Canada and North American Integration

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Depuis bien avant la Confédération, l'identité nationale du Canada est définie en partie par les liens qu'elle entretient avec les États-Unis. Le présent article étudie les tendances qui ressortent de l'intégration nord-américaine et leurs répercussions sur divers aspects de la vie canadienne, tout particulièrement les aspects économiques et politiques. Il présente le concept de l'intégration, donne un bref historique de l'intégration nord-américaine, résume les conclusions des travaux de recherche parus dans ce domaine et souligne les nouveaux thèmes, les répercussions stratégiques, et les besoins en recherche. L'hypothèse principale de l'article est la suivante : les répercussions de cette intégration continentale n'ont pas eu l'envergure escomptée. Le Canada a toujours une marge de manœuvre importante, même dans les domaines stratégiques les plus touchés par l'intégration économique grandissante.

Since before Confederation, Canada's national identity has been defined in part by its relationship to the United States. This article examines trends in North American integration and their consequences for various aspects of Canadian life, focusing on the economic and political dimensions. It introduces the concept of integration, provides a brief survey of the history of North American integration, summarizes the findings of recent research in the area, and highlights emerging themes, policy implications, and the need for future research. The main theme is that the consequences of continental integration have not been as formidable as widely believed. Canada still retains significant room to manoeuvre, even in the areas of policy most affected by growing economic integration.

Since before Confederation, Canada's national identity has been defined in part by its relationship to the United States. In Canada, this relationship has been characterized by divisive tensions between believers in the economic benefits of closer commercial relations with the US and those who have feared that free trade would "Americanize" Canada, either literally in the form of joining the union or figuratively in terms of values and culture. These conflicts have been particularly evident over the past 15 years, as Canada entered into the Canada-US Free Trade Agreement in 1988, which was expanded six years later to include Mexico in the North American Free Trade Agreement (NAFTA). Opponents of these agreements argued that they would cause jobs to be lost, wages to decline, inequality to increase, Canada's national identity to be undermined, and the capacity to forge distinctive policies to be vitiated. Proponents of free trade claimed that it would foster tremendous economic benefits and vehemently denied that it would lead to the Americanization of Canada.

This article examines trends in North American integration and their consequences for various aspects of Canadian life, focusing on the economic and political dimensions. It focuses on four questions.

- How has closer integration of Canada with its giant neighbour to the south affected the things Canadians care about?
- How might changes over the next decade influence these concerns?
- What are the crucial gaps in our knowledge in this area?
- What are the policy implications — how should Canada maximize the opportunities and minimize the risks of its relationship with the United States?

The Project on Trends research team on North American integration produced nine papers on a range of topics. This article is based in part on that work. It introduces the concept of integration, provides a brief survey of the history of North American integration, summarizes the findings of recent research in the area, and highlights emerging themes, policy implications, and the need for future research.

North American integration is one part of the more sweeping phenomenon of globalization that has become so dominant of late in popular as well as academic and policy discourse.[1] Despite the more sweeping international context, the focus here on continental integration in North America is justified. For Canada, globalization is effectively 80 percent Americanization. That figure represents the percentage of Canadian exports that go to the United States. Clearly, it is too simplistic to reduce the complex nature of US influence to trade relations. Nonetheless, that percentage is an effective representation of the importance of the United States in Canada's external relations with the world. Indeed, when one considers the cultural content of the media to which Canadians are exposed, the 80 percent figure is probably conservative.

The main theme of the North American integration research for the Project on Trends is that the consequences of continental integration have not been as formidable as widely believed. Despite a sharp rise in trade dependence as a result of the Free Trade Agreement and growing American dominance of global media, the border between the two countries still matters. Admittedly, some policy instruments have been surrendered in exchange for access to larger markets. In addition, pressures for harmonization do exist, and have probably increased. But Canada still retains significant room to manoeuvre even in the areas of policy most affected by growing economic integration.

Conceptualizing North American Integration

The phenomenon of North American integration can be investigated in three spheres of Canadian life: economic, cultural, and political. Generally, integration can be conceptualized as a *process*, moving along a continuum from "fundamentally distinct and unrelated" at one end to "fully integrated" at the opposite end. For each sphere, the two poles of the continuum can be identified, as outlined in Table 1, and at any given time it is possible to locate the approximate position of Canada's relation to its external environment.

The phenomenon of integration is perhaps best measured and understood in the economic sphere. At one end would be the unlikely world of economic autarky, where there were no exchanges across borders. At the other, fully integrated end of the continuum, there would be no barriers at all to exchange of goods, services, or capital across borders. Clearly, the economies of Canada and the US are highly integrated, but they still have a long way to go before they reach full integration. This conclusion can be illustrated by examining five economic

TABLE 1
The Continuum for Integration

	Unrelated	*Fully Integrated*
Economic	No international exchanges	Common currency; customs union; economic transactions a function of size and distance (no border effect)
Political	Autonomous nation-states; distinctive policies reflecting domestic conditions	All relevant decision-making authority transferred to supranational authority, or if there is a continued division of powers, nation-states get full political representation in supranational bodies; uniform policies imposed from the supranational level
Cultural	Distinctive national values	Identical values resulting from assimilation or some other form of external influence

phenomena: trade and investment, macroeconomics, labour markets, migration of skilled workers, and infrastructure.

In the political sphere, we need to distinguish the structures of governance from the content of public policies emerging from those structures. At one end of the spectrum we would expect to see autonomous nation-states adopting distinctive policies reflecting their own domestic circumstances. The fully integrated end of the spectrum would involve the transfer of all formal decision-making authority to a supranational entity, although perhaps room should be left for a federal union, in which specific powers were reserved for the lower levels of government. In policy terms, complete integration involves uniform policies imposed from outside the domestic entity by a supranational entity joining the formerly separate domestic units. In North America, there has been very little formal political integration, but concerns have been growing. In assessing political integration, the article addresses state-society relations, federalism, and policy autonomy.

