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The Role of Subnational Governments in Sectoral Integration

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*by Earl H. Fry**

I. THE EVOLUTION OF INTERNATIONAL RELATIONS

Think back to when you took basic political science or International Relations 101. We used to depict international relations in terms of the so-called billiard ball model. The only significant actor in the international arena was the nation-state. There were three characteristics associated with the nation-state: 1) it was simple to distinguish between what was a nation-state's domestic policy and what was its foreign policy; 2) it was very easy to determine what the national interest of a nation-state was; the goal of a nation-state was to protect and maximize its national interest in the international arena; and 3) foreign policy decision making by a nation-state was synonymous with the office of the Chief Executive and the central policy apparatus in the national capital.

That is how we viewed international relations. As time went on we refined the notion a little bit. Recall what Graham Allison had to say about international relations two decades ago. He said that foreign policy making may not be such a rational process after all, and that it is difficult at times to determine what the national interest really is. He introduced the notion of bureaucratic politics and organizational process and said there is a lot of pulling and hauling that goes on before a foreign policy decision is made. But if there is all of this pulling and hauling going on in a momentous crisis situation such as the Cuban missile crisis or the Suez Canal crisis, then how are you going to make rational policy in the economic arena, where there are much more mundane issues?

Our thinking evolved to the point of discussing transnational and transactional and transgovernmental politics. We discovered there were significant actors in the international arena other than just nation-states. There were, for example, multinational corporations, churches, international labor movements, and special organizations such as the Palestinian Liberation Organization. The actors were no longer limited exclusively to nation-states, or to the representatives of national governments.

I would contend that today, in a very complex and increasingly interdependent world, we must add the activities of what I call subnational governments, such as state and provincial governments, to the list of sig-

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** Remarks given at Conference.

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nificant actors in the international arena—at least insofar as the economic sector is concerned. A representative of a business that is thinking of expanding abroad must be aware of the impact which different levels of government and bureaucracies can have on the business community.

II. Economic Challenges Facing Canada and the United States

Canadians have traditionally felt a sense of vulnerability about close economic ties with the United States. I think they generally perceive their nation as a middle-sized, dependent, and relatively open market system; and the U.S. as a large, relatively open, well integrated, independent, domestic-oriented system, with all of the important trade and investment related policy being made either in the Executive branch or in the Congress. I would assert, however, that an increasing number of Americans also feel a sense of vulnerability because of increasing global economic interdependence.

Here are some rather impressive statistics. The United States continues to be the number one industrial power in the world. It accounts for about 23% of the world's gross product. It also remains the number one trading nation in the world, and the number one foreign direct investor. We live in a dollar dominated world economy. The dollar since 1980 has gone up by an average of 60% against the major currencies of the world. It is estimated that as much as 80% of trade in the non-communist world is denominated in U.S. dollars. Furthermore, 75% of all the reserves held by central banks around the globe are denominated in U.S. dollars.

There has been impressive GNP growth in the United States, particularly over the last few years: approximately 7% in both 1983 and 1984. It has been estimated that at least 50% percent of the growth in the LDCs and in Western Europe over the past two years is directly attributable to expanded exports to the United States.

There are other signs of interdependence. The United States is the number one host nation in the world for foreign direct investment. (A direct investment is one which provides an investor in one country with a controlling interest in the management of a firm in another country; thus it is quite different from a portfolio investment.) The U.S. Department of Commerce has recently published new statistics on foreign direct investment. They show that in 1984, foreign direct investment in the U.S. was more than $150 billion. That is an increase of 1200% since 1970, and provides the U.S.A. with almost three times as much investment as the number two host nation, Canada. In addition, about 2.5 million Americans now work for foreign-controlled enterprises in the United States.

Consider, for example, the banking sector. In the two major financial centers, California and New York, 40% of the banking activity is carried out by foreign-controlled banks. In California, nine of the fifteen largest banks are foreign-controlled. In the overall domestic production arena, at least 70% of U.S. products are now subject to direct foreign competition.

For the first time since World War I, the United States is a debtor nation. Within the next 18 months, the U.S. will probably become the world's largest debtor nation, surpassing Brazil and Mexico. In 1984, 40% of the U.S. government deficit was financed by foreign investment. This has certainly had a direct impact on the level of interest rates. In the international exchange markets, the volume of Euro-dollars is very high in relation to the overall dollar supply. These exchange markets are also having a very significant and disturbing impact on trade flows.

