

# **FROM LEAPS OF FAITH TO HARD LANDINGS: FIFTEEN YEARS OF 'FREE TRADE'**

*Andrew Jackson, Senior Economist  
Canadian Labour Congress*

## **INTRODUCTION**

This paper evaluates the impacts of increased economic integration with the US in the wake of the FTA and NAFTA against the backdrop of the 'great free trade debate' of the late 1980s. Part One briefly summarizes the key issues raised in the debate, when proponents claimed that the FTA would boost long-term economic growth with minimal impacts on the Canadian social model, while critics expressed concerns about the loss of needed economic policy levers and the dangers of 'downward harmonization' to the US social model. Part Two looks at the economic record of the past 15 years, and argues that the promises of a significant boost to productivity growth and positive restructuring of Canadian industry have been largely unrealized. The Canadian economy has changed, but long-standing structural problems such as excessive resource dependency and the underdevelopment of a sophisticated 'knowledge-based' economy very much remain with us. Part Three looks at the impacts of closer economic integration on wages, income distribution and social programs, and argues that fears of 'downward harmonization' were amply justified. The paper does not address the impacts on Canada of the addition of Mexico to the original FTA, but concentrates on the much more important impacts of Canada-US integration. For reasons of space, little is said about pressures to policy convergence outside of economic and social policy, though environmental and cultural policies are clearly important.

It is worth underscoring at the outset that Canada-US economic integration was already well advanced before the FTA, and has not been only factor-shaping Canadian economic and social performance over the past 15 years. As argued in the successive Alternative Federal Budgets of the CCPA, restrictive fiscal and monetary policies were the major factor behind Canada's dismal record from the late 1980s to the latter part of the 1990s. And, as argued by Clarkson (2002), the 'new constitution' of trade deals has interacted in complex ways with other elements of the 'neo-conservative agenda' which have a life of their own. While it is true that economic integration has given the right a stronger political hand, the left falls into a trap if it believes that politics has been made irrelevant by trade deals. Our history under 'free trade' could have been different, and this paper attempts to separate out what can be reasonably attributed to deepening economic integration as opposed to other factors. Moreover, critical assessment of the FTA should not be read as a call to return to the status quo ante. The real challenge is to construct an alternative policy agenda for a profoundly changed Canada.

## **THE GREAT FTA DEBATE**

In line with the neoclassical argument for gains from trade based upon comparative advantage and increased competition, proponents of Canada-US free trade forecast a boost to long-term economic performance. The central case for further reduction of tariff and regulatory barriers to trade and investment in the mid- to late 1980s was that it would help close the long-

standing productivity gap between Canadian and US manufacturing. Tariff elimination was expected to lead to gains from increased specialization and economies of scale as manufacturing production shifted from short, diversified product runs for national markets to longer runs of more specialized products for continental markets. The official forecast of the Department of Finance was that there would be a long-term increase to real GDP of about 3%, a modest one-time boost reflecting the rather low level of remaining ‘barriers’ to trade with the US (Department of Finance, 1988). There was also expected to be a boost to long-term productivity growth arising from greater exposure to a more dynamic US economy. This was the famous “*leap of faith*” of the Macdonald Commission. Labour adjustment was seen as a small, manageable problem because it was assumed that there would be a small net job gain as both capital and labour flowed from shrinking to expanding sectors and firms. The FTA was also advocated for purely defensive reasons (‘protection from US protectionism’) and because it complemented and ‘locked in’ the key policy reforms of the mid- to late 1980s: privatization, deregulation and dismantlement of Trudeau-era cultural and economic nationalism. With respect to distributive issues, the explicit assumption was that the gains from trade would be shared with workers in the form of higher wages in better jobs, and that higher growth would support and sustain social programs.

For their part, left critics of free trade argued that the FTA deprived Canada of the interventionist economic policy tools needed to deal with excessive resource dependency and an underdeveloped manufacturing sector (Cameron, 1988). Both sides of the debate accepted that Canadian manufacturing was less efficient and less innovative. Proponents said that the free market would help solve the problem, while critics argued that Canada needed to use policy tools which were undercut by the trade deals (foreign investment review, use of government procurement, resource processing requirements, etc.). The difference was not so much over whether trade with the US was good or bad, as over how much policy space was needed to ‘shape comparative advantage’ in the interests of Canadian workers and communities. Critics argued that greater liberalization of trade and investment would increase the bargaining power of mobile capital compared to workers and governments, and that threats to move investment, production and jobs to the US would work towards “*downward harmonization*” of wages in relation to productivity, and of social standards which add to business costs. Free trade was seen as a threat to the more progressive Canadian social model of stronger unions, higher levels of income protection and broader access to public and social services. It was also feared that adjustment costs in terms of lost jobs would be much greater than forecast. Underpinning the debate were very different assumptions about the relationship between economic space and policy space. The fundamental fear of FTA opponents was that greater economic integration would undermine, if not ultimately destroy, the capacity of Canadians to maintain a distinctive society.

### *Structural Economic Change*

Canada-US economic integration in terms of two-way trade flows proceeded extremely rapidly in the wake of the FTA, far faster than anyone envisaged. Exports rose from 25.7% of (nominal) GDP in 1989 to 45.5% in 2000, while imports rose from 25.7% in 1989 to 40.3% in 2000. Trade has since fallen back as a share of GDP. The extremely rapid growth of Canadian

exports, entirely accounted for by trade with the US, was not, however, mainly due to the FTA, but rather to strong growth of the US domestic market, a rising US trade deficit with all countries, and the significant depreciation of the Canadian dollar after 1992. Industry Canada estimates that 90% of export growth is explained by non-NAFTA factors (Ram et al., 2001). It is notable that the US share of Canadian merchandise exports (85% in 2001 compared to 73% in 1989) has risen much more rapidly than the US share of Canadian imports (73% in 2001 compared to 70% in 1989).

