the election primarily focused on the bilateral free trade agreement. When the electoral results came out, the Tories garnered a majority of the seats in the House of Commons, winning 170 of 295 seats. Equipped with a mandate to proceed with the enactment of the free trade legislation, the new Tory government resubmitted the free trade bill to the Parliament, where it was quickly passed and received royal assent on December 30, 1988.

The North American Free Trade Agreement: Defensive Positioning and Deepening Integration

As Prime Minister Mulroney was on his way to visit Mexican President Carlos Salinas de Gortari in March 1990, he received news from Derek Burney, Canadian Ambassador to the United States at the time, that the Mexican president had earlier requested that the United States and Mexico initiate bilateral free trade negotiations. When Mulroney was informed by Salinas of Mexico's free trade initiative, the Prime

[87] The Pro Canada Network (PCN) was an anti-free trade civil society-based umbrella organization composed of environmental, church, women, and native groups.

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Minister left unanswered whether Canada was interested in joining or would remain out of future free trade talks. As Cameron and Tomlin point out, Mulroney emphasized that "Canada already had its free trade agreement with the United States in place," leaving unclear the position of Canada on this matter.[88] From March to late September, the Mulroney government carefully analyzed the issue, weighing the pros and cons of a trilateral free trade agreement. On September 24, the Prime Minister announced that Canada was interested in participating in trilateral talks.

Initially, support for a trilateral agreement was thin, while the reasons for opposing such an engagement appeared to dominate the debate. A number of reasons were used to oppose a trilateral free trade arrangement. First, if Canada's interest in free trade was based on the understanding that market forces would transform Canada's industrial structure by forcing rationalization, enhancing specialization, and improving efficiency and productivity, it was believed that the added competition derived from the integration of the Canadian economy with a market as large and already interconnected as that of the United States would produce this desirable effect. Mexico's smaller market and the limited trade between Canada and Mexico initially convinced many in Canada that the economy would not benefit in terms of achieving more industrial transformation and economic growth if Canada were to opt to integrate its economy with that of Mexico's.

Second, the Canadian economy still felt the pressures of adjustment derived from CUFTA and the recession only made matters worse. Although industrial restructuring did create new employment opportunities and lead to business expansion, one could not avoid hearing about plant closings and layoffs attributed to investment outflows and the

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[88] Maxwell Cameron and Brian Tomlin, *The Making of NAFTA: How the Deal Was Done* (Ithaca: Cornell University Press, 2000), p. 64.

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recession. It was believed that integration with Mexico, a low-cost producer, would only lead to greater job losses and plant closings, particularly in the furniture, shoe, and garment industries, as investors relocated to Mexico to take advantage of lower costs of operation. Finally, the Tory government had gambled hugely when it decided that Canada would enter into a free trade agreement with the United States. Although it managed to marshal sufficient votes in support of the bilateral agreement, post-1988 public opinion trends appeared to be shifting against free trade. In a February 1991 opinion survey, 46 percent of Canadians supported a trilateral agreement whereas 50 percent opposed it.[89]

By late spring of 1990, the debate was much more even-handed between those in favor and against; by late summer, a consensus in support of a trilateral agreement had emerged within the government and a pro-NAFTA domestic coalition, involving the Tories, the BCNI, and most provinces with the exception of Ontario, Manitoba, and British Columbia, was formed. A number of elements contributed to this important shift in the dynamic of the debate. First, the government became concerned with protecting the relative gains it had secured through the CUFTA. Central to this concern was the belief that a bilateral Mexico-United States free trade agreement would undercut Canadian gains derived from its own bilateral arrangement with the United States. This would come about partly by improving Mexico's trade position relative to Canada and partly by enhancing United States' position relative to both countries. The logic of this argument was furnished by two economists, Richard Lipsey and Ronald Wonnacott, in

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[89] Lorraine Eden and Maureen Appel Molot, "The View from the Spokes: Canada and Mexico Face the United States," in Stephen Randall, Herman Konrad, and Sheldon Silverman, eds., *North America Without Borders?: Integrating Canada, the United States, and Mexico* (Calgary: University of Calgary Press, 1992), p. 75

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their respective work on the hub-and-spoke model.[90] According to the model, two separate bilateral free trade arrangements, both involving the United States, would confer on United States (the hub) the benefit of free trade access to both Mexico and Canada (the two spokes), while the two spokes would not enjoy free trade access to each other's markets and would confront the possibility that one could end up receiving more favorable free trade access to the United States than the other.

In terms of distribution of gains, this model demonstrated how Canada could be at a disadvantage if it chose not to participate in negotiations. American exporters would enjoy duty-free access to both countries, whereas Canada and Mexico would only enjoy such access to United States, and Canada's losses in the United States caused by Mexican competition could not be offset by an increase in Canadian trade in Mexico. In addition, Canada's losses could become greater if the bilateral Mexico-United States agreement provided Mexico with more preferential access to the United States than what Canada obtained under CUFTA. The model gained further attention when it was applied to investment patterns. Absent a deal that gave the two spokes reciprocal duty-free access to each other's markets, Canadian firms seeking to do more business in Mexico, could decide to relocate to the United States where they could enjoy such access to the Mexican market. The hub-and-spoke model advanced a scenario in which the United States would become the preferred location for investors seeking access to the two spokes and consequently drain Canada's industrial strength.

In sum, Canada's decision to join the NAFTA negotiations and its chief goal in the negotiations were profoundly shaped by what Grieco calls the 'defensive positionalist'

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[90] See Richard Lipsey, *Canada at the U.S.-Mexico Free Trade Dance: Wallflower or Partner*, Commentary no. 20 (Toronto: C.D. Howe Institute, 1990) and Ronald Wonnacott, *U.S. Hub-and-Spoke Bilaterals and the Multilateral Trading System* Commentary no. 23 (Toronto: C.D. Howe Institute, 1990).

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rationale.[91] In particular, Canada's overriding objective in the trilateral negotiations was to protect the gains of exchange it had secured in the CUFTA and which had made the arrangement worthwhile in terms of achieving Canada's industrial adjustment goals and being able to challenge American trade remedy decisions and other trade-related actions through the institutionalized dispute settlement mechanisms. As Minister of International Trade Michael Wilson remarked in 1991, "Canada is not going to let the United State get through the back door [NAFTA] what it failed to get through the front [FTA] door."[92]

The second factor contributing to Canada's decision to enter into trilateral talks was Ottawa's interest in improving the CUFTA. As Wilson notes, "We were not just looking to protect what we had won in the FTA, we wanted to enhance the FTA."[93] On the one hand, Canada could attempt to improve existing provisions or include new provisions in the expanded free trade arrangement. Of particular interest was the addition of a new chapter on intellectual property rights and expansion of existing chapters on government procurement and financial services. On the other hand, improvement could be achieved by resolving particular problems caused by some provisions in CUFTA, particularly with respect to rules of origin and Chapter 19.