The cultural sphere has always been a highly contested aspect of North American integration, and here it is more difficult to identify the appropriate extremes of the continuum. At one extreme, there would be distinctive national cultures resulting from historical experience. At the other extreme, one would expect to see the emergence of identical values across borders as the result of assimilation or some other form of cultural influence. In Canada, the major challenge has been maintaining and promoting a sense of Canadian distinctiveness amidst intensifying pressure for cultural homogenization. While the issue of cultural integration is fundamental to assessing the consequence of North American integration for Canadian life, this article restricts itself to examining the economic and political spheres.

While dividing the phenomenon of integration into three spheres is a useful organizational device, it is also interesting and important to consider the *relationship* between the spheres. In particular, there is a great amount of concern about the relationship between greater economic integration and the survival of a distinctive Canadian identity or of meaningful capacities for domestic policy choices. The intense political conflicts around free trade in Canada have been driven largely by different beliefs about the relationships between the economic sphere and the other two.[2] Nationalists have been concerned that greater economic integration will inevitably lead to the destruction of Canada as a cultural and political entity. Champions of free trade have been dismissive of this view, arguing instead that there is, in reality, little connection between the economic sphere and the political and cultural spheres. Part of this conflict results from an ideological difference about the desirable role of the state in the economy, but there is also a vital empirical dimension about the nature of the linkages between the spheres. This article helps illuminate these empirical relationships in the economic and political spheres.

History

North American integration, the idea that the pattern of east-west relationships upon which Canada was founded is being increasingly replaced by north-south exchanges with the United States, is certainly not a new phenomenon. According to historian Jack Granatstein, the issue of free trade with the United States is second only to the Quebec question as an enduring and troubling challenge throughout the history of Canadian politics.[3] The issue first emerged in the 1850s when Great Britain repealed the corn laws and committed itself to free trade, thus exposing British North America's exports to Britain to competition from the US. In response, Canada negotiated the Reciprocity Agreement of 1854, which obtained free access for Canada's resource exports, including grain and lumber, in exchange for granting the US navigation rights on the St. Lawrence and fishing rights off the Atlantic colonies. The agreement lasted only 12 years, however, as growing opposition from US commercial interests and tensions resulting from the Civil War led Congress to abrogate the agreement in 1866. The termination of the agreement contributed to the forces promoting Confederation.[4]

Repeated attempts to renegotiate a reciprocity agreement failed, setting the stage for the introduction of Macdonald's National Policy in 1878. Avowedly protectionist in nature, the National Policy constructed a tariff wall to promote the fledgling manufacturing sector and an economy built on an east-west axis. As such, it was the first and most explicit attempt in Canadian history to use policy to resist deliberately the powerful economic forces channelling trade into north-south flows. In 1891, Sir Wilfrid Laurier's Liberal Party ran against Macdonald's Tories on a campaign to create a commercial union with the United States. Rallying loyalty to the empire with the cry "A British subject I was born, and a British subject I will die," Macdonald won this, the first free trade election.

Laurier was eventually elected in 1896, and successfully negotiated a new reciprocity agreement in 1911. In the second great free trade election, however, the Conservatives appealed to Canadian allegiance to Britain and fears of being swallowed up by American manifest destiny. The Liberals lost the election, and the agreement died.

Another trade agreement with the US was not reached until 1935, after the disastrous Smoot-Hawley tariff of 1930 had taught Americans the harsh consequences of beggar-thy-neighbour protectionism. The 1935 agreement, along with another one signed three years later, reduced tariff levels between the two countries to about where they were in 1920 before the protectionist wave emerged.[5]

The Second World War brought about a sea change in continental relations, as the magnetism of the growing global power to the south overwhelmed the historic affinity for the mother country.[6] The militaries and the economies of the two countries became increasingly linked. After the war, both Canada and the United States turned to multilateralism with the General Agreement on Tariffs and Trade (GATT), ratified in 1947. At about the same time, Canadian and US officials were negotiating the equivalent of a customs union, but Prime Minister King killed the idea.[7] The next major event occurred in 1965 with the Auto Pact, which eliminated duties for Canadian automobiles and parts exported to the United States, triggering a dramatic increase in sectoral trade.

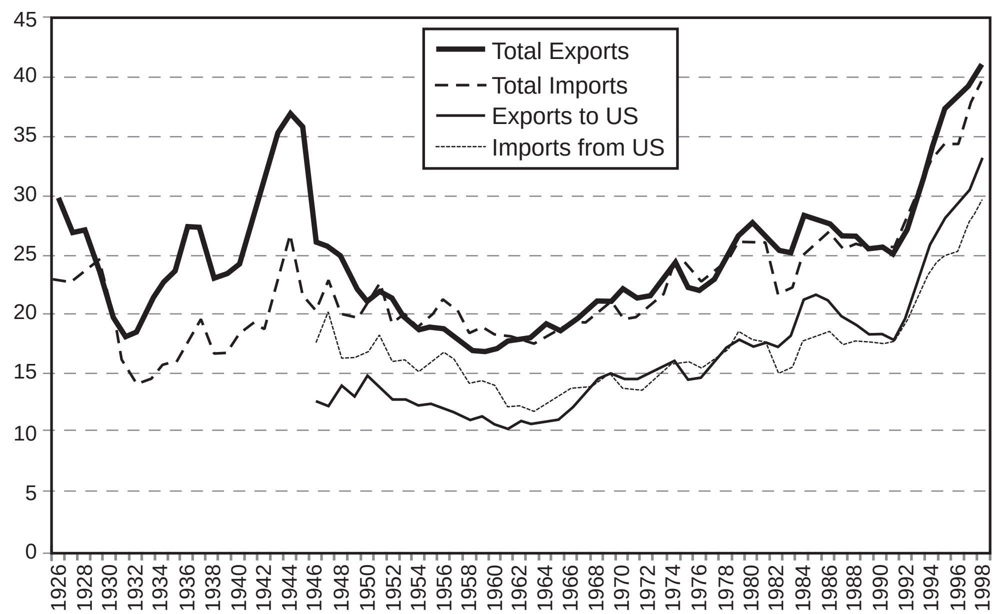
Events of the 1980s brought more comprehensive free trade back onto the political agenda.

