THIRD OPTION REVISITED: AN INSTITUTIONAL ANALYSIS OF CANADIAN INDUSTRIAL ADJUSTMENT IN THE 1970S AND EARLY 1980S

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Comments Welcome

Canada's industrial adjustment problem began to weigh heavily in the minds of government officials starting in the late 1960s. Its origin can be traced to Canada's differential rate of economic progress relative to the United States and to other advanced industrial economies. The adjustment problem assumed three interlocking characteristics: first, the relative decline of Canada's share of world manufacturing activities, second, the increasing penetration of American capital in Canadian industries and its contributing role in creating economic structural deficiencies, and third, the increasing vulnerability of the Canadian economy to American economic policy changes.

By the 1960s the postwar pattern of economic activities between Canada and the United States was beginning to have serious economic and political consequences on the Canadian economy. The economy struggled to remain internationally competitive, accomplish technological progress, and increase exports of high-technology manufactured goods. Politically, bilateral interdependence was increasingly undermining Canada's autonomy, deepening its vulnerability to changes in American policies, and reducing Canadian leverage over domestic economic development. Starting in the early 1970s, Ottawa undertook a series of industrial adjustment measures aimed at changing Canada's course of economic progress and ultimately repositioning Canada on a more secure economic and political balance relative to the United States.

The Third Option was the course of action that Ottawa pursued throughout the 1970s and early 1980s in order to achieve industrial adjustment. The Third Option's key objectives were to regulate foreign investment, enhance Canadian control and ownership of domestic assets, increase high-technology manufacturing activities, and diversify Canada's trade pattern. To accomplish these strategic goals, Ottawa created the Canada Development Corporation in 1971, the Foreign Investment Review Agency in 1973, and an institutional structure to facilitate economic planning. It also struck individual 'contractual links' with the European Community and Japan in 1976 in order to enhance economic cooperation and diversify Canada's trade and investment patterns.[1]

The Third Option departed from Ottawa's past economic policy routines in that it sought to promote greater state activism in the economy. The building of Ottawa's interventionist capacity was witnessed in three areas. As an entrepreneur, the federal state created the Canada Development Corporation (CDC) and used it to invest in high technology and natural resources industries and to facilitate the transfer of corporate decision-making power from 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 foreign investment through the establishment of the Foreign Investment Review Agency (FIRA). The objective of filtering foreign capital was to ensure that incoming investments would better serve the industrial needs of Canada and limit the transfer of domestic managerial control to foreign interests. On the international front, the state-as-a-gatekeeper sought to diversify Canada's trade and investment patterns so as to reduce the country's reliance on the American market and

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[1] For more on the Third Option see Gordon Mace and Gerard Hervouet, "Canada's Third Option: A Complete Failure?" *Canadian Public Policy* (1989): 387-404; Mitchell Sharp, "Canada-U.S. Relations: Options for the Future," *International Perspective* (Autumn, 1972): 1-24; and Harald von Riekhoff, "The Third Option in Canadian Foreign Policy," in Brian Tomlin, ed., *Canada's Foreign Policy: Analysis and Trends* (Toronto: Methuen, 1978): 87-111; C.C. Pentland, "Domestic and External: Dimensions of Economic Policy: Canada's Third Option," in Wolfram Hanrider, ed., *Economic Issues and the Atlantic Community* (New York: Praeger Publishers, 1982): 139-162.

intensify its economic ties with third markets, such as Europe and Japan. Finally, as an administrator, Ottawa sought to spearhead economic development plans to promote industrial development at the regional and the national levels.

This paper seeks to shed light on an analytical puzzle that has received scant attention among scholars interested in Canadian industrial adjustment. What explains the failures of the Trudeau governments in the 1970s and early 1980s to implement effectively the programs of the Third Option? I argue that the institutional dynamic of increasing returns played a significant role in undercutting the implementation of the Third Option. By implementation I mean the ability of government officials to rework key political economic institutions to fit or accommodate the tasks of an adjustment strategy. The increasing returns dynamic refers to a self-reinforcing process in which an initial institutional choice among various options becomes increasingly entrenched as time passes and consequently gradually reduces the possibility of effecting a reversal of the initial institutional selection without incurring high costs.[2] Once created, an institutional arrangement will gradually gain consolidation (get locked in) through positive feedback and concurrently foreclose viable institutional alternatives. Institutions display such a path dependent characteristic, and insofar as institutions form a principal component of domestic politics, political outcomes are shaped by the dynamic of increasing returns.

The institutionalist approach I develop advances two propositions. First, the success of a strategy depends on the presence of a supporting set of political economic institutions.[3] Institutions equip their occupants with institutional capacity and policy instruments.[4] When a problem arises, policy makers will use whatever instruments and organizational advantages they have at their disposal to deal with an emerging problem. However, when a new set of problems emerges which call for a new plan of action (strategy), it is often the case that the available resources will be inappropriate for carrying out new tasks under the new strategy. When such a situation emerges, as John Zysman has pointed out, efforts will get under way to create "a new match between tasks and [state] capacities."[5] Government officials will attempt to rework specific institutional

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[2] For more on path dependence see Margaret Levi, "A Model, a Method, and Map: Rational Choice in Comparative and Historical Analysis," in Market I. Lichbach and Alan S. Zucherman, eds, *Comparative Politics: Rationality, Culture, and Structure* (Cambridge: Cambridge University Press, 1997): 19-41; Paul Pierson, "Increasing Returns, Path Dependence, and the Study of Politics," *American Political Science Review* (June 2000): 251-267; Kathleen Thelen, "Historical Institutionalism in Comparative Politics," *Annual Review of Political Science* (1999): 369-404; and Kathleen Thelen, "Timing and Temporality in the Analysis of Institutional Evolution and Change," *Studies in American Political Development* (Spring, 2000): 101-108.

