Canada-United States Free Trade:

Concern over Social Programs

By K. A. Frenzel *and* Douglas J. McCready*

Abstract. The *Canada-U.S. Free Trade Agreement* (FTA) which came into force January 1, 1989 caused heated debate within *Canada* about the impact it would have on *social programs,* either directly or indirectly. It was argued that Canada would have to give up some social programs because they would be deemed to be *subsidies* to the production of goods or services. Alternatively, it was feared that firms would argue that the programs would need to be cut in order to ensure that they could compete with U.S. firms in terms of taxes. It is shown that public unease about the fate of social programs was based both on a misunderstanding of FTA provisions, and on a "misperception" of the magnitude of social program expenditures. Social programs such as *unemployment insurance,* even when they subsidize particular groups of people (*e.g.* fishermen) are not normally deemed to be *unfair competition* which would be countervailable. In addition, firms do not experience any greater *benefit costs* in Canada than in the U.S., albeit there is a different public/private split and thus there is no justification for firms to argue for cutting social programs in order to be competitive, other things being equal.

I

Introduction

The electorate of Canada on Nov. 21, 1988 returned the majority Conservative government of Prime Minister Brian Mulroney, thus effectively ending a titanic battle that had been raging over the desirability of forging an even closer economic union with the U.S. The official opposition Liberal Party, and the social democratic New Democrats, had been virtually unanimous in their opposition to the Canada-U.S. Free Trade Agreement (FTA), on which negotiations had begun in the middle of 1986.

While Canadian economists as a group tended to stay on the sidelines (Lipsey, 1989), there were a number of very vocal participants over the whole political economy spectrum,[1] and a number of encouraging studies on the long-run eco-

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nomic impact of the FTA (Dept. of Finance, 27–36). It was anticipated that the transitional movement to free trade would cause dislocation and a need for adaptation, but long-run estimates of once-and-for-all real income increases ranged upwards of 10%, with a conservative consensus of about 2.5–3.5% (Lipsey, 1989, 8). Given the close trade interdependence between the two countries and already low prevailing tariff walls, one might wonder what all the fuss in Canada over the FTA was about. One dominant theme that caught the public imagination was the imagined effect of the FTA on Canadian social programs and more generally the Canadian way of life.

Of the many things that distinguish nations, the type, level and extent of social programs are certainly an important determinant of national identity and difference. Because economic policies distinguish between national and extranational interests, the removal of barriers is often seen, by the public as a process of nation unbuilding. While some U.S. economic sectoral interests were interested in the implications of competition and trade enhancement, the American public displayed great disinterest in the FTA and hardly knew of its existence. Surely, it held no threat to U.S. social programs. The Canadian story was quite different. Dozens of commentators spoke as if the very core of Canadian culture and social programs, and all things having to do with what is unique in the Canadian system, were at real risk. One major newspaper, the Toronto Star, marshalled its resources far beyond the editorial page in an attempt to defeat the FTA. The following quotation is not atypical:

> The image of the American frontier with the help of Hollywood, firmly established from childhood for anyone growing up south of the border is the rugged individualism of the lone cowboy riding off into the sunset. The counterpart, picture of Canada's frontier period, by contrast, is a barn raising; neighbors all pitching in to help new arrivals build their barn in a day. Under the circumstances, it is not surprising that Canada has created a far more extensive set of social programs than has the United States . . .[2]

II

FTA Provisions

CANADA had avowed four major goals at the outset of negotiations: i) more-open access for Canadian exports into the U.S.; ii) more secure-access; iii) special provisions for sensitive sectors; and, iv) the opportunity to set an international example for trade liberalization.[3] In light of the public debate over the FTA, the most striking feature of its contents is that it is entirely silent on the issue of social programs. All public policy debates must, perforce, display disagreement as to the empirical consequences of policy alternatives, and perhaps as to normative ends, otherwise there would be no debate, but there is usually a community of agreement about the substantive content of the policies themselves.

