CANADIAN TRADE NEGOTIATIONS

RESEARCH PAPERS: POLICY ISSUES

DEPARTMENT OF EXTERNAL AFFAIRS
DECEMBER 5, 1985

FOREWORD

As background to its decision to initiate discussions with the United States to explore the scope and prospects for a new bilateral trade agreement, the government released a booklet containing an introduction to the issues involved as well as a number of selected documents and suggestions for further reading. In that booklet, the government noted that as part of its preparations for possible bilateral and multilateral trade negotiations, the Department of External Affairs commissioned a variety of studies by various government departments as well as outside experts. In order to stimulate an informed debate in Canada of the issues involved in trade negotiations, the Government has decided to make a number of these studies publicly available. This volume contains a series of studies on individual policy issues prepared by outside experts. Papers prepared by government analysts will remain confidential to the government as part of the analytical background to the preparation of more detailed negotiating positions.

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ARNOLD & PORTER

September 3, 1985

CONFIDENTIAL

M E M O R A N D U M

TO: Embassy of Canada

RE: Modification of Trade Remedy Laws
in a Canada-U.S. Free Trade Agreement

This memorandum evaluates the political and legal constraints that would affect the acceptability in the United States of a free trade agreement ("FTA") modifying the applicability to Canada of the U.S. import relief laws.

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Executive Summary

The Canadian Government is currently considering whether to enter into discussions with the U.S. Government regarding the creation of a bilateral Free Trade Agreement. This memorandum discusses the political and legal feasibility in the United States of various proposals, which Canada might make in those discussions, to modify the way U.S. import relief laws are applied to Canadian exports.[1] In accordance with your request, we discuss in some detail (i) the legal and institutional constraints on the U.S. negotiators, (ii) the current political attitudes on trade in the Administration, Congress, and key interest groups, and (iii) the likely reaction of the U.S. Government to each of the various proposals that have been made to create a special position for Canada under the U.S. import relief laws.

The deteriorating U.S. trade position has inspired a protectionist sentiment in the Congress and public, and led to increased pressure on the Administration to limit imports and reduce foreign barriers to U.S.

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[1] Undoubtedly, special phase-in procedures will be needed in a Canada-U.S. FTA to protect domestic industries from a prospective flood of imports caused by the removal of tariffs. This memorandum does not address that transitional import relief, but rather discusses proposals to permanently modify application of the U.S. import relief laws to all Canadian exports.

exports. Consequently, although elements of a Canada-U.S. FTA may be generally welcomed, individual provisions that are perceived as weakening the U.S. import relief laws are likely to generate considerable controversy.

The President would have to submit an FTA with Canada to Congress for ratification as either a treaty or "congressional-executive agreement." In either case, Congress will be able to shape, or even block, a proposed agreement. A "congressional-executive agreement" can be submitted to Congress under a "fast-track" procedure that is the most desirable in many respects (and which may be insisted upon by Congress). To proceed under the fast-track procedure, the Administration is required to keep the relevant congressional committees closely informed on the progress of the negotiations. In practice, the fast-track procedure gives Congress a continuing and persuasive influence over the U.S. negotiators that permits it to limit significantly their discretion.

Our preliminary conclusions are as follows:

1. The Administration is likely to be willing at least to discuss modification of the application of the trade remedy laws to Canada, especially if the

Canadian Government is prepared to offer concessions on the issues in which the Administration is most interested, such as trade in services and investment.

2. Recent legislative activity suggests that Congress believes that the import relief laws are currently inadequate or underutilized, and that it will strongly resist any efforts to limit their application to Canada.

3. The protectionist private interest groups, including some concerned specifically about imports from Canada, are already mobilized and can be expected to oppose any such proposals strongly.

4. We therefore feel that proposals explicitly to single out Canada for special treatment, such as through creation of a higher injury standard, are unlikely to be politically acceptable in the short term. We are cautiously optimistic that less visible, more process-oriented provisions that give Canada a special role and influence in U.S. import relief decisions affecting Canada would give Canada the improved predictability it seeks without generating strident political opposition in the United States. (Such provisions are described further below.)

Issue Posed

You have informed us that some analysts believe that Canada now faces a decision as to whether to attempt to preserve its domestic market from foreign competition or whether to attempt to become more integrated with the international market. In the opinion of these analysts, unilateral protection of the domestic economy through tariff and nontariff barriers would ultimately limit Canadian industry to the relatively small domestic market, while integration with the international market through the reduction of trade barriers would give Canadian industry the opportunity for much greater growth.

However, these analysts recognize that the reduction of trade barriers would also make Canadian industry more vulnerable to foreign competition in the domestic market. Therefore, before reducing barriers that serve to protect the domestic industry, it is essential to ensure that the Canadian economy is poised to experience the benefits, as well as the costs, of expanded international trade.

According to these analysts, the United States is important to the Canadian economy not only as a market for sale of Canadian products, but also as a base for

Canadian competitiveness in other foreign markets. This is because for many industries, Canada alone is not a sufficiently large market to develop the product diversity, product quality, and financial support necessary to compete successfully in the international market. These industries need a larger "home" market and the economies of scale it would provide. Therefore, assured access to the U.S. market is necessary if these industries are to be internationally competitive and Canada is to benefit fully from expanded international trade.

At present, the access of Canadian industries to the U.S. market is increasingly threatened by U.S. import relief actions. These actions -- imposed most often under the countervailing duty, antidumping, and safeguards laws -- are always costly to defend against and often unpredictable in outcome. They can result in increased duties or quotas on imports of Canadian products to the United States.

In large part because of the threat of future import relief actions, some industries that would otherwise locate in Canada are shifting their production facilities to the United States, thereby assuring themselves of guaranteed access to the U.S. market.

The elimination of tariffs through creation of a Canada-U.S. Free Trade Agreement would likely further accentuate the shift in investment, as Canadian industries would become more vulnerable to competition from U.S. exports. This shift of investment from Canada to the United States may seriously limit Canada's ability to compete in the international market.

Because of the above factors, we understand that in discussions of a possible Canada-U.S. FTA, the Canadian Government would pursue measures that would increase the predictability of the effects of the U.S. import relief laws. You have asked us to evaluate the likelihood of U.S. acceptance of various proposals to limit application of the import relief laws to Canadian exports.

I. GENERAL DESCRIPTION OF U.S. POLITICAL SETTING IN WHICH THE NEGOTIATIONS WILL TAKE PLACE

As you know, the United States is currently experiencing much difficulty with its international trade relations. Most U.S. policymakers acknowledge that the poor trade performance of the United States can, at least in part, be attributed to the unusually

strong U.S. dollar. But many of them feel that certain foreign industries have gained an important competitive advantage over U.S. industries independent of the value of the dollar. And many believe that this advantage results from barriers to foreign market access for U.S. products or from "unfair" support the foreign industries receive from their governments. These policymakers feel that the U.S. government must take action to reestablish a "level playing field" on the international market by securing a reduction in foreign barriers to U.S. products, eliminating or offsetting foreign subsidies, and/or by erecting more U.S. barriers to imports.

In the eyes of the public, increased imports are directly linked to the loss of business and jobs in the United States.[2] Consequently, protectionist measures have found broad-based support among both management and labor, and often inspire emotional support from politicians. The Reagan Administration officially favors free international trade, but has come under increasing pressure to take firm action to protect domestic industries, and in some cases has responded

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[2] See Phillips, "The Politics of Protectionism," in Public Opinion (April/May 1985) p. 41, which reviews the results of a number of recent public opinion polls.

to this pressure by imposing significant import restrictions.

In the current political atmosphere, bilateral negotiations to develop an FTA with Canada that reduces barriers to U.S. exports should be welcomed by the Administration and some key leaders in the House and Senate. Certain issues connected with a proposed FTA, however, may generate considerable controversy and opposition. One such issue would be created by an effort of the Canadian Government to increase the certainty and predictability of trade for Canadian industries by negotiating a special status for Canada under the U.S. import relief laws.

II. LEGAL AND INSTITUTIONAL CONSTRAINTS

Under the U.S. Constitution, the Congress is given the power "to regulate Commerce with foreign nations" and to "levy and collect . . . duties. . . ." Therefore, the Executive Branch can take very little effective action on this subject without specific authorization from Congress. Even though Congress has for some years delegated substantial authority to the

Executive Branch to conduct international economic affairs, Congress has traditionally felt that it has preeminent power in this area, and has maintained tight restrictions over the President's discretion. One can confidently predict, on the basis of both the past practice of Congress in trade matters and its current distrust of the Executive Branch, that Congress will insist on playing a strong role in decisions about the terms of an FTA with Canada.

A. Types of International Agreements and Their Status Under U.S. Law

There are two principal ways in which the President may enter into an international agreement such as an FTA -- by treaty or by "congressional-executive agreement." U.S. treaties and "congressional-executive agreements" have equal status under both international and domestic law.

1. Treaties

Article II of the Constitution specifically grants the President the power to enter into treaties with the "advice and consent" of a two-thirds majority of the Senate.

2. Executive Agreements

Although the Constitution does not expressly confer authority to make international agreements other than treaties, the courts have upheld the ability of the President to enter into international "executive agreements." In fact, the vast majority of international agreements to which the United States is a party are executive agreements rather than treaties. Executive agreements can take any of several forms:

(a) An executive agreement approved by Congress through advance delegation -- in this situation, Congress enacts a statute granting authority to the President to negotiate and enter into a future international agreement.

(b) An executive agreement authorized subsequently by Congress -- in this situation, the President negotiates the agreement and then submits it to Congress for approval. Congress then passes a statute ratifying the President's action in entering the agreement, or authorizing the President to proceed to sign it.

(c) An executive agreement authorized by treaty -- sometimes the President is deemed to be granted authority, under treaties or other executive agreements, to enter into derivative executive agreements designed to carry out the purpose of the prior treaty without further submission to Congress.

(d) An executive agreement authorized by the President's "inherent powers" -- on some occasions, the President has claimed he had power to enter into international agreements without any congressional input or approval whatsoever. This power has been upheld by the courts when it was closely tied with specific Presidential authorities, such as his authority as "Commander in Chief" or his authority to "receive diplomats." However, this power is very controversial, and prior efforts by Presidents to extend it have been met with considerable opposition in Congress. A claim of presidential power to enter an executive agreement on trade would be especially weak in light of the strong power over that subject vested by the Constitution in Congress.

Executive agreements explicitly approved through (a) advance congressional delegation or (b) subsequent congressional authorization are known as "congressional-

executive agreements" and, as stated above, are equivalent to "treaties" under both U.S. and international law.

3. Status of International Agreements Under U.S. Law

Article VI of the U.S. Constitution provides that the Constitution, federal legislation, and treaties "shall be the Supreme Law of the Land." This Article has been interpreted by the courts to mean that international agreements, once implemented, have equal status with federal legislation. Consequently, international agreements must conform to the requirements of the Constitution, and take precedence over state law and prior federal legislation.

It is also well-established in U.S. law that federal legislation enacted subsequent to an international agreement supersedes the international agreement.[3] While it may seem logical that a two-thirds majority of the Senate would be required to abrogate a treaty, that is not the case. In fact, there is no legal restraint preventing Congress from enacting legislation

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[3] See Restatement of Foreign Relations Law (Tent. draft) §§ 131, 135 (1980). U.S. law includes a principle of interpretation that courts should, when possible, construe domestic laws in such a way as not to bring them into conflict with international agreements. See Murray v. Schooner Charming Betsy, 6 U.S. (2 Cranch) 64, 118 (1804).

inconsistent with either a prior treaty or congressional-executive agreement. In addition, Presidents have occasionally terminated treaties without consulting Congress at all.