[3] For a similar argument see, John Zysman, "How Institutions Create Historically Rooted Trajectories of Growth," *Industrial and Corporate Change* 3, no. 1 (1994): 243-283; G. John Ikenberry, *Reasons of State: Oil Politics and the Capacities of American Government* (Ithaca: Cornell University Press, 1988); Margaret Weir and Theda Skocpol, "State Structures and the Possibilities for "Keynesian" Responses to the Great Depression in Sweden, Britain, and the United States," in Peter Evans, Dietrich Rueschemeyer, and Theda Skocpol, eds., *Bringing the State Back In* (New York: Cambridge University Press, 1985): 107-163; and Kathryn Sikkink, *Ideas and Institutions: Development in Brazil and Argentina* (Ithaca: Cornell University Press, 1993)

[4] In this study, I focus on three particular political economic institutions: government-business relations, intergovernmental relations (inter-provincial and provincial-federal relations), and federal bureaucracy.

[5] John Zysman, "How Institutions Create Historically Rooted Trajectories of Growth," p. 259.

arrangements in order to create those state capacities necessary to implement the programs of the new strategy.

The second proposition asserts that increasing returns processes foiled the attempts of government officials to modify political economic institutions. I argue that the lack of public support was not the determining factor that undermined institutional adaptation efforts. Public opposition did not stop policy entrepreneurs from making significant inroads in reworking key institutional arrangements, as the creation of FIRA, CDC, and economic planning apparatus would suggest. Instead, the operation of increasing returns dynamic as institutional innovators attempted to modify institutional arrangements caused significant engineering flaws in the designs of these new institutions. Although the efforts of influential sponsors had elevated the ideas embodied in the Third Option to political prominence in the 1970s and early 1980s, it was their inability to overcome the dynamic of increasing returns which contributed to the failure of implementation. This paper will proceed in the order of these two arguments.

Political Economic Institutions and the Logic of the Third Option

The pursuit of an industrial strategy requires an appropriate set of political economic institutions. The Third Option called upon the state to play a more activist, discretionary role in the economy, particularly for the purpose of attaining such national goals as increasing Canadian ownership, developing a more sophisticated industrial structure, and maintaining economic independence. In addition to requiring a heavier injection of public authority, this strategy called for the development of vertical and horizontal linkage institutions to foster greater coordination among private sector actors, between economic actors and the state, within the federal state, and between the provinces and the national government. These institutional arrangements would help define and substitute collective engagements linked to the goals of the Third Options for the self-interested goals of private agents, the provinces, and bureaucratic actors. How fitting was Canada's preexisting political economic institutions for the implementation of the Third Option? I address this question below.

Government-Business Relations

Historical choices have put Canada on a path that has shaped its economy to resemble a liberal market economy.[6] For the most part, the private sector has historically lacked the capacity to coordinate among private sector actors. Inter-firm relations have been competitive and based on short-term contractual exchanges. Relations between labor and management have been shaped by the flexible labor market structure which militates against corporatist bargains. The financial system has been modeled on the market-based system whereby capital markets rather than the banking system constitute

[6] For more on the institutional features of liberal market economy and how this model contrasts with coordinated market economy, see Peter Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001) and David Soskice, "Divergent Production Regime: Coordinated and Uncoordinated Market Economies in the 1980s and 1990s," in Herbert Kitschelt, Peter Lange, Gary Marks, and John D. Stephens, eds., *Continuity and Change in Contemporary Capitalism* (New York: Cambridge University Press, 1999.

the principal channel through which larger companies have obtained long-term capital. Since these economic institutions induce private actors to look after their own interests, the possibilities of coordination are extremely limited without institutional change. The prominence of free contractual arrangements in the Canadian economy results in situations where economic agents are relatively free to enter into or exit out of arrangements depending on what their short-term, material interest dictates.

The relationship between the government and firms, however, deviates slightly from this variety of capitalism. Historically, the Canadian state has used public finance, market instruments, such as tariffs, and public enterprises to foster industrial development and economic growth.[7] The impetus for state intervention has been linked to geopolitical concerns. From the 1870s to the first half of the twentieth century, Canadian governments were forced to take extraordinary measures to integrate an economy of continental scale, quicken the pace and spread of industrial development, and achieve self-sustaining growth as a way to defend the new nation against possible economic and political absorption by the United States. Because this challenge far exceeded private capacity, the state, as Hugh Aitkens has pointed out, assumed "primary responsibility for maintaining and strengthening this policy of defensive expansionism."[8]

The business community and Canadians welcomed defensive expansionism because it was this form of state activism that enabled them to improve their economic well-being and secure national unity. In spite of this legacy of state intervention, private entrepreneurship has always been the principal engine of the Canadian economy. Private sector actors have recognized the importance of upholding market-based outcomes and of protecting the autonomy of the private sector from those state initiatives that are too restrictive and intrusive. As Michael Atkinson and William Coleman have pointed out, "The prospect of a concertative relationship, in which business and government collaborate in making longer-term investment [and other collective] decisions is greeted with hostility." Canadian business has been "unwilling to surrender prerogatives acquired in the economic system to pursue endeavours in politics."[9]

A closer inspection of the historical development of the Canadian state reveals that the prevailing form of state capacity exercised by the federal state resembles that of a "nightwatchman state." Such a state lacks the capacity to mobilize the consent of societal actors, as well as foster non-market coordination among private actors in the economy in order to pursue state goals. Consistent with a minimalist state, the Canadian state has never developed informal networks with business or created deliberative councils through

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[7] Concerned about American expansionism, the first government of Sir John A. Macdonald passed the National Policy of 1878 which established high tariffs as a way to build and protect new industries and accelerate the pace of national economic integration, two objectives that proved central in enabling Canada to stand on its own. To attain this overarching goal, the government complemented the tariff policy with efforts to attract immigrants and build a national railroad system (which it did by injecting huge sums of public funds in railroad building projects). For more on this topic see Michael Bliss, *The Evolution of Industrial Policies in Canada: An Historical Survey* (Ottawa: Economic Council of Canada, 1982), Lorraine Eden and Maureen Appel Molot, "Canada's National Policies: Reflections on 125 Years," *Canadian Journal of Political Science* (1993): 232-251.