Trudeau's National Energy Policy, and rising protectionism in the US in the wake of the 1982 recession, escalated trade tensions between the two countries. Supported by President Reagan, the idea of free trade was given greater legitimacy in Canada when the prestigious Royal Commission on the Economic Union and Development Prospects of Canada (the Macdonald Commission) urged the country to pursue free trade as a "leap of faith." After several years of controversial and heated negotiations, the two countries reached agreement in 1987. Despite the support by the Mulroney government, the implementation of the agreement was for a time thwarted by the failure of the Liberal-dominated Senate to approve it. This act set the stage for the pivotal election of 1988, which, in a reversal of the historic pattern, pit the pro-free-trade Tories against the anti-free-trade Liberals, led by John Turner. Despite the mobilization of a nationalist popular sector against the agreement,[8] the Tories won the election, and the Canada-US Free Trade Agreement came into effect on the first day of 1989.

Five years later, with some reluctance, Canada entered into a more elaborate North American Free Trade Agreement, extending the free trade area to include Mexico. Meanwhile, both Canada and the US were active in finalizing the latest round of GATT negotiations, which gave birth to the World Trade Organization in 1995. NAFTA's accession clause seemed to presage its enlargement into a hemispheric agreement. Despite the support of successive US presidents, negotiations toward a Free Trade Area of the Americas have been stalled by the refusal of the US Congress to provide the president with the "fast track" negotiating authority provided by US trade law.

Figure 1 shows the evolution of Canada's foreign trade, both with the US and the world. The figure

FIGURE 1
Canadian Exports and Imports, Total and with the United States, as a Percentage of GDP



Source: Generated by Ronald Kneebone, based on CANSIM.

charts exports and imports as a percentage of GDP from 1926 through 1998. As the figure shows, Canada did have an earlier period of high export dependency: for the period 1926-1945, exports as a percent of GDP ranged from 18 percent to 37 percent. After the Second World War, trade dependence dropped precipitously, and remained below 20 percent until 1967. Beginning around 1960, trade dependence began to increase gradually, reaching around 28 percent in the early 1980s. After the implementation of the Canada-US Free Trade Agreement, trade dependence skyrocketed to about 40 percent in 1998, making Canada one of the most trade-dependent nations in the world.

The US has been the dominant actor in Canadian trade at least since the early twentieth century. Up until 1900, trade with the United Kingdom rivalled trade with the US, but the relative importance of the US increased up through the Second World War. During this period, Canadian exports to the two countries were comparable, but imports from the US were much greater than imports from the UK.[9] The differential effects of the Second World War on the different economies created a sharper break in the relationship, as Canadian trade took on an even stronger north-south orientation. By 1951, 70 percent of Canada's imports came from the US, and 60 percent of Canadian exports went to the US. The US share of exports continued to increase until it matched the import share of about 70 percent around 1970.

In the wake of the Free Trade Agreement, there was a sharp (15 percentage point) increase in Canada's dependence on trade with the US. In 1998, total exports constituted a staggering 40 percent of GDP, with the US accounting for 84 percent of that total, or 33 percent of GDP. Thus, while trade dependence was quite high previously, the current levels of trade dependence, globally and on the US in particular, are record setting. I turn now to evaluating the effects of heightened integration on the economy and politics.

Economics

The economic aspects of greater North American integration can be investigated under five headings: trade and investment flows, macroeconomics, labour markets generally, the migration of skilled workers, and various aspects of infrastructure.

Trade and Investment

Figure 1, discussed above, shows the dramatic increase in trade flows between the two countries over the last several years. The US also dominates foreign investment in Canada, but not by as much as it does trade. In 1995, the US share of stock in foreign direct investment in Canada was 67 percent. Interestingly, this share has declined over the past several decades — in 1966, the US share was 82 percent. While it has continued to increase over the past decade, it has experienced nothing like the growth witnessed in trade. These diverging trends in trade and investment flows suggest that "firms are expanding output at their most efficient sites and phasing out smaller facilities that were once required by trade barriers."[10]

In an effort to provide a measure of the degree of trade integration, Helliwell, Lee and Messinger analyze the relative importance of trade flows between the provinces and across the border with the United States, and how they have changed over time — the so-called "border effect."[11] Raw figures such as Canada's overall trade dependence on the US (about 33 percent of GDP in 1998 as measured by exports) can be misleading, because they do not take into account geography, the effects of distance from markets and the size of the export market. Elaborating and updating Helliwell's earlier work, these authors use the "gravity model" to control for distance and size.[12]

Their research yields two striking findings. First, the implementation of the Free Trade Agreement led to a substantial reduction in the "border effect," as trade between Canada and the United States grew far more rapidly than did trade among the provinces within Canada. Second, despite this dramatic change, interprovincial trade linkages remain far more powerful than international trade linkages — by an order of magnitude. Controlling for size and distance, the ratio of interprovincial to international trade dropped from around 20 prior to the Free Trade Agreement to about 12 after its implementation. Thus, this analysis raises questions about just how integrated the Canadian economy is with that of its southern neighbour. Even with the virtual elimination of trade barriers, Canadians still strongly prefer to trade more among themselves than with other countries, including the US. All else being equal, the border still matters.

