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RESEARCH PAPERS

POLICY HARMONIZATION: IMPLICATIONS OF A CANADA-UNITED STATES TRADE AGREEMENT

C. D. HOWE INSTITUTE

DEPARTMENT OF EXTERNAL AFFAIRS
OTTAWA
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FOREWORD

Following publication by the C.D. Howe Institute of *Taking the Initiative: Canada's Trade Options in a Turbulent World* in May 1985, it became clear that the implications of a comprehensive trade agreement with the United States for Canada's economic policies required further examination. Questions had been raised about what freer bilateral trade would imply for Canada's cultural, social, tax, expenditure, and monetary policies; about the implications for Canada's economic relations with third countries; and about the impact on such sectors as agriculture and the cultural industries where regulatory policies are often intertwined with trade barriers.

As part of a larger study by the federal government of the implications of a comprehensive trade agreement with the United States, the C.D. Howe Institute was requested to study these questions of policy harmonization.

The purpose of the study was twofold. First, to assess how Canadian policies might develop in the absence of a bilateral trade agreement. Second, to assess as accurately as possible the pressures for harmonization of domestic policies that might arise at the bargaining table or after the conclusion of negotiations.

The Institute commissioned papers to examine specific policy issues and to examine questions pertaining to particular industrial sectors.

Professor Donald Brean, of the University of Toronto, analyzed the implications of such an agreement for tax, public spending, and subsidy policies. Murray Smith, Senior Policy Analyst, C.D. Howe Institute, examined the implications for the conduct of Canadian commercial policy. Professor

Steven Globerman, Simon Fraser University, prepared a briefing paper on some of the trade issues that might arise in the cultural industries. Professor Richard Barichello, Department of Agricultural Economics, University of British Columbia, and Professor T.K. Warley, Department of Agricultural Economics, University of Guelph, investigated the implications for Canadian agricultural policies of freer cross-border trade. Debra Steger, of McCarthy & McCarthy, examined the implications of present and proposed U.S. trade law remedies.

Richard Lipsey, Senior Economic Advisor, C.D. Howe Institute, and Murray Smith drew the results of the studies together in an overview of the harmonization issues. They were assisted in this endeavor by participants in a symposium that included the following experts: Professor Richard Bird, Department of Economics, University of Toronto; Mr. Michael Hart, Special Advisor, Canada-U.S. Relations, United States Branch, Department of External Affairs; Mr. Peter Gorrell, Manager, Public affairs, IBM Canada; Professor Klaus Stegemann, Department of Economics, Queen's University; Professor Michael Trebilcock, Faculty of Law, University of Toronto; and Professor Bernard Wolf, Department of Economics, Glendon College, York University.

As with all of the Institute's independent research, the purpose is to contribute balanced and relevant analysis to an important national debate. The views expressed in these papers are those of the authors. They do not necessarily reflect those of the Institute's staff or members.

Wendy Dobson
President

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An Overview of Harmonization Issues

Richard Lipsey and Murray Smith

C.D. Howe Institute

December, 1985

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What will happen to a small country such as Canada, if it agrees to trade freely with a large country such as the United States? Canadians worry that the forces that would be set loose by a "free trade" agreement with the United States might seriously erode Canada's political and cultural sovereignty and social integrity. More specifically, the issue is: Will the forces set up by a free trade area (FTA) agreement impel Canada to harmonize its policies with those of the United States in ways that seriously reduce Canada's policy independence in some key dimensions? We understand harmonization to mean to "force Canadian policies to become more similar to, or in the limit become identical with, U.S. policies in the same area."

Negotiating an FTA should not be confused with the laissez-faire mythology evoked by the term "free trade". In the free trade caricature, virtually any government policy is regarded as a nontariff barrier. Canadian governments thus would have to conform to a nineteenth-century model — which only Hong Kong comes close to approximating among modern societies. The General Agreement on Tariffs and Trade (GATT) has rules about FTAs and modern examples exist of such arrangements, including those between former members of the European Free Trade Association (EFTA) — Sweden, Norway, Austria, Switzerland, and Finland — and the European Community (EC).[1] A more recent example is the Australia-New Zealand Closer Economic Relationship.

Any international agreement constrains the signatories' independence in some way. An FTA between Canada and the United States would constrain each country's ability to erect trade barriers; that is the purpose of the agreement. Many Canadians fear, however, that such an agreement would mean that because of the relative sizes of the two countries, Canada's policies would have to be harmonized with those of the United States and further, that harmonization would be necessary beyond the sphere of trade policy. The fact is that powerful pressures already exist to harmonize policies of the two countries. The close links between the two countries make it difficult for Canadian policies to get too far out of line with those ruling in the United States. The question is: Would a free trade association with the United States seriously increase these harmonization pressures?

Background

Canada is a small country situated next to a colossus. In 1984 its population was 11 percent of that of the United States and its total output — as measured by the GNP — was 9 percent of U.S. output.

Canadians have considerable familiarity with the United States. They travel to the United States on business or holiday; they retire in Florida; they invest in New York, Texas, and California; they emigrate to the United States in significant numbers. It has been estimated that there are more persons of French-Canadian ancestry in the Northeastern United States than in the whole of Quebec and, if you scratch any profession, occupation, or trade in the United States, you will quickly encounter people who were born in Canada or who are of Canadian ancestry.

Yet, there are profound differences between the two peoples. For example, Canadians have traditionally looked to governments at all levels as friendly partners in the economic development of a vast country, which seems to defy "economic logic". They do not share the deep distrust that most Americans have for strong or activist governments.[2]

Canadians have maintained a set of social policies closer in spirit to European social democracy than to anything existing south of the border. Many Canadians also feel that theirs is a very fragile culture that could become fully Americanized unless protected and nurtured by public support.

This sense of cultural fragility is, in part, rationally based on the harsh economies of small size; certainly, the smallness of the Canadian market makes it hard for specialized cultural activities to thrive under free market competition. It is also, in part, rationally based on the fact of the pervasive influence of U.S. radio, television, magazines, and books in Canada. Sharing a common language with the United States certainly makes Canada much more susceptible to this kind of influence than are Mexico and the small countries of Central America. Finally, this sense of cultural fragility is, in part, irrationally based on Canadians' lack of understanding of the depths and strengths of their differences from Americans.

So, to use the correct analogy for the size discrepancy, two Canadian hippopotami -- one Francophone and one Anglophone -- live uneasily in the shadow of the American elephant. Or as Canadians see it -- and perceptions are at least as important as objective reality in these matters -- the Canadian mouse lies precariously in the shadow of the American elephant.

Canadians cannot help being influenced by the United States and being aware of this influence. Certainly, U.S. pressures tend to impinge on Canada much more than do Canadian pressures on the United States. If university graduate programs are superior in the United States, many good Canadian students do their graduate training there. If universities are better in the United States, Canadian academics who aspire to make good in the world league go there. If U.S.-based firms offer more and better research jobs, Canadian scientists migrate there. If living standards are higher in the United States, some Canadians move there. If the tax and subsidy treatment of firms is more favorable in the United States, some internationally oriented Canadian capital will leave for that country. If a market of 250 million provides a chance for artists to live reasonably on what they can earn, whereas a market of 25 million does not, many Canadian painters, pop singers, and musicians will move south of the border. (Analogous pressures in the other direction are rare, the only recent case occurring during the Vietnam War, when Canada's neutrality led many thousands of Americans to come to Canada rather than fight in that war.)

These one-way pressures have always been, and will always be, present. They have made Canadians aware of U.S. influence; they have made Canadian policymakers take account of this influence when setting policy; but they have not prevented some profound differences from developing in ingrained attitudes, and in social, cultural, and economic policies.

The purpose of this paper is to consider some of the dimensions in which there are concerns that the negotiation of an FTA with the United States would reduce Canada's ability to pursue an independent economic policy. We do not consider the question of an independent foreign policy or the issues around any alleged erosion of our existence of an independent political entity — although we have discussed these elsewhere.[3] However, since some of our economic policies are directed at the market for cultural services, we do consider cultural policy. The paper draws on the results presented in a number of more detailed papers prepared for the C.D. Howe Institute by outside experts on specific topics. In the present paper, we first assess the status quo: pressures that currently act on Canada in the absence of an agreement, and those that may develop in the future. These pressures take two main forms. One is reactions in Canadian economic behavior to policy differences between the two countries. The other is U.S. regulations, policies, and laws that attempt to change Canadian behavior in ways that the United States considers desirable.

We then examine how an agreement to form an FTA might affect these pressures. Before commencing negotiations it is important to form an estimate of whether and where an FTA is likely to increase pressures on Canada to harmonize its policies with those of the United States.

The Status Quo

By the status quo, we mean a continuation of existing policies in both countries, not a continuation of the existing state of the economy. The outcome of the status quo is called the "base case" — the benchmark against which to assess the changes in pressures caused by moving to an FTA. An understanding of the base case is critical to judging the significance of what would happen during and after negotiation of an FTA, and it is particularly important if pressures already in existence are not to be confused — as they so often have been in the debate on free trade with the United States — with those that may be created by an FTA.

To develop this understanding, the discussion of the status quo can be divided into three parts. The first is an analysis of reactions in Canadian economic behavior to policy differences between the two countries. These reactions manifest themselves in undesirable changes in flows of goods, services, capital, and labor. Since they are part of the workings of the two economies in the status quo, we call these reactions the working of "economic forces" that may push the small country to harmonize its policies with those of the larger one.

The second part focuses on U.S. laws, policies, and regulations consciously designed to pressure that country's trading partners to change their laws, policies, and regulations so as to reduce any "unfair" advantage they are perceived to confer on exports to the United States. We call these "political and legal forces".

The third part of the analysis deals with "imagined forces": motivations for political and legal arrangements to induce policy harmonization that are reactions to imagined advantages and disadvantages that are, in fact, nonexistent. Both the second and third parts of the discussion refer to political and legal actions taken by the U.S. government. The distinction between the two parts lies in what is being reacted to. In the second part, reactions are to Canadian policies that are correctly believed to affect our trade flows — although disagreement may occur over whether or not they confer "unfair" advantage. In the third part, reactions are to Canadian policies that are incorrectly believed to affect our trade flows.

Economic Forces

The first set of pressures to harmonize policies operates through the mobility of goods and services and of factors of production — both capital and labor.

The Mobility of Goods and Services

Left unhindered, internationally tradable goods will move between countries so as to equalize their prices net of tariffs and transport costs. This mobility exerts a powerful harmonization pressure on policies that work through the prices of goods. Any government or private-sector policy designed to raise prices of tradable commodities solely by restricting their supply in a small country is doomed to failure by the international mobility of such commodities. For example, an agricultural marketing board that engages in supply management by restricting domestic production of a particular commodity would be unable to raise the domestic price of that commodity above the world price unless the marketing board also has the power to restrict imports.

The imposition of tariffs makes it possible for policies to force price differentials to the maximum the tariffs allow. Quotas are more powerful because they remove most harmonization pressures stemming from the mobility of goods.

The mobility of traded services also exerts powerful pressure for policy harmonization. For example, deregulation of the airline and telephone industries in the United States has encouraged Canadian firms to engage in "border skipping" — routing via Buffalo-Seattle instead of Toronto-Vancouver direct. Changes in U.S. regulatory practices thus put economic pressure on Canada to emulate such changes or lose business to U.S. companies.

Capital Mobility

Highly integrated capital markets exert policy harmonization pressures on monetary and tax subsidy policies.

The pressure on monetary policy that follows from capital mobility is that the price of capital — the interest rate — will tend to be the same everywhere and, thus, a small country's ability to have an independent monetary policy is limited. In spite of some assertions to the contrary, both economic theory and a volume of experience from around the world show that a small country such as Canada has only a limited ability to make its interest rates deviate from world rates. Where almost complete policy independence does exist is on the inflation rate. Attempts to set up interest-rate and/or exchange-rate divergences from their free-market values affect the rate of monetary expansion and, hence, the rate of inflation. Evidence from around the world shows all too clearly that small countries have major policy independence with respect to their inflation rates and only minor, and short-term, policy independence with respect to both their interest rates and their exchange rates.

The international mobility of capital and the possibility of capital flights results in harmonization pressures on tax, subsidy, and social policies. Policies that lower the return on capital relative to what can be earned in the United States cause capital movements and set up harmonization pressures on such policies. For example, a reduction in the U.S. corporate tax rate could be expected to increase the after-tax return to capital in the United States. A lower U.S. tax rate would also reduce the value of the tax credit that corporations operating in the United States receive for payment of Canadian corporate taxes by their operations in Canada. Both of these factors could be expected to create an incentive for foreign and Canadian firms to invest in the United States rather than in Canada. The resulting outflow of direct investment could create pressures for Canada to harmonize its tax policies with those in the United States.

Incentives for capital migration can be created when the cost of social policies is imposed on firms, rather than being met out of general taxation. Such pressures occurred, for example, when many countries of the EC introduced "redundancy policies" in the 1970s. These policies, by requiring large severance payments to be paid to virtually all full-time employees, made it very costly to close down an operation. Thus, they raised the cost of risk-taking -- which must include calculation of the cost of failure — and lowered the incentive, particularly to large multinationals, to invest in EC countries. These consequences then set up pressures to make redundancy policies in the EC more similar to those of countries who were receiving the investment that might otherwise have gone to the EC.

No clear examples of these pressures seem to exist with respect to Canada and the United States. One major reason for this is that interprovincial and interstate differences seem to matter more than clear international differences. Consider minimum wage legislation, for example. A high minimum wage tends to cause firms that use much unskilled labor to migrate. This provides some harmonization pressure on minimum wage differentials. The large differences that exist among state and provincial minimum wage laws, however, give rise to no strong average international differences and, hence, little international harmonization pressure.

Labor Mobility

Similar considerations apply to labor as to capital. Harmonization pressures that work through labor mobility follow from policies that influence international income differentials. Overall per capita income, real wages by sector, industry, and occupation, and the general quality of life all matter.

Sharp differentials in personal tax rates, <u>not matched by perceived differentials in benefits from government expenditure</u>, can set up flows of emigration and immigration. The underlined qualification is important. Most Canadians who consider moving to the United States are aware, for example, that they must obtain their own private medical and hospital insurance, which, for complete coverage, can be quite expensive. They will thus set this cost against any higher after-tax income that they expect to earn.

In the usual case, some specific service is provided in both countries but by different methods. The incentive to migrate then depends only on the cost-benefit differential. This may be hard for potential migrants to estimate, particularly when the service must be purchased on the free market in one country but is provided out of general government revenues in the other.

There are also some extreme cases. For example, incentives to migrate will be stronger when taxes are used to finance expenditures that many people do not value. For example, taxes used to finance major pollution control schemes, while giving no migration incentive to people who value the reduction in pollution, do provide such an incentive to those who do not value it. A similar incentive for migration can occur if benefits are received at one stage of a person's life cycle, but the bill is presented later in the life cycle. Publicly funded higher education provides one such example. Beneficiaries are subject to higher tax rates during their working lives, thereby creating an incentive for the highly skilled to migrate to other jurisdictions with relatively lower tax rates after they, and their children, have received their education. Interest payments on the national debt provide a second example. More mobile and highly skilled individuals could choose to migrate when faced with the eventual consequences of current high deficits in terms of higher taxes and/or reduced public services.

Migration incentives may also exist when a policy is provided in one country and not in the other (family allowances, for example). This increases the incentive to migrate for those who neither benefit from, nor value, the policy as much as the taxes they pay to finance it. At the same time, it reduces the migration incentive for those who value the service more than it costs them.

Political and Legal Forces

In the previous section, we dealt with harmonization pressures that result from the working of economic forces. In this section, we examine pressures created by U.S. political and legal measures aimed at preventing, or offsetting, the effects of certain Canadian policies that the United States perceives as undesirable. These U.S. measures can be separated broadly into two categories: unfair trade legislation and commercial policies.

U.S. Unfair-Trade Legislation

In the absence of changes in Canadian trade policy, U.S. trade laws aimed at penalizing perceived unfair competition from exporters abroad -- known as "unfair trade laws" — create pressures on Canadian policies. Complicating the picture is the fact that the United States tends unilaterally to define what constitutes "unfair trade". Given the current protectionist climate in Congress, it is no longer only unreasoned hysteria that makes one wonder how soon the United States will decide that Canada's unemployment assistance, health and welfare policies, or domestic regulatory policies are unfair trade practices and apply legal sanctions against them.

Subsidies and countervailing duties: The main policy instrument U.S. legislators employ to counteract perceived foreign subsidies is the application of countervailing duties. This is now one of the most contentious issues in Canadian-U.S. economic relations. The United States has developed a mechanism that investigates the subsidy practices of other countries and levies countervailing duties on imports to the extent of the subsidy when material injury — or the threat of such injury -- to a U.S. domestic industry has been demonstrated. For the purpose of U.S. legal procedures, it does not matter whether the subsidies take the form of grants, low-interest loans, government equity infusions, tax incentives, or other measures. Since 75 percent of Canadian exports are shipped to the United States, U.S. countervail practices have much greater significance for Canada than for other industrial countries.

The evolution of U.S. trade legislation and its interpretation by the courts over the last two decades has resulted in a broadening of the definition of subsidy in U.S. law. This was first illustrated by the Michelin

Tire decision in 1973, in which the United States found Canadian regional development grants — not previously a target — to be a subsidy that called for countervailing U.S. duties. Some legislation currently before Congress, by defining many Canadian resource policies as subsidies, is part of the trend to U.S. unilateral action to redefine what constitutes unfair trade. If the legislation is passed, pressure will be put on Canada to change its resource policies. In addition, present U.S. practice allows countervailing duties to be imposed on any domestic subsidies that are determined to be targeted to a "specific industry or group of industries." The application of countervailing duties in such cases is determined through what is referred to as the "specificity test". At the same time, political pressures exist in the United States to reverse the current rule that widely available domestic subsidies — such as Canada's subsidy to research and development — are not countervailable under U.S. law.

Canadian forest product policies are under particular legislative pressure in Congress. The Gibbons and Bonker bills aim to overturn the U.S. International Trade Administration's softwood products decision in 1983, which found Canadian stumpage policies not to be countervailable subsidies under U.S. law.[4] Both bills would impute a subsidy based on a comparison of average Canadian stumpage rates with average U.S. stumpage rates, disregarding the differences in the stumpage and resource-tenure systems of the two countries.

The Gibbons bill has broader implications than the current dispute about lumber trade since it is intended to make any discrimination between domestic and export prices for resource products a countervailable subsidy. If successful, such legislation would create important new constraints on the range of policies Canada traditionally has employed. For example, made-in-Canada energy prices, which were an important element of the National

Energy Program, have not been regarded as countervailable subsidies unless targeted to specific industries such as petrochemicals. Under the Gibbons bill, such prices would become countervailable.

The proposed widening of the specificity test poses potential problems for other policy areas such as accelerated depreciation and even for broadly based public expenditure programs such as medicare or occupational training. It is conceivable that, in future, the United States could act unilaterally to make such expenditure programs subject to countervailing duties.

Other unfair trade laws: A variety of other U.S. legal provisions pressure Canada to harmonize its competition laws, intellectual property laws, and regulations with those of the United States. One such pressure is in the extraterritorial application of U.S. antitrust laws and sanctions. In the areas of "conspiracies in restraint of trade" and "attempt to monopolize" under Sections 1 and 2 of the Sherman Act, there is considerable scope for the application of U.S. law in Canada. The 1979-80 uranium case, in which U.S. utilities brought private antitrust actions in U.S. courts against Canadian producers who had participated in government quota arrangements, is a recent example of such extraterritoriality.

Other remedies are available to U.S. industries subject to competition from unfairly traded imports in the domestic market. Under Section 337 of the Tariff Act of 1930, for example, companies that infringe on U.S. patents or breach U.S. antitrust laws are liable to have their imports into the United States seized.

The U.S. administration has also recently stated that it intends to be more aggressive in launching unfair trade actions under Section 301 of the Trade Act of 1974. This section authorizes the president to retaliate against a country whose practices are prejudicial to U.S. commerce. The only example of a Section 301 action to date is the border broadcasting case, where the United States enacted mirror tax legislation to counteract Canada's special income tax regulations intended to discourage Canadian firms from advertising on U.S. border stations.

<u>Regulatory issues in particular sectors</u>: In highly regulated sectors, U.S. unfair trade laws can be directed against Canadian domestic regulatory policies. Two sectors in which such actions are particularly evident are agriculture and services.

Normal economic forces limit the policy instruments that are available to Canadian governments for their agricultural policies. The United States, being a large trading nation, can adopt policies designed to influence world prices of internationally traded agricultural commodities. A small country such as Canada must accept world prices as given. This means that the subsidy must be the major instrument used to transfer income to producers of exported agricultural commodities.

U.S. countervail law, however, is currently threatening to restrict the use of subsidies. A subsidized export to the U.S. market is countervailable (if it passes the injury test), even if similar subsidies exist for U.S. producers. Because U.S. countervail law works on gross foreign subsidies rather than on the net difference between foreign and often large U.S. subsidies, it does not work to create the much-touted "level playing field". Instead, it puts pressure on Canadian governments to alter their agricultural support policies to conform with a laissez-faire ideal that differs greatly from the reality of agricultural policies in the United States or elsewhere.

In the service industries, a number of economic and institutional pressures exist for harmonization of regulatory policies in the two countries. For example, Section 301 of the Trade Act of 1974 creates harmonizing pressure by providing for retaliatory action if Canadian regulatory policies are perceived to have discriminatory effects on U.S. commerce. With no change in Canadian trade policy, Canadians may also face reciprocity legislation — introduced in Congress in 1989 — directed against foreign regulatory policies in telecommunications.

Commercial Policies

Unfair trade legislation is one set of U.S. policy instruments that have the effect of encouraging policy harmonization under the status quo. The second set consists of commercial policies, which refer to tariff and nontariff measures that affect trade. Some policies are dictated by both countries' obligations under the GATT.

An interesting example of how these obligations create harmonization pressures can be illustrated by how they formulate standards and technical regulations. Many regulations and standards are intended to serve health, safety, and environmental objectives, but they also affect the manufacture and distribution of goods.

Packaging and labelling standards and regulations, for example, deal with the quality and performance of manufactured articles. With the adoption of the Agreement Concerning Technical Barriers to Trade (Standards Code) emanating from the Tokyo Round of the GATT, there have already been substantial efforts to limit the potential effects of standards as nontariff barriers to trade. According to the Standards Code, regulations and standards do not necessarily have to be harmonized, but imported products have to be

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another country because of perceived but imaginary channels by which these policies are thought to work to the detriment of the other country.

Most imagined pressures come from what may be called "generally available advantages". It is basic to an understanding of international trade that such advantages do not affect the pattern of trade, which depends on differential advantages — that is, on one industry having a greater advantage than another in the export market.

The reason generally available advantages do not affect the pattern of trade is, of course, to be found in the operation of flexible exchange rates. If a country starts with a zero current account balance and then gains an across-the-board advantage in all products, a surplus will emerge and the external value of its currency will rise until the current account balance is once again restored.[5] At this point, the overall advantage is removed and trade once again follows the pattern of comparative advantage. It does not matter if the initial advantage was created by a slower rate of inflation than in the other country; by a general subsidy to all that country's industries; by a general tax placed on all the other country's industries; by faster productivity increases than in the other country; or by any other generalized cost reduction at home or cost increase abroad.

In summary, because of the workings of flexible exchange rates, anything that raises costs of production by an equal percentage across all of a country's industries does not put it at a long-term disadvantage in foreign trade. By the same token, an across-the-board lowering of its costs does not give a country a long-term advantage. No generally available advantage or disadvantage affects the flow of trade.

It is worth noting, however, that generally available advantages or disadvantages may cause international movements of factors of production. Say, for example, that Canadian efficiency fell by 10 percent across the board. The exchange rate would adjust so that the pattern of trade was unaffected. But relative Canadian living standards would be reduced, thus creating incentives for labor migration. The only way to remove these incentives through policy would be to attack the cause of low Canadian productivity. A generally available 10 percent subsidy to business costs, for example, would not do the trick. Real standards of living depend on real output, which, in turn, depends on real productivity. A subsidy that lowers the money costs of production for business must be financed by tax revenues that take the equivalent purchasing power from taxpayers, so that the net tax-subsidy effect on living standards is zero.[6]

As this example shows, a generally available advantage stemming from differences in economic performance may set up migration pressures because of resulting differences in living standards. But a generally available advantage that is set up by a policy measure will be cancelled out by the exchange rate, leaving only second-order effects on migration incentives. For example, a Canadian tax subsidy policy that lowered Canadian money costs across the board by 10 percent would be offset by a change in the exchange rate. The only economic pressures set up by such a policy stem from any deadweight losses of tax collection that lower overall living standards, and any redistributive effects that lower some people's incomes and raise others. In both cases, migration pressures are put on those who lose by the policy, but in such across-the-board policies these pressures are probably negligible.

The Effect of a Free Trade Area

We now come to the key issue: the effect of a free trade area on pressures for policy harmonization between the two countries. As we have already pointed out, a crucial issue for Canada in developing its negotiating strategy is knowledge of how the negotiations are likely to affect existing pressures to harmonize. Will the negotiations increase certain pressures, leave them unchanged, or reduce them?

<u>The General Presumption that Harmonization Pressures will be Unchanged</u>

There are two reasons for holding — where special considerations do not apply — the presumption that a Canadian-American FTA would leave harmonization pressures unchanged. The first reason follows from the fact that Canada and the United States would form what would be called a "free trade area" under Article XXIV of the GATT. Unlike the closer associations of a customs union or a common market, an FTA is designed specifically to reap the advantages of free trade without requiring the partners to harmonize their other, noncommercial policies or any policies directed toward third countries. Furthermore, an FTA does not normally involve the negotiation commitments on internal tax subsidy policies or fiscal transfers among members of that are frequently a feature of common markets. Nor would an FTA involve the exchange rate pegging and the coordination of monetary policy that are essential features of a currency union.

Harry Johnson, during his lifetime the most famous Canadian economist, put it this way:

> It is important...to distinguish between the philosophy of free trade and the philosophy of a common market. The latter...generally places an emphasis on uniformity of competitive conditions that is not logically necessary for the attainment of most of the benefits of free trade. In so doing, it suggests needs for harmonization of policy and the surrender of national sovereignty in policy-making that are not at all inherent in the more limited objective of a free trade area.[7]

The experience of the EFTA bears out Johnson's contention. In the words of Victoria Curzon:

> The whole point of a free trade area is that it requires an absolute minimum of policy coordination and little freedom of movement of factors of production. This is what made it possible for such different nations as Portugal, Sweden and Switzerland...to join together in EFTA.[a]

So the presumption of any free trade area is that policy coordination will not be required, except in those cases where special circumstances create coordinating pressures. Of course, there may well be more special cases in a Canadian-American FTA than in other existing FTAs.

The second reason follows from the fact that much perceived harmonization pressure is based on a neglect of the role of the exchange rate as an overall adjustment mechanism. The worry is often expressed, for example, that pressures will arise for harmonization of such overall forces as labor compensation policy from a general inability of Canadian exports to compete across the board. Such a situation, in the unlikely event of its occurring, would cause the exchange rate to change until trade once again flowed in a balanced manner between the two countries. (This is in conformity with the basic economic law that trade depends on comparative rather than absolute advantage.) This theme of imagined pressures as a result of a failure to appreciate the mechanism that equilibrates trade flows was first raised earlier in this paper and is taken up several times below.

Assessment of the FTA

Notwithstanding the important differences between a customs union or common market and an FTA, the terms of an FTA would almost certainly imply some constraints on discretionary Canadian policy. To the extent that Canada succeeds in negotiating limitations on U.S. contingent protection and elimination of U.S. government procurement preferences, Canada would have to make similar commitments. But this is what an FTA is all about. Harmonization pressures that are of concern are those that could affect policies directed at domestic goals rather than at gaining an unfair advantage in international trade. These pressures can be expected to come either from economic forces set up by the FTA or from political agreements made in the bargaining process. It is important to distinguish between them.

Economic pressures

The institution of an FTA may change the rules of the trading game in a way that creates undesired economic flows of factors or of goods and services. Canada then would need to modify its policies in order to stop such flows. These are the economic pressures for policy harmonization and we call them "post-agreement pressures". To study them rationally, we need to be able to predict the new economic forces set in play by an FTA.

Negotiating pressures

More important, perhaps, the negotiations themselves may cause Canada to harmonize its policies, or its institutions, by agreements made at the bargaining table. These negotiating pressures could have four distinct sources.

The first source of negotiating pressures is a correct appreciation of the economic forces set up by an FTA which, if they are not addressed at the bargaining table, could put pressure on Canada to harmonize some aspects of its policies. These can be rationally anticipated and analyzed, and avoided through careful negotiation of the agreement. Basically this represents an attempt to avoid an undesired post-agreement pressure by negotiating exemptions to the general rules of an FTA. Canadians might correctly anticipate, for example, that with free trade in media services, Canadian-content rules would put Canadian media sources at a competitive disadvantage. In this case, Canada would be put under post-agreement economic pressure to harmonize media policies with the United States by dropping content regulations. To avoid this, Canada could seek in negotiations to exempt some media policies from general free trade rules.

The second source of negotiating pressures is a correct appreciation of the economic forces operating under the status quo that are perceived to run counter to the interests of one of the parties. For example, the United States might correctly perceive that some of Canada's existing economic policies — such as intellectual property law — adversely affect its economic interests. Canada might expect the United States to bring such issues to the bargaining table as a quid pro quo for an agreement. Of course, just because the forces at work are correctly perceived does not mean that Canadians must accept the policies proposed for dealing with them.

The third source of negotiating pressures is an incorrect appreciation of the economic forces set up by an FTA followed by political pressure to harmonize based on this incorrect appreciation. This one is more difficult to anticipate and to cope with rationally because it can be based on imagined economic pressures. Examples of this source could come from incorrectly perceived economic pressures concerning Canadian taxes, generally available subsidies, and generally available social services. To illustrate, let us assume that Canadians were to adopt a value-added tax (VAT) — a tax which is currently under serious consideration in Ottawa. Such a policy would probably follow precedents in Europe, where the VAT is remitted on all exports. The United States might maintain — as it has with the VAT in the EC — that this procedure gives an unfair subsidy to Canadian exports. It might then press at the bargaining table for Canada to harmonize tax policies by dropping the VAT. This would be an irrational pressure because it follows from an incorrect evaluation of the economic forces at work.

The fourth source of negotiating pressures is a set of political and legal pressures that, for want of a better name, we call "philosophical". For example, the United States might decide that it just does not like the tenor of Canada's unemployment insurance system or Canada's health-financing system. It might feel Canada's regulatory policies are not sufficiently market oriented, and so on. In such cases, it could put pressure on Canada to abandon these systems just because it did not like them. Once again, there is no reason for Canada to accede to these pressures.

Policy Areas with Marginal Increases in Economic Pressures

Concerns are frequently expressed about various kinds of potential, post-agreement, economic pressures that will act to promote the harmonization of taxation and social security charges. Earlier in this paper, we mentioned that broad-based differences in the two countries' tax systems, overall level of wage compensation, or social security charges will not set up post-agreement economic pressures. Nonetheless, problems could arise from anomalies within the tax structures of either country or from differences in the pattern of wage rates in the two countries that are predicated on trade barriers.

Tax and Subsidy Policies

A review of tax and subsidy policies in Canada and the United States leads us to conclude that the high degree of integration of their markets already creates substantial harmonization pressures. The relative ease with which Canadian firms and individuals can migrate to the United States constrains Canadian tax and subsidy policies, regardless of trade arrangements. Existing pressures have not, however, led to complete policy harmonization, any more than did similar pressures in the EFTA or the EC; rather, they are no more than a constraint on overly large divergences between the two countries' policies in these areas.

The formation of an FTA should not cause more than marginal changes in these very strong existing pressures. An FTA would cause some shifts in harmonization pressures in either direction. On the one hand, the ability to serve the North American market out of either country could lead to some movement of firms to the United States in order to take advantage of the substantially higher after-tax executive remunerations that are available there. On the other hand, it is a well-known result that a lowering of tariffs tends to make the payments to similar factors more equal across countries. Since there are important forces pulling in either direction, it is probably impossible to make an overall assessment of the balance of those forces since they can be identified only qualitatively.

One important pressure for further harmonization would come from calculating and administering border tax adjustments that would be required for Canada's manufacturers' sales tax. (A border tax adjustment is a tax rebate on exports at the border, since the tax is directed at consumption, not production.) The manufacturers' sales tax is already beset with administrative problems and negotiation of an FTA could accelerate pressures for revision or replacement of this tax.

Wage Compensation and Social Security Charges

Concern is sometimes expressed that removal of trade barriers between Canada and the United States will put downward pressure on Canadian wages since Canadian firms will be uncompetitive. Along with wage costs, there is concern that nonwage compensation — such as pension benefits — and mandatory charges for worker compensation, social security, health care, and unemployment insurance are greater in Canada than in the United States. As a result, there would be pressure on employees to accept lower wages and on governments to reduce charges for social security programs.

The general concern is unfounded for two reasons. First, we have already argued that broad-based taxes and social security charges cannot render the whole Canadian economy uncompetitive. Second, the facts are contrary to the supposition of excessively high Canadian wage and nonwage costs. In the manufacturing sector, which will be subject to increased import competition as tariffs are reduced, total compensation costs are lower in Canada than in the United States. In 1983, average hourly compensation in all Canadian manufacturing was 90 percent of the U.S. manufacturing average when expressed in a common currency.

Although there is unlikely to be a general problem of high wages for the manufacturing sector as a whole, there could be problems for an industry that has higher compensation costs relative to the Canadian manufacturing average, than does the same industry in the United States relative to the U.S. manufacturing average. If the higher relative wages of a particular Canadian industry are protected by import barriers, then freer trade could put pressure on compensation levels in that industry. These competitive pressures on a particular industry with higher wages relative to the Canadian average could be intensified if overall wage levels in Canada rose relative to U.S. wages during the adjustment to freer trade.