The Honda customs case illustrated that more precise rules were needed to assist in the evaluation of rules of content. In March 1992, the U.S. Customs Service ruled that

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[91] As Grieco notes, "States seek to ensure...that their collaborative arrangements produce 'balanced or 'equitable' achievements of gains" and when "balanced sharing among partners of the gains" is undermined, a disadvantaged state may exit the arrangement or decide to defend its relative position. See Joseph Grieco, *Cooperation Among Nations: Europe, America, and Non-Tariff Barriers to Trade* (Ithaca: Cornell University Press, 1990), pp. 47-8. Although Grieco does not address the scenario in which Canada found itself as the United States and Mexico were about to initiate a bilateral that could possibly undermine Canada's distributive gains derived from its own bilateral arrangement with the United States, one can deduce the following from this realist-informed argument. If the gains from exchange have been important enough to Canada and more generally if the institutional framework that guides joint actions is crucial for advancing the interests of Canada, one would expect Canada to join trilateral talks in part to protect those distributive gains it has benefited from.

[92] Quoted in Cameron and Tomlin, p. 77.

[93] Michael Wilson, "Free Trade: Then and Now," in *Free Trade: Risks & Rewards*, p. 209.

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Canadian exports of Honda Civics from 1989 to 1990 failed to meet the CUFTA rules of content requirement. According to the U.S. Customs Service, the American made engines used in these Canadian assembled cars were made with too many foreign parts. The ruling provoked a strong response in Canada because Revenue Canada had concluded that these engines conformed with the agreement's rules of origin standard when they were imported into Canada.[94] In Article 1906 of Chapter 19 of CUFTA, Canada and the United States had agreed that "the provisions of this Chapter [would] be in effect for five years pending the development of a substitute system of rules in both countries for antidumping and countervailing duties as applied to their bilateral trade." The provision went on to state that both countries would be given an additional two years to come up with a common set rules, and if no agreement emerged at the end of this extension period, either country could choose to abrogate Chapter 19. Because this set of provisions was crucial for Canada, trilateral talks would give Ottawa an opportunity to fix the loophole tied to the provisional nature of Chapter 19.

The least important of the three factors that persuaded Canada to participate in trilateral talks was gaining access to the Mexican market. Canada began to appreciate the opportunity to increase trade with Mexico, regardless of how insignificant it was in the 1980s and the low priority Canadian businesses placed on this market. Of particular importance was that NAFTA would lower Mexican tariffs and non-tariff barriers to Canadian exports much more than it would for Canadian and American tariffs on each other's exports. The multilateral trade regime (GATT) allowed Mexican exports to enter the Canadian and American markets with lower tariff restrictions, but did not require

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[94] See "Customs Rules that Canadian Honda Civics Failed to Meet Content Standards under FTA," *International Trade Reporter* 10 (March 4, 1992), p. 384.

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Mexico to lower its tariffs to the same levels.[95] In sum, when the three governments announced in February 1991 that they would proceed with trilateral talks, Canada's chief concern was to "prevent any backsliding on the benefits it had received under the FTA and to make incremental improvements in the new agreement wherever possible."[96] Accordingly, Ottawa was going to sell NAFTA to Canadians by demonstrating how the new deal conserved and selectively improved Canada's position within a larger free trade area.

After an arduous eighteen months of negotiations, Ottawa was able to present a deal to Canadians which guaranteed the preservation of the distribution of gains it had secured under the CUFTA by folding many of the agreement's provisions into NAFTA and attained important improvements from CUFTA .[97] With respect to improvements, Chapter 4 of NAFTA specifies more clearly standards applying to rules of content, Chapter 10 increases the liberalization of government procurement markets, and Chapter 17 requires member countries, in particular Mexico, to adhere to rules applying to the protection of intellectual property established by international agreements, such as the Berne Convention. Moreover, unlike the investment chapter in CUFTA which only covered direct foreign investment, Chapter 11 of NAFTA covers a broader range of investment activities, such as equity and debt securities of a firm, loans to a firm, business real estate, for example. Also, it establishes a dispute settlement mechanism that allows an investor to challenge the treatment it receives in another NAFTA country.

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[95] Michael Hart, *A North American Free Trade Agreement: The Strategic Implications for Canada* (Ottawa & Halifax: Centre for Trade Policy and Law and Institute for Research on Public Policy, 1990).
[96] Gilbert Winham, "NAFTA and the trade policy revolution of the 1980s: a Canadian perspective," *International Journal* (Summer 1994). p. 504.
[97] Michael Hart, *A Trading Nation: Canadian Trade Policy from Colonialism to Globalization* (Vancouver: University of British Columbia, 2002), p. 395.

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Canadian and American negotiators went head-to-head particularly on three issues. Since CUFTA had come into effect in 1989, the American Congress was particularly incensed with Chapter 19 since it undercut its ability to exert influence over the conduct of American trade policy. Thus, in the negotiations the American negotiating team, led by Carla Hills, fought hard to weaken the dispute settlement mechanism of Chapter 19 of CUFTA. It sought to make it easier for a country to challenge a decision of a binational panel by modifying the extraordinary challenge procedure in Article 1904. Under this article, a country could invoke the extraordinary challenge procedure in which an Extraordinary Challenge Committee would be formed specifically to determine if a binational panel abused its powers or violated procedures or acted improperly.

By seeking to establish a special review mechanism in NAFTA, the American proposal, according to Canadian negotiators, would challenge the authority of binational panels. Canada effectively resisted such an effort, and after threatening to leave the negotiations an agreement was struck which incorporated Chapter 19 of CUFTA into NAFTA with minimal changes. Under the NAFTA's Chapter 19, the provision that allowed for the abrogation of this dispute mechanism once the 7 year period expired ("sunset termination") was removed, thus ensuring its permanency. Moreover, a number of new provisions were added that required Mexico to institute a trade remedy regime similar to that of Canada and the United States and to perform administrative practices of trade remedy laws similar to those in the other two countries.

Canada was also able to retain the right to screen foreign investment as outlined in CUFTA. In the trilateral negotiations, Canadian negotiators were adamant about not giving up Canada's foreign investment screening authority. In making his case to the

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American negotiators, International Trade Minister Wilson stated that "when you have as much Japanese investment in the US as we do from you, then you will understand our position."[98] In an attempt to bolster Canada's bargaining position, Canadian negotiators managed to convince Mexican negotiators not to give up their foreign investment screening powers which they were prepared to do with some exemptions.