This finding, that interprovincial trade linkages remain 12 times stronger than international trade linkages, needs to be squared with the trade statistics showing that one-third of Canadian GDP consists of exports to the United States. This apparent paradox is created by applying the gravity model which controls for size and distance. Because Canada is so geographically dispersed, and the US market is both so large and so close to many Canadian centres of commerce, the gravity model creates a very large disparity between its results and actual trade flows. As economist Paul Krugman quipped, "Canada is essentially closer to the United States than it is to itself."[13]

Both results are very important. The factor of 12 border effect revealed by Helliwell, Lee and Messinger is important because it shows that *despite* the exceptionally strong pull of geography, there is still a very powerful bias in economic transactions in favour of trading with fellow Canadians. The causes and consequences of this "home bias" are important subjects for future research. Nonetheless, the aggregate trade dependence effect is arguably more important when attempting to assess the consequences of economic integration for other spheres of Canadian life. *Because* of the exceptionally strong pull of geography, one-third of gross domestic product is tied up with trade with Americans.

Macroeconomic Policy

In terms of Canadian macroeconomic performance in the North American context, the results are generally poor.[14] The one bright spot has been Canada's success at reducing inflation. Since January 1992, the Canadian rate of inflation has been consistently less than the US rate. Unemployment rates have been considerably higher in Canada. The rates diverged in the 1980s, and that divergence increased in the 1990s, when the gap averaged about four percentage points by standard measures.[15] Canada has experienced higher interest rates for most of the past several decades, but that situation was reversed for 1997 and 1998. Perhaps the most discouraging indicator for Canada has been the fact that per capita income — both in terms of absolute amount and growth — has lagged that of the US.

There has been intense controversy over the issue of Canada's productivity performance in recent years, when international reports and politicians of various stripes claimed that Canada's poor productivity growth explained the lagging standard of living. However, the data show that Canada's overall productivity growth performance has not been poorer than the US performance: productivity growth in the manufacturing sector alone has been worse, but multifactor productivity growth has been comparable. While the news on productivity *growth* is good, Canadian productivity *levels* still are significantly below that of the US. The fact that Canadian productivity *growth* is not faster means that Canada is not catching up to the US as fast as some other countries are.[16]

In terms of macroeconomic policy, Canada has made three key policy choices over the past dozen years: the decision by the Bank of Canada to adopt a zero inflation target, the decision to pursue free trade agreements, and the fiscal policy choices of the federal and most provincial governments to rein in their deficits and debt.[17] Each one of these decisions has had important, measurable consequences. Tighter monetary policy has reduced inflation considerably and since 1992 have dropped to levels below the US. Originally, this policy choice imposed costs in terms of higher interest rates, but then Canadian interest rates dipped below those in the US from 1996 through 1998. The Canada-US Free Trade Agreement (and its extension through NAFTA) has intensified Canada's international trade with the United States, as discussed earlier. Canada has been slower than the US in getting its government deficits and debts under control, although substantial progress has been made in deficit reduction beginning in the late 1990s.

Labour Market

In many ways, the most intense concerns about the impact of economic integration have been about labour markets. Given the complexity of economic forces at work, it is difficult to disentangle the effects of freer trade from other phenomena, such as tighter monetary policy, technological change, and business cycles. A recent survey of the effects of free trade concluded "Overall, I don't think that we know whether the FTA led to a rise or a fall in total jobs."[18]

A recent study by Daniel Trefler provides some estimates of the effect of free trade during the 1989-1996 period. Trefler estimates that the Free Trade Agreement reduced jobs in manufacturing by 4 percent overall, and by 18 percent in the most affected industries. These figures suggest substantial adjustments. He also notes, however, that the rebound in manufacturing employment since 1996 probably reflects the reallocation of resources from inefficient sectors to more efficient sectors. He also observes the surprising result that the reductions in tariffs actually slightly increased wages. Because earnings of more poorly paid production workers increased more rapidly than better paid non-production workers, the tariff cuts actually reduced income inequality slightly.[19] This equality result is surprising, because evidence from the US and elsewhere supports the argument that trade liberalization tends to foster increased wage inequality.[20] In another Canadian study, Beaulieu finds that through 1996, the FTA had a small negative effect on manufacturing employment, particularly in sectors with less-skilled workers. His study shows no effect on earnings.[21]

Moving beyond the direct effect of economic integration on labour markets, Gomez and Gunderson analyze the implications for labour market institutions, practices, and policies. [22] One place where there is continued divergence between the two countries is rates of unionization among workers. After having quite similar rates for decades, there was a sharp divergence after 1964, with unionization in the US declining sharply, and Canadian unionization remaining relatively high. By the 1990s, the rate of unionization in Canada was double that in the US. In contrast, strikes have shown a clear pattern of downward convergence.

"Brain Drain"

One of the most potentially troubling consequences of increasing economic integration with the US has been the prospect of the "brain drain," the loss of highly skilled workers as a result of a combination of lower taxes, higher wages, greater opportunity, and easier immigration rules.[23] Recently, Canadian media outlets have often been filled with stories about the loss of Canada's best and brightest, and many have used the issue to promote cuts in marginal tax rates. The alarmist tone of much of this discourse has been fueled by a report published by the C.D. Howe Institute, claiming that the brain drain cost Canada $7 billion between 1982 and 1996 in lost subsidies to higher education, and an additional $12 billion from 1989-1996 in "churning" costs to replace better trained and paid emigrants to the US with immigrants to Canada.[24]

John Helliwell presents a careful analysis of the evidence regarding the magnitude of the brain drain, and argues that the extent of the problem is vastly overrated.[25] First, Helliwell shows that the present rate of migration of skilled workers is quite small compared to earlier periods. The flow during the 1990s was less than one-fourth the flow in the 1960s. Moreover, the flow of highly educated immigrants into Canada from other countries far exceeds the net loss of highly educated Canadians to the US. Helliwell identifies serious methodological flaws in the "churning cost" estimates presented in the C.D. Howe study, suggesting its cost claims are grossly exaggerated.

One major area of uncertainty is the apparent dramatic increase in temporary workers, a new status created under the FTA and NAFTA. The number of highly skilled temporary workers going to the US is much higher (by about a factor of 10) than the number of permanent emigrants. The concern is that many will choose to emigrate permanently. Helliwell points to some serious measurement problems with this group of workers, and urges that more solid census data be awaited before sounding the alarm. A recent study by the Conference Board of Canada argues that the data are strong enough to merit serious concern.[26] Given its importance, this issue is a high priority for future research and analysis.

