

Integration without convergence? The North American model of integration

A DECADE OF FREE TRADE

After a decade of the FTA, NAFTA, and intense globalization, Canada and the United States have entered a period of transition, yet the emergence of a North American policy space with shared values, assumptions, policies, and goals has failed to coalesce. The newest development is that the Canadian state is not being dismantled, as was once confidently predicted. Rather, it is being redefined in many ways that can only be explained by changes in elite politics and notions of governance. While NAFTA and globalization are powerful benchmarks, they do not alone account for the fundamental changes in the Canada–U.S. relationship.

With among the highest levels of economic integration in the industrialized world, it was expected that the dual effects of NAFTA and globalization would lead to greater convergence in key policy areas between Canada and the United States and, further, that Canada’s distinctive programs, policies, and values would be jeopardized. Certainly there is now a greater degree of interconnectedness between the local economies in Canada and the larger American-centred north–south regionally based markets than ever before. Trucks, railways, airlines, ports, e-commerce, water, and electricity grids transect the continent in real time.

In the past, many experts claimed that such a high degree of integration meant that Canada would not sustain its own particular social and institutional arrangements. It was considered that the worlds of the state, politics, and economics had to have congruent boundaries so that state action and the behaviour of economic actors could be addressed through strong, nationally based politics. This proposition has to

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be rethought for one basic reason—after a decade of integration, the leading indicators do not reveal, to the degree predicted, strong evidence of across-the-board convergence.

DIVERGENCE IS ALSO THE TREND

The theory predicted that in government spending Canada would adopt the “less state, less tax” U.S. model. In productivity, the gap between Canadian and U.S. firms would close. In social program expenditures, Canadian spending would drop to U.S. levels. In health care, Canada’s health care sys-

tem would move toward the U.S. private system of health delivery. As for labour and collective bargaining, Canadian unions were expected to go down the U.S. road toward a non-union workplace. Finally, with regard to values, American individual self-interest would replace the Canadian belief in collective responsibility and fairness. So far, all these critical gaps have not disappeared; many have grown more pronounced, despite the promise of closer economic integration.

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The bare-knuckle reality is that the disciplinary code of markets is less than anyone could have imagined and that the NAFTA effects are far less significant, as a public policy factor. Canadians have held their own despite the pressures from the Republic’s moving frontier, not well, but better than most of the policy experts anticipated. Contrary to almost every prediction, Canadian economic and social space, although troubled, is more resilient. The traditional structural fault lines of the economy—low per capita spending on new technology, too few Canadian middle-ranking firms, the absence of a developed venture capital market, and a poor skills acquisition strategy to upgrade the workforce—continue to drag down Canada’s economic performance. Any or all of these factors would undermine Canada’s competitive position with or without integration. If the critical test is to examine the gaps be-

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tween Canada and the United States in key areas of the economy, it reveals something quite startling: high levels of integration marked by many characteristics of social divergence and spatial distinctiveness.

How can so much divergence be accounted for?

The best explanation is that the motor for change comes as much from within Canada, due to the fiscal and monetary policies adopted by Ottawa, as from without. Institutions make a real difference. The evidence may not be conclusive but it is compelling enough to sit up and take notice of it.

WHAT THE EVIDENCE SHOWS— KEY INDICATORS

In terms of tax policy, there has been no collapse of the higher tax regime in Canada over the decade. We remain above all of our trading partners but only slightly above the G7 average. We continue to be 8.9 percent higher than in the United States and Canada continues to rely more on personal income taxes. By comparison, Ottawa taxes middle- and upper-income Canadians more, while lower-income Canadians are better off than their U.S. counterparts. The villain is that, since 1986, Canadian tax rates were not indexed against inflation, while in the United States they were and thus the tax bite in Canada has been deeper.

In terms of per capita income, Canadians earn roughly 20 percent less than their U.S. counterparts and there is no closing of this gap. Indeed, many experts, such as Benny Tal, believe it is widening. Since 1989, real pre-tax income rose in Canada by Can.\$500 compared with U.S.\$2,850 in the United States. If Canadian family incomes are rising by the late 1990s, it is because more people are working and a strong job market has helped reverse a decade-long income decline. In 1998, income tax increased 3.7 percent, the biggest single year gain since 1989. But with taxes and transfers no longer balanced,

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In the area of employment the two countries again diverge. Between 1989 and 1997, employment rose by 10.4 percent in the United States, this is compared with only 6.5 percent in Canada. Statistics Canada found that, in the United States, most of the growth occurred among full-time employees, while in Canada self-employment accounted for 80 percent of the overall employment increase.

One of the largest areas where the two countries differ is their unemployment rate. In 1981, Canada and the United States had the same rate. During the 1980s this grew larger and by the 1990s the gap had risen 4 percentage points. With a lower rate of inflation, Canada had almost twice the U.S. level of unemployment. The productivity gap in manufacturing has only marginally changed. In 1988, the gap in manufacturing was 78 percent of U.S. levels and by 1998 it had fallen to 72 percent. Canada persistently lags the United States in research and development (R&D), equipment, machinery, and new product development.