At the same time, however, international law provides that a nation may not rely on provisions of its own law to justify a breach of its obligations under international laws.[4] The United States recognizes the latter principle, and acknowledges that the superseding of an international obligation of the United States by a subsequent federal law does not relieve the United States of that international obligation or the consequences of its breach of that obligation.[5]

Therefore, if Congress were to enact legislation inconsistent with the FTA at some time in the future, the U.S. courts would require the U.S. Government and individuals subject to U.S. law to implement the provisions of the subsequent legislation, even if in violation of the FTA. However, the FTA would remain binding under international law, and Canada would be entitled to invoke the dispute settlement mechanism

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[4] I. Brownlie, Principles of Public International Law 36 (1979).

[5] Restatement (Tent. draft) § 135.

of the FTA or to utilize other international enforcement mechanisms.[1]

It should also be noted that international agreements entered into by the United States are often not "self-executing" under U.S. domestic law. In such cases, the Congress must enact implementing legislation. Consequently, the task of the foreign government does not necessarily end with the conclusion of the international agreement; special care must be taken that implementing legislation does not undermine the agreement.[2]

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[1] Treaties and congressional-executive agreements always take precedence over state law, no matter when enacted. See Missouri v. Holland, 252 U.S. 416 (1920). Therefore, individual states would not be able to undermine an FTA through local legislation. For this reason, an FTA could provide very effective protection for Canada against state laws limiting the purchase of Canadian products through "buy American" provisions or restrictive product standards.

[2] Although there was extremely strong support for the U.S.-Israel FTA, Congress was somewhat reluctant to implement the required tariff reductions.

B. Congressional Ratification: The Traditional and Fast-Track Procedures

1. Traditional Procedure

Under the traditional method for obtaining congressional approval, the Executive Branch would negotiate an international economic agreement with little or no congressional input. The President would then submit it to Congress.

International economic agreements -- such as an FTA -- are normally submitted as congressional-executive agreements rather than as treaties[8] because

- the House of Representatives (especially the Ways and Means Committee) has a very strong interest in these agreements;[9] and

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[8] As previously noted, a treaty is submitted only to the Senate, where it must be approved by a two-thirds majority. A congressional-executive agreement must be approved -- before or after execution -- by a majority of a quorum in both Houses of Congress.

[9] This strong interest stems from the Constitutional requirement that "revenue measures" -- such as tariffs -- originate in the House of Representatives. The House (especially the Ways and Means Committee, which has jurisdiction over these matters) has had for years a strong involvement with international trade matters, and its cooperation is needed by the President for any significant trade program.

- congressional-executive agreements permit, in practice, more advance consultation between the President and Congress and thereby give more assurance that Congress will approve the final agreement.

If the FTA were submitted as a congressional-executive agreement, the procedures applied to domestic legislation would apply. The proposed bill to authorize the agreement would first be referred to the House and Senate Committees with jurisdiction over the subject matter of the bill. (In this case, the House Ways and Means Committee and Senate Finance Committee would have primary jurisdiction, although other committees may have jurisdiction over individual elements of the bill.) Those committees could then conduct public hearings on the bill and make alterations they determined were necessary. If and when the committees felt it appropriate,[10] the bill would be referred to the full House and Senate for consideration. After referral to the "floor," the bill can be subject to virtually unlimited debate by individual Congressmen, and amendments can be made. Finally, if the House and Senate pass

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[10] Many bills are essentially "killed" by the Committees and are never referred for consideration by the full Houses.

different versions of a bill, a "conference committee" must be formed to negotiate a compromise, which itself must be voted upon by the full Houses.

Treaties are subject to a similar procedure. A treaty is first referred to the Senate Foreign Relations Committee, which may conduct hearings on the treaty. The Committee is under no obligation to refer a treaty to the full Senate for consideration, and may hold it indefinitely. Although a treaty signed by the President and submitted to the Senate for ratification technically may not be "amended," the Senate may attach "reservations" and "understandings" to the treaty that ultimately have the same effect by limiting the United States in its future compliance with or interpretation of the treaty. Unlike congressional-executive agreements, however, treaties must be approved by a two-thirds vote of the Senate only, rather than a majority vote of a quorum of both Houses.

2. Fast-Track Procedure

The traditional procedure described above has sometimes proved to be inadequate for the negotiation of international economic agreements. During the Kennedy Round in the late 1960s, the U.S.T.R. concluded a

multilateral agreement after arduous negotiations that, inter alia, required the U.S. Government to alter the way it valued certain goods for customs purposes. When the agreement was submitted to Congress under the traditional procedure for congressional-executive agreements, Congress rejected the agreement, thereby severely embarrassing the Administration.

It was then recognized that a new approval procedure was needed in order to restore the credibility of the United States negotiators. Under the special "fast-track" procedure created by Section 102 of the Trade Act of 1974, the Executive Branch was committed to extensive consultation with the relevant congressional committees, and Congress, in turn, was committed to an expedited consideration procedure. On the occasions it has been used, the fast-track procedure has virtually assured congressional ratification of negotiated agreements, thereby restoring the confidence of foreign governments in the ability of the Executive Branch to negotiate on behalf of the U.S. Government in this area.

Specifically, under the 1974 Act, the President was authorized to negotiate and enter into trade agreements to harmonize, reduce, or eliminate nontariff barriers, which could then be submitted for approval

under an expedited procedure if the President (i) gave the Congress at least 90 days prior notice of his intent to enter into the agreement, and (ii) submitted a copy of the executed agreement together with a draft implementing bill, a statement of proposed administrative action, and a statement of how the agreement served U.S. interests. The Committees would then be required to refer the bill to the floor after 45 days, and each House would have 15 days to act on the bill, with no amendments permitted and special limits on debate.

These procedures permitted the relevant congressional committees to have significant influence over the U.S. negotiators during the Tokyo Round.[11] Consequently, when the bill that became the Trade Agreements Act of 1979 was ultimately introduced using this procedure, it was passed with almost unanimous votes in both Houses.

The Trade and Tariff Act of 1984 extended the availability of the "fast-track" procedure to bilateral trade agreements that provide for elimination or reduction of duties as well as nontariff barriers.[12] Duty reduction

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[11] In fact, congressional representatives were included in the negotiations as observers.

[12] The prospective agreement with Israel was exempted from the advance consultation and 90-day prior notification requirements. At the same time, duty reduction agreements with other countries were not exempted from these requirements.

agreements, however, are subject to the following additional requirements: (i) the foreign country must request negotiation of the agreement; (ii) the President must notify and consult with the House Ways & Means and Senate Finance Committees at least 60 legislative days in advance of the 90-day notice; and (iii) the Committees must not disapprove of the negotiation during the 60-day period.[13] This provision was designed to give Congress "veto" power over trade negotiations. At the same time, the law does not prohibit the Administration from holding informal discussions with the Canadian Government and developing proposals prior to reporting to Congress.

As with the 1979 Trade Agreements Act, the fast-track procedure gave the Congress considerable input into the formulation of the U.S.-Israel FTA. The implementing legislation for that international agreement also passed both Houses with near unanimity.

The original Senate version of the 1984 Trade Act would have authorized the President to negotiate

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[13] Committee disapproval makes the bilateral agreement ineligible for the fast-track procedure, but does not invalidate the negotiations as such. Therefore, the Congress felt that this statute was not the type of legislative veto that has been declared unconstitutional by the U.S. Supreme Court.

an agreement with Canada as well as Israel under the original fast-track procedures, and with other countries subject to the added requirements described above. The final compromise legislation exempted Israel from the consultation and 90-day notification requirements and placed Canada in the same category as all other countries.

Section 406 of the Trade Act of 1984 specifically provided that the prospective U.S.-Israel FTA should not alter the U.S. import relief laws. There is no such limitation on agreements with countries other than Israel. However, the report accompanying the original Senate bill to grant authority for trade agreements with Israel and Canada states that "[t]he [trade] agreements would make clear that they will not affect the normal operation of the domestic trade laws; for example, procedures for domestic industries to seek relief from unfairly traded imports would operate without regard to such agreements."[14]

Consequently, it is essential to be prepared for congressional limitations on the Administration's negotiating discretion. Even though the negotiating authorization in the Trade Act of 1984 prohibited the

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[14] S. Rep. No. 98-510, 98th Cong., 2d Sess. 6 (1984).

Administration from modifying the trade remedy laws in an FTA only with Israel, the Finance or Ways and Means Committee could easily require an informal commitment on this issue from the Administration before approving negotiations with Canada. It should be noted, in this regard, that the Senate Finance Committee's report on the U.S.-Israel FTA implementing legislation stated:

> As the law requires with all such agreements, the Committee expects the President, when he considers negotiating a free-trade agreement with Canada, to consult fully with the Committee regarding all fundamental aspects of the potential agreement, including the subject matter under negotiation and possible U.S. approaches.[15]

Although this statement is not binding law, it is a strong expression of the attitude of the current membership of the Finance Committee.

It is of course not necessary to negotiate a Canada-U.S. FTA under the fast-track procedure; any agreement negotiated could be submitted to Congress under its normal procedures. However, the advantages of the fast-track (automatic committee discharge, nonamendability) are substantial enough that it seems

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[15] S. Rep. No. 99-55, 99th Cong., 1st Sess. (1985).

advisable to use the fast-track if it is available.[16] As explained above, a trade agreement not considered under the fast-track procedure is subject to potential delay and modification by the Committees as well as the full House and Senate.

III. POLITICAL AND POLICY CONSTRAINTS

A. Traditional U.S. Policy Favoring Multilateral Trade Agreements

The U.S. Government has historically favored multilateral over bilateral trade agreements. In recent years, however, the United States has become frustrated with the slow, fractious nature of the multilateral process. Therefore, the U.S. Government has been more favorably disposed toward bilateral and regional arrangements, such as the U.S.-Israel FTA and the Caribbean Basin Initiative. Nonetheless, it is possible that the U.S. Government position on a Canada-U.S. FTA

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[16] The fast-track procedure is due to expire in January 1988. Many feel that renewal of the procedure by the Congress is essential for the Administration to pursue a new GATT round.

may be influenced by its progress in launching a new multilateral trade negotiation. If a new GATT Round looks likely, U.S. policymakers may view a Canada-U.S. FTA as a potential threat or impediment to a successful multilateral negotiation.

B. U.S.-Israel FTA as Precedent

There are many differences between Canada's and Israel's trade and political relations with the United States. Nonetheless, because the U.S.-Israel FTA is the first such agreement to which the United States has been a party, it will inevitably be treated as a precedent for some purposes. Therefore, it may be useful to review the elements and history of the U.S.-Israel FTA that are directly relevant to proposals to limit the application of the U.S. trade remedy laws to Canada.

The U.S.-Israel FTA itself does not mention the countervailing duty law, but Annex Four of the FTA lists several specific subsidy programs the Israeli Government has agreed to phase out. The FTA also contains an "anti-sideswipe" provision for safeguard actions, which is discussed in Section IV.C.2., below.

During the congressional hearings on the proposal for a U.S.-Israel FTA, there were several strong comments opposing any limitation on the trade relief laws. Perhaps most significantly, during the hearings before the Subcommittee on Trade of the House Ways and Means Committee, Chairman Sam Gibbons made the following statement to the Deputy U.S. Trade Representative and the Deputy Undersecretary of Agriculture for International Affairs and Commodity Programs:

> I would say to both of you that I don't expect you to negotiate anything that would tear down our laws that I generally describe as keeping the playing field level, the laws against subsidies, the laws against dumping essentially. Nor do I want you to do anything that gives any country a distinct advantage in what are the basic areas.
>
> This is a reduction of tariffs and any nontariff barriers that we have, but I don't include the countervailing duty laws and dumping laws as being nontariff barrier laws. Those are basic laws designed to keep the trade free and open.
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> Subsidized trade, as I have said so often, is not free trade. It is the worst kind of Government intervention in the marketplace.
>
> So I don't want to see you attempting

to negotiate any of those away.[17]

The implementing legislation for the U.S.-Israel FTA clearly reaffirms the principle that the trade remedy laws were not to be affected by the FTA. It provides that in cases where the FTA conflicts with any U.S. statute, the statute will take precedence. The report accompanying the Senate bill explains that "although there is no apparent inconsistency between U.S. unfair trade laws and the agreement, section 5 makes clear that such U.S. laws are not modified by the agreement."[18]

However, it is important to note that Congressman Gibbons' statement and the Senate report quoted above focus on the unfair trade practice laws. Congress therefore may have a different, more receptive reaction to changes in the safeguards law than it would to changes in the countervailing duty and antidumping laws.