In fact, the pattern of hourly compensation costs in Canadian manufacturing is remarkably similar to the pattern in the United States, as is evident in Table 1. The two industries with relative compensation costs significantly higher in Canada than in the United States are wood and paper products. Both these industries already have a strong export orientation and wages in these industries are unlikely to come under pressure as a result of freer bilateral trade. If the Gibbons bill were passed, the potential application of U.S. countervailing duties would pose a much more severe threat to the wage levels in these industries than would an FTA.

Among industries with high import barriers, only the textile industry has higher relative wages in Canada. Most Canadian industries with high import barriers have relative compensation levels similar to or lower than their U.S. counterparts. Thus, compensation levels in particular Canadian industries are unlikely to come under pressure as a result of freer bilateral trade.

Policy Areas Where Economic Pressures Could Increase Substantially

In highly regulated sectors where domestic policies are intertwined with trade barriers, economic pressures for policy harmonization would increase substantially if those sectors are subject to all provisions of an FTA. Two prominent examples are agricultural and cultural support policies. Because economic pressures could be substantial in these sectors, some will press for full or partial exclusion of these sectors from a bilateral trade agreement.

Agricultural Support Policies

If most of the agricultural sector is to be included in a comprehensive trade agreement, a number of difficult harmonization issues will arise with respect to marketing boards, income support, and other regulatory policies. Both countries have complicated subsidy and price-support policies for different agricultural commodities. Bilateral trade has been relatively free in some commodities, such as red meat, except for occasional gluts when quotas have been imposed. (The recent hog and pork countervail case alters the situation considerably.) In other commodities, such as dairy products, both countries have elaborate systems of price and income support. Although the levels of support in the dairy sector are similar in both countries, the policy instruments are different. An open border in dairy products would put downward pressures on the price pf dairy products as well as increase Canadian producers' exposure to U.S. policy changes. Similarly, freer trade would cause significant adjustments for Canadian farmers of other commodities, such as poultry and eggs, where marketing boards are the primary mechanism for Canadian domestic policies. The commodities under supply management would be subject to considerable harmonization pressures if they were brought within the scope of an FTA agreement because the domestic economic policies operate through manipulation of commodity prices.

Different types of problems could arise for the Canadian Wheat Board, which does not engage in supply management, from an opening of the borders for grain trade. At present, the Wheat Board issues licenses for grains, flour and bakery products imported into Canada. The Wheat Board's objectives are to charge higher prices to Canadian consumers of grains and to preserve quality standards that allow Canadian wheat to obtain a premium price on world markets. The implications of an FTA agreement for the Wheat Board will depend upon the precise arrangements that are negotiated. One reasonable compromise proposed by a consortium of Alberta Wheat Pool, Manitoba Pool Elevators and Saskatchewan Wheat Pool was that the Wheat Board retain its role as the sole seller of Canadian grain and continue to issue import licenses for wheat and wheat flour.[9] However, the Wheat Board would be required to issue import licenses to any bonafide consumer who wished to purchase U.S. wheat. Consequently, the Wheat Board would be prevented from charging a higher price to domestic consumers for grains, but the integrity of the Wheat Board as a seller of premium wheat would be protected.

Issues involving harmonization of agricultural policies also arise for U.S. trade policy. For example, the U.S. sugar support program depends on import restrictions. Although small amounts of Canadian sugar beet production do not pose a threat to U.S. sugar producers, problems could arise with trade in refined cane sugars and sugar products, unless very restrictive rules of origin were applied to these products.

Cultural Support Policies

The cultural issue is different from most other harmonization issues. In other areas, such as tax policy, the worry is that freer trade may enhance harmonization pressures acting on policies not directly concerned with trading relations. In the cultural area, many Canadian support policies are directly aimed at reducing both the free flow of trade in goods and services and international capital movements. Therefore, cultural policies run into direct harmonization pressures because so many of them conflict with what would be understood to be pure "free trade".

Complete free trade in the broadly understood cultural area would set substantial economic forces in train. The elimination of Bill C-58 would mean that advertisers on each side of the border could deduct advertising costs in the other country's radio and TV as an expense for tax purposes. This would hurt the owners of Canadian border radio and TV stations by the net difference in the transborder flow of advertising expenses. While it might reduce the wealth of owners, it is doubtful if it would significantly reduce the number of such stations on either side of the border.

Canadian-content rules, in so far as they reduce the ability of Canadian stations to compete with stations unfettered by such rules, would violate pure free trade but the practice could be acceptable as long as distributors of U.S. programs had adequate opportunity to exhibit their product in Canada.

Replacement of U.S. with Canadian advertising by cable networks who pick up U.S. signals cost free would certainly be found an infringement of free trade principles. Its elimination would lower the profits of the owners of Canadian cable networks and lower the demand for Canadian advertising. (We do not enter the debate as to whether or not advertisers are part of the "cultural community".)

Removal of the regulation forcing divestiture of Canadian subsidiaries when one multinational publishing firm takes over another would have significant effects. There will be substantial international pressure to remove this rule in any case. But if it were to be removed as a result of FTA talks, this would return us to the status quo and to the situation in which every other small country finds itself. It would not mean the end of a subsidization program for Canadian authors, since nothing in an FTA would preclude our subsidizing them. But it would mean the end of a policy that reduces the value of any Canadian branch or affiliate of a multinational by forcing assets sales.

Removal of the restrictions on Canadian editions of U.S. magazines and periodicals such as <u>Time</u> no doubt would lead to the introduction of some U.S. editions. Although this would reduce the profitability of many Canadian publications, it is unlikely that any of the major publications, such as <u>Macleans</u>, would be lost. The main casualties would be smaller commercial and trade magazines that would find it difficult to compete with their larger and better-financed U.S. counterparts.

These and many more economic pressures would be set up in the cultural policy area by a complete FTA between Canada and the United States. But free trade in this area would not set up economic forces that would cause subsequent policy harmonization. Rather, the anticipated actions of economic forces would lead Canadian negotiators to resist a harmonization of policies that would be dictated by the pure principles of free trade. Disagreements between the negotiators are possible over how these economic forces would really work and over how much deviation from the principles of free trade can be permitted in support of Canadian policies designed to support an independent Canadian cultural industry. These issues are discussed below in the section on negotiation pressures.

<u>Policy Areas Where Pressures Could Be Prevented</u>

In some policy areas, potential harmonization pressures could be reduced or avoided through careful negotiation of the agreement.

Commercial Policy

Two types of pressures to harmonize commercial policies might arise from an FTA agreement. One dimension might be to harmonize bilateral institutions and trade policies. The other might be to harmonize commercial policies for trade and economic relations with third countries.

On bilateral trade, the key objectives of an FTA agreement are to harmonize bilateral tariffs at a rate of zero and to reduce or eliminate nontariff barriers to trade. As a result of the common GATT obligations of both countries, the import regulation regimes of Canada and the United States are already remarkably similar. An important Canadian objective in the negotiations is to limit the application of U.S. trade laws to Canadian exports. Any obligations regarding import procedures would apply to both partners and thus imply some further harmonization of bilateral institutions and procedures for import regulation.

Central to the concept of a free trade area is the principle that each member country is allowed to maintain its own commercial policies toward nonmember countries. This means that there will be no formal pressures arising from the nature of the contemplated arrangement to harmonize any Canadian economic policies with respect to third countries.

Problems could arise, however, if there were substantial discrepancies between the levels of protection provided by Canada and the United States against imports of particular products from third countries. Such discrepancies would provide an incentive to nonmember countries to export to the FTA through the member levying the lower tariff on the commodity in question.

To prevent this "pass-through" trade, virtually all FTAs impose "rules-of-origin" criteria before products are allowed to pass from one member country to the other duty free. These criteria set minimum levels of value added by member countries according to the type of product involved. For example, certain primary products such as fresh fruit might simply have to be produced in one of the member countries, while in the case of manufactured end products, a certain percentage of the value added in processing and manufacture must occur in the member countries in order to qualify for duty-free access among all of them.

Rules-of-origin criteria avoid the need for members of an FTA to adopt common import restrictions. However, whenever discrepancies in import barriers among the member countries are large, there is an incentive to locate production in the member country with the lowest import barriers in order to capture the benefits of the pass-through effect. In the case of Canada and the United States, this problem could arise in sectors characterized by managed trade, where quotas and tariffs already are being applied to particular products. In sectors such as textiles or clothing, the potential discrepancies between import barriers can be very large, and considerable administrative difficulties exist in ensuring compliance with rules-of-origin criteria. For example, offshore imports of such products might flow through a member country with relatively lower import barriers and then be given the minimum value added needed to gain tariff-free entry to the member with higher import barriers. In this case, the member with higher barriers might urge the other to raise its external barriers. Furthermore, if the country with the lower barriers has a domestic import-competing lobby to reinforce these pressures, that country might be persuaded to emulate the higher import barriers.

One way to respond to such pressures is to apply different rules-of-origin criteria to different types of products. For goods that already trade freely, or that are subject to low trade barriers, the value-added requirement could be relatively low — say, 30 percent. In sectors that are highly protected by tariff and nontariff barriers, a higher value-added requirement could reduce the likelihood of production deflections and lessen pressures for harmonization of external trade barriers.

A similar set of issues arises in the application of controls on the export of energy and resource commodities to nonmember countries. The potential exists for nonmember countries to evade export controls in one member country by exporting through the other member country. It is an open question whether a bilateral trade agreement would eliminate export controls on sensitive resource products; if it did, each country could retain "emergency" powers, at least, for the application of export controls or there could be common controls on exports to nonmember third countries -- say, on logs to Japan.

Tax and Subsidy Policies

Forces diminishing harmonization pressures on tax and subsidy policies could follow from negotiations in two ways. First, if a comprehensive trade agreement reduces the risk of the United States' imposing additional import barriers and raises the return to investment in Canada, it could ameliorate economic pressures for harmonization of corporate tax policies. Second, if limitations could be placed upon the application of U.S. countervail laws and procedures, an FTA could significantly reduce harmonization pressures on Canadian subsidies. Application of the level playing field principle -- of eliminating the trade-distorting effects of subsidies -- should allow Canada to diminish these pressures.

To reduce these pressures, the negotiations might address the following specific points:

o basing countervailing duties on the net differential subsidy to a specific industry in Canada and the United States;

o allowing cost offsets for regional development subsidies or a permitted threshold level of such subsidies before countervailing duties become applicable;

o exempting Canadian resource management and environmental subsidies such as reforestation and pollution control from possible countervailing action;

o giving greater legislative precision and certainty to the exemption from countervailing duties of widely available subsidies;

o developing agreed-upon procedures and methods for the calculation of countervailable subsidies.

Resource Policies

Under the status quo, the Gibbons Bill and similar legislative proposals represent a direct assault on Canadian resource policies ranging from forestry stumpage practices to the pricing of hydroelectric power and petroleum. A trade agreement that clarifies the subsidy/countervail rules would reduce or eliminate these potential pressures on Canadian resource management policies. In return for limiting the potential application of countervailing duties to Canadian resource policies, the United States might seek to negotiate restrictions on two-price systems that charge lower prices to domestic users than those paid by exporters.

Policies Subject to Negotiating Pressures

Some policies will be subject at the negotiating table to increased pressures for policy harmonization. This will be the case with intellectual property regimes and some investment policies. Such pressures could also arise in some service sectors.

Intellectual Property Regimes

Disentangling existing pressures to harmonize policies from those that are likely to result from a comprehensive trade agreement is particularly difficult with respect to intellectual property regimes. The United States can be expected to seek harmonization at the bargaining table of the subtle but important differences in the intellectual property systems of the two countries. One outstanding issue exists in the pharmaceutical industry, where the Canadian government might respond to pressures from multinational drug companies to repeal compulsory licensing — an action that would be independent of a trade agreement. U.S. negotiators almost certainly will raise the general issue of compulsory licensing of patents as a political quid pro quo for an agreement if this issue is not resolved before negotiations begin.

Investment and Competition Policies

Another contentious issue that will arise in trade negotiations is that of national policies towards the selling and investment policies of firms. In Canada, competition policies have not been vigorously pursued. The federal government, however, sometimes has used its regulatory powers to induce foreign firms to meet Canadian criteria for economic performance in such areas as job creation, research and development, investment, and foreign trade. A GATT panel finding on the practices of the Foreign Investment Review Agency — now Investment Canada — established that Canada could not require foreign-owned firms to reduce their imports of goods. However, neither services nor export performance requirements fall within the GATT's purview, and Canada continues to require undertakings by foreign firms with respect to trade in services and the export of goods. The United States likely will seek Canadian commitments to refrain from imposing import and export performance requirements on foreign firms.

In addition, the United States is likely to pressure Canada to allow foreign firms the right of establishment in some sectors of the economy and to apply national treatment to foreign-owned firms.[10] At the same time, key sectors might be designated where foreign investment is restricted or precluded. If Canada were to agree to such commitments, then it would have to cease screening only foreign acquisitions of firms in those industries not designated as key industries. Instead, it would have to choose between screening all acquisitions of firms under a revamped merger policy and allowing mergers and acquisitions to be unregulated. The result might be a tendency to harmonize merger policies in the two countries; the choice, however, would be up to Canada.

Other than the possible harmonization of policies towards acquisitions and mergers, the degree of further harmonization of competition policies that an FTA would require appears to be limited. This is especially so if antidumping systems are retained for trade between the two countries. Retention of these systems will mean that there is no need to harmonize antiprice-discrimination laws between the two countries. However, if antidumping laws were to be eliminated or drastically curtailed between the two, policy harmonization of antiprice-discrimination laws could become a much more important issue.

Regulation of Services

Trade in services is a relatively unexplored area in international trade agreements. At present, the GATT does not cover services, although the

United States and other industrial countries have made this a priority for the next round of multilateral negotiations. Bilateral negotiations, therefore, are likely to be coordinated closely with multilateral negotiations since the same issues will arise in both.

One precedent for bilateral negotiations was established mid-1985 in preparing the United States-Israel Free Trade Area Agreement. Both parties agreed to broad principles for trade in services, including both the right of establishment and national treatment. The key element of the U.S.-Israeli agreement provides for future sector-by-sector negotiations that will implement these principles for particular service sectors.

Following the U.S.-Israeli model, a bilateral agreement about trade in services could involve commitments to permit right of establishment and national treatment in service sectors included in the agreement. In principle, granting national treatment to foreign firms and permitting them to enter a service industry would not necessarily eliminate differences between the domestic regulatory systems in the two countries. For example, some U.S. trucking firms operate in Canada and some Canadian firms operate in the United States despite the fact that the industry is more heavily regulated in Canada. The recent dispute between the two countries over trucking regulation, however, illustrates the potential difficulties: since Canadian firms already have licenses to operate routes in Canada, U.S. firms perceived Canadian limitations on the entry of new carriers on particular routes to be discriminatory.

Agreements on trade in services are likely to be more easily negotiated in sectors where the pattern and level of regulatory activity in the two countries is broadly compatible. Right-of-establishment and national-treatment commitments could place potential limitations on regulatory policies and thus might accelerate economic pressures for deregulation in some sectors. The implications for domestic regulatory policies of agreements intended to promote freer trade in services are worthy of further analysis, but this would require careful consideration of the regulatory policies in particular service sectors.

Cultural Support Policies

Many of the negotiating issues in cultural support policies are novel because current international agreements do not deal with trade in services or investment issues. These issues are, however, likely to be on the agenda for bilateral negotiations and the next GATT round.

Pressures can be anticipated from the Canadian side to request blanket exemption in FTA or GATT negotiations for all policies falling under the generic title of "cultural support". It seems unlikely that any country bargaining for an FTA would agree to such blanket exemption for its partner country, for two reasons. First, no one can be sure just what constitutes a cultural support policy. Second, considering the broad and uncertain scope of the concept of cultural support, the exemption would be open to abuse by attempts to slip noncultural policies into the cultural category.

If this is the case, exemptions for specific cultural support policies will have to be negotiated piecemeal. Nonetheless, there would probably be value in reaching some agreement on broadly based principles. One might be that cultural support policies are a legitimate aim of policy and where local markets are not large enough to support them, conflicts between the principles of free trade and the need for support policies could be resolved in favor of the latter.

Some guidance on these issues can be obtained from GATT rules regarding trade in goods. Canada would contravene GATT rules if it prohibited the importation of hockey pucks on the grounds that foreign pucks debased the national sport. In contrast, Article IV of the GATT provides for screen-time quotas in exhibiting films. Thus, the cultural exemption from existing trade rules for goods is narrowly focused.

Four policy areas where strong negotiating pressures may be felt are the use of U.S. signals by Canadian cable TV companies with substitution of Canadian advertising; the deductibility for Canadian tax purposes of advertising in U.S. radio, TV, and magazines; customs regulations prohibiting entry into Canada of foreign magazines with significant amounts of Canadian-specific advertising; and the forced divestiture of Canadian subsidiaries when one multinational publishing firm is taken over by another.

The forced divestiture regulations are being strongly attacked in any case on grounds of retroactivity and destruction of value of foreign subsidiaries after the investment has been made. Forcing Prentice-Hall to repatriate the distribution of their non-Canadian list to the United States reduces the value of their investment in a Canadian distribution system to no obvious gain to Canadian culture. A much surer route to encouraging Canadian authors to publish would be increased direct subsidies to publishers of Canadian books. The only risk here would be countervailing duties in the United States. It is unlikely, however, that sales of a subsidized Canadian author or publisher in the United States would be large enough to cause the injury needed to trigger countervailing duties.

Strong pressure may also be exerted on Bill C-58. The extent to which the bill keeps Canadian border stations in business is problematic and, once again, the subsidy route might be another means to the same end worth considering.[11]

Assessing the bargaining pressures on cultural support policies is difficult because the effects of Canada's various programs are themselves uncertain. For example, restrictions preventing Canadian editions of U.S. newsmagazines have encouraged similar, wholly Canadian magazines. But the effect on smaller, locally based news and arts publications is more doubtful, and many people involved in these have argued that they are hurt by such legislation. Another contention is that border broadcasting regulations have been ineffective in sustaining a substantial number of stations that would not otherwise exist. These issues are important because, if the effects of cultural support programs could be established, U.S. negotiators might be pressed to grant exemptions to measures that significantly increased the amount of Canadian activity but not pressed to grant exemptions that merely raised profits for owners of facilities that would exist in any case.

We see a number of possible negotiating positions:

- Exemptions could be sought for all existing policies without attempting to evaluate their success.
- Such a general exemption could be advocated, while at the same time Canadian policy attempted to replace some existing support measures with ones that are less distorting to cultural trade. For example, existing Canadian-content rules — which are basically quotas — might be replaced by rules that a specific total of expenditures be devoted to Canadian content.[12] This is a more flexible position and it might be more acceptable internationally.
- Exemptions could be sought in the cultural sector from "right-of-establishment agreements" — whereby foreign firms are allowed to invest freely in certain sectors — that may be arranged in other "noncultural" sectors. This would give Canada much room for maneuver, and since the United States has to keep such exemptions in some sectors — radio and television, for example — a blanket exemption for specific cultural

industries might be a mutually acceptable compromise on an otherwise-vexing issue.

o Negotiations could take place after a major Canadian review had been made of cultural support policies, with a view to distinguishing between those policies that really have the desired effects and those that merely transfer income to people who would be in the industry anyway. Policies that had little effect, or that were actually counterproductive, could be "bargained away" and exemptions sought only for those policies that really were judged to be effective.

o Bargaining could take place in the context of a policy change that provides Canada with a strong initiative to focus its subsidies on nationality-specific activities while buying nonspecific cultural output -- such as mass-audience television programs — as cheaply as possible.

Policy-harmonizing pressures certainly will exist in the cultural area. The above list — which is only illustrative of some possible Canadian positions — suggests two basic points. First, unless blanket exemption can be negotiated, Canadian policymakers are going to have to do some hard thinking about their own cultural support policies. Second, Canada's ability to subsidize and otherwise support a range of cultural activities need not be compromised in any well-orchestrated set of FTA negotiations, although specific methods of attempting to do so may be ruled out.

Policy Areas Outside the Scope of the FTA

Some policy areas lie outside of the scope of any previous FTA agreement and would not be subject to post agreement economic pressures. Two prominent policy areas are monetary and fiscal policies and broad-based social policies. These policy areas are sometimes perceived to create unfair trade advantages or burdens but those perceptions are mistaken. In our view, these policy issues should be kept off the negotiating table in any bilateral trade negotiations.

Monetary and Fiscal Policies

Fiscal policy should be unaffected by an FTA; one country can have a more active stabilization policy than the other, with or without an FTA. As a small open economy, however, Canada has severe restraints on its fiscal policy. For example, the stimulus to domestic demand that results from a higher federal budget deficit in Canada is usually reduced because part of it leaks into imports. The reduction of bilateral trade barriers is not likely to change such restraints significantly.

The conduct of monetary policy also is unlikely to be affected in the long term. While each country could follow different monetary policies, the exchange rate would fluctuate — assuming both countries continue with flexible rates. Harmonization pressures on Canada then would arise from the high mobility of short-term capital flows between the two countries. If fixed rates were to be adopted, the pressures on Canada would change because of the multilateral coordination of monetary and fiscal policy that would ensue. In neither the fixed nor the flexible rate case, however, would the creation of an FTA be expected to influence those harmonization pressures.

There is one possible exception to this conclusion that is worth some notice. If the FTA were to be such a failure for the Canadian economy that it caused major outflows of capital from Canada to the United States, this would drive down the value of the Canadian dollar below its purchasing power parity rate vis-à-vis the U.S. dollar, and give a temporary advantage to Canadian export- and import-competing industries. A Canadian current account surplus then would appear as the inevitable counterpart of the capital outflow from Canada. Under such circumstances, the sentiment for trade restrictions might grow in the United States -- just as it has in the current situation of an overvalued U.S. dollar -- only this time it would be directed solely at Canada rather than at the whole world. Since an FTA would rule out tariffs and quotas, the United States might place pressure on Canada to try to hold up the external value of the Canadian dollar. Assuming the Canadian government could not regulate the capital flight that would result, pegging the Canadian dollar would set up severe recessionary forces in Canada. (To support the dollar, the Bank of Canada would have to buy Canadian dollars, thus contracting the Canadian money supply.) The current account surplus needed to finance the capital flight would then be effected by the fall in Canadian imports that would result from a fall in income and employment in Canada -- rather than by a rise in Canadian exports due to a fall in the value of the Canadian dollar, as in the case of a free exchange rate. This is a serious scenario for Canada. The normal corrective to capital flight -- a falling Canadian dollar and an expanding export industry -- would be frustrated by the fixed exchange rate, and the capital flight likely would be combined with a serious Canadian recession.

Opposite forces would be set up if the initial capital flow went the other way. If the FTA caused a boom in the Canadian economy sufficient to attract a major capital inflow, the value of the Canadian dollar would be driven upwards. This would put Canadian export- and import-competing industries under pressure and would open up a current account deficit. Canada might then pressure the United States to stop its currency from depreciating vis-à-vis the Canadian dollar.

Some such developments could conceivably occur after an FTA is formed, and it is clearly better to have the exchange rate play its natural equilibrating role rather than pegging it, thereby compounding the problem of the capital-exporting country. Thus, some general statement about the exchange rate being left free to be determined by market forces would be useful in an FTA agreement. Any attempt to peg the Canadian-U.S. exchange rate while the currencies of other industrial countries float should be resisted.

Social Policy

For Canadians, one of the most worrying issues — because it is so difficult to come to grips with -- is the possibility that an FTA would create harmonization pressures on such broad-based social policies as unemployment insurance and hospital and medical care. Some Canadians have expressed fears that the United States might argue during the FTA negotiations that some Canadian social policies have the incidental effect of distorting trade. For example, Canadian unemployment insurance could be thought of as a generally available subsidy. Special features of Canada's unemployment insurance system, such as additional benefits in regions of high unemployment or programs for particular industries, are more likely to be regarded as subsidies. Competing U.S. industries, which do not have these subsidies, might argue that they have a legitimate complaint. Indeed, this is currently being argued with respect to East Coast Canadian fisheries. Thus, pressures on some Canadian social policies already exist through normal U.S. countervail procedures. It is hard to see why these would increase after the implementation of an FTA, but they may well come up during the negotiations.

Canada's best negotiating position on these issues would seem to be to argue four interrelated points:

o that broad-based policies are not aimed at distorting trade and that any such effects are incidental;

o that virtually any broad-based policy, such as unemployment insurance or defense spending, has some distorting effects on trade. To put one such policy on the table is to put all of them on the table, thus opening myriad arguments about impossible-to-measure secondary and tertiary effects of such policies as U.S. defense spending;

o that, to a great extent, the advantages given by such policies come under the category of illusory advantages because they are generally available; and

o that it is in the national interests of both countries to leave such policies off the table. This could be done by accepting the following necessary conditions for a policy to be on the table: (i) it should be targeted directly at distorting trade and/or (ii) it should actually have a major effect on distorting trade. The first condition would confine concerns to trade policy measures -- a secondary injury rule could then confine such measures to significant cases. The second condition would ensure that the first is not abused by stating some other target when the real target was to distort trade.

These conditions, plus good will, should keep broad-based social policies where they belong: outside of the scope of negotiations.

Conclusion

The overall conclusion that emerges from this study is that an FTA agreement would leave the bulk of the pressures for Canada to harmonize its domestic economic policies with those of the United States more or less unchanged. In particular, those policy areas that Canadians consider to be important to goals of political and cultural sovereignty, high employment, and enlightened social programs are unlikely to be seriously affected — although some specific cultural support policies may be subject to review. There may be some increases in harmonizing pressures in some policy areas, but these should be more than balanced by decreases in other areas. There are three main reasons for reaching this conclusion.

First, the high degree of economic interdependence between Canada and the United States already creates substantial pressures for policy harmonization. Without a change in the status quo, economic incentives exist for the migration of firms and skilled individuals, and Canadian policies will continue to be constrained by these economic forces. Furthermore, existing legal and political pressures, and the threat of unilateral actions by the United States to redefine "unfair trade practices", exert serious harmonizing pressures today.

Second, an FTA is designed to allow the partners to achieve the economic gains from expanded trade without placing them under the policy-harmonizing pressures that arise in the closer associations of a customs union or a common market.

Third, Canada's objective with respect to nontariff barriers in general, and countervailing duties in particular, is to make these measures come closer to fulfilling their real purpose of creating the conditions for fair trade and further away from acting as nontariff barriers to trade. This can be accomplished by agreeing on better, and more certain, definitions of what constitutes unfair trade. A greater degree of certainty on what is a countervailable subsidy, and some restrictions on the United States' ability to redefine the rules of fair trade unilaterally, would provide a major reduction in existing harmonization pressures.

Where Pressures Should Be Unchanged

There are some exceptions to the general conclusion that added pressures to alter commercial policies are unlikely because an FTA, by definition, allows both countries to pursue their own. Retaining independent commercial policies would require, however, that agreed-upon criteria for rules of origin be negotiated to determine which goods qualify for duty-free trade between the two countries. Both countries also could be expected to pursue their own commercial policy objectives in future multilateral trade negotiations.

Added pressures to harmonize monetary and fiscal policies are unlikely as long as the Canadian-U.S. exchange rate is allowed to adjust in response to market forces. Pressures to harmonize the two countries' tax systems are unlikely to change significantly, although administrative problems with the Canadian manufacturers' sales tax could be compounded by the difficulty of establishing appropriate border tax adjustments.

Containing some possible harmonization pressures depends on reaching agreement on the view accepted by economists that, despite perceptions to the contrary, broadly based policies that confer "advantages" or "disadvantages" across the whole economy do not affect trade flows significantly. Thus, for example, the negotiation of an FTA should not affect Canada's decision about the imposition of a value-added tax. Similarly, broad-based social policies such as medical insurance, health and education expenditures, or income security policies could be unaffected because they do not affect trade patterns either. Canada should reject as nonnegotiable any suggestion that it alter its social services and income redistribution programs to correspond more closely to those of the United States. The view that such programs constitute subsidies to Canadian producers is mistaken, just as is the view that Canada will need to have an identical tax system to that prevailing in the United States if Canadian firms are to be able to compete.

Where Pressures May Increase

Added pressures to harmonize policies could be expected in intellectual property regimes, in agriculture, and in certain areas of cultural and commercial policy. Although Canada might alter such policies as the compulsory licensing of pharmaceuticals quite independently of bilateral trade negotiations, the United States might seek to have Canada harmonize remaining differences in intellectual property systems with current U.S. practices as a quid pro quo for negotiation. Pressures in agriculture could increase because both countries would be required to curtail the powers of marketing boards for those commodities brought under a free-trade agreement. Achieving free trade in goods might require Canada to harmonize export controls that currently take the form of different prices for oil and logs destined for domestic and export uses. In cultural policy, Canada likely would be asked to alter some of its more discriminatory policies, such as commercial substitution regulations for cable television and special tax provisions pertaining to advertising deductions. Although Canada would need to develop a carefully articulated negotiating strategy, Canadians could expect, however, to retain the essential elements of policies necessary to promote Canada's cultural identity and autonomy.

During the negotiations, the United States might press its objections to Canadian regulation of foreign acquisitions under Investment Canada. At a minimum, Canada might have to agree to refrain from seeking undertakings from foreign firms about import and export performance. If Canada were to agree to grant national treatment to foreign firms and permit them to invest in at least some sectors of the economy, then it would have to decide whether it wished to implement nondiscriminatory regulation of mergers and acquisitions.

Aside from this issue, pressures to harmonize antitrust or competition policies would be limited. One exception, however, could be in the area of antidumping policies and domestic price-discrimination laws. If antidumping procedures were eliminated for bilateral trade, then the issue of harmonization of price-discrimination laws would have to be considered. However, if Canada's objectives in the negotiations are merely to streamline antidumping policies to remove harassment, the issue would not arise.

Where Pressures Will Decrease

Most significant in this concluding assessment are the areas in which Canada is likely to seek negotiations to reduce pressures and, therefore, to increase its policy choices. The magnitude of such relief provides one important rationale for embarking on the negotiations in the first place. Piecemeal U.S. pressures through unfair trade legislation and commercial policy are now considerable. Reducing the mounting pressures in the United States to use duties to penalize perceived Canadian subsidies to such goods as softwood lumber and other resources could be halted; pressures to prevent Canada from using regional subsidies as instruments of social policy could diminish; pressures on cultural policy could stop if Canada were able to negotiate an acceptable approach. Finally, freer and more secure access to the U.S. market probably would enhance the return to investment in Canada and widen the range of opportunities for highly skilled individuals.

To the extent that issues are not settled at the bargaining table, there will be post-agreement harmonization pressures. One area where continuing pressures are likely is in regulation of the services sector. The reason is that these waters are largely uncharted; no significant international negotiations have yet been undertaken. Under current circumstances, two possibilities exist: either negotiations will have to be undertaken piecemeal, sector by sector, in trucking, airlines, banking, and so forth, or negotiations will have to be postponed. This decision will be influenced by the degree to which the two countries' regulatory regimes resemble each other. Since the key issues will be right of establishment and national treatment, the closer these regimes are at the outset of negotiations, the more likely they will be dealt with; the more they differ, the less likely negotiations will be straightforward.

In conclusion, it is clear that a bilateral agreement would increase integration of goods markets and constrain the application of additional tariff and nontariff barriers. Since many of the existing harmonization pressures on domestic policy arise from financial market integration and mobile capital and labor, further goods market integration is not likely to add significantly to those pressures. And as the smaller economic partner, Canada has a vital interest in limiting unilateral definition of unfair trade by the United States.

Footnotes

1. GATT Article XXIV 8 (b) defines an FTA in the following words: "A free trade area shall be understood to mean a group of two or more customs territories in which duties and other restrictive regulations on commerce (except for special purposes defined by the GATT] are eliminated on substantially all trade between the constituent territories in products originating in such territories."

2. For a detailed study of some of these differences, see S. Lipsett, "Canada and the United States: The Cultural Dimension," in C.F. Doran and J.H. Sigler, eds., Canada and the United States: Enduring Friendship, Persistent Stress (New York: Prentice-Hall, 1985).

3. See R.G. Lipsey and M.G. Smith, Taking the Initiative: Canada's Trade Options in a Turbulent World, Observation no. 27 (Toronto: C.D. Howe Institute, 1985).

4. "Stumpage" refers to payments to the landowner for logs cut on his property. Canadian payments, because they are often lower then U.S. payments, mean that Canadian producers are often perceived to have lower production costs. The argument over stumpage as a subsidy to Canadians disregards differences in the quality of timber and the cost of harvesting it.

5. The issues we wish to address are current-account ones, so we take net capital flows as given (at zero for simplicity).

6. This is to put it at its best because there is always some deadweight loss from collecting taxes and distributing subsidies.

7. H.G. Johnson, "The Implications of Free or Freer Trade for the Harmonization of Other Policies," in H.G. Johnson, P. Wonnacott, and H. Shibata, Harmonization of National Economic Policies Under Free Trade, Canada in the Atlantic Economy no. 3 (Toronto: University of Toronto Press for the Private Planning Association of Canada, 1968), p. 15.

8. V. Curzon, The Essentials of Economic Integration: Lessons of EFTA Experience (London: Macmillan for the Trade Policy Research Centre, 1974), p. 222.

9. Deloitte, Haskins & Sells Associates, "Canadian Agricultural Trade Issues, Volume 1: Free Trade with the U.S.A., Executive Summary and Conclusions," (Brief prepared for Prairie Pools Inc., August 19, 1985), p. 32.

10. In this context, national treatment refers to equal treatment before the law in tax and regulatory matters for domestic and foreign firms.

11. See Lipsey and Smith, Taking the Initiative, pp. 100-102.

12. For a specific suggestion, see S. Globerman, "Potential Implications of Canadian-U.S. Trade Negotiations for Canadian Cultural Support Policies" (C.D. Howe Institute, Toronto, 1985, Mimeographed), a background paper for this overview.

