

# ADJUSTING TO FREER TRADE: TWO POLICY FAILURES

Judith Maxwell and Ron Saunders

One of the core objectives of the Canada-US Free Trade Agreement was to get Canadian industry to modernize and look outward — to climb the value-added chain. But the Mulroney government did not buttress the trade agreement with the adjustment policies required to help workers adapt to new skill requirements. And the monetary policy of the Bank of Canada impeded firms' investment in new technology and production processes. High interest rates, by dampening investment in capital equipment, also slowed growth in labour productivity in Canada throughout the 1990s and contributed to a widening of the Canada-US productivity gap — the opposite of what had been expected when the FTA was signed. Meanwhile, the three strategies of social policy in the Mulroney years — dissuasion, program restriction, and expenditure freezes — closed the door to serious investments in skill development. Facing large deficits, the Chrétien government also failed to increase investment in active labour market measures. Canada's investment in policies and programs designed to improve skills and/or help unemployed people find jobs has been declining since 1985. By 2006 it was only half the OECD average. This leaves Canada poorly prepared for the coming era of slowing labour force growth.

L'un des objectifs clés de l'Accord de libre-échange avec les États-Unis (ALE) était d'amener l'industrie canadienne à se moderniser et à se tourner vers l'extérieur. Mais le gouvernement Mulroney n'a pas adopté les politiques d'ajustement nécessaires pour aider les travailleurs à s'adapter aux nouvelles exigences professionnelles. De plus, la politique anti-inflationniste exagérément offensive de la Banque du Canada a entravé l'investissement des entreprises dans les nouvelles technologies. Ce faisant, les taux d'intérêt élevés ont également ralenti la croissance de la productivité du travail tout au long des années 1990 et creusé l'écart avec les États-Unis, soit exactement le contraire de ce qu'on prévoyait lors de la signature de l'ALE. Entretiens, la stratégie Mulroney en matière de programmes sociaux a empêché de véritables investissements en matière de formation professionnelle, et le gouvernement Chrétien n'a guère fait mieux. C'est ainsi que les investissements dans le perfectionnement des compétences et le soutien à l'emploi pour les chômeurs n'ont cessé de baisser depuis 1985. Si bien qu'en 2006, ils ne comptaient plus que pour la moitié de la moyenne de l'OCDE.



I t's time for Canada to shift its focus to manufacturing higher-value-added goods. This was the clarion call used by the proponents of Canada-US free trade in 1987-88. Achieving this shift would require two kinds of investments: physical capital investments in new technologies and production processes and human capital investments in education and training programs to produce more highly skilled labour. Neither one was able to achieve its full potential.

Michael Hart, writing in a recent volume entitled *Transforming the Nation: Canada and Brian Mulroney*, says that the Mulroney government set three overriding objectives for the Canada-US Free Trade Agreement (FTA). The

first was domestic economic reform — creating an incentive for firms to restructure, modernize and become more efficient, productive and outward-looking. This goal had been signalled in Michael Wilson's first major policy statement in November 1984, where he talked about inculcating a more entrepreneurial spirit in Canada. The second was to achieve more open and secure access to the US market by establishing a bulwark against US protectionism in the form of the omnibus trade bill making its way through Congress. The third was to create a more modern basis for managing the Canada-US relationship by creating new and more enforceable rules to govern trade along with more sophisticated institutional machinery for settling disputes.

By definition, then, the free trade agreement was meant to cause “adjustment.” Firms were expected to specialize in order to capture a larger share of the North American market. But economic restructuring on a national scale requires an adjustment plan. How can the economy move as smoothly as possible from the initial “equilibrium” to a new, higher-income one? How can we ensure that the ben-

efits of the change are widely dispersed and not just accruing to a minority of the population? In this article we argue that Canadian policies during the time of implementation of the free trade agreement made the adjustment much more difficult than it needed to be, contributed to a polarization of earnings and led to a failure to fully realize the promise of freer trade. There were two policy failures in the early years after the agreement came into effect. The first was overly restrictive monetary policy. The second was the failure to invest in active labour market measures, particularly skill development programs, that could have facilitated the adjustment to the restructuring associated with the FTA as well as to the rapid pace of changes in technology in that period.