Proponents of the FTA repeatedly asserted that social programs were not at risk or even mentioned, but with little apparent effect. The more sophisticated opponents knew that the FTA was silent on social programs, but they believed and argued that the programs, and thus the national identity, would be altered and damaged, nonetheless. The vehicle for such damage would be through the indirect forces for harmonization across a broad spectrum of economic and social institutions. In the narrow sense, the FTA uses the concept of harmonization in the most prosaic context of the International Convention on the Harmonized Commodity Description and Coding System, which came into effect in Canada on Jan. 1, 1988, but the critics of the FTA had a much less innocuous meaning of harmonization in mind. For them, the FTA would develop irresistible forces for a general reduction in the level of social program differences between Canada and the U.S. in order to maintain Canadian competitiveness at the risk of job loss or capital outflow. It was and is widely believed that Canadian social programs are superior to those of the U.S., and that their costliness will be their undoing under the FTA.

III

Social Programs

THE BOUNDARIES of what constitutes a social program in Canada or the U.S. are hardly fixed. Definitions and coverage vary by country, as do the sources of financing, and it probably would not be possible to find a congruent set that would be broadly acknowledged between the countries. The very strongly held Canadian public perception, which during the debate was the target of opportunistic and sometimes cynical exploitation, is that Canadian social programs are superior to those of the U.S. While Canadian social programs, particularly in health care, may be more comprehensive than those of the U.S., they are not dramatically more generous. Thus a recent O.E.C.D. study showed that the Canadian share of GDP spent on direct public expenditure in education, health services, pensions, unemployment compensation and other income maintenance programs and welfare services was 21.5% in 1981, and, that of the U.S. 20.8%. Between 1960–1975 real Canadian expenditure increased at the rate of 9.3% per year, and at 3.1% per year during 1975–1981; whereas U.S. growth rates were 8.0% and 3.2% respectively (OECD, 21–22). Both Canada and the U.S. rank at the bottom of the G7 O.E.C.D. subset of nations, with only Japan, at 17.5% in 1981, spending a smaller percent of her GDP on social programs. The average for all G7 nations in 1981 was 24.8%, and for all O.E.C.D. countries, 25.6%, ranging from a high of 37.6% for Belgium to 13.4% for Ireland, both in 1980.

What does stand out clearly is that the relative burden of the public and private sectors in social expenditure is quite different between the two countries. In a 1985 I.M.F. study of social expenditure (medical care, education, welfare, public pensions and unemployment insurance) among G7 nations, the overall average was 27% of GDP with government carrying an average of 23.5 percentage points. The respective numbers for Canada are 24.5% and 20.5% and for the U.S., 26.5% and 17.5% (I.M.F., 1985). Whatever the Canadian perception of overall social program spending, it is this confirmation of the relative role of government that is at the heart of the issue. Of course, that is not an inappropriate division of the burden in the eyes of those who are at the lower end of the socio-economic spectrum and who might well be at highest risk from the shortrun dislocations of the FTA and perhaps be least able to participate in gaining from it. The role of dependence on government in Canada is a very long standing one. While many Americans might look at the encroachment of government with disquiet if not strong distaste, in Canada it is different. The British North America Act, which defined the role of government in the last century, spoke of "peace, order and good government," and not "life, liberty and the pursuit of happiness." Such a philosophical difference has engendered a rather unquestioning dependence on government that pervades all aspects of Canadian life. It is therefore not surprising that the level, extent and preservation of social programs has become a shibboleth irrespective of the facts.

IV

Social Programs Under The FTA

THE FTA IS SILENT on social programs, though recognizing that subsequent Working Group discussions under Article 1907 could open the issue of social programs as subsidies. Critics, nonetheless, have argued that costly Canadian economic institutional differences will lead to inexorable pressures, at the risk of disinvestment, to lower Canadian costs to bring them in line with those of the U.S.[4] While GDP shares of direct government provision of social programs in Canada do not substantially exceed those of the U.S., and the I.M.F. study indicates that total social spending on narrowly defined programs in the U.S. exceeds that in Canada, such facts did not play any important part in the free trade debate in Canada, and widespread public concern continues to this day. Nor was anxiety eased when the government took steps to tighten unemployment insurance entitlement qualifications and increase contributions since the 1988 election. However, even if the facts had been different during the debate, there should not have been a real basis for concern for at least three reasons (Lipsey, 1989, 18–19). First, any general increase in costs of social programs from those of existing levels, insofar as they cause higher Canadian prices, should be reflected in the exchange rate, thus leaving the relative Canadian competitive position unchanged. Second, both Canada and the U.S. began to evolve complex and somewhat different welfare state programs in the 1930s. At the time of the Smoot-Hawley Tariff, average levels were at a record high of 59%; bilateral trade liberalization began in 1935, and in 1945 the ratio of duties to total dutiable imports had already fallen to 21.1%, with a further fall to 11.5% in 1985 (Dept. of Finance, p. 16). How can it be that further reductions in tariff protection will threaten the fabric of social programs that were able to proliferate in a half century of tariff liberalization?