Table 1

Relative Total Hourly Compensation Costs[a]
In Manufacturing Industries
Canada and the United States 1983

	Canada	United States
All Manufacturing		
U.S. Dollars	$10.92	$12.04
Index	100	100
Food Beverage & Tobacco	92	94
Textiles	73	65
Apparel	57	56
Leather Products	58	59
Leather Footwear	56	57
Lumber	101	84
Furniture	71	71
Paper & Allied	128	114
Printing & Publishing	98	100
Chemicals	105	126
Petroleum	152	162
Rubber and Plastic Products	89	91
Rubber Products	111	111
Plastic Products	76	82
Stone, Clay & Glass Products	108	106
Glass & Glassware	107	117
Pottery & Related Products	85	90
Primary Metal Industries	135	146
Iron & Steel	135	176
Non-Ferrous	133	127
Fabricated Metal Products	100	104
Machinery (Not Electrical)	109	109
Transportation Equipment	115	141
Motor Vehicles	117	152
Aerospace	113	138
Ship & Boat Building	111	114
Instruments	91	99
Misc. Manufacturing	71	74

[a] Hourly compensation costs includes wages, all fringe benefits such as pensions, and mandatory social security charges or payroll taxes paid by employers.

Source: Hourly Compensation Costs for Production Workers in Manufacturing Industries: Canada, 1975-83 and Hourly Compensation Costs for Production Workers in Manufacturing Industries: United States, 1975-84, U.S. Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, June 1985.

Agriculture and Negotiation of a Free-Trade Area: Issues in Policy Harmonization

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Introduction

In any policy move by Canada and the United States to a free-trade area (FTA), one of the more contentious elements will be the treatment of agricultural policy. Domestic interests are particularly strong in this area and domestic objectives often appear to conflict with that of liberal and enhanced international trade flows. Already, several farm organizations in Canada have called for the partial or complete exemption of agriculture from a bilateral trade agreement.

The purpose of this paper is to examine, sector by sector, changes to Canadian agricultural policy that could be necessary if agriculture were to be included in the negotiated agreement. Although Canada might prefer to exclude some agricultural sectors from such an agreement, we proceed on the assumption that there will be no exemptions.

Conflict in agricultural trade relations, between responsible and stabilizing international behavior on the one hand and domestic political interests on the other, is not unique to Canada and the United States. Such conflict is at the core of numerous bilateral trade disagreements around the world and has hampered successive rounds of negotiations under the General Agreement on Tariffs and Trade (GATT). Recent confrontations between the European Community (EC) and the United States over market access and export subsidies in wheat and wheat flour, corn gluten feed, vegetable oils, and wine -- to name a few examples — largely represent a debate over where the

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sovereignty of domestic agricultural policy ends and where GATT obligations to liberalized trade flows begin. In the longer term, the proliferation of exceptions to GATT articles and special waivers that allow quantitative import restrictions to agricultural products under certain conditions runs counter to the general GATT objective of trade liberalization and establishes numerous precedents for protectionist agricultural policy.

Agricultural policy is unlikely to be exempted from bilateral trade negotiations; indeed, strong external pressures and sound policy reasons exist for including it. First, in response to the GATT's continued ineffectiveness in this area, current efforts to make agricultural trade a central part of the forthcoming new round of GATT negotiations indicate some international consensus that agricultural-trade liberalization can no longer be ignored. One such effort is the Trade Mandate Study undertaken by the Organisation for Economic Co-operation and Development (OECD).[1] In addition, the current U.S. administration has a strong commitment to liberalize multilateral agricultural-trade arrangements, particularly those involving the EC and Japan. The current U.S.-EC conflict over agriculture stems from a desire by the United States to constrain EC export subsidies and other elements of what it sees as unfair international competition; the trade issue with Japan primarily concerns improving international access to that country's highly protected domestic market. In other words, despite earlier U.S. demands for exemption from, and the waiver of, certain GATT obligations, and despite current protectionist measures being argued and adopted within Congress, the United States is increasingly committed not to ignore agricultural trade and to be consistent across countries, if not commodities, in pursuing more liberal agricultural trade.

Second, a Canadian-U.S. trade agreement that includes agriculture could be a catalyst for multilateral negotiations which would reduce agricultural trade barriers. It would illustrate with action, not only with words, that the United States is committed to freer trade, and it would be a positive example to Japan and the EC for subsequent multilateral — or, if necessary, bilateral — trade liberalization. Thus, the United States has a strong interest in an FTA that specifically includes agriculture. However, to the extent that an FTA increases the likelihood of multilateral agricultural-trade liberalization, Canada has a very large interest in such an agreement as well. Whatever the gains to each country from removing the remaining agricultural-trade barriers between them, both would benefit even more from a multilateral reduction in trade restrictions. The complete removal of trade barriers in Japan and the EC, for example, would increase their imports of Canadian and U.S. feed grains by $4-8 billion and wheat by $1-3 billion.[2]

Third, a comprehensive trade agreement between Canada and the United States would make it more difficult for lobby groups in the various sectors to engage in socially unproductive "rent-seeking" behavior, by seeking exemptions, special considerations, and compensation.[3]

The nature of agricultural-policy harmonization that an FTA would require is less clear. It obviously would include open borders and equal market access for each country. But as current subsidy and countervail disputes in freely traded farm commodities such as hogs and small fruits suggest, this is not likely to be sufficient. Many other forms of agricultural protection exist within national borders — including product and input subsidies, tax expenditures, statutory monopoly rights, and government expenditures on research, extension, and infrastructure — most of which affect trade flows.

Policy harmonization is unlikely to extend to all of these policies for all commodities. However, the more significant among them, at least in terms of their effect on trade flows, are likely to be included in discussions and negotiations. Furthermore, these bilateral negotiations likely will cover broader ground and involve more policy harmonization than do multilateral negotiations, which aim

> to devise a set of commitments, rules and arrangements which will require countries to modify their national farm policies in ways that contribute to the overall objectives of the agricultural negotiations, but without [emphasis added] requiring them to make explicitly negotiated and legally-binding changes in the fundamental objectives of their policies, the instruments which are used, or the character and coverage of national programs, regulations, and institutional arrangements.[4]

The guiding objective or desired result in FTA negotiations, following equal market access, is not likely to be individual policy harmonization but, rather, a comparable level of protection or subsidy for all sectors — that is, in the familiar U.S. phrase, a "level playing field". In sectors such as grain, where both countries intervene with many different types of policies, comparable protection might be achieved with relatively little harmonization of specific policies. In sectors that have very different levels of protection and where relatively few interventionist instruments are used, harmonization of specific policies is more likely.

There are three general areas in which an FTA likely would require changes in Canadian policy objectives, instruments, and program coverage. The first is in the level of support any particular sector is accorded, where harmonization likely would be required. The second is in the use of quotas or tariffs that limit access to the Canadian market, which would make supply-management activities of Canadian marketing boards or price discrimination in the domestic market ineffective. The third is in the specificity or targeting of support to specific sectors, which is already being challenged by the unilateral imposition of U.S. countervail law on some Canadian exports. Since multilateral trade exists in many agricultural products, an FTA might be workable only if additional policy constraints, or rules-of-origin criteria, are included to govern "pass-through" trade — that is, when incentives exist to divert trade to one FTA member in order to gain access to another member. The most notable example of agricultural pass-through trade is in sugar, where U.S. protection substantially exceeds that in Canada and where rules-of-origin criteria are difficult to enforce.

In this discussion of policy harmonization under an FTA, it should be emphasized that not all the anticipated changes would result from freer bilateral trade. Powerful forces already are pushing Canada and the United States toward greater harmonization of policies. Furthermore, this process will be accelerated following the next round of GATT negotiations if, as is likely, agriculture becomes an important component of the negotiations. Bilateral negotiations also would speed up this process, but might increase only modestly the eventual overall degree of policy harmonization.

Anticipating the Major Policy Changes

To anticipate the likely pressures on Canadian agricultural policy in bilateral trade negotiations, we begin by examining measures of protection accorded Canadian agriculture. According to recent evidence, which provides documentation of most of the elements of support for agriculture, except for tax expenditures, the average effective rate of protection — adjusted for the effect of trade barriers on farm inputs — is estimated to be 60 percent during the past decade across all commodities.[5]

Protection varies considerably from one commodity to another. This is significant, since it is the individual commodity level that is relevant to trade negotiations. As one might expect, the measures differ by year and by study, but in general, oilseeds, pork, and corn receive little protection; milk, eggs, and poultry consistently exhibit high, if not the highest, rates of protection; and the results for the remaining commodities are quite mixed. Four major policy areas generate most of the protection: those marketing boards that are able to control aggregate supply; grain marketing, licensing, and freight-rate regulations; stabilization or insurance programs at the federal and provincial levels; and border controls, including tariff and nontariff barriers.

Although these protectionist measures could dominate perceptions of where policy changes are most likely to occur, their importance could be misleading in two respects. First, if calculated with reference to a unilateral movement to free trade, they could overstate the degree of protection offered in Canada relative to that in the United States, a situation found in the dairy and grain sectors. Second, if the protection applies only to domestic production, its removal might not change international trade flows, as is likely to be the case with poultry and eggs. Once market access is achieved through liberalized border controls, the principle of a level playing field is only relevant to that production which is traded -- that is, with respect to explicit or implicit export subsidies.

Let us now examine existing policy measures in the major agricultural sectors and assess how FTA negotiations might require Canada to make changes in these areas.

Poultry and Eggs

The protection afforded Canadian egg and poultry producers is significant, visible, and well documented. In addition to the calculations on effective protection cited earlier, at least four studies have measured producer benefits in the 1975-80 period to be in the range of $110-170 million annually. These calculations place the per-farm benefit at $25,000 or more — higher than that received by any other major commodity group.[6] In addition, this protection is highly visible to the United States because of the large margins of Canadian over U.S. prices and small Canadian import quotas — 0.7 percent of previous year's production for eggs and 6.3 percent for chicken — that restrict U.S. access to the Canadian market. As a result, the commonly held U.S. perception is that the Canadian industry is much less competitive than its U.S. counterpart and that Canadian poultry- and egg-marketing boards are a barrier to significant exports of poultry products from the United States.[7] By contrast, the United States imposes no important nontariff barriers on imports of such commodities, and has a tariff schedule that is modest and generally lower than that applicable at the Canadian border.

FTA negotiations, therefore, would create pressures for Canada to provide the United States with open access to the Canadian market by removing import quotas, Article XI of the GATT notwithstanding.[8] Once border access is harmonized, other harmonization pressures would become unimportant, in part because supply control is the primary form of policy intervention in this sector. More importantly, supply-management regimes would be unable to preserve price differentials exceeding usual transportation costs, and it would be no longer in the interest of the boards or of Canadian producers to restrict Canadian production. Marketing quotas would lose both their usefulness and their value. This change in market access would force Canadian poultry and egg prices down to levels prevailing in the northern United States plus transfer costs, which would entail a drop of 25 to 30 percent at current exchange rates.

Open borders would also provoke a considerable rationalization of production within Canada, from smaller, less competitive farms to larger operations that currently are constrained by board regulations. Furthermore, these adjustments would occur across provinces. The Canadian market is allocated by province in a manner that is unlikely to be sustainable if there was open border access. Some of the Maritime and Prairie provinces could lose some or all of their poultry and egg production, while the more competitive provinces would see increases in production per farm and, possibly, in the number of farms. The importance of these interprovincial adjustments should not be understated. It is possible, and rather ironic, that a move to free trade within Canada could provoke more farm-level resource movements and adjustments across regions than a subsequent move to free trade with the United States.

Removal of production restrictions would affect the level of Canadian production. Statistical estimates of the new level are not possible because no estimates exist of a Canadian supply function for eggs or poultry. However, detailed analyses of egg and broiler quota prices — in those provinces where a market for quotas is allowed to operate — provide the basis for at least an estimate of the supply price — or marginal cost of production — at the current quota level of output.[9]

One analysis estimates that in 1980, the supply prices — that is, the marginal costs, excluding costs of holding the quota — of broilers and eggs in Canada were comparable to those in the northern U.S. states.[10] Indeed, if quota restrictions and import controls had been removed at that time, there likely would have been net exports of eggs from Canada. This would have meant a resumption of the patterns prevalent before supply-management systems were introduced.[11]

Since 1980, major farm input prices have remained constant or have fallen, productivity growth in this sector appears not to have abated, either absolutely or relative to the U.S. industry, and the Canadian dollar has fallen in value by at least 10 percent relative to the U.S. dollar. If Canada were now to remove import controls in this sector, the likelihood is that it would, with adjustments, achieve a net export position, at least in eggs. At the very least, there is little evidence for predicting sizable long-term imports of poultry and eggs from the United States.

Such a longer-term scenario would not occur without some significant changes at the farm level, which would differ greatly across producers. All producers would face a lower price and, hence, reduced gross cash flows, but would be unconstrained in their production. The responses of individual farmers would depend on the level of their marginal costs and in which of four categories they find themselves.

First, there are those farmers who have been purchasing quota in the major and competitive producing provinces and whose unit costs appear to be at or below the price of the landed U.S. product. These farmers would be competitive under an FTA and some would even expand production. In fact, the challenges these farmers would face from an open border are likely to be less difficult than those they faced if they entered the industry with costly debt-financed quota purchases.

Second, there are those farmers who, while not buying quota, have maintained their productivity and remain competitive with the first group, or who could become competitive by upgrading their operations during a period of adjustment.

Third, there are those farmers who are typically older, who have not purchased quota, who have seen their unit costs rise, and who are not earning the normal return on all their assets. The typical farmer in this group owns assets (in fact, he must have some equity) for which he has chosen to accept a lower-than-normal return. For example, a farmer who received his quota at the outset of the scheme could afford to see his costs rise compared to those of his neighbor and might choose to consume some of the rent his quota could otherwise earn in the form of reduced efficiency.

Fourth, there are those farmers in less competitive regions and provinces who, despite good management, have unit costs that are so high that they are unable to bid the going price for quota selling in the major competitive provinces. This last group would be unable to compete if there was free trade within Canada, and would likely leave the poultry and egg business. It is these last two groups of farmers who would feel the greatest competitive pressures with free bilateral trade.

Evidence to predict the number of farmers who would fit into each of these four categories is unavailable. If we know the rate of entry into the industry, however, we can determine the number of entrants who must have acquired a quota in order to begin production. From census data, we note that the rate of gross entry into, or exit from, the poultry sector has been unusually high, particularly in the 1976-81 period.[12] Among the largest 25 percent of farms, for example, more than one-quarter of those farming in 1981 had entered since 1976; it is possible that, by 1985, about one-half of these poultry and egg producers have begun farming since 1976. Considerable entry to poultry and egg production from other farming activities (not counted above) exists as well, and there is likely to have been some expansion by ongoing farms. All this evidence points to a very large amount of quota transfer, and even allowing for nonmarket transfers and below-market-price rollovers to some producers' children, a considerable number of producers must have purchased quotas. On average, these producers would at least be able to compete with U.S. border prices. Moreover, the high rate of exit indicates that many uncompetitive producers likely have already left the industry.[13]

In addition to basic production efficiency, there is also the question of financing. Producers who have recently purchased quota through debt financing would, if border controls were lifted suddenly, be faced with servicing that debt without the income flow anticipated to meet interest payments, and a number of them could be placed in considerable financial difficulty or even bankruptcy.

Three other facts should be taken into account in assessing the dimensions of this possible financial difficulty. First, few farmers have purchased all of their quota holdings recently. Many have received quotas from their marketing board without charge, in the form of both initial allocations and increments to the base quota as consumption has increased, and quota purchasers typically time their purchases over a number of years.

Second, farmers treat a quota investment as a very risky undertaking. Its purchase entails a risk that marketing board or government policy will change to reduce the income stream which the quota allows. The possibility of trade liberalization is one example of this risk. As a result, rents from the quota are heavily discounted by purchasers, to the extent that purchasers on average require the investment to pay for itself in three to four years. Because the average buyer pays for his quota purchase this quickly, the potential financial difficulties to recent buyers can be minimized or avoided by incorporating in the negotiations an appropriate adjustment period to free trade.[14]

Third, current Canadian tax provisions provide capital-cost allowances for purchased quotas. If border controls for poultry and eggs were removed, the resulting loss of quota value would be a capital loss, one-half of which would be tax deductible.

In sum, analysis of the Canadian poultry and egg industry provides important evidence that producers in this sector could be competitive with those in the United States at current exchange rates. An FTA would result in important adjustments at the farm level, and some producers would leave the industry. But important competitive adjustments have already been made in the course of high rates of farmers entering and exiting the industry. Interprovincial rationalization of production in line with comparative advantage would cause the exit of a number of poultry farmers in uncompetitive regions, but there is no evidence to suggest a major loss in the rest of the country. Offsetting this, however, is the fact that a large amount of wealth — probably close to $1 billion — would be removed with the loss of quotas, which would generate not only heated opposition to an open border but also demands for compensation should import controls in these products be removed. Whatever the merits for compensating producers at large for removal of this current protection, the large risk premium found in quota markets makes unpersuasive those arguments for rewarding recent quota purchasers with special compensation as long as a reasonable period of adjustment is negotiated.

Dairy Products

The other major component of the supply-management system is the dairy industry, where the value of the benefits of protection is the largest of any segment of Canadian agriculture. In 1980, benefits to dairy producers exceeded $1 billion; since that time, productivity has continued to increase and there has also been some increase in milk prices.[15]

These benefits have been achieved by producer prices that are now above those in most other Western countries and by a system of fluid and industrial milk quotas that keeps surplus production to a minimum. The system generates surpluses — some 95,000 tonnes of skim milk powder and 1.7 million hectoliters of evaporated milk — that are exported or used for food aid. In addition, Canada has strict controls that permit 20,400 tonnes of cheese imports per year but largely exclude all other dairy imports. Margarine imports are prohibited to encourage butter consumption, and refined vegetable oil imports currently face a 20 percent tariff for the same reason. Finally, strict health and licensing regulations inhibit interprovincial, not to mention international, trade in fresh or liquid milk.

U.S. policies generally are similar to those in Canada, except that quotas are not used to restrict domestic production. Instead, surplus production in the form of butter and skim milk powder is purchased, stored, and generally exported. Prices for industrial milk have begun to fall since 1980 to reduce this surplus, and are now lower than those in Canada, which have risen over the period. U.S. border controls generally take the form of import quotas. In the case of cheese, for example, imports are permitted to provide 5 percent of the U.S. market. Fluid milk imports are subject to tariff-rate quotas, with a tariff of 2¢ per gallon up to 3 million gallons.

Because policies and price levels in the two countries are already similar, one might anticipate that policy harmonization under an FTA would be minor. In fact, it likely would provoke significant changes. An open border, with milk and milk products moving freely in each direction, would lower farm prices for both fluid and industrial milk in Canada, with the price fall of the former being more significant — 20 to 40 percent, depending on the region. In the United States, the current regional pattern of fluid milk price differentials also might be difficult to maintain in some northern states. Further reductions in the Canadian industrial milk price could be anticipated, as the U.S. price is widely expected to fall further in future. Equalization of industrial milk product prices could also be expected, with small volumes of cross-border trade.

The most difficult problem that an open border would create concerns possible production surpluses. The only solution that appears readily workable is for U.S. and Canadian industrial milk prices to fall until there is no North American surplus production. This could well require a fall of as much as 20 percent in Canada's industrial milk prices and obviously it would make quotas unnecessary. To judge from quota values in Ontario, Quebec, and British Columbia, farmers who purchase quota would still be competitive at such a reduced price. Not only could they be expected to provide for the increased Canadian consumption that would result from lower prices but it is possible that at current exchange rates, there could be regional or local exports to the U.S. market. The open border would equalize dairy product (e.g. butter and skim milk powder) prices as well as raw milk prices, and harmonization likely would require elimination of the federal direct subsidy on industrial milk.

If each country were to continue to follow its current surplus policies — quotas in Canada, government purchases in the United States, and prices above equilibrium levels in both countries — at the same time that the border was opened up, some arbitrary decisions on market sharing between the two countries would be needed. For example, Canada could hold quotas at a level equivalent to total domestic consumption. However, not only would this prevent the lower-cost country from achieving any net market penetration in the other, it would also make it difficult to prevent Canadians from shipping milk produced in excess of their quotas into the United States. Thus, it would appear that the combination of current policies with a truly open border is not workable, even with equal farm gate prices. In addition, this scenario would depend on the U.S. government's willingness to continue purchasing surplus U.S. production, and Washington necessarily would end up determining the degree to which milk prices exceeded an equilibrium level. In other words, complex policy harmonization would be required, enforcement would be difficult, and the level of acceptable budgetary outlays by the U.S. government would likely dominate decisions.

A third alternative would be for Canada to follow U.S. policy more completely, by removing quota restrictions and purchasing surplus production, as is the case in the United States and as was the case in Canada during the 1960s. Policies would be harmonized not only by open borders and equalized prices but this option also would require an agreed sharing of the costs of purchasing surplus milk.

As in the poultry industry, an important result of an open border for the dairy industry would be the removal of existing regulatory barriers to interprovincial movement in fluid and industrial milk (or products). Furthermore, quota values for both industrial milk and fluid would fall, the former to zero, and the latter to reflect whatever price margin could still be earned on local markets, given open borders and transfer costs.

The main resource effects of this dairy policy harmonization reflect qualitatively most of the issues already discussed for poultry. The key motivations for change are the fall in prices and the removal of border, interprovincial, and quota constraints. Producer response again depends on the individual's real (nonquota) costs, and four categories of farms can be described, ranging from relatively productive, quota-purchasing, typically larger-than-average farms that at least would be able to compete with border prices, to farms unable to compete due to regional or individual cost disadvantages.

Although prices likely would not fall by as much as in the poultry and egg industries, there might be more farms in the disadvantaged categories (groups three and four discussed earlier). This would be due partly to a large expected interprovincial reallocation of both fluid and industrial milk production. Saskatchewan, Manitoba, and, perhaps, New Brunswick could experience reduced milk production — in some cases, significant reductions — and, in the course of rationalization of production to more efficient operations, a number of producers and processors likely would leave the milk industry. However, there is also much less evidence of turnover, entry, and exit within the dairy industry. Using the same census data as reported earlier, dairy-farm entry and exit is just less than one-half that reported for poultry.[16] In addition, and consistent with less farm adjustment taking place, dairy-cost surveys for years to 1981 continue to show a great deal of diversity in cost structure across individual farms. This evidence suggests that differences might exist between the marginal costs of quota-purchasing farms and those of the more inefficient, smaller, older farms that have not bought quotas. In other words, there could be relatively fewer farmers who are competitive with border prices and relatively more farmers who would have difficulty being competitive, compared with those in the poultry industry.

These adjustments might be larger in the fluid milk sector and in those provinces that depend more heavily on fluid milk markets, simply because the price fall would be greatest here. As in the poultry industry, financing problems could affect those farmers who have recently purchased quotas, particularly fluid milk quotas. But, as noted earlier, these problems will be moderated by the widespread anticipation of this risk in milk quota markets, and arguments for compensation for these particular producers are correspondingly reduced with an appropriate adjustment period for implementation.

Not all of the effects of an FTA are at the farm level. On the processed-product side, an open border could enhance local and specialized product flows in both directions, and trade in milk products generally could be expected to shift in either direction over time with changes in various circumstances, such as one finds currently with beef and pork. But an open border would also subject some milk processing plants to additional competition from high-volume, low-cost U.S. plants. This competition could be expected to increase pressures on those Canadian plants to rationalize operations to achieve the size economies available from volume production of standardized products. As an offset to these adjustments, specialty operations producing high-quality products would have the opportunity to expand their sales.

In summary, despite comparable levels of protection for the U.S. and Canadian dairy industries, policy harmonization in these industries would appear to provoke some significant changes in the Canadian industry. First, an open border largely would equalize industrial and fluid milk prices between the two countries, and although this primarily would mean some increased production and major reductions in rents to producers in the fluid sector, it also would mean a removal of industrial milk quotas and open-market-determined prices in the industrial milk sector. This appears to be where the U.S. industry is heading, and even if it were not, the difficulties in harmonizing each country's current policies with surplus-inducing price levels in both countries would be challenging.

Although many Canadian dairy farmers are efficient enough to accommodate this fall in prices — indeed, localized exports to the United States are possible — many others have costs that are too high to allow them to continue producing milk. This adjustment problem appears to be larger than in the case of the poultry industry. As in poultry, the probable loss in milk quota values would be very high, as much as $2.1 billion in fluid milk quotas and $3.1 billion in industrial milk quotas using current market values. Although the dairy industry could survive and even prosper under an FTA, this large loss in wealth and the reduction in the number of dairy farms would make the prospects of an open border particularly unattractive to most dairy farmers. Some general form of compensation, without singling out recent quota purchasers, might be necessary for political reasons and an appropriate adjustment period would be called for.

Grains and Oilseeds

Although Canada's grains and oilseeds sector is internationally competitive, exports about 70 percent of production, and sends very little of this export trade to the United States, it features a number of important policies that are bound to emerge in FTA negotiations. In part, this is because the United States and Canada are competitors in these products on the world market and neither country would wish the other to keep policies that, on balance, offer it an unfair advantage.

The main elements of Canadian policy and institutional arrangements that are relevant here are:

- o import controls that restrict access of U.S. grains and grain products to Canadian markets — thus permitting the Canadian Wheat Board (CWB) to charge higher domestic prices — or to Canadian marketing and transportation channels — thus preserving an orderly and equitable flow of product into the Canadian elevator and transportation system;
- o grain licensing restrictions that prohibit licensing of lower-quality wheats visually indistinguishable from Canadian Hard Red Spring wheats;
- o monopoly grain export privileges possessed by the CWB;
- o subsidized freight rates under the Western Grain Transportation Act — especially to U.S. destinations — and under Feed Freight Assistance, which in some regions allows Prairie grains to displace local grain production; and

o stabilization programs such as the Agricultural Stabilization Act and the Western Grain Stabilization Act, which provide periodic payments to producers.

In the United States, there are three major programs affecting this sector:

o a price support operated with government purchases and deficiency payments, augmented with storage subsidies and land diversions;
o credit facilities to encourage export sales; and
o export subsidies designed to offset foreign export subsidies.

One noteworthy feature of the U.S. price-support system is that in some years, U.S. government offers-to-purchase effectively provide a floor to world grain prices, benefiting grain producers in Canada as well.

In any one year, either country's policies might provide more protection than the other's, but when compared over a number of years, protection for wheat is slightly higher in Canada.[17] Harmonization issues relate more to Canadian import controls, CWB powers, and to some elements of subsidized freight rates and the nature of each country's stabilization or price-support programs.

On Canadian import controls, the United States likely will press for open-border access. This access will allow entry of lower-quality wheat and bakery product imports, forcing domestic selling prices on these items closer to export price levels. These pressures from an open border on domestic prices of higher-quality wheats will be moderated by existing transportation costs. Depending on particular markets, adjustments in some other grain prices may occur. Some believe that this open border would jeopardize Canada's grain licensing system, the ability to guarantee high-quality wheat abroad, and the consequent quality premium in price.[18] In any case, the easing of these import restrictions to allow entry of lower-quality wheats is occurring anyway, independent of the course of free trade negotiations. A pool for unlicensed wheat already exists through the CWB, and an FTA may only speed these developments.

The monopoly selling power of the CWB might be threatened by policy harmonization, either because the United States would argue that such powers constitute an unfair advantage on export markets or because it would be difficult to enforce these powers with an open border. If it were cheaper to move Canadian grain south to export in the winter months, it would further weaken the single-seller power of the CWB.

Subsidized freight rates likely would be an issue, if only because they are an important element of current grain sector protection and are now highly visible. If their removal is not sought would U.S. grain producers have access to this subsidized transportation? Canadians who export oilseed and milling by-products to the United States benefit from these freight rates and U.S. objections to this particular advantage are already being made. A possible response could be to eliminate freight subsidies for that grain shipped to the United States.

Finally, in the area of stabilization or price-support programs, questions of comparable support are likely. Both the Agricultural Stabilization Act and the Western Grain Stabilization Act offer relatively modest payments, the latter being jointly funded with producers and oriented to market conditions. By contrast, U.S. programs remain less market oriented and provide greater producer assistance. Harmonization could be sought here, particularly through such U.S. policy adjustments as lowering deficiency payments. Attention would also be given to the United States' use of subsidized export credits and the use of government stocks to make U.S. grain more competitive in domestic markets. Although such measures often have been implemented to compete with countries other than Canada — such as the EC — their use could be injurious to Canada by reducing Canadian markets or by forcing Canada to adopt similar policies.

Canada likely would not seek reductions in U.S. support programs by lowering U.S. trigger prices because that provision already provides stop-loss support to producers as do Canada's stabilization programs. As it is, some policy harmonization could proceed without an FTA because the U.S. administration is trying to make its support payments more market oriented, like those in Canada, and this could include reductions in U.S. trigger prices. Although the U.S. grain sector still would affect significantly world grain prices, the U.S. government would no longer be underwriting them.

Because so much of the economic health of this sector depends on world markets and because an open U.S.-Canadian border likely would generate only minor trade flows between two countries, the economic or resource-allocation effects of an FTA on the grains and oilseeds industry would be much less major than on the poultry and dairy industries. Nevertheless, there would appear to be a number of important changes. First, the ability to price domestically used wheat above world prices would be lost, reducing average Canadian producer prices modestly. Second, increased importation of low-quality U.S. wheats into Canada could lower Canada's export price premium unless mixing of different qualities could be avoided or nonvisual quality-control measures could be adopted. This would also make existing variety-licensing practices for production difficult, if not impossible, to enforce. Should low-quality varieties be more widely planted and should the current quality premium be lost on exports, increased yields could offset — and even outweigh — revenue losses. This change would make lower-quality U.S. flour available to the Canadian baking industry and is ...

likely to reduce its demand for hard wheat Canadian flour. Due to the current lack of Canadian milling capacity for these wheats, this change can be expected to create difficulties for the baking and milling industries as they begin accommodating lower-quality wheats.

It is doubtful that, with an open border, the CWB could enforce its single-seller role for export grains. Grain delivery to the U.S. system by Canadian farmers would place the CWB in the role of a major grain exporter — indeed, a state trading agency — but competing with other exporters for grain supplies. CWB pooling activities still would be attractive to many producers, but to ensure CWB supply commitments, some form of contracting with producers may be necessary. Although such a role is one the CWB has played in the past, this change would be perceived, particularly on the Prairies, as a major shift in policy.

In localized markets for soft wheats, coarse grains, and oilseeds, trade flows would increase locally, moving products in a north-south direction instead of east-west as is currently the case. Overall, export opportunities would compensate for increased domestic competition, but these grain trade flows between Canada and the United States are likely to be small.

Finally, there is the issue of subsidized freight rates. As already noted, there will be pressure to remove the subsidy under the <u>Western Grain Transportation Act</u> for U.S.-destined grains and oilseeds. More importantly, with an open border Canada's subsidized freight rates would make marketing grain through Canada an attractive proposition for a number of U.S. grain producers. Although Canada probably would prefer to avoid subsidizing the transportation of U.S. grain and congesting the Prairie-elevator system accordingly, an open border would make it difficult and discriminatory for Canada to deny access to U.S. grain. It would force Canada to pay the freight subsidy directly to the farmers instead of to the railways, and allow the railways to charge compensatory rates. This form of payment could invite U.S. charges that the subsidy constituted an unfair advantage (although this charge more likely would emerge in multilateral than bilateral negotiations). There might be consequent pressures for removal or reduction of the subsidy, to be weighed against Canadian claims for reduced U.S. protection — from deficiency payments and export subsidies, for example.

Feed Freight Assistance may be under U.S. pressure for removal. If this program were removed, feed-grain-deficit regions such as Eastern Canada likely would be supplied more by local feed grains, and displaced Prairie barley would be sold offshore. This, too, would have little effect on Canadian-U.S. trade.

In summary, an open border for grains and oilseeds could lead to some, perhaps minor, reductions in grain prices on the Prairies, but would cause more significant changes by admitting more lower-quality wheats, flour, and grain products into the Canadian system and by removing the export sales monopoly of the Canadian Wheat Board. Even if the CWB were maintained, the quality standard of, and quality premium for, Canadian export wheats might be at risk, price premiums from the domestic wheat market would not be possible (except for transportation cost margins), and freight-rate subsidies on U.S.-bound grains and oilseeds might be removed. The CWB's ability to provide equitable access to the elevator and transport system could be eroded, there may be changes in freight subsidies under the <u>Western Grain Transportation Act</u> and Feed Freight Assistance might be removed. Only small and local increases in cross-border trade in these products could be expected. U.S. policies also could change, <u>in</u> the direction of smaller deficiency payments and smaller or more targeted export subsidies.

For all these prospective changes that an FTA would bring to the grains and oilseeds sector, it would do little directly to open third markets for Canada or the United States and would be unlikely to cause major changes in farm prices or incomes in either country. As noted earlier, the real advantages to both countries would come from the opening of third countries' markets in a movement to freer multilateral trade.

Red Meats

Of all agricultural commodity producers in Canada, it is beef and hog producers who would be most interested in a bilateral trade agreement with the United States. In both commodities, Canada is internationally competitive, protection is modest, trade flows occur both for live animals and dressed beef or pork, and the major export destination is the United States.

While this extensive trade is facilitated by low tariff walls, there are two nontariff barriers at each border. The first consists of quantitative meat import restrictions. These are, however, high enough to be generally nonrestrictive. Moreover, they rise over time, and are best interpreted as safeguard, rather than protective, measures. The second nontariff barrier, and the one of considerably greater significance, consists of the health and sanitary restrictions both countries impose. In the case of Canada, beef animals — except for slaughter cattle — imported from the United States are generally subject to quarantine and on-farm testing for brucellosis, tuberculosis, bluetongue, and anaplasmosis. During part of the year, feeder cattle may enter Canada less restrictively. Live hog imports, however, are effectively prohibited due to the existence of pseudorabies in the United States. For their part, U.S. restrictions involve veterinary certification of imports of beef and veal into the United States. Although imports of live animals from Canada are generally unaffected by such technical barriers to trade, the recent refusal by some states to allow entry of Canadian live cattle and swine due to the use of chloramphenicol in Canada is a prominent exception.

In addition to border controls, Canadian red meat producers benefit from government stabilization programs at the federal and provincial levels. The federal program, the Agricultural Stabilization Act, has provided a deficiency payment in low-price years, but payments have been small and infrequent. A revised stabilization program for hogs and cattle has now been announced, which is to be financed by producers and by both levels of government, and which will be available to producers in those provinces that choose to belong. Because it features a strong market orientation, and, like the Western Grains Stabilization Act, covers cash costs only, the new program is unlikely to generate serious reservations from the United States in FTA negotiations. In fact, because the program will have modest resource-allocation costs and will stabilize production, the instrument may well be internationally attractive.