The United States also has the world's largest trade deficit. Moreover, it has the largest current account deficit and both trade and current account deficits will probably go up significantly in 1985. In addition, the U.S. will not even come near to achieving a 7% growth rate in 1985. Keep in mind as well that in the next year or two, the total government deficit will reach $2 trillion dollars. Furthermore, the nine largest U.S. banks have made loans to Third World nations equivalent to about 200% of their equity base; and there are many other banks that are heavily exposed in overseas markets.

It is clear from these statistics that the United States has entered the era of complex economic interdependence. Frankly, Americans are not accustomed to interdependence and there is concern that they will adopt a knee-jerk stance in favor of protectionism. One would hope, though, that the President and the Congress would understand that by becoming more protectionist and forming a "Fortress America," they would be working against America's long-term interests.

It is not difficult to understand, however, why Congress could "fall" into protectionism. 84% of the government deficit is linked to just three categories of expenditures: defense, entitlement programs, and servicing the national debt. There are vèry strong constituencies for the first two and it would be very difficult for Congress to attack them. On the other hand, it would be much easier to place a surcharge on foreign companies and foreign investors—they do not vote.

I'm very concerned about such a Congressional action and about the possibility of the U.S. getting into a protectionist "war" with Japan or the European Economic Community. I believe that if we do that, the major victim will be Canada. 76% of all Canadian exports in 1984 went to the United States. So, even though protectionist legislation might not be directed against Canada, our northern neighbor will still suffer dramatically from the loss of competitive access to the U.S. Therefore, it is imperative that Canada seek enhanced and assured access to the U.S. market—and do this in the very near future.

III. THE SUBNATIONAL DIMENSION

Quite surprising to most observers, U.S. state governments have become very much involved overseas. They recognize that that government deficit in Washington is hurting them as well. It is injurious to their exporters and to their local companies that have to compete directly against the foreign products pouring into the United States. In 1970, there were four states which had opened offices overseas for trade and investment purposes. Today, two-thirds have opened them, and almost all the states sponsor trade and investment missions.

Governor Thompson of Illinois, for example, recently lead a 160-member delegation to Asia. He now goes to Japan four times a year. Why? Because since 1980, U.S. direct investment in Japan has stagnated, yet Japanese direct investment in the United States has tripled. If you are an elected official, whether at the state or provincial level, and if you want to be re-elected, you are going to have to expand the economic base, create new jobs, and diversify the economic base so that your economy down the line becomes more recession-proof. To do this, officials are looking increasingly abroad for investment funds.

Take, for example, what happened with VolksWagen a few years ago. At that time the German mark was very robust in comparison to the U.S. dollar. VW was literally being priced out of the U.S. market. It had to come to the United States and begin to assemble cars here in order to survive in that market. What happened? VolksWagen announced it was going to establish a plant in the United States, and thirty-five states entered the bidding. Eventually, it narrowed down to Ohio and Pennsylvania. Pennsylvania won out by offering an incentive package worth in excess of $60 million. For a company which is partially owned by the government of West Germany and which had to come to the United States in order to survive, the incentives were undoubtedly a special bonus. Recently, Nissan announced it was going to set up an assembly plant. Once again, thirty-five states entered the bidding. Tennessee won the bidding war by offering an incentive package worth in excess of $60 million dollars.

These subnational governments are after both foreign and domestic investment—and the competition has evolved into a cutthroat poker game. South Dakota actively seeks to entice companies from neighboring Minnesota, and claims it has already taken sixty away. Indiana business development officers spend time in Michigan. Missouri's governor meets with business representatives in Illinois. North Dakota officials host receptions for companies in Manitoba. And Ottawa, of course, works with various provincial governments to entice firms to locate in Canada instead of neighboring U.S. border states. As an illustration, it took about $70 million, pieced together by Ontario and Ottawa, to convince Ford to locate a new plant in Ontario instead of Ohio.

Moreover, these subnational governments are more powerful and influential than is often perceived. California and New York by themselves rank within the top dozen industrial powers in the world. California has a population base which is greater than that of Canada. Its annual budget is about $30 billion, and it does not have to pay for defense or interest on the national debt out of that budget. Japan's number two trading partner, after the United States, is California. The number one trading partner of the United States is Ontario; Japan ranks number two; and the rest of Canada ranks number three. What the states and provincial governments do will have a growing impact on trade, direct investment, and capital flows between the two North American nations.