[8] H.G.J. Aitken, "Defensive Expansion: The State and Economic Growth in Canada," in W.T. Easterbrook and M.H. Watkins, eds., *Approaches to Canadian Economic History: A Selection of Essays* (Toronto: McClelland & Stewart, 1967), p. 221.

[9] Michael M. Atkinson and William D. Coleman, *The State, Business, and Industrial Change in Canada* (Toronto: University of Toronto Press, 1989), p. 40.

which the state could orchestrate a plan of action to attain mutually beneficial economic outcomes. As the Science Council of Canada has observed, "there would seem to be an ideological aversion on the part of federal officials to become involved in any policy which requires government cooperation with industry."[10]

However, this in no way suggests that the Canadian state has been weak. The Canadian state's actions in the economy have been guided by a set of institutionalized ideas which favor market solutions to economic problems. Throughout history the deployment of market instruments has had important transformative effects on the Canadian economy. "What appears to be a minimalist state strategy that involves enforcing market processes" as John Ikenberry has observed concerning "nightwatchman states" such as the Canadian state, "may be as efficacious [in attaining state objectives] as the juggernaut of extensive and systemic direct intervention."[11] Indeed, no other instrument has had such a profound impact on the economy since World War II than trade liberalization, particularly the tariff cuts in the wake of the GATT Tokyo Round in 1979.

The Federal Economic Bureaucracy

The federal economic bureaucracy has never acquired expertise in the area of indicative planning. This lack of planning capacity has been the product of the state's inability to gather vital information from industries, forecast economic changes and respond proactively on the basis of such findings, and engage in credit activism. Nowhere has this been more evident than in the area of manufacturing industry. Before 1963, the year Prime Minister Lester Pearson established the Department of Industry, Canada was without a bureaucratic entity specifically in charge of advancing the country's manufacturing interests.

Historically, the Canadian federal state has been composed of internally differentiated bureaucratic units, each protective of its own prerogatives. As for the economic bureaucracy, no permanent coordinative mechanism has existed to facilitate policy formulation and decision-making within the bureaucracy. This posed a real problem in the 1960s and early 1970s as the economic bureaucracy increased in size as new bureaucratic organizations—such as the Departments of Industry (which later became Industry, Trade and Commerce) and of Regional Economic Expansion—were established, and hitherto less influential economic-related departments—such as the Departments of Communications, Agriculture, Consumer and Corporate Affairs, and External Affairs—gained more prominence. The result of such bureaucratic expansion was that it worsened the existing problem of scattered authority and intensified bureaucratic conflicts between the traditional center of power, represented by the Ministry of Finance and of Trade and Commerce, and the new players.[12]

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[10] Science Council of Canada, *Forging the Links: A Technology Policy for Canada* (Ottawa: Ministry of Supply and Services Canada, 1979) p. 21.

[11] G. John Ikenberry, "The irony of state strength: comparative responses to the oil shocks in the 1970s," *International Organization* 40 (1986), p. 137.

[12] See Richard Phidd and G. Bruce Doern, *the Politics and Management of Canadian Economic Policy* (Toronto: Macmillan Company of Canada Limited, 1978), Richard French, *How Ottawa Decides: Planning and Industrial Policy-Making, 1968-1980* (Toronto: Lorimer, 1980), Michael Jenkins, *The Challenge of Diversity: Industrial Policy in the Canadian Federation* (Ottawa: Science Council of Canada, 1983), Michael M. Atkinson and William D. Coleman, *The State, Business, and Industrial Change in Canada*, and

The ideology of free market enterprise has been a guiding force—that is, a basis for appropriate behavior—for economic bureaucrats as they have sought to understand and react to various economic problems. In the postwar period, policymakers understood that in order to stimulate economic growth, boost employment, and ensure steadily rising incomes they had to push for continued multilateral tariff reductions, expand export markets, attract foreign investment, and provide incentives to spur private sector initiatives. Indeed, this set of economic ideas, which was largely conceived by C.D. Howe—who between 1940 and 1957 served as Minister of Munitions and Supply, of Reconstruction, and finally of Trade and Commerce—was the cornerstone of Canada's economic strategy until the 1970s.[13]

Even public enterprises at both federal and provincial levels were created to follow the logic of the market. As Jeanne Laux and Maureen Molot have pointed out, although the number of Canadian state enterprises increased in the twentieth century, many were "commercial enterprises operating in profitable or competitive sectors of the economy."[14] Thus, business's dislike of selective state intervention was shared by the federal economic bureaucracy.

The Federal System

Canada's federal system has been based on the notion of division of jurisdictions.[15] Canadian federalism has induced the provinces and Ottawa to be as functionally similar as possible, and to maintain as much freedom of action and autonomy as possible within their own constitutional spheres of jurisdiction. The exception to this general rule was witnessed between the 1910s and 1960s. The social turmoil brought about by the Great Depression, the exigencies of participating in two World Wars, and the development of the Canadian welfare state strengthened Ottawa's position vis-à-vis the provinces and centralized the federal system.[16]

However, the emergence of province-building in the 1960s reversed this trend. Quebec's Quiet Revolution in the 1960s attacked the province's established social conservative norms and asserted francophone control over the economy and social spheres. In order to promote the latter goal, Quebec authorities strived to bring about economic modernization and demanded greater freedom of action and autonomy from Ottawa over all policy arenas which fall under provincial jurisdiction. Province-building in the other provinces did not assume the ethno-cultural dimension evident in Quebec. However, it was a force to be reckoned with, for it entailed provincial assertion of independence and expansion of ambitions. In effect, the emergence of province-building was spurred by the expansion of the bureaucratic capacities and of the financial resources

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Colin Campbell, *Governments under Stress: Political executives and key bureaucracies in Washington, London, and Ottawa* (Montreal: McGill-Queen's University Press, 1977).