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[17] Proposed United States-Israel Free Trade Area: Hearings Before the Subcomm. on Trade of the House Comm. on Ways and Means, 98th Cong., 2d Sess. 26 (1984).

[18] S. Rep. No. 99-55, 99th Cong., 1st Sess. 8-9 (1985).

C. Attitude of Executive Branch

1. General Factors Likely To Affect Administration Reaction

The reaction of the Executive Branch to proposals to modify the trade remedy laws will likely be influenced by three general factors: (a) its recent experience with international economic policy, (b) its recent experience in negotiating international economic agreements, and (c) public perceptions of a current lack of strong leadership on trade matters.

a. Recent Experience with International Economic Policy

During the Reagan Administration, international economic policy has generally been given a subordinate position to domestic economic policy. When the Administration proposed its domestic economic program in 1981, it appeared that little consideration was given to the program's possible effect on the nation's international economic position. Indeed, the official Administration view is that trade policy is a function of domestic economic policy.

In the past three years, the impairment of the U.S. competitive position, due to the high value of

the dollar, has made it more difficult for trade policy officials to get the serious attention of Congress, business leaders, or foreign governments for trade liberalization measures. In fact, the surge of imports caused by the overvalued dollar has focused Executive Branch attention and energy on strengthening the import relief laws and administering import relief cases.

The competitiveness gap between U.S. and foreign industries now appears so wide that large segments of the U.S. business and labor communities have lost the confidence normally necessary to support significant trade liberalization negotiations, whether multilateral or bilateral. Therefore, business and labor interests will require even more reassurance than in the past that any U.S. trade concessions will yield significant U.S. export benefits and will not severely jeopardize vulnerable U.S. industries.

Most recently, trade policy has become a controversial political issue. Both Democratic and Republican Senate leaders are asserting emphatically that the Administration has no trade policy at all, and that therefore Congress must take the lead on trade issues. Many members of Congress feel that the President has created a trade crisis by refusing to confront the

consequences for U.S. competitiveness of his domestic economic program. Indeed, there is some exasperation and anger because although the members of Congress are facing negative political reactions from their constituents over the trade situation, the President has not provided them with a comprehensive trade program they can point to as a solution. This poor relationship with Congress on trade policy is likely to affect the Administration's judgment on what it can offer the Canadian Government in an FTA.[19]

b. Recent Experience with Trade Negotiations

Early in the Reagan Administration, former United States Trade Representative ("U.S.T.R.") Brock made strong efforts to foster interest in new multilateral trade negotiations. These efforts were frustrated both by Congress and foreign governments. Partly as a result, the Administration turned its attention to regional and bilateral negotiations, resulting in the Caribbean Basin Initiative and the U.S.-Israel FTA. Although the Administration continues to press for a new

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[19] It has been reported that the Administration, reacting to the criticism of Congress, is now preparing a major policy statement to be released by early September. The statement is being prepared by U.S.T.R. Yeutter and will be released only after approval by the Cabinet Economic Policy Council.

multilateral round, its recent success with bilateral negotiations is likely to encourage a receptive attitude toward some further bilateral agreements.[20] The Administration may, in particular, view a Canada-U.S. FTA as a vehicle for sending a signal to the world that the U.S. Government intends to reward its most reliable trading partners -- such as Canada -- with trade liberalization while it erects barriers to trade from unreliable countries.

c. Public Perceptions of Lack of Strong Leadership on Trade Issues

The Administration has recently lacked strong leadership on trade issues, a deficiency caused in part by the recent high turnover of personnel in the trade policy positions. Indeed, the course of negotiations on a Canada-U.S. FTA may be significantly influenced by which agency and individuals take the lead for the U.S. Government.

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[20] It was recently reported that the U.S.T.R. would be receptive to negotiating an FTA with the ASEAN nations. ASEAN includes Thailand, Singapore, Indonesia, the Philippines, Malaysia, and Brunei. The prospects for such a negotiation are in fact probably rather remote, since the ASEAN group has not yet established effective free trade among its own members.

Under U.S. law, the U.S.T.R. is charged with primary responsibility for negotiation of international economic agreements, and such was the case during the Tokyo Round. The law also states that the interagency Trade Policy Committee, which is chaired by the U.S.T.R., is responsible for officially coordinating the formation of trade policy. During the Reagan Administration, however, the influence of the U.S.T.R. has declined. Trade policy is now in fact established primarily by the Cabinet Economic Policy Council, which is chaired by Treasury Secretary Baker. Consequently, although the Canadian Government will nominally be negotiating with the U.S.T.R., the White House Staff and Mr. Baker may exercise dispositive influence on the major issues.

Historically, the Treasury Department has been less interested in tariff matters than in financial issues, such as exchange rate policy. However, recently Secretary Baker stated publicly that "a return to protectionism would be a very unfortunate thing for the country and the world trading system generally." He added that the Administration must continue "forcefully to try to obtain access to foreign markets to the same degree that our markets are open to our trading system [sic], and to enforce the current laws on the books,

aggressively, against unfair trade practices." It is difficult to gauge Mr. Baker's views on trade policy with sufficient detail to judge what his attitude might be toward modification of the trade remedy laws. Because Mr. Baker is currently heavily involved in major tax reform and budget issues, he may not be prepared or willing to spend significant time and effort on a Canada-U.S. FTA.[21]

The participation and influence of the U.S.T.R. and the Commerce Department may be handicapped, at least initially, by their recent significant turnover in personnel. New officials have recently been appointed to the positions of both the U.S.T.R. and the Undersecretary of Commerce for International Trade.

Clayton Yeutter, who has just been confirmed as U.S.T.R., has yet to make a comprehensive announcement of his policy goals. During his confirmation hearing before the Senate Finance Committee, Mr. Yeutter asserted that the United States must "neutralize" unfair trade practices. At the same time, Mr. Yeutter stated his opposition to protectionist legislation and seemed

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[21] Chief of Staff Regan, who was Treasury Secretary during the first term of the Reagan Administration, potentially could also have a significant influence over FTA negotiations.

noncommittal on the issue of whether he would ask the Administration to self-initiate safeguards actions.[22] In response to questions from the Committee members, Mr. Yeutter said that the Canadian lumber problem would be one of his "top priorities." Mr. Yeutter has not yet indicated whether he has a strong interest in pursuing bilateral trade agreements. Because Congress is skeptical over the prospects for a new GATT Round, Mr. Yeutter may feel that a Canada-U.S. FTA would be an attractive and feasible first step for him.

Mr. Yeutter recently announced a major reorganization of U.S.T.R. Deputy U.S.T.R. Michael Smith will be responsible for trade policy and trade negotiation functions. An Assistant U.S.T.R. (not yet named) will be responsible for Canada and Mexico and will report to Mr. Smith.[23] Alan Woods, who has been nominated to replace former Deputy U.S.T.R. Robert Lighthizer, will, if confirmed, be responsible for management, congressional and public affairs, and sectoral trade issues. Peter Murphy will continue as the U.S.

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[22] Privately, Mr. Yeutter has been encouraging U.S. industry to use section 301 actions to open foreign markets.

[23] It has been rumored that a new Deputy U.S.T.R. position may be created in the future with responsibility for Canada and Mexico.

Ambassador to the GATT. And, these recent shifts in the top trade officials have been accompanied by significant changes in staff personnel.

Bruce Smart was appointed Undersecretary of Commerce for International Trade in June. Mr. Smart, who was previously chairman and chief executive officer of Continental Group, Inc., has not had extensive exposure to international trade policy. He is, however, well respected in the business community, and could be very influential in building support for an FTA.

2. Likely Administration Reaction

Based upon the factors described above, we feel that the Administration is likely to have the following reactions to the three principal questions that will be raised during a discussion of possible modification of the trade remedy laws in an FTA:

(a) Is the proposal reasonable?

(b) Does the proposal fit in with U.S. objectives?

(c) What will be the reaction to the proposal by Congress and business and labor interests?

a. Reasonableness of Proposal

As discussed earlier, to be competitive internationally, Canadian industries need open access to the U.S. market. The threat of impediments to Canada-U.S. trade encourages industries to locate in the United States, rather than Canada, to guarantee their access to the much larger U.S. market. We feel that the Administration, in general, would recognize the validity of the above concerns of the Canadian Government and would be sympathetic to the Canadian objective of predictability.

b. Consistency with U.S. Objectives

(i) Canada is generally considered a reliable trading partner, in that it participates actively in the pursuit of an open world trading system, maintains relatively open markets for U.S. products, and does not distort trade through aggressive targeting of exports with subsidies and coordinated industry efforts.[24] Indeed, Canada is thought to have attitudes

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[24] On the other hand, Canada does have the largest trade surplus with the United States of any country except Japan, a fact which is likely to be strongly emphasized if FTA talks proceed. In addition, Canada has some programs of government support for industry which are considered objectionable in the United States and are subject to countervailing duties under U.S. law if they cause injury to a U.S. industry.

thereby building support among other nations for broader trade liberalization.

c. Influence of Congress and Public

As discussed above, Congress and business and labor interests have lost confidence in the ability of the United States to compete internationally. They have also lost confidence in the soundness of U.S. trade policy. Consequently, the Administration will have a great fear of adverse reactions from Congress and various interest groups. To avoid "frightening" these interests, it may be essential to the Administration that any proposals to modify the trade remedy laws be incorporated into a balanced trade package before release to Congress and the public. Such a package would need to offer benefits that will be appealing to U.S. industry and labor to such an extent that they will justify the costs industry and labor would be asked to bear.

D. Attitude of Congress

1. Background Factors

Certain general factors have contributed to a recent dramatic change in the political atmosphere that forms a background against which members of Congress establish their positions on trade issues:

- Trade is now a much more significant component of U.S. GNP than it has ever been (21.6% in 1984);[25]
- The U.S. trade deficit is much larger than it has ever been;
- There is a lack of confidence by the large majority of U.S. industries in their ability to compete internationally;
- In the view of many Congressmen, the dollar is greatly overvalued, making imports cheaper and exports more expensive. The Administration's economic policy is considered the principal cause of the high dollar, although the economic policies of the E.C. and Japan have been a contributing factor;

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[25] Source: Bureau of Economic Analysis, Department of Commerce.

- Many Congressmen feel that the other developed country markets that could potentially absorb much of the world's exports -- Japan and the E.C. -- are not as open as that of the United States. Consequently, the world's exporters focus on the U.S. market more than they would otherwise. In addition, the countries that profit most from exporting to the United States, such as Brazil, Taiwan, South Korea, and Japan, keep their markets closed to U.S. exports and to exports from each other. (Canada is not typically included in the list of countries with closed markets.);

- Most members of Congress now find it politically necessary to take an active role in and speak out on trade policy issues, whereas formerly only a few Congressmen paid attention to these issues;

- Congressmen that are confronted by angry import-affected constituents are unable to point to strong Administration leadership as holding out hope for policy steps that will resolve the problem;

- There has been a breakdown in the traditional bipartisan support for U.S. trade policies, as some Democratic members of Congress now see an opportunity to blame the Republicans for the trade situation. This breakdown, in turn, makes each Congressman -- whether Republican or Democrat -- more cautious about supporting trade liberalization since each feels vulnerable to a new wave of protectionist criticism that could sweep him out of office.

All of the above factors will influence the behavior of Congress and, through Congress, the Administration.