There are two basic reasons for the growing influence of these subnational governments. First, the subnational governments on both sides of the border are increasingly involved in influencing and regulating the business sector. For example, forty-three state legislatures met in 1981, compared to only 18 in 1960. State legislative staffs have expanded dramatically, and both legislators and staffs have shown an increasing interest in business matters. In 1980, seven times as many business-related laws were passed at the state level as at the Congressional level. Moreover, sixteen times as many laws of all categories were passed at the state level. This is why many U.S. corporations are now strengthening their government liaison offices. They are finding that at the state level—or even at the municipal level—more laws and statutes are being implemented which impact upon the way they do business.

Over forty states now have "Buy American" or "Buy State" procurement codes. Several of the states still have unitary taxation. State governments continue to exercise broad powers in the areas of land use, insurance and banking, environmental controls, hazardous waste disposal, labor relations, civil rights, and corporate taxation and chartering. There are in the United States fifty different liability laws, and these laws may differ dramatically from one state to the next.

States have also passed various disclosure laws which impact upon foreign investors. Ohio, for example, passed a law in 1979 which mandates that nonresident aliens and foreign-based corporations which acquire real estate, minerals or mineral products over a stated value, must file information with Ohio's Secretary of State. Failure to do so could result in a fine of not less than $5000 nor more than 25% of the value of the investment. Ohio also imposes a nondiscriminatory property tax on imported goods, whether finished or raw materials, when they are stored in the state.

A few years ago, the Attorney General of Oklahoma actually tried to force foreign investors to divest themselves of landholdings in that state. Fortunately, he was unsuccessful in his quest. In mid-1983 five states limited or prohibited altogether investment of public funds in companies doing business in South Africa. Fifteen states placed an embargo on the sale of Soviet spirits, following the downing of the KAL passenger jet in September 1983. One year later, seven of these states were still enforcing that embargo. A Pennsylvania state court has recently determined that five nations have violated Pennsylvania's Trade Practices Act of 1968, which means that products from these countries cannot be used in state government sponsored construction products. All of these examples have extraterritorial connotations.

Secondly, the state and provincial governments are slowly but surely developing their own localized industrial policies. As mentioned previously, cut-throat competition characterizes relations among many subnational governments which are trying to attract both new domestic and foreign direct investment. Two dozen states are directly involved in venture capital projects and are expected to commit more than $300 million dollars to these over the next few years. State agencies are providing low interest loans, help in securing private financing, and offering technical and managerial assistance to targeted companies. Several states have also set up industrial parks, enterprise zones and greenhouse projects, in an attempt to spur economic development. Fifteen state governments now offer export aid and have their own mini-import/export banks for local companies. Ten additional states have legislation pending in this area.

State governments are, therefore, becoming very actively involved in economic matters, particularly international trade and investment. They recognize the interdependence which exists among economies around the globe. Ironically, however, these governments can also be highly parochial, especially if they are trying to protect a depressed industry. Such industries have a great deal of influence at the state and local levels. This political influence can be rather onerous at times, particularly if a foreign company wants to compete with that industry in the regional marketplace.

IV. SUBNATIONALISM AND FREE TRADE

It is quite clear that both provincial and state governments will be important actors in any free-trade arrangement between Canada and the United States. Such an arrangement will impact upon the nature of federal-provincial relations and federal-state relations. They therefore need to be included in the negotiating process.

There is occurring in both countries the development of a new type of economic federalism based on increasing interdependence, an evolutionary process which will certainly impact upon future trade and investment activity in North America. Does this mean that growing subnationalism will be a barrier to the conclusion of a free-trade arrangement? I do not think so. A great majority of the provincial and state governments have endorsed the concept of freer trade. The subnational economic challenge, although formidable, should not be viewed as an insurmountable obstacle.

In conclusion, if the Reagan Administration is to actively pursue freer trade with Canada, it will require the expenditure of a great deal of political capital. Moreover, if the Administration is going to expend that political capital— particularly in view of its policy statements concerning the "new" federalism—it will have to be done for something more substantial than a sectoral agreement. The main goal of both Washington and Ottawa should be the implementation of a comprehensive Canada-U.S. bilateral trade agreement.

Thank you very much.