[13] See David Wolfe, "Economic Growth and Foreign Investment: A Perspective on Canadian Economic Policy, 1945-1957," *Journal of Canadian Studies* 13, no. 1 (Spring 1978)

[14] Jeanne Kirk Laux and Maureen Appel Molot, *State Capitalism: Public Enterprise in Canada* (Ithaca: Cornell University Press, 1988), p. 12.

[15] 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) and Donald V. Smiley, "Territorialism and Canadian Political Institutions," *Canadian Public Policy* 111 (1977).

[16] Howard Cody, "The Evolution of Federal-Provincial Relations in Canada: Some Reflections," *The American Review of Canadian Studies* 7 (1977): 55-83.

of the provincial state. Province-building emboldened provincial governments to compete with the central government in an attempt to move into, occupy, and shape those public policy areas which neither level of government could claim exclusively for itself. It also prompted the provinces to resist federal intrusions into provincial spheres of jurisdictional responsibilities.[17]

Intergovernmental relations were changed when the pendulum returned to a decentralized federal structure by the 1970s. Competition and conflict between the two levels of government and among provinces were inevitable in the decades to come now that provincial states had more instruments at their disposal and were willing to pursue their political ambitions. In the face of the industrial adjustment problem of the late 1970s and 1980s, for which neither the provinces nor the central government could exclusively claim responsibility, each level tended to employ its respective policy instruments to control this disputed policy area.[18]

Consequently, competition and discord between the two orders of government emerged, unless there were powerful incentives for them to coordinate policy actions. On a range of policy issues, Canada's federal system has provided the two levels of government with some degree of flexibility when deciding how best to advance their interests and respond to public demands. Some cases have compelled them to act competitively relative to each other, whereas other situations have prompted them to cooperate. The outcome has depended on the extent of interest convergence and the level of mutual trust among governments.[19]

In conclusion, Canada's preexisting political economic institutions did not offer the right kind of institutional terrain to facilitate the implementation of the Third Option. Whereas the Third Option required an institutional arrangement capable of eliciting consensus from particular private sector actors and of orchestrating a common course of adjustment action, the prevailing institution nurtured an arm's-length pattern of relationship between the state and the private sector in which the latter's freedom of action was to remain as unfettered as possible. Whereas the Third Option needed an institutional arrangement capable of centralizing economic decision-making and of fostering consensus among those selected bureaucratic and political actors with access to decision-making, the institutional reality was that the structure of authority was fragmented and decentralized and exposed to political checks by outsiders. Finally, whereas the Third Option called for an institutional arrangement capable of mobilizing the collective adjustment efforts of the provinces and the federal state, the prevailing arrangement put a premium on flexibility of action whereby the occurrence of

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[17] For more on province-building see Edwin Black and Alan Cairns, " A Different Perspective on Canadian Federalism," *Canadian Public Administration* 9 (1966): 27-45, 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).
[18] Alan Cairns, "The Other Crisis of Canadian Federalism," in Douglass Williams, ed., *Constitution, Government, and Society in Canada* (Toronto: McClelland and Stewart, 1988).
[19] See Martin Painter, "Intergovernmental Relations in Canada: An Institutional Analysis," *Canadian Journal of Political Science* 24 (1991): 269-288; and Douglass Brown, *Market Rules: Economic Union Reform and Intergovernmental Policy-Making in Australia and Canada* (Montreal & Kingston: McGill-Queen's University Press, 2002).

competition or cooperation has rested on the prevailing level of mutual trust and ability to recognize mutual interests.

Why Institutional Reorganization Failed

The implementation of the industrial adjustment strategy, it can be argued, was foiled because policy entrepreneurs could not mobilize sufficient public support. This was attributed to two factors. First, the 1970s and early 1980s were years in which the industrial adjustment problem had to compete with other pressing issues for attention and limited resources. The political space was crowded, occupied by various issues such as the oil shock in the 1970s, the souring of provincial-federal relations, growing inflationary pressures in the economy, and the problem of industrial adjustment. Furthermore, the issue of Quebec nationalism, with its threat of secession, was increasingly preoccupying Ottawa during the same period. Thus, from the outset, the political landscape was not propitious for achieving profound institutional change to deal with the adjustment problem. Ottawa was engaged on various political battlefronts simultaneously, with the specter of Quebec separation figuring increasingly prominent in the minds of government officials.

The lack of public support was also owed to the fact that there was widespread divergence of preferences and interests concerning how to deal with the adjustment problem. Societal interests were deeply divided. Most of the business community and associations representing their interests, Business Council on National Issues and the Canadian Manufacturers' Association, favored a market-oriented approach. In contrast, labor and its political allies, the Waffle and the New Democratic Party, advocated greater state intervention. Rejecting the two extremes of the debate, the Committee for an Independent Canada, founded by Walter Gordon, sought a centrist solution.