Given Canada's intransigence and the fact that Mexico now wanted to retain its screening power, the United States had to drop its original demand of eliminating foreign investment screening. For Canada, this meant the incorporation into NAFTA under Chapter 11 the same investment screening rights it had secured under CUFTA—namely, review foreign takeovers that exceed $150 million and review any acquisition in the oil, gas, and uranium sectors. Finally, Canada managed to retain its right to protect the cultural industry—in particular, film and videos, musical recording, radio and television broadcasting, and printing publication. Knowing very well that Canada would not yield to the American request that it open its cultural industry, American negotiators discontinued their challenge of the cultural industry exemption Canada had gained through Article 2005 of CUFTA. As such, this complete exemption was incorporated into Chapter 21 of NAFTA, with a specific provision in Chapter 17 stating that intellectual property obligations do not apply to Canada's cultural industry.

NAFTA intrudes into provincial jurisdiction to a greater extent than had CUFTA. As a result, the provinces were consulted and briefed regularly throughout the trilateral negotiations using an intergovernmental mechanism similar to the one used in the CUFTA negotiations. In total, six First Ministers' meetings were held, in addition to the numerous meetings and discussions among officials from both levels of government.

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[98] Quoted in Cameron and Tomlin, *The Making of NAFTA*, p. 172.

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Moreover, the two side deals of NAFTA, the North American Agreement on Environmental Cooperation and the North American Agreement on Labor Cooperation, have affected the provinces far more than the federal government. Accordingly, the imperative of working closely with the provinces in order to formulate a Canadian proposal and ultimately to gain provincial compliance once the two side deals were finalized figured prominently in the way Ottawa proceeded in these negotiations. In no other previous international negotiations had the provinces been so involved as in the negotiations leading to the finalization of the side deals.[99]

Significantly, the combined effect of CUFTA and NAFTA on the internal market of Canada is that negative integration has taken place between the federal and provincial spheres of jurisdiction. The two regional free trade arrangements have caused some negative integration to the extent that they have required the two orders of government to limit their ability to employ particular policies that impede internal trade. Specifically, Ottawa and the provinces are prohibited from imposing restrictions on investment (Chapter 11 of NAFTA) and on financial services (Chapter 14 of NAFTA), the provinces are required to lower barriers on the distribution of wine and distilled spirits (Chapter 8 of CUFTA), both levels of government are prohibited from imposing restrictions in the energy sector, and the federal and provincial governments were restricted from having policies that interfere with the principle of national treatment.

What is unique about these coordinated efforts between the two levels of government is the fact that they have been the principal driving force behind the mutual withdrawal of federal and provincial states from the economy. Equally important is that

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[99] Grace Skogstad, "International Trade Policy and Canadian Federalism: A Constructive Tension?," in Herman Bakvis and Grace Skogstad, eds., *Canadian Federalism: Performance, Effectiveness, and Legitimacy* (Don Mill, Ont.: Oxford University Press, 2002), pp. 164-5.

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these joint actions have operated alongside these governments' respective individual market-imposing efforts, which was expected when competitive federalism is allowed to prevail. On the one hand, the autonomy afforded to provinces through competitive federalism has allowed them to pursue market liberalism in accordance with their interests, often following the same course of policy actions that have proven effective in other provinces. On the other hand, when both levels of government have recognized a common intergovernmental interest mobilized around a particular policy item. it has led to coordinated efforts such as those witnessed in the negotiations of CUFTA and NAFTA. As an industrial adjustment strategy, market liberalism has prevailed in Canada in part because it thrives through competitive federalism, that is through both autonomous and coordinated efforts of provincial and federal governments. This is in marked contrast to economic nationalism because, as illustrated in the two previous chapters, when this strategy is applied to competitive federalism it leads to competitive interventionism, which has frequently degenerated into a zero-sum game.

While NAFTA was negotiated when the Tories were in office, it came down to the Prime Minister Jean Chrétien's Liberal government to approve and implement the agreement. The general elections in October 1993 delivered a major defeat for the Tories, ending up with only 2 seats in the House of Commons after enjoying a comfortable majority for the past 8 years. With the Liberals in power many officials, remembering the party's anti-free trade position in the 1988 elections, believed that the new government would not enact NAFTA. On the contrary, the Liberals accepted free trade; in fact, they committed themselves to proceed with the strategy of market liberalism as the Tories had done. As Bradford notes, Chrétien's Liberals "exhibited

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important continuities with its PC predecessors. The basic policy direction was unchanged: the steady embedding of a neo-liberal national economic policy discourse."[100]

The institutionalization of market liberal policies was demonstrated with the ratification of NAFTA; it was also illustrated when the provinces and Ottawa negotiated the 1995 Agreement on Internal Trade (AIT).[101] The AIT reflected a growing interest among first ministers and Ottawa to accelerate the reduction of interjurisdictional barriers resulting from non-tariff barriers used by provinces. This reflected their commitment to achieve domestically what CUFTA and NAFTA had achieved in terms of deepening and broadening trade within the North American region.

Although the AIT does not undermine provincial ability to act autonomously, the agreement does help enhance negative integration in several ways. It eliminates some discriminatory procurement practices and most discriminatory pricing, it prevents governments from using residency requirements as a condition for occupational licensing and professional services, and prevents governments from using various investment restrictions as well as certain types of industrial and agricultural subsidies.[102] In addition to the general operating procedure of mutually reducing and eliminating barriers to trade in goods and services and mobility of people, the AIT sets up a dispute settlement procedure to adjudicate disputes arising from cases of nonconformity with the AIT. The AIT represents an important development in intergovernmental relations for governments

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[100] Neil Bradford, *Commissioning Ideas*, 1998, p. 126.
[101] The AIT was negotiated between March 1993 and June 1994.
[102] See Douglas Brown, *Market Rules: Economic Union Reform and Intergovernmental Policy-Making in Australia and Canada* (Montreal & Kingston: McGill-Queen's University Press, 2002), pp. 146-178.

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have made a commitment to substitute market forces for political judgments in important though not all aspects of the operation of the Canadian internal market.

Unlike the strategy of economic nationalism, domestic institutions enabled domestic agents of continentalism to proceed effectively with this adjustment strategy in a consistent and continuous manner and to achieve policy institutionalization. The strategy has capitalized on those state strengths and limitations that are closely derived from the existing domestic institutional structure. First, the strategy did not require the creation of new interventionist instruments nor demand the centralization of bureaucratic administration which the existing organizational structure failed to yield. In fact, Prime Minister Mulroney's government dismantled or streamlined many of the bureaucratic apparatuses that Prime Minister Trudeau had built in an attempt to bring about more coherent, coordinated, and centralized economic planning. Instead, the strategy of continentalism made wide use of the federal state's market instruments already at its disposal and bureaucratic affinity with the ideology of limited government intervention and with the economic policy approach of incremental (and silent) continentalization which had contributed to bringing Canada and the United States closer together over the course of several decades. The result of this has been a bureaucratic apparatus tailored for the promotion of market governance.