The resource and auto sectors were already very heavily export-oriented before the FTA, and most manufacturing industries have now also become overwhelmingly oriented to the North American rather than domestic market. Supply chains in manufacturing have become more deeply integrated on a continental basis, as shown by the fact that the share of imported inputs in goods production has risen from 29% in 1990 to 37% in 1997 (Ram et al., 2002, p.33). While two-way trade flows of intermediate goods have increased in most sub-sectors, the metaphor of a single production chain spanning both sides of the border is most true of just two major industries - auto and 'high-tech' electrical machinery and equipment - which have very tightly integrated North American production chains.

While tariff changes played only a modest role in deepened trade and investment links, the FTA cemented the *strategic* integration of most large Canadian goods producers to North American economic space. The great majority of large Canadian and transnational corporations with major operations in Canada are now strongly oriented to the North American market, rather than to the domestic Canadian market. The US is a larger market for Canadian manufacturers than is Canada (exports account for about 53% of manufacturing production), and only a minority share of the Canadian market for manufactured goods is now met from Canadian production.

The FTA and NAFTA have had some impact on direct investment flows as transnational corporations have restructured production chains and invested across the border. The stock of US Foreign Direct Investment (FDI) in Canada climbed from 12% to 20% of Canadian GDP between 1989 and 2001, but fell from 70% to 65% as a share of the total stock of FDI in Canada (O'Neill, 2002). Inward FDI can come in the form of new 'real' investments, or in the form of takeovers. The latter seem to have predominated, and the relative failure of Canada to attract large new 'greenfield' investment from US and other manufacturing transnationals serving the North American market has been a source of disappointment to proponents who had expected inward investment to increase. (See, e.g., McCallum in Macdonald (Ed.), 2000.) Large foreign-owned plants tend to be the most productive and technologically advanced, but the ratio of new entries to exits has changed for the worse in the post-FTA era (Baldwin and Gu, 2003). On the other side of the ledger, the stock of Canadian FDI in the US has risen from 10% to 18% of Canadian GDP between 1989 and 2001, and is less likely than inward investment to be financed from retained earnings. Canadian corporations have made major investments in US financial services, and, to a lesser extent, in manufacturing (e.g., Nortel, Magna, Bombardier). Changes in FDI flows and stocks as between Canada and the US have been roughly balanced, though there has probably been more 'real' Canadian investment in the US than 'real' US investment in

Canada. These flows probably help explain why real investment in industrial machinery and equipment was much weaker in Canada than in the US through most of the 1990s.

Despite the reality of close economic integration with the US in terms of trade and direct investment, its extent can be exaggerated. First, Canadian capitalism has 'globalized' to an astonishing extent, outside North America. Between 1990 and 2001, despite roughly balanced FDI flows with the US, the ratio of Canadian FDI abroad to FDI in Canada jumped from 0.75 to 1.2. The US share of very rapidly rising Canadian Foreign Direct Investment has fallen from a high of 70% in the mid-1980s to about half today (O'Neill, 2002). Second, the growth of Canadian exports to the US, while significant, is highly overstated if not adjusted for growing imports of intermediate goods. In 1997, exports represented 40.2% of GDP, but net exports (exports minus imported inputs) were a significantly smaller though still substantial 27.7% of GDP. Third, Helliwell (2002) has detailed still very strong 'border effect' on Canada-US trade. The Canada-US border is still at least 10,000 miles wide in terms of its impact on goods trade flows thought of as a function of distance alone, mainly because national networks and tastes continue despite advanced 'comparative advantage' specialization. Finally, the FTA and NAFTA do not extend to many services. Domestic regulation remains important in many services industries (finance, communications, culture, social services); services trade remains small relative to the size of the domestic market, and the US share of Canadian services trade (58% of exports and 63% of imports) is surprisingly low. In sum, it is an exaggeration to speak of a single North American economy as opposed to a Canadian economy which is tightly integrated with the US in some industries (auto, energy, high tech), but also has strong investment links with the rest of the world, and a domestic services economy which remains national in many respects despite high levels of foreign ownership.

As noted, the FTA was expected to boost weak manufacturing productivity and help close the long-standing Canada-US productivity gap. Given that increased trade was much greater than anticipated, the productivity gains should have been substantial, but this has not been the case. Analysis suggests that there were, indeed, small average productivity gains in previously heavily protected sectors attributable to the tariff changes (Trefler, 1999). While widely seen as proof of the success of free trade, this is misleading. Average sector productivity rose in tariff protected sectors as weak firms went out of business and the survivors shed workers. The productivity change due to tariff changes was the result of the increased exit rate of uncompetitive plants, rather than the increased economies of scale expected by FTA proponents (Gu, Sawchuk and Whewell, 2003). Huge layoffs in 1989-91, amounting to more than one in five manufacturing workers, were driven more by the high dollar than by the FTA itself, but were relatively concentrated in the previously most protected sectors. These huge adjustment costs for workers and communities were far greater either proponents or critics had imagined, and there was little in the way of compensation for the 'losers.'