2. Recent Legislative Activity

Because of the factors identified above, congressional leaders have threatened to enact a broad series of protectionist laws. In some cases, such as with the natural resource subsidy bills, the legislation is designed essentially to impose newly devised notions of fairness upon the way foreign governments implement their national policies. Some of the major bills currently pending are as follows:

a. Import Surcharge Legislation

There have been several bills introduced that would impose a surcharge of 10% to 25% on imports from either all or selected countries. The latest, and most important, was introduced on July 17 by House Ways and Means Committee Chairman Dan Rostenkowski, Ways and Means member Richard Gephardt; and the senior Democratic member of the Senate Finance Committee, Lloyd Bentsen. The bill calls for a 25% surcharge on imports from those countries -- specifically Japan, Brazil, Taiwan, and South Korea -- whose exports to the United States are 65 percent greater than their imports from the United States, and whose exports on a global basis are 50 percent greater than imports. In addition, the U.S.T.R. would have to find that such countries impose unfair trade barriers to imports. The surcharge will not take effect if such countries reduce their surpluses by June 30, 1986 or if the U.S. trade deficit falls below 1.5 percent of the U.S. gross national product. (Currently, this bill would not apply to Canada.)

This bill reflects the loss of confidence by Congress in the U.S. import relief laws and in the good faith of certain foreign governments. The underlying theme of the bill is that, instead of dealing with import

problems on a product-by-product and country-by-country basis, the United States will apply a "wholesale" approach that places the entire burden on foreign governments to reduce their trade surpluses with the United States.

b. Textile and Apparel Trade Enforcement Act of 1985

This bill would impose a highly restrictive import quota on textile and apparel products from all sources except Canada and the E.C. The legislation would abrogate some 34 bilateral restraint agreements and would be in violation of the Multifibre Arrangment and the GATT.

c. Legislation to Restrict Lumber Imports

Bills have been introduced calling for imposition of quantitative restrictions on imports of softwood lumber from Canada.

d. Natural Resource Subsidy Legislation

Several bills have been introduced that would expand the definition of subsidies in the countervailing duty law to encompass certain foreign government policies on natural resources. At least one of these bills is aimed specifically at Canadian lumber.

e. Trade Law Modernization Act of 1985

This is a comprehensive trade bill that, among other things, would make relief from import competition more accessible for U.S. industries. Key provisions of the bill would liberalize the injury standard for safeguards relief and make industrial targeting an "unfair trade practice" under U.S. law.

3. Democratic and Republican Positions on Trade

Traditionally, trade liberalization has been an essentially bipartisan issue in the Congress. However, it now appears that the Democrats will attempt to make U.S. trade policy an issue in the next election. Therefore, although the Republicans in Congress, in many cases, are as frustrated as the Democrats with the Administration's inaction, attitudes toward trade liberalization may soon begin to split along party lines.

a. Democratic Position

At the beginning of the current Congress, a Senate Democratic working group was established under Senator Bentsen to undertake a review of the effectiveness of

the U.S. Administration's trade policy.[26] On April 25 the working group released its preliminary report, which is entitled "The New Global Economy: First Steps in a United States Trade Strategy."

The report, which is considered to reflect the opinion of most of the Congressional Democratic policymakers on trade, is highly critical of the Administration's management of trade policy and describes trade as "the weak link in U.S. economic policy." It argues that the Administration has in fact failed to develop a consistent trade strategy that is responsive to current conditions in the "new global economy." In particular, it deplores the unprecedented size of the U.S. trade deficit, the high level of U.S. government borrowing, the failure of the Administration to address exchange rate issues, and the loss of U.S. leadership in international trade. The report also argues that the GATT is no longer adequate to deal with the problems of the international economy today since existing GATT rules are not observed by many countries and many key areas of trade are not covered (e.g., trade in services

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[26] The members of the working group are Lloyd Bentsen, Robert Byrd, Russell Long, Quentin Burdick, Ernest Hollings, Thomas Eagleton, Spark Matsunaga, Max Baucus, Alan Dixon, Frank Lautenberg, Jeff Bingaman, Tom Harkin, and Donald Riegle.

and petroleum, currency exchange, barter and trade by government-owned corporations, and so on).

The main theme of the report, however, is a rather precarious balancing of support for free trade versus calls for further protectionism. The report is somewhat contradictory in this regard. It criticizes the Administration for having "imposed more trade barriers on U.S. imports than any Administration since the 1920's" and emphasizes that, rather than increasing protectionism, efforts should be directed towards opening the international trading system. At the same time, however, one of the report's key recommendations calls upon the Administration to make greater use of existing authorities, such as Section 201 of the Trade Act of 1974, to provide relief from injurious imports. It is argued that relief should be as easy to obtain as is permitted under GATT rules.

Comments by several influential Democratic leaders in the House of Representatives reinforce the sense of frustration expressed in the Senate working group report. For example, Representative Rostenkowski, the Chairman of the House Ways and Means Committee, recently stated that:

> America is fast approaching a trade crisis. The dike against sheer protectionist legislation is about to break. This [the Bentsen import surcharge bill] is a kind of last call from congressional moderates.

Representative Gephardt, who is also on the Ways and Means Committee, has said "I simply believe that the Administration's trade policy is out of touch with reality." Finally, Representative Jones, another member of the Ways and Means Committee, has commented that:

> There is frustration with the trade debt, which is costing jobs in everybody's district. There is a natural human response to blame foreigners for our problems and not ourselves.

b. Republican Position

Like the Administration, Republican Congressmen have tended to view trade policy as a function of domestic economic policy. Republican Congressmen have prepared a report on trade policy that focuses on strengthening the competitive position of the United States through education and increased productivity, rather than trade law reform.

However, Republican Congressmen are becoming increasingly sensitive to the potential role of trade policy as a destructive political issue, and some have

attempted to distance themselves from the President on this issue. For example, Representative Larry Craig, a Republican from Idaho, organized the "timber summit," a bipartisan meeting held on June 25 at which about 60 members of the Senate and House of Representatives severely criticized the Administration (represented at the meeting by Commerce Secretary Baldrige, then-Acting U.S.T.R. Smith, and White House advisor Friedersdorf) for failing to take action to limit imports of Canadian lumber. Among the participants in this meeting was Trent Lott, the second-ranking Republican in the House of Representatives, who stated that "Canada has to be made to understand that there's a freight train coming down the tracks on this issue and there's no brakeman." In addition, Senator Jeremiah Denton (R. Alabama) recently asserted that the U.S. lumber industry has lost 22,000 jobs to Canadian imports during the past five years.

E. Interest Groups

1. Interest Groups Likely To Oppose Proposals

There appear to be two categories of industries that are likely to oppose proposals to modify application of the trade remedy laws to Canada.

The first category includes those U.S. industries that are currently complaining about alleged Canadian unfair trade practices, such as those involved in the production of lumber, pork, steel, raspberries, grains fish, aircraft, and fresh vegetables. Indeed, a number of industry groups came forward during negotiation of the U.S.-Israel FTA to request exclusion from the FTA's coverage, including those involved in the production or sale of jewelry, bromine, textiles, citrus, and certain chemicals.[27] We would expect similar requests from various industries if negotiation of the Canada-U.S. FTA goes forward. In addition, there have been suggestions that certain Congressmen and the lumber industry will attempt to link a possible Canada-U.S. FTA to reduction of imports of Canadian lumber.

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[27] When the textiles industry failed to delay the reduction of duties on Israeli imports, it retaliated by demanding a "call" on Israeli cotton flannel sheets under the Multifibre Agreement.

The second category includes those industries and groups with complaints about imports from countries other than Canada, who are likely to oppose the proposals on the grounds that a precedent would be established for modifying application of the trade remedy laws to other countries. Included in this category are such groups as the Labor-Industry Coalition for International Trade (LICIT)[28] and the textiles industry.

2. Interest Groups Likely To Support Proposals

The interest groups most likely to support proposals to modify the trade remedy laws in an FTA are as follows:

- U.S. groups that support trade liberalization on principle, such as the Emergency Committee on American Trade, the American Association of Exporters and Importers, and Consumers for World Trade.

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[28] LICIT is a broad-based coalition of large manufacturing concerns and labor unions in the steel, clothing and textile, electronics and aerospace sectors. LICIT drafted and strongly supports the Trade Law Modernization Act of 1985, and can be expected to react negatively to any attempt to limit the trade remedy laws.

- U.S. industries that would benefit from limitations on the Canadian trade remedy laws.

- U.S. importers and consumers of Canadian products that are interested in preserving their access to reasonably priced Canadian goods.[29]

- U.S. industries and groups that have such a strong interest in other elements of the FTA that they will support the entire package even though they are not specifically interested in modifying the trade remedy laws.[30]

- Companies or groups that are interested in generally stronger U.S.-Canadian ties, such as the Canadian-American Committee.

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[29] In general, the political influence of U.S. importers and consumers is presently somewhat weaker than it has been in the recent past.

[30] During the hearings on the proposed U.S.-Israel FTA, the U.S.T.R. noted that there was strong interest in the United States for negotiating with Canada for trade liberalization on the following products: furniture, cosmetics, lawn mowers and snow blowers, alcoholic beverages, home appliances, and high technology items. Proposed United States-Israel Free Trade Area: Hearings Before the Subcomm. on Trade of the House Comm. on Ways and Means, 98th Cong., 2d Sess. 17 (1984).

F. Factors that May Influence Policy in the Future

Certain future events may affect the feasibility of proposals to modify the import relief laws:

1. Reduction of the U.S. Trade Deficit

If the value of the U.S. dollar declines significantly in the near future, the trade deficit may shrink over the next few years. Trade policy might then become a less significant political issue, and the chances would improve for acceptance of significant limitations on use of the import relief laws. At the same time, however, in that situation the U.S. government (including Congress) might become significantly more interested in pursuing multilateral trade agreements than a bilateral agreement with Canada.

2. Resolution of the Dispute over Lumber Imports

The present large scale effort by some U.S. lumber companies to secure legislation limiting imports of Canadian lumber suggests that some in Congress may try to link progress on the FTA to agreement by Canada to restrain lumber exports. However, the substantive argument for making such a linkage is weak, as

- Lumber imports are already duty free and would not be facilitated by an FTA, and
- The U.S. Commerce Department in its 1982-83 investigation established that imports of lumber from Canada were not benefiting from countervailable subsidies.

Thus, the U.S. industry and its congressional supporters have little basis for arguing that an FTA would facilitate lumber imports either by reducing tariffs or by reducing U.S. restraints on Canadian subsidies. Based on these facts, the Canadian Government could point out that efforts to link these two issues would be clearly the product of protectionist interests in one industry, would be unrelated to the merits of the FTA, and would be an impediment to the efforts of the United States to pursue an FTA with Canada.

3. Increased Application of Canadian Import Relief Measures to U.S. Exports

Several significant applications of the Canadian countervailing duty and safeguards laws to U.S. exports might make the reciprocal benefits of predictable market access more explicit for U.S. policymakers.

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The future course of all the events discussed above is very difficult to predict. And, of course, other policy changes and irritants affecting U.S. and Canada are likely to occur in the future. Completing an FTA agreement may in any event take one or more years, during which time new events could impede progress. We see no advantage -- and considerable risk -- in postponing FTA discussions in the hope of finding a more propitious time for U.S. acceptance.

IV. FEASIBILITY OF MODIFICATION OF THE TRADE REMEDY LAWS IN AN FTA

We understand that in the discussions of a Canadian-U.S. FTA the Canadian Government would pursue, in addition to the elimination of duties, measures which would increase the predictability of access for Canadian products to the U.S. market. At present, the threat of U.S. countervailing duty, antidumping, and safeguards actions inhibits investment in Canadian industries that would produce for the U.S. market. Therefore, one key element of the FTA for Canada would be provisions designed

to increase the predictability of the effects of the import relief laws. The purpose of these provisions would not be to sanction dumping or unfair subsidy practices, but rather to enable investors and industries to have a greater degree of certainty as they make long-range plans about production for the U.S. market.