Second, market liberalism has been facilitated by the arm's-length pattern of business-government relations that has been a principal feature of Canada's domestic structure. Such a pattern is based on the normative expectation that the private and public sectors should remain distinct spheres and relatively autonomous, and that state initiatives in the private sector should reflect the interest of market players rather than the state.

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Continentalism builds on this internal logic of arm's-length relations by seeking to enhance the autonomy of the private sector while gradually reducing the scope of state authority. Finally, market liberalism capitalizes on competitive federalism, the prevailing mode of intergovernmental relations in the economic arena. Market liberalism produces positive industrial adjustment results when the two levels of government act either autonomously or jointly. This is in contrast to economic nationalism's demand for constant joint action between the two levels of government, which competitive federalism failed to facilitate.

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CHAPTER NINE

CONCLUSION: REVIEWING THE HYPOTHESES

Since its adoption in the mid-1980s, the strategy of economic liberalism has successfully guided Canadian industrial adjustment efforts. Canada's industrial structure has moved away from its branch-plant character to become a sophisticated, diversified, and technology-oriented one. Canadian exports of manufactured and technology-intensive goods have increased drastically. Although over 80 percent of its exports go to the United States and Canada's dependence on its neighbor has increased, current patterns of bilateral economic exchange have proven to be relatively more advantageous for Canada than they were prior to continental free trade.[1] The relative economic gains generated through the present terms of exchange have not only ensured continuous economic growth and industrial development in Canada, but have preserved and enhanced Canada's position vis-à-vis the United States.

Embedding market governance continues to be Ottawa's response to the constant need to adjust Canada's industrial structure. In 2002, Ottawa launched a national strategy designed to assist the private sector in achieving a commanding international position in science by 2010. The objectives of the strategy are for Canada to be among the top five countries that lead in research and development performance, to double Canada's

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[1] In 2001, 43 percent of Canada's GDP was accounted for by exports. Approximately 85 percent of Canadian exports were destined for the United States, representing 19 percent of America's total imports. In the early 2000s, American-owned companies operating in Canada were responsible for creating 1 million jobs in the country and their combined activities accounted for 10 percent of Canada's GDP. Importantly, although bilateral dependence remains asymmetrical between the two neighboring countries, the gap has narrowed slightly since the 1990s. In 2001, the United States exported more to Canada than to the 15 European Union countries. Canada received 22 percent of the United States' total exports in 2001. Canadian-owned companies operating in the United States have created 640,000 jobs in the United States. See Michael Hart and William Dymond, *Common Borders, Shared Destinies: Canada, the United States and Deepening Integration* (Ottawa: Centre for Trade Policy and Law, 2001) and Earl Fry, "Canada-US Economic Relations: A Window of Opportunity," *Policy Options* (February, 2003).

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investment expenditures in research and development, to be among the leading countries whose private sectors account for the largest share of innovation development, and to match the American level of venture capital investments per capita.[2] Consistent with economic liberalism, Ottawa has striven to attain these goals by employing market instruments. In particular, Ottawa has focused on creating an ideal business climate in part to induce domestic private sector actors to work toward these goals, but also to attract foreign investors who can assist Canada in attaining these objectives. Below I will assess the three hypotheses I made at the outset of this study.

STATE RESPONSES TO SYSTEMIC CHANGES

States respond to changes in their external environment. Such changes frequently open new or close existing windows of opportunity for state action. This study has attempted to show how Canada responded to changes in its external environment and in turn affected the way in which Canada dealt with the problem of industrial adjustment. More specifically, the systemic level of this study's framework of analysis focused on shifts in relative capabilities and in exposure to negative externalities, particularly vis-à-vis the United States. In this study I argued that the deterioration of Canada's relative economic capabilities and increased exposure to American externalities in the late 1960s and early 1970s pressured Ottawa to pursue the Third Option, which sought to diversify the country's export markets and commodities. Moreover, because such a shift in Canada's position restricted Ottawa's ability to maneuver internationally, the Third

[2] Department of Foreign Affairs and International Trade, "Notes for an Address by the Honourable Pierre Pettigrew, Minister for International Trade at a luncheon with Business and Science Executives," *Statements* (April 5, 2002).

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Option was heavily geared toward domestic adjustment through gatekeeping and economic planning.

The moderate improvement in Canada's relative capabilities in the late 1970s and early 1980s, plus continued exposure to American externalities disposed Ottawa to consider seriously the option of entering into a free trade arrangement with the United States. This foreign policy reorientation confirms Grieco's "relative disparity shift" argument, in which he posits that a weaker state will become more favorable to the idea of deepening economic ties with a powerful state if the former's relative economic capabilities have at a minimum been stable and, at best, registered modest improvements in recent years.[3] In contrast to economic nationalism, economic liberalism had an important international component. It was based on the goal of achieving a free trade deal which not only established the right conditions to help Canada redress the problem of industrial adjustment, but also secured Canada's relative position and dealt effectively with the rising threat presented by American trade remedy laws. This strategy's international focus became an important catalyst for domestic-level adjustment measures, most notably the embedding of market governance through privatization and deregulation.

This study's attempt to marry theories of international politics and comparative politics is certainly not a new enterprise among political scientists. For instance, in the past years some realist-informed theorists, neoclassical realists as they are referred to, have used basic realist propositions to explain the foreign policies of countries. Walt observes that "power is the underlying variable in the neoclassical version of realist

[3] Joseph Grieco, "Sources of Variation in Regional Institutionalization in Western Europe, East Asia, and the Americas," in Edward Mansfield and Helen Milner, eds., *The Political Economy of Regionalism* (New York: Columbia University Press, 1997), p. 176.

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theory, but the causal logic of the theory places domestic politics as an intervening variable between the distribution of power and foreign policy behavior."[4] Although this study was partly inspired by this new line of thinking, my framework of analysis goes beyond the sole focus of relative power to include exposure to externalities, which is derived from the systemic condition of interdependence. This is an important complement to an analysis of power relations in part because interdependence does create certain systemic opportunities and constraints on state action. In addition, the treatment of the two systemic variables is insightful given the fact that cross influences occur between the two variables. For instance, shifts in relative capabilities affect the way in which a government will deal with its country's pattern of interdependence with another country.

