CANADA AND THE NEW AMERICAN EMPIRE

North American Economic Integration and the Canadian Social Model

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Key Issue: Economic Integration and Downward Harmonization

In the 'great free trade debate' of 1988, proponents argued that economic gains would be shared with workers in the form of higher wages in better jobs, and that higher growth would support and sustain social programs. 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 social standards which add to business costs. Free trade was seen as a threat to the more progressive and more equal Canadian social model of stronger unions, higher levels of income protection and broader access to public and social services.

The critics were right, mainly because, 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. However, these come more from the increased power of business to trump the views of citizens than from any fundamental contradiction between progressive social policy and economic success.

Canada has a different social model than the US, which is highly valued by most Canadians. Among the enduring elements of difference, Canada has a 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 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. 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. Greater equality has sustained better social outcomes in terms of health, crime and educational attainment.

Since the late 1980s, there has been a very significant increase in earnings inequality in Canada. The share of all pre tax income going to the very top 1% of taxpayers, those making more than about $150,000 per year, has risen from 9.4% to 13.6%. (Emmanuel Saez and Michael Veall. The Evolution of High Incomes in Canada. National Bureau of Economic Research Working Paper. 2003.) While incomes at the very top have risen sharply, real wages for most workers have stagnated, and the ranks of the working poor have grown. Increased earnings inequality combined with cuts to income transfers (mainly social assistance and Unemployment Insurance) have also increased gaps in after tax/ transfer incomes of Canadians. Between 1989 and 2001, the share of after tax/transfer income of the top 20% of families, which was unchanged in the 1980s, rose from 36.9% to 39.2%, at the expense of the bottom 80%.

Rising income inequality has been driven by income growth for high earners, and by cuts in social transfers. Neither can be blamed directly upon North American economic integration and, undoubtedly, a complex range of factors has been at play. However, there is a link between continental integration and the increased incomes of the most affluent, given that closer trade and investment links have led to some upward convergence of salary and options for corporate executives. Also, the FTA and NAFTA can be plausibly associated in a direct way with downward pressures on worker's wages in the manufacturing sector, which is most exposed to the greater threat of relocation of production or new investment to the US or Mexico. The post-FTA era has been a period in which real wages in manufacturing have barely increased, while productivity and corporate profitability have grown. The unionization rate in manufacturing has fallen, from 36% to 32%, in the post FTA era. It is 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. Employment Insurance (EI) cuts by the Liberal government in 1995, cuts in federal transfers to the provinces for social programs and provincial welfare cuts were all driven by deficit reduction and political/ideological considerations. However, cuts to transfers, particularly EI, were also consciously intended to promote greater labour market and wage 'flexibility' and to make Canada more competitive compared to the US. The US model of a more minimalist welfare state was attractive to those who worried about the relative strength of Canadian workers

Economic pressures to social policy convergence are exaggerated to the extent that progressive and redistributive social models have significant economic pluses . 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 (e.g., Denmark, the Netherlands) did very well in the 1990s in terms of productivity and job creation. The lack of a demonstrable link from progressive social 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 copy 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 location 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.

Economic arguments for tax cuts for competitiveness are suspect since foregone public expenditures have positive impacts on productivity. Further, Canada-US corporate tax differences in the mid-1990s were 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 modest in the aftermath of the Clinton Administration's tax hikes, and the alleged 'brain drain' was hugely exaggerated. Nonetheless, the ideological and self-serving argument for tax cuts largely won the day after deficits were eliminated.

Driven by personal and corporate income tax cuts, the federal revenue share of GDP has fallen by more than 2 percentage points since the deficit was eliminated, and the provincial share has fallen by about 1 percentage point of GDP. This translates into almost $30 Billion of foregone social investment. Unknown to most Canadians, the share of our national income now raised by personal income taxes and employee social security contributions combined is now almost exactly the same as in the US (at 18% of GDP) and the modest Canada - US tax difference which remains is now almost entirely the product of higher sales taxes in Canada (8.7% of GDP vs. 4.6% in the US.) The tax harmonisers have largely won the day, and the major .
beneficiaries have been corporations and higher income earners who gained the most because of much reduced taxation of capital gains and stock options.

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, despite the fact that lower income groups had been hit hardest by the earlier deep cuts to federal and provincial program spending. While Canadian governments still spend more on social programs and public services than US governments, the difference has been shrinking dramatically. Canadian governments collectively spent 34.8% of Canadian GDP on programs in 2001, while US governments spent 31.9% of US GDP. The difference of 2.9 percentage points is down from a much bigger difference of almost 10 percentage points in the early 1990s. 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. Canada now spends relatively less than the US on public education, the result of recent cuts in Canada and increases in the US, relatively more on incoem supports, 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).

It is important to spend money wisely and efficiently, but the scale of public 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. 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. 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.

The cleavage between elite and non-elite views on the tax cuts vs. social spending debate has 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 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.

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 pressures towards increased earnings inequality in a more integrated economic world, and strong downward pressures on our capacity to finance social spending to promote greater equality. The latter 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, and will only increase in importance if economic integration continues and deepens.

(For a more extensive analysis and references, see Andrew Jackson, "From Leaps of Faith to Hard Landings: Fifteen Years of "Free Trade'. Canadian Centre for Policy Alternatives. December, 2003. www.policyalternatives.ca)

Choices for Canadians and Potential Flash Points:

Likely, the current level of economic integration between Canada and the US will continue to deepen to some degree over the next 10-15 years. However, two-way trade flows have stabilized, and Canadian trade and investment ties with the rest of the world may grow even more rapidly given that world growth is fastest in Asia. Change is unlikely to be sudden, unless there is a major new agreement, such as the creation of a Canada-US Customs Union. This would have profound implications for social policy, since most forms of customs unions require the partners to take a single position on trade and investment policies (as the European Union does at the World Trade Organization.) Many issues relevant to social policy - most importantly the decision on whether to allow or not allow private sector delivery of health care and other social services - are impacted by trade and investment rules and the US would be unlikely to support the current position of the Government of Canada that delivery of social services through the public sector should be protected.

In the absence of a major change in trade agreements themselves, integration will continue to be one factor, but only one factor, influencing the continuing national debate over what proportion of national income should be raised through taxes to spend on social programs, and on how the tax burden should be divided between corporations and persons, and different income groups. Given that taxes and social spending have already been harmonized down towards US levels, the issue may be less salient in the years ahead than in the recent past. It is even possible that US taxes and social spending could rise towards Canadian levels, if there was a change in the political winds in the US.

Options/Recommendations:

In the view of the author, Canada has some considerable room to maintain and improve the distinctive Canadian social model. Progress in this direction will be greatest to the extent that advocates of social investment can point to economic as well as social gains, and the role of social spendign in maintaining a highloy productive and innovative economy.