In this section we evaluate the feasibility of various proposals for achieving this goal. We have derived these proposals from the recent literature on the topic, suggestions from the Canadian Government, and our own analysis.

Before discussing specific proposals, we express two general conclusions with respect to this effort:

First, in view of the current trade deficit, the protectionist sentiment in Congress, and the effort of some Democratic legislators to make trade an election issue, we feel it is unlikely that an explicit proposal to create special import relief standards for exports from Canada will be acceptable to the Administration or Congress, as such special standards will create an easy target for criticism by protectionist interests. On the other hand, we are cautiously optimistic about the prospects for agreement on less visible, more process-

oriented provisions that build a system for avoiding and resolving conflicts in U.S.-Canadian trade and which give Canada a special role and influence in U.S. import relief decisions. An agreement of this nature may give Canada the predictability it seeks without generating strident political opposition in the United States.

Second, we believe the chances of achieving a satisfactory agreement will be increased if, before negotiating on specific proposals to limit the U.S. import relief laws, Canada suggests in general terms that one of the objectives of the FTA should be a balanced package of measures to enhance the predictability of access to both markets. It seems likely that U.S. officials, legislators, and business interests would have an interest in an agreement that would improve predictability of access to the Canadian market. Thus, they may be willing to acknowledge the value of negotiating reciprocal measures designed to reduce the danger of trade disruptions that would frustrate the plans of businesses operating in the newly created free trade area.

A package of such measures can potentially cover a wide range of topics, some of greater interest to one side, and some of greater interest to the other.

In addition to import relief measures, they might include provisions on:

- Government procurement.
- Local content laws.
- Regulations on investment.
- Intellectual property.
- Trans-border data flows.
- Provincial and state regulatory practices.

If both parties negotiate with the goal of improving predictability of market access, there is a reasonable chance that an agreement could be reached which includes measures of interest to Canada which reduce the threat of U.S. import relief actions.

The following paragraphs discuss specific proposals relating to the U.S. countervailing duty law, which creates the greatest threat of U.S. import relief actions affecting Canada. Thereafter, consideration is also given to the antidumping law and the safeguards law.

Each proposal is followed by an "evaluation," in which we offer our judgment on the feasibility or

desirability of the proposal. When a proposal can be implemented in more than one manner, each alternative is followed by a "comment" containing our views on that alternative.

A. Proposals To Limit U.S. Countervailing Duty Actions

In general, "subsidy" conflicts arise when the government-business relations vary in two countries that trade with each other. Many benefits available in Country A not available in Country B will be viewed as a subsidy by companies in Country B. Therefore, any program to establish open trade between the countries will, as it becomes successful, inevitably bring to the forefront "subsidy" questions. Enterprises and workers will feel that, if they are being expected to compete in a common market with enterprises and workers in another country, the benefits available to all enterprises competing in that market should be essentially the same -- or offsetting tariffs should be imposed at the border to establish a parity of competitive opportunity. It is to be expected that these questions would be especially important in trade between the United

States and Canada, in light of the advanced state of tariff reductions, the vast amount of trade between the two countries, and their rather different customs concerning government inducements for business enterprises.

The approach to further trade liberalization in the form of an FTA would be incomplete or one-sided if it did not address the question of how to resolve conflicts over "subsidies," i.e., differences in government-business relations. It would leave U.S. industries with the feeling that their home market has been opened further to competitors who have unfair government support; and it would leave Canadian industries with the feeling that the benefits of the FTA are illusory because the threat of U.S. countervailing duties would still impede their access to the U.S. market. It therefore appears appropriate that Canada raise the question of avoiding disruptive subsidy conflicts that will discourage enterprises from pursuing the full benefits of an FTA. By the same token, the United States could benefit from new limitations on subsidy programs in Canada. What is needed is a cooperative process for analyzing the trade impact of differences in governmental practices between the United States and

Canada and eliminating trade distortions in the least disruptive fashion.

Under U.S. law, exports from Canada can be subject to a countervailing duty action only if the U.S. Government finds, after extensive investigation, that there is both a countervailable subsidy and "injury" to the U.S. industry. Subsidy determinations are made by the International Trade Administration ("ITA") of the Commerce Department. Injury determinations are made by the International Trade Commission ("ITC"), an independent government agency. Potentially, modifications could be made in the standards and procedures governing both subsidy and injury determinations, as discussed below.

1. Proposals Relating to Determinations and Calculations of Subsidies

The element of the U.S. countervailing duty law that causes the most uncertainty is the discretion given to the ITA and the courts to determine what programs are countervailable subsidies and how the size of the subsidies is calculated. It is often difficult to predict how the ITA and the courts will rule on new subsidy issues.

Ideally, the FTA would bring as many subsidy decisions as possible under the "rule of law" by establishing guiding principles, specific rules where possible, and objective procedures for applying the principles and rules to individual government programs that are alleged to be subsidies. This system could be beneficial for Canada, as it would reduce the possibility of decisions based exclusively upon the U.S. view of the proper relationship between government and private industry. The system would also commend itself to the United States, however, since it is consistent with a long-range interest of the United States in promoting stability and predictability in the world economy.

As the basis for this system, the FTA could set forth comprehensive normative principles as guides for determining which economic programs would be countervailable and which would not. These principles would be based upon the objective of establishing an effective open marketplace between Canada and the United States.

The agreed-upon principles could then be implemented in several ways: by setting forth in the

FTA which existing economic programs, or types of programs, would be countervailable and which would not; by modifying domestic countervailing duty law to incorporate the principles; and/or by establishing a respected and knowledgeable Joint Committee, with members from both countries, to apply the principles in an objective and reasoned fashion to future economic programs and new subsidy issues.

The elements of such a rule of law system are discussed briefly below. In our judgment, there is a reasonable possibility that U.S. officials would find the overall program acceptable. However, even if only some of the elements were accepted, they would provide a useful starting point for future improvements in the system. As indicated below, we feel that the process-oriented proposals (such as for establishment of guiding principles, development of a list of types of acceptable government programs, and creation of a Joint Committee to resolve subsidy issues) are more likely to be acceptable than proposals that expressly create a favored position for Canada in U.S. law.

a. Governing Principles or Guidelines for Determining Which Economic Programs Will Be Countervailable and Which Will Not

The FTA could state, for example, that each nation is free to adopt macroeconomic policies of its own choosing and that programs essential to the conduct of those policies would be presumptively considered not countervailable subsidies, even though they might make it more attractive to engage in a particular business in one country than in the other. This principle would include, for example, tax rates; money supply and interest rates; natural resource utilization policies; environmental regulations, etc.

The principles could also state that both countries will try to avoid programs which are not essential elements of macroeconomic policy and which confer benefits on individual industries in a way which is likely to discourage investors from establishing or pursuing business in the other country. Such programs could be presumptively considered as countervailable subsidies.

Evaluation: We see no reasonable basis for the U.S. Government to object to a formulation of governing principles; indeed, we would expect this proposal to be welcomed.

b. List of Programs that Will/ Will Not Be Countervailable

A somewhat more specific approach to increasing predictability for Canadian industry would be for the U.S. and Canadian Governments to evaluate all of the current economic programs of Canada and the United States and prepare a list of those programs that would be countervailable and those that would not.[31] Alternatively, the list could indicate types of programs (for example, those designed to promote research and development, or for worker retraining). This list would then be given dispositive influence in countervailing duty actions involving the listed programs.

In addition, this list could be the basis of a commitment from both governments to limit subsidy programs that affect Canada-U.S. trade.[32] Currently,

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[31] Conceivably, some economic programs exempted under this procedure might still be limited with quantitative restrictions.

[32] Such an obligation is already imposed by section 11.2 of the GATT Subsidies Code, which provides that

> Signatories recognize that [domestic] subsidies . . . cause or threaten to cause injury to a domestic industry of another signatory . . . , in particular where such subsidies would adversely affect the conditions of normal competition. Signatories shall therefore seek to avoid causing such effects through the use of subsidies.

However, this provision has not been given meaningful effect.

members of the General Agreement on Tariffs and Trade ("GATT") rely upon the GATT countervailing duty provisions that permit member countries to protect themselves from subsidies practices of other countries. It would be a logical next step for Canada and the United States to agree to exercise self-restraint over subsidy programs in exchange for new restrictions on the use of countervailing duty actions.[33]

> Evaluation: One possible drawback to this proposal is that some U.S. industries (see section III.E.1. above) may insist on participating in any review of Canadian subsidies practices, just as they would in a typical countervailing duty case. However, if the review is limited to types of subsidies, rather than specific subsidy programs, that problem might be avoidable.

c. Canada-U.S. Joint Committee

The FTA could establish a Canada-U.S. Joint Committee to apply the general principles on subsidies established by the FTA in answering questions and resolving disputes over subsidy and countervailing practices. The Committee, which could have both consultative and adjudicative functions, could take

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[33] In the case of the U.S.-Israel FTA, the Israeli Government committed to eliminate certain subsidy programs without obtaining any limitations on the application of the U.S. countervailing duty law.

any one of a number of forms, but should be designed to ensure that Canada has a voice in the decisions that have a fundamental effect on the Canadian economy.[34]

Ideally, an independent Joint Committee would be formed and charged with the task of interpreting and applying the FTA. The Committee could both

- apply specific rules in the FTA (for example, determine whether an economic program was of a "type" listed in the FTA), and
- interpret the general principles on subsidies in the FTA to determine issues not covered by a specific rule.

Through its decisions in individual cases, the Committee would establish a body of interpretation that would provide the needed guidance and predictability for both

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[34] There have been several failed attempts to improve the dispute resolution mechanism in the GATT. If an effective mechanism could be created as part of a Canada-U.S. FTA, some might suggest -- and others might fear -- that it would then be viewed as a model for the GATT. However, it seems that the U.S. Government would be likely to concede more decision-making authority in the context of a bilateral agreement with a close ally such as Canada than it would in the context of a multilateral agreement. For this reason, it would probably be advisable to characterize any proposal concerning bilateral dispute resolution as a unique method to be used by the United States and Canada in light of their uniquely close relationship, and not as a possible model for wider application.

U.S. and Canadian industries.[35]

To ensure that the Joint Committee's decisions as to what is a countervailable subsidy have the requisite effect in the United States, it would need to be given a position as a replacement for or supplement to the ITA in cases involving exports from Canada. Alternatively, the Joint Committee's determinations might be deemed persuasive, but not binding, for the ITA.

The Committee could also be available to render advisory opinions when no specific dispute was pending. For example, either of the governments could consult the Committee before a new economic program was established to ensure that the program was in compliance with the FTA. In addition, private parties could raise issues with the Committee prior to initiating an expensive countervailing duty case. Presumably, such advisory opinions could help reduce conflicts over subsidy issues.

To enable the Joint Committee to function with authority and legitimacy, its members should be nonpolitical, respected experts on international trade

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[35] The FTA could contain a procedure for periodically reviewing the determinations of the Joint Committee and making necessary adjustments in the FTA or domestic law.

issues. They might be selected from the ITC and the Canadian Import Tribunal, or they could include former senior government officials or well-known scholars. In any event, the Committee should be composed of individuals known for their commitment to establishing fair rules for international trade, rather than persons who might be suspected of political partisanship.[36]

> Evaluation: We anticipate strong initial resistance to the concept of a Joint Committee. However, because this proposal has been advanced (in varying forms) in the past,[37] we feel there is a reasonable chance that sufficient support for a Committee eventually could be mobilized. The Committee may have to be limited to an advisory role for an initial period during which it would establish its legitimacy and both countries would become comfortable with the idea of limited joint dispute settlement.

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[36] To ensure that the Joint Committee commands the respect of the public, its procedures should provide for objectivity, transparency, careful factual determinations, reasoned decisions closely linked to stated principles, and comprehensive written opinions.