LINKING INDUSTRIAL ADJUSTMENT STRATEGIES WITH INSTITUTIONAL FRAMEWORKS

As this study has illustrated, the pursuit of different industrial adjustment strategies requires the presence of an appropriate institutional framework. More specifically, institutions must equip policy makers with the organizational and instrumental capacities that are necessary to implement and attain the goals of an adjustment strategy. Coordination is a key aspect of implementing any industrial adjustment strategy. As this study has shown, economic nationalism—which seeks to redress the problem of industrial adjustment by subjecting economic decisions to greater state discretion—requires an institutional framework that facilitates non-market coordination. According to Streeck, non-market coordination requires a national institutional structure which relies

[4] Stephen Walt, "The Enduring Relevance of the Realist Tradition," in Ira Katznelson and Helen Milner, *Political Science: State of the Discipline* (New York: WW. Norton, 2002), p. 211.

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"on various forms of hierarchical and organizational coordination that sometimes requires heavy injections of public authority, with vertical control or horizontal collective bargaining."[5] On the other hand, economic liberalism—which seeks to address the problem of industrial adjustment by subjecting economic decisions to market governance—strives in an institutional setting that facilitates market coordination. Hall and Soskice have recently made a similar observation in their work on 'varieties of capitalism.' They note that "in liberal market economies, where coordination is secured primarily through market mechanisms, better economic performance may demand policies that sharpen market competition, while coordinated market economies may benefit more from policies that reinforce the capacities of actors for non-market coordination."[6]

Moreover, economic nationalism functions best within an institutional framework which centralizes authority. In such an institutional setting, one finds a centralized pattern of intergovernmental coordination, a centralized and coherent bureaucratic apparatus, and a centralized pattern of interest representation that underpins the interface between particular economic groups and the state. Economic liberalism works best within an institutional framework where authority is decentralized. For instance, economic liberalism is suitable in countries where competitive federalism is found, which maximizes the flexibility of governments by allowing them to act autonomously or to coordinate their policy actions, depending on what is in their best interest. This

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[5] Wolfgang Streeck, "Introduction: Explorations into the Origins of Nonliberal Capitalism in Germany and Japan," in Wolfgang Streeck and Kozo Yamamura, eds., *The Origins of Nonliberal Capitalism: Germany and Japan in Comparison* (Ithaca: Cornell University Press, 2001), p. 6.

[6] Peter A. Hall and David Soskice, "An Introduction to Varieties of Capitalism," in Peter Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York: Oxford University Press, 2001), p. 46.

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adjustment strategy is also compatible where an arm's-length pattern of government-societal relations prevails. Such political economic institutionalization maximizes the autonomy of the atomized, private sector and minimizes the scope of public action. Finally, economic liberalism is suitable where the national politico-administrative structure is fragmented and decentralized, and thus exposed to numerous veto points which hinder centralized strategic economic decision-making. Instead of laboring within an unsuitable bureaucratic system to make the kind of state decisions that would produce effective adjustment in the economy, the market is designated the key mechanism to attain such a goal.

The extent of non-market coordination and centralization of authority significantly shapes the organizational capacities that policy makers can marshal as they seek to pursue industrial adjustment policies. Particular industrial adjustment strategies require specific constellations of organizational capacities and policy instruments. Policy makers are most efficacious in pursuing economic liberalism when they are situated in a national political economic structure that makes it easy to expand market coordination, which is facilitated by the fact that the decentralized character of authority keeps the state largely fragmented, detached from key economic players, and incapable of expanding its interventionist capacities. Not only does this type of national institutional system confer upon policy makers these organizational capacities, but it will also equip them with valuable market instruments that will help policy makers embed market governance. On the contrary, policy makers can better pursue economic nationalism when they are situated in an institutional framework that makes it easy to enhance non-market coordination given the fact that authority is already centralized through centralized

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structures. In addition to possessing these organizational capacities, policy makers will also benefit from policy instruments that enable them to act strategically in the economy by engaging in selective capital allocation as well as other measures.

This study has attempted to show that Canada's national political economic system was more appropriate to pursue economic liberalism than economic nationalism as a means of industrial adjustment. This study has broader implications with respect to the logic of state response to economic problems. The past decade has seen an increase in the literature on comparative capitalism or models of capitalism.[7] Hall and Soskice, for example, suggest that different types of capitalist models have distinct comparative institutional advantages which produce distinct state capacities for action. In their efforts to deal with such an economic problem as industrial adjustment, "coordinated market economies," such as those found in Japan and Germany for example, tend to confer upon governments the capacity to mobilize industry collaboration and coordinate industrial strategy, capacities that are central to the strategy of economic nationalism.[8] "Liberal market economies," such as those found in the United States and Canada, tend to be less effective in pursuing coordination-based adjustment policies because key economic groups are less organized and not willing to be guided by an implicit contract with the government. Consequently, such a model of capitalism confers on governments the

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[7] A small sample would include Michel Albert, *Capitalism vs. Capitalism* (Paris: Seuil, 1991); Wolfgang Streeck and Kozo Yamamura, eds., *The Origins of Nonliberal Capitalism: Germany and Japan in Comparison* (Ithaca: Cornell University Press, 2002); Peter Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York: Cambridge University Press, 2001); Peter Gourevitch, "The Macropolitics of Microinstitutional Differences in the Analysis of Comparative Capitalism," in Suzanne Berger and Ronald Dore, eds., *National Diversity and Global Capitalism* (Ithaca: Cornell University Press, 1996); Herbert Kitschelt, Peter Lange, Gary Marks, and John Stephens, eds., *Continuity and Change in Contemporary Capitalism* (New York: Cambridge University Press, 1999); and Robert Gilpin, "Economic Evolution of National Systems," *International Studies Quarterly* 40 (1996).

[8] Coordinated market economies tend to have strong producer-group organizations that, according to Hall and Soskice, are willing to "enter into 'implicit contracts' with the government to administer" coordination-oriented policies. Hall and Soskice, "An Introduction to Varieties of Capitalism," p. 48.

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capacity to implement market-incentive policies as they seek to effect industrial adjustment in their national economies. Such market-enhancing policies will engender positive adjustment by creating more room for free contracting among private actors and enforcing such transactions by institutionally embedding market governance.

Although this study builds on this body of literature, it differs slightly to the extent that I put more emphasis on key political structures, namely the organizational structures of provincial-federal relations and of the national bureaucracy. Although the recent literature on comparative capitalism has not abandoned this particular area of focus, it appears that there is less attention being paid to the influence of political structures and more on the organization of particular economic groups, the type of linkage arrangement among them, and the type of interface that exists between economic groups and the state. My judgment is based on a comparison of past and recent literature on this topic. For example, Katzenstein, Ikenberry, Zysman, Shonfield, and Hall's past works appreciate more explicitly the role of different structures of bureaucracy in determining a government's ability to respond to economic problems.[9] Even less work has been done to compare the effects of different patterns of intergovernmental relations on state capacity; for the most part, country-specific studies of particular federal systems, such as my study on Canada, have generated knowledge about the link between federalism and

[9] Peter Katzenstein, *Small States in World Markets: Industrial Policy in Europe* (Ithaca: Cornell University Press, 1985; Peter Katzenstein, ed., *Between Power and Plenty: Foreign Economic Policies of Advanced Industrial States* (Madison: University of Wisconsin Press, 1978); G. John Ikenberry, *Reasons of State: Oil Politics and the Capacities of American Government* (Ithaca: Cornell University Press, 1988); John Zysman, *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change* (Ithaca: Cornell University Press, 1983); Andrew Shonfield, *Modern Capitalism: The Changing Balance of Public and Private Power* (New York: Oxford University Press, 1970); and Peter Hall, *Governing the Economy: The Politics of State Intervention in Britain and France* (New York: Oxford University Press, 1986).