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As Tom Courchene noted in his article in the October 2007 issue of *Policy Options*, the Bank of Canada in the late 1980s began a concerted effort to drive down inflation. The bank rate rose from 8.6 percent in January 1988 to a peak of 14 percent in May 1990. Since interest rates in the US rose less rapidly during this period, Canada attracted an influx of funds which drove the value of the Canadian dollar up from under 77 cents US in January

1988 to over 89 cents in November 1991. The combined effect of high interest rates and an overvalued dollar was to dampen investment as well as large consumer purchases, reduce exports, bring about a deeper recession in Canada than the US, substantially raise the cost of servicing government debt and weaken the fiscal position of Canadian governments. The Bank of Canada gave inflation a knockout

punch. By the mid-1990s, inflation had fallen below the 2 percent target set in 1991. But the punch had major repercussions in other policy areas, including especially the adjustment to freer trade. We raise this in the context of a discussion of the free trade agreement because the timing of the overvalued dollar coincided with the early years of the free trade agreement, meaning that many more Canadian plants closed in the process of adjustment to the FTA than would have done so if the Canadian dollar had been at a level that reflected its real purchasing power at that time. High interest rates, by dampening investment in capital equipment, also slowed growth in labour productivity in Canada throughout the 1990s and contributed to a widening of the Canada-US productivity gap — the opposite of what had been expected when the FTA was signed.

The impacts also spilled over into fiscal and social policies. The unnecessarily deep recession of the early 1990s contributed to soaring social assistance caseloads in Ontario, which provoked the federal government to impose a cap on Canada Assistance Plan payments to Ontario, British Columbia and Alberta in 1991. The ongoing effort to balance the federal budget contributed to an even deeper reduc-

tion in federal transfers to the provinces in 1995. The cuts in transfers, combined with the collapsing of the major transfers into the Canada Health and Social Transfer, led to a permanent loss of federal influence. (Some would regard this latter effect as a good thing.)

The second major policy failure of the post-FTA period was the lack of action on active labour market measures. Active measures are policies and programs designed to improve skills and/or help unemployed people find jobs. They include placement services, training programs, job creation incentives and support for unemployed people to start their own businesses. Passive measures are income support for the unemployed, which consists mainly of unemployment insurance benefits. Some countries also include programs that enable the early retirement of older workers.

The Economic Council of Canada (ECC) addressed adjustment policies in its report on the proposed trade agreement in 1988. It recommended, first, that all labour market programs should be generally available to workers who face the most difficulty in finding and holding a new job (not just to those affected by freer trade), and, second, that the government should place a greater emphasis on skill development (only 15 percent of labour market expenditure at the time).

The Advisory Council on Adjustment chaired by Jean de Grandpré repeated the ECC advice but went on to make much more far-reaching recommendations to help workers adjust to the ramp-up in export and import competition. It urged the government to:

- Strengthen formal education to make it more responsive to the evolving needs of Canadian society. “Canadians must begin to become better educated as a people.”
- Rethink the approach to training: “Businesses must develop a train-

ing culture...It is the private sector that must take on most of the costs of training and retraining its workforce. It has neglected this responsibility in the past and now must make it part of the corporate plan.” De Grandpré and his colleagues were especially concerned about general literacy, math and science skills.

- Develop a new spirit of cooperation between business and labour to work together to make business competitive and successful internationally.

To foster this new training culture, the advisory council recommended a stick and a carrot. The stick was a training tax levy on business which could be offset by firms’ investment in training. This was later implemented in Quebec, but not in the rest of Canada. The carrot would be to expand government programs that would serve as trampolines to help workers adapt to higher skill requirements, while reducing expenditure on passive income support.

**D**id the investment in active labour market measures happen? No. Data compiled by the OECD (see table 1) show that Canada’s spending on active measures as a share of GDP actually fell slightly in the period following the signing of the FTA: from 0.6 percent in 1985 to 0.5 percent in 1990 and 1997 and then to 0.4 percent in 2004. The (unweighted) OECD average rose from 0.7 percent to 0.8 percent over this period. By 2004, Canada’s investment was half the OECD average.

No surprise, then, that in 1998, the new training culture was far from evident:

TABLE 1: SPENDING ON ACTIVE LABOUR MARKET MEASURES (AS PERCENTAGE OF GDP), 1985-2004

	1985	1990	1997	2004
Canada	0.6	0.5	0.5	0.4
OECD average	0.7	0.7	0.8	0.8

Source: OECD.

Gordon Betcherman and colleagues (*Training for the New Economy*) reported that only 10 percent of Canadian firms (employing 25 percent of the workforce) would qualify as learning organizations. They were mainly large companies. Almost two-thirds of employers offered only incidental learning opportunities.

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And generally speaking, workplace learning was made available only to well-educated employees.

Now, 20 years after the trade agreement was signed, research by Canadian Policy Research Networks (Karen Myers and Patrice de Broucker) shows that less-educated and less-skilled workers have the most difficulty accessing publicly funded skill development programs. Employers are making the same mistake in targeting workplace training primarily to well-educated employees, even though workers with an initial education of high school or less were more likely to report that an education or training program helped them improve their labour market outcomes.