Provincial stabilization programs, however, are another matter. They have provided deficiency-payment support to maintain remunerative- or incentive-price levels in several provinces, which has contributed to countervail efforts in the United States. To limit the risk of trade reactions against Canada for subsidies in one or two provinces and to maintain some elements of comparative advantage in regional production patterns, the revised stabilization plan for beef and hogs makes the provinces' participation in the scheme conditional upon phasing out their own provincial subsidies.

Policy harmonization in the red meats sector could involve relaxing health regulations, coordinating trade measures aimed at offshore products such as import quotas and antidumping rules to minimize the risk of product diversion from one market to another, and finding acceptable stabilization arrangements, particularly concerning the provincial practice of "top loading" the federal program. Minor changes, such as eliminating remaining tariffs, would favor Canadian exports of portion-ready beef cuts, while exempting each country from provisions of the other's meat import legislation would remove short-term uncertainty. Relaxation of health and veterinary restrictions likely would increase trade in feeder cattle and calves and decrease Canada's imports of live slaughter cattle. Because of the possibility that greater animal health risks would be incurred in Canada, a concern in the negotiations will be to distinguish between those restrictions that are concerned with legitimate health issues and those that constitute nontariff trade barriers. The impact of these changes is particularly important for breeding animals, semen, and embryos, but is not significant for pork and hogs. Coordination of all offshore product restrictions is likely to focus on import quotas. In particular, the United States may press Canada to replace its rising minimum access commitment with a fixed quota.

The issue of harmonizing farm income support and stabilization policies between Canada and the United States is more difficult. In this sector, it is mostly a question of which forms and techniques of stabilization policy are mutually acceptable, a question thath has yet to be answered properly in the GATT. Despite the economic advantages in Canada of federal market-oriented, stop-loss programs, provincial programs and subsidies have been introduced in part because the federal plan has generated uncertain, belated, and too-small payments. Yet, provincial subsidies distort trade and cause trade policy problems with the United States, and the federal government has limited ability to control provincial agricultural programs. The United States is likely to find the proposed federal stabilization program for hogs and cattle to be acceptable, as long as it provides no more than market-oriented floor prices below equilibrium levels. Although it raises average returns and reduces risks, it is also partly producer financed, and it represents a policy direction increasingly sought by the U.S. administration. This program is, however, more visible than the current hodge-podge of federal and provincial programs, and will likely attract attention in negotiations. The debate is likely to hinge on objective measures to distinguish between acceptable — that is, not countervailable — "stabilization" and unacceptable "support".

Finally, the important benefit to Canada of an FTA that includes red meats is the prospect of reducing present uncertainties regarding access to the U.S. market. Such an agreement would help to insulate Canada from the seemingly erratic application of contingency-protection measures — such as countervail actions — and could provide recourse to more effective dispute-settlement mechanisms. The importance and costly nature of current uncertainties is well illustrated by the hogs and pork case. The immediate gain to the hog sector and the potential gain to beef if U.S. countervail duties were applied in a less arbitrary fashion is likely to dominate all other potential benefits of an FTA to Canadian agriculture.

In addition to these direct effects, the red meats sector, like the dairy sector, also will be affected by any changes in local feed grain prices due to an FTA. The most important factor here is whether there are changes to the grain freight subsidies. The most dramatic effects on the red meats sector could result from payment of the Crow benefit under the WGTA to the farmers instead of the railroads — lowering feed grain prices and stimulating beef finishing and calf production in Western Canada — and removal of Feed Freight Assistance — raising feed grain prices and inhibiting beef production in the Maritimes.

Horticulture

The horticultural sector makes up only a relatively small part of total Canadian agriculture — 8 percent of total farm cash receipts — but features important trade flows in both directions between Canada and the United States. On balance, Canada is a net importer in each of the categories of fruits, vegetables, and floriculture and nursery items, and U.S. prices dominate most of these markets. Despite Canadian tariff protection, forty percent of U.S. agricultural exports to Canada are of horticultural products. As a result, an FTA with the United States is of particular significance to this sector.

The principal policy instrument used to protect this industry in Canada is the tariff, especially seasonal tariffs that are imposed during the Canadian harvest season and that are usually in excess of 15 percent. There are also significant nontariff measures, including requirements that imports of products grown in Canada be sold on a firm-price basis, that bulk imports be prohibited when domestic supplies are available, and that a fast-track surtax be imposed when increased U.S. produce volumes are sold at depressed prices, particularly at the end of the harvesting season. In addition, there are several federal government assistance programs, such as Advance Payments for crops, stabilization support under the Agricultural Stabilization Act (deficiency payments), the Agricultural Products Board (government purchases), and subsidies for storage construction projects. Provincial government stabilization, capital grant, and loan programs provide additional subsidy support.

One element of U.S. policy support is a system of marketing orders that attempts to improve markets and permit more orderly marketing by imposing a variety of "quality" restrictions. On the input side, in addition to capital grants and loans, many fruits and vegetables in the United States are grown with government-supplied irrigation water sold at rates much below market prices. The latter measures rarely turn up in the public accounts because the water systems typically were built in years past, but they constitute input subsidies nevertheless.

Policy harmonization in the horticultural sector probably would center around removing or harmonizing tariff and nontariff border measures, but the issue of comparative protection, or the level playing field, would first have to be addressed. U.S. marketing orders and input subsidies might involve sufficient U.S. protection to justify some Canadian border protection, while provincial stabilization and capital grant schemes could attract attention from U.S. negotiators.

If an open border became a reality, the economic effects within Canada are uncertain. Prices would fall and some production would shift to other commodities, but the extent of these shifts is unknown. The economic information base — a knowledge of supply functions for these sectors — is sufficiently incomplete that one is unable to predict major cutbacks in production or the extent of ensuing losses to farmers. Indeed, with a 75-cent Canadian dollar, losses could be quite small. In a number of small fruits — such as raspberries, blueberries, and cranberries — as in red meats, Canada has demonstrated sufficient comparative advantage to benefit from more secure market access due to an FTA which reduces the risk of U.S. countervailing duties being applied. One area in which import competition might create significant difficulties, however, is the fruit- and vegetable-processing industries, where tariff walls are often highest and capital grants and subsidies are prevalent. These industries would still enjoy the considerable advantage the current exchange rate provides, but rationalization of operations, fewer firms remaining competitive, expansion of scale, and expansion into new markets by remaining firms are likely outcomes.

In summary, negotiations for an FTA are of particular interest to the horticulture sector. Much of the protection for this sector is in the form of tariff and nontariff barriers, and these could be subject to some reduction. Although small fruits, cole crops, potatoes and other storable vegetables likely would benefit, the rest of the sector would be harmed to an unknown extent. One could anticipate opposition from the industry at large — particularly from processors — to a more-open border, although producers of small fruits would support an FTA which reduced their exposure to erratic application of U.S. contingent-protection measures.

Other Agricultural Commodities

In this section, we focus on two agricultural commodities — tobacco and wine — of particular relevance to U.S. trade negotiations, and close with some comments on the processing sector.

Although tobacco is largely a regional — that is, an Ontario — crop, it accounts for 1.6 percent of Canada's agricultural output and $100 million of Canadian exports, most of which go to the United States and Western Europe through the large U.S. and British tobacco companies. Tobacco imports into Canada are subject to a moderate tariff — 15 cents per pound (unstemmed) in 1984 — but additional protection is provided by supply management in the form of a quota system for Ontario producers. Attempts currently are being made to form a national tobacco marketing board that would permit the introduction of quantitative import controls.

The U.S. tobacco industry is governed by similar policies of border protection and production controls. Although stabilization through government purchase is undertaken, it is producer financed to limit inventory growth. U.S. prices have fallen modestly in nominal terms during the 1980s and attempts are being made to recapture lost export markets through export subsidies.

A trade agreement that includes this sector could require resolution of Canadian concerns over U.S. export subsidies and probably would increase both Canadian exports to, and imports from, the United States. Overall, this would result in a loss of Canadian tobacco quota values, it likely would result in small net changes in trade flows, and it would forestall the possible formation of a national supply-management agency in Canada.

The Canadian grape and wine industry provides a more-contentious topic for trade negotiations because of the high levels of protection presently provided, particularly by provincial policies. Sources of this protection include discriminatory procurement and margin policies of provincial liquor monopolies, capital grants to wineries, periodic stabilization program support for grape prices, and occasional support to grape growers for planting different varieties of grapes.

Provincial liquor monopoly practices have the most important implications for trade with the United States. For example, the markup for local wines in Ontario and British Columbia is between 45 and 50 percent, while the markup on California wines is 110 percent in Ontario and 100 percent in British Columbia. In addition, minimum-pricing provisions apply to wine sales in these provinces. In Quebec, California wines must compete against French bulk wines receiving the lowest markup, and are discriminated against both by region and because of their reluctance to sell in bulk. Discrimination against foreign beers is even greater, with a markup sometimes four times that accorded domestic (provincial) beers.[19]

These trade issues fall into the larger category of government procurement practices and are likely to be an important negotiating topic. The irony of this particular matter is that gaining access to U.S. government procurement practices is one of the main Canadian objectives in seeking an FTA, yet in beer and wine it is Canadian government procurement practices which are at issue. With some reduction in these varied forms of protection, domestic wine and beer production, grape prices, and grape production could be reduced. Marginal elements of those industries, in turn, would be under pressure to exit their industries. The likelihood of these changes is unsure; following the Tokyo Round of GATT negotiations, difficulties arose in the interpretation of voluntary provincial commitments about the distribution of alcoholic beverages.

Finally, the processing sector is likely to be an important factor in bilateral trade negotiations. While some significant changes in the farm sector could arise from harmonizing agricultural policies, the greatest effect such a trade agreement would have on the agricultural sector as a whole could well come about from increased competition and new opportunities to exploit economies of size in food processing. Areas that would feel U.S. competition most keenly include fruit, vegetable, and milk processing, meat packing, and the milling of lower-quality wheats. In those areas such as fruit and vegetable processing, where transnational firms are important, some Canadian plants may become uncompetitive without tariff protection, and thus be closed in favor of U.S. plants of the parent firm. This is relevant not only to calculating the net benefits from freer bilateral trade but also in anticipating the firms, industries, and provincial governments that are likely to express strong opposition to freer trade. Against these risks, there is the advantage that some processing firms would be able to buy their raw product at lower prices than is currently the case. Removal of this "negative protection" (to processors) would work to increase Canadian food processing competitiveness. This competitiveness will be enhanced further by removal of tariffs on packaging materials and machinery.

Conclusion

This paper has identified, on a commodity-by-commodity basis, the main agricultural issues that might arise from bilateral trade negotiations between Canada and the United States. In particular, we have focused our attention on possible or likely paths of agricultural policy harmonization, and have tried to anticipate the economic effects and implications of such an agreement. To examine the likely results we have assumed that no sectors would be exempted, although exemptions could well occur.

The policy harmonization pressures outlined ignore some useful information. For example, an examination of agriculture in the two countries reveals many similarities in basic economic conditions, including similar available resources, similar technologies or production methods, and the fact that farmers in both countries often sell into the same markets. As a result, the problems facing each country's agricultural sector are remarkably similar, and government policies share many common objectives. However, despite these many similarities, quite different policy instruments have arisen in each country. A better understanding of why this is so would shed much light on those courses of harmonization that are likely to be acceptable to both countries. Furthermore, a thorough review of the agricultural trade policy objectives being sought by each country in bilateral and multilateral negotiations would be useful. This information would suggest which of the possible courses of harmonization and compromise would be most likely.

A bilateral trade agreement could subject the structure, policies, and institutions of Canadian agriculture to some change. All sectors would survive such an agreement and, indeed, many would prosper. But some sectors would experience considerable pressures to rationalize production, a process which is already under way but which a trade agreement would speed up. This would happen most clearly in the dairy industry and, to a lesser extent, in the poultry and some parts of the fruit and vegetable sector. Gains would be likely only for beef, hogs, small fruits, cole crops, and storable vegetables, and none of these gains appear to be particularly large. That is why there appears to be little real enthusiasm for free trade within Canadian agriculture. Most groups, red meats excepted, either oppose inclusion of agriculture in such an agreement or support free trade for others but want their sector exempted.

How many of Canada's farmers or agricultural sectors are, in fact, competitive with their U.S. counterparts depends, among other things, on the value of the Canadian dollar. Much of the foregoing analysis is based on current exchange rates, and if the Canadian dollar rose by more than, say, 10 percent, the prognosis for Canadian agriculture under an FTA would be more pessimistic. Indeed, from the perspective of a traded commodity-producing industry like agriculture, the attractiveness of an FTA would depend on whether there was a substantial appreciation of the Canadian dollar that was not offset by improved commodity prices or lower domestic inflation.

In identifying harmonization pressures and policy options, we have not appraised whether free trade in agriculture would, in the long term, be good for the industry or for the Canadian economy at large. By focusing on adjustment costs and on disadvantages from reducing the economic rents farmers receive and from changing the status quo, we have mentioned only briefly the new opportunities that might arise from freer trade. First, in both the livestock and food processing sectors, some input costs, such as feed grain and raw materials costs, may fall, encouraging increased production in those sectors. Secondly, a market ten times that of Canada could become more accessible, and many Canadian agricultural regions are well located to serve large U.S. population centers. Economies of size and product specialization from increased production potentially would be available, certainly for processed products, if existing firms are able to meet the competition. Specific possibilities, like most new growth opportunities, are almost impossible to predict. These opportunities can act as the catalyst for productivity enhancement to improve Canada's competitive position, and this is the argument presented in the Macdonald Commission.

Finally, the fall in product price that is likely to force adjustment difficulties on producers of milk, poultry and eggs, some vegetables, and perhaps domestic grain products will generate, in total, large benefits to Canadian consumers. With the exception perhaps of certain health regulations, an open border for agricultural products would be to the advantage of consumers across a wide variety of products. On the basis of available measures, these consumer gains would be large enough to outweigh producer losses, meaning that efficiency gains or increases in income to the Canadian economy as a whole would come about from including agriculture in an FTA.

NOTES

1. The Trade Mandate Study was commissioned in 1982 by the OECD Ministerial Council to study the costs and benefits of trade-related measures. The report was received by the Council in 1985, and a summary is available. See "Cost and Benefits from Protection," OECD Observer 134 (May 1985): 24-34.

2. C.A. Carter, "Issues in U.S.-Canadian Free Trade in Agriculture" (Paper presented to the Research Symposium on U.S.-Canadian Free Trade Issues, Royal Commission on the Economic Union and Development Prospects for Canada, Ottawa, October 6, 1983).

3. T. Hazledine, Liberalized Trade Relations Between Canada and the United States: The Consumer Interest (Vancouver: University of British Columbia, Department of Agricultural Economics, September 1985).

4. T. K. Warley, Canada's Agricultural and Food Trade Policies: A Synoptic View (Guelph, Ont.: University of Guelph, School of Agricultural Economics and Extension Education, February 1985), pp. 69-70.

5. R.G. Lattimore, "Canadian Agricultural Trade Policy, Commercial Market Relationships, and its Effects on the Level and Stability of World Prices" (Paper presented at the International Agricultural Trade Research Consortium meeting, Airlie House, Va., December 16-18, 1982).

6. R.R. Barichello, "Government Policies in Support of Canadian Agriculture: Their Costs" (Paper presented at the International Agricultural Trade Research Consortium meeting, Airlie House, Va., December 16-18, 1982).

7. K.F. Harling and R.L. Thompson, "The Economic Effects of Intervention in Canadian Agriculture" Canadian Journal of Agricultural Economics 31 (July 1983).

8. Article XI of the GATT permits the use of quotas on imported goods necessary to enforce domestic supply management of agricultural and fisheries products.

9. R.R. Barichello, "Analyzing an Agricultural Marketing Quota" (Paper presented at the 4th Triennial Congress of the European Association of Agricultural Economists, Kiel, West Germany, September 3-7, 1984).

10. Barichello, "Government Policies in Support of Canadian Agriculture."

11. On the basis of other evidence, chicken exports also would have been likely. See E.L. Menzie and B.E. Prentice, Barriers to Trade in Agricultural Products Between Canada and the United States, Economic Research Service Staff Report no. AGES 830414 (Washington, D.C.: U.S. Department of Agriculture, International Economics Division, 1983).

12. M. Kapitany and R.D. Bollman, "Entry, Exit and Structural Changes in Agriculture: Summary Results from the 1966 to 1981 Census of Agriculture Match" (Paper presented to the Annual Meeting of the American Statistical Association, Toronto, August 18, 1983).

13. For poultry farmers with sales above $35,000 in 1976, 26 percent had exited by 1981, for a compound rate of exit of 5.8 percent per year. Extrapolating this exit rate over 10 years from the mid-1970s to date, about one-half of the poultry farmers who were in the industry in the mid-1970s remain. If these farmers are split equally between those who are competitive and those who are not — a pessimistic assumption — about one-quarter of current farmers, in groups three and four, would be forced out of poultry production by the removal of border controls. Because these farmers produce less than average, they account for less than one-quarter of total Canadian production.

14. For example, a payback period of three years is roughly equivalent to a six-year, straight-line reduction in price from current levels to the U.S. level. If the Canadian supply price at current quota levels is less than the U.S. price, this six-year adjustment process would be worth more to producers than the quota value, given a three-year payback period.

15. Barichello, "Government Policies in Support of Canadian Agriculture."

16. Kapitany and Bollman.

17. C.A. Carter, M. Glenn, and O. Tangri, "Government Support in the Grains Sector: A Canadian-U.S. Comparison" (Unpublished working paper, University of Manitoba, Center for Transportation Studies, Winnipeg, 1983).

18. One can question these fears on at least two grounds. First, is it clear that the price-premium gains under current policy outweigh the yield advantages from lower-quality wheats? Secondly, given current technology, is visual inspection the only reasonable way to determine wheat quality? A growing number suggest the answer to both these questions is no.

19. Menzie and Prentice.

Fiscal Policy Harmonization and Negotiation of a Free-Trade Area

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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 freer bilateral trade. With respect to such tax questions, familiar analyses of trade diversion and trade creation are far too simple to govern free-trade negotiations when both parties have national policies that entail multiple objectives pursued through multiple policy instruments, many of which intentionally or unintentionally distort trade. The present discussion proceeds with the modest purpose of outlining mutually relevant principles of taxation and trade while drawing, where pertinent, the implications for the free-trade initiative. The emphasis on structural issues leads to the conclusion that if Canada and the United States were to establish an FTA, the need for fiscal coordination in addition to what has evolved to date and beyond what is already required — because of the current volume of trade and investment — is relatively slight.

Sovereign countries design their own tax systems according to their national needs and priorities. A sovereign nation is free to choose its tax base, tax rates, and other dimensions of its fiscal system in line with internal objectives for distribution, stabilization, and preferences for the mix of private- and public-sector activities. In an integrated world economy, however, national tax policies are not isolated in terms of their economic impact. Tariffs and customs duties are obvious examples of taxes with international impact; so too are taxes on foreign investment and professional incomes earned abroad. International trade and competitiveness are affected by subsidies and preferences given to specific industries as well as other forms of government involvement in business. In general, overlapping or conflicting fiscal policies in different nations have implications for economic efficiency, for the effectiveness of tax policies, and for the distribution of gains from international integration. Such contentious issues will certainly arise in any free-trade negotiations.

The debate is at risk, however, of being misdirected by certain problems of perception of what taxes can and cannot do for an open, trading economy. Fiscal harmonization is a matter of choosing to augment the benefits of liberalized trade, rather than being a necessary condition to achieve such gains in the first place. Harry Johnson put the point nicely:

> In the context of a free trade area...the harmonization issue with respect to structure appears partly as an obligation on participants not to use other policies to nullify the economic consequences of the elimination of trade barriers and partly, and more importantly, as a question of what changes or alignments to make in other policies in order to facilitate the desired efficiency-increasing results of free trade or to augment those results beyond what they would otherwise be.[1]

The economic point is that major gains are offered by freedom of trade *per se*, while incremental gains derived from harmonization of policies in other areas of economic management are of a much lower order of magnitude.[2] The political point — the point pertinent to trade negotiations — is that differentials in tax structure and policies that are viewed as protective — including transportation subsidies, selective tax incentives, regional tax concessions, and the like — are potentially disruptive of negotiations on basic trade issues. In an earlier examination of these questions, Hirofumi Shibata concluded:

> (T)ax-harmonization programs needed if Canada and the United States were to form a free trade area would not impose any significant economic and political sacrifices on either country, but rather would accelerate in both countries — particularly in Canada — the rationalization of domestic tax structures that is required for domestic reasons.[3]

To some extent, the belief that economic integration requires extensive harmonization of taxes and other social policies that operate through the tax system results from confusion of absolute costs and comparative costs, together with failure to appreciate the workings of international adjustment mechanisms, especially the exchange rate. In the long term, a country's exchange rate must be such as to secure a rough balancing of its balance of payments. Persistent imbalance leads to compensating adjustment of the exchange rate. Thus, many of the differences in tax systems that might appear to favor producers in one country are eventually offset by a movement in the exchange rate. For example, a higher average corporate tax rate in one country versus another, or a higher social security tax for workers' compensation, or differences in comprehensive unemployment insurance programs, or similar general differences in fiscal systems — either on the tax or the expenditure side — cannot create permanent competitive advantages or disadvantages in trade if exchange rates are flexible.

On the contrary, the true source of trade distortion and violation of the principle of comparative advantage is the presence of differentials in incidence of fiscal costs and benefits — more accurately, net fiscal benefits — on goods entering international trade and on factors of production (capital and labor) to the extent that they are internationally mobile. If viewed otherwise, the misconception arises that comprehensive alignment of tax policies and social programs is the *sine qua non* of free trade and international economic efficiency. The correct view, however, focuses only on those particular policies that cause substantially more or substantially less than the average burden of taxation to apply to particular traded or import-competing goods. Fiscal harmonization addresses cases in which the incidence of domestic fiscal and other policies deviates from the norm for the generality of economic activity in such a way as to impose exceptional burdens on, or provide exceptional advantages to, a particular group of domestic or foreign producers.

Economists have understood these general principles for over 150 years from the work of David Ricardo. A comprehensive exploration of current economic, institutional, and policy considerations involving international tax harmonization is presented in Fiscal Harmonization in the Common Market.[4] Most modern economists regard flexible exchange rates as an efficient device to adjust the overall competitive position of a country to balance with its trading partners following trade liberalization.[5]

The necessary adjustment of the exchange rate following trade liberalization is a long-term phenomenon. Despite general agreement that appropriate adjustment must eventually occur, there is less agreement concerning short-term transitional impacts because of problems of instability and overshooting that beset foreign-exchange markets. Studies for the Royal Commission on the Economic Union and Development Prospects for Canada (the Macdonald Commission) addressed questions of exchange rates and adjustment in broad perspective as well as in the context of Canadian-U.S. relations.[6] There is consensus that the Canadian-U.S. exchange rate would not be unstable in the long term if monetary authorities in both countries maintain targets for levels of nominal variables such as money growth. Trade liberalization would eventually raise or lower the exchange rate relative to its trend value to restore a balanced pattern of trade.

Focusing on structural tax questions, "international tax harmonization" invariably must distinguish between direct and indirect taxes. This is an approximation of a more fundamental distinction between general taxes and specific taxes. A general tax in virtually any form will not distort international competitiveness or trade. Instead, as noted, its effect is absorbed in the exchange rate. However, a tax that is specific to a particular good, tradable or nontradable, or even to a specific factor of production — which is the case for most direct taxes — potentially will distort trade. Trade is motivated by anything causing relative commodity costs to vary between countries. For the fiscal system to be neutral with respect to international trade, taxes and public expenditures are required to be sufficiently general to leave relative domestic prices undisturbed.

Both direct and indirect taxes are capable of creating tax wedges — artificial disparities in relative commodity prices — and, hence, both are able to encourage or discourage trade. The mechanisms by which wedges are created, however, differ markedly, and policy implications differ as well. These differences are examined below.

Harmonization of Indirect Taxes

In Canada, the important federal indirect taxes include the manufacturers' sales tax, customs and excise duties, and the assortment of federal levies on oil and gas. The provinces impose sales taxes, fuel taxes, and taxes on alcohol and tobacco.[7] The federal government derives approximately 40 percent of its revenue from indirect taxation, a figure virtually identical to the indirect tax take of all provinces combined.[8]

In the United States, the main indirect taxes are state retail sales taxes and excise taxes imposed by the federal government. Unlike the Canadian provinces, the U.S. states have sovereign taxing powers — subject to very limited federal restrictions — within the confines of their own boundaries. For both provinces and states, taxing authority over interprovincial or interstate activity is restricted.

Questions of international harmonization of indirect taxes necessarily raise the distinction between the "destination" and "origin" basis of tax. Under the destination principle, an indirect tax is levied by the country of consumption regardless of whether production is domestic or foreign. Imports are thus taxed and exports leave the country exempt from domestic tax. The destination principle is appropriate if taxes on goods and services are used to finance general government services that provide directly consumable benefits and local public goods. On the other hand, there is no rationale for the destination principle if government services reduce production costs to the benefit of nonresidents who import the goods. If the destination principle is applied on a bilateral basis, neither tax costs nor benefits of government services are transferred internationally. International differences in tax rates reflect differences in government services available to consumers in the respective countries.

The destination principle is inappropriate if government services reduce costs of production of tradable or import-competing goods. If indirect taxes are used to finance services that reduce production costs, application of the destination principle extends de facto subsidies to exports and effective protection to import-competing industries. Domestic consumers are discriminated against in favor of consumers abroad. Consequently, to achieve tax neutrality the destination principle should not be applied to user charges or benefit taxes.

Under the origin principle, indirect taxes are levied by the country of production, the "origin" of the goods. When goods are exported, domestic tax is not rebated at the border nor does the receiving country levy an import tax. Therefore, if the origin principle is applied to goods and services, such items are taxed in the country where they are extracted, manufactured, or rendered, irrespective of where they are consumed. On a bilateral basis, trading nations eliminate fiscal frontiers when they mutually adopt the origin principle. There is no call for export exemptions, rebates, or compensating import taxes. Tax-inclusive prices paid by consumers for a given product will be equal in both countries aside from costs of transportation. Differences in rates of tax between countries are absorbed by producers. The origin principle, therefore, is appropriate if indirect taxes are used for government services that reduce production costs. Since the value of such services is presumably higher in the high-tax country than in the low-tax country, no net advantage accrues to producers in the low-tax country.

In summary, whether a destination-principle system or an origin-principle system is less trade distorting depends essentially on the nature of the government expenditures financed by indirect taxes. If public expenditures are for directly consumable benefits, the destination principle produces a neutral effect; if expenditures reduce private-production costs, the origin principle produces a neutral effect. This distinction is relevant both for partial indirect taxes as well as general indirect taxes such as the value-added tax. The argument also stresses the importance — not to mention the difficulty — of focusing on the "fiscal residuum" rather than tax rates in analysis of allocative effects of taxation.[9] Such an approach is generally more consistent with a comprehensive view of fiscal incidence, evaluating _net_ effects of government policies — benefits less taxes.[10] Peggy Musgrave comments:

> A correct approach to fiscal harmonization might simultaneously take into account both the revenue and expenditure sides of the national budget in evaluating fiscal impact on each category of factors or commodities. To do this, the incidence of both taxes and government benefits must be known. Excess burdens might be evaluated with respect to "net fiscal burdens" or the difference between taxes paid and benefits received. Such an heroic task requires much greater knowledge of tax incidence than is at present available and presents the prodigious difficulty of allocating government-provided benefits.[11]

In North America, indirect taxes, in large part, are imposed by provinces and states. Canadian constitutional requirements demand provinces' strict observance of the destination principle. Individual states likewise are substantially committed to the destination principle. It can reasonably be assumed, therefore, that in an FTA the tradition of the destination principle in general, will facilitate indirect tax harmonization, at least insofar as these are provincial or state levies.

Border Tax Adjustments

The harmonization mechanism for indirect taxes is a system of border tax adjustments. A border tax, properly interpreted, is a tax imposed when goods cross an international border; its existence conflicts with achievement of full gains from trade. A border tax adjustment, however, is an adjustment of the taxes imposed on a producer when goods are exported. Such an adjustment may involve an addition to, or a subtraction from, taxes already paid. The function of the border tax adjustment, in contrast to the border tax *per se*, is to equalize conditions of competition between domestic and foreign producers.

Both Canada and the United States have chosen to be governed by the destination principle, remitting domestic indirect taxes on exports and levying duties on imported goods equal to indirect taxes paid on comparable domestic products. Agreement to establish an FTA will neither necessitate adoption of identical indirect tax structures nor eliminate the need to maintain a properly designed system of border tax adjustments.

The major practical problem of administering border tax adjustments, especially in light of complex, multistage production processes for traded goods, is that of accounting accurately for the sum of indirect taxes embedded in the value of the export in question. Accounting for proper border tax adjustments is made difficult by the necessity of assigning indirect taxes to output and by the ambiguity in distinguishing certain indirect taxes from direct taxes. Trade distortions result from overgenerous remittance (an export subsidy), insufficient remittance (a _de facto_ export tax), an inflated import charge (a _de facto_ tariff), or an insufficient import charge (a bias in favor of imports).

In practice, border tax adjustments applied to a diverse set of exports and imports give rise to accounting errors in all four forms. If the system of adjustments is properly designed, errors will be random. They will neither penalize nor favor trade in one direction. On the other hand, trade distorting adjustments result from systematic inclusion or exclusion of ineligible or eligible taxes from the calculation. Like any general trade advantage, however, a bias built into the calculation of border tax adjustments cannot persist. A systematic bias eventually is offset by general adjustment mechanisms, notably the domestic-price level and the exchange rate.

The more serious issue is that, even after general adjustment mechanisms have come into play, particular sectors may be favored or disadvantaged by border tax adjustment rules. This can occur, for example, when taxes to which general adjustments relate are not truly general taxes, and/or when the adjustment is calculated as an average of a nonuniform set of indirect taxes. In the latter case, adjustments for all but the coincidentally "average" case are trade distorting. Consequently, conflict over border tax adjustment rules tends to be not so much a contest over the balance of trade as it is a contest between competing industries.[12] While such concerns have no greater or less validity in an FTA than in the current environment, inevitable expansion of the volume and diversity of trade would require redoubled efforts to identify and correct distortions caused by improper assessment of border tax adjustments.

In broad principle, then, there is no need to harmonize either border tax adjustment systems or rates of indirect tax among members of an FTA. To be consistent with the general intent of free trade, indirect taxes should be made general taxes. They should have the effect of raising prices of goods and services proportionately and they should not change the relative price structure that would prevail in the absence of indirect taxation. To achieve this end, all indirect taxes should be made an ad valorem tax applicable to all goods and services at an equal rate at a stage as close to final consumption as administrative considerations will allow.

Even though automatic adjustment processes maintain equal competitive conditions between domestic and foreign producers when exporters are subject to border tax adjustments, the general perception of neutrality is less assured. Differences of perception may stem from the particular method used to harmonize indirect taxes. Practical people tend to look at the form of the border tax adjustment without appreciating the implications for the exchange rate and domestic price levels. Domestic exporters tend to regard the destination principle, to consider the method relevant in the U.S.-Canadian context, as imposing an unfair competitive disadvantage if consumption tax rates in the nation to which they export are higher than domestic rates. Domestic exporters see their foreign counterparts — those who deliver goods to the domestic exporters' country — paying a lower border tax adjustment than they do. Exporters from a low- (indirect) tax country perceive that they pay a "higher price of admission" to the foreign market than do foreign producers to sell in the higher-tax country. Such problems of perception inevitably create political pressure to appease those who feel hard done by. Harmonization of taxes must not only be fair, it must also be seen to be fair.

Destination-based taxes may also create the illusion of an export subsidy, insofar as the domestic price exceeds the (border-tax-adjusted) price at which goods enter the world market. The proper interpretation is "taxed domestic consumption", not "subsidized export production". For example, when Canada maintained a two-price policy for wheat sales — charging domestic consumers more than the world price — an observer may have been led to the incorrect conclusion that Canada was dumping wheat on international markets. The correct view is that Canada was taxing domestic consumption of wheat.[13]

In the next section, we briefly consider an important indirect tax that appears to violate most principles of neutrality and thus is a case requiring especially close scrutiny in tax-harmonization negotiations.

The Federal Manufacturers' Sales Tax

The federal manufacturers' sales tax, long recognized as a distorting tax within Canada, would cause two problems in the context of an FTA. First, it is difficult to specify the correct (destination principle) border tax adjustment for the manufacturers' sales tax; second, the tax is not neutral with respect to the organization of the exporting industry. Each of these points will be considered in turn, following a brief description of the tax.

The federal general sales tax was introduced in 1923 as a levy on all goods manufactured in Canada or imported into Canada. With few alterations, the tax has been in effect ever since. Collected at the manufacturers' level, it is one of the most "hidden" federal taxes.[14] The general rate of federal sales tax is currently 10 percent, the rate on alcohol and tobacco products is 13 percent, and the rate on building materials is 5 percent. Several categories of goods are exempt, including foodstuffs, pharmaceuticals, electricity and fuels, clothing and footwear, materials incorporated into manufactured goods, construction equipment, and production, mining, and farming equipment. The manufacturers' sales tax accounts for approximately 13 percent of total federal tax revenue and approximately one-third of federal indirect tax revenue. The tax applies to a large share of Canadian exports and imports.

Correct administration of the destination principle is difficult under the present system of the federal manufacturers' sales tax. The problem is one of multistage or "cascading" taxation, notwithstanding the general intent of the exemption of capital goods, producers' goods, and manufacturers' materials from the tax. Without complete exemption of all goods associated with productive processes prior to the point at which the tax is levied, some parts of the final value of a product will be taxed two or more times. The greater the extent to which taxable goods are used in production, the greater the effective rate of tax on the final product.[15]

The actual amount of tax embedded in production or distribution costs varies according to the method of production and the channels of distribution. Thus, it is not possible to compute, from the value of the product, the amount of tax that should be rebated on an export when its production involves the use of various taxable intermediate goods. Furthermore, since no single composite rate exists for a given product, there is no definable rate of compensatory import tax that would place on the import exactly the same tax burden as that borne by a comparable domestic product. Given the heterogenous product mix of Canadian imports and exports, the problem of differing effective tax rates presents an especially serious impediment to the design of an appropriate set of border tax adjustments.