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state capacity. The comparative capitalism research design may thrive even more than it has in recent years by integrating more systematically economic and political institutions.

THE POLITICS OF INSTITUTIONAL CHANGE

Path dependence means that the entrenched nature of institutional arrangements increases the cost of deviating from previous institutional choices as policy makers seek to respond effectively to a new problem. The existing institutional order significantly affects human agency because of its enabling and constraining effects. In understanding this dynamic between structure and agency, the increasing returns process that underpins path dependence can shed some light. As Pierson observes, three factors generate increasing returns. First, the start-up costs in the creation of new organizations and institutions are high, a condition which is partly attributed to the fact that old institutions generate learning effects which dispose individuals to prefer maintaining them over creating new ones. Over time, individuals become accustomed to working within existing institutions which in turn generates experience and greater effectiveness in achieving the goals of individuals. Second, institutions produce coordination effects to the extent that the benefits an institutional actor receives from an activity are enhanced when other institutional actors align or coordinate their activities accordingly. Finally, increasing returns are generated by the process of adaptive expectation, whereby a political actor will make a choice based on how it expects others to respond.[10]

Because institutional politics exhibits dynamics of increasing returns, the adaptation efforts of institutional innovators will be obstructed if such efforts mark a

[10] Pierson notes that adaptive expectations are prevalent in political life, particularly when institutional innovators seek to change institutions. "When picking the wrong horse may have very high costs, actors must constantly adjust their behavior in the light of how they expect others to act." Pierson, "Increasing Returns, Path Dependence, and the Study of Politics," p. 258.

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significant departure from the existing institutional order. The increasing returns dynamic shapes institutional adaptation outcomes by influencing the preferences and the strategies used by institutional innovators to effect institutional change. As Wood points out, this dynamic will manifest itself in a particular sequence of causal processes. "First, policies [and institutions] generating learning, coordination, and adaptive expectations effects shape the interests of key actors; second, these actors press for the maintenance of the conditions responsible for these effects."[11] Importantly, path dependence does not preclude institutional change. Instead, institutional changes are path dependent to the extent that alterations typically follow a track that takes advantage of increasing returns stemming from the existing institutional design. Thus, Levi suggests that "perhaps the better metaphor" for path dependent institutional change "is a tree, rather than a path. From the same trunk, there are many different branches and smaller branches..., the branch on which a climber begins is the one she tends to follow."[12]

This study has attempted to show how the interaction between human agency and the enabling and constraining effects of structures have affected the way Canada has dealt with the problem of industrial adjustment. In Chapter two, I elaborated on two types of political strategies that policy makers have resorted to in order to bring about the necessary institutional changes that support a particular industrial adjustment strategy. The relational power strategy focuses on changing the internal organization of the federal state in order to produce better coordination and planning. This strategy also seeks to

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[11] Stewart Wood, "Labour Market Regimes under Threat? Sources of Continuity in Germany, Britain, and Sweden," in Paul Pierson, ed., *The New Politics of the Welfare State* (New York: Oxford University Press, 2001), p. 375.

[12] Margaret Levi, "A Model, A Method, and a Map: Rational Choice in Comparative and Historical Analysis," in Mark Irving Lichbach and Alan S. Zuckerman, eds., *Comparative Politics : Rationality, Culture, and Structure* (New York: Cambridge University Press, 1997), p. 28.

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enhance the capacity of the state to act unilaterally. The meta-power strategy seeks to improve coordination of actions between the federal state and societal groups and between the federal state and the provinces. This study has shown that neither political strategy produced optimal institutional change when they were used by Trudeau to pursue economic nationalism. However, these two strategies did generate optimal institutional change when Mulroney used them to implement economic liberalism.

This study has attempted to reveal the crosscutting currents that pushed for and against institutional change associated with economic nationalism. What is particularly interesting is the clash that occurred between the determined effort of Ottawa to erect the necessary institutional structures that would support the Third Option, on the one hand, and the obstruction posed by resistant institutional actors, on the other hand. The latter was attributed to the dynamic associated with the increasing return process. This was illustrated with respect to the changes to the three institutional arrangements this study has focused on: the organizational structure of the federal state, the organizational structure of state-society relations, and the organizational structure of intergovernmental relations.

Rational management was an effort launched by Prime Minister Trudeau in the 1970s and early 1980s to reorganize the federal political executive in order to improve its planning and administrative capacities. The attempt proved quite important given the fact that the Third Option—particularly the gatekeeping and planning components of this adjustment strategy—depended on the existence of a cohesive group of policy makers who could formulate a coherent course of policy actions to achieve the goals of the Third Option. However, consistent with the path dependent process, Trudeau's efforts to reform

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the organization of federal decision-making authority were not sufficient to overcome the institutional inertia that favored the preservation of a diffused, fragmented, and decentralized bureaucratic structure. The cost of creating new horizontal organizations to facilitate coordination were high, in part because bureaucratic actors were required to learn new roles, become familiar with new modes of interaction, and follow new decision-making procedures which they did not support. Also, there was evidence of adaptive expectations at work on the part of the Trudeau government toward the later years of gatekeeping and economic planning efforts. This partly explains why Trudeau slowly pulled back from gatekeeping by retreating from his campaign promise of toughening FIRA in 1980 and subsequently partially liberalizing FIRA in 1982. A similar move occurred with respect to economic planning as Trudeau settled for the national industrial planning design—namely, megaprojects—that required the least amount of centralized, state intervention.

With respect to state-society relations, Trudeau attempted to enhance Ottawa's capacity to coordinate change with the business community and labor. In many respects, Trudeau sought to improve Ottawa's "transformative capacity," which Weiss defines as the establishment of linkages between the state and "key economic groupings [through which] the state can extract and exchange vital information with producers, stimulate private-sector participation in key policy areas, and mobilize a greater level of industry collaboration in advancing national strategy."[13] In the 1970s, Ottawa embarked on a number of initiatives that sought to strengthen its ties with the business community (and labor with respect to economic planning) as a way to diversify Canada's exports away from the American market and arrive at a new industrial development policy. For

[13] Linda Weiss, *The Myth of the Powerless State* (Ithaca: Cornell University Press, 1998), p. 39.