In addition to arguing the drain of skilled workers to the US is small in historic terms, Helliwell also believes it is small compared to what one would expect, given that the US job market has been much tighter, and there is a higher wage premium for skilled workers south of the border. He concludes his examination of the data as follows: "The burden of data examined in this paper, however, is that the numbers involved are small enough, relative to either existing stocks of skills, or the scale of current training, that they are not likely to have a large or long-lasting effect on the availability of skills in Canada." Finally, because he believes the data "provide no evidence of a current crisis, or any great cause for alarm," Helliwell argues that "it would be a mistake to use the brain drain as a spur for changes to taxes and expenditures that do not otherwise pass the tests of economic and political logic."

Business Infrastructure

In addition to trade and investment, macroeconomic issues, and labour concerns, integration is also about the nuts and bolts of how the economic links between the two countries work at the operating level. McNiven performs a very general survey of a wide array of areas, ranging from transportation to banking and communications. His analysis yields two conclusions.[27] First, little research has been done on the extent of convergence in many extremely important aspects of the North American economy. "No one has yet developed the database that might underpin an assertion that the NAFTA zone is more or less integrated or even harmonized." This gap in our understanding is significant and needs to be filled.

Second, the evidence McNiven was able to gather suggests some movement toward integration in some areas, but a surprising lack of integration in many others. Transportation networks are constrained by limits on *cabatoge*, the right to transport goods or people between two points in a foreign country. Canada and the US have quite different banking rules regulating the types of services financial institutions can perform. The countries have quite different patent rules and building codes. The US stubbornly adheres to the non-metric system of measurement in many areas of commerce. McNiven concludes that "technology is eroding some distinctions between Canada and the US, but in many other areas, practices seem as far apart as ever."

Politics

There are also important political aspects of continental integration. Thus far, Canada has experienced very little continental political integration, in the sense of policymaking powers being transferred from Canadian governments to supranational institutions. In comparison to the European Union, where autonomous supranational executive, legislative, and judicial institutions have emerged, political integration in North America has been quite limited. The NAFTA side agreements created trilateral commissions on both labour and the environment, but their powers are extremely limited. Despite the absence of political integration, however, continental economic integration does have important political dimensions and implications. This article assesses the consequences of economic integration for state-society relations, federal-provincial relations, and finally Canada's capacity for distinctive policy choice.

Challenges to State-Society Relations

Laura Macdonald examines the impact of economic integration on the relations between the government and various aspects of civil society.[28] She argues that the manner in which the 1988 Free Trade Agreement was negotiated privileged one sector, the business sector, at the expense of others. The consultative mechanisms, particularly the Sectoral Advisory Groups on International Trade (SAGITs) were "heavily weighted toward business involvement." Some of the blame for this bias, however, rests with labour unions, who were invited but declined to participate.

Macdonald is critical of this style both on principled and instrumental grounds. On principle, she argues that past structures of consultation are inconsistent with modern "inclusionary and democratic norms of decision-making." She also argues that a powerful "popular sector" has emerged which is no longer politically practical to ignore, an argument made all the more compelling by the "battle in Seattle" in late 1999 that set back the new round of WTO negotiations. Indeed, the Free Trade Agreement itself seems to have fomented political forces that require revisions to the process of providing domestic consultations on such agreements in the future.[29] Macdonald defines this popular sector as a diverse array of "non-elite groups ranging from trade unions, women's groups, social agencies, Native peoples, and farmers to the churches."[30] She argues for a need to develop a more multi-stakeholder style of consultations that have characterized various aspects of Canadian domestic policy, and points to potentially appropriate models from international environmental agreements.

Federalism

North American economic integration may also have implications for another central feature of Canadian political life: federal-provincial relations. The dominant view in the literature is that economic integration will make the federal government less relevant. Some policy options are stripped away by trade agreements, others are dealt with by supranational institutions. Many important supporting functions are provided by the local or regional governments, leaving the federal government with a significant reduction in functions. Thomas Courchene has referred to this process as "glocalization."[31]

An alternative view, presented by Rocher and Rouillard, argues that the harmonization of policy that (they assume) inevitably follows integration is inimical to the very essence of federalism as they understand it. "The emphasis on economic efficiency, which includes amongst other things a harmonization and homogenization of fiscal/budgetary policies, and indeed of the larger socio-economic environment, is antithetical to federalism which, by definition, is conducive to deep diversity and to the recognition of regional and provincial distinctiveness."[32] Their assumption that integration inevitably produces harmonization is challenged by evidence from the work of a number of other researchers described here.

Policy Autonomy

One of the most troubling concerns about North American integration is whether closer economic ties with the United States will reduce the capacity of Canada to adopt policies that reflect distinctive national preferences. Hoberg, Banting and Simeon emphasize the distinction between policy convergence — the process of policies across countries becomes increasingly alike — and the effects of international integration.[33] They identify four major forces behind convergence:

- *parallel domestic pressures*, rather than relations between two countries;
- *emulation*, when governments choose to adopt policies similar to another country's because

they find them attractive, not because they are being compelled by circumstance;

- *international legal constraints*, when countries enter into international agreements that involve some (voluntary) giving up of national sovereignty;

- *international economic integration*, when increasingly mobile capital creates pressures to avoid any policy that has the potential to raise the cost of production in one country, threatening a "race to the bottom" in policy.

These distinctions are emphasized because convergence is not necessarily a manifestation of constraints emerging from the international economic environment. Unfortunately, these distinctions are not clear-cut, with the most troubling potential link being that between the cultural spheres of the two countries. What might appear to be parallel domestic pressures may, in fact, be the result of some more subtle process of American influence on Canadian values.

