

**SMART SOVEREIGNTY:
CANADIAN PROSPERITY IN AN INTEGRATING WORLD ECONOMY**

By

Jack M. Mintz
President and CEO
C. D. Howe Institute

And

Arthur Andersen Professor of Taxation
J. L. Rotman School of Management
University of Toronto

*Prepared for the Canadian Club, April 2, 2001, Royal York Hotel

I am pleased to be with you here today, and especially pleased to be able to talk about a subject of great interest to me – Canadian sovereignty in an integrating world economy.

INTRODUCTION

My reasons for speaking to this issue today are two.

The organization which I have had the honour of heading since 1999 has a long and well-earned reputation for balanced, insightful analysis of the pressing economic issues of the day. Now you might think that the status of Canada's sovereignty would not seem to be one of them. Surely health care or taxes or the slow down in the economy would loom as most urgent and much more relevant.

However, as any physician will tell you, sometimes the nagging dull ache deserves as much attention as the short sharp pain. I believe Canada's sovereignty and globalization is one of those chronic issues that needs attention.

One reason is that there is a suspicion among many in this country that the pace of global economic change, Canada's openness to the world, is chipping away at what it means to be Canadian and the ability of Canada to control events. Canada's sovereignty, perhaps its very existence as a nation is believed by many to be at risk.

The other reason, to be honest, is very much news driven.

In just under three weeks the heads of democratically elected governments from North, Central and South America will meet in Quebec City. Gathering also will be Canadian citizens and groups, as well as visitors, for the purpose of objecting to the agenda of the official meeting.

If past such events are any guide, the messages of all parties will be washed away in the media storm. So I thought I'd get my oar in the water early.

FEARS ABOUT ECONOMIC INTEGRATION AND SOVEREIGNTY

The worries about international economic integration and the state of Canada's sovereignty seem to coalesce around three issues:

- that international trade agreements and associated institutions – NAFTA, the WTO and so on – will undermine Canada's efforts to protect its environment, provide public services and regulate its economy as decided upon through its own democratic processes.
- that increased trade with less prosperous countries will itself create a "race to the bottom" in taxes, public services, social policies, environmental regulations and

labour standards.

- that growing economic integration with the US will lead to national policies – especially in the areas I’ve mentioned above – that mirror those in US and lose their distinctively Canadian character.

These are valid and legitimate concerns. We should be worried. After all, history has not granted the people of Canada, or of any country, the unequivocal “right” to act collectively at the level of public policy or cultural expression. Or for that matter even to exist at all.

Through the centuries nations have disappeared or been swallowed through war, mismanagement or simple bad luck. There are no guarantees.

But I do believe – and the evidence to back me up is overwhelming – that the best chance to increase Canada’s strength as a nation, the prosperity of all its people and the influence it has in the world, lies in the wholehearted embrace of the global economy.

NATIONAL SOVEREIGNTY AND WHAT IT IS GOOD FOR

Before diving into the specific policy prescriptions, I believe it is worth reflecting on the idea of sovereignty and why it is useful.

Sovereignty is about the freedom to make independent choices as a nation, and it is this freedom that is sometimes held at risk. But part of the trouble with notion that sovereignty is at risk is the assumption that more sovereignty is necessarily better than less. Or that in some golden age past Canada has had fuller sovereignty, and now is in danger of losing it.

Neither of these propositions stands up to scrutiny.

Absolute national sovereignty – what I would define as the ability of a national government to act and govern without reference to any outside influences in the form of politics, or trade in goods or ideas – is impossible to achieve, and of dubious value to pursue.

For any country that has tried – even large ones – it has led almost without exception to economic and social disaster. Soviet Russia of the 1930s, China of the 1970s, and Mr. Milosovic’s rump Yugoslavia of the 1990s are especially terrifying examples of the pursuit of absolute sovereignty.

The mere hoarding of sovereignty – as if it were oil or ammunition – is by itself meaningless.

As for the unrealistic dreams of past Canadian independence from the rest of the world, well they were never a reality. From the days before Confederation Canada has *always* been intimately tied to the world beyond its borders.