NORTH AMERICA IS NOT A SEAMLESS MARKET

At the provincial and state levels, all Canadian provinces have had higher unemployment rates. With few exceptions, American states experienced an overall decline in unemployment rates. The contrast with Canada could not be sharper. Provincial unemployment rates have not succeeded in reducing unemployment to the same degree. Also, in the area of job creation, the labour market experience is sharply contrasting. In the land of opportunity and risk taking, full-time employment played more of a role in the U.S. economy. In the more conservative Canadian society, a greater number of jobs were created by self-employment.

In terms of collective bargaining and trade-union coverage, the latest figures indicate that, with about 38 percent of the workforce covered by collective bargaining, there has been no collapse of the Canadian union movement equivalent to that in the United States. There is a decline in private sector unionism but this has been in effect for the last 40 years and, more recently, this decline has largely been arrested.

Industry Canada has commissioned a new series of studies to examine the effects of foreign direct investment (FDI). FDI has more than doubled in Canada in the past decade, reaching 22.6 percent of GDP. Here a brief comment is in order. Canadian industry is getting the short end of the stick. FDI in-

flows promise much but, in terms of their impact on output, domestic spillovers pay larger dividends, if these studies are to be believed. At present, only about one-third of FDI flows into manufacturing, and the technology and transfer spillovers on productivity are disappointing. There appears to be no significant relationship between foreign direct investment and R&D capital.

Domestic R&D spillovers were greater than those from new capital inflows. Total factor productivity, one of the key measures that economists rely on to explain the different contributions to a better industry performance, was a meagre 0.11 percent per year over the period 1973 to 1992. By contrast, Germany gets a big increase from FDI flows, 0.27 percent for every 1 percent increase in FDI. So, if a productivity gap is still significant, more integration is not likely to have much of an impact on making Canadian firms more competitive now that they have new access to the U.S. market. The large differences in productivity that have dogged Canadian industry for the last 40 years have more to do with best managerial practice and technological know-how than any other significant factor. In both categories the differences between Canadian and U.S. firms have deteriorated since free trade was introduced. Evidently management strategies are not responding to optimal market price signals.

Since 1984, Canadian exports to the United States have jumped from \$85 billion, rising to \$100 billion in 1988, the year of the first trade deal, and topping \$200 billion in 1996. At the same time, interprovincial trade also rose from \$106 billion to \$160 billion. By the end of the 90s, eight out of ten provinces—with only Nova Scotia and PEI being the exceptions—traded more internationally than interprovincially. If the Canadian economy is buoyant, it is because of the \$.67 dollar and the recovery in international commodity prices. There is nothing new in the fact that Canada's best industrial hope, at the moment, is to ride on the back of the U.S. business

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cycle until it abruptly runs out of steam. Every Canadian government has tied its star to the same policy, seemingly indifferent to being burned at the stake of U.S. policies.

DEFYING CONTINENTALIST LOGIC

None of these “leading” indicators explains the unique situation of North American integration—high levels of interdependency without convergence. With so much policy divergence, instead of lockstep convergence, the role of government and the organization of civil society continue to defy either a strict continentalist logic or the nationalist *cri-de-coeur*. The empirical evidence is a powerful reminder that despite all the talk about the triumph of markets, the Canadian state has not been dismantled as once feared. This is hardly reason to be complacent, because the combination of NAFTA effects and globalization dynamics raises a whole array of governance issues that need addressing. These are the hard issues of public life for which no political party seems to have readied answers.

First, since the income gap between Canada and the United States is larger than ever, can it be closed? Second, with so much pressure on English Canadians and their identity, does it have the political desire to differentiate the Canadian experience from the American any longer? Finally, will the political elites

protect Canadian identity and distinctiveness when these collide with the free flow of ideas and goods?

Becoming more Canadian rather than North American could be helped by the fact that there is hardly anything left of what used to be called the special Canada–U.S. relationship. Old-fashioned “good neighbourliness” has been replaced by U.S. foreign policy largely carried out on behalf of private rather than public interest. The NAFTA linkage has not given Canada a step up in U.S. policy circles. At present, Ottawa has to line up with all the other lobbyists to cut deals with the U.S. Congress when it has special needs or concerns. One unintended consequence is that, in the hemisphere, Canada is increasingly seen as an indispensable counterweight to U.S. policy by many Latin American countries in the OAS and other regional bodies.

In this new environment, rethinking North America will be helped by the fact that the Canadian economy is booming and, after a decade of disappointment, unemployment is down and growth is much stronger than ever before. So the question is, does it matter anymore that Canada and United States are on two different paths economically and politically? Who cares if NAFTA did not create the great level playing field? No one save a few die-hards seemed to notice that all the hype around market access has turned out to be a false penny. 