The provinces were also divided. The western provinces—especially Alberta and Saskatchewan—were concerned that Ottawa's adjustment policies would confer more benefits on Ontario and Quebec where Canada's industrial base was concentrated. Any adjustment policies, they argued, should provide these provinces with the necessary assistance to help them develop their industrial base, particularly the development of their energy resources. The Atlantic provinces, eager to attract foreign investment since domestic investment was insufficient and concerned that the central provinces would receive the bulk of Ottawa's adjustment assistance, sought adjustment policies that would channel market forces more in their favor. Quebec derided Ottawa's past and present industrial policies because they provided more assistance to the Ontario economy. Determined to modernize its industrial base and bolster the economic power of francophones, Quebec sought from Ottawa adjustment assistance that would give provincial authorities nearly full autonomy on how to disburse and manage federal funds and other programs.[20]

There also was evidence of discord within the different Trudeau governments concerning how to deal with Canada's adjustment problem. At the cabinet committee level, Richard French has noted that two competing 'planning systems' emerged in the 1970s, distinguished by the particular position of each system's principal bureaucratic sponsor on the issue of economic planning and by the planning instruments a system

[20] For more on this issue see Michael Jenkins, *The Challenge of Diversity: Industrial Policy in the Canadian Federation*.

designates to achieve planning.[21] One planning system was based on the hands-off, free market enterprise views of the Department of Finance, the other on the hands-on, indicative planning views of the Cabinet Planning System, in which the Privy Council Office and Priorities and Planning Committee figured prominently. As federal policy advisory councils, the Science Council of Canada's "technological sovereignty" plan advocated state activism in the economy, whereas the Economic Council of Canada supported market liberalization, stressing the imperative of free trade with the United States.[22] Among senior officials in the Liberal Party, Herb Gray, Alistair Gillespie, Jean-Luc Pépin, Walter Gordon, among others were more supportive of the Third Option than Simon Reisman, Mitchell Sharp, Bud Olson, and Allan MacEachen, among others.

Although there was insufficient support for drastic institutional change, opponents of such a change faced the problem of collective action. Their strength in numbers was undercut by their organizational weakness and absence of a common solution around which their preferences converged. In fact, public opposition and the non-crisis nature of the adjustment problem did not stop Ottawa from creating the CDC and FIRA, from engaging in economic planning, and from engaging in export diversification, all of which a substantial institutional changes. Although these factors hindered the efforts of institutional innovators, the main cause of implementation failure lies elsewhere. I argue that the dynamic of increasing returns, an institutional effect that causes institutional reproduction and resilience, was the primary factor that created barriers for those institutional adaptations aimed at supporting the implementation of the Third Option.

Increasing returns processes leave an imprint on political life by producing an institutional status quo bias. In particular, the development of increasing returns resulting from the existence of an institutional arrangement over a stretch of time renders current attempts to switch to once-feasible institutional alternatives difficult. As Pierson observes, increasing returns processes are not only "prevalent in politics," but also "particularly intense" in this sphere.[23] Increasing returns effects take on four characteristics. First, large set-up costs are associated with creating new institutions. Because old institutions have sunk costs—assets which are specific to an institution, are institutionally embedded, and are not recoverable—the new institutions will have to produce immediate and sufficient benefits to make up for abandoning investments in the old institutions.

Another characteristic of increasing returns is that the operation of existing institutions tends to generate learning effects. Actors within old institutions will perform their specific tasks and functions with greater efficiency than those in new institutions because of the cumulative knowledge, refined skills, and competence acquired by repeating the same tasks regularly over a long period. The third type of positive feedback concerns the notion that institutions tend to establish sets of stable relations with each other, facilitating coordination of activities and giving rise to institutional complementarities. How well an institution functions and generates benefits depend on its opportunity to rely on the resources that other institutions produce in the system.

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[21] Richard French, *How Ottawa Decides: Planning and Industrial Policy-Making, 1968-1980*.
[22] Science Council of Canada, *Forging the Links: A Technology Policy for Canada*, and Economic Council of Canada, *Looking Outward: A New Trade Strategy for Canada* (Ottawa: Information Canada, 1975).
[23] Paul Pierson, "Increasing Returns, Path Dependence, and the Study of Politics," p. 257.

Finally, adaptive expectations can have the effect of making the option of creating new institutions unattractive. Institutional innovators are often pressured to proceed with institutional change based on how other actors in the system are inclined to coordinating their actions with the new institutional arrangement.

These last two characteristics are closely associated with the "tightness of fit" argument. Because institutions tend to complement and develop dependencies with each other, as Susan Berger points out, it "makes it extremely unlikely that any one practice or institution, even if dysfunctional, can be readily changed without requiring change in other pieces of the system."[24] If a group of institutional players somewhere in the system resists institutional innovation, then political entrepreneurs—dependent on the coordination of others in the system—will most likely fail to change the operation or function of a particular institution the way they have envisioned it.

The Obstructing Effects of Increasing Returns

The institutional dynamic of increasing returns affected institutional change associated with the Third Option in three institutional domains—organizational structures of the federal state, of government-business relations, and of intergovernmental relations.

The Federal State

Rational management was an effort launched by Prime Minister Trudeau in the 1970s to reorganize the federal political executive in order to enhance its planning and administrative capacities.[25] The attempt proved quite important given the fact that the gatekeeping and planning components of the Third Option depended on the existence of a cohesive group of policy makers who could chart a coherent course of policy actions to achieve the goals of the adjustment strategy. However, consistent with the path dependent process, Trudeau's efforts to enhance the state's coordination and interventionist capacities were foiled due to the resilience of the prevailing institutional equilibrium which favored the preservation of a diffused, fragmented, and decentralized bureaucratic structure and which adhered for the most part to the ideas of free market enterprise.

The creation of new organizations at the federal level, such as the FIRA, the CDC, and the apparatus to administer the economic development planning, proved costly and generated learning effects, coordination effects, and adaptive expectations. The cost of creating these institutions were high because bureaucratic actors were required to learn how to perform new functions, become accustomed to working within new interaction settings, and follow new decision-making procedures which were intended to facilitate policy coordination. The adaptive expectations dynamic was also present, for institutional innovators had to make sure new institutions won sufficient support among reluctant federal officials. The result was that the CDC and FIRA were given weak mandates and policy tools.