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instance, between 1975 and 1977, Ottawa was pressured into initiating consultations with business and labor as the government pursued a policy of price and wage controls. This set the stage for succeeding rounds of consultation, this time on the issue of industrial development. The Enterprises 77 initiative, the creation of 23 industry sector forces in 1978 and of the Tier II Committee, and the Blair-Carr Task Force were four important efforts launched by Ottawa to extend and deepen its institutional ties with the business community and labor in order to find common objectives that were to inform Ottawa's industrial development policy.

Again, increasing returns dynamics obstructed progress toward mobilizing societal consensus and enhancing coordination with key economic groups. Although noteworthy for the amount of information and ideas shared between Ottawa and business and labor, the historical absence of routine mutual collaboration as well as the entrenchment of the arm's-length pattern of state-societal relations limited the accomplishments of these efforts. The arm's-length arrangement between the state and economic groups has historically reflected the latter's desire to limit state involvement in their affairs and preserve their autonomy and flexibility of action, and reflected the belief (more so for the business community than for labor) that the private sector is more efficacious than the state in dealing with most economic issues. As for the state actors, the prevalence of this pattern of relations obviated the need for developing institutional networks through which it could elicit the coordination of particular economic groups and for developing specific policy instruments with which to induce private actors to assist in advancing state goals. This institutional arrangement therefore created very high learning and coordination costs as both sets of actors were required to learn new roles, learn to work with each other and

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give up some autonomy, and learn to identify and attain collective and mutual goals rather than particularistic and private ones.

With respect to intergovernmental relations, the competitive nature of Canadian federalism was a major obstacle to attaining coordination of industrial adjustment policies between the two orders of government, a crucial institutional requirement to ensure the successful pursuit of economic nationalism. Still, Ottawa undertook important efforts in that direction. Trudeau sought to achieve intergovernmental coordination through two modes of interaction: multilateralism and bilateralism. Whereas multilateralism refers to an arrangement encompassing the federal government and two or more provinces, bilateralism involves the federal government and one province. Most notable among the multilateral efforts were the two First Ministers Conferences on the Economy in 1978; the DREE's GDAs were important bilateral efforts. Between multilateralism and bilateralism, the latter has been more frequently employed by Ottawa to promote intergovernmental cooperation to pursue the Third Option. Bilateral agreements between Ottawa and a province have in many cases paved the way for multilateral agreements, but in other cases Ottawa has used them strategically to avert the difficulty of arriving at agreements with ten self-interested actors, as well as the prospect that it has to go up against a common provincial front. That was the advantage in arranging individual GDAs with each province.

The need for intergovernmental coordination was often beset by competitive federalism in the policy arena of industrial adjustment, which invites both autonomous actions by individual governments and collective action only when convergence of interests emerges among governments. Of some significance, the postwar period had

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seen provinces become more than ever before willing to assert their constitutional prerogatives and expand their range of responsibilities within provinces. Therefore, as provinces learned this role and became more effective at being masters of their own jurisdictional domain, they would become less inclined over time to substitute national goals for provincial goals, especially in such a policy arena as economic development. Thus, although some coordination did take place between the two levels of government, some episodes of intergovernmental relations were marked by a thrust and riposte mode of interaction.

Such a dynamic was caused when the two levels of government acted independently in a policy sphere which required either coordination or the voluntary extrication by one order of government. As Leslie puts it, thrust and riposte arises when "neither order of government [can] oust the other from [a policy field]," and both are pursuing competing objectives therein. The mode of interaction that emerges is "akin to a form of signal-sending between rival powers," and often becomes a situation resembling the "domestic brinkmanship of federal and provincial governments...leading to formation of policy by a sequence of unilateral actions."[14] For instance, this dynamic was set in motion after the introduction of GDAs. GDAs emboldened provinces to pursue economic provincialism more assertively which was subsequently counteracted when Trudeau attempted to shift economic planning efforts to the national level after experimenting at the regional level. It was repeated in wake of the National Energy Program as Alberta and Ottawa went head-to-head over the program's energy measures.

There was a broader increasing returns process at work when Trudeau was seeking to lay down the appropriate institutional groundwork to pursue economic nationalism.

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[14] Peter Leslie, *Federal State, National Economy* (Toronto: University of Toronto Press, 1987), p. 66.

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As I discussed in the early section of this chapter, economic nationalism required an institutional design that facilitated coordinated policy actions. Its success depended on the simultaneous creation of compatible government-societal, federal-provincial, and bureaucratic institutional arrangements that all enhanced coordination. This is what Pierson refers to as the coordination effects; that is "the benefits of our individual activities or those of an organization are often enhanced if they are coordinated or 'fit' with the activities of other actors or organizations."[15] Thus, because Trudeau muddled through at various speeds and with failed results the task of building an appropriate institutional design that would accommodate economic nationalism, Trudeau never achieved "coordination effects," which significantly undermined Ottawa's ability effectively to pursue this industrial adjustment strategy.

If increasing returns dynamics obstructed the process of building the necessary institutions to support the Third Option, this self-reinforcing dynamic eased the process of implementing and institutionally embedding market liberalism. This outcome, in many respects, signified "bounded change" or the development of "new branchings."[16] Institutional change followed the institutional logic of previous institutional choices and consequently reinforced the trajectory of previous institutional developments. Economic liberalism had the effect of not only preserving competitive federalism but also of subjecting it to a greater degree of market coordination, as NAFTA and the Agreement on Internal Trade have achieved. The result is that market governance has been embedded in the institutional framework governing provincial-federal relations. With

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[15] Pierson, "Increasing Returns, Path Dependence, and the Study of Politics," p. 254.
[16] Paul Pierson, "Not Just What, but When: Timing and Sequence in Political Processes," *Studies in American Political Development* 14 (Spring 2000) and Kathleen Thelen, "Timing and Temporality in the Analysis of Institutional Evolution and Change," *Studies in American Political Development* 14 (Spring 2000).

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respect to the arm's-length pattern of state-societal relations, economic liberalism has extended the private sphere and further exposed economic transactions therein to the regulatory force of market governance. This signifies an important reinterpretation of the role of government in the economy and suggests a definitive movement away from the public enterprise culture. This movement, however, does not represent a significant departure from the previous institutional trajectory since the public enterprise culture limited state intervention in the economy to specific functions that did not interfere with private sector initiatives.