Canada exacerbates the problem of proper border tax adjustments by not adhering well to the destination principle in taxing products moving in international trade. Under the rules of the General Agreement on Tariffs and Trade (GATT), Canada, as a country of destination, may impose sales taxes on the CIF (charges, insurance, <u>and</u> freight) value of imports. Canada follows the principle only partially, since the freight component (transportation costs to Canada) generally escapes tax. Recent published commentaries on the sales tax deal at length with this problem.[16]

The manufacturers' sales tax is not neutral with respect to industrial organization or investment. Although such distortionary influence is already present in the current structure of Canadian industry, the competitive consequences of the distortions would need to be reviewed in the context of free-trade tax harmonization and thus are relevant here.[17]

An indirect tax is said to be neutral with respect to business organization if it produces no difference in cost between different forms of organization — for example, between firms that are vertically integrated and firms that specialize at some vertical level. The tax is also neutral with respect to investment if it produces no difference in costs between relatively capital-intensive and relatively labor-intensive methods of production.

In regard to its effect on business organization, the manufacturers' sales tax gives a certain degree of arbitrary encouragement to vertical integration and penalizes specialization. A firm that reduces the proportion of taxable intermediate goods it buys from outside sources will, in general, tend to carry less tax in its total production costs.

With respect to investment, the manufacturers' sales tax also introduces a bias against capital-intensive production methods to the extent that the tax is hidden in the cost of capital goods and structures. Thus, the tax discriminates in favor of labor-intensive production methods.

Insofar as effective tax rates vary according to production methods, relative commodity prices diverge from relative real costs of production to an uncertain extent, unlike the case where a uniform effective tax rate applies to all products. Since international trade is driven by differences in relative domestic prices between countries, the manufacturers' sales tax distorts flows of international trade, in contrast to the situation where Canadian domestic prices correctly reflect relative real costs of production in Canada.

The agenda for tax harmonization in bilateral trade negotiations must address the manufacturers' sales tax because of its trade-distorting influence and because current administrative problems could be exacerbated. Replacement of the tax by a retail sales tax, as recommended by the Carter Commission, would be a preferred solution. Another possibility would be to implement a value-added tax. At a minimum, scrupulous attention to stemming seepage of the tax to producers' and capital goods is necessary and would help achieve objectives of domestic and international tax neutrality.

Harmonization of Direct Taxes

This discussion deals first with the objectives of direct tax harmonization: to reduce distortions in allocating resources and to establish an acceptable international division of tax revenue. It is assumed in this discussion that direct tax policies are general and uniform and that no sectoral, regional, or other economic unit is permitted preferential rules or rates. In other words, all producers in the national jurisdiction face the same effective rate of income taxation.

We then consider several significant exceptions to the assumption of generality and uniformity in direct taxation. Such exceptions — invariably designed to encourage industrial activity in particular regions, sectors, or industries — affect the net fiscal burden on the production of particular goods and, hence, can result in a competitive advantage in trade. Because of the specific, as opposed to the general, nature of such policies, the adjustment mechanisms of domestic price levels and the exchange rate fail to eliminate the advantage. Consequently, a natural focus in free-trade negotiations should be the distorting influences created by preferences in the domestic administration of direct taxation. To address explicitly whether pressure to eliminate such distortions would be greater under an FTA, the question is, if not moot, then one with no logical answer; such distortions are inconsistent with the concept of free trade and, presumably, negotiations would be directed at eliminating them.

Unlike indirect taxes, which are levied on units of output or consumption, direct taxes are levied on the income of factors of production. This distinction has become blurred, because when the effects are fully traced through a closed economy, direct as well as indirect taxes can be shifted either forward to consumers or backward to producers. If an economy trades and allows free movement of capital and labor, the incidence of direct taxes tends to fall on the least mobile factor(s) of production, because mobile factors move to the most favorable fiscal environment. Thus the working rule for bilateral tax harmonization of direct taxes is to eliminate differentials between effective tax rates, with special concern for the most mobile factor: capital.

Direct tax harmonization is essentially an arrangement to preserve the integrity of domestic tax systems while reconciling one system to another. It entails three major objectives. The first is to increase the efficiency of the international allocation of factors of production. This particular objective is sometimes referred to as "elimination of double taxation" but, in principle, it is broader than that. The aim is to coordinate direct tax systems so that taxation in either the domestic or foreign country does not sway decisions between investing at home or abroad.

Direct tax harmonization is concerned with the "excess burden" of tax, a term used to describe the output lost through tax-induced economic distortions. Excess burden is a pure or "deadweight" loss resulting from misallocation of resources. It does not involve gains by one nation at the expense of another. There are no distributional tradeoffs. A "neutral" tax is one that does not distort economic decisions, and, thus creates no excess burden. In the international setting, excess burden is the loss of aggregate output as a consequence of national policies that create barriers to trade and restrictions on international factor movements. We have seen that harmonization of indirect taxes addresses tax barriers to trade. Direct tax harmonization is, to a larger extent, concerned with factor movements. In the absence of harmonization, disparities in direct taxes may also distort trade because of capital- and labor-cost differentials that affect relative commodity prices and trade flows.

A second objective of direct tax harmonization is to establish an acceptable distribution of tax revenue derived from the income of "expatriate factors" — foreign-owned capital and migrant labor. As a practical matter, arrangements to achieve a particular degree of allocative efficiency simultaneously determine a corresponding distribution of fiscal revenue. To illustrate, decisions about capital exports that are influenced by taxes can be eliminated unilaterally by the capital-exporting country through either a foreign tax credit — against the tax liability in the capital-exporting country — or outright exemption of foreign-source income from tax. In either case, the capital-exporting country pays the fiscal price; it gives up tax revenue to promote capital-export neutrality.

The capital-exporting country, however, may take a narrower view of "neutrality". Capital invested domestically generates revenue for the government while investments made abroad invariably provide less tax revenue -- indeed, often zero revenue — under the foreign-tax-credit scheme. Counting tax revenues as part of the social return from domestic investment -

and noting that investors make their decisions in the light of net-of-tax returns, the social return on domestic investment is greater than the return on foreign investment since tax revenue is foregone on the latter. The implication is that nations intent on maximizing national welfare — and not international welfare — treat foreign taxes as costs of doing business abroad. Foreign taxes are then deducted, not credited, against the residence liability.

The third major objective of direct tax harmonization is to harmonize income redistribution policies to reduce the chances of factors migrating in response to differences in net tax burdens between countries. Income redistribution is inherently a political issue. For this reason, consideration of conflicts created by the use of direct taxes for income redistribution purposes in Canada and the United States will have to be sensitive to the political nature of income distribution as well as to the sovereign right of nations to establish such priorities and programs. In any case, the fact that people and capital will move in response to favorable differences in such policies serves as an important, implicit constraint on national policies.[18]

Current arrangements to maintain direct-tax harmonization could remain structurally unchanged in a Canadian-U.S. FTA. The system has evolved over a long period of time and the main elements, which entail a working compromise of residence and territorial principles of taxation, have been formalized in a comprehensive tax treaty. The recent successful completion of that set of negotiations is evidence that current integrative arrangements for direct tax harmonization achieve an appropriate degree of allocative efficiency, an acceptable distribution of revenue, and no serious compromise of domestic internal policies.

Pressure for additional harmonization of direct taxes in an FTA will not be due to deficiencies in the structure for dealing with foreign-source income, built on such features as the U.S. foreign-tax credit and Canada's exempt-surplus and tax-accounting provisions. Rather, contentious issues will be real or perceived violations of the generality of direct taxation as applied within one country.

Neoprotectionism

In this section, we examine the negotiating issues that could arise from the use of subsidies or tax preferences to confer advantages on specific industries. A subsidy to production in a specific industry is a negative tax, essentially a negative direct tax. Subsidies and tax preferences are more-subtle variants of protection that have arisen to replace the more-heavy-handed traditional forms of the tariff. The term "neoprotectionism" pertains primarily to direct tax devices.[19] For example, subsidized export finance programs are unequivocally interventionist in trade. Unlike subsidies to import-competing industries or more general incentives to potential exporters, subsidized export finance programs cannot be disguised as domestic policies within the purview of national industrial development.

The traditional forms of protectionism, such as tariffs, are indirect taxes on foreign goods. But whatever protective effects can be achieved with tariffs can be duplicated by a system of domestic taxes and selective subsidies.[20] For example, a tariff is equivalent to a combined tax on consumption from all sources and an equal rate subsidy to domestic production of the taxed item. While tariffs determine trade volumes and can, at most, extinguish trade, taxes can determine the direction of trade and are thus potentially more distorting than tariffs.[21] Subsidies can stimulate domestic supplies until they are more than adequate to meet domestic demands. Taxes, on the other hand, may discourage domestic production to the point where a commodity formerly exported is instead imported.

The effectiveness of neoprotectionist policies depends to a large extent on the size of the country initiating intervention relative to the size of its major trading partners. If a small country subsidizes its exports, it generally does so because exports account for a large share of production. Retaliatory action in the form of countervailing duties by the large country could seriously affect the industrial policy of the smaller one. However, if a large country subsidizes its exports and a small country imposes a countervail, the latter is little more than an irritant to the large country. As a case in point, by itself, Canada was unable to counteract the U.S. Domestic International Sales Corporation (DISC) program; only after several years, following complaints by numerous nations and chastisement by the GATT Council, did the United States eventually modify the structure of the program.

Similarly, if a small country subsidizes import substitutes, there is little effect on the volume of production of a large country that happens to export some of its production. Retaliation is unlikely. But if a large country subsidizes its import substitutes, the policy could destroy the export industries of its small trading partners by eliminating their market.

Neoprotectionist devices — such as subsidized, guaranteed, and insured export finance — are nominally "general" but, in fact, may be highly selective.[22] Large export undertakings, in particular, often involve tailor-made financial arrangements. In a bilaterally enhanced trade arrangement, mutual agreements regarding these more subtle forms of protection can lead to trade diversion — the shifting of production from low-cost, offshore suppliers to a member country — as is commonly associated with bilateral tariff reduction. Trade diversion tends systematically to provide greater benefit to the relatively small country. For example, to break even in market penetration, Canadian products would need to gain 1 percent of the U.S. market to compensate for losing 10 percent of the domestic market.

Strict international harmony with respect to tax-based, trade-inhibiting, neoprotectionist policies would call for bilateral agreement to eliminate such tactics completely. It would entail more than just elimination of subsidized export finance or tax concessions to import-competing industry; it would also mean foregoing every specific grant, incentive, tax allowance, or government cooperation in private production of tradable, and perhaps even nontradable goods, to the extent that any policy-induced, inter-industry relative cost differential is viewed as affecting trade. The prospect for strict harmony in this sense is as unreasonable as it is unlikely. Neither Canada nor the United States is willing to forego its national prerogative to establish regional development programs, industrial policies, or selective fiscal assistance to critical sectors.

The United States has long taken the position in international negotiations that many, if not all, industry- or firm-specific tax incentives in some sense constitute unacceptable subsidies to exports, and this position won some acceptance in the recent GATT agreement on subsidies.[23] Given the volume of cross-border trade and investment flows, it is not surprising that this issue has often arisen in Canadian-U.S. relations.

From the United States' point of view, the central issue here appears to be the allegedly unfair distortion in trade and factor flows resulting from what it considers "excessive" subsidization abroad — which often appears to mean <u>any</u> subsidization, since the United States often seems able to find an "injury" wherever it can find a "subsidy". From Canada's point of view, the problem is that the equity of the proposed U.S. remedies depends too often on the assumption that all countries are equal when, in the real world, they clearly are not.

A classic example of the application of the U.S. position is the well-known Michelin Tire case, where the United States condemned as unfair and excessive export subsidization the regional development subsidies given to the Michelin company to locate its tire factory in Nova Scotia. Obviously, a worldscale tire manufacturing facility cannot be located in a region such as Eastern Canada without most of its output being exported. Several such plants could exist in the United States, however, given the greater size of its domestic market, with a much smaller part of their output being exported — even if those exports swamped the Canadian market.

For Michelin, the subsidy arguably was an offset to a natural cost disadvantage of locating in a particular region and was thus equivalent to a rebate of a location tax on exports. Viewed in this light, the countervailing duty became a protectionist device, rather than an instrument for preserving trade neutrality.[24] It also served to thwart the goals of Canada's regional development policies. So long as the United States continues to consider subsidies to export-oriented firms and industries to be selective export subsidies, the system is obviously heavily biased against countries, such as Canada, with a smaller domestic market.[25]

The threat of U.S. countervailing duties imposes heavier constraints on Canadian policy because of the asymmetry in the size of the Canadian and U.S. economies and their relative dependence on bilateral trade. At present, Canadian governments risk domestic subsidies and incentives being collected by the U.S. Treasury through the potential imposition of countervailing duties.

It is puzzling to watch the United States attempting to reduce the use of subsidies in international commerce while stubbornly maintaining programs such as DISC or its modified version, the Foreign Sales Corporation (FSC).[26] These tax-based export subsidies have no counterpart in any other industrial country. In effect, they amount to applications of the "territorial" principle of income taxation — the principle under which some countries, such as France, exclude income from the tax base that their resident corporations earn abroad — to activity that takes place entirely within the territorial jurisdiction of the United States. Most of the effects of the DISC on Canadian industry have probably been offset by the manufacturing and processing credit, which, unlike the DISC, is not an export-related subsidy.[27] It is difficult to see how a country that was willing to maintain a device like DISC in the face of repeated international condemnation can be quite as principled in international economic discussions as the United States has been with respect to subsidies.

Problems could arise in bilateral trade negotiations from concerns about whether either country's tax system indirectly subsidizes domestic industries that produce goods for export or import competition. Important subsidy issues that might be of concern include various regional, sectoral, or other tax preferences that might provide cost advantages to domestic producers.

Again, to address the question of whether pressures for tax harmonization would be greater in an FTA, pressures to alter neoprotectionist policies would arise during negotiations and would be resolved one way or another by the time an agreement — if any — is reached.

More harmonization would undoubtedly exist in an FTA as reflected, for example, in the few deviations from uniformity and generality in the administration of direct-tax policy — such deviations as currently may be identified by U.S. countervail policy. Most policies at issue — for example, regional or wage subsidies built into unemployment insurance, and export production by state-owned industry — are inconsistent with a domestic or internationally neutral direct-tax system. Nevertheless, a sovereign nation should retain the right to pursue such policies in view of national priorities for income redistribution, industrial development, and regional expansion.

While certainly relevant to the broad question of harmonization of policies en route to establishing an FTA, these are not issues of tax harmonization *per se*. Achieving a workable compromise between the prerogative of one nation to intervene in its economy for social purposes and the equally legitimate right of another to defend its commercial interests through such mechanisms as countervail is a negotiating exercise.[28]

Canadian-U.S. Tax Coordination: The New Treaty[29]

International tax interaction between Canada and the United States primarily involves mutual accommodation of two sovereign systems of direct taxation. An appropriate focal point of discussion is the most recent concrete manifestation of such accommodation — the new Canadian-U.S. tax treaty. Negotiations to replace the 1942 treaty began in 1972 and required almost 12 years to complete. Following two supplementary protocols amending the initial draft, joint ratification concluded and made effective the world's most comprehensive tax convention, one which governs the largest volume of bilateral trade and investment flows in the world. There can be few other areas in the modern world where the rules remained unaltered after the game had changed so much.[30] The new treaty represents a major advance in international fiscal coordination, a document incorporating elements of hard-fought negotiation and prudent compromise.

Tax treaties can be viewed from several perspectives. In their legal dimension, for example, they are contracts between nations, which do not come into effect unless and until appropriate legislation is enacted within each nation. The resulting legal documents, like all laws, reflect each country's political objectives and constraints. As far as international investors and entrepreneurs are concerned, a tax treaty is a comprehensive set of rules defining their tax liabilities. In this sense, a tax treaty is a bilaterally coordinated tax system, complementing or accommodating the basic international aspects of different domestic income tax systems — those relating to the taxation of foreign source income and income of nonresidents. Its purpose is to preserve the integrity of each domestic tax system while reconciling differences between systems. Finally, the rules, rates, and regulations embodied in the tax treaty have international economic implications. The terms of the treaty affect the international allocation of capital, labor, and technology, and determine the international division of the tax base.

Each country's approach to treaty negotiations reflects its attitudes and interests with respect to international flows of capital, its desire to get a good share of the tax revenues generated by foreigners, the political influence of its capital exporters and importers, and — but by no means least — the strength of its desire for better relationships in general with its potential treaty partner. Since these factors may change from time to time, and from negotiation to negotiation, it is not always easy to pin down exactly why a provision in a treaty between countries X and Y is inconsistent with one in a treaty between X and Z. In the case of the recent Canadian-U.S. treaty negotiations, however, each side appears for the most part to have played its customary and expected role.

Canada's approach to international tax negotiations is shaped largely by its position as a significant importer of foreign capital. Consequently, Canadian tax negotiators seek to safeguard Canada's revenue position and to strengthen domestic ownership.[31] In negotiations with the United States, Canada asserted its intention to levy higher withholding taxes on dividends, royalties, and interest than provided for in the model treaty, and reserved its position on the "nondiscrimination" article of the Organisation for Economic Co-operation and Development (OECD) tax convention.[32]

The OECD model treaty — like the closely related U.S. model unveiled a few years later — clearly reflects the dominant influence of capital-exporting nations in that it generally favors tax reductions in the country of source and unrestricted taxation in the country of residence. Capital importers obviously stand to lose tax revenue from shifting to taxation based on residence rather than source or from any equal reciprocal reduction in withholding tax rates. Even though Canada has, in fact, been a net capital exporter for a number of years now, the stock of foreign-owned capital in Canada remains much larger than the stock of Canadian-owned capital abroad. It is the relative size of these stocks that governs the size of the income flows subject to tax.[33] Canada, therefore, was bound to lose from the reduction — to 10 percent from 15 percent — in the withholding tax on dividends negotiated in the new Canadian-U.S. treaty. Moreover, the revenues thus foregone, for the most part, would flow directly to the U.S. Treasury, not to the taxpayers and, hence, would have little or no effect on capital flows.[34]

One reason Canada was willing to make this concession was perhaps to fend off constant U.S. criticism that its refusal to extend the dividend tax credit to nonresident shareholders was "discriminatory".[35] In treaty negotiations, the United States generally follows its traditional line — unsurprising for the country with the largest stock of direct investment abroad — of attempting to reduce withholding rates and to follow OECD principles of nondiscrimination and reciprocal concessions. The United States had, for example, successfully persuaded the United Kingdom to extend its dividend credit to certain U.S. investors in the U.K.-U.S. treaty concluded in the 1970s. In general, it also has steadfastly maintained its position that "nondiscrimination" requires countries providing dividend relief to domestic shareholders to do the same for foreign shareholders.[36] Thus, the lower treaty withholding rate was, in the words of one of Canada's principal negotiators, "a resolution of a fundamental issue by way of a concession in the rates of tax."[37] As this example makes clear, no single feature of a complex international agreement like the Canadian-U.S. treaty can be understood in isolation from the document as a whole — or, for that matter, from the prevailing context of Canadian-U.S. relations at many levels.[38]

Moreover, since international tax affairs are never static, it is also not surprising that several new issues have surfaced (or resurfaced) since the treaty was originally concluded, among them: treaty shopping, treaty interpretation in light of changing domestic rules and definitions, unitary taxation, and the capital export bias arising from the U.S. treatment of foreign source income.[39] These problems are subjects of current attention of policymakers, practitioners, and analysts of international tax matters.[40]

Conclusion

The need for additional tax harmonization, and, correspondingly, the perceived loss of fiscal sovereignty generally tends to be overstated in discussions of free trade. One major source of exaggeration of the necessity for full fiscal alignment is the natural tendency to confuse the limited objective of an FTA with the far-reaching objectives of more comprehensive forms of economic integration. In the taxonomy of international economic integration, a free-trade area — as distinct from a customs union, a tax union, or full political integration — is an arrangement for deriving the benefits of trade in a larger economic area without integration of policies. Increased output, expanded consumer choice, and the rationalization of industry that result from freer trade contribute to the economic potential of the trading nations. The pursuit of these gains from free, international trade need not compromise national policies that alter the outcome of domestic market forces because of social decisions to produce a variety of public goods and to achieve a more equitable distribution of income.

Fiscal sovereignty must take precedence over commercial arrangements for free trade. Although fiscal sovereignty per se is not to be compromised, specific policies may hinder the realization of the greater economic benefits of trade. Thus, it is wise to consider alternative means of achieving the purposes of particular policies in a different scenario, that is, in an FTA. That is the essence of evaluating one's negotiating position with an emphasis on flexibility and with an awareness of alternative means of satisfying domestic priorities. Economists can estimate the economic costs — in terms of lower GNP, jobs foregone, or higher consumer prices — of various policies in various scenarios, thus attaching what might crudely be termed "national price tags" to preferential domestic policies. The focus is on those policies that, through taxation, have a bearing on relative costs and thus influence trade. The ultimate weighing of costs and benefits of policies, including consideration of the economic risks inherent in structural change, is a political prerogative.

Prior to negotiations with the United States, Canadian representatives ought to divide national policies carefully into two categories: those whose rationale is to distort conditions of competition in international trade, and those that are essential to the pursuit of Canadian objectives. National policies that fall into the latter category must be respected in any international trading arrangement that falls short of complete economic integration. Such policies need to be thoroughly reviewed, however, when they differ among nations and distort trade or international investment significantly.

The conclusion of this assessment of how pressures for international tax harmonization — including the alignment of domestic expenditure and redistribution policies — would change in an FTA is that they would not. Both indirect- and direct-tax mechanisms and the presence of a flexible exchange rate are effective in maintaining independence of the U.S. and Canadian systems of taxation and government expenditure. The two principles required to avoid distortion of trade by the tax system — consistent application of each general tax according to either the origin or destination principle, and the remission to exporters of particular taxes that bear especially heavily on their products — are both independent of the existence of a free-trade area.

In certain sectors, decisions have been made to distort the workings of competition to serve domestic objectives. These distortions undoubtedly would prove to be contentious in negotiations but, in the context of the present discussion, sector-specific or product-specific issues essentially are outside the realm of tax harmonization. To the extent that such distortions currently exist and would remain acceptable in free-trade negotiations, the area in question is ipso facto recognized as being outside the scope of trade negotiations. If a distortion was removed in negotiations, the pressure for alignment likewise would be eliminated.

Perhaps the greatest impediment to bilateral trade negotiations arising from differences in the two countries' tax or public expenditures systems could result from perceived, rather than real, economic effects. Broadly based social policies covering public expenditures for health care will not distort trade flows in an FTA. Nonetheless, Canadian firms might perceive themselves to be at a disadvantage because health care is financed by tax revenues that impose a burden on them, while U.S. firms might perceive themselves to be at a disadvantage because health care is provided "free" by the Canadian government.

Similarly, Canada could introduce a value-added tax that would be rebated at the border according to the destination principle; bilateral trade patterns would not be significantly affected. U.S. import-competing industries might perceive the rebate of the value-added tax to be an export subsidy, although, in fact, it would not have this effect. The negotiations will have to distinguish clearly between perceived and real economic effects of differences in the tax, social security, and public spending policies of the two countries.

Existing evidence from the European Community, which explicitly sought to harmonize fiscal measures, underlines the realities. As Wayne Thirsk has observed:

> It is a common perception that increasing economic interdependence and a higher degree of economic integration, such as that which has occurred within the European Economic Community, requires strong and concerted measures to harmonize different tax systems. Actually this is a misperception since little harmonization has been accomplished within this market and, despite much discussion and writing on the topic, no progress in that direction can be anticipated. Income tax systems, both corporate and personal, are likely to remain uncoordinated. Within the large free trade area border tax adjustments and heavy reliance on the destination principle of commodity taxation have acted to reconcile the existence of disparate commodity tax systems with the desire to minimize tax induced trade distortions.[41]

NOTES

1. H.G. Johnson, "The Implications of Free or Freer Trade for the Harmonization of Other Policies," in H.G. Johnson, P. Wonnacott, and H. Shibata, Harmonization of National Policies under Free Trade, Canada in the Atlantic Economy no. 3 (Toronto: University of Toronto Press for the Private Planning Association of Canada, 1967), p. 2. Although substantially abbreviated, the following paragraphs closely follow Johnson's theme.

2. This is, of course, a judgment that ought not to be considered as fact without extensive empirical investigation. Among the studies that strongly support the view is R.G. Harris with D. Cox, Trade, Industrial Policy and Canadian Manufacturing (Toronto: Ontario Economic Council, 1983). For contrary remarks, see J. Whalley, "Discriminatory Features of Domestic Factor Tax Systems in a Goods Mobile-Factors Immobile Trade Model: An Empirical General Equilibrium Approach," Journal of Political Economy 88 (December 1980): 1177-1202.

3. Hirofumi Shibata, "Fiscal Harmonization Under Freer Trade: Principles and Their Applications to a Canada-U.S. Free Trade Area", in Capital Flows and International Policy Harmonization (Toronto: University of Toronto Press for the Private Planning Association of Canada, 1973).

4. Carl Shoup, ed., Fiscal Harmonization in Common Markets, Volumes I & II (New York: Columbia University Press, 1976). This study comprises the most comprehensive treatment of tax harmonization to date. An especially important piece is Douglas Dosser's "Economic Analysis of Tax Harmonization", Chapter 2 of Volume I.

5. See, for example, Paul Wonnacott and R.J. Wonnacott, Free Trade Between the United States and Canada (Cambridge, Mass.: Harvard University Press, 1967); and John Williamson, The Exchange Rate System (Cambridge, Mass.: MIT Press for the Institute for International Economics, 1983).

6. John Whalley, ed., Volume 11, Canada-United States Free Trade; and idem, ed., Volume 12, Domestic Policies and the International Economic Environment (Toronto: University of Toronto Press, 1985). Tax questions receive explicit attention in A. Moroz, "Some Observations on Non-Tariff Barriers and Their Use In Canada" (Volume 11), pp 239-266. The role of exchange rates in the adjustment process is debated in the papers by Roderick Hill, John Williamson, J. David Richardson and David Longworth in Volume 12.

7. The federal/provincial allocation of taxing authority restricts provinces to direct taxation only. A direct tax — good examples of which are income and property taxes — is understood to be extracted from the very person intended to bear its burden. Provincial sales taxes, by being legislated as consumer-purchase taxes with retailers designated as agents of the Crown for purposes of collection, fall within the direct-tax category. In the conventional structure of tax analysis, however, provincial sales taxes are considered to be indirect taxes.

8. See Canadian Tax Foundation, The National Finances 1983-84 (Toronto, 1984); and idem, Provincial and Municipal Finances 1983 (Toronto, 1983). Figures exclude health insurance, social insurance, and pension plan contributions.

9. For a more complete discussion of problems of policy and implementation of a system of harmonized indirect taxes — with pertinent real world examples — see H. Shibata, "Fiscal Harmonization under Freer Trade: Principles and Their Applications to a Canada-U.S. Free Trade Area," in H.E. English, ed., Capital Flows and International Policy Harmonization, Canada in the Atlantic Economy nos. 9 and 10 (Toronto: University of Toronto Press for the Private Planning Association of Canada, 1973), especially pp. 40-55.

10. Such questions are addressed by Paul Wonnacott, "Policy Harmonization in Free Trade Groupings with Special Reference to the European Economic Community" in Johnson, Wonnacott, and Shibata, Harmonization of National Policies under Free Trade.

11. Peggy Musgrave, "Harmonization of Direct Business Taxes: A Case Study," Shoup, Fiscal Harmonization in Common Markets, Volume II, p. 220.

12. G. Hufbauer and J. Erb, Subsidies in International Trade (Washington, D.C.: Institute for International Economics, 1984), pp. 51-56.

13. W.R. Thirsk, "Should Taxes Be Included in Trade Agreements?" in Canadian Trade at a Crossroads: Options for New International Agreements (Toronto: Ontario Economic Council, 1985).

14. The November 1981 federal budget announced the government's intention to move the manufacturers' sales tax to the wholesalers' level, effective July 1, 1982. The switch was subsequently postponed and, in the February 1984 budget, rescinded. Recently, the government has announced that, rather than changing the general application of the tax, tax authorities would review any identified inequities or distortions due to the application of the tax and would address the problems on a sector-by-sector or product-by-product basis. Changes would be considered regarding the level at which the tax is imposed in a given sector or on specific goods. In the May 1985 budget, the government removed the exemption of several categories of products, thus broadening the tax's base.

15. The international problems created by domestic indirect taxation in the form of the manufacturers' sales tax are basically the same — although substantially less serious — as those encountered by European countries trying to harmonize their cumulative, multistage "turnover" taxes. The European case involved multiple taxation on virtually every part of value added before the product reached the trader, who then added the last taxable value to it. The Canadian manufacturers' sales tax involves multiple taxation only on that part of the value added by the use of taxable goods in production. The European solution was to abandon cascade-type turnover taxes and to adopt value-added taxes. With value-added taxation, the tax burden at each stage of production is proportional to the value that has been added at that stage; the sum of the tax paid at the successive stages is the same as the tax that would be payable if it were charged on the full value of the final product and collected on final payment.

16. See Malcolm Gillis, "Federal Sales Taxation: A Survey of Six Decades of Experience, Critiques, and Reform Proposals," Canadian Tax Journal 33 (January-February 1985): 68-98, and Robin Boadway and Harry Kitchen, Canadian Tax Policy, Canadian Tax Paper no. 63 (Toronto, Canadian Tax Foundation, 1980).

17. The following comments closely follow Shibata, "Fiscal Harmonization under Freer Trade," pp. 52-53.

18. Further discussion of the theory of direct-tax harmonization is presented in H. Shibata, "Free Trade Areas and Policy Coordination with Special Reference to the European Free Trade Area", in Johnson, Wonnacott, and Shibata, Harmonization of National Policies under Free Trade, pp. 71-84. For an extensive description of current Canadian and U.S. practices, as well as analysis of the effects of prevailing policy for both international investment and the distribution of revenue, see D.J.S. Brean, International Issues in Taxation: The Canadian Perspective, Canadian Tax Paper no. 75 (Toronto: Canadian Tax Foundation, 1984).

19. For examples and discussion, see Ibid., pp. 29-31; and R.M. Bird and D.J.S. Brean, "Canada-U.S. Tax Relations: Issues and Perspectives," in J. Whalley, ed., U.S.-Canada Trade and Investment Frictions (Toronto: Ontario Economic Council, 1985), pp. 391-425.

20. These points are developed at greater length in Thirsk, "Should Taxes Be Included in Trade Agreements?" pp. 138-51.

21. J.R. Melvin, *The Tax Structure and Canadian Trade: A Theoretical Analysis* (Ottawa: Economic Council of Canada, 1975).

22. Brean, *International Issues in Taxation*, Chapter 3.

23. C.F. Bergsten, "The Need for International Cooperation in the International Investment Area," *U.S. Department of the Treasury News* no. B-1594, May 11, 1979.

24. See Thirsk, "Should Taxes Be Included In Trade Agreements?"

25. R. de C. Grey, *Trade Policy in the 1980s: An Agenda for Canadian-U.S. Relations*, Policy Commentary no. 3 (Montreal: C.D. Howe Institute, 1981).

26. "DISC Substitute Detailed in Administration Draft Proposals," *Tax Notes*, July 18, 1983.

27. See R.M. Hyndman, "The Efficacy of Recent Corporate Income Tax Reductions for Manufacturing," *Canadian Tax Journal* 22 (January-February 1974): pp. 84-91; and L. Eden, "DISC, CMTC and the Multinational Enterprise," (Brock University, Department of Economics, St. Catharines, Ont., 1983 Mimeographed).

28. See R.G. Lipsey and M.G. Smith, *Taking the Initiative: Canada's Trade Options in a Turbulent World*, Observation no. 27 (Toronto: C.D. Howe Institute, 1985), Chapter 3, for a useful guide to this exercise.

29. This section closely follows R.M. Bird and D.J.S. Brean, "Canada-U.S. Tax Relations: Issues and Perspectives", in D. Fretz, R. Stern and J. Whalley, eds., Canada/United States Trade and Investment Issues (Toronto: Ontario Economic Council, 1985), pp. 391-425.

30. Although there were amending conventions in 1950, 1956, and 1966, the basic treaty framework remains that established in 1942.

31. See G. Coulombe, "Certain Policy Aspects of Canadian Tax Treaties," in Report of Proceedings of the Twenty-Eighth Tax Conference (Toronto: Canadian Tax Foundation, 1977), pp. 290-303; and P.G. Cantor, "Business Profits," in Report of Proceedings of the Thirty-Second Tax Conference (Toronto: Canadian Tax Foundation, 1981), pp. 330-50.

32. Organisation for Economic Co-operation and Development, Model Double Taxation Convention of Income and Capital (Paris, 1977).

33. For a recent review of Canada's international investment position, with emphasis on tax factors, see Brean, International Issues in Taxation.

34. A. Deutsch and G.P. Jenkins, "Tax Incentives, Revenue Transfers, and the Taxation of Income from Foreign Investment," in W.R. Thirsk and J. Whalley, eds., Tax Policy Options in the 1980s, Canadian Tax Paper no. 66 (Toronto: Canadian Tax Foundation, 1982), pp. 217-47.

35. M. Burge and R.D. Brown, "Negotiations for a New Tax Treaty between Canada and the United States - A Long Story," Canadian Tax Journal 27 (January-February 1979): 94-104; and R.J. Patrick, "The Proposed Canada-United States Income Tax Treaty: Nondiscrimination, Mutual Agreement, and Exchange of Information," in Report of Proceedings of the Thirty-Second Tax Conference, pp. 735-42.

36. See G. Carlson, International Aspects of Corporate-Shareholder Tax: Integration, OTA Paper 40 (Washington: U.S. Department of the Treasury, Office of Tax Analysis, 1980). The U.S. position is far from being accepted by everyone — see, for example, R.M. Bird "International Aspects of Integration," National Tax Journal 28 (September 1975): 302-14; and OECD, Model Double Taxation Convention, pp. 100-01 — but this is not the place to pursue this abstruse (though important!) controversy.