The case of the CDC illustrates the effects of the dynamic of increasing returns. Initially, the Trudeau government encountered two strands of thinking concerning the proposed CDC plan. One strand, advanced by former finance minister Walter Gordon in

[24] Suzanne Berger, "Introduction," in Suzanne Berger and Ronald Dore, eds., *National Diversity and Global Capitalism* (Ithaca: Cornell University Press, 1996), p. 22.
[25] Peter Aucoin, "Organizational Change in the Machinery of Canadian Government: From Rational Management to Brokerage Politics," *Canadian Journal of Political Science* 19: 3-27.

the Pearson government in the 1960s, sought to make the CDC an instrument of the state and use it to bolster Canadian control of national economic assets. The other line of thinking, advanced by Mitchell Sharp, a prominent cabinet minister in the Liberal governments of Pearson and Trudeau, sought to give the CDC sufficient autonomy from the government and designate profit-making its key objective.[26] Sensing that there was more support for Sharp's plan, the Trudeau government adapted its actions to conform to that plan while assigning lower priority to the political aim of the CDC.

In addition, Ottawa encountered major learning effects when it sought to employ a readily used policy instrument, public ownership, 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 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 at odds with each other. On the one hand, the commercial mandate forced the CDC to single out and move into those sectors of the economy in which opportunities for growth and profit making existed. On the other hand, the nationalist mandate, the least important of the two, 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 were not always commercially viable.[27]

When FIRA was established, as Glen Williams and Maureen Molot have observed, "the agency was more an exercise in symbolic politics than a genuine effort to regulate foreign investment coming into Canada."[28] Just as adaptive expectations had pressured the Trudeau government to dilute CDC's nationalist objective, it also forced the government to weaken FIRA's mandate to the extent that it denied few foreign investment applications. The data show that the percentage of rejected applications gradually declined over the course of the 1970s, reaching a low of 5.01 percent in 1977, and relative lows of 8.11 percent in 1978 and 7.31 percent in 1979.[29] 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 this form of investment activity accounted for 80 percent of all foreign investments entering Canada.

FIRA's authority was further undercut because the criteria used to review foreign investment were defined ambiguously. FIRA assessed foreign investment on the basis of

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[26] See William Dimma, "The Canada Development Corporation," Ph.D. Dissertation (Harvard University, 1974) and E.P. Neufeld, "Some Qualifying Thoughts on the CDC," *The Canadian Banker* (Summer 1966): 29-33.

[27] See Stephen Brooks, "The State as Entrepreneur: From CDC to CDIC," *Canadian Public Administration* 26 (1983): 525-543 and Jeanne Kirk Laux and Maureen Appel Molot, *State Capitalism: Public Enterprise in Canada* (Ithaca: Cornell University Press, 1988).

[28] 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.

[29] Barbara Jenkins, *The Paradox of Continental Production*, 1992, p. 116.

whether it contributed “significant benefits” to Canada.[30] Without specific benchmarks, there was no way to measure the significance of foreign investment contribution, thus leaving FIRA little ammunition with which to shoot down foreign investment applications. At issue was the lack of experience in screening foreign investment. During committee hearings on Bill C-132, the legislation that created FIRA, its key sponsor Minister of Industry, Trade and Commerce Alistair Gillespie pointed out that “at this stage, precise standards for measuring acceptability cannot be spelled out. [The] 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.”[31] In effect, before FIRA could adequately perform its task, its agents needed to acquire a proficiency in the screening of applications, which posed a huge temporal barrier.

The prominence of free market enterprise ideas within the federal economic bureaucracy conflicted with FIRA’s mandate. No department offered an appropriate home within which FIRA could operate. The Department of Finance, for example, contended that restricting foreign investment would produce balance of payments problems, among other adverse effects. 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.[32] Sensing that these and other departments were unlikely to coordinate their actions with FIRA, Trudeau opted to create a weak, tractable agency. The agency was not endowed with independent decision-making capacity and it was designated a non-departmental, advisory body, two features that rendered FIRA’s decisions subordinate to the judgment of the Cabinet.[33] Facing high learning and coordination barriers, the Trudeau government slowly pulled back from gatekeeping, retreating from its 1980 campaign promise of toughening FIRA, and partially liberalizing FIRA in 1982.

In the second half of the 1970s, the Trudeau government made important inroads with regard to the development of horizontal and vertical institutions to facilitate coordination in the area of industrial development planning. The creation of the DM-10 in 1976 and the Interdepartmental Committee on Trade and Industrial Policy (ICTIP) in 1977, both of which were composed of deputies from economic departments, were notable for their pioneering work in coordinating their efforts to develop an industrial policy.[34] In late 1978, a new cabinet committee, the Board of Economic Development Ministers, was created and a new central agency, the Ministry of State for Economic Development, was established to assist the BEDM. The BEDM and MSED comprised

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[30] Foreign Investment Review Agency, *Foreign Investment Review Agency: Annual Report, 1975-76* (Ottawa: Supply and Services, 1976)

[31] Alastair Gillespie, “Statement before the Standing Committee on Finance, Trade and Economic Affairs of the House of Commons, (June 5, 1973), p. 7.

[32] 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, 1980).

[33] 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) and Schultz, Swedlove, and Swinton, *The Cabinet as a Regulatory Body*, 1980.

[34] For more on this, see Richard French, *How Ottawa Decides: Planning and Industrial Policy-Making, 1968-1980* (Toronto: Lorimer, 1980).

the principal organizational apparatus that oversaw the process of charting and implementing an industrial development policy.

However, these and other institutional modifications designed to enhance bureaucratic coordination were beset by two fundamental problems. First, institutional changes failed to centralize decision-making authority by designating a selected set of actors with the exclusive responsibility of charting a course of action. Instead, these modifications intensified bureaucratic pluralism by giving economic departmental actors as well as central agencies a voice in the process and thus rendering coordination unmanageable.