[37] See, e.g., S. 2228, 98th Cong., 2d Sess. (1984) ("to authorize the President to negotiate an agreement establishing a joint Commission to resolve trade and other economic disputes between the United States and Canada"); S. Con. Res. 13, 97th Cong., 1st Sess. (1981) ("Expressing the sense of the Congress with respect to an international agreement establishing a North American Commission for Cooperation and Development").

d. Modify Domestic Law

The U.S. and Canadian Governments could agree in the FTA on some specific ways in which the general principles on subsidies would be reflected in their respective domestic laws on countervailing duties. Some of the policies proposed for consideration in this context include:

(i) A guarantee that the ITA will maintain its current practice of refusing to countervail programs formally and actually available to more than a limited number of producers or industries (the "general availability" rule).[38] For example, in the countervailing duty case involving Canadian softwood lumber, the ITA determined that, because stumpage policies made timber available on the same terms to several different industries, the alleged stumpage subsidies, even if they existed, were generally available and therefore not countervailable. (Comment: An agreement on maintaining the current application of the general availability rule may be attractive, as it would involve the classic common law method of gradually adding

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[38] This policy is based upon the statutory definition of a countervailable domestic subsidy as one granted "to a specific enterprise or industry or group of enterprises or industries." 19 U.S.C. § 1677(5).

certainty and clarity to the law by interpreting general legislative standards in individual cases and then codifying the interpretations so that they are easier to understand and apply.)

(ii) Application of the "differential subsidy" concept. Under this principle, either (1) domestic industries that are themselves subsidized would be prohibited from initiating a proceeding or (2) only the differential between the subsidies of the domestic and foreign industries could be countervailed. (Comment: The differential subsidy approach appears unrealistic, since it is novel and would involve complex two-country investigations.)

(iii) An increase in the de minimis standard. Under current ITA practice, a subsidy generally is deemed de minimis if it results in a margin of 0.5% or less. An FTA could raise the standard for Canada, requiring a de minimis finding if the margin was, for example, 2% or less. (Comment: Since raising the de minimis standard would expressly permit Canada to engage in subsidy practices to a greater extent than it may currently, that proposal would likely be unacceptable to the U.S. Government unless attractive reciprocal concessions were made.)

Evaluation: There is, of course, a danger that any of these proposals to modify U.S. law, no matter how technical and well-justified, may attract rigorous scrutiny in Congress. The recent flurry of legislation on import relief -- particularly the natural resource bills which would alter the "general availability" rule and the bills that would restrict lumber imports -- indicates that many Congressmen and interest groups have become quite sophisticated and knowledgeable about the import relief laws and therefore would not overlook such provisions. Indeed, the danger exists that a proposal to change a U.S. statute or interpretation could generate a backlash that could lead to an unfavorable amendment to the law. Therefore, we recommend that the Canadian Government focus on process-oriented provisions, rather than proposals, such as those above, that would give Canada a special position in U.S. law. This conclusion, of course, could be reevaluated depending on the progress of the negotiations.

2. Proposals Relating to Injury Determinations

As described above, exports from Canada can be subject to a countervailing duty action only if there is a countervailable subsidy and if "there is a reasonable indication that . . . an industry in the United States . . . is materially injured, or . . . is threatened with material injury . . . by reason of imports of that

merchandise. . . ."[39] There are two elements to an injury determination: the finding of injury itself and the finding that the injury was actually caused by the imports. In the U.S. countervailing duty statute, "material injury" is defined very broadly as "harm which is not inconsequential, immaterial, or unimportant."[40] The causation standard -- "by reason of" -- requires only that the imports be a contributing cause to material injury.[41] In practice, the injury standard in the countervailing duty statute is relatively easy to meet.

Determinations of injury are made by the ITC, an independent agency.[42] Although all of the decisions of the ITC cannot be predicted with absolute certainty, its discretion is limited by the relatively clear standards set forth in the law. The ITC's inquiries

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[39] 19 U.S.C. § 1671(a)(2).

[40] Id. § 1677(7).

[41] The U.S. Court of International Trade recently stated that the ITC, in applying this standard, "must rule in the affirmative [on injury] if it finds even slight contribution from imports to material injury, and . . . should not weigh that contribution against the effects associated with other factors . . . ." Gifford-Hill Cement Co. v. United States, No. 83-12-01737, slip op. 85-79 (July 31, 1985).

[42] ITC Commissioners must be nominated by the President and confirmed by the Senate. By law, no more than three of the six Commissioners may belong to the same political party.

and decisions are based primarily on the specific facts in each case, rather than on interpretations of law or exercises of discretion. Therefore, the case for improving predictability does not appear to be as compelling in the context of injury determinations as it is in the context of subsidy determinations. Nonetheless, an FTA potentially could limit application of the countervailing duty law by altering the injury standard and/or by requiring injury issues to be resolved through dispute resolution mechanisms.

a. Alterations in Injury Standard

(i) One way to limit the applicability of the countervailing duty law to Canadian exports would be to increase the level of injury required for a countervailing duty action to proceed against imports from Canada. The standard now applied in U.S. safeguards actions under section 201 of the Trade Act of 1974 might be the most logical to apply, as the ITC has extensive experience in its application. That standard requires the imports to cause "serious injury" to the domestic industry. Although "serious injury" is not defined in the statute, it is well-accepted that "serious injury" is significantly more difficult to prove than "material injury." (Comment: Because recently there have been

proposals to loosen the injury standard for safeguards actions to make import relief more accessible (see Section IV.C.1.a below), it seems very unlikely that the U.S. Government would agree to tighten the injury standard for countervailing duty cases.)

(ii) Another possibility would be to require that the injury result exclusively from the countervailable subsidy, rather than the total quantities of imports. In other words, if the Canadian products undersold the U.S. products by 10%, but the subsidy only contributed a 1% benefit, the ITC would evaluate only the injury caused by the 1% benefit. This principle was formerly applied in U.S. import relief actions, but, in practice, the ITC now considers only the total volume of subsidized imports and not the amount of the subsidy. (Comment: This issue has been the subject of some controversy in the United States. However, we think it unlikely that the U.S. Government would agree to change current ITC practice through an FTA.)

(iii) Another alternative would be to create an injury threshold -- that is, prohibit a finding of injury if Canadian exports constituted less than a specified percentage of all imports or of the U.S. market. Thus, a countervailing duty action

would be terminated if imports of a product from Canada amounted to under, e.g., 5% of imports from all countries, or under 5% of the entire U.S. market for that product. (Comment: Although the ITC already considers market share in its analyses, the U.S. Government would be unlikely to agree to make market share the dispositive factor in injury determinations.)

(iv) Finally, the FTA could eliminate cumulation for Canadian exports. Under current U.S. law, if parallel countervailing duty actions are initiated against imports of the same products from more than one country, the ITC is required to cumulate the effect of imports from all of the subject countries in determining whether the U.S. industry is injured. The Canadian Government could suggest that the ITC be required, in future cases involving Canada, to isolate Canadian imports from imports from other countries in determining whether the Canadian imports were causing injury. (Comment: We feel that elimination of cumulation for Canadian exports is a controversial, but not entirely unrealistic, possibility, as cumulation is a relatively new addition to the U.S. statute.)

Evaluation: Modifying the injury standard, or the way it is applied, could clearly provide Canada with greatly increased security by eliminating certain

marginal cases which presently result in countervailing duties. But, for that very reason, we feel that, in general, the proposals relating to the injury standard would not be acceptable politically in the United States.

b. Joint Committee for Injury Determinations

Potentially, the same Joint Committee described above for subsidy issues could also resolve disputes over injury issues.

Evaluation: Because the ITC is already considered an impartial body primarily concerned with factfinding rather than legal interpretation or discretionary determinations, it may be very difficult to justify involvement of the Joint Committee in injury determinations.

3. Political and Diplomatic Resolution

It may come to pass that Canada and the United States will be unable, or unwilling, to agree on a set of general principles to govern subsidy and injury determinations. In that event, it may be advisable for the FTA to require consultations between the two governments immediately after a countervailing duty

action is initiated.[43] During the consultations, the governments would determine, based upon political and diplomatic considerations, whether the case should be allowed to proceed; should be terminated unconditionally; or should be terminated upon the imposition of quotas, added duties, voluntary price increases, or voluntary subsidy reductions. The FTA could provide either that the results of the consultations would be binding or that they would be nonbinding.

a. Binding Dispute Settlement

An example of a binding consultative mechanism is the EEC Treaty. Under the Treaty, the European Commission ("Commission") has wide discretionary power to determine whether the various types of aid granted by the member states are compatible with the Common Market. Commission control takes the form of constant review; member states are under a continuous obligation

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[43] A strong argument could be made for a provision on consultations based on the fact that the GATT Subsidies Code requires consultations with the exporting country before a countervailing duty case is initiated. Current U.S. law contains no such requirement; the Commerce Department's regulations require only that a copy of the countervailing duty petition, with confidential information deleted, be delivered to a representative in Washington, D.C. of the affected country. 19 C.F.R. § 355.26(g). On the other hand, foreign governments normally do have the opportunity to participate in the countervailing duty investigation after the case is initiated.

to report to the Commission on their subsidy practices. The Commission is empowered to initiate legal action in the European Court of Justice to enforce decisions against member states.[44] (Comment: The EEC model seems too extreme for both Canada and the United States, as it would require both countries to yield substantial sovereignty over these issues.)

b. Nonbinding Dispute Settlement

An example of a nonbinding dispute settlement mechanism is contained in Article 19 of the U.S.-Israel FTA. Although Article 19 expressly does not apply to the imposition of antidumping or countervailing duties, it serves as a recent example of an international dispute resolution procedure that the U.S. Government considered reasonable. Under Article 19, disputes concerning the FTA are subject to several levels of conciliation:

- First, the parties are obliged to attempt to arrive at a mutually agreeable resolution through consultations.

- Second, if the consultations fail, a joint committee is to be formed, which has 60 days to resolve the dispute.

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[44] See Treaty Establishing the European Economic Community Art. 93 (1957); J. Cunnane & C. Stanbrook, Dumping and Subsidies 16 (1983).

- Third, if the joint committee fails, a three-member conciliation panel is to be formed; each party selects one member and those two members select the third. If the panel fails to reach a resolution within three months, it is to present the parties with a report containing findings of fact, determinations, and proposals for settlement. The report is non-binding.

- After the panel has presented its report, the affected party is entitled to take any appropriate measure.

(Comment: Because it does not provide for binding decisions, the U.S.-Israel FTA model may not provide sufficient security for Canada.)

Evaluation: Acceptance of the above types of political and diplomatic dispute resolution in the United States seems very unlikely. Because U.S. industries historically have been concerned about being "sold out" by the U.S. government for political or diplomatic reasons, the 1974 Trade Act and the 1979 Trade Agreements Act greatly increased the automaticity and transparency of the import relief laws. Political/diplomatic dispute resolution of countervailing duty cases would be in sharp conflict

with this trend.[45]

B. Proposals To Limit Antidumping Actions

Under U.S. law, Canadian exports to the United States are subject to antidumping duties if Canadian companies sell their products at a lower price (after appropriate adjustments) in the United States than in Canada and the imports are causing injury to the U.S. industry. The dumping determinations are made by the ITA, while the injury determinations are made by the ITC.

Theoretically, elimination of tariffs may reduce, if not completely remove, the impetus to dump. An industry whose domestic market is protected by a high tariff can sell at one price in its home market and at a lower price in a foreign market because its home market price cannot be undercut by imports of its own or others' lower-priced goods. If the high tariff is

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[45] As discussed in section IV.A.1.d. above, joint decisionmaking through an impartial Joint Committee that applied legal standards, rather than political and diplomatic considerations, might be acceptable. For example, the Committee might screen cases at their outset to determine whether the alleged subsidy, if proven, would be countervailable.

removed, competition in the home market is enhanced and prices in the home and foreign markets will tend to equalize.