37. R.A. Short, in Report of Proceedings of the Thirty-Second Tax Conference, p. 412.

38. This observation may appear to lend some support to U.S. courts' common practice of turning to legislative history in interpreting tax laws, including treaties. One trouble with this practice, however, is that U.S. courts understandably look only at U.S. legislative history, thus ignoring completing the essence of a treaty as a bilateral agreement. See S.I. Roberts, "Great-West Life Assurance Company v. United States: Exploration of the U.S. Interpretation of Treaties," Canadian Tax Journal 30 (September-October 1982): 759-66. Other aspects of treaty interpretation are discussed briefly later in the present paper.

Potential Implications of Canadian-U.S.

Trade Negotiations for Canadian Cultural Support Policies

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September, 1985

Contents

Introduction

The purpose of this paper is to examine Canada's major cultural support policies and to evaluate the potential implications of their existence for negotiating a comprehensive trade agreement with the United States. It evaluates how Canadians might reconcile trade and political objectives in negotiations on cultural issues.

While there is a substantial amount of anecdotal evidence that Canadian authorities have erected a wide array of cultural trade barriers, there are major difficulties associated with specifically identifying existing barriers to free, bilateral trade in cultural services. Most of the relevant barriers are of the nontariff form and, hence, are not readily identified through published tables or formal schedules. Furthermore, it is difficult to distinguish between nontariff barriers designed to protect domestic producers and those that represent "legitimate" expressions of sovereign political policies. The latter complication is especially acute in the cultural sector, since protectionism is heavily tied to expressed goals of promoting "cultural identity" and "political sovereignty".

In order to evaluate how Canada would be able to support legitimate cultural policies in a free-trade area without asking for a blanket exemption in negotiations on a range of policies whose boundaries are impossible to define -- which the United States probably would find unacceptable -- it is useful to identify and evaluate the major policies in place from two broad perspectives:

- What impact do existing policies have on the bilateral flow of trade in cultural services?

o What impact do these policies have on the legitimate expression of Canadian cultural objectives?

Policies that have little or no impact on bilateral cultural trade flows presumably are innocuous with respect to any free-trade agreement with the United States. Exemptions for such policies should raise no concerns for the negotiating process. Similarly, policies that significantly affect trade flows but that serve no legitimate purpose in promoting Canadian culture pose no special policy concern. Conceptually, at least, such policies should not be exempted from an agreement; indeed, Canada should abandon them unilaterally. The problematic set, therefore, consists of those policies that address legitimate cultural concerns but that clash with free-trade principles.

Ideally, this paper should identify all relevant barriers to cultural free trade and assign them to one of the three categories described above. A more realistic approach, however, is to identify the major barriers and offer a necessarily cursory assessment of the category into which they fall. The focus is on cultural policies at the federal level, because they are quantitatively most important and most easily documented and because provincial cultural policies would (presumably) not be a direct object of negotiation between Canadian and U.S. officials. Moreover, the Quebec government has erected many of the relevant provincial trade barriers; given the natural — that is, language — trade barrier that exists between the United States and Quebec, specific cultural barriers imposed by Quebec are less contentious than those imposed by other governments in Canada.

Canadian-Content Broadcast Regulations

In an effort to promote the use of Canadian nationals in key artistic and technical roles, Canadian broadcasting regulations require television and radio stations to maintain certain levels of "Canadian content" in their programming. These levels are determined by various formulas, but briefly, 60 percent of television broadcast material must qualify as Canadian, and at least 30 percent of musical compositions a radio station broadcasts must qualify as Canadian.

Content regulations may be seen as equivalent to local purchasing requirements. In the case of television and radio, the services of "local" creative inputs must be used in certain minimum quantities. To the extent that content regulations "reduce" the demand for imported cultural services -- U.S. situation-comedy shows, for example -- they are a potentially significant nontariff barrier to cultural free trade.

There has been a great deal of controversy over whether Canadian-content regulations have generated any significant net demand for Canadian artists. Some observers have argued that such content regulations have been met largely through increased sports and public affairs programming, which would have been forthcoming in the absence of content requirements. On the other hand, Canadian broadcasters argue that Canadian-content regulations significantly increase their programming costs without expanding their audience size. There is fairly persuasive evidence to support the broadcasters' argument. The expensive and largely ineffectual nature of Canadian-content regulations has led some observers to propose that they be replaced by expenditure requirements. Specifically, Canadian broadcasters would be required to spend a minimum percentage of their profits (or revenues) on Canadian programming. In this way, critical expenditures at some fixed level could be concentrated on specialized programming.

There is little doubt that an expenditure quota makes more economic sense than a content quota, in the same way that allowing producers to determine the least-cost way to achieve certain pollution standards, makes more sense than dictating by fiat the way that emissions should be controlled. Furthermore, an expenditure quota might be a less-contentious trade barrier than current content regulations, since it would leave greater scope for U.S. programming on Canadian television channels while improving the "quality" of a more focused Canadian programming effort.

It is impossible to establish whether or not Canada's cultural identity and political sovereignty are enhanced by encouraging the production of clones of popular U.S. television programs such as Cheers or Dallas. I, and others, have argued that the widespread application of any such national-sovereignty argument is specious.[1] Unfortunately, it cannot definitively be dismissed. There is, therefore, at least a conceptual basis for arguing that even with respect to mass, popular culture, encouraging original Canadian programming is a national priority. In a later section, however, I argue that direct forms of protectionism are not the preferred way to encourage Canadian programming in sectors where "the market" would (possibly) produce suboptimal results.

Copyright Provisions and Ownership Restrictions

Canadian practices that are perceived to infringe on U.S. copyrights are a major irritant between the two countries. Canadian cable operators, for example, are required to substitute local television signals (including commercials) for U.S. border-station signals when the programming on both stations is identical. And early in 1984, the Canadian Radio-Television and

Telecommunications Commission authorized cable operators to carry specialized U.S. satellite channels as program options for pay-television subscribers in Canada.

Foreign citizens or corporations are prevented from owning more than 20 percent of any Canadian broadcasting or cable undertaking. Such ownership restrictions in the cable sector are definitely a trade irritant to the United States, especially since that country's Communications Act of 1934 does not restrict foreign ownership of cable systems (although foreign ownership of conventional U.S. television and radio stations is severely restricted). However, ownership regulations may well be seen as outside the scope of any contemplated free-trade agreement, since "key sector" ownership restrictions are a widespread and fairly well-accepted phenomenon. Hence, if such restrictions are seen as contributing to legitimate cultural objectives, they may represent a valid subject for exemption under any trade agreement with the United States.

I would take a less benign view of substitution rules for cable broadcasters. The primary impact of such rules is to increase demand for Canadian advertising services. Not only is this an obvious trade restriction, it cannot be viewed legitimately as contributing either to Canada's sovereignty or to Canada's cultural identity. Rather, the restriction merely bids up the prices of Canadian advertising services while encouraging an increase in the supply of Canadian advertising inputs in the long term. The social welfare benefits of such a policy are dubious at best. It would seem, therefore, that cable substitution rules should be dropped as part of any trade-negotiating stance.

Bill C-58

Bill C-58 prohibits firms in Canada from claiming tax deductions for advertising on U.S. border radio and television stations and in foreign-owned publications. This legislation has been especially contentious and has provoked U.S. retaliation. To argue its merits as a subject for exemption from negotiations would require a demonstration that it significantly and efficiently promotes Canada's identity and political sovereignty.

The ostensible purpose of Bill C-58 was to promote increased spending on Canadian publications and broadcasting. The notion was that by diverting revenue to Canadian-owned stations and publications, spending on original Canadian productions and literary material would increase. In fact, this goal has been largely unrealized, since there is no incentive for domestically owned media to dissipate on Canadian content the windfall profits that the bill created. Moreover, entry restrictions into the broadcasting sector perpetuate the length of time over which these windfalls can be maintained. Hence, there is no compelling social-welfare argument for seeking an exemption for Bill C-58, or similar legislation, in any trade pact with the United States. Instead, the recent passage of U.S. mirror tax provisions, which penalize Canadian broadcasters penetrating the U.S. market, suggests that this group would actually benefit from removal of such measures in a free-trade area.

Capital Cost Allowance for Films

The Capital Cost Allowance (CCA) for films is a tax shelter that allows investors who are deemed to have put "money at risk" by investing in a Canadian film to deduct a certain percentage of their share of the project plus any interest on the money borrowed to finance their investment.

The CCA has not raised any bilateral controversy and would seem to be an innocuous trade issue. Furthermore, it is analogous to other tax instruments designed to promote domestic production that are accepted as legitimate instruments of economic policy. Hence, it is likely that an exemption for such investment tax expenditures could be obtained without significant concessions, especially since comparable U.S. legislation exists.

It is worth noting in passing, however, that the CCA's effectiveness in promoting Canadian feature films has been criticized. Specifically, while the CCA undoubtedly has been responsible for a sharp increase in Canadian filmmaking, most films lost money for their investors. Furthermore, few of the films produced were, in any meaningful way, "Canadian". Whatever the overall economic impact, neither the CCA nor the feature films it has helped to finance can be considered to have contributed to Canada's national identity.

Content Requirements for Film Distributors

While no formal Canadian-content requirements similar to those affecting broadcasters exist for film exhibitors, informal quota arrangements have been attempted in the past. At present, "moral suasion" is being relied upon to encourage theater owners to exhibit Canadian-content films. However, should content requirements for film distributors be implemented, they undoubtedly would constitute the kind of trade irritant that broadcasting content regulations now pose, and with similar dubious benefits for Canada's cultural identity and political sovereignty.

Direct Government Expenditures

In an effort to stimulate "more commercial" Canadian film productions, the federal government recently introduced a policy to subsidize private film producers to a much greater extent while continuing to fund film production by the Canadian Broadcasting Corporation (CBC). The agency established to accomplish this objective is Telefilm Canada, which chips in up to one-third of all film production costs, with the remainder coming from broadcasters and other private sources. In the year ending June 30, 1984, the agency invested $36.2 million in Canadian film development.

Direct government funding of film production might be seen as a form of nontariff barrier to trade, as it seems clear that the funding is designed, at least in part, to displace U.S. films for television. However, a substantial portion of this assistance might also be seen as an attempt to fill a gap in uniquely Canadian programming. For example, approximately one-half of the films funded were undertaken by the French network of the CBC or by the private French-language network. In this respect, government financing assistance through Telefilm Canada, by advancing legitimate social and political objectives, arguably would constitute a legitimate exemption in any trade negotiations with the United States.

To the extent that the United States sees direct government funding by Telefilm Canada as a trade barrier, it might be worth arguing for an exemption for targeted funding assistance — for French-language programming, for example — especially since targeted funding can be a legitimate way to overcome the market's failure to produce cultural goods.

Other Cultural Trade Barriers

A number of other cultural trade barriers exist that may have to be addressed in any negotiations with the United States on a free-trade area. One that is difficult to document, with respect to both its frequency and its importance, is immigration restrictions — including visa requirements — on foreign performers and other producers of cultural services. While in most cases appropriate visas are granted, documented cases exist of foreign performers being denied entry into Canada. However, similar entry restrictions confront Canadian performers seeking to work in the United States.

Whether these immigration restrictions would pose an issue in negotiations for a trade agreement with the United States depends on the scope of the agreement. Since what appears to be at issue is trade liberalization rather than economic union, autonomy with respect to immigration policy would seem a legitimate subject for exemption. Whether such restrictions contribute to legitimate Canadian social objectives is a broader and more problematic issue.

Another source of government intervention into the culture sector is provided by the terms of the Foreign Investment Review Act, under which Investment Canada (formerly the Foreign Investment Review Agency) reviews the effects on the Canadian economy of all sales to foreigners of companies with Canadian branches. While recent revisions to the act exempt many formerly reviewable transactions, cultural industries will continue to be reviewed comprehensively. Experience so far suggests that where cultural businesses are concerned, it is virtually impossible to obtain approval under the act.

The Foreign Investment Review Act has been a periodic source of concern to the United States. While direct screening of foreign direct investment seems to be acceptable in principle, preventing transfers of ownership from one foreign investor to another is a contentious issue and one that may not be easily exempted from any trade negotiations. Encouraging domestic ownership of cultural industries is clearly a national priority, although the economic basis for the priority is unclear; in any case, more appropriate and acceptable policy instruments to encourage domestic ownership should be used. Restricting ownership transfers between foreign investors may be seen as an indirect way of expropriating foreign assets, by forcing those assets to be sold at a cheaper price to Canadian investors. This policy represents, therefore, a potentially inflammatory procedure with limited cultural benefits.

One other major subsidy that could be construed as an indirect trade barrier is government funding of the CBC, with its associated 80 percent Canadian-content mandate. Since so much of the CBC's production, at least to date, takes the form of specialized, noncommercial programming, it is unlikely that the CBC constitutes a major potential bone of contention in bilateral trade negotiations. Furthermore, it can be argued that the CBC addresses an important "failure" in the market for cultural services and, therefore, deservedly merits exemption from any bilateral trade agreement.

A Rationale for Canadian Cultural Support Policies

Notwithstanding a general presumption of economic benefits from free trade, some observers argue that even in a general free-trade regime, cultural industries should be excluded. The analytical starting point is that cultural industries generally supply "merit goods". These are goods whose social benefits exceed their private benefits and, therefore, will be undersupplied by a free market. Such goods can be thought of as having a national-cultural component and a general-cultural component.

There are two aspects of the national component of the merit-good argument. First, there is the pride individuals feel in the achievements of their countrymen, especially if these achievements are recognized internationally. Second, there is the pride individuals feel in the expression of their national culture and perspective. Although the efficacy of this argument is difficult to establish because people receive a free ride -- they receive benefits regardless of what they pay -- there is some empirical verification of the proposition.

The general-cultural component of the merit-good argument can also be accepted as a rationale for government subsidies to cultural industries. The general-cultural component consists of contributions to international culture not specific to nation states. Although Canadians may wish to support international cultural activities, this objective hardly justifies protectionist policies.

The national-cultural argument is often given as a rationale for protectionism, intertwined as it is with the notion of "cultural identity", which implies that "cheap" imported culture threatens a nation's indigenous culture, thereby exacerbating the market's unwillingness to supply cultural merit goods.

It is impossible in this short paper to evaluate the cultural-identity argument in any detail; however, the protectionist argument as applied to culture does not appear to be stronger than that applied to any other industry. Nor is there evidence of any great popular support for cultural protectionism. In a recent survey, Ontario residents felt that while the promotion of Canadian content should have a high priority, imports would damage neither Canadian content nor a Canadian cultural identity. These findings are similar to an earlier national survey, which concluded that while Canadians overwhelmingly support government financial support for films that "promote a distinctive Canadian identity," an even larger percentage oppose government control of which U.S. television signals are allowed into Canada. Thus, while many Canadians apparently believe in subsidies for some uniquely Canadian culture, they do not see its existence as necessarily threatened by foreign culture. This position is supported in principle by the insight that some culture has content of unique value to the population of an area. Thus, even in a free-trade environment, an irreducible amount of "national culture" is likely to be produced.

This is not to say that the market will necessarily produce an "optimal" amount of Canadian-specific culture. Rather, it is to say that any underproduction problem of this sort is more properly addressed through government subsidies. The impact of import restrictions largely will be to increase the short-term returns to specific factors of production. In the longer term, domestic output in protected sectors should expand. But sectors such as feature films are likely to be non-Canadian specific in nature, so the national-merit-good argument will be largely irrelevant in this context. The general-merit-good argument for direct (or indirect) protectionism is also fairly weak for "tradable" cultural services, since the impact of increased Canadian supply will be marginal against the background of international supply.

Conclusions and Policy Implications

A fairly widespread rejection of the relevance of neoclassical trade models to the culture sector, along with a fear of a loss of indigenous culture, has contributed to Canadian policymakers' taking a defensive posture toward cultural trade. I argued elsewhere that conventional arguments for free trade are as applicable to cultural industries as to other industries.

More specifically, while free trade would encourage a reallocation of cultural resources, this reallocation likely would be circumscribed to a fairly narrow set of cultural activities. For example, activities that draw upon a small number of specific talents and whose output is nationality specific present few problems.

Even where output is not nationality specific, there is no reason to believe that Canadian producers of cultural goods would be at a competitive disadvantage in activities such as the visual arts, creative writing, music composition, and so forth. To be sure, under a protectionist regime, relatively more of these cultural products would be supplied indigenously than would otherwise be the case. But the social costs likely would exceed the social benefits, since overall consumption would be lower.

Dislocation of resources likely would be greatest in those cultural sectors characterized by scale economies and whose output is largely nationality nonspecific. It is in these areas that the United States' absolute and comparative advantage poses a particular problem. However, U.S. output of this type may be just as valuable as Canadian output to Canadian cultural consumers.

The intellectually valid and irreducible concern of free trade in cultural services is that Canadians will substitute cheaper U.S. products and services for Canadian-specific cultural services. While it is individually rational for Canadians to make this substitution, collectively it may lead to an underconsumption of Canadian content, given that some of the benefits of Canadian culture have merit-good characteristics. Of course, it must also be pointed out that there is an income effect associated with cultural free trade. That is, Canadians would be able to consume more "real units" of culture, given lower real prices in that sector. Given a sufficiently strong income effect, the overall consumption of Canadian culture might well increase.

In summary, while cultural free trade is arguably good for Canada, conventional market-failure problems may still exist and the issue of domestic subsidies for culture remains relevant. I would suggest that, in a free-trade environment, small countries such as Canada have a strong incentive to focus their cultural support subsidies on nationality-specific activities while buying nonspecific cultural output as cheaply as possible. If production subsidies are deemed desirable, tariffs and other cultural trade barriers such as content requirements are not efficient substitutes.

NOTES

1. See S. Globerman and A. Vining, "Bilateral Cultural Free Trade: The U.S.-Canadian Case" (Simon Fraser University, Vancouver, 1984, Mimeographed); and S. Globerman, Cultural Regulation in Canada (Montreal: Institute for Research on Public Policy, 1983).

Implications for Canadian Commercial Policy of Negotiating a Free-Trade Area with the United States

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Introduction

In principle a free-trade area (FTA) between Canada and the United States should leave both countries free to pursue their own commercial policies toward third countries. Pressures may arise, however, to harmonize the application of such policies to trade with each other or with third countries. Both parties will have to identify such pressures at the outset and decide how to deal with them at the negotiating table.

This paper defines the issues that are likely to arise, in two steps. First, it examines some of the economic, legal, and political pressures that operate in the status quo to promote harmonization of Canadian and U.S. commercial policies with respect to both bilateral trade and trade relations with third countries. Commercial policies include border measures, such as tariffs and quotas, and domestic policies that can operate as nontariff barriers. The paper then focuses on some additional issues that could arise from the negotiation of a comprehensive trade agreement between Canada and the United States. These issues include harmonization of institutions and procedures for bilateral trade; harmonization of commercial policies for trade with third countries; longer-term strategic implications for the conduct of future Canadian trade policy; and the resolution of disputes about trade rules.

The Current Situation

Both Canada and the United States are signatories to the General Agreement on Tariffs and Trade (GATT) and all of the subsidiary agreements on nontariff barriers (NTBs) concluded during the Tokyo Round of multilateral trade negotiations.[1] These GATT agreements — supplemented by the Organisation for Economic Co-operation and Development (OECD) and other forums — provide the basic framework within which the two countries conduct their commercial relations with each other and with third countries. The GATT framework includes rules and procedures governing tariffs and quotas, and remedies against import competition. GATT rules also apply, with varying degrees of effectiveness, to such NTBs as domestic commodity tax policies and technical standards.

Tariffs and Quotas

The GATT process has been particularly successful in achieving gradual tariff reductions and, with the notable exception of agriculture, in largely eliminating the use of quotas and other quantitative restrictions. Through successive rounds of GATT negotiations, both Canada and the United States have reduced substantially their tariff levels. Although post-Tokyo Round Canadian tariffs remain higher on average than those in the United States, the pattern across industries in both countries tends to be very similar, as is illustrated in Table 1. This similarity reflects the concerns both countries share about the effects of import competition on labor-intensive industries — such as clothing and textiles — as well as the impact of the GATT negotiating process on both countries.

Contingent Protection

The import regulatory procedures of the United States and Canada have evolved into very similar systems. Two factors may account for this phenomenon. The first is the influence of successive rounds of GATT negotiations. After the Kennedy Round, for example, Canada introduced the requirement that there be an injury finding before antidumping duties are imposed. After the Tokyo Round, the United States introduced a similar prerequisite for the levying of countervailing duties.

The second factor is the tendency both countries have had to emulate each other's procedural protectionism. As Rodney Grey has argued, the process of codifying import regulatory procedures may have made it more acceptable for different countries to imitate the protectionist measures adopted by their trading partners.[2]

Each country's trade legislation has two elements. The first consists of remedies -- such as antidumping and countervailing duties, and measures against such practices as copyright or patent infringement -- that are intended to limit unfair trade practices. Both countries require, for example, that an independent tribunal make a determination that an industry is experiencing "material injury" -- or the threat of such injury -- before antidumping or countervailing duties are imposed. The second element, sometimes referred to as the "escape clause" or as "safeguards", is intended to provide temporary relief to domestic industries that are suffering from surges in imports. If industries can demonstrate "serious injury" from imports -- a stricter definition and more difficult to prove than "material injury" -- then quotas or additional tariffs may be imposed without demonstrating that the imports are unfairly traded.

Nontariff Measures

The GATT process has been more successful in negotiating limitations on the use of tariffs or other border measures than with domestic policies that may constitute NTBs. GATT trade rules, however, do deal with NTBs. The key GATT provision concerning NTBs is Article III, whereby signatories must grant "national treatment" — treatment no less favorable than that accorded products which originate in the home country — to imported goods. Countries are not permitted, for example, to assess discriminatory commodity taxes that may have protectionist effects similar to tariffs. This obligation admittedly imposes constraints on domestic policies, but it does not imply that countries need to have identical policies.

Standards and Technical Barriers

The GATT approach to dealing with standards or other technical regulations that may act as NTBs provides a useful illustration of how national treatment need not create harmonization pressures. Many government regulations and voluntary standards are intended to serve health, safety, and environmental objectives, and they affect the manufacture and distribution of goods. The negotiation of the Agreement on Technical Barriers to Trade (the Standards Code) in the Tokyo Round involved substantial efforts to limit the potential effects of standards as NTBs, which built on the commitment to national treatment embodied in Article III of the GATT. According to the Standards Code, regulations and standards do not necessarily have to be harmonized, but imported products have to be accorded national treatment. Thus, Canada can require bilingual labeling or stricter safety standards for products than does the United States as long as the same requirements are imposed on both domestic and imported goods.

In addition to the mechanism of the Standards Code, there are continuing efforts to achieve voluntary harmonization of Canadian and U.S. technical standards for the quality, performance, and safety of manufactured articles. This harmonization, however, does not extend to the same degree to other areas, including health and safety inspections — especially for food and agricultural products — and medical supplies.

Certification procedures and product-testing methods may create trade barriers to the export of manufactured products. While the principle of national treatment embodied in the Standards Code applies to these areas as well, problems can arise when, for example, one country refuses to accept the other country's test data. Scope exists for more bilateral cooperation in these areas, regardless of whether or not a trade agreement is negotiated.

Commercial Policies toward Third Countries

Pressures currently exist for Canada to harmonize its commercial policies toward third countries with those of the United States. One prominent example is the application of export controls to high-technology goods motivated by national-security objectives. Canada's NATO commitments oblige it to impose restrictions on the export of technologically advanced or sensitive products. In addition to this consensus framework within NATO, there is the extraterritorial application of U.S. laws to U.S. multinational companies, subsidiaries, or their licencees operating in Canada.

Harmonization pressures also exist in sectors characterized by managed trade. Recently, for example, Canada acted to impose country-of-origin marking requirements on imported steel in order to ensure that offshore steel was not entering Canada for reshipment to the United States.

While these examples suggest that harmonization pressures exist under the status quo, there can be no doubt that Canada and the United States pursue their own separate commercial policy objectives, both in trade negotiations and in the day-to-day administration and conduct of trade policy. The crucial question now to be considered is how a comprehensive trade agreement between the two would affect their economic relations with each other and with third countries.

Effects of a Comprehensive Trade Agreement

A trade agreement between Canada and the United States could be either a narrow one involving sectoral arrangements like the auto pact or a comprehensive one involving the elimination of substantially all bilateral barriers to trade. One problem with a sectoral approach is that obtaining the necessary GATT waiver — as the United States did with the auto pact in the 1960s — would be very difficult. More significantly, a sectoral approach would make a balance between the trade interests of the two countries very difficult to achieve in the negotiations. For practical purposes, then, Canada is left with the option of negotiating a comprehensive agreement, one that would meet the formal requirements for an FTA under Article XXIV 8(b) of the GATT. Such an arrangement is quite distinct from any proposal for a customs union, which would involve common external commercial policies for both countries.

Two types of pressures to harmonize commercial policies might arise from an FTA agreement. One would be to harmonize institutions and procedures for bilateral trade. The other would be to harmonize commercial policies for trade and economic relations with third countries.

Bilateral Trade

The key objectives of an FTA agreement would be to harmonize bilateral tariffs at a rate of zero and to reduce or eliminate NTBs. One of

Canada's key objectives in negotiating an FTA will be to limit the application of U.S. contingent-protection mechanisms to Canadian exports. A number of options for treating these U.S. actions have been suggested, including:

- complete bilateral exemption from the application of such contingent-protection mechanisms as antidumping and countervailing duties;
- binational administration of bilateral contingent-protection systems;
- exclusion of imports from other countries in determining injury; and,
- negotiation of stricter criteria for applying antidumping and countervailing duties combined with very tight restrictions on, and almost complete exemption from, the bilateral application of escape-clause measures.

The first three options were suggested in the Report of the Macdonald Commission.[3] The fourth option is essentially the one Richard Lipsey and I outlined in Taking the Initiative[4] and proposed by Debra Steger in another paper in this series. The option that is chosen will influence the degree of harmonization of bilateral institutions and procedures for import regulation that will be required.

The first option — complete bilateral exemption from antidumping and countervailing duties -- raises a number of issues. In the case of antidumping duties, bilateral exemption might make sense once tariff barriers -- which segment national markets -- are removed, because the potential for harassment of exporters from the other country would be greatly reduced. On the other hand, if antidumping duties were likely to be applied only rarely, then retaining such mechanisms for bilateral trade could be a relatively costless way to reassure domestic firms that fear being overwhelmed when bilateral barriers are reduced. Morever, if antidumping duties were eliminated, the issue then arises of harmonization of domestic laws proscribing price-discrimination. Robinson-Patman, for example, would apply to Canadian exports with similar effects.

The issue of bilateral exemption from the application of countervailing-duty laws raises difficult problems as well. What commitment would each government have to make about its subsidy practices in order for the other government to exempt it from the application of countervailing duties? The European Community, for example, does not permit application of countervailing duties to trade among member countries; instead, it has a complex, supranational regulatory and legal system intended to control the subsidy practices of member states.

The Macdonald Commission's second option — to have countervailing and antidumping laws administered on a binational basis — would provide an administrative process to deal with bilateral trade disputes. Some important questions, however, still would need to be resolved. For example, what would be the criteria for the application of these duties, and when would they be applied? In any event, binational administration of import regulation implies a remarkable degree of harmonization of laws and institutions.

The third and fourth options, dealing with injury rulings and the criteria for application of trade remedies, would involve both countries accepting common disciplines on their recourse to contingent-protection devices. The degree of harmonization of trade regulatory procedures and institutions, however, would not differ significantly from that which has already resulted from the common GATT obligations of the two countries.

Trade with Third Countries

Central to the concept of an FTA is the principle that each member country is allowed to maintain its own commercial policies toward nonmember countries. Thus, no formal pressures would arise from the nature of the contemplated arrangement with the United States to harmonize any Canadian economic policies with respect to third countries. For example, each country could make independent decisions about trade embargoes or other economic sanctions motivated by foreign policy objectives. Canada could choose to participate in a U.S. embargo of grain shipments to the Soviet Union, as occurred after the invasion of Afghanistan, but there would be no formal obligation to participate. In other cases, such as the current U.S. embargo on trade with Nicaragua, Canada could maintain its present independent stance.

Although each country would maintain its own independent commercial policies and trade relations with third countries, there remains the question of whether an FTA would set in motion subtle economic and political pressures for harmonization of the two countries' commercial policies.

Deflections of Trade and Production

The simplest type of harmonization pressure that can arise in an FTA results from what is called "pass-through" trade. If substantial discrepancies exist in the level of protection afforded particular products in the member countries, then third countries have an incentive to export to the member country that has the lowest import restrictions on that particular product, in the hope that the product can then be exported duty free to the other FTA members. Left unchecked, this evasion of import barriers creates pressures for the FTA members to harmonize their import barriers. As a result, there could be a tendency for the FTA eventually to evolve into a customs union.

In principle, at least, the problem of pass-through trade can be solved relatively easily. When a product moves from the FTA member with the lower external barrier into the territory of the FTA member with the higher external barrier, then the difference in tariff duties simply would have to be paid at that point. In fact, Article I of the GATT requires that this type of solution be implemented.

The example of pass-through trade illustrates the general problem of determining what products ought to qualify for duty-free access between FTA members. Pass-through trade might be regarded as a special case of the more general phenomenon of trade deflection. Only modest amounts of processing or manufacturing in the member country with the lower import barrier might render it very difficult to recapture the discrepancy in tariff levels when the product in question enters the other member country with the higher external duties.

Rules of Origin

To prevent problems of trade deflection, virtually all FTAs impose rules-of-origin criteria before products can qualify for duty-free access. These criteria set minimum levels of value added by member countries according to the type of product involved. Thus, primary products such as fresh fruit simply would have to be produced in one of the member countries in order to qualify for duty-free entry. But manufactured end products might require that thirty, forty, or fifty percent of the value added in processing and manufacture must occur in the member countries in order to qualify.

The purpose of rules of origin is to avoid the need to harmonize import restrictions. If discrepancies in import barriers are very large, however, they can create incentives for production deflections — that is, incentives to locate production in the country with the lowest import barriers in order to capture the benefits of the pass-through effect.

Effective Protection

Since production deflections to satisfy rules-of-origin criteria must involve significant amounts of value added, the issue here involves the structure of effective protection. Thus, it is not so much the disparity of import barriers on particular end products that matters but, rather, the potential anomalies in the entire structure of effective protection between the two countries.

Effective-protection rates calculate the advantage afforded a particular production activity through a tariff on its output adjusted for the effects of tariffs on its inputs. The effects of a tariff on the incentives to relocate a particular production process can be magnified greatly by the interaction of input and output tariffs.

Consider the following examples. In each case, a manufacturing industry assembling a consumer durable has an output tariff of 10 percent. In Case A, however, there is no input tariff, while in Case B there is an input tariff of 10 percent.

	CASE A No input tariff	CASE B Input tariff of 10 percent
Price of components on world markets	$ 50	$ 50
Duty paid on components	0	$ 5
Cost of inputs	$ 50	$ 55
Break-even cost of assembly	$ 60	$ 55
Sale price, inclusive of the tariff	$110	$110

In either case, if foreign manufacturers can assemble the good for $50 and the final product is available for import at a cost of $100, an import duty of 10 percent would raise the price of the imported consumer product to $110. In Case B, where an import duty of 10 percent must be paid on the input, the domestic manufacturer could have costs 10 percent higher than those of the foreign manufacturer and still be competitive in the domestic market. In Case A, where there is no import duty on the input, then the domestic manufacturer's assembly costs could be as high as $60 -- that is, as much as 20 percent higher than those of the foreign manufacturer -- and still remain competitive. The combined effect of output and input tariffs on the break-even level of costs is known as the "level of effective protection".

The magnification of effective-protection rates of low-input tariffs becomes greater when the amount of value added by a particular production process is relatively less. Suppose that the foreign manufacturer can assemble the product for $30. With an import tariff of 10 percent on the consumer product, the product will sell for $88 in the domestic market. With an input tariff of 10 percent, the domestic manufacturer could have costs of $33, or 10 percent higher than those of the foreign manufacturer. With no input tariff, the domestic firm can have assembly costs as high as $38, or 27 percent higher than those of the foreign manufacturer.

Consider the situation in an FTA. Suppose that both member countries have a 10 percent tariff on the final good, but Country 1 levies a tariff of 10 percent on the components, while Country 2 does not. If rules-of-origin criteria require 50 percent value added, then a manufacturer in Country 2 can have assembly costs as high as $60 and still supply the product to Country 1. By comparision, assembly costs in Country 1 can be $55, while offshore manufacturers can have costs of $50. Consequently, a manufacturer in Country 2 can have costs 20 percent higher than those of offshore manufacturers and up to 8 percent higher than those of manufacturers in Country 1, while remaining competitive both in the domestic market and in exports to Country 1.

If rules-of-origin criteria require only 30 percent value added, then discrepancies in costs of production within the FTA potentially can be even greater. In such a scenario, a manufacturer in Country 2 can have costs 15 percent higher than those in Country 1 and still remain competitive.

Of course, if the input and output tariffs are the same in both countries, there is no difference in the rates of effective protection for manufacturers in either country. When both countries' input and output tariffs are similar — and, in particular, when input tariffs are low or zero in both countries — then there is no trade deflection, even when rules-of-origin criteria contain a low value-added requirement.

The issue, then, is whether quantitative discrepancies in effective-protection rates across different economic activities in Canada and the United States are sufficient to distort significantly the incentives to locate production in one country rather than the other. If discrepancies in these rates are low, very liberal rules of origin could be implemented.

Duty Drawback

An issue related to rules-of-origin criteria is the question of whether "duty-drawback" provisions should be applied to trade between the FTA partners. Such provisions, by remitting duties on imported components when products that incorporate the components are exported, permit an exporter to have costs that more closely correspond to world prices. In this context, duty drawback is not an export subsidy but simply a means of removing an impediment to trade. Following this reasoning, the GATT Subsidies Code excludes the drawback of duties on imported components from its illustrative list of export subsidies.