Perhaps it is the sheer expanse of the country that has led some to believe otherwise, but economically Canada has always been a small ship afloat on the large sea. The flows of investment and trade and people have shifted over the decades, but this is not an isolationist country and we are not by nature an insular people.

Our prosperity rests in huge measure on exchange with people of other countries, exchange in ideas, goods and services.

The pace of economic change is certainly greater than in decades past, and the velocity of these movements much increased, but they have always influenced who we were and how we conducted ourselves.

Second, sovereignty is without value unless you know what you want you want to do with it. North Korea is very likely the most sovereign power on the planet today. Yet except for an ability to blow up its neighbours, its government is without influence beyond its borders. And North Koreans are among the most impoverished and miserable people in the world.

Lots of sovereignty – more than any other country – and yet manifestly bad, domestic policies have led North Korea to disaster.

As an alternative to this admittedly extreme example of short-sighted sovereignty, I believe Canadians should be talking about *smart sovereignty*.

The key to smart sovereignty lies in understanding an essential truth: our success in engaging with the global economy will determine our ability to carve out areas of distinctiveness and influence in an unpredictable and even dangerous world.

The wealthier the Canadian economy and the more prosperous our people, the greater our ability to determine our own future and influence events beyond our borders. And just as certainly, the refusal to engage, or incompetence in so doing, will lead to relative decline in national wealth, and a greatly diminished capacity to do the things that matter most to us.

LOSS OF SOVEREIGNTY MYTHS

Lets look at three of the common worries about global economic integration I mentioned earlier.

First: that entering into international agreements undermines Canada's ability to

regulate its economy, protect its environment, and design its own public and social services.

I believe this idea stands reality on its head. The quickest way to undermine sovereignty in these important areas is economic decline. The proof that this is so lies in what happened to Canada in the 70s and 80s – unrelated to NAFTA, the WTO, and the Hemisphere gathered together for trade summits.

What occurred was that fiscal mismanagement so broad and continuous that it left us with high unemployment, low productivity, high taxes, a depreciated currency and a staggering debt load.

By the early 1990s Canadian governments regardless of ideological proclivity faced precisely two policy options: ruin or retrenchment. Talk about a loss of sovereignty. Decades of bad public policies presented the Canadian democracy with almost no room to manoeuvre.

No consolation can be found in this national debacle. Among industrialized countries, Canada had one of the poorest economic growth rates in per capita income during the 1990s.

Second is the prospect of an international “race to the bottom” with jobs fleeing to low-wage countries, and Canada cutting education and health spending to stem the flow.

“Race to the bottom” is an alarming catch-phrase; however, there’s no evidence at all that it is happening or in fact has ever happened before. Past experience and current trends point the other way.

We can see within our own borders significant variation between provinces on tax levels and taxation structures. Alberta, Ontario and Quebec are examples. However despite mobility of capital and labour that dwarfs that going on internationally I doubt we will see tax rates converging on zero at anytime. The race instead is to excellence in infrastructure, education and opportunity.

Between countries the same holds true. Bangladesh and Canada are not competing for the same capital and the same employment opportunities. First class knowledge-based jobs and businesses will continue to locate here if we continue to have a productive social and economic infrastructure. The jobs and capital that goes to Bangladesh, will be appropriate for a developing economy and will help Bangladesh grow too. The principle of comparative advantage stands true.

The Third notion is that increased integration through trade agreements with the US will lead us to adopt American ways. That somehow if we have more exchanges and investment with the US we will abandon what is distinct about Canadian policies in everything from health care to literature to gun control.

This notion is a real puzzle. Since Canada always has had and always will have intensive economic relations with the US, precisely what level of intensity is it that is supposed to tip the balance between being real Canadians and would-be Americans? Is there a trade or an investment figure to aim at? How will we know when we've gone too far?

The answer—this is my speech so I'm allowed to answer my own questions—is that the whole construct is wrong-headed. Actual experience shows that the quickest way to lose identity is to follow a path of economic decline so that citizens no longer believe that a country can succeed.