Even if antidumping actions remain a concern, modifications to the antidumping law through the FTA may not be feasible or appropriate. The predictability of the U.S. antidumping law is already substantial.[46] In many situations, companies can review and adjust their pricing policies in advance to avoid a finding of dumping. Nonetheless, we discuss below some adjustments that potentially could be made in the rules governing antidumping actions.

1. Proposals Relating to Determinations of Dumping and Calculations of Dumping Margins

a. Governing Principles for Determining Dumping

As with government economic programs (see section IV.A.1.a above), the FTA could set forth principles and guidelines to govern findings of dumping.

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[46] The principal uncertainty in antidumping cases arises from choices of alternative accounting techniques for calculating the various adjustments which the statute provides should be made before U.S. prices are compared with foreign prices, and in "constructing" a foreign value when foreign market prices are not available. These uncertainties are similar to those involved in general accounting practice, and can be reduced through the building of a body of precedent through the published decisions of the ITA.

Evaluation: Because the predictability of the antidumping law is already substantial, and government behavior is not at issue, there appears to be little merit in attempting to define a new set of principles to govern dumping.

b. Canada-U.S. Joint Committee

As discussed for countervailing duty cases (see section IV.A.1.c. above), the FTA could establish a Canada-U.S. Joint Committee to resolve new dumping issues.

Evaluation: Again, because the predictability of the current law is substantial, and government behavior is not at issue, there does appear to be a useful role for a Joint Committee.

c. Modify Below-Cost-Sales Rule

As part of its determination of the U.S. and foreign prices of the products in question, the ITA makes adjustments for a number of factors, including commissions, marketing costs, packing costs, transportation costs, taxes, etc. As noted above, the principles applied by the ITA in this determination are relatively straightforward and predictable.

However, one of the required adjustments -- for below-cost sales -- may no longer be appropriate after the elimination of tariffs. Currently, the antidumping

law requires that the ITA, when calculating the foreign market prices that will be compared with U.S. market prices, completely disregard foreign market sales that have been made below the cost of production "over an extended period of time and in substantial quantities."[47] In practice, when such sales are disregarded, the average foreign market price is higher than it would be otherwise, thereby increasing the chances of a finding of dumping. The FTA could possibly eliminate application of the below-cost-sales rule in antidumping cases involving Canadian exports. This modification could be justified on the grounds that currently

- Companies located in the United States could sell their products in the U.S. at below the cost of production without penalty,[48] and

- Canadian companies that make sales below cost in both markets could potentially be subject to antidumping duties even though they had not engaged in price discrimination.

Evaluation: Modification of the below-cost-sales rule would eliminate

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[47] 19 U.S.C. § 1677b(b).

[48] Such sales, of course, would be subject to the U.S. law prohibiting "predatory pricing."

one source of antidumping complaints and appears to have reasonable political and economic justifications. However, because this modification would require a special amendment to the antidumping law, strong opposition is likely and the costs of seeking the change probably would outweigh the benefits.

2. Proposals Relating to Injury Determinations

The same injury standard is applied in antidumping cases as in countervailing duty cases: there must be "a reasonable indication that . . . an industry in the United States . . . is materially injured, or . . . is threatened with material injury . . . by reason of imports of that merchandise . . . ."[49] Also as in countervailing duty cases, injury determinations are made by the independent ITC.

a. Alterations in Injury Standard

The proposals relating to modification of the injury standard in countervailing duty cases are also applicable in the antidumping context:

- The FTA could raise the level of injury needed for imposition of antidumping duties by requiring "serious injury" rather than "material injury" to the U.S. industry;

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[49] 19 U.S.C. § 1673(2).

- The FTA could require that the injury result from the dumping margin, rather than the total quantities of imports;

- The FTA could create an injury threshold that would prohibit imposition of antidumping duties if Canadian exports constituted less than, e.g., 5% of U.S. imports from all countries, or less than 5% of the entire U.S. market for that product;

- The FTA could prohibit cumulation of Canadian exports with exports from other countries when the ITC makes injury determinations in parallel cases.

Evaluation: As indicated previously, because the ITC is a relatively impartial body and its decisions are based primarily on facts, rather than interpretations of law or exercises of discretion, the case for improving predictability in injury determinations is not very strong. Therefore, we feel that the above proposals are not likely to be acceptable.

b. Joint Committee for Injury Determinations

Also as discussed for countervailing duty actions (see section IV.A.2.b. above), the FTA could bestow

authority to make injury determinations on an impartial Joint Committee composed of respected experts on international trade issues.

Evaluation: Because the ITC is already considered an impartial body primarily concerned with factfinding, it would be difficult to justify transferring its authority to the Committee.

3. Political and Diplomatic Resolution

The FTA could provide for early consultation and a bilateral process for resolving dumping cases on a political or diplomatic basis (see section IV.A.3. above).

Evaluation: Political/diplomatic resolution of antidumping actions appears inappropriate, as government policies are not normally at issue in this context. Therefore, neither binding nor nonbinding dispute resolution of antidumping injury determinations would likely be acceptable to the U.S. Government.

C. Proposals to Limit Safeguards Actions

GATT Art. XIX ("the escape clause") permits member countries to impose import relief on products being

imported in such increased quantities as to cause serious injury to competing domestic producers. Under U.S. law, such safeguards relief may be imposed only after a two-stage process:

First, the ITC must find that "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,"[50] and must recommend a specific form of import relief to the President. In safeguards actions, the ITC considers the effect on the domestic industry of imports from all countries; it is not necessary, as it is in countervailing duty and antidumping actions, for the petitioners to identify a specific country as the source of injury. In addition, it is not necessary to allege that the imports are subsidized or dumped.

Second, the President may provide for import relief for the domestic industry "unless he determines that provision of such relief is not in the national economic interest of the United States."[51] The forms of import relief available to the President include:

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[50] 19 U.S. § 2251(b)(1).

[51] 19 U.S.C. § 2252(a)(1)(A).

- an increase in, or imposition of, any duty;
- a tariff-rate quota;
- imposition of quantitative restrictions on imports;
- orderly marketing agreements with foreign countries; or
- any combination of the above.

In practice, if the ITC has found injury, the President has enormous discretion in deciding whether to impose relief and what form the relief should take.

The various options for modifying application of the safeguards law are as follows[52]:

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[52] Some might complain that any modifications of the safeguards law to benefit Canada would be "selectivity" and a violation of the GATT. The concept of "selectivity" is normally used to describe a situation in which a country applies safeguards measures to imports from only a small minority of the countries that export the subject product. Selectivity is thought to violate GATT Art. I, which requires member countries to extend equal treatment to all other members. However, since (i) GATT Art. 24 expressly permits the formation of free trade areas and customs unions (subject to certain conditions) and (ii) an exemption of Canada from safeguards relief would be an integral part of the Canada-U.S. FTA, our preliminary view is that exemption of Canada from U.S. safeguard actions would not violate the GATT. (U.S. law does not prohibit selectivity.)

1. Complete Elimination of Safeguards Actions

Because the ultimate goal of an FTA is to eliminate all barriers to fair trade, it is arguable that safeguards actions should not be permitted at all after an initial transition period. Alternatively, the FTA could require the governments to consider elimination of safeguards actions after a specified period.

Evaluation: We feel it is highly unlikely that the United States would ever totally give up its ability to limit imports from any country in a safeguards action, especially as the proposed Trade Law Modernization Act of 1985 and the proposals of the Senate Democratic Working Group on Trade both call for increased use of safeguards actions.

2. Proposals Relating to Injury Determinations

As described above, safeguards relief can be granted only if imports are "a substantial cause of serious injury" and the President decides that relief is appropriate. The degree of injury required in a safeguards action -- "serious injury" -- is more difficult to establish than that required in countervailing duty and antidumping actions -- "material injury." "Substantial cause" is defined as "a cause which is

important and not less than any other cause."[53]

a. Alterations in Injury Standard

The FTA could make one or both of the following modifications in the injury standard for safeguards actions:

(i) The FTA could require that in safeguards actions, the ITC would always consider the effect of Canadian exports in isolation, rather than including them with the exports of all other countries, as is now done.[54] Then, unless the Canadian exports themselves were the cause of injury, the ITC's recommendations to the President for relief would exclude Canada. (Comment: This proposal could also be implemented at the Presidential determination stage, as discussed below.)

(ii) The FTA could impose a stricter causation standard for safeguards cases involving Canadian exports. Instead of the current requirement that imports be at least as important a cause of the injury as any

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[53] 19 U.S.C. § 2251(b)(4).

[54] To this end, the FTA could create a percentage threshold (e.g., 5%) of total imports under which Canadian exports would automatically be excluded from the injury determination.

other cause, the FTA could require that imports be the principal cause of injury. (Comment: Because protectionist interests are now pressuring Congress to make the current causation standard for safeguards cases more liberal,[55] it seems highly unlikely that any proposal for a stricter standard would be accepted. In addition, this proposal would have little meaning unless Canadian exports were considered in isolation.)

> Evaluation: Because both of the above proposals would require amendments to the safeguards statute to give Canada a special position under U.S. law, it seems unlikely that the U.S. Government would consider them.

b. Joint Committee for Injury Determinations

The FTA could confer the authority to make injury determinations in safeguards cases on the impartial Joint Committee of respected trade experts described in section IV.A.1.c. above.

> Evaluation: This proposal could not be implemented unless the U.S. Government also agreed to consider the effect of Canadian exports in isolation

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[55] The recently proposed Trade Law Modernization Act of 1985 would ease this standard to conform to the more liberal standard of the GATT: "in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers." Under this standard, it would be sufficient for imports to be even the least important cause of injury.

> at the injury stage. In any event, because injury determinations are not primarily discretionary or legal in nature, it seems likely that the U.S. Government would object to this proposal.

3. Proposals Relating to Presidential Determination of Relief

The Presidential determination of relief is highly discretionary and subject to influence by a wide variety of political factors. Nonetheless, the FTA could provide guidelines for Presidential determinations involving Canadian exports. Setting forth such guidelines would not require an amendment to the U.S. statute.

Specifically, the FTA could include an "anti-sideswipe" provision encouraging the President to exclude Canadian exports from relief measures when the Canadian exports at issue are themselves not a substantial cause of the injury to the U.S. market. The U.S.-Israel FTA contains such a provision, which provides:

> "3. When, in the view of the importing Party, the importation of a product from the other party is not a substantial cause of the serious injury or threat thereof . . ., the importing Party may except the product of the other Party from any import relief that may be imposed with respect to imports of that product from third countries, taking into account the objective of achieving bilateral free trade as embodied in this Agreement, the domestic laws and international

obligations of the Parties."[56]

Evaluation: Although Canadian trade with the United States is much more significant than Israel's, it might be possible for Canada to obtain an assurance of this nature from the United States. The net effect is to avoid cumulation in safeguards cases and to exempt Canada unless its exports, considered alone, are the source of injury. Because an amendment to current U.S. law would not be needed, we feel that Canada is much more likely to obtain this type of assurance than a modification in the injury standard.

4. Political/Diplomatic Resolution

Because the Presidential decision on whether to grant import relief in safeguards cases is highly discretionary -- as well as political -- it is vital that the exporting countries be able to present their views on the proposed relief. Indeed, GATT Art. XIX requires a country contemplating the imposition of safeguards relief to consult with the exporting countries at the earliest possible stage. This principle was reaffirmed in the U.S.-Israel FTA, which provides:

"1. When a product is being imported in such increased quantities as to be a substantial cause of serious injury or the threat thereof to domestic producers of like or directly competitive products, the importing Party shall consult with the other party in accordance with

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[56] U.S.-Israel FTA Art. 5.

Article 18 before taking any action affecting the trade of the other Party."[57]

The Canada-U.S. FTA could contain a similar commitment.