The effects of duty drawback are potentially different within an FTA. Under these circumstances, the application by one member of duty drawback on imports from third countries can be perceived as having the effect of an export subsidy to other FTA members. Duty-drawback provisions within the FTA, therefore, can increase substantially the potential for deflections of production. In effect, duty-drawback provisions imply that input tariffs will be effectively zero for export industries. Thus, there is a tradeoff between having relatively liberal rules-of-origin criteria and permitting duty drawback.[5]

Of course, domestic producers of raw materials or components may resist the application of duty drawback within the FTA for reasons other than efficiency objectives. Such provisions, for example, might lead to a significant lowering of the effective protection afforded input producers selling to export industries and, thus, adversely affect profits and capacity utilization in those sectors.

Sectors Involving Managed Trade

The stakes involved can become much higher in sectors where combinations of both quotas and tariffs are applied to particular products. In the textiles and clothing sectors, for example, the stacking of quotas and tariffs creates very large potential discrepancies in effective protection on particular products or stages of processing. (Furthermore, there may be administrative problems in ensuring compliance with rules-of-origin criteria in such sectors.) If offshore imports flow through one country, then the country with the higher import barriers is likely to urge the other country to raise its external barriers.

If there is a domestic import-competing lobby to reinforce these pressures, then there could be a tendency to emulate the higher import barriers of the other country. Thus, the pressures for harmonization of commercial policies could be greater in sectors characterized by managed trade. At the same time, however, countries may also have incentives to tilt their structure of effective protection so as to increase potential production deflections. Imposing stricter rules-of-origin criteria on sectors characterized by managed trade could help resolve these difficulties.

Administration of Rules of Origin

The administration of any system of rules of origin in an FTA requires coordination of customs administrations in the member countries and the retention of customs points between them. Although any system of rules of origin imposes a compliance burden on firms, a system analogous to that used by the European Free Trade Association (EFTA) is likely to be less costly to administer than a cumbersome and complicated system similar to that used in the agreements between the European Community and the former EFTA countries.[6]

Export Controls

Some of the issues associated with export controls on technology-related goods and services have already been mentioned. A much more difficult and contentious set of issues concerns export controls or taxes on resource products. Under an FTA, each country would retain the right to such controls, and the GATT, in fact, does permit export taxes and allows the use of export controls for a number of purposes.[7]

Two sorts of issues arise in the application of export controls to resource products. One involves the problem of emergencies or supply disruptions. Although the two countries might have divergent views on the applicability of export controls in these areas, it should be possible to reconcile these views.

Much more contentious is the issue of permanent export controls or taxes on primary resource products. To Canadians, such controls are both an essential element of their sovereignty and a legitimate means of protecting their ability to manage their resource base. To Americans, any disparities between foreign, domestic and world resource prices that result from the operation of export controls are unjustified subsidies to resource-based industries — at least when this is the practice of other countries. The Gibbons bill (HR2541), currently before Congress, is aimed directly at the resource policies of Canada and Mexico.

If, in the context of a bilateral comprehensive trade agreement, Canada did agree to obligations proscribing export controls on resource products, this would undercut the logic of the Gibbons bill or similar proposals. Regardless of any differences in resource tenures or management policies between the two countries, if primary resource products can trade freely between them, then little or no advantage will be conveyed to the processing industries except for modest differences in transport costs.

If bilateral export controls are to be removed, however, some problems must be considered. First, Canadians will want to be assured that they can effectively manage the extraction and exploitation of their resource base. Second, they will want to ensure that trade in resource products across the Canadian-U.S. border occurs on an arms-length basis or is valued on the basis of market prices. Canadians might be concerned about intracorporate transfers of primary resources in situations where a market price for particular products cannot be readily determined. Sensitivities about transfer pricing are particularly acute in the case of resource products. Third, the obligations should be reciprocal.

Although these concerns could be remedied or addressed in a bilateral arrangement, other problems are likely to prove more elusive. Let us take the example of the export of logs. Recent data compiled by the Canadian forest industry suggest that the prices of comparable logs available to processing facilities on both sides of the border correspond very closely indeed. Thus, while allowing free trade in logs between the two countries likely would have negligible economic affects, it would deflect many of the allegations by U.S. producers that Canadian sawmills or pulpmills are subsidized by virtue of differences in stumpage practices and resource tenures.

The problem that arises in this context is that both countries have significant trade in both logs and lumber with a third country, Japan. Furthermore, Japan has a high tariff on imported lumber. Thus, free trade in logs between Canada and the United States could result in logs being moved from Canada into the United States and then being re-exported to Japan, thereby allowing Japanese purchasers of logs to circumvent Canadian export controls. This problem is analogous to that of pass-through trade with imports discussed above.

In principle, the problem of pass-through exports could be addressed by a processing provision analogous to rules of origin. But it could be more difficult to administer because the existing system of export administration is much less developed than that of import control regimes.

Contingent Protection

It is uncertain whether there will be any additional limitations on, or perhaps bilateral exemption from, the application of contingent-protection mechanisms. However, even if there were special features or even exemption in bilateral contingent protection, would it be necessary for the two countries to have common external contingent-protection mechanisms?

We do not need to know the answer to the first question to be able to answer the second. Each country would retain its own customs agents and customs points and the same administrative arrangements involving rules of origin would apply to goods that were subject to antidumping and countervailing duties or other contingent-protection remedies. Thus, even if there were bilateral exemptions in the application of contingent-protection devices, each country could still retain separate external systems. Not only would it be unnecessary for Canada and the United States to merge their contingent-protection systems for dealing with third countries, it is very unlikely that either would ever want to do so.

The Conduct of Multilateral Trade Negotiations

An essential feature of an FTA is that each country goes its separate path in the negotiation of trade barriers with third countries. Are there any qualifications to this situation? Are there any subtle economic or political pressures that might constrain the commercial policy of one or the other country in their negotiations with third countries? What will be the implications for the evolution of the multilateral trading system?

The conduct of tariff negotiations is relatively straightforward. Within the GATT context, tariff negotiations are conducted on a bilateral basis between the principal supplier of a product and the importing country. Under these rules, bilateral negotiations with the United States have always been the dominant consideration in multilateral negotiations by Canada. One result of an FTA agreement would be that other countries would become the principal suppliers of products that were previously the focus of Canadian-U.S. negotiations. Thus, Canada could shift the focus of its tariff-negotiating strategy to its trade with these other countries.

The general situation would be analagous to that which prevailed during the Tokyo Round tariff negotiations on automobiles. The United States is by far the largest supplier of automobiles to Canada but, under the special provisions of the auto pact, automobiles from the United States enter Canada duty free. As a result, the principal focus of automotive tariff negotiations shifted to other countries, notably Japan. Since, in an FTA, Canada would no longer be conducting its principal tariff negotiations with the United States and then making this tariff offer available to other countries under the GATT Most-Favored Nation rule, the effect could be to enhance Canada's negotiating leverage in tariff negotiations with third countries.

At the same time, however, either country might attempt to exert subtle influence over the other's tariff negotiations. Canada, for example, might lobby the United States to retain particular U.S. tariff barriers that have the effect of creating preferential treatment to Canadian producers who would have duty-free access under the FTA. The United States might lobby Canada to retain tariff barriers that yield particular benefits to U.S. producers given the preferential access that they would have under the agreement. Although each country likely would try to influence the other to retain these types of external trade barriers, each would have an incentive to lower these barriers in order to attain their own individual objectives in negotiations with third countries.

Future multilateral trade negotiations are likely to achieve reductions in the external tariff barriers of both countries. One result of this process would be that the margins of preference that each would have into the other's market under an FTA agreement would be progressively reduced. At the same time, there is no reason to suppose that direct improvements in access achieved on a bilateral basis would be eroded through subsequent negotiations by either country with third countries.

The situation in an FTA would be quite different from that which characterized bilateral reciprocal arrangements made during the nineteenth century. Under those types of agreements, an improvement in bilateral access that was obtained under a particular treaty subsequently could be completely dissipated if one of the parties negotiated reductions in tariffs with a third country to levels below those available to the other partner to the original bilateral agreement. Impairment of bilateral market access could not occur in the case of an FTA agreement where the member countries go to zero tariffs among themselves.

The question of the longer-term effects of bilateral FTA agreements was recently considered by U.S. Secretary of State George Shultz:

> From a global perspective, a splintering of the multilateral trading system into a multitude of bilateral arrangements would be a backward step. Bilateral free trade agreements, however, such as we have negotiated with Israel and have offered to discuss with other countries, need not have this result; they can stimulate trade and strengthen the multilateral system. Free trade agreements are sanctioned by the international rules and involve a tighter trade discipline; they can promote freer trade than the multilateral system is currently prepared to accommodate. Our hope, nonetheless, is that the example of greater liberalization — and the recognition that the United States can pursue another course — will help motivate a larger group of nations to tackle the job of expanding trade on a global basis.[8]

Elaborating on this theme, the Council of Economic Advisers argues that "the possibility of an FTA...offers the United States and others the option of using a free-trade instrument, rather than protectionism, as a lever against protectionist countries."[9] The Council argues that the preferred access available to members of an FTA provides an incentive for other countries to engage in trade negotiations. This strategy of liberalizing trade is preferable to attempts to use threats of trade restrictions to induce other countries to negotiate: since such measures would impose costs on the home country, the threats would lack credibility. Furthermore, if implemented, they would invite retaliation.[10]

Dispute Resolution

Inevitably, disputes will arise in future economic relations between Canada and the United States. Similarly, disputes can be anticipated between either country and third countries. How might a bilateral agreement affect the future management of Canada's economic relations?

Simply because Canada and the United States seek to enter into an FTA agreement does not mean that their existing multilateral obligations under the GATT become irrelevant. Both countries would continue to manage their relations with third countries through the GATT. Similary, GATT rules would still apply to bilateral trade. The U.S.-Israeli FTA agreement, for example, incorporates the common GATT obligations of the two countries. From a Canadian perspective, an FTA agreement is only attractive in terms of what U.S. Secretary of State Shultz refers to as "tighter trade disciplines" within the GATT framework.

If existing GATT rules are considered to be satisfactory to both countries on particular issues, then the bilateral agreement could incorporate these multilateral rules. If a dispute arose on those issues, then either country could have recourse to existing dispute-settlement procedures under the GATT. Canada would not, however, have recourse to the GATT for the settlement of disputes on issues where the bilateral obligations go beyond GATT rules. This situation already prevails with the auto pact. Canada would be unable to lodge a GATT complaint if U.S. policies derogated from the auto pact provisions but did not contravene the GATT.

Although the United States has not introduced measures that directly undermine the auto pact, there is considerable risk that future U.S. legislative or policy actions could erode the benefits obtained from an FTA agreement.[11] For this reason, I recommend a formal bilateral dispute-settlement process and the creation of a binational arbitral tribunal.[12] Such a tribunal could investigate the facts on particular disputes and interpret the terms of the agreement. While its findings — like those of GATT panels — would not be formally binding on the two countries, they likely would be persuasive in most cases. In the event of a severe breakdown in the bilateral agreement, both countries simply would revert to their common obligations under the GATT.

Conclusion

The purpose of negotiating an FTA is to apply common rules to bilateral trade. The degree of further harmonization of bilateral contingent-protection systems that will be required depends on the approach that is taken to bilateral import administration in the FTA agreement. Under the most likely approach — tighter rules governing each country's trade laws and procedures — the degree of additional harmonization will be modest.

The essential feature of an FTA is that each member continues to have separate and distinct commercial policies for relations with third countries. The removal of bilateral trade barriers creates incentives for trade deflection -- because of differences in external trade barriers -- but most problems can be resolved in advance through negotiation of rules-of-origin criteria. As Victoria Curzon says about the EFTA experience:

> It was an amazing technical success, in that the various administrative problems associated with operating a free trade area worked smoothly and did not impede the growth of trade. Visible distortions in the pattern of production and investment due to variegated national tariffs did not occur. The EFTA experience therefore confounded the critics of the negotiations and proposals in the late 1950s for a pan-European free trade area, who had predicted dire consequences if no harmonization of external tariffs took place.[13]

This discussion of some of the effects of an FTA on trade flows suggests two quite contradictory influences on the commercial policies of the member countries. On the one hand, one member is likely to urge the other to harmonize its external commercial policies to prevent increases in trade deflections or diversions. This problem can largely be solved by the rules-of-origin criteria, but careful negotiation of these criteria will be required. Indeed, far from harmonizing their external trade barriers, members of the FTA can be expected to use their external trade barriers as bargaining chips in multilateral trade negotiations.

On the other hand, the commercial policies of Canada and the United States will continue to evolve if an FTA agreement is concluded. There is little evidence or analysis to support the contention that an FTA inevitably will lead to a closer form of economic integration, such as a customs union. An alternative and perhaps more likely outcome, suggested by Gary Hufbauer of the Institute of International Economics in Washington, D.C., is that future rounds of multilateral trade negotiations eventually will result in a free-trade area involving most of the OECD countries.[14] The negotiation of an FTA agreement between Canada and the United States could contribute to this process.

Both countries have a common interest in reinforcing multilateral dispute-settlement mechanisms. In addition, developing an effective bilateral dispute-settlement process will be vital to the sucessful operation of a free-trade arrangement between the two countries.

NOTES

1. The five new agreements on nontariff measures reached during the Tokyo Round are: an agreement on interpretation and application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade (the Subsidies Code); an agreement on technical barriers to trade; an agreement on government procurement; an agreement on import licensing procedures; an agreement on customs valuation procedures. In addition, the Antidumping Code negotiated during the Kennedy Round was revised in the Tokyo Round Negotiations.

2. R. de C. Grey, "A Note on U.S. Trade Practices," in W.R. Cline, ed., Trade Policy in the 1980s (Washington, D.C.: Institute for International Economics, 1983), p. 248.

3. Canada, Royal Commission on the Economic Union and Development Prospects for Canada [Macdonald Commission], Report, vol. I (Ottawa: Supply and Services Canada, 1985), pp. 310-322.

4. R.G. Lipsey and M.G. Smith, Taking the Initiative: Canada's Trade Options in a Turbulent World, Observation no. 27 (Toronto: C.D. Howe Institute, 1985), pp. 148-159.

5. Secretariat of the European Free Trade Association, Stockholm Convention Examined (Geneva: Secretariat of EFTA, 1963), p. 24.

6. See the European Community agreements with Finland, Norway, Sweden, and Iceland in Collection of the Agreements concluded by the European Communities, Volume 2 (Luxembourg: Official Publications of the European Communities, 1977).

7. The GATT permits export controls for the following reasons:

o "To prevent or relieve critical shortages of foodstuffs or other products essential to the exporting contracting party." Article XI:2(a)

o To conserve "exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption." Article XX (g)

o In conjunction with price controls on raw materials. Article XX (i)

o For national security purposes. Article XXI

One GATT authority concludes that "these exceptions...leave very little if any, effective GATT policing of export control policies" (J.H. Jackson, World Trade and the Law of the GATT [Indianapolis: Bobbs-Merill, 1969], p. 502). This situation has led to proposals for new trade rules for export controls and taxes (see C.F. Bergsten, Completing the GATT: Toward New International Rules to Govern Export Controls [Washington, D.C.: British-North American Committee, 1974]).

8. The Hon. G. Shultz, "National Policies and Global Prosperity" (Address by the Secretary of State before the Woodrow Wilson School of Public and International Affairs, Princeton University, Princeton, New Jersey, April 11, 1985), p. 22.

9. United States, Executive Office of the President, Economic Report of the President, transmitted to the Congress February 1985, together with the Annual Report of the Council of Economic Advisers (Washington, D.C.: U.S. Government Printing Office, 1985), p. 126.

10. Ibid.

11. M.G. Clark, "Nontariff Measures: Perceptions and Reality," in D.W. Conklin and T.J. Courchene, eds., Canadian Trade at a Crossroads: Options for New International Agreements (Toronto: Ontario Economic Council, 1985) p. 274.

12. M.G. Smith and D.P. Steger, "Canada's Constitutional Quandary: The Federal/Provincial Dimension in International Economic Agreements," in Conklin and Courchene, Canadian Trade at a Crossroads, p. 375.

13. V. Curzon, The Essentials of Economic Integration: Lessons of EFTA Experience (London: Macmillan, 1974), p. 18.

14. G. Hufbauer, "The Next International Trade Negotiations — A Reagan Round?" Looking Ahead (National Planning Association) 7 (February, 1985): 1-5.

Table 1

Post-Tokyo Round Tariffs on Industrial Products by Sector:
Canada, United States, and All Industrial Countries
(percentage)[a]

Sector	Canada	United States	All industrial countries
Textiles	16.7	9.2	8.5
Wearing apparel	24.2	22.7	17.5
Leather products	6.3	4.2	3.0
Footwear	21.9	8.8	12.1
Wood products	3.2	1.7	1.9
Furniture and fixtures	14.3	4.1[b]	7.3
Paper and paper products	6.7	0.2	4.2
Printing and publishing	1.0	0.7	1.5
Chemicals	7.5	2.4	6.7
Rubber products	6.7	2.5	4.1
Nonmetal mineral products	6.4	5.3	4.0
Glass and glass products	7.2	6.2	7.9
Iron and steel	5.4	3.6	4.4
Nonferrous metals	2.0	0.7	1.6
Metal products	8.5	4.8	6.3
Nonelectrical machinery	4.5	3.3	4.7
Electrical machinery	5.8	4.4	7.1
Transportation equipment	1.6	2.5	6.0
Miscellaneous manufactures	5.4	4.2	4.7
All industries	5.2	4.3	5.8

a. Weighted by own-country imports, excluding petroleum.
b. Estimated from incomplete data.

Source: A.V. Deardorff and R.M. Stern, "Economic Effects of Complete Elimination of Post-Tokyo Round Tariffs," in W.R. Cline, ed., Trade Policy in the 1980s (Washington, D.C.: Institute for International Economics, 1983), pp. 674-675.

The Impact of U.S. Trade Laws on Canadian Economic Policies

by

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CONTENTS

Introduction

Since the negotiation of the General Agreement on Tariffs and Trade (GATT) in 1947, tariff barriers gradually have come down. In their place, however, has arisen an elaborate system to regulate foreign imports and to counter what are viewed as "unfair trade" practices of foreign countries. The United States, in particular, has developed an elaborate import regulatory system that now constitutes one of the most contentious issues in Canadian-U.S. trade relations. These procedures create private rights for domestic U.S. industries to seek redress against the practices of foreign governments and business and to limit disruptive import competition.

The major U.S. trade acts of 1962, 1974, 1979 (the Trade Agreements Act of 1979, which implemented U.S. obligations negotiated in the Tokyo Round of multilateral trade negotiations), and 1984 (the Trade and Tariff Act of 1984) demonstrate the growth in the United States of a legalistic and complex governmental system of import regulation, or "contingent protection". A private U.S. citizen now can invoke a dozen different procedures and processes to seek relief from imports. To counter growing protectionist sentiments in the U.S. Congress, emerging administration policy appears to be to initiate more unfair trade actions on behalf of the U.S. government. The system of remedies now contained in U.S. trade law includes countervailing duty and antidumping procedures; investigation of unfair trade practices such as patent, copyright, or antitrust infringement under Section 337 of the Tariff Act of 1930; initiation of complaints against unfair foreign government practices affecting U.S. exports or other trading activities under Section 301 of the Trade Act of 1974; procedures for escape clause relief; and a variety of other proceedings.

Rodney de C. Grey has characterized contingent protection systems as "power-oriented":[1] only a large industrial state can operate effectively the large bureaucratic establishment and mass of detailed legislation required to maintain such a system. The impact of countervailing duty and antidumping actions, Grey argues, will be greater on a smaller, trade-dependent economy such as Canada. Plants in a smaller country export a large portion of their output and, thus, a countervailing duty or antidumping action taken in another country can have devastating effects on their overall profitability. Plants in a large economy such as the United States, on the other hand, sell most of their production in the domestic market and, thus, are not as vulnerable to unfair trade actions taken in other countries.

In 1984, Canada shipped 76 percent of its exports to the United States. The elaborate U.S. contingent protection system thus has a profound impact on Canadian government policymaking and on the business activities of Canadian exporters. From Canada's perspective, the main trade irritants in the U.S. contingent protection arsenal can be classified broadly into two groups. The first consists of countervailing duties and other measures directed at Canadian government policies or business practices that the United States views as constituting unfair trade. In the second group are formal or informal restraints directed at Canadian exports deemed to be disruptive to U.S. industry.

This paper describes these two groups of trade irritants and examines their implications for Canadian economic policy. It then offers suggestions as to how bilateral trade negotiations might limit the impact on Canada of U.S. trade laws.

Unfair Trade Laws

U.S. Countervailing-Duty Laws

Canada's practice of subsidizing its industries and the United States' adoption of retaliatory measures in the form of countervailing duties undoubtedly are the most important trade irritants between the two countries. Countervail is defined as a procedure by which an importing country levies duties to counteract the unfair trade practice of a foreign country subsidizing the exportation or production of a product. U.S. countervailing duty law dates back to 1890, and Article VI of the GATT authorizes countervailing duties. However, only since the United States enacted the Tokyo Round arrangements in the Trade Agreements Act of 1979 has it brought countervail cases in any numbers. Since the end of the Tokyo Round, the United States has been far and away the most active enforcer of domestic countervailing duties. Between 1980 and 1984, the United States initiated 123 actions, compared with 8 by Canada and Australia, 6 by the European Community, and 1 by Japan.[2]

The United States' greater emphasis on countervailing duty procedures reflects its philosophical commitment to free-market principles. It pioneered, both in its own trade legislation and in multilateral negotiations, the whole question of disciplining the use of subsidies and countervailing duties. It approached the Tokyo Round with the objective of persuading other countries to discipline their use of subsidies. Most of the other participants, however, viewed the use of subsidies — with the exception of export subsidies -- as strictly a question of national or internal policy,[3] and their objective was to have the United States adopt an injury test in its countervailing duty actions.

The Subsidies Code agreed to in the Tokyo Round contains a two-track procedure. Track I regulates the imposition of countervailing duties by a signatory on products imported from another signatory. Article 2 of the Code stipulates that countervailing duties may be imposed only after there has been an investigation and findings of (a) a subsidy and its amount, (b) material injury or the threat of material injury to a domestic industry, and (c) a causal link between the subsidized imports and the alleged injury.

Track II of the Subsidies Code provides for government-to-government consultations, conciliation, dispute settlement, and authorized countermeasures within the context of the GATT system. Articles 8 through 11 of the Code recognize the right of governments to use subsidies to promote important objectives of social and economic policy, prohibit the use of export subsidies on products other than certain primary products, and enjoin signatories to avoid causing, through the use of any subsidy, injury to a domestic industry or serious prejudice to the interests of another signatory. Article 11 has particular importance for Canada, since it acknowledges the right to use domestic (nonexport) subsidies to promote such policy objectives as the elimination of industrial, economic, and social disadvantages of regions; to facilitate the restructuring of certain sectors made necessary by changes in trade patterns; to combat unemployment and promote retraining; to encourage research and development, especially in high-technology industries; to promote economic and social development of developing countries; and to encourage redeployment of industry to avoid congestion and environmental problems.

As a result of their unique histories and political cultures, the United States and Canada have developed different philosophical views both on the use of subsidies as an instrument of government policy and on the international discipline of subsidies through the use of countervailing measures. Of the major industrial countries, the United States, since 1952, has persistently exhibited the lowest ratio of subsidies to gross domestic product. In 1980, the U.S. ratio was 0.43, a decline from 0.50 in 1968. Between 1968 and 1980, only Canada and Italy noticeably increased their relative levels of subsidization (France and the United Kingdom have had extensive subsidy systems in place since the end of World War II). Canada's subsidy-to-GDP ratio rose from a low of 0.39 in 1956 to 0.87 in 1968 and to a high of 2.34 in 1980.[4]

Current U.S. Procedures

Current U.S. countervailing duty laws — contained in Title VII of the Trade Agreements Act of 1979 and Title VII of the Tariff Act of 1930 as amended by the Trade Act of 1974 -- provide procedures whereby a manufacturer, producer, wholesaler, union, group of unions, trade association, or the U.S. government can initiate a complaint against imports of subsidized products from another country.[5] Under Section 701 of the Trade Agreements Act of 1979, the complaint procedure involves two U.S. government agencies. The Commerce Department's International Trade Administration (ITA) is charged with determining whether a foreign government "is providing, directly or indirectly, a subsidy with respect to the manufacture, production, or exportation of a class or kind of merchandise imported into the United States." For its part, the International Trade Commission (ITC) is to determine whether "an industry in the United States is materially injured, or is threatened with material injury, or the establishment of an industry in the United States is materially retarded, by reason of imports of that merchandise." If the finding is affirmative in both cases then, in the words of Section 701: "there shall be imposed upon such merchandise a countervailing duty, in addition to any other duty imposed, equal to the amount of the net subsidy [emphasis added]."[6]

The proceedings can be initiated by private petition or by the ITA. After a petition is filed, the ITC has 45 days to make a preliminary determination of injury or threat of injury. If its determination is negative, the investigation ceases. The ITA, meanwhile, has 85 days after the petition is filed to make a preliminary determination concerning the provision of a subsidy. If the ITA's preliminary determination is affirmative, all entries of the merchandise are halted at the border and suspended in warehouses, and the exporter must post a bond in the amount of the "net subsidy" on all imports of the merchandise into the United States.[7] "Net subsidy" means the gross subsidy adjusted for deferral of receipts from, or special charges by, the foreign government.

Within 75 days of the date of its preliminary determination — after holding public hearings and giving all interested parties an opportunity to be heard — the ITA must make a final determination of whether a subsidy is being provided. Similarly, the ITC has 120 days after its preliminary determination — or 45 days after the ITA's final determination — to conduct hearings, investigate, and make a final determination of material injury.[8] If the ITA and ITC both make affirmative final determinations, the ITA then orders customs officials to assess countervailing duties equal to the net subsidy provided on the imported merchandise.[9]

Current U.S. countervailing duty laws are administered as a time-limited, mandatory, quasi-judicial system. Judicial review of the decisions of the ITA and ITC has been available to private citizens since the Trade Act of 1974. There is no room for discretion or intervention by the executive branch in the process. These procedures, however, while providing predictability, freedom from corruption, certainty, and fairness in the application of the law to U.S. private interests, can be used by special interests to harass foreign export industries and foreign governments and thus to manipulate U.S. foreign policy.[10]

Definition of Subsidy

There are three substantive issues in a countervailing duty action as prescribed by Article 2 of the GATT Subsidies Code and Section 701 of the U.S. Trade Agreements Act of 1979:

- o the existence of a subsidy;
- o material injury to a domestic industry, threat of material injury to a domestic industry, or material retardation of the establishment of a domestic industry; and,
- o a causal link between the subsidized imports and the alleged injury.

In U.S. law, material injury means "harm which is not inconsequential, immaterial, or unimportant." It is to be assessed in terms of, first, the volume of imports of the merchandise; second, the effect of the imports on prices in the United States for similar products; and third, the impact of the imports on domestic producers of similar products.[11] Generally speaking, injury will be found whenever there is an absolute increase in the volume of imports and an actual or potential decline in the output, sales, market share, profits, productivity, return on investment, or utilization of capacity in the U.S. domestic industry.

The injury test is not onerous and causation is not really a separate issue in practice. An increase in the volume of imports need be only one cause of injury to a U.S. industry; it need not be the predominant cause.

Rodney de C. Grey has criticized the concept of injury in the GATT as having "little if any economic content." He argues that,

> this defect in the international system has been reinforced by the fact that in importing countries, particularly in the United States, injury as a concept has been taken into domestic trade relations law primarily as a legal, not economic, concept. As a practical matter, this has tended to buttress the restrictive and protective effect of the system of contingency measures.[12]

In recent cases, determination of the existence of a subsidy has been a more significant issue. The GATT Subsidies Code and U.S. law recognize basically two categories of subsidies. The first consists of export subsidies that are prohibited by the Code except on certain primary products. The second category consists of domestic production subsidies that may be granted to encourage regional development, alleviate unemployment, provide assistance for worker retraining, promote research and development, or facilitate adjustment and restructuring of an industry.

Export subsidies are benefits provided by a foreign government contingent upon export performance or benefits that operate and are intended to stimulate export sales. Annex A to the GATT Subsidies Code — specifically incorporated into U.S. law — lists some examples:

o provision by governments of direct subsidies to a firm or industry contingent upon export performance;

o currency retention schemes or any similar practices that involve a bonus on exports;

o full or partial exemptions, remission, or deferral specifically related to exports, or direct taxes or social welfare charges paid or payable by industrial or commercial enterprises;

o provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programs, or of exchange risk programs, at premium rates, that are manifestly inadequate to cover the long-term operating costs and losses of the programs.

Both the GATT Subsidies Code and U.S. law have treated export subsidies as inherently bad, and both the U.S. Treasury Department and the ITA have countervailed such subsidies consistently. For example, Export Development Corporation's $563 million loan to Bombardier Inc. at 9.7 percent interest over 15 years was clearly an export subsidy and the ITA and the ITC determined it to be countervailable in 1983.[13]

Although the United States levied countervailing duties on some foreign domestic subsidies as early as the 1920s, it was not until the 1960s, with increasing U.S. trade deficits, that the Treasury Department began to apply countervailing duty laws more aggressively to imports bearing production subsidies. In 1973, the Michelin Tire case became the first in which countervailing duties were imposed on domestic subsidies. In 1967, after an intense North American competition, Michelin Tire had been induced to locate a plant to manufacture steel-belted radial tires in Nova Scotia. Michelin's decision was influenced by a package of grants and special accelerated depreciation from the federal government, grants and low-interest loans from the Nova Scotia government, and concessions on property taxes from the municipalities involved. The U.S. Treasury Department's 1973 ruling was based on the theory that the subsidies had an export stimulative effect, since 75 percent of the plant's production was to be exported to the United States.

The Trade Agreements Act of 1979 was the first U.S. trade legislation specifically to include a definition of domestic subsidy. According to the act, countervailable domestic subsidies include:

- the provision of capital, loans, or loan guarantees on terms inconsistent with commercial considerations;
- the provision of goods or services at preferential rates;
- the grant of funds or forgiveness of debt to cover operating losses sustained by a specific industry; and,
- the assumption of any costs or expenses of manufacture, production, or distribution.[14]

In addition to this list of specific subsidies, Section 771(5)(B) of the Trade Agreements Act of 1979 defines domestic subsidy as one "provided or required by government action to a specific enterprise or industry, or group of enterprises or industries."[15] Article 11.3 of the GATT Subsidies Code refers to "subsidies granted with the aim of giving an advantage to certain enterprises...either regionally or by sector."

Current issues in the definition of domestic subsidy include "specificity" or general availability, regional development subsidies, upstream subsidies, research and development subsidies, and natural resource subsidies.[16] It has long been U.S. administrative practice not to impose countervailing duties on generally available subsidies because they do not have demonstrable trade-distorting effects. Since the imposition of a specificity test by the Trade Agreements Act of 1979, the ITA has imposed countervailing duties only on programs targeted to specific enterprises, industries, or regions.

The ITA based its interpretation of specificity on the economic theory that a widely available benefit usually does not distort comparative advantage within a country and any advantage would be washed out by floating exchange rates. Furthermore, it argued, if countervailing duties were levied on generally available subsidies, then almost every article in international commerce could be countervailed and measurement of the net subsidy on any given product would be unusually difficult. The signatories to the GATT Subsidies Code noted that "countervailing measures [should] not unjustifiably impede international trade" and that the objective of the Code was "to reduce or eliminate the trade restricting or distorting effects of non-tariff measures...recognizing that subsidies are used by governments to promote important objectives of national policy." If the United States were to countervail generally available subsidies, other countries would very likely retaliate against U.S. programs.[17]

The ITA has had to defend its interpretation of specificity in two recent appeals before the U.S. Court of International Trade. In a 1983 decision, Carlisle Tire and Rubber Company, the court held that two accelerated depreciation programs for equipment available under South Korean tax law were not subsidies, inasmuch as the benefits accorded under these programs were not preferential but were generally available to the whole business community of South Korea.[18] The court agreed, however, with the ITA's interpretation of a "bounty or grant" as connoting some special or comparative advantage conferred on an industry or group of industries and not available to all manufacturers and producers within an industry. While the court found some support in previous case law for its interpretation, it also agreed with the ITA's submissions that to countervail widely available subsidies would lead to an absurd result and that Congress, in using the word "specific" in the act, had meant to limit subsidies to those that are preferential in nature.

In a 1984 case, the same court emphatically rejected a broad rule that generally available programs are not subsidies. It held that an income tax deduction available to companies in South Africa for employee training programs was not a subsidy on the ground that "the practice in question was a tax law, and tax laws are not subsidies to the taxpayer if their terms are generally available."[19] The judge's comments on the broad rule of general availability or specificity do not constitute a binding precedent. However, the fact that he went to great lengths to criticize the ITA's reasons for a specificity test and to distinguish his ruling from the precedent set by <u>Carlisle</u> indicates an unwillingness on the part of at least one judge on the court to accept the ITA's interpretation of this section of the act. His views thus create some uncertainty about the strength of the specificity test in U.S. countervailing duty law.

<u>Recent Cases Involving Canada</u>

In its recent decisions, the ITA has continued to countervail only those subsidies that are targeted to specific enterprises, industries, groups of enterprises or industries, or regions in a country. The specificity test was applied to Canada's benefit in two recent cases. One case was <u>Certain Softwood Products from Canada</u> (<u>Softwood Products</u>).[20] The other was <u>Live Swine and Fresh, Chilled, and Frozen Pork Products from Canada</u> (<u>Swine and Pork</u>).[21]

In <u>Softwood Products</u>, numerous federal and provincial programs were found to confer subsidies because assistance was made available only to certain industries or to certain regions. These programs were not countervailed, however, because the net <u>ad valorem</u> subsidies were <u>de minimis</u> — less than the .5 percent level required in the law. The following federal programs were determined to confer subsidies:

- regional development aspects of the Investment Tax Credit, because credits over 7 percent were available only within specific regions;
- the Program for Export Market Development, because it provided interest-free loans for exporters;
- the Forest Industry Renewable Energy Program, for grants made available only to forest industry firms;
- Regional Development Incentives Program grants and loan guarantees provided by the Department of Regional Economic Expansion (DREE) to create stable employment opportunities in underprivileged regions, because the benefits were limited to companies in specific regions; and
- the Community-Based Industrial Adjustment Program, created to alleviate distress in cabinet-designated communities caused by large-scale permanent industry dislocation.

