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Hollowing out the 'hollowing-out' theory of free trade with the U.S.

Lower tariffs led to more investment in Canada, not less

BY WILLIAM WATSON

Jan. 1 marked the 10th anniversary of the Canada-U.S. free trade agreement, as well as the final phase-out of what, a decade ago, had been the very highest tariffs between the two countries.

Last Friday's employment numbers, which kept the unemployment ratio even at 8% and showed the employment ratio — the share of the working-age population with jobs — at its highest level since 1991, will persuade many people that the job market is finally getting over the ravages done to it by the adjustment to the free trade agreement.

The lead article in the latest issue of the *Canadian Journal of Economics* suggests such people have it wrong: There very likely weren't any ravages to get over.

Three U.S.-based economists analyzed confidential U.S. Commerce Department data on employment and investment by 701 U.S. multinationals with operations in Canada and found that, between 1983 and 1992, when Canadian tariffs went down, the firms' investment and employment in Canada went up.

That's right. Lower Canadian tariffs led to more economic activity in Canada, not less. For most people, that's a surprising result. The more common view, as Brian Mulroney himself put it during the Tory leadership campaign in 1983, was that when Canadian tariffs were lowered: "All that would happen . . . would be the boys cranking up their plants throughout the United

States in bad times and shutting their entire branch plants in Canada . . . We'd be swamped." At most we'd be left with a warehouse or two. As the saying goes, our industry would be "hollowed out."

It was fun twitting the Left during the 1988 Great Free Trade Debate for its lamentations that because of the trade agreement all the U.S. branch plants would leave — the very branch plants whose pernicious effects on Canadian society they had spent the previous 20 years denouncing. But, truth be told, many of us free-traders thought the branch plants really were there mainly because of the tariff, and that when it went, they probably would, too. It seems we were wrong.

Granted, the study stops in 1992 and therefore doesn't cover the entire adjustment to the free trade agreement. But during the nine years it does cover, Canadian

tariffs in the manufacturing industries covered fell by almost two thirds, from nearly 8% on average to only 3%. Unless doing away with the final 3% had drastically different effects than all previous tariff cuts, the years covered should give a good clue as to how final adjustment to the FTA would have worked.

They suggest it should have worked pretty well. On average for the 701 firms studied, a one-percentage-point fall in the Canadian tariff increased their Canadian firms' assets by between 4.5% and 5.6% and their employment by almost 3%. And that's the pure tariff effect — that is, what's left after controlling statistically for changes in capital and labour costs and differences in the business cycle and other economic variables between the two countries.

It turns out a lot of the branch plants weren't here just for the

tariff. To be sure, they may have ended up doing things differently after the tariffs went. A number of businessmen interviewed for the study — that's right, three economists actually talked to some real-world executives about how they run their businesses — said they'd had to adapt their Canadian operations to the new environment. One firm retooled to achieve high productivity in relatively small plants, while another devoted its Canadian operations to fulfilling small-batch orders for the global parent.

At bottom, that's not a surprising evolution. The country's biggest industry, autos, has had free trade for producers for 34 years now, ever since the Auto Pact of 1965, which revolutionized our industry. We now make a much smaller range of cars than we used to and are much more integrated into a continentally rationalized industry. But there's more employment and investment here than there ever was.

What the Auto Pact did for cars, the FTA did for all other manufacturing industries: It allowed them to rationalize on a continental basis, and while some

firms have made headline-grabbing reductions in their Canadian operations, this new study suggests most will have stayed and adapted.

The study's other surprising conclusion is that there is more variation in how firms respond to a given cut in tariffs within an industry than there is between industries. Lots of time-honoured economic theory suggests that different industries will respond to tariff cuts in different ways, as resources move to sectors in which the country has a "comparative advantage" and away from those in which it doesn't.

But this study suggests that may not be so; rather, there is a wider variation of responses *within* industries. While some firms in an industry do shut down their Canadian operations, others expand them dramatically, even though all are supposedly producing similar products.

It's just one more example of how complicated the real world is, and how difficult it would be to plan.

William Watson, editor of *Policy Options*, teaches economics at McGill University.