Evaluation: U.S. law, in fact, already provides extensive opportunity for foreign governments to present their views. After the ITC reports to the President that imports are injuring the U.S. industry, there is, by law, a 60-day period during which the Executive Branch may engage in consultations with foreign governments, foreign industries, and U.S. importers, as well as the injured domestic industries, before making its determination. Therefore, if Canada can obtain an "antisideswipe" provision like the one discussed above, we see little advantage in seeking a commitment on consultations more extensive than the one in the U.S.-Israel FTA.[58]

Conclusions

1. Although bilateral negotiations to develop an FTA that reduces barriers to trade are likely to be welcomed by the Administration and some key leaders in Congress, Canadian proposals to limit or modify the import relief laws may generate considerable controversy

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[57] U.S.-Israel FTA Art. 5.

[58] The nonpolitical Joint Committee discussed earlier would not serve a useful role at the Presidential determination stage, as the decision is a highly political one that does not involve the application of neutral legal principles. In addition, we feel it is highly unlikely that the U.S. Government would forfeit its discretion in these matters by submitting to binding dispute resolution by any type of bilateral committee.

and opposition because of the current protectionist concern over trade.

2. Because congressional approval will be necessary for the FTA, Congress will play an important role in the negotiations. To maximize the chances for obtaining congressional approval, the President is likely to use the fast-track procedure, which requires early and continuous consultations between the U.S. negotiators and the Senate Finance Committee and the House Ways and Means Committee. Consequently, although the Administration may be sympathetic to Canadian concerns, it will be extremely concerned about the congressional reaction to Canadian proposals.

3. Despite the likely opposition from protectionist interests, we feel there is a reasonable possibility of achieving agreement on certain proposals to increase the predictability of Canadian access to the U.S. market.

a. to maximize the chances for acceptance of such proposals, the U.S. Government should be encouraged to view the FTA as a balanced package of measures to enhance the predictability of access to both markets,

of which the provisions pertaining to the import relief laws would be one component.

b. Instead of seeking specific modifications in standards or exemptions, we recommend that the Canadian Government seek agreement on procedures that will give Canada a special role and influence in U.S. import relief decisions. Such an approach may give Canada the predictability it seeks without generating strident political opposition in the United States.

c. The U.S. countervailing duty law appears to pose the greatest threat to Canadian exports because there are substantial differences in the customs and practices of Canada and the United States concerning government assistance to industry and it is difficult to predict how the U.S. Government will rule on new subsidy issues. Ideally, the FTA would bring as many subsidy issues as possible under the "rule of law" by establishing guiding principles, specific rules, and objective procedures for applying the principles and rules to individual programs. To implement

this goal, the FTA could contain some of all of the following elements:

- governing principles or guidelines for determining which economic programs would be countervailable and which would not;
- a list of programs, or types of programs, that would and would not be countervailable;
- creation of an impartial, knowledgeable, and respected Joint Committee, with members from both countries, to apply the principles in an objective and reasoned fashion to future economic programs and new subsidy issues. The Joint Committee could participate in countervailing duty cases and/or render advisory opinions.

We are less optimistic that the United States would accept either modification of the injury standard applied in countervailing duty cases or political/diplomatic resolution of countervailing duty cases through dispute settlement procedures.

d. Because the predictability of the U.S. antidumping law is already substantial, we feel it will be difficult to justify any modifications in the application of the antidumping law to Canada.

e. The U.S. safeguards law gives the President very broad discretion to determine whether to impose import relief if imports have been found to be causing injury to the domestic industry. We feel that Canada should be able to obtain an assurance that the President, in deciding how to impose relief, will take into account (i) whether the subject Canadian exports are a substantial cause of the injury and (ii) the principles and objectives of the FTA. The net effect of such a provision would be to avoid cumulation of Canadian exports with exports from other countries and exempt Canada, unless its exports considered alone are the source of the injury.

ECONOMIC INTEGRATION - SOME ASPECTS OF THE EUROPEAN EXPERIENCE

BY

A. W. A. LANE

OTTAWA

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ECONOMIC INTEGRATION - SOME ASPECTS OF THE EUROPEAN EXPERIENCE

SCOPE

The paper looks first at some of the salient features of the movement towards economic integration in Europe. It then examines the experience of the original six member of the European Economic Community (EEC) with integration in the industrial field (agriculture is not covered here). Attention is given particularly to the expectations as to the likely benefits and problems, mechanisms put in place to deal with the latter and what actually happened. The paper also deals, along similar lines, with Britain's experience in the Community. It concludes with some comments on the implications for consideration of a comprehensive trade agreement with the United States. A short note is appended on some of the trade and economic effects of the European Free Trade Association (EFTA).

A. SALIENT FEATURES

A Long Process

The movement towards economic integration in Western Europe has been going on for a long time and it is still far from complete. In the nineteenth century, formation of a customs union between the German states preceded political union by several decades. Abortive attempts were made to get rid of trade barriers within particular groups of European countries, such as Belgium and the Netherlands and the states of central Europe. There was a short-lived experiment in reducing tariff barriers between most of the major European countries to very low levels. In the 1920's and 1930's, efforts were made to liberalize trade between certain neighbouring countries (e.g., Belgium and the Netherlands again). Proposals were made, particularly by French political leaders, for some kind of European federal union.

However, practically all the solid progress towards integration has been made in the 40 years since the end of the Second World War. In the removal of tariffs and quantitative restrictions (QRs) on trade in industrial goods, the achievements have been impressive. Western Europe

is now a vast tariff - and quota-free zone where such barriers are a rarity. It is not the same for agriculture, where there are not only tariffs but also variable import levies and other restrictive devices. In addition, a variety of non-tariff barriers still exist, even between members of the EEC. They include differing product standards and safety and health requirements, government procurement practices and cumbersome customs procedures. Moreover, except within the EEC, European countries are still free to use measures of contingent protection against one another, such as anti-dumping and countervailing duties though generally only after prior consultation and joint study. On the other, the members of the Community, although they have not completed their hand common market, have in some respects moved beyond this level of integration towards economic, and perhaps eventually political, union. How far they will actually succeed in going in this direction is a matter for speculation at the moment.

Different Approaches

Especially in the early post-war years, a variety of approaches were taken towards integration. Even before the war was over, the governments-in-exile in London of Belgium and Luxembourg (which had formed an economic union in 1922) and of the Netherlands agreed to establish the customs union which became known as BENELUX. Instead of starting with a detailed blueprint, enshrined in a treaty (as the EEC countries did later), they took a series of practical steps based on protocols, conventions and ministerial agreements over a period of almost 15 years. Then they capped the process with a Treaty of Economic Union which codified and consolidated what had been done and reaffirmed the principles and intentions.

In 1948, the Organization for European Economic Cooperation (OEEC) was set up to help in distributing Marshall Plan aid and to further economic cooperation between the member countries. The convention establishing OEEC provided for the rapid completion of customs unions and free trade areas already agreed upon (this effectively meant BENELUX) and the study of other possible arrangements along these lines. However, this

part of the work rapidly degenerated into an effort to standardize descriptions of tariff items, largely it seems because of British opposition to anything more ambitious. OEEC concentrated on freeing up international payments and getting rid of QRs. It also set up a number of industry sector committees, with a view to coordinating European investment plans and avoiding duplication.

The disappointing results of this approach was probably one of the factors leading to the decision of Germany, France, Italy and the BENELUX countries to set up the European Coal and Steel Community (ECSC) in 1951. In effect it was a sectoral customs union with some elements of supra-nationality and provisions to maintain a competitive environment, ensure a greater degree of stability in production and trade and promote rational development of the coal and steel industries. The very success of this initiative and the relationship of iron and steel and coal to their many downstream products and to other forms of energy, especially atomic power, strengthened the arguments for a much broader integration of the economies of the six members. This was part of the economic background in the creation of the European Economic Community (EEC) and the European Atomic Energy Community (EURATOM), both of which came into existence at the beginning of 1958. (There was also a political background as we shall see later).

The Rome Treaty, establishing the EEC, provided for not only a customs union (i.e. removal of internal tariffs and other trade restrictions and establishment of a Common External Tariff (CET) and a common commercial policy towards third countries) but also the following other important measures of integration:-

- free movement of capital and persons and freedom to supply services
- a common agricultural policy
- a common transport policy
- a system for ensuring competition

- procedures for coordinating domestic economic policies and dealing with balance of payments problems
- removal of differences in national laws where necessary for operating the common market
- a social fund to facilitate adjustment
- a European investment bank to assist development
- the association of dependent overseas territories
- provisions for admitting other European states to the Community
- provision for concluding "Unions of states" or association arrangements with other third countries or international organizations

The Treaty also set up institutions to run the Community, particularly a Council of Ministers, a Commission, a Court of Justice and a Parliament.

While the Six were moving towards a relatively high level of integration, other European countries, unable or unwilling to go so far, negotiated the European Free Trade Area (EFTA). Known as the "Outer Seven", as opposed to the "Inner Six", the founding members were Britain, Norway, Sweden, Denmark, Austria, Switzerland and Portugal. With minor exceptions, their association did not cover agricultural products. Nor did it involve setting up a common external tariff or operating a common commercial policy towards the rest of the world, though the Seven did work together to a considerable extent in their relations with the Six and in their approach to international trade issues generally.

Today, there are two types of groupings in Western Europe -- a common market, on the way to becoming a full economic (and perhaps someday political) union, and a free trade association. The EEC has undergone two enlargements. First Britain, Denmark and Ireland (which had concluded a free-trade agreement with Britain in 1965) joined in 1973. Then in 1981 Greece became a member. Spain and Portugal have concluded accession agreements and will be entering the Community at the beginning of 1986.

EFTA, on the other hand, after expanding to include Finland and Iceland (making 9 member all told) has now contracted with the entry of three of its members into the EEC and will soon lose a fourth. The members of EFTA are all linked to the Community by association agreements, which essentially provide for elimination of tariffs and QRs on industrial products but differ somewhat according to the special circumstances of each country. The EEC also has association agreements with Turkey and with a host of overseas countries (mostly former colonies) as well as non-preferential trade agreements with many other nations.

The "Ups and Downs"

This state of affairs was by no means the result of a smooth, orderly and harmonious process. Even within the EEC, the progress that has been made has been punctuated by crises, and periods of virtual immobility or even backsliding. Five years after it came into being, the EEC was under severe strain, when, after a year of negotiations for British entry, General de Gaulle declared this to be politically unacceptable. A little over two years later, the decision-making process of the Community was almost brought to a halt for seven months when France withdrew from the Council of Ministers and a number of committees over differences regarding the powers of the Community and its institutions and the relationship between Europe and the United States. On numerous other occasions, Community decisions have been the result of hard-fought battles stretching over lengthy periods. Deadlines have been met by negotiating day and night (the famous "nuits blanches" of Brussels) and by the practice of "stopping the clock".

More recently, the economic and monetary upheavals, "stagflation", and recessions of the seventies and early eighties have made it difficult to go ahead in such areas as eliminating differences in product standards and government procurement. There is much debate about how to restore the momentum and whether this may require revisions in the Rome Treaty and/or a "two-speed" Europe, where member states prepared to integrate faster would move ahead of the others.

The Community's relations with the rest of Western Europe got off to a bad start with the failure, while the Treaty of Rome was being negotiated, of efforts to associate all of them together in a pan-European industrial free trade area. The Six, and particularly the French, were concerned that this would lead to distortions of trade (because of differences in the level of external tariffs) and would dilute and weaken the EEC. Besides this, it would be unbalanced because of the exclusion of agriculture. When most of those outside the EEC formed EFTA, it was partly with a view to bringing the Community to terms. But efforts to build a "bridge" between the two groupings were not successful. Europe was then divided into two completely separate, and in some respects rival, trading blocs. It was not until after the departure of General de Gaulle from the scene that the first enlargement and the association arrangements with the EFTA countries could be carried through.

Political Factors

This underlines the extent to which political factors have influenced the pace and nature of the moves towards European economic integration. Efforts along these lines before the Second World War foundered mainly on the rivalries and suspicions between the great powers. In