The jobs lost between 1989 and 1991 were, over time, more than offset by gains in the firms and sectors which survived restructuring and began to grow as the dollar depreciated from about 1992. The extent of total change in manufacturing is underlined by the fact that 47% of all the plants in existence in 1988 - accounting for 28% of all jobs - had closed by 1997, while 39% of all plants in 1997 - accounting for 21% of all jobs - did not exist in 1988 (Baldwin and Gu,

2003). Many of the new plants were, however, small and not highly productive. Depreciation of the dollar gave a major boost to Canadian goods exporters, and set the stage for a major recovery in manufacturing output and employment. This has been good news for Canadian workers and the Canadian economy. However, closer North American integration has done nothing to close the long-standing Canada-US productivity gap in manufacturing, making the FTA pretty much a bust in terms of its key goal of improving the relative long-term efficiency of Canadian manufacturing.

As shown in Table 1, both output and employment grew rapidly in the economic recovery between 1992 and 2001. Real output rose by 43.9% (a bit more than in the US), and employment rose by 20.7% (compared to almost zero job growth in the US). However, manufacturing productivity growth between 1992 and 2001 was much lower than in the US. Output per hour rose by just 16.1% compared to 41.5% in the US. Between 1995 and 2000 - the peak years of the US boom - labour productivity growth in Canadian manufacturing averaged just 1.1% per year compared to 4.5% in the US.

Even though wage growth was even slower in Canada than in the US, cost competitiveness would have deteriorated very seriously had not the dollar depreciated. While the dollar fell more than was strictly necessary to preserve cost competitiveness, our healthy export position in the US market, under the FTA until 2003, was almost entirely due to the continuing fall of the dollar after 1992 which resulted in falling relative unit labour costs despite much slower productivity growth.

Our poor relative productivity performance is due to the long-standing structural problems of Canadian industry: too many small, undercapitalized plants; relatively low firm investment in machinery and equipment, R and D, and training; over-dependence on resources and low value-added industrial materials; and, an under-developed advanced capital goods sector. Canadian industries in the same sector are often just about as productive as US industries. We are more productive in primary metals, the forest industry and the auto industry, and very close to US productivity levels in food processing and furniture. The key problem is a much smaller and less productive advanced industrial sector. In 1997, the two major capital goods industries - electrical and electronic equipment (e.g., computers and telecommunications equipment) and industrial machinery and equipment (which includes aerospace) - accounted for 34.8% of US manufacturing production compared to just 13.5% in Canada. Between 1989 and 1997, the production share of the capital goods sector in US manufacturing almost doubled (from

**Table 1**

<b>Productivity and Competitiveness in Manufacturing</b>		
<b>Key Comparisons in 2000 (1992 = 100)</b>		
	<b>US</b>	<b>Canada</b>
<b>Output per Hour</b>	141.5	116.1
<b>Output</b>	137.3	143.9
<b>Employment</b>	97.6	120.7
<b>Hourly Compensation</b>	130.7	117
<b>Unit Labour Costs</b>		
National Currency	94.1	101.5
\$US	94.1	79.2
<b>Average Annual Rate of Change</b>		
<b>Output per Hour</b>		
1990-95	3.3	3.8
1995-00	4.5	1.1
<b>Hourly Labour Compensation</b>		
1990-95	3.5	3.7
1995-00	4	1.4
<b>Unit Labour Costs - National Currency</b>		
1990-95	0.2	-0.1
1995-00	-0.5	0.4
<b>Unit Labour Costs - \$US</b>		
1990-95	0.2	-3.3
1995-00	-0.5	-1.2

Source: US Bureau of Labour Statistics. Release of February 26, 2003 (revisions to 2002 report).

18.5% to 34.8%), far, far ahead of the modest increase in Canada from 11.9% to 13.5%. US productivity gains in the second half of the 1990s came from very rapid productivity gains in the high productivity information-based technology sectors. Our productivity performance was depressed by a much smaller capital equipment sector, and by much slower productivity growth in that sector (Nadeau and Rao, 2002). The fact that the manufacturing productivity gap is a product of industrial structure is shown by the fact that Canada has not done nearly as badly compared to the US in terms of productivity growth in the business sector as a whole. Business sector labour productivity growth averaged 1.5% per year in Canada over the whole period, 1988- 2001, just a little below the US rate of 1.9%, and the gap began to close after 1997 (Statistics Canada. *The Daily*. September 13, 2002).

Deeper integration of the manufacturing sector in the North American economy has done little to decisively shift the structure of our industrial economy away from natural resources and relatively unsophisticated manufacturing towards the more dynamic and faster-growing, 'knowledge-based' industries. Machinery and equipment exports did grow somewhat more rapidly than total exports between 1990 and 2001, mainly because of the growth of the telecom and aerospace sectors. As a share of Canadian goods exports, machinery and equipment increased modestly from 19% in 1990 to 22% in 2001. Meanwhile, the export share of the large and highly productive auto sector (largely unaffected directly by the FTA and NAFTA, but totally integrated into the North American market) has remained unchanged at about 23% over this period. One big change has been the increased energy share of exports, up from 9% to 13% of the total since 1990, driven mainly by a huge increase in natural gas exports and rising energy prices. This has hardly been a long-term gain for Canada given that conventional oil and natural gas resources are rapidly depleting. Resources, resource-based manufacturing and crude industrial material production combined (i.e. agriculture and fish products, energy products, forest products, and basic industrial goods, including iron and steel and smelted minerals) still make up about 45% of all exports, down a little from 1990, but still a hugely important part of the economy.