Second, no matter what sort of institutional innovations were undertaken, they could not settle the conflict between the two dominant planning systems, one favoring restricting government intervention, and the other supporting greater intervention. The new institutions could not escape the clash of ideas over the issue of planning; instead, they became embroiled in it. This was evidenced when Bud Olson, Minister of State for Economic Development, and Herb Gray, Minister of Industry, Trade and Commerce advanced competing proposals in response to Prime Minister Trudeau's promise of promoting a national development policy which he made in his 1980 Speech from the throne. Aware that Gray's pro-interventionist proposal lacked support, Trudeau sided with Olson's pro-market proposal which called for the development of Canada's energy resources.[35] In the end, the decision to pursue energy-based 'megaprojects' was one that required the least amount of indicative planning on the part of the government and of coordination among the business, labor, and the government.[36]

Government-Societal Relations

With respect to state-society relations, Trudeau attempted to strengthen Ottawa's capacity to coordinate change with business. In many respects, Trudeau sought to enhance Ottawa's "transformative capacity," which Linda Weiss has defined 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."[37] In the second half of the 1970s, Ottawa undertook a number of institutional modifications to strengthen its ties with the business community (including labor with respect to economic planning). The goal of such initiative was to mobilize consensus on a national industrial development policy, one in which the state would offer incentives to business to encourage them to take on selected production activities. Moreover, by forging closer ties with business, Ottawa hoped that

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[35] For more on this debate see, Herb Gray, "Economic Nationalism and Industrial Strategies," Notes for an address to the Annual Symposium, École des Hautes Étude Commerciales. (Montreal, June 3, 1980), Les Whittington, "Herb Gray's plea to cabinet," *Financial Times of Canada* 69 (September 16, 1980), and G. Bruce Doern, "The mega-project episode and the formulation of Canadian economic development policy," *Canadian Public Administration* 26 (1983): 219-238, and Government of Canada, *Economic Development for Canada in the 1980s* (Ottawa, November 1981).

[36] G. Bruce Doern, "The mega-project episode and the formulation of Canadian economic development policy," and Government of Canada, *Major Canadian Projects: Major Canadian Opportunities*. Report of the Major Projects Task Force, (Ottawa: Supply and Services Canada, 1981).

[37] Linda Weiss, *The Myth of the Powerless State* (Ithaca: Cornell University Press, 1998), p. 39.

it could encourage business to diversify Canada's exports away from the American market.

The dynamic of increasing returns obstructed progress toward mobilizing societal consensus and enhancing coordination with key economic groups. During the second half of the 1970s, Ottawa launched the Enterprise 77 initiative and created 23 industry sector task forces, the Tier II Committee, and the Blair-Carr Task Force. These initiatives were designed to enhance the capacity of the state to coordinate industrial change with business and labor.

Although these consultative networks generated much information about the market conditions different industrial sectors were facing and the public policy needs these sectors required, three flaws were particularly evident. First, the historical absence of routine mutual collaboration as well as the entrenchment of the arm's-length pattern of government-societal relations limited the accomplishments of these efforts. Historically, private sector actors have sought to limit state involvement in their affairs and preserve their autonomy and flexibility of action. Moreover, the private sector has championed the idea (more so for the business community than for labor) that the public sector is less efficacious than the private sector. The state's adherence to free market enterprise also reinforced the arm's-length pattern of interaction, preferring to intervene in the economy only when the consent of the private sector could be secured. The new set of institutional networks that the Canadian state was attempting to create therefore created very high learning and coordination costs as both sets of actors were required to learn new roles, give up some autonomy, and strive to identify and attain collective goals rather than private ones.

The fragmented character of the organizational structure of both business and labor was another obstacle to strategy implementation. Such institutional fragmentation impeded societal efforts to define their long-term, cross-sectoral, inter-regional industrial development views and convey their perspective to the Department of Industry, Commerce and Trade, the principal department in this initiative. Instead, what occurred resembled a bottom-up process whereby private actors flooded the government with an uncoordinated stream of recommendations which did not reflect a thorough consideration of strategic trade-offs among alternative solutions.[38] Moreover, both societal groups were reluctant to assume greater responsibility in defining collective objectives. Such a position 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 final drawback was that government officials were reluctant to influence the behavior of business and labor representatives. On the contrary, influence flowed in the other direction, from business and labor to the government. The fact that the government had not attempted to mobilize the consent of key economic groups once receiving private sector information suggests that the government had failed to formulate any clearly defined industrial development goals which in turn could be pursued collaboratively with the private sector. The constant bureaucratic reorganization plus increased bureaucratic pluralism within the federal state foiled efforts to achieve policy cohesion.

[38] Douglas 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).

Coordination between business and the state was also in short supply when it came to implementing the contractual links which Ottawa struck with the European Community and Japan.[39] If the contractual link were to have any meaningful impact on Canada's trade pattern, two developments needed to occur. First, Canadian exporters needed to change their preference which prioritized the American market over European and Asian markets. Similarity of management styles, lower transaction costs, and geographical proximity were key factors that made the American market more attractive than European and Japanese markets. Second, to induce a change in the export market preference of Canadians, Ottawa's trade promotion capacity needed to be enhanced and brought directly to bear on Canadian exporters. Thus, in order to take advantage of the opportunities created by the contractual links, the government and business had to be willing to change their habits and bear the cost of external adjustment.

In an attempt to assess the adequacy of Canada's export promotion capacity and recommend ways to enhance consultation between the government and private sector on the issue of export development, the ITC established the Export Promotion Review Committee in 1978. Comprised of members from the private sector, the committee did not see Canada's trade dependence with the United States as a reason for concern. Instead, it noted that if access to the American market was enhanced it would "encourage selective rationalization [of Canada's industries] and provide [Canadian] innovators with a market big enough to reward innovation handsomely."[40] Moreover, committee members concluded that Ottawa's export financing services were not sufficient to give Canadian companies the ability to outperform other foreign companies operating in Europe and Japan.