These convergent forces are met with countervailing pressures from divergent forces: distinctive national values, different political institutions, and the legacy of past policies. The key question is the following: what is the net impact of the convergent forces of international economic integration and the divergent forces? The impact of international factors varies from policy sector to policy sector. In some cases, Canada has entered into international agreements that eliminate the ability to use particular policy tools, in exchange for benefits such as market access and stronger international rules to constrain US behaviour. These agreements affect certain sectors, for example, industrial development or policies toward magazines, but leave others unaffected. In the case of international economic integration, constraints "vary significantly from sector to sector, depending on the mobility of the factors of production that the policy is seeking to influence."[34]

Hoberg *et al.* examine the degree of policy convergence in two sectors: social and environmental policy. In social policy, Canada has been able to maintain distinctive programs. These programs are more generous and have been more effective at reducing inequalities. These differences are explained by a combination of value and institutional differences, as well as the lack of labour mobility across the border. The case of environmental policy reveals more convergence and more constraint. Canadians concerned about the "race to the bottom" in the environmental area are fortunate that the US has a relatively strong track record of environmental protection, which has reduced some of the downward pressures on standards that might otherwise be present. In some cases, pressures from south of the border have actually helped pull Canadian standards up.

Other researchers address the issue of policy autonomy in other policy sectors. Kneebone assesses Canada's ability to forge its own social, fiscal, and monetary policies. He shows that Canada still has considerable autonomy, even in areas like macroeconomic policy where one would expect it to be most constrained. The integration of capital markets clearly places limits on any country's macroeconomic policy. In what Obstfeld refers to as the "open-economy trilemma," a country can only choose to have two of the following three options: a fixed exchange rate, open capital markets, and the ability to use monetary policy for domestic objectives.[35] Within these constraints, however, countries still have room to manoeuvre. In recent decades, Canada has chosen open capital markets and allowed its exchange rate to float, permitting the use of macroeconomic policy to pursue domestic objectives like fighting inflation. The question of whether Canada should continue to float its exchange rate is addressed in the next section.

Economic integration does seem to have increased the pressure to reduce deficits and debts. Kneebone argues that integration does not prevent governments from borrowing to fund programs, but just that they do so responsibly. The one concern about integration he highlights for social policy is that it may increase the resistance of the "have" provinces to continuing the current regime of equalization payments. In terms of monetary policy, Canada has chosen a different inflation target from the US, and has been successful in achieving lower inflation. The interest rate premium that Canada paid for two decades from 1975 to 1996 was reversed in 1996, in part because of the monetary discipline of the Bank of Canada and the growing fiscal discipline of Canadian governments.

The potential feedback effects between economic integration and labour market policies are explored by Gomez and Gunderson, who examine the prospect that capital mobility might pose pressures to reduce costly labour market policies and regulations. They argue that while there are a number of countervailing forces, there is reason to believe the net effect is pressure toward downward harmonization. The influence of these pressures, however, has yet to be demonstrated by any empirical research. They note that there is "remarkably little evidence" on how important labour market regulations are to "influencing investment and plant location decisions."[36]

Hoberg *et al.* also report results from broader cross-national research on the links between economic integration and policy autonomy. Indeed, when considering future trends in economic integration, it is useful to look at the European experience where economic and especially political integration have gone further than in North America. While this is a relatively new area of research and our state of knowledge is still in flux, there are some very important findings.

Generally, the research tends to downplay the threat globalization poses for the ability of countries to forge distinctive policies. Take the area of corporate taxes. This is probably the area where one would most expect to see the direct impact of global economic integration. In a world of high capital mobility, it would seem that any country that attempted to impose higher taxes on capital would experience capital flight, leading to a clear case of a "race to the bottom." Remarkably, the evidence shows just the reverse. Over the last several decades, corporate tax rates across OECD countries have not only failed to converge, but actually diverged somewhat.[37] In terms of social spending, not only has globalization failed to produce a "race to the bottom" among developed countries, but there is actually a positive correlation between openness to trade and size of the public sector.[38] Studies of OECD countries have not been able to detect a statistically significant link between social spending and several crucial indicators of international economic integration: imports from low wage countries, the amount of foreign direct investment, and financial capital mobility.[39]

One study closely examines the intensive integration among the Benelux countries and Germany. It shows that divergence in tax structures increased as integration advanced, and confirms that the smaller countries were able to create and maintain a far more expansive welfare state. The study concludes that there is "no reason why economic convergence by itself should force Canada to the mode of lower taxes and reduced public spending preferred by the United States."[40]

The cross-national quantitative studies do reveal some definite constraints related to international economic integration. Governments are clearly constrained in their ability to run budget deficits: those who do so are required to pay interest rate premiums.[41] A recent finding in an unpublished study raises special concerns for Canada. When comparing *levels* of social spending to *levels* of trade dependence, the two are positively correlated. But comparing *changes* in trade dependence to *changes* in social spending does reveal a small but statistically significant link between greater trade dependence and lower social spending.[42] Given Canada's significant increase in trade openness over the past decade, this area of research is worthy of careful attention.

While this latest finding is cause for some concern, the preponderance of evidence suggests that the rhetoric about the constraints of international economic integration on domestic policy capacities is overblown. There is still significant room to manoeuvre. As Hoberg *et al.* conclude, "The biggest constraint on Canada's ability to maintain a distinctive welfare state is not globalization or Americanization but the willingness of the Canadian people to pay taxes to support it."

Research and Policy Implications

The literature reviewed in this article has identified a number of areas where more research is essential to understanding the implications of Canada's relations with the US.

- There is a remarkable persistence of a "home bias" in trade flows; Canadians (and citizens of other nations) seem to prefer trading within national borders. The causes and consequences of this phenomenon need to be better understood.

- The productivity issue, linked to North American integration through both its implications for trade flows and macroeconomic performance, has perplexed both economists and policymakers, and needs to be a high priority on the research agenda.

- The analysis of both labour and environmental policy reveals that we know remarkably little about the determinants of plant location and business investment in Canada, a vital ingredient to our understanding of the constraints on regulation posed by "footloose" capital.