As shown in Table 2, production of resource-based commodities and basic industrial materials, such as wood and paper, minerals and primary metal products (but not including food), still account for over one-third of manufacturing sector value-added, while machinery production (machinery plus aerospace) accounts for just 17.5%. Despite increased trade, there have been only very modest shifts in the overall sectoral structure of the traded goods sector of GDP with resources and resource-based manufacturing shrinking a bit, and advanced industrial goods sectors expanding very modestly. Limited Canadian transition to a more sophisticated industrial economy is suggested by our continuing low level of investment in research and development, and the particularly low level of business investment in R&D in Canada. Despite a modest increase in the 1990s, private sector financing of research and development amounts to 0.83% of GDP, less than half the US rate of 1.88% (Conference Board, 2002-03), and a huge share of business R&D is undertaken by just a handful of companies, such as Nortel and Bombardier. Reflecting resource dependency, the Canadian dollar is still mainly driven by the trend in commodity prices.

Despite the collapse of the high-tech bubble of the 1990s, the capital goods sector remains hugely important to the long-term economic future of advanced industrial countries given the ongoing shift of consumer goods production to lower wage developing countries. A strong resource-based and commodity production sector is no bad thing to the extent that it is an important source of wealth and jobs, and helps sustain regional economies. The distinction between a resource-based economy and a knowledge-based economy glosses over the fact that the resource industries are increasingly technologically sophisticated. Still, the long-standing Canadian structural bias to production of relatively low value-added commodities in capital intensive industries, such as smelting, pulp and paper, oil and gas production, and petrochemical production, carries important costs. Commodity and raw material prices, energy aside, have tended to increase only very slowly, explaining why Canadian personal incomes, adjusted for consumer price inflation, have grown at a much slower pace than real GDP in the 1990s. (Between 1989 and 2001, real GDP per capita grew by a total of 18.1%, while real personal income per capita grew by a cumulative total of just 7.2%.) It will be very hard

to raise Canadian living standards over the long-term and create well-paid jobs if we do not shift production towards goods and services which command rising rather than falling prices in world markets. That means producing more unique or sophisticated goods and services. Our dependence on large-scale crude energy exports is particularly unwise in a world of finite conventional resources, and is environmentally unsustainable from a global perspective.

**Table 2****Structure of Traded Goods Sectors of GDP: 1988 and 2001**

	% Total Real GDP (\$1997)	
	1988	2001
<b>Sector (NAICS)</b>		
Agriculture, Fishing, Hunting, Forestry	2.7%	2.2%
Primary Oil and Gas	2.4%	2.4%
Mining (excluding Oil and Gas)	1.7%	1.5%
<b>Total Primary</b>	<b>6.8%</b>	<b>6.1%</b>
<b>Manufacturing</b>	<b>17.5%</b>	<b>17.0%</b>
<b>Structure of Manufacturing (Sub-Sector as % Real Manufacturing GDP)</b>		
Wood and Paper	15.5%	13.0%
Petroleum and Coal	1.1%	1.1%
Primary Metals	7.1%	6.7%
Non-Metallic Mineral Products	3.6%	2.6%
Chemicals (including pharmaceuticals)	9.0%	8.6%
	1.4%	1.9%
<b>Sub-Total: Resources/Industrial Goods and Materials</b>	<b>37.7%</b>	<b>33.9%</b>
<b>Food</b>	<b>10.8%</b>	<b>10.1%</b>
<b>Beverages and Tobacco</b>	<b>4.3%</b>	<b>3.1%</b>
<b>Textiles and Clothing</b>	<b>4.9%</b>	<b>3.0%</b>
<b>Furniture</b>	<b>2.4%</b>	<b>3.0%</b>
<b>Printing</b>	<b>4.4%</b>	<b>2.7%</b>
<b>Plastics and Rubber</b> (approximately one-third auto related)	<b>3.9%</b>	<b>5.3%</b>
<b>Fabricated Metal Products</b>	<b>6.3%</b>	<b>6.9%</b>
<b>Motor Vehicles and Parts</b>	<b>9.0%</b>	<b>11.0%</b>
<b>Other Transport Equipment</b> (including aerospace)	<b>4.5%</b>	<b>5.5%</b>
	<b>3.1%</b>	<b>4.1%</b>
<b>Machinery</b>	<b>5.6%</b>	<b>6.0%</b>
<b>Computer and Electronic Products</b>	<b>3.6%</b>	<b>7.4%</b>
<b>Sub-Total: "Capital Goods"</b> (Machinery, ITC, Aerospace)	<b>12.3%</b>	<b>17.5%</b>
<b>Miscellaneous</b>	<b>1.8%</b>	<b>1.3%</b>

Source: Statistics Canada National Accounts Data via Informetrica Inc.

The striking fact of the matter is that getting the so-called ‘fundamentals’ right - free trade, balanced budgets, low interest rates, lower corporate and personal taxes - has failed to build a much more sophisticated industrial economy. Leaving it all to the market has not worked, and debate over appropriate industrial and energy policies to actively shape comparative advantage should resume. This does not necessarily mean a return to pre-FTA policies, though there is a role for the state in leading the transition to a knowledge-based and environmentally sustainable economy through public investment, regulation and subsidies.