In addition, internal bureaucratic struggles undermined the policy of diversification. The Department of External Affairs aspired to control Canada's foreign economic policy and to make it an instrument of the department's efforts to enhance Canada's international position. The expansionist ambitions of External Affairs provoked a strong response by officials in Finance and ITC. As Ernie 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."[41]

Moreover, officials from the two departments criticized the diversification policy for being too dirigiste in its design. Such a policy intruded in business affairs by imposing on the business community a politically motivated design. They also criticized the policy because it shifted attention away from the concern of enhancing Canadian international competitiveness and it deviated from the traditional multilateralist track which had been credited with bringing about postwar economic growth and industrial development.

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[39] See 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," *Statements and Speeches* no. 76/33 (1976); and J.L. Granatstein and Robert Bothwell, *Pirouette: Pierre Trudeau and Canadian Foreign Policy* (Toronto: University of Toronto Press): 158-177.
[40] Report of the Export Promotion Review Committee, *Strengthening Canada Abroad* (Ottawa, November 30, 1979), p. 17.
[41] Ernie Keenes, "Rearranging the deck chairs: A political economy approach to foreign policy management in Canada," *Canadian Public Administration* (Autumn 1992), p. 395.

Intergovernmental Relations

The competitive nature of Canadian federalism was a major obstacle to achieving coordination of industrial adjustment policies between the provinces and Ottawa. Still, Ottawa undertook important efforts in that direction. Trudeau sought to achieve intergovernmental coordination through two modes of interaction: multilateralism and bilateralism.[42] 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 Department of Regional Economic Expansion's General Development Agreements (GDA) were important bilateral undertakings.

The need for intergovernmental coordination was often beset by competitive federalism, which invites both autonomous actions by individual governments and collective actions only when a convergence of interests among governments has emerged. Of some significance, the postwar period had seen provinces become increasingly willing to assert their constitutional prerogatives and expand their range of responsibilities within provinces. Accordingly, provinces expanded their repertoire of policy tools to match their more expansive ambitions, and consequently became more effective at being masters of their own jurisdictional domain. The end result was that the provinces became less willing to substitute national goals for provincial goals.

Although some coordination did take place between the two levels of government concerning industrial adjustment, 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 field that required either coordination or the voluntary extrication of one order of government. As Peter 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."[43]

For instance, this dynamic was set in motion after the introduction of GDAs. GDAs emboldened the provinces to pursue economic development policies that were competitive rather than complementary to each other and lessened the visibility of the national government in the co-management of these bilateral agreements.[44] The national government counteracted by shifting economic planning efforts from the regional level to the national level, which coincided with the creation of the BEDM and MSED.[45]

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[42] Kenneth McRoberts, "Unilateralism, Bilateralism and Multilateralism: Approaches to Canadian Federalism," in Richard Simeon, ed., *Intergovernmental Relations* (Toronto: University of Toronto Press, 1985).
[43] Peter Leslie, *Federal State, National Economy* (Toronto: University of Toronto Press, 1987), p. 66.
[44] N. Harvey Lithwick, "Regional Policy: The Embodiment of Contradictions," in G. Bruce Doern, ed., *How Ottawa Spends Your Tax Dollars* (Toronto: James Lorminer & Company, 1982) and Donald Savoie, *Regional Economic Development: Canada's search for solution* (Toronto: University of Toronto Press, 1986).
[45] Janine Brodie, *The Political Economy of Canadian Regionalism* (Toronto: Harcourt Brace Jovanovich, Canada, 1990).

Consequently, DREE, the coordinating body of GDAs and designed uniquely to cater to the needs of the provinces, was demoted and lost its influence in the area of economic planning.

Once the task of planning returned to the national level, consensus on what should be included in the emerging national industrial development plan never flowed from the 1978 consultations or those that followed.[46] 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, as Neil Bradford has noted, 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."[47]

The uneven spatial effects of previous economic interventions of the national government on the provinces certainly contributed to their ambivalent responses to the Third Option in general. From the perspective of the western and Maritime provinces, Ontario and Quebec had benefited from past federal interventions, particularly from the National Policy. From Quebec's perspective, Ontario had gained more than any other provinces. The dirigiste design of the Third Option and its supporting institutions caused concern for the provinces, for past experiences had taught them that such interventions created few winners, but many losers. This factor figured prominently in the minds of provincial officials as they became involved in the programs of the Third Option and was an insurmountable obstacle to the mobilization of coordination between the two levels of government.

Conclusion

The ascent of the Third Option was largely spurred by international factors; the descent of this adjustment strategy was principally driven by domestic factors. This analysis has attempted to show that the institutional dynamic of increasing returns played a significant role in undermining the implementation of the Third Option. Although the causal weight of interests and economic ideas should not be dismissed, the existing institutional framework distorted their effects. From the start, the rise of the Third Option set off a clash of interests between the strategy's supporters and opponents. While the proponents made notable progress in implementing the strategy, what ultimately tipped the balance in favor of the opponents—despite the collective action problem they encountered—was the intervening effect of increasing returns.

As a political economic idea largely inspired by economic nationalism, the Third Option offered a coherent and calculated response to the constraints and opportunities facing Ottawa. Notwithstanding this idea's strategic logic, it could not find a home in the prevailing set of institutional arrangements. Just as oil and water do not mix, the Third Option and Canada's political economic institutions could not be merged together despite the heroic efforts of institutional innovators to rework the institutional-strategy nexus.

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[46] Brown and Eastman, *The Limits of Consultation: A Debate Among Ottawa, the Provinces and the Private Sector on an Industrial Strategy*.

[47] Neil Bradford, *Commissioning Ideas: Canadian National Policy Innovation in Comparative Perspective* (Toronto: Oxford University Press, 1998), p. 105.