- The examination of infrastructure highlights the need for additional research into the dynamics of integration, or the lack thereof, at the operating level in many areas of the economy.

- More research is needed on the links between economic regulation and continental integration in areas like financial services, telecommunications, transportation, and energy.

- Research on state-civil society relations reveals the need for new models for consultation on international agreements. Assessing the experience of other countries and other areas of international collaboration would be extremely valuable.

- It is time to reassess the degree of ownership and control of the Canadian corporate sector, particularly for its implications for Canada's ability to develop and implement distinctive public policies.

Canada has challenging choices ahead. The road ahead for multilateral negotiations on trade liberalization is unlikely to be smooth, as the events surrounding the WTO meeting in Seattle in late 1999 show. The same can be said for hemispheric trade. The Free Trade Area of the Americas is under negotiation, but the US Congress denied President Clinton the "fast-track authority" necessary to get Americans properly engaged. Nonetheless, the momentum still appears to be in the direction of increasing rather than decreasing international economic integration. Given the geography of trade, it seems unlikely that even if these agreements fail to go forward, the close integration of the Canadian and US economies is likely to change in any fundamental way.

Some have argued that it would be desirable to further intensify this integration by abandoning the floating exchange rate in favour of the US currency, a position presented forcefully in a paper by leading economists Thomas Courchene and Richard Harris.[43] This move would involve surrendering a valuable policy instrument. So the question is whether the benefits gained outweigh the loss to sovereignty, in both economic and political terms. At this point, neither the evidence about the costs of exchange rate volatility nor about Canadian productivity appear to warrant such a momentous change.[44]

Another major controversy has been marginal personal income tax rates, which have been linked to discussions of the "brain drain." The migration of skilled, high income personnel is an exceptionally important issue, not only because Canada may be losing too many of its "best and its brightest," but also because the dynamic may put pressure on the government to reduce the higher taxes that are able to fund Canada's more generous social programs. Helliwell argues that the evidence currently available does not justify "changes to taxes and expenditures that do not otherwise pass the tests of economic and political logic." This issue is critically important and needs to be monitored carefully.

International relations have always involved complex and delicate choices between the potential gains from international agreements and the loss from the surrender of autonomy. To maximize opportunities and minimize risks, Hoberg, Banting and Simeon argue that the following strategies should be pursued:

- Minimize Canada's vulnerability to international capital markets, as Canada has done and is doing through eliminating deficits and reducing public debt.

- Use Canadian influence in international forums not only to pursue the global goals, but also to ensure that the rules do not impose unnecessary constraints on domestic policy.

- Maintain and enhance the domestic capacity for autonomous policy debate and policy analysis, so that when Canada borrows or emulates, it does so on its own terms and in accord with its own values.

- Enhance the openness and transparency of government participation in international forums. If there is a need for domestic policy-making to be more informed about global influences, there is an equal need for Canadian participants in the international arena to be more responsive to domestic policy concerns.

- Enhance intergovernmental cooperation, in order to permit Canada to speak with one voice abroad, to avoid the potential for divide and rule as international forces affect the country, and to enhance the capacity for effective policy-making.

The consequences of continental integration have not been as formidable as widely believed. While some policy instruments have been surrendered in exchange for access to larger markets and pressures for harmonization have probably increased, Canada still retains significant room to manoeuvre, even in areas of policy most affected by growing economic integration. Canadians should not be deceived by the illusion of false necessity.

Notes

1The literature on globalization is exhaustive. For a flavour of the debate, see Thomas Friedman, *The Lexus and the Olive Tree: Understanding Globalization* (New York: Farrar, Straus and Giroux, 1999); Kenichi Ohmae, *The End of the Nation States: The Rise of Regional Economies* (New York: Free Press, 1995); William Watson, *Globalization and the Meaning of Canadian Life* (Toronto: University of Toronto Press, 1998); Richard Gywn, *Nationalism without Walls: The Unbearable Lightness of Being Canadian* (Toronto: McClelland & Stewart, 1995); Gary Burtless *et al.*, *Globaphobia: Confronting Fears about Open Trade* (Washington, DC: Brookings Institution, 1998).

2Kim R. Nossal, "Economic Nationalism and Continental Integration: Assumptions, Arguments, and Advocacies," in *The Politics of Canada's Economic Relationship with the United States*, ed. Denis Stairs and Gilbert Winham (Toronto: University of Toronto Press, 1985).

3Jack Granatstein, "Free Trade between Canada and the United States: The Issue that Will Not Go Away," in Stairs and Winham, *Canada's Economic Relationship,* p. 11.

[4]Ibid., and Michael Hart, "The Road to Free Trade," Background paper for the McGill University Conference on Free Trade at 10, Montreal, 4-5 June 1999. Available at http://www.freetradeat10.com/hart.html

[5]Granatstein, "Free Trade between Canada and the United States," p. 33.

[6]J.L. Granatstein and Norman Hillmer, *For Better or for Worse: Canada and the United States to the 1990s* (Toronto: Copp Clark Pittman, 1991), Ch. 5.

[7]Granatstein, "Free Trade between Canada and the United States," p. 42.

[8]Jeffrey Ayres, *Defying Conventional Wisdom: Political Movements and Popular Contention against North American Free Trade* (Toronto: University of Toronto Press, 1998).

[9]Data from Historical Statistics of Canada, series G396-400, and G396-395.

[10]Gary C. Hufbauer and Jeffrey J. Schott, "North American Economic Integration: 25 Years Backward and Forward," Paper No. 3, *Canada in the 21st Century*, Industry Canada Research Publications, November 1998, p. 14.

[11]John F. Helliwell, Frank C. Lee and Hans Messinger, "Effects of the Canada-U.S. FTA on Interprovincial Trade," paper prepared for the Project on Trends.

[12]See John Helliwell, *How Much Do National Borders Matter?* (Washington, DC: Brookings Institution, 1998).