Finally, economic liberalism facilitated the development of a leaner federal bureaucratic structure, which proved more appropriate given the fragmented and decentralized character of authority that has been a key feature of this structure. By substituting market governance for state-guided initiatives, Mulroney eliminated the friction points that had gained intensity as competing bureaucratic interests, nationalist and liberal advocates, were brought together by the new horizontal and vertical bureaucratic structures that Trudeau had attempted to create. Under economic liberalism, the federal economic bureaucracy has channeled its capacity toward ensuring that market governance functions properly, which has led to the development of a minimalist state.

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Appendix I: Residence and Citizenship of Directors and Presidents in Firms With Assets Above $25 Million By Degree of Non-Resident Ownership

	Director			President		
Degree of Non-resident Ownership	Total Dir	# of firms with Directors Residing in Canada	# of Directors Residing in Canada Who are Canadian Citizens	Firms	Firms with a President residing in Canada	Presidents Residing in Canada who are Canadian Citizens
95% & over	841	391	317	94	66	39
75 to 94.9%	232	145	123	21	19	10
50 to 74.9%	259	165	152	23	18	13
25 to 49.9%	236	192	186	22	21	20
5 to 24.9%	438	399	392	39	38	35
Under 5%	155	150	148	18	18	17
Total	2,162	1,442	1,304	217	180	134

Source: Government of Canada, *Foreign Direct Investment in Canada* (Ottawa, 1972), p. 143.

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Appendix II: Cases of Extraterritoriality (initiated by American Government)

Case	Intensity of Conflict	Value of Solution for Canadian Government	Issue Area
Ontario documents (1950)	high	favorable	antitrust
Alcoa (1950)	low	unfavorable	antitrust
Canadian Industries (1951)	low	unfavorable	antitrust
Ford trucks (1957)	high	unfavorable	export controls
Rayonier (1958)	low	favorable	export controls
Alcan-China (1959)	low	unfavorable	export controls
Fairbanks-Morse (1959)	low	favorable	export controls
Radio patents pool (1959)	high	unfavorable	antitrust
Peat moss (1959)	low	favorable	antitrust
1965 guidelines (1965)	high	favorable	balance-of-payments
Cuba flour (1965)	moderate	unfavorable	export controls
Vietnam drugs (1965)	low	unfavorable	export controls
Schlitz-Labatt (1966)	low	neutral	antitrust
Standard Oil-Potash (1966)	low	neutral	antitrust
1968 guidelines (1968)	very high	favorable	balance-of-payments
Chrysler wage freeze (1971)	high	unfavorable	balance-of-payments

Notes: This data was compiled by the author from David Leyton-Brown's study on American multinational corporations operating in Canada. The 16 cases of extraterritoriality form the largest category of cases out of a total of 27 cases studies by Leyton-Brown.
Source: David Leyton-Brown, "The Multinational Enterprise and Conflict in Canadian-American Relations," *International Organizations* (1978).

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Appendix III: Guidelines of Good Corporate Citizenship

(a) pursuit of sound growth and full realization of the company's productive potential, thereby sharing the national objective of full and effective use of the nation's resources;
(b) realization of maximum competitiveness through the most effective use of the company's own resources, recognizing the desirability of progressively achieving appropriate specialization of productive operations within the internationally affiliated group of companies;
(c) maximum development of market opportunities in other countries as well as in Canada;
(d) where applicable, to extend processing of natural resource products to the extent practicable on an economic basis;
(e) pursuit of pricing policy designed to assure a fair and reasonable return to the company and to Canada for all goods and services sold abroad, including sales to the parent company and other foreign affiliates;
(f) in matters of procurement, to search out and develop economic sources of supply in Canada;
(g) to develop as an integral part of the Canadian operation wherever practicable, the technological, research and design capability necessary to enable the company to pursue appropriate product development programs so as to take full advantage of market opportunities domestically and abroad;
(h) retention of a sufficient share of earnings to give appropriate financial support to the growth requirements of the Canadian operation, having in mind a fair return to shareholders on capital invested;
(i) to work toward a Canadian outlook within management, through purposeful training programs, promotion of qualified Canadian personnel and inclusion of a major proportion of Canadian citizens on its board of directors;
(j) to have the objective of a financial structure which provides opportunity for equity participation in the Canadian enterprise by the Canadian public;
(k) periodically to publish information on the financial position and operations of the company;
(l) to give appropriate attention and support to recognized national objectives and established government programs designed to further Canada's economic development and to encourage and support Canadian institutions directed toward the intellectual, social and cultural advancement of the community.

Source: Government of Canada, *Foreign Direct Investment in Canada*, (Ottawa: Information Canada, 1972), pp. 324-325.

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Appendix IV: Principles of International Business Conduct ("Gillespie Guidelines")

(a) pursue a high degree of autonomy in the exercise of decision-making and risk-taking functions, including innovative activity and the marketing of any resulting products;
(b) develop as an integral part of the Canadian operation an autonomous capability for technological innovation, including research, development, engineering, industrial activities,; and for production, marketing, purchasing and accounting;
(c) retain in Canada a sufficient share of earnings to give strong financial support to the growth and entrepreneurial potential of the Canadian operation, having in mind a fair return to shareholders on capital invested;
(d) strive for a full international mandate for innovation and market development, when it will enable the Canadian company to improve its efficiency by specialization of productive operations;
(e) aggressively pursue and develop market opportunities throughout international markets as well as in Canada;
(f) extend the processing in Canada of natural resource products, to the maximum extent feasible on an economic basis;
(g) search out and develop economic sources of supply in Canada for domestically produced goods and for professional and other services;
(h) foster a Canadian outlook within management, as well as enlarged career opportunities within Canada, by promoting Canadians to senior and middle management positions, by assisting this process with an effective management training program, and by including a majority of Canadians on boards of directors of all Canadian companies, in accordance with the spirit of federal legislative initiatives;
(i) create a financial structure that provides opportunities for substantial equity participation in the Canadian enterprise by the Canadian public;
(j) pursue a pricing policy designed to assure a fair and reasonable return to the company and to Canada for all goods and services sold abroad, including sales to parent companies and other affiliates. In respect to purchases from parent companies and affiliates abroad, pursue a pricing policy designed to assure that the terms are at least as favourable as those offered by other suppliers;
(k) regularly publish information on the operations and financial position of the firm;
(l) give appropriate support to recognized national objectives and established government programs, while resisting any direct or indirect pressure from foreign governments or associated companies to act in a contrary manner;
(m) participate in Canadian social and cultural life and support those institutions that are concerned with the intellectual, social, and cultural advancement of the Canadian community; and,
(n) endeavour to ensure that access to foreign resources, including technology and know-how, is not associated with terms and conditions that restrain the firm from observing these principles.

Source: Government of Canada, Board of Economic Development Ministers, *Action for Industrial Growth: Continuing the Dialogue* (Ottawa, February 1979), Annex II.

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