Better yet, we can achieve greater prosperity if we are distinctive, not copycats. Canada's best path for achievement is to be innovative in its policies. This means that our policies will be different, not harmonized with the policies of other countries, including the US.

We live next door to the most powerful economy in the world today. So in order to maximize our choices we need to follow two paths simultaneously:

We need to tie the Americans to as many bilateral and multi-lateral agreements as possible so as to make the relationship "rules based" where we have a fighting chance, rather than simply a power game, where Canada is the clear loser.

And second, the wealthier we become as a society the less vulnerable we will be to every American twitch, grunt and whim. The goal of smart sovereignty is to enlarge the economic space Canadians have to choose their public policies through their democratic institutions.

DOMESTIC POLICY PRESCRIPTIONS

I hope that you see a common theme is beginning to emerge here.

Genuine sovereignty means having choices. We increase our choices through economic growth and job creation. Intense engagement with the global economy is a pre-requisite for that growth.

Note that I didn't say global engagement was sufficient. There is another essential ingredient, and that is the right set of domestic economic policies.

Of course, Canadians will differ on how to achieve greater prosperity; however, that is one of the benefits of smart sovereignty. You get to debate, struggle and choose.

Here's my contribution to the debate, a four-point prescription to be first rank in prosperity by the year 2015:

We must reward success not failure—We need to radically alter the premise under which public services are delivered. Public programs need to be judged by what they accomplish: successful ones funded, failures de-funded.

Public sector workers need to be paid and rewarded in monetary and non-pecuniary ways, according to their success in meeting objectives. I include in this category civil servants, teachers, professors, medical workers – anyone whose wages comes from taxpayers' money.

I believe we need to introduce the element of competition into the supply of public services as a whole. There is no reason schools, universities and hospitals should not be competing among themselves to deliver services to the public.

We must tackle the public debt—The issue of Canada's public debt may have receded from the headlines, probably because the Federal Government no longer runs an annual deficit. However, the debt we accumulated for ourselves over 25 years remains large and it is a monster waiting in the wings. Our sovereignty is in peril if we ignore it.

Government debt is about \$850 billion, as a proportion of the economy it is exceeded among developed nations by Italy, Belgium and more recently and bizarrely Japan.

This is only the half of it, however. If you add in unfunded liabilities for public pensions and public health care we are looking at a debt of at least 2 *Trillion* dollars, not including other liabilities, such as environmental degradation.

If the problem is left untouched, by the year 2015, the government—without spending a single dollar on new programs—will need to levy taxes equal to eight percent of GDP just to service the liabilities.

The big kicker in all of this is demographic time bomb. In 15 years, these debts will need to be serviced by a tax base made up of decreasing numbers of paid workers and rising numbers of elderly “baby boomers” collecting pensions and drawing on health care services.

Many of those gathering to object to the summit in Quebec later this month will be between 20 and 30 years old. I think what they really ought to be furious about is this nice little gift we've left them. And you and I know they would be right in their anger.

The squandering of our childrens' legacy is inexcusable. However, managed prudently now, for example by setting a target range for the public debt relative to the size of the economy of say 30 percent, Canada could reduce citizens' tax burdens by about 5 GDP percentage points by 2015.

We must have smart and efficient Government—At the moment, Canadian governments command well over 40 percent of the economy. But many successful

countries' governments such as Australia, Iceland, Ireland and Switzerland operate at about one third or less of their national economies – and deliver education, health and other public services of admirable quality. Given the comparison, it seems to me hard to argue that Canada should be spending even more than it is today.

Surely, there is an efficiency gap somewhere. Part of the inefficiency is reflected in the excessively high level of debt that our governments took on in recent years. Another part of the inefficiency has been poor program management – too little use of insurance principles for our social “insurance” programs like Employment Insurance, too many ineffective business subsidies, and an inadequate review to ensure that programs are accomplishing their objectives.

Some governments have been improving their management practices. Many governments have not been through the management and administrative revolutions that have already transformed many central departments of the Federal Government and those of provinces like New Brunswick and Alberta.