[13]Paul Krugman, *Geography and Trade (*Cambridge, MA: MIT Press, 1991), p. 2.

[14]Ronald Kneebone, "Canadian Macroeconomic Policy-Making in an Increasingly Integrated North America," paper prepared for the Project on Trends.

[15]There is evidence that the gap in unemployment is overstated because the US and Canada count "passive" job-seekers differently. One estimate is that this measurement difference explained 17 percent of the unemployment gap between the two countries. See Craig Riddell and Andrew Sharpe, "The Canada-U.S. Unemployment Rate Gap: An Introduction and Overview," *Canadian Public Policy/Analyse de Politiques* 24 (Supplement, February 1998):S1-S37.

[16]For a clear summary, see Andrew Sharpe, "New Estimates of Manufacturing Productivity Growth for Canada and the United States," Centre for the Study of Living Standards, Ottawa, 13 April 1999. For a recent study suggesting Canada's productivity growth performance has been significantly better than that of the US since the implementation of the FTA, see Daniel Trefler, "The Long and the Short of the Canada-US Free Trade Agreement," paper prepared for the Micro-Economic Policy Analysis Division, Industry Canada, 21 June 1999.

[17]Kneebone, "Canadian Macroeconomic Policy-Making."

[18]John McCallum, "Two Cheers for the FTA: Tenth-year Review of the Canada-US Free Trade Agreement," Royal Bank of Canada, Economics Department; presented at the Conference on Free Trade at 10, McGill University, Montreal, 4-5 June 1999, p. 8.

[19]Trefler, "The Long and the Short of the Canada-US Free Trade Agreement."

[20]There is considerable dispute over the relative importance of trade liberalization and "skill-biased technical change" in promoting this inequality. For two recent surveys of the literature, see Susan Collins, "Economic Integration and the American Worker: An Overview," in *Imports, Exports, and the American Worker*, ed. Susan Collins (Washington, DC: Brookings Intitution Press, 1998); William R. Cline, "Trade and Income Distribution," International Economics Policy Briefs, No 99-7, Institute for International Economics, September 1999.

[21]Eugene Beaulieu, "The Canada-US Free Trade Agreement and Labour Market Adjustment in Canada," *Canadian Journal of Economics*, forthcoming.

[22]Raphael Gomez and Morley Gunderson, "The Integration of Labour Markets in North America," paper prepared for the Project on Trends.

[23]For an overview of the debate, see the various articles in the September 1999 edition of *Policy Options*.

[24]Don DeVoretz and Samuel Laryea, *Canadian Human Capital Transfers: The United States and Beyond*, Commentary No. 115 (Toronto: C.D. Howe Institute, 1998).

[25]John F. Helliwell, "Checking the Brain Drain: Evidence and Implications," paper prepared for the Project on Trends.

[26]Mahmood Iqbal, "Are We Losing our Minds? Trends, Determinants, and the Role of Taxation in Brain Drain to the United States," Ottawa, Conference Board of Canada, July 1999.

[27]James D. McNiven, "The Emergence of a New 'North American Economic Space' in the Global Economy," paper prepared for the Project on Trends.

[28]Laura C. Macdonald, "Governance and State-Society Relations in Canada: The Challenges from Regional Integration," paper prepared for the Project on Trends.

[29]Ayres, *Defying Conventional Wisdom.*

[30]For more detail on the emergence and role of this popular sector, see Ayres, *Defying Conventional Wisdom*.

[31]Thomas Courchene and Colin Temler, *From Heartland to North American Region State: The Social, Fiscal and Federal Evolution of Ontario* (Toronto: Centre for Public Management, University of Toronto, 1998).

[32]François Rocher and Christian Rouillard, "Continental Integration and Redefining the Locus of Power in Canada," paper prepared for the Project on Trends.

[33]George Hoberg, Keith G. Banting and Richard Simeon, "North American Integration and the Scope for Domestic Choice: Canada and Policy Autonomy in a Globalized World," paper prepared for the Project on Trends.

[34]Ibid.

[35]Maurice Obstfeld, "The Global Capital Market: Benefactor or Menace?" *The Journal of Economic Perspectives* 12, 4 (Fall 1998): 9-30.

[36]For studies on the determinants of plant location in the US, see Arik Levinson, "Environmental Regulations and Manufacturers' Location Choices: Evidence from the Census of Manufactures," *Journal of Public Economics*, 61,1 (1996); Robert Crandall, *Manufacturing on the Move* (Washington, DC: Brookings Institution Press, 1993).

[37]Geoffrey Garrett, "Global Markets and National Politics: Collision Course or Virtuous Circle?" *International Organization* 52 (Autumn 1998): 787-824; Nancy Olewiler, "National Tax Policy for an International Economy: Divergence in a Converging World?" delivered at the "Room to Manoeuvre? Globalization and Policy Divergence" conference, Queen's University, 5-6 November 1998.

[38]Garrett, "Global Markets and National Politics"; Duane Swank, "Funding the Welfare State," *Political Studies* 46 (1998): 672-92; Dana Rodrik, *Has International Economic Integration Gone too Far?* (Washington, DC: Institute for International Economics, 1997).

[39]Geoffrey Garrett and Deborah Mitchell, "Globalization and the Welfare State," unpublished manuscript, July 1999, available at http://pantheon.yale.edu/~gmg8/research.

[40]Hufbauer and Schott, "North American Economic Integration."

[41]Garrett, "Global Markets and National Politics."

[42]Garrett and Mitchell, "Globalization and the Welfare State."

[43]The options range from pegging the Canadian dollar to the US dollar, to adopting the US dollar as the official Canadian currency, to creating a new "North American Monetary Union." See Thomas Courchene and Richard Harris, "From Fixing to Monetary Union: Options for North American Currency Integration," Toronto: C.D. Howe Institute, June 1999.

[44]See Kneebone, "Canadian Macroeconomic Policy-Making."