Federal-provincial Agriculture and Rural Development Agreements (ARDA) and DREE's General Development Agreements with the provinces also were found to confer subsidies, because their assistance was limited to companies in specific, generally rural, economically depressed regions within a province. Several provincial programs were deemed to provide subsidies, including Alberta's Stumpage Payment Deferral; British Columbia's Low-Interest Loan Assistance (LILA) and Stumpage Payment Deferral; Ontario's Stumpage Pricing for Non-Integrated Licensees and Stumpage Payment Deferral; and Quebec's Stumpage Pricing on Timber Limits, its Aide à la Promotion des Exportations, Société de Récupération, d'Exploitation et de Développement Forestiers du Québec (REXFOR), and its FRI Tax Abatement and SDI Export Expansion programs.

Particularly interesting was the ITA's handling of REXFOR, a Quebec crown corporation that owns sawmills and pulp and paper mills, manages programs was not a subsidy on the ground that "the practice in question was a tax law, and tax laws are not subsidies to the taxpayer *if* their terms are generally available."[19] The judge's comments on the broad rule of general availability or specificity do not constitute a binding precedent. However, the fact that he went to great lengths to criticize the ITA's reasons for a specificity test and to distinguish his ruling from the precedent set by *Carlisle* indicates an unwillingness on the part of at least one judge on the court to accept the ITA's interpretation of this section of the act. His views thus create some uncertainty about the strength of the specificity test in U.S. countervailing duty law.

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provincially owned forest lands, and invests in the Quebec forest industry. DRIE grants to REXFOR and Quebec government assistance in the form of grants, loans, loan guarantees, loss coverage, and equity purchases on terms inconsistent with commercial considerations were all found to be subsidies because they were targeted to the crown corporation.

In terms of its potential impact on the Canadian economy, the most important finding in the Softwood Products decision was that federal and provincial government stumpage programs do not confer subsidies. The ITA came to this conclusion because the programs are not targeted to stimulate export sales over domestic sales nor are they offered contingent on export performance. Moreover, the stumpage programs were found not to be countervailable domestic subsidies because they were not targeted to a "specific enterprise or industry, or group of enterprises or industries." In fact, the programs are available within Canada on similar terms regardless of the industry or enterprise of the recipient, there is no governmental targeting to limit use to a specific industry, and stumpage is widely used by more than one group of industries. However, the ITA's determination that stumpage programs are not targeted to specific industries has met with some criticism.[22]

Even if stumpage is provided to a specific group of industries, the ITA reasoned, it is not a domestic subsidy under the Trade Agreements Act of 1979 because stumpage programs do not provide goods at preferential rates — that is, rates more favorable to some than to others within Canada — and because the programs do not assume a cost of production, since "assumption" refers only to government activity that relieves an enterprise or industry of a pre-existing statutory or contractual obligation.

In addition to stumpage programs, a number of other generally available federal and provincial programs were found by the ITA not to confer subsidies. These include the federal Income Tax Act's Deductible Inventory Allowance and Capital Cost Allowance, federal employment programs, enterprise development programs, rail freight rates, and loans and loan guarantees provided by DREE at above average interest rates. Again, most of these programs passed the specificity test because they were not targeted in their enabling legislation, regulations, or administration to specific regions or industries.

In the 1985 Swine and Pork case, as with the earlier Softwood Products case, the ITA found that some federal and provincial agricultural assistance programs conferred subsidies while others did not. The ITC subsequently split the case into two parts and held that the U.S. pork industry was not being injured by Canadian imports but that imports of Canadian hogs were injuring the U.S. hog-producing industry.[23] Countervailing duties thus will be levied on imports of Canadian hogs but not on imports of Canadian pork products, valued at U.S.$248 million.

The distinction the ITA made between those programs determined to confer subsidies and those deemed widely available was based on a broad interpretation of the specificity test.[24] If a program, in its enabling legislation, regulations, executive or administrative directives, or actual implementation, appeared to select or favor one or more industries within the general rubric of agriculture or one or more regions of a province, then it was found to confer a subsidy. If, on the other hand, benefits under a program were legally and actually available on the same terms to all farmers or enterprises engaged in agriculture throughout a province, in the case of a provincial program, or the country, for a federal program, then it was determined not to confer a subsidy.

Comparisons can get quite technical. Take the federal Agriculture Stabilization Act, for example. Payments made under the act were found to be subsidies because the legislation establishing the program specifically listed those products eligible for price support payments: livestock (cattle, hogs, and sheep), certain dairy products (industrial milk and cream), and certain grains (corn, soy beans, oats, and barley), and allowed the Governor in Council to designate other agricultural products for coverage. The ITA found that the payments were made only to selected agricultural producers and that the level of price-stabilization payments varied because different formulae were prescribed for each named product. The federal-provincial Record of Performance herd-testing system was found to confer a subsidy because it applied only to hogs, beef, dairy cattle, sheep, poultry, and honey bees. On the other hand, the Hog Carcass Grading System under the Livestock Grading Program and the Canada Agricultural Products Standards Act were deemed not to provide subsidies because numerous agricultural products were similarly graded under these federally funded programs.

The Ontario Farm Tax Reduction Program, which provides for a rebate of 60 percent of municipal property taxes on farmland to all eligible farmers in Ontario, was found to be region specific and, therefore, to confer a subsidy because the eligibility criteria were different for farms located in eastern or northern Ontario than for farms located elsewhere in the province. Long-term loans provided under the federal Farm Credit Act and Farm Syndicates Credit Act, on the other hand, were determined not to confer subsidies because financing under these plans was available without restriction to the producers of any agricultural product in Canada. Similarly, provincial agricultural assistance programs, such as the Ontario Farm Adjustment Assistance Program, New Brunswick's Farm Adjustment Act, the Alberta Agricultural Development Corporation, and the British Columbia Agricultural Credit Act, were found not to grant subsidies because producers of a wide range of commodities in all regions of the provinces had received benefits from these programs.

As the *Softwood Products* and *Swine and Pork* cases illustrate, the specificity test does not require that subsidies be generally available across all industries to escape U.S. countervailing duty law. Rather, benefits that are widely available to more than a specific enterprise or industry, or group of enterprises or industries, are not countervailable. The ITA thus has some discretion in determining how specific a benefit must be before it constitutes a subsidy.

The U.S. *Trade and Tariff Act of 1984* specifies the circumstances under which the ITA may determine an "upstream subsidy" to be countervailable. Section 613 of this act adds a definition of upstream subsidy to Section 771(5) of the *Trade Agreements Act of 1979*. An upstream subsidy is any subsidy provided to an input product that is used in the manufacture or production of merchandise under investigation in a countervailing duty proceeding. Examples would be subsidies granted to coking coal, which is an input in the production of steel, or natural gas, which is an input in the production of ammonia. An upstream subsidy is countervailable if the ITA determines that it confers a competitive benefit on the merchandise under investigation — that is, where the price paid for the input product is lower than the price that the producer of the merchandise otherwise would have paid in an arms-length transaction — and that it has a significant effect on the cost of manufacturing or producing the merchandise.[25]

The ITA regards regional development programs as countervailable because they are treated as if they were limited to a specific enterprise or industry, or group of enterprises or industries. Offsets for locational disadvantages were previously permitted in the calculation of net subsidy but are no longer available under the *Trade Agreements Act of 1979*.

Generally, the ITA treats research and development subsidies the same as any other subsidies. The problem is in quantifying the effect of the subsidy on the merchandise under investigation. The ITA has taken the position that where the research is made publicly available, the subsidy is not a benefit to the product under investigation, since all producers benefit equally from the research. Where the research is not made publicly available, a countervailable subsidy is deemed to exist.[26]

Employment, training, or vocational programs are treated as subsidies if they meet the specificity test. Only if they are made available on the same terms to a wide range of industries without preference to a certain region will they escape the imposition of countervailing duties.

To summarize, any form of government assistance, direct or indirect, can be considered a countervailable benefit if it is more than de minimis and is targeted to a specific industry or group of industries or regions. Grants, loans, loan guarantees, government-equity infusions, and forgiveness of debt on terms inconsistent with commercial considerations may be characterized as subsidies under U.S. countervailing duty law.

Legislative Proposals

The Trade and Tariff Act of 1984, the first comprehensive piece of legislation amending the Trade Agreements Act of 1979, made some relatively minor changes to the definition of a countervailable subsidy. Numerous bills currently before Congress would add more practices to the definition. Two such bills — Congressman Gibbons' bill, HR2451, and Congressman Bonker's bill, HR1648 — would make a countervailable subsidy the sale of a government-owned resource at a price lower than the price of a comparable resource in the United States.

The Bonker proposal would amend the definition of subsidy to include "[t]he furnishing of stumpage rights on government lands by a country under a program or system in which those rights are furnished to an enterprise in exchange for compensation by that enterprise that is less than the current price for comparable stumpage rights on government lands in the United States."[27] The Gibbons bill would add a category of "resource-input subsidy" to the current definition. Included would be a resource product or removal right, which is provided or sold by a government or government-regulated entity for input use within that country at a domestic price lower than fair-market value, where the product or right constitutes a significant portion of the total cost of the manufacture or production of the merchandise under investigation. For an input product, fair-market value would mean "the price that, in the absence of government regulation or control, a willing buyer would pay a willing seller for that product from the exporting country in an arms-length transaction." For a removal right, fair-market value would be "the price paid for a comparable removal right in a comparable region in another country which has the largest number of arms-length sales of such rights" — in other words, the United States.[28]

These two bills are nothing more than specific attempts to overturn recent ITA negative determinations in the Canadian Softwood Products case and the Mexican Anhydrous Ammonia, Carbon Black, and Cement cases. In all of these cases, U.S. domestic producers complained that foreign competitors had lower production costs because their governments sold them resources — that is, stumpage rights, natural gas, petroleum feedstock, and heavy fuel oil, respectively -- at rates much lower than those available to domestic producers in the United States for comparable inputs. When the ITA applied the specificity test to reject their requests for countervailing duties, disgruntled U.S. producers lobbied hard to launch a lateral attack in Congress. Congressman Gibbons introduced a bill in 1984, HR4784, which included a definition of natural resource subsidy designed to counter the

Mexican Anhydrous Ammonia, Carbon Black, and Cement cases. After prolonged debate in the House, HR4784 was defeated in the Senate.

These proposed bills demonstrate the uncertainty and fluidity of the definition of subsidy in U.S. law. Apart from judicial and administrative conflicts in interpretation, foreign governments and producers must contend with the possibility that Congress can change the ground rules even after an ITA determination. Particularly dangerous in these latest congressional proposals is the attempt to impose the U.S. way of doing business on foreign countries. At issue in the resource input cases is, in fact, government ownership and management of natural resources. Because U.S. producers have to purchase resource inputs in the open market, they have challenged foreign governments' resource pricing as providing unfair subsidies. To define the fair market value of a resource input owned by a foreign government as the same as the price of a comparable resource input in the United States is not a fair determination of unfair subsidy. It is an assault on the sovereignty of another nation to determine its own natural resource policies.

Other features of the complex U.S. contingent protection system that deal with what the United States regards as unfair trade practices include actions against patent, copyright, trademark, or antitrust infringement under Section 337 of the Tariff Act of 1930, and actions against unfair foreign government practices affecting U.S. exports and other trading actions under Section 301 of the Trade Act of 1974.

Section 337: Unfair Practices in Import Trade

Section 337 of the U.S. Tariff Act of 1930, as amended by the Trade Act of 1974, is aimed at imported goods that are tainted with unfair trade practices, such as patent, copyright, or trademark infringement, or unfair methods of competition. The ITC, either on receiving a private complaint or on its own initiative, conducts an investigation to determine if there have been any

> unfair methods of competition or unfair acts in the importation of articles into the United States...the effect or tendency of which is to destroy or substantially injure an industry, efficiently and economically operated, in the United States, or to prevent the establishment of such an industry, or to restrain or monopolize trade and commerce.[29]

Any such acts are unlawful, and if the ITC determines that a violation of Section 337 has occurred, the goods concerned will be refused entry into the United States or the importer or owner will be warned to stop engaging in the unfair acts or methods. The ITC's determination is final unless overruled by the president. Section 337 does not apply to claims involving U.S. patents on goods procured by the government of the United States. In the 1980-85 period, there were 14 Section 337 cases involving imports of Canadian goods. Exclusion orders were made in three cases and settlement agreements were reached in five cases.

<u>Section 301: Retaliation Against Unfair Trade Practices of Foreign Governments</u>

Section 301 of the U.S. <u>Trade Act of 1974</u>, as amended by Title IX of the <u>Trade Agreements Act of 1979</u> and Title III of the <u>Trade and Tariff Act of 1984</u>, provides the president with broad powers to enforce the rights of the United States under any trade agreement, or to respond to any act, policy, or practice of a foreign government that is inconsistent with, or denies benefits to, the United States under any trade agreement, or is "unjustifiable, unreasonable, or discriminatory and burdens or restricts United States commerce."[30] Where one of those conditions exists, the president is obliged to take "all appropriate and feasible action within his power" to enforce U.S. rights or to eliminate the foreign government's practice. In addition, he may suspend or withdraw concessions and impose duties, quotas, or other import restrictions on the products or services of the foreign country.

Section 301 is a statutory retaliatory power that exists in the office of the president independently of the GATT or any other trade agreement. In contrast to the GATT and the multilateral codes, this provision applies to services as well as to products.

Section 301 actions are initiated by the delivery of a petition to the U.S. Trade Representative (USTR) by any "interested person". The USTR conducts an investigation involving public hearings, consultations with the foreign government and, if appropriate, initiation of dispute-settlement proceedings under a trade agreement, and recommends a course of action to the president.

The section is used principally in cases where U.S. exports are being hurt by a foreign government's policies or practices. The only case that went completely through the Section 301 process to culminate in a retaliatory action involved U.S. border broadcasters. In 1976, the Canadian government enacted Bill C-58, which denied Canadian companies tax deductions for payments to U.S. television and radio stations for advertising directed primarily at Canadian audiences. In 1978, a group of U.S. border broadcasters filed a Section 301 complaint. The USTR recommended to President Carter in 1980 that mirror tax legislation be enacted by Congress. Section 232 of the <u>Trade and Tariff Act of 1984</u> is that response. It denies a deduction to U.S. companies for foreign advertising expenses in countries that deny similar deductions for U.S. advertising.

U.S. Antidumping Law

Antidumping law is an international variant of price discrimination law. Section 731 of the Trade Agreements Act of 1979 mandates that where the ITA finds that a foreign exporter is dumping a class or kind of merchandise in the United States, and where the ITC determines that a U.S. industry is materially injured, or threatened with material injury, by the imports of that merchandise, then an antidumping duty is to be imposed on the imports. "Dumping" occurs when an exporter sells his merchandise abroad for a price lower than the price he sells it for in his home country. Antidumping laws are designed to discipline the pricing decisions of private, foreign firms and to provide relief for domestic firms against the unfair trade practices of foreign firms.

U.S. Measures against Disruptive Imports

In addition to countervailing duties and other measures aimed at combating what the United States regards as unfair trade practices of foreign governments, the U.S. contingent protection system contains a set of measures directed at foreign business practices seen as disruptive to U.S. industry. The most significant of these measures from a Canadian perspective is Section 201 of the Trade Act of 1974 — the escape clause. A number of U.S. import regulations pertain only to agricultural products. These include Section 22 of the Agricultural Adjustment Act of 1933 and the Meat Import Act of 1979.

Section 201: Escape Clause

Section 201 of the Trade Act of 1974 is the U.S. safeguards or escape clause. It allows an industry representative to petition for import relief where an article is being imported into the United States "in such increased quantities as to be a substantial cause of serious injury, or the threat thereof, to the domestic industry producing an article like or directly competitive with the imported article."[31] Section 201 is not designed to provide relief against foreign unfair trade practices. Instead, safeguard provisions exist to facilitate orderly adjustment to the pressures of import competition arising out of the increasing trade liberalization brought about by the series of GATT and other multilateral trade agreements.

A private petition, a request of the president or the USTR, a resolution of the House Committee on Ways and Means or the Senate Committee of Finance, or a motion by the ITC itself all can initiate a Section 201 investigation by the ITC. In its inquiry, the ITC must consider all economic factors and, after holding public hearings, report its findings to the president.

If the ITC finding is affirmative, the president is obliged to provide import relief for the industry unless he deems it not in "the national economic interest of the United States." Import relief can be in the form of an increase in duties on the article, the imposition of tariff-rate quotas, the modification or imposition of quantitative restrictions, the negotiation of orderly marketing agreements or voluntary export restraint agreements with the foreign government involved, or any combination of the above. The president also may order that adjustment assistance be provided to the industry. The president has the absolute discretion to decide whether he will take action and what type of import relief he will impose. Any order for import relief that the president makes under Section 201 is technically subject to most-favored-nation treatment under Article I of the GATT. All GATT countries exporting that article to the United States thus must be treated alike. Futhermore, if sanctions or restrictions are imposed on a foreign country under Section 201, that country has the right to retaliate with compensatory measures against the United States under Article XIX of the GATT.

Recent Section 201 cases involving Canada resulted in the imposition of quotas and tariffs on imports of stainless steel and alloy tool steel and the negotiation of voluntary export restraint agreements on carbon and certain alloy steel products.

The Administration's Response

The U.S. Congress currently is in a dangerous protectionist mood. For its part, the administration fought down to the wire in 1984 to defeat a package of protectionist bills, the end result of which was the much watered-down Trade and Tariff Act of 1984. The administration may be powerless, however, to defend against the latest onslaught, and the presidential veto can be defeated by a two-thirds majority of both Houses. Its current strategy is to step up government enforcement of unfair trade laws in order to placate domestic complainants and to slow the protectionist tide in Congress.

In attempting to resist protectionist pressures, the administration has launched an offensive against unfair trade practices. President Reagan, in rejecting import quotas in a Section 201 investigation into the shoe industry in August 1985, directed the USTR to "initiate investigations to root out any unfair trade practices that may be harming U.S. interests."[32] The ITC, at the urging of the Senate Finance Committee, had recommended that shoe-import quotas be imposed because the domestic industry was being seriously hurt by imports. In his policy statement, the president spoke out strongly against protectionism. It is now administration policy that the U.S. government will use Section 301 to open up foreign markets to U.S. producers.

Issues for Negotiation

Bilateral trade negotiations provide Canada with a unique opportunity to discuss and recommend changes to U.S. unfair trade laws. Given their importance as a trade irritant between the two countries, U.S. countervailing duty practices and other trade remedies undoubtedly will be high on the list of topics to be negotiated.

One option in the negotiation of a bilateral free-trade agreement would be for each country to exempt the other from the application of its countervailing duty and antidumping procedures. The two countries could follow the precedent set by the European Community (EC) and create a bilateral agency that makes rulings on countervailing duty or antidumping complaints against imports from outside countries, regulates domestic subsidy policies, and administers price-discrimination laws within the Community. The EC also has an internal regulation that lists the types and amounts of subsidies permitted within the Community, and there are EC-administered competition laws. Within the Community, there is free movement of labor, goods, and capital unencumbered by domestic countervailing duty or antidumping countermeasures.

It is very unlikely, however, that the United States would accept a blanket exemption for Canada from its countervailing duty and antidumping processes. The United States refused to consider exemption as an option in its recent negotiations with Israel. Section 406 of the Trade and Tariff Act of 1984, authorizing the president to negotiate a free-trade agreement with Israel, states explicitly that the agreement may not affect existing U.S. laws under which relief from injury caused by import competition or by any unfair import trade practices may be sought. Since 1979 at least, the U.S.

contingent protection system has provided a system of private rights to domestic industries. Rights, once given, are very difficult to take away. The administration is not likely to surrender its GATT-approved escape valve for domestic protectionist pressures.

As an alternative to a blanket exemption of bilateral trade from the application of antidumping or countervailing duties, the Royal Commission on the Economic Union and Development Prospects for Canada proposes binational administration of these procedures for bilateral trade, with both countries retaining their own procedures for imports from third countries.[34] However, this proposal would have administrative costs and is unlikely to be acceptable to the U.S. Congress for the reasons cited above. Even if it is possible to negotiate binational administration of unfair trade remedies, key questions would remain about the criteria for application of these remedies.

It likely would be more fruitful for Canada to propose some specific, incremental changes to the current U.S. trade regulation system. Canadian negotiators should focus on features of U.S. trade laws that are particular irritants for Canadian business and government policymaking. The negotiators could seek clarification of the criteria for application of U.S. trade remedies as well as tighter standards of injury and causation in the U.S. law.

A high priority for Canada is to obtain greater precision and certainty for the definition of subsidy in U.S. countervailing duty law. In cases such as Swine and Pork, the application of this test appears arbitrary. More particularly, the definition is in a state of flux as a result of the Gibbons bill and other bills pending in Congress. Since it is difficult to repeal legislation, clarification of the administration's interpretation of the definition of subsidy could foreclose the Gibbons or similar bills. If the Gibbons bill passes in the House, it would be extremely difficult to overturn through bilateral or multilateral negotiations.

One useful starting point for negotiations about countervailing duties is the GATT Subsidies Code, which, although ambiguous, has a different emphasis than the U.S. law. The preamble states that the objective is to "reduce or eliminate the trade restricting or distorting effects" of subsidies. The problem is to reconcile the inherent tension between the exercise of national sovereignty through the use of domestic subsidies and to limit their possible (or perceived) trade-distorting effects.

The Subsidies Code contains a list of export subsidies that should be prohibited in a bilateral trade agreement. There are different options for implementing the principle that domestic subsidies should be permitted where they serve important national economic, social, or industrial policy objectives and do not adversely affect trade. One option is that the two countries could negotiate a list of current assistance programs or, alternatively, general categories of domestic subsidies that are to be exempted from countervailing duty procedures. Adopting this approach would enable the two governments to take account of the offsetting effects of each other's various subsidy programs. Each country's list would be different and would reflect government policy priorities. The lists could be specific and capable of amendment by application to a binational commission, or they could be more general and delineated by categories such as regional development, natural resource, environmental, health and safety, agricultural, and cultural programs. The advantages of this approach are that Canadian governments would be more certain about which programs might be subject to countervailing duties.

Another option to limit the application of U.S. countervailing duties would be to negotiate the requirement that there must be a strong causal link between particular Canadian subsidies and injury to U.S. industries. For example, in the <u>Fresh Groundfish</u> case currently under investigation, there is a considerable possibility that the ITA will find countervailable subsidies and the ITC will find injury from the imports. Yet, since Canadian fish production is limited by strict harvest quotas, it would seem that Canadian subsidies to fishermen are not causing injury to U.S. producers. In the absence of subsidies, Canada likely would harvest and export the same amount of fish, but fewer fishermen probably would be employed in the industry.

Canada could seek exemption from the recently enacted cumulation provision in countervailing duty actions. As a result of the Trade and Tariff Act of 1984, the ITC is required to cumulate effect from imports from all countries in determining injury to a U.S. domestic industry in a countervailing duty case. Canada could suggest that only Canadian imports be considered in injury determinations affecting the importation of subsidized Canadian products.

With regard to antidumping duties, Canada should seek the elimination of the "sale below cost" provision contained in Section 321 of the Trade Act of 1974. This is a protectionist provision that does not deal with dumping at all.

Canada could seek to limit the impact of U.S. trade laws by negotiating tighter standards of injury for all U.S. trade remedies. In particular, a tighter standard of injury for the initial determination by the ITC would greatly reduce the potential for harassment of Canadian exporters. Furthermore, Canada could seek to reverse the inclusion of Canadian exports in U.S. trade actions directed at third countries.

Conclusion

When activated, the complex U.S. contingent protection system can present a substantial nontariff barrier to Canadian trade. As such, it places considerable constraints on Canadian domestic policymaking. Since the Trade

Agreement Act of 1979, there has been in place a privately initiated, time-limited, mandatory, quasi-judicial machinery for investigating, hearing, and determining antidumping and countervailing duty cases. Readily accessible to private complainants, the administrative process provides quick and effective remedies against foreign unfair trade practices. The antidumping and countervailing duty procedures form a system of guaranteed private rights to U.S. producers and industry representatives. There is no room in the U.S. law for government-to-government consultations, negotiations, or compromise short of the foreign country agreeing to cease entirely the challenged subsidy practice.

Two features of the U.S. contingent protection system raise particular concerns for Canadian business and government. First, the process, with its strict time limits and mandatory, legalistic, quasi-judicial procedures, can be a source of harassment for Canadian exporters. By its very diversity and complexity, the system inhibits imports. U.S. producers can initiate countervailing duty, antidumping, Section 301, and Section 201 complaints simultaneously and may also launch a lateral attack in Congress. It is extremely expensive and time-consuming for Canadian business interests to defend themselves against quasi-judicial actions and to lobby the president, the USTR, the ITC, and individual congressmen on all fronts simultaneously. It is difficult to obtain information about how and who to lobby in a complex foreign administrative and legislative system.

The second important feature of the system is its treatment of substantive issues. The ITC determination of material injury to a domestic industry as a result of subsidized imports is not an onerous test for U.S. producers to meet if there has been increasing import penetration and declining sales, profits, employment, prices, or market share for the domestic industry. The more important issue, from the perspective of Canadian government policymakers, is the ITA determination of subsidy. The composite definition of countervailable subsidy, gleaned from administrative determinations, judicial interpretations, and Congressional amendments, tells foreign governments what the U.S. considers to be an unfair government practice. Unfortunately, the U.S. definition has become so broad in recent years that virtually no government policy — with the probable exception of universally available tax advantages or social benefits — is immune from potential attack. Recent judicial pronouncements and Congressional amendments attacking the specificity test illustrate that there may be even more tinkering with an already broad definition. At present, protectionist forces are lobbying Congress to change U.S. law to countervail even generally available foreign domestic programs with no trade-distorting effects. When U.S. administrative, judicial, and legislative authorities can decree any form of government involvement in the economy countervailable, what is at risk is the sovereignty of a foreign government. The U.S. countervailing duty law constitutes a unique and aggressive interpretation of the GATT Subsidies Code. With its domestic countervailing duty laws, the United States seeks to impose discipline on the internal subsidy practices of foreign governments.

President Reagan has announced that he intends to increase enforcement of other unfair trade measures in the contingent protection arsenal. He has shown a reluctance lately to use the escape clause to impose quotas, to enter into voluntary export restraint agreements with foreign governments, or to provide adjustment assistance to domestic industries. Instead, he has indicated a preference to use Section 301 of the Trade Act of 1974 to open up new markets for U.S. exporters.[33] A new emphasis also is being placed on Section 337 of the Tariff Act of 1930, which allows entries of merchandise to be automatically refused at the border where the goods are tainted with an unfair trade practice such as patent, trademark, copyright, and antitrust law infringement.

The compromise that is being struck between protectionist interests in Congress and the administration is increased enforcement of the U.S. arsenal of trade remedies. This compromise has some benefits for Canada, but it also poses risks.

Canada benefits from the legalistic U.S. import regime because it deflects protectionist pressures and provides a reliable mechanism for dealing with trade disputes. The risk for Canada is that, as the definition of unfair trade practices in U.S. trade law becomes broader, more Canadian government policies will be subject to U.S. trade remedies. As the smaller partner in the world's largest bilateral trading relationship, Canada has a vital interest in obtaining clarification of trade rules and limiting the impact of U.S. trade remedies on Canadian exports.

NOTES

1. Rodney de C. Grey, "A Note on U.S. Trade Practices", in William R. Cline, ed., Trade Policy in the 1980's (Washington, D.C.: Institute for International Economics, 1980).

2. Gary C. Hufbauer and Joanna S. Erb, Subsidies in International Trade (Washington, D.C.: Institute for International Economics, 1984), p. 16.

3. Richard R. Rivers and John D. Greenwald, "The Negotiation of a Code on Subsidies and Countervailing Measures: Bridging Fundamental Policy Differences," Law and Policy In International Business 11 (1979): 1447, 1448-49.

4. Hufbauer and Erb, Subsidies in International Trade, p. 3.

5. United States, Trade Agreements Act of 1979, 19 U.S.C. § 1671.

6. Ibid., section 701(a), 19 U.S.C. § 1671.

7. Ibid., section 702, 19 U.S.C. § 1671h.

8. Ibid., section 705, 19 U.S.C. § 1671d.

9. Ibid., section 706, 19 U.S.C. § 1671e.

10. See, for example, John H. Jackson, "Perspectives on the Jurisprudence of International Trade: Costs and Benefits of Legal Procedures in the United States," Michigan Law Review 82 (1984): 1570.

11. United States, Trade Agreements Act of 1979, section 771(7), 19 U.S.C. § 1303.

12. Grey, "A Note on U.S. Trade Practices," p. 250.

13. "Final Affirmative Countervailing Duty Determination, Rail Cars from Canada," Federal Register 48 (1983): 6569.

14. United States, Trade Agreements Act of 1979, section 771(5), 19 U.S.C. § 1303.

15. 19 U.S.C. § 1677 (5)(B).

16. I am heavily indebted throughout this discussion of current subsidy issues to Gary N. Horlick, former Deputy Assistant Secretary of Commerce for Import Administration, and to Judith Hippler Bello, former Deputy for Policy, Office of Import Administration, U.S. Department of Commerce, both now with O'Melveny & Myers, Washington, D.C., for three unpublished papers: Horlick, "Current Issues in the Definition and Measurement of Subsidies under U.S. Countervailing Duty Law"; Bello, "Subsidies and Natural Resources: Congress' Lateral Attack on the Countervailing Duty Law's Specificity Test"; and Bello and Horlick, "The Trade and Tariff Act of 1984."

17. General Agreement on Tariffs and Trade, Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the GATT [relating to subsidies and countervailing duties], Preamble.

18. United States, Court of International Trade, Carlisle Tire and Rubber Company v. United States, 564 F. Supp. 834, 1983.

19. United States, Court of International Trade, Bethlehem Steel Corp. v. United States and Highveld Steel and Vandium Corp., slip op. 84-67, at 5 (June 8, 1984).

20. "Final Negative Countervailing Duty Determination, Certain Softwood Products from Canada," Federal Register 48 (1983): 159.

21. "Final Affirmative Countervailing Duty Determination, Live Swine and Fresh, Chilled and Frozen Pork Products from Canada," Federal Register 50 (1985): 25097.

22. Most notably, Gary Hufbauer and Joanna Shelton Erb have commented that in their view, "neither in practice nor intent were cheap stumpage rights in Canada and cheap natural gas in Mexico generally available. In both cases, a few resource-intensive industries were able to best take advantage of the bounty of nature and the promotion policies of the government." Hufbauer and Erb, Subsidies in International Trade, p. 98.

23. United States, Department of Commerce, International Trade Commission, Live Swine and Pork from Canada (Washington, D.C.: USITC, 701-TA-224, Publication 1733, July 1985).

24. The ITA found the following programs to confer subsidies: the federal hog stabilization payments provided under the Agricultural Stabilization Act, the federal/provincial Record of Performance Program, provincial hog income or price stabilization programs, hog marketing programs, financial assistance for livestock and irrigation, the Ontario Farm Tax Reduction Program, the Nova Scotia Transportation Assistance Program and Swine Herd Health Policy, and the New Brunswick Swine Assistance Program and loan guarantees and grants under the Livestock Incentives Program. Federally financed programs deemed not to confer subsidies included those under the Farm Credit Act and the Farm Syndicates Credit Act, the federal hog carcass grading system pursuant to the federal Livestock Grading Program and the Canada Agricultural Products Standards Act. Provincial programs in this category included grants and low-interest loans provided under Quebec's Act to Promote the Development of Agricultural Operations, Industrial Assistance Act, and Act to Promote Farm Improvement; Ontario's Farm Adjustment Assistance Program, Beginning Farmer Assistance Program, and Young-Farmer Credit Program; New Brunswick's Farm Adjustment Act; Newfoundland's Farm Development Loan Act; the Nova Scotia Farm Loan Board Program; the P.E.I. Lending Authority; the Alberta Agricultural Development Corporation; British Columbia's Agricultural Credit Act and Partial Interest Reimbursement Program; Manitoba's Agricultural Credit Program, and the Saskatchewan Economic Development Corporation.

25. United States, Trade and Tariff Act of 1984, section 613, 19 U.S.C. § 1671(g).

26. See, for example, "Fresh Cut Roses from Israel," Federal Register 45 (1980): 58516; and "Certain Steel Products from France," Federal Register 47 (1982): 39332.

27. United States, Congress, House, A Bill to amend the Trade Act of 1974 to promote expansion of international trade in wood products, HR1648, 99th Congress, 1st Sess., section 4.

28. United States, Congress, House, A Bill to amend Title VII of the Tariff Act of 1930 in order to apply countervailing duties with respect to resource input subsidies, HR2451, 99th Congress, 1st Sess., section 771(B).

29. United States, Trade Act of 1974, Section 341.

30. Ibid., Section 301.

31. Ibid., Section 201.

32. Bernard Weinraub, "Reagan Rejects Shoe Import Curb," New York Times, August 27, 1985, pp. 27, 31.

33. Clyde H. Farnsworth, "Section 301 is Polished as U.S. Trade Weapon," New York Times, August 27, 1985, pp. 29, 41.

34. Canada, Royal Commission on the Economic Union and Development Prospects for Canada, Report, vol. 1 (Ottawa: Supply and Services Canada, 1985), p. 314.

39. D.J.S. Brean and R.M. Bird, "The Interjurisdictional Allocation of the Tax Base and The Unitary Tax Debate" (University of Toronto, Institute for Policy Analysis, Toronto 1985, Mimeographed); D.J.S. Brean, "The Relevance of Canadian Tax Rates for Foreign Investment in Canada" (Economic Council of Canada, Ottawa, 1985, Mimeographed); and J. Murray, "The Tax Sensitivity of U.S. Direct Investment in Canadian Manufacturing," Journal of International Money and Finance 1 (1982): 227-40.

40. See Brean, International Issues in Taxation, Chapter 10, for an overview.

41. Thirsk, "Should Taxes Be Included in Trade Agreements?" pp. 146-7.