Introduction

The proposed Canadian-U.S. trade agreement is the latest step in an ongoing process of international economic integration. Increased economic ties among nations have meant that differences in national tax and subsidy policies have gained in importance, for two reasons. First, mobile business capital and highly skilled workers will migrate to jurisdictions that yield higher after-tax returns. Second, differences in tax and subsidy policies may alter, or be perceived to alter, trade patterns among nations.

This paper deals with tax policy in a free-trade area (FTA). It examines the basic principles of fiscal coordination and the degree to which national tax policy is likely to be affected by a free-trade arrangement. It focuses on the structure of national tax systems rather than on specific taxes. Many specific characteristics of both the U.S. and Canadian fiscal systems receive less detailed analysis than is likely in FTA negotiations because an understanding of the tax structures and their implications for trade ought to pre-empt much of the need for detailed, policy-by-policy approaches to tax questions within free trade negotiations.

As one might expect, consideration of an FTA between Canada and the United States raises serious questions about whether such an arrangement would bring the current tax systems in the two countries into conflict and, if so, whether freer trade necessarily requires the two national systems to be more closely aligned and coordinated. Thus, it is important to identify the pressures for U.S.-Canadian tax harmonization that currently exist and to determine whether such pressures might be altered by further movements toward