There is any case a great deal of financial slack left to be taken up when it comes to delivering public services to citizens at lower cost and higher quality.

We must reform Canada's dysfunctional tax system—If Canada wanted to make a really distinctive move – more smart sovereignty – we would overhaul our tax system.

The existing system is a drag on investment and work. High marginal taxes on labour discourage work effort, especially for low income earners who are faced with a barrage of special provisions that clawback any public program benefits they may receive. Taxes on capital and saving discourages investments and therefore growth.

Instead of taxing individuals on what they contribute to production, we should tax what they consume. Taxes related to consumption can be accomplished in four ways.

First, we should make greater use of excise and value-added taxes.

Second, we should liberalize our income tax system by converting it to an expenditure tax. After all, expenditure is simply income minus savings. The current system that requires people to pay a second level tax on their savings from earnings that have already been subject to tax is unfair to savers.

More importantly, for Canada, an expenditure tax would substantially improve prospects for growth. An expenditure tax is not difficult for Canada to achieve. We already have it in place with our current system that allows people to avoid double taxation of retirement savings and housing. All we need to is to remove the limits that subject other forms of savings from excessive taxes.

Third, we should tax the consumption of public goods and services by following more

the user pay principle. The tax system would be more efficient and fair because people would contribute to the costs of programs according to the benefits they receive from a particular service – those who do not benefit should not have to contribute.

Fourth, we should reduce much more significantly corporate income and capital taxes on business investments. Instead, business taxes – that will not disappear – should be based on the use of public goods and services and value-added.

The result of an overhaul of our tax system would be a substantial increase in the incomes of all working Canadians as Canada becomes a nation of unequalled attractiveness for capital investment.

PRIVATE SECTOR RESPONSIBILITY

All this has been aimed at government. But all Canadians, each of us in this room, have a similar obligation to examine how we can help grow the economy and increase our sovereignty. A few examples:

The Canadian business community has a fair bit of reflection of its own to do on the issue of rewarding success not failure. The size of payouts to de-hired executives and the salaries paid to top officers of money losing firms makes me wonder what has happened to the incentive system.

And too many businesses continue to take government subsidies of one form or another. As I've stated already government should stop giving them. However, business has the obligation to stop asking for them – full stop.

Subsidies are anti-competitive, they thwart innovation, and they simply don't work. The billions lost in the swamps of Canada's late, unlamented regional development schemes showed us that but their ghosts still live on in the design of employment insurance and job creation programs.

Finally, the business community needs to more active in supporting policies that break monopolies, keep markets competitive and provide maximum information to consumers. Freer international trade would go a long way to increasing competition and providing benefits to consumers; however, business continues to show marked ambivalence towards the global economy.

Canada may have free trade with the US, but a blizzard of quotas, tariffs and other trade barriers face importers from many other parts of the world. And protectionist demands from business is one of the reasons they exist.

This last example brings me back to the Quebec City summit. Much of the anti-free trade rhetoric we will hear expresses fear of "corporate power." And it is certainly true that unbridled corporate power holds the potential to be dangerous in a democratic

country. However, the greatest break on corporate power is competition, not regulation or isolation.

I believe that the protestors are holding forth at the wrong event. If they are worried about Canadian sovereignty, they should instead be in Washington protesting against those large American companies and their political allies who would restrict lumber imports from Canada.

And if they really wanted to give the people in poor nations the chance to raise their standard of living, they would be petitioning the Government of Canada to stop protecting domestic manufacturing interests with barriers to imports from Third World countries.

CONCLUSION

None of the proposals I've laid out here today will be easy to accomplish. And there are no doubt many storms to come our way. As I said earlier there are no guarantees. However, the other route – of isolation, restriction and yes, reaction – is a much more dismal prospect not just for Canadians but for all the world's peoples.

Canadians are internationalists – traders and travellers – and we are good at it. Canadians are better equipped than almost any other people in the world to face the challenges of growing sovereignty for ourselves. So let's get on with smart sovereignty.