The FTA was also, of course, expected to deliver the holy grail of secure access to the US market and protection from US protectionism. But, even the most fervent fans of ‘free trade’ must acknowledge that the US still actively uses its countervail and anti-dumping trade laws to selectively harass and penalize Canadian exports. Binational dispute settlement panels can only decide if US trade law was fairly applied, and procedures can take years making the notion of a ‘win’ a hollow victory. Our few ‘wins’ have, in any case, been eclipsed by continuing US management of trade in politically sensitive sectors such as lumber and agriculture. Some Canadian FDI in the US - for example, by the steel industry and Bombardier - has been prompted by protectionist US border measures and the political need for transnationals to establish a US production base. Many large Canadian companies, from Nova to Nortel, have shifted their real head offices to the US, giving rise to acute concern about the ‘hollowing out’ of corporate Canada even on the part of FTA proponents like the Canadian Council of Chief Executives. Ironically, the defenders of free trade now argue that still deeper integration is needed to secure the original key goal of market access for which so much policy space was surrendered.

## **DOWNWARD HARMONIZATION: SOCIAL DIMENSIONS OF INTEGRATED ECONOMIC SPACE**

In the great free trade debate of the late 1980s, advocates argued that a stronger economy would support higher wages and better social programs. However, after the deal was signed, business increasingly argued that decent wages and high social expenditures, financed from progressive taxes, make Canada uncompetitive in a shared economic space. ‘Competitiveness’ came to be defined as lower taxes, lower social spending, and more ‘flexible’ labour markets. Experience has shown that there are, indeed, downward pressures from North American economic integration on progressive, redistributive social policy which arise mainly from the tax side.

Canada has a very different social model than the US, which is highly valued by most Canadians. Among the enduring elements of difference, Canada has a significantly more equal distribution of both earnings and after-tax/transfer (disposable) income. Our more narrow distribution of earnings reflects higher unionization, somewhat higher minimum wages, and a smaller pay gap between the middle and the top of the earnings spectrum. More equal after-tax incomes and lower rates of after-tax poverty than in the US reflect the impacts of a more ‘generous’ system of transfers acting upon a somewhat more equal distribution of market income. Until the ‘reform’ of the mid-1990s, the Canadian Unemployment Insurance system

was notably more generous than that of the US, and Canadian welfare programs benefit a much larger share of the non-elderly poor. All Canadian provinces, but very few US states, provide welfare to singles and families without children, and benefits, while low and falling in real terms, are generally higher than in the US. In the mid-1990s, the Canadian poverty rate for all persons was 10% compared to 17% in the US, using a common definition of less than half of median income, and the minimum distance between the top and bottom deciles of the family income distribution was 4 to 1 compared to almost 6.5 to 1. Comparing Canadian and US after-tax income distributions in real purchasing power terms, the bottom one-third of Canadians are much better off than the bottom one-third of Americans, and the US average income advantage of about 15% goes overwhelmingly to the top one-third or so of the income distribution. In other words, affluent Americans have significantly more disposable income than affluent Canadians, but the gap is very small for middle-income families (particularly if adjusted for out-of-pocket health care costs), and does not exist at all for lower income families (Wolfson and Murphy, 1998). The level of public provision of services on a citizen entitlement basis is also higher in Canada than the US, reducing dependence on market income for some basic needs. Medicare is the key example, but Canada also provides a somewhat higher level of community services, such as not-for-profit child care, home care, and elder care services. Greater equality has sustained better social outcomes in terms of health, crime and educational attainment (see Table 3).

It is far beyond the scope of this paper to detail changes in income distribution and social outcomes in the 1990s. But, there has been a significant increase in income inequality among working-age Canadian families. Table 4 shows the distribution of both market (wage and investment) income and after-tax and government transfer income among families of two persons or more. The population of families is divided into five groups of equal size (quintiles). The 1989 to 2001 change in the post-FTA era is what economists would term ‘structural’ since the start and end years both came at the end of a period of strong job growth and economic recovery. Real family incomes from the market grew most in both dollar and percentage terms for higher income families. The inflation-adjusted market incomes of the top 20% rose by 16.5% compared to a loss of almost 7% for the bottom 20%. The share of market income of the top 20% rose from 42.4% in 1989, to 45.6% in 2001, while the share of all other income groups fell. The after-tax/transfer share of the top 20% of families also rose, from 36.9% to 39.2%, and the share of all other income groups fell.

**Table 3**

Indicators of Social Development		
	Canada	US
<b>INCOME AND POVERTY</b>		
Poverty Rate	10.3%	17.0%
Child Poverty Rate	15.5%	22.4%
<b>JOBS</b>		
Low Paid Jobs	20.9%	24.5%
Earnings Gap	3.7	4.6
<b>SOCIAL SUPPORTS</b>		
Health Care (Public Share as % GDP)	69.6%	44.7%
Tertiary Education (Public Share)	60.0%	51.0%
Private Social Spending (as % GDP)	4.5%	8.6%
<b>HEALTH</b>		
Life-Expectancy (Men)	75.3	72.5
Life-Expectancy (Women)	81.3	79.2
Infant Mortality/100,000	5.5	7.2
<b>CRIME</b>		
Homicides per 100,000	1.8	5.5
Assault/Threat per 100,000	4	5.7
Prisoners per 100,000	118	546
<b>EDUCATION</b>		
Adults with Post Secondary Education	38.8%	34.9%
High Literacy (% Adults)	25.1%	19.0%
Low Literacy (% Adults)	42.9%	49.6%

**Notes and Sources:**

Data are from the OECD Social Indicators Database.

Poverty defined as less than half the median income of an equivalent household.

Low pay is employed in a full-time job and earning less than 2/3 the median hourly wage.

Earnings gap is ratio of bottom of top decile to top of bottom decile.

Poverty rates rose between 1989 and 2001 for Canadians aged 18 to 64, but fell among the elderly.