Canadians should take comfort in the fact that broad harmonization pressure must have been at least as strong within the European Community since 1968 as it will be between Canada and the U.S. in the years to come, and yet Europeans have been able to maintain a wide variety of differences.[5] Finally, it could be argued that particular program costs differentiated by income group, product, regional or political sub-divisions might be so unique, or perhaps so small, that exchange rate adjustments would be an inadequate remedy; or, it might be argued that differences are so substantial that they resist all harmonization pressures, and thus threaten unilateral retaliation. As an illustration, on May 17, 1989 the province of Ontario introduced budget proposals that removed individual health and hospitalization insurance premium charges, and in their place has added a substantial payroll tax to compensate for lost revenue. Such a cost might indeed induce a production shift to another province, or even off-shore, but the changes themselves and their incidence are entirely independent of the FTA and of any level of tariff.

Variations in the direct tax burden on firms by jurisdiction will doubtless be of some relevance in investment flows within the two countries and between them in the years to come. Suppose for a moment that elements within the FTA were indeed relevant for such purposes; do firms have an incentive to leave Canada, or would such considerations put Canadian firms at a competitive disadvantage? In Table 1, we see that in Canada, corporations in 1986 paid about 19.5% of all taxes levied on incomes, profits and capital gains, in comparison to 15% respectively in the U.S. Such a difference is probably the source of some pressures for tax harmonization, but that is so before and after the FTA.

Of far greater importance are corporate income tax rates, both federal and provincial or state. The rate alone is not the whole story, as what is included in the tax base is very critical, and for corporations the most important inclusion or exclusion would be depreciation. Depreciation schedules between the two countries are very similar. Without attempting to be synoptic, it is not at all clear from a first look that Canadian corporations are at a relative disadvantage. In

Table 1

CONSOLIDATED FEDERAL GOVERNMENT ACCOUNTS, 1986

	Canada			United States		
RECEIPTS	Actual (millions)	Per Capita	% of GDP (1986)	Actual (billions)	Per Capita	% of GDP (1986)
Income, Profits, Capital Gains Taxes	50,640	1,974.50	11.3	412.31	1,709.06	10.7
Corporations	9,861	384.29	2.2	63.35	262.59	1.6
Social Security Contributions[1]	14,483	564.42	3.2	279.15	1,157.10	7.2
Employers	7,861	306.35	1.7	146.28	606.34	3.8
TOTAL[2]	65,123	2,537.92	14.5	691.46	2,866.16	17.9
EXPENDITURES						
Health	7,464	290.88	1.7	119.27	494.38	3.1
Hospitals	5,512	214.81	1.3	112.84	467.73	2.9
Social Security & Welfare	41,574	1,620.19	9.2	290.40	1,203.73	7.5
Social Security	34,248	1,334.68	7.6	239.64	993.33	6.2
Welfare	7,326	286.91	1.6	50.76	210.40	1.3
TOTAL[3]	49,038	1,911.07	10.9	409.67	1,698.11	10.6

Notes:

1 Includes contributions to Canada Pension Plan, Unemployment Insurance, Workmen's Compensation, and health care premiums in Canada. Includes Social Security and Workmen's Compensation in the United States.

2 Includes the aggregate of Taxes on Income, Profits, Capital Gains and Social Security Contributions.

3 Includes only the aggregate of health and social security and welfare.

Source:

International Monetary Fund. Government Finance Statistics Yearbook, 1988, pp. 250-251, 997-998, and World Tables 1987, Fourth Ed. Washington, D.C.: World Bank, 1988.