Nor is there evidence of a leap forward in general literacy. In 2003, 42 percent of working-age Canadians had literacy skills below the level considered necessary to function well in today’s society, unchanged from 1994. Yet, in a forthcoming paper, Serge Coulombe and Jean-François Tremblay find that increasing the average literacy skills of all individuals has a greater effect on growth than increasing the percentage of individuals that achieve high literacy skills.

Finally, none of the reports issued in the late 1980s and early 1990s paid much attention to the risk of a polarization in earnings. It is clearer now that both the FTA and the North American Free Trade Agreement were designed to increase the mobility of capital,

through the investment codes, and of highly skilled workers. This made it easier for Canadian firms to establish low-skill operations in low-wage countries. The result was a power shift away from less-skilled labour, which helps to explain the growing inequality in earnings between low-skill and high-skill

occupations. With the benefit of hindsight, we can see that governments ought to have paid particular attention to improving the skills and knowledge of less-skilled workers, as the de Grandpré report recommended.

**G**oing back to the policy failures of the late 1980s, why did Canada not make a serious commitment to adjustment policies that would help workers with low skill to improve their skills and to qualify for higher-value-added jobs?

Part of the answer lies in political hubris: the FTA was about more jobs, more trade and more income. Politicians did not want to talk about any of the downsides associated with restructuring the economy. Beyond hubris, however, were two other factors: The first was that the Mulroney government had a different perception of governments’ capacity to solve social problems. The second was that macroeconomic conditions would come to dominate policy choices in the period from 1989 to the mid-1990s.

In the 1984 election campaign, Mulroney indicated he would not be making radical moves on social policy. In an effort to reassure Canadians that his approach to social policy would not be very different from that of the previous government, he promised to maintain the “sacred trust” of universal income benefits.

However, the policy choices he made did differ in important ways. The

government worked consistently to contain social expenditures and to redefine the boundaries of government responsibility in the social domain. Michael Prince and James Rice, also writing in *Transforming the Nation*, describe the three strategies of social policy in that era as dissuasion, program restriction and expenditure freezes.

Dissuasion was used to reduce expectations for what governments could do: the government “advocated self-reliance, extolling the virtues of charity and voluntarism.” Program restriction narrowed eligibility criteria and reduced benefits for programs like unemployment insurance. And expenditure freezes enabled the government to reduce commitments to social housing, legal aid and post-secondary education among others.

This kind of social policy climate did not augur well for adjustment policies to smooth the transitions of workers who were negatively affected by industrial restructuring.

And, indeed, the Mulroney government did ignore the report of the Advisory Council on Adjustment. The question of adjustment policies was therefore punted to the next government, elected in 1993, which promptly commissioned the Social Security Review Task Force. The task force spent a lot of time on labour market issues, but its proposals for active labour market programs were sideswiped by deficit reduction. Fiscal restraint trumped social reform in the 1995 budget. And then Prime Minister Chrétien decided, after the 1995 Quebec referendum, to delegate active labour market programs to the provinces through Labour Market Development Agreements.

Even today, when the exchange rate is at parity with the United States, commodity prices are soaring and manufacturing industries are under severe stress, Canada still does not have a coherent approach to active labour market measures which help workers to improve their skills and/or to find new jobs. The result is that many low-skill workers are caught in a low-wage trap, with little or no access to skill development.



Jason Ransom, PMO

**Prime Minister Stephen Harper and Finance Minister Jim Flaherty at Budget 2007: Can the current Conservative government fill the gap left by the Mulroney government regarding measures to help workers adjust to the new labour context? The 2007 announcement of \$500 million per year to help the most vulnerable labour market groups and the further \$100 million set aside to increase the skills of Aboriginal people are a start, write the authors.**

This blockage is not sustainable, however. Barriers to adult training and education have to be dismantled on an urgent basis. This will be the most promising way to overcome the emerging challenges of slower population growth and selected labour shortages.

Perhaps those shortages are helping to turn the tide at last. The 2007 federal budget announced new spending of \$500 million per year beginning next April to be devoted to the most vulnerable labour market groups, including

recent immigrants, persons with disabilities, Aboriginal people and older workers as well as employed workers with low skills or low education. A further \$100 million was set aside to increase the skills of Aboriginal people. These are helpful measures, but we are still a long way from the training culture visualized by Jean de Grandpré and his colleagues.

*Ron Saunders is vice-president, research, at the Canadian Policy Research Networks, and Judith Maxwell is senior fellow.*