Rising income inequality has been driven primarily by stronger wage growth for high income earners, and by cuts in social transfers which have reduced the income equalizing effects of social programs. Neither can be blamed directly upon North American economic integration and, undoubtedly, a complex range of factors have been at play. However, there is a link between continental integration and the increased market incomes of the most affluent, given that the (still limited) labour mobility measures of NAFTA and closer trade and investment links have almost certainly led to some salary and options upward convergence for highly mobile professionals and managers in the corporate sector. Also, the FTA and NAFTA can be plausibly associated in a direct way with downward

pressures on wages in sectors most exposed to the threat of relocation of production or new investment to the US and Mexico. Increased competitive pressures help explain the very sharp decline in the unionization rate in Canadian manufacturing, which has fallen from 45.5% in 1988 to just 32.4% in 2002, and the more modest decline in the private sector as a whole (Jackson and Schetagne, 2003). Union decline reflects disproportionate closures of unionized plants, and the disproportionate concentration of new hiring in non-union plants, not to mention legislative assaults on union organizing capacity. Real manufacturing wage growth has lagged consistently behind manufacturing sector productivity in both Canada and the US, as indicated in Table 1 which shows that Canadian *nominal* wages (unadjusted for consumer price increases) have just about matched increases in *real* (inflation adjusted) output per hour. Within manufacturing, the wages of less skilled and hourly paid workers have eroded compared to those of technical workers and managers. The post-FTA era has been generally a period in which real wages have lagged productivity, and corporate profitability has increased. The 1980s peak for corporate profits as a share of GDP was in 1988 (10.6%), but the high point of the recent expansion was 12.2% in 2000, and pre-tax corporate profits, including in most of manufacturing and the resource sector, have remained above 1988 levels. In short, it is hard to sustain the argument that workers have fully shared in the relatively modest productivity gains that some have

**Table 4**

Family Income Trends in the 1990s				
	1989	2000	2001	% Change 1989-2001
<b>Market Income</b>				
Bottom Quintile	\$8,969	\$8,781	\$8,362	-6.8%
Second Quintile	\$33,729	\$32,688	\$32,362	-4.1%
Middle Quintile	\$53,144	\$54,115	\$54,127	1.8%
Fourth Quintile	\$73,844	\$78,039	\$78,389	6.2%
Top Quintile	\$124,953	\$142,451	\$145,580	16.5%
<b>Shares of Market Income</b>				
Bottom Quintile	3.0%	2.8%	2.6%	
Second Quintile	11.5%	10.3%	10.2%	
Middle Quintile	18.0%	17.1%	17.0%	
Fourth Quintile	25.1%	24.7%	24.6%	
Top Quintile	42.4%	45.1%	45.6%	
<b>Post Tax/Transfer Income Shares</b>				
Bottom Quintile	7.7%	7.3%	7.1%	
Next Quintile	13.6%	12.8%	12.7%	
Middle Quintile	18.2%	17.6%	17.6%	
Next Quintile	23.6%	23.5%	23.4%	
Top Quintile	36.9%	38.8%	39.2%	
<b>Poverty (Post-Tax LICO)</b>				
All Persons	10.0%	10.9%	10.4%	
Children	11.5%	12.5%	11.4%	
18-64	9.3%	11.0%	10.6%	
65 plus	10.9%	7.3%	7.3%	

(Data are for Economic Families of Two Persons or More. Statistics Canada. Income in Canada CD-Rom 2001.)  
(Constant \$ 2001)

Statistics Canada: Income in Canada CD-ROM. Table T802.

attributed to the FTA, and hard to deny that integration has tended to tilt the bargaining scales against workers.

Closer integration can also be linked to the erosion of income transfers to the working-age population. Most observers would argue that the Employment Insurance (EI) cuts imposed by the Liberal government in 1995, cuts in federal transfers to the provinces for social programs and provincial welfare cuts were driven by fiscal and political/ideological rather than competitive considerations. There is no doubt that the drive to eliminate federal and provincial deficits played a major role in cuts to income transfers, and that some provincial governments, such as those of Ontario and Alberta, were ideologically hostile to 'hand-outs' to so-called 'employable' recipients. However, the Department of Finance, the OECD and the IMF have long argued that welfare state 'generosity' in Canada is associated with a higher NAIRU (non-accelerating inflation rate of unemployment) than the US because income benefits strengthen the bargaining power of workers and thus raise the wage floor. Cuts to transfers, particularly EI, were consciously intended to promote greater labour market and wage 'flexibility.' This has been seen as particularly desirable given closer economic integration with the US. In short, integration made the US model of a more minimalist welfare state attractive to those who worried about the relative strength of Canadian workers (Jackson, 2000c).

Economic pressures to social policy convergence are exaggerated to the extent that progressive and redistributive social models have significant economic pluses (Jackson, 2000a, 2000c). Economic integration does not eclipse the space for national choice in social policy, and there is no universal trend towards decreased social expenditures and lower taxes in advanced capitalist countries. Some high-equality countries with high levels of spending on public and social services, high taxes, and very high levels of collective bargaining coverage did well in the 1990s in terms of productivity and job creation (e.g., Denmark, the Netherlands, Sweden from the mid-1990s). The lack of a demonstrable link from egalitarian policies to poor economic performance even under conditions of increased global competition is not surprising if one takes account of the positive impacts of relative equality on 'human capital' and 'social capital' and the greater efficiency of public over market delivery of many key services. In short, a good economic argument can be made that integration *per se* does not mean that Canada has to harmonize down to US levels of social spending and public services in order to build a productive economy.

Yet, the operative, endlessly repeated proposition of business and the policy mainstream has been that economic success will go to countries which most closely emulate the US model of deregulated labour markets, low taxes and low social spending. Over the 1990s, particularly after the elimination of the federal deficit in 1997, the political argument was constantly advanced that taxes had to be harmonized down to US levels to maintain competitiveness and fuel growth and job creation. The argument has been that Canadian business taxes (corporate income taxes and capital taxes) and personal income taxes on higher earners are too high relative to the US, helping make the US a more attractive locale for mobile corporations to invest and produce. While many advocates of tax cuts would also argue that lower taxes *per se* boost economic efficiency, a great deal of stress has been placed on Canada-US tax differences as a factor in weaker Canadian economic performance through much of the past decade. The major

advocates of the ‘tax cuts for competitiveness’ argument have been business lobby groups, such as the Canadian Council of Chief Executives and the Chamber of Commerce, and conservative think-tanks, such as the CD Howe Institute. The November 2002 pre-Budget Report of the Standing Committee on Finance of the House of Commons reported that submissions from business organizations continued to stress that Canadian tax rates — particularly personal income tax rates on high income groups and business taxes — should be “competitive” with the US. The report underlined that “tax competitiveness is a key component of the federal government’s strategy to become a magnet for investment and skilled labour,” and heeded calls from business for the elimination of capital taxes and ensuring that corporate income tax rates are kept at or below US levels.

Arguments for tax cuts for competitiveness are suspect since foregone expenditures have positive impacts on productivity. Canada-US corporate tax differences in the mid-1990s were very small, and were offset by other cost factors, such as lower energy prices and lower health costs for workers. On the personal income tax side, high income earners did tend to pay somewhat more than in the US, but the gap was quite modest in the aftermath of the Clinton Administration’s tax hikes, and the alleged ‘brain drain’ was hugely exaggerated (Helliwell, 2002). Nonetheless, the ideological and self-serving argument for tax cuts won the day after deficits were eliminated. Driven by personal and corporate income tax cuts, the federal tax share of GDP has fallen from 17.4% of GDP in 1997-98 to 15.9% in 2001-02, and will fall to just 15.2% by 2004-05 as the tax cuts are fully implemented (Federal Budget 2003, Table 8.6). The reduced fiscal capacity of the federal government amounts to foregone potential expenditures of about \$20 billion. Provincial tax revenues have also fallen since 1997-98, by a bit under one per cent of GDP.

The major beneficiaries of the changes to personal income tax rates and brackets were those making more than \$70,000 who will pay about 5% less of their taxable income in income tax. The lower paid got a smaller proportional tax cut, ranging from almost nothing at the bottom to about 3% of taxable income for an average worker. The very affluent also won the elimination of the 5% high-income surtax and a major reduction (from 75% to 50%) in the proportion of capital gains income which is liable to tax, a measure which has cost the federal government about \$1 billion in foregone revenues, with about half of the benefit going to very high-income persons earning more than \$250,000 per year. Reduction of capital gains taxes, which apply to profits earned on stocks and stock options, was top on the business agenda in 2000, with Canada-US tax competition arguments featuring heavily in the debate. The federal government tax plan also featured a phased-in reduction of the corporate income tax rate from 28% to 21% with the explicit objective of cutting the rate to levels that are lower than in the US. The key point is that, after the deficit was eliminated, the growing federal surplus went to personal income and corporate tax cuts rather than to a renewal of social spending. The tax cuts were tilted to the more affluent and business despite the fact that lower income groups had been hit hardest by the earlier federal program spending cuts.

While Canadian governments still spend significantly more on social programs and public services than US governments, the difference has been shrinking dramatically. Table 4, based on data from a research paper from the Department of Finance, details program spending

differences between Canada and the US in 1992 and 2001 for all levels of government expressed as a share of GDP. The bottom line is that Canadian governments collectively spent 34.8% of Canadian GDP on programs in 2001, while US governments spent 31.9% of GDP. The difference fell from 10.9 percentage points of GDP in 1992, to just 2.9 percentage points in 2001, as Canadian government spending fell by almost 10 percentage points. The spending gap between the two countries is greater for non-defence spending, at a still significant 5.7 percentage points of GDP, but this is down dramatically from a much greater difference of 15.2 percentage points in 1992. Non-defence program spending actually increased in the US under Clinton, while falling by almost 10 percentage points of GDP in Canada. The main differences between Canada and the US are in national defence (where we spend much less) and in income security programs. Here, we still spend 11.0% of GDP compared to 7.1% in the US, but the gap has shrunk greatly since 1992, reflecting cuts to welfare and EI benefits as well as falling unemployment. Canada now spends relatively less than the US on public education, the result of recent cuts in Canada and increases in the US, and we spend only a bit more on health (though we spend much more efficiently because of public delivery and a single-payer Medicare system).

**Table 5****Canada-US Fiscal Comparisons**

Function	Change in Government Spending as % GDP					
	US	1992			2001	
		Canada	Gap	US	Canada	Gap
Income Security	7.9	14.3	6.4	7.1	11	3.9
Housing and Community Services	0.7	1.9	1.2	0.5	1.4	0.9
Economic Affairs	3.2	5.8	2.5	3.2	3.5	0.3
Recreation and Culture	0.3	1.3	1	0.3	1	0.7
Education	5.7	7.7	2	6.2	5.9	-0.3
Health	6	7.3	1.2	6.7	7	0.4
General Public Services	2	2.4	0.4	1.9	1.9	0
Public Order and Safety	1.9	2.3	0.5	2.2	1.9	-0.2
National Defence	6	1.7	-4.3	4	1.2	-2.8
<b>Total Program Spending</b>	<b>33.7</b>	<b>44.6</b>	<b>10.9</b>	<b>31.9</b>	<b>34.8</b>	<b>2.9</b>
<b>Non-Defence Program Spending</b>	<b>27.7</b>	<b>42.9</b>	<b>15.2</b>	<b>27.9</b>	<b>33.6</b>	<b>5.7</b>

Source: "Government Spending in Canada and the US." Department of Finance Working Paper 2003-05.