Table 2 we see that the U.S. federal tax rate is 34%, whereas that of Canada is 23% on manufacturing and 28% on non-manufacturing. Provincial tax rates vary from a low of 29% for manufacturing in Quebec to a high of 43% for non-manufacturing in Ontario; whereas U.S. rates vary from a low of 34% in several low tax states, to a high of 46% within New York City. In the post-FTA world, if anything, corporate tax rates themselves would not seem to be the source for Canadian harmonization, and the role of the FTA would seem more to be a matter of provisions that free the flow of investment.

While the GATT is silent on investment issues, the FTA in Articles 1601-1611 recognizes the potentially distorting effects of investment flows and the importance of liberalizing the process. Canada agreed to raise the review threshold for direct acquisitions of Canadian firms from the present level of 5 million dollars Cdn. to 150 million by 1992, and agreed to phase out the review of indirect acquisitions. Canada did retain some review rights in energy, transpor-

Table 2

TAX RATES ON CORPORATIONS FOR SELECTED LOCATIONS

Federal tax (U.S.)	34%
Low-tax states (U.S.)[1]	34%
New York	40%
New York City[2]	46%
California	41%
Florida	37.7%
Federal tax (Canada) - manufacturing	23%
Federal tax (Canada) - non-manufacturing[3]	28%
Ontario - manufacturing[4]	37%
Alberta - manufacturing	32%
Ontario - non-manufacturing	43%
Quebec - non-manufacturing	34%

Notes:

1 This represents the U.S. States with 0% Gross Corporate Tax Rates; 18 U.S. States have less than 6% Gross Corporate Tax Rates.

2 Includes Federal, State, Municipal Corporate Tax Rates.

3 Includes service companies, retail, and wholesale operations, etc.

4 Includes Federal and Provincial Corporate Tax Rates; there are no municipal rates in Canada.

Source:

Material supplied by Peat Marwick, Chartered Accountants, Toronto, Ontario February 14, 1989.

tation and cultural activities. Both countries agree to reduce content, and export and import performance requirements. The net effect of the FTA will certainly help promote further warranted U.S. investment activity in Canada, and existing corporate tax rates will doubtless induce a second look at those options.

Finally, suppose that we hold the implausible scenario that Canadian social programs are demonstrably generous by share and by level, and that there are real pressures for harmonization arising from the FTA. Irrespective of the FTA there will be demands from within Canada by the business community for social program reductions.[6] Whether they believe it or not, they will argue that the FTA necessitates it, and U.S. employers will argue that Canadian competitors benefit from subsidized programs.

Are there employee benefit cost burdens that are indirectly relevant to pressures for harmonization or investment flows? Given some level of employee benefits, statutory or contractual, that are similar in the two countries, then if either employee benefit costs, or payroll tax costs, are substantially higher in one country than in the other, the differences will have to be made up from general tax revenues. Accordingly, employers in the country whose employee benefits are not as fully met by general taxes will claim that the employers in the other jurisdiction are receiving an unfair subsidy. While we are in want of really good data in this area, and costs vary tremendously by type of benefit and jurisdiction, overall, in both countries, benefit costs expressed as a percent of gross annual payroll in 1986, as in Table 3, are almost identical. There are variations by manufacturing and non-manufacturing, and particularly in contrasting payments for time not worked with legally required payments, yet overall national differences pretty much balance out. We see no support in this data that would strongly imply either harmonization pressures or incentives for investment flows.

Aggregate figures do not indicate the whole story. There are social programs on both sides of the border which do discriminate in terms of making some commodities relatively cheaper. Starting in the 1956 and continuing in the 1971 Unemployment Insurance Act in Canada, for instance, fishermen have been eligible for Unemployment Insurance in such a way as to require government contributions.[7] Similarly, in the United States, farmers receive major payments from the government for production of farm products.[8] If, however, the subsidy was to the individual rather than to the production of a particular commodity, or if true social insurance principles were the guide, there could be little objection by those on either side of the border as commodity prices would not be manipulated unfairly. It is interesting to note that in the investigation of Atlantic Groundfisheries, the Unemployment Insurance Benefit program was not found to be countervailable.[9] Still, the possibility exists that in the future there may

Table 3

COMPARISON OF EMPLOYEE BENEFIT COSTS AS A PERCENTAGE OF GROSS ANNUAL PAYROLL, 1986

			Manufacturing		Non-manufacturing	
	U.S.	Canada	U.S.	Canada	U.S.	Canada
Payments for time not worked[1]	8.0	11.2	8.3	10.5	7.6	11.9
Legally required payments[2]	9.6	5.5	10.9	5.1	8.5	6.0
Pension and other agreed payments[3]	16.7	16.3	16.7	15.5	16.6	17.1
Other[4]	2.4	3.1	2.8	4.4	2.0	2.0
OVERALL	36.6	36.3	38.8	35.5	34.8	37.0

Notes:
1 Includes paid vacations, jury duty or personal time off.
2 Includes old age, social security, unemployment, workmens compansation, etc.
3 Includes pension plan payments, moving expenditures, lunch period pay, etc.
4 Includes profit sharing, tuition payments, etc.
Source:
Stevenson Kellogg Ernst & Whinney Employee Benefit Costs in Canada, 1986. Toronto: Stevenson Kellogg Ernst & Whinney, 1986, p. 37.

need to be a change in the way subsidies are administered but that does not mean a wholesale dismantling of social programs in general.[10]

V

Conclusion

WE HAVE ARGUED that a major self-characterizing feature of the Canadian national image, one that is widely and uncritically believed, is that Canada is a particularly socially generous country, especially in comparison to the U.S. De Montaigne said that nothing is so firmly believed as that which is least known, and the facts about Canadian social program expenditures, while they certainly do not portray Canada as a mean spirited land, are not well known. That public misunderstanding was exploited by the opponents of the FTA and such arguments almost carried the day. In the end the arguments made by the government along the lines of overall gains, even if requiring a leap of faith for the electorate, won out, but a strong residue of uneasiness over the fate of Canadian social programs remains.

Notes

1. For example, see Paquet, Gilles, 1987; Rotstein, Abraham, 1987; Watkins, Mel, 1987.

2. Shifrin, Leonard, "Are Social Programs in Danger?" *Toronto Star* 13 Oct. 1987. At a slightly higher level see, Ontario Federation of Labour, *It's Not Free: The Consequences of Free Trade with the U.S.* Don Mills, Ontario: OFL, 1986, or, Shifrin, Leonard, "Free Trade in Social Programs," *Perception* 12.1 (Winter 1988): 27–29.

3. Economic Council of Canada, 1988: 5. Also see, External Affairs, Canada, n.d.; and, Johnson, Jon R., and Joel S. Schachter, 1988.

4. See Marty Logan, 1990: 24–27. Reference is made to the call by the Canadian Chamber of Commerce and the Royal Bank of Canada for deficit reduction through social program reduction. Mention is also made to the "clawback" to family allowances and old age pensions as examples of government's wish to be more like the U.S. in its benefits.

5. O.E.C.D., and, Mahant, Edelgard, and Andrew Preston, 1986: 13–15.

6. Tony Van Alphen discussed the hidden agenda which the Canadian Association of Manufacturers appears to have to reduce social programs in Canada supposedly to reduce the deficit but also related to Free Trade.

7. In 1982, for instance, fishermen's premiums at $112 million paid less than 10 per cent of their costs. For a discussion see Kesselman, 1983: 45, 55–6, 76–7.

8. In 1987, 4,200,000,000 bushels of corn were produced under the price support program. United States Department of Agriculture, 1988.

9. Final Affirmative Countervailing Duty Determinations, 1986: 10059.

10. In 1971 a White Paper presented to Parliament suggested that self-employed fishermen be removed from coverage when a fishing income stabilization scheme had been developed. By 1986, although there had been changes, the Forget Commission also recommended phasing out the special fisherman's Unemployment Insurance program over a five-year period. The 1990 revisions to the Unemployment Insurance Act, Bill C-21, did not change the provisions for fishermen.

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Whimsical Wisdom

I am a great believer in luck, and I find the harder I work the more I have of it.

I know of no way in which a writer may more fittingly introduce his work to the public than by giving a brief account of who and what he is. By this means some of the blame for what he has done is very properly shifted to some of the extenuating circumstances of his life.

STEPHEN LEACOCK (1869–1944)