It is important to spend money wisely and efficiently, but the size of spending clearly matters as well. The Canada-US difference has shrunk dramatically in the 1990s because of deep cuts to Canadian spending on social programs and public services, and this was clearly driven in significant part by the campaign of the right for downward harmonization of taxes, financed through social spending cuts. Competitive pressures trumped the desire of most Canadians to renew social spending once deficits had been eliminated. Public opinion survey evidence shows that there was a deep class cleavage over the key issue of tax cuts or social reinvestment after the federal budget was balanced. Polling in 1998 for the Department of Finance by the Earncliffe Group found that all broad income groups placed a greater priority on social investment than on tax cuts and rejected harmonization of Canadian and US tax policies, albeit with a clear difference by income level. However, an EKOS survey ("Reinventing Government") which regularly charts differences between elite and non-elite opinion has found that the former very strongly favoured corporate and personal tax cuts as the best use of the emerging federal surplus (Mendelson, 2002. See Charts 56, 118, 119, 123, 124, 149, and 152).

In the final analysis, corporate elite views were clearly the most influential in policy terms, and the desire of middle and lower income Canadians for significant social reinvestment went largely unheeded until the Chrétien 'legacy Budget' of 2003.

The cleavage between elite and non-elite views on the tax cuts vs. social spending debate has probably been influenced by the cultural and not just the economic implications of North American integration. In an ever more closely integrated economic space, corporate elites increasingly see their personal prospects and future in continental terms, and make comparisons of their personal well-being to their American peers rather than to other Canadians. Career prospects have been continentalized to some extent at this level given the increasing linkages between the Canadian and US economies mediated through transnational corporations operating on both sides of the border. The Canadian trade-off of higher taxes for better services and greater security is also less relevant to high-income groups who can afford to buy what they need on the market. By contrast, for middle class and lower income families, the trade off of higher taxes for social programs is still relevant, and comparisons to US disposable income are not relevant. Public opinion evidence shows no loss of support for the Canadian social model and, indeed, increasing divergence between Canadian and US values (Mendelson, 2002).

To summarize, there continues to be space for autonomy in social policy, and the Canadian social model is not doomed to extinction because of closer trade and investment ties. But, there are strong downward pressures on our capacity to finance social spending which arise mainly from pressures to lower business taxes and taxes on high-income earners to US levels. Canadian expenditures on public and social services have been severely constrained, and financed to a greater degree from relatively less progressive forms of taxation. Privatization of public services, such as health and education, has been aided by the erosion of quality public programs. Economic integration has thus been a factor in the pronounced erosion and downward harmonization of the Canadian social model in the 1990s.

## **MOVING FORWARD**

The FTA has significantly increased Canada-US economic integration, but has left us with a weak 'knowledge-based' economy. And, economic integration has tilted the political scales against re-building and renewing the damaged but still intact Canadian social model. The champions of deeper economic integration in North America are (almost) all champions of deregulation of economic space and admirers of the US social model. For them, still deeper integration is desirable because it involves the prospect of limited gains - a more seamless border - at no real cost in terms of valued economic, social or environmental policies. If free trade has not worked out as well as expected in terms of growth and productivity, as many will concede, their answer is to say that we have not done enough to break down remaining 'barriers' and that 'there is no alternative.' For those of us of who want to maintain Canadian distinctiveness, the path forward is not so clear.

The left, which opposed the FTA in the late 1980s, has changed, just as Canada has changed. In the wake of the shift from the FTA to NAFTA to the proposed FTAA, the

transformation of the GATT into the WTO and the emergence of the so-called 'anti-globalization' movement, there has been a partial shift from economic nationalism to 'progressive internationalism.' The argument has been increasingly heard that the way forward is not so much to re-connect economic and political space at the national level as to build a different kind of global economic order. Key issues, such as environmental sustainability, global inequality and justice for the developing world - not to mention the instability of global capitalism - have to be addressed at a supranational level, and this task has been taken up by new social movements. In Europe, the social democratic left has attempted to re-connect political and economic space through the explicit 'social dimension' of the EU. While instructive, the lessons for progressive North Americans seem limited given the huge political weight of the US in the Americas and the weakness of potential political allies in the US.

The way forward for Canada is to retain as much room for manoeuvre as we can *vis-à-vis* the US, while advancing a progressive agenda at the national and international level. There can, realistically, be no return to the somewhat more insulated economic space of the late 1980s given the realities of globalized capitalism and close continental integration in terms of trade in goods and, to a much lesser but growing extent, services. But, there is reason and space to exercise sovereignty in key domains: to maintain regulation of the cultural sector; to more actively review foreign investment; to actively shape comparative advantage through public investment in positive industrial restructuring, innovation, education and training; to rebuild and renew social programs and public services; and, to take environmental sustainability seriously. Small, open economies still retain considerable capacity for political choice at the national level, and can help shape a different international agenda. The FTA may have led to a hard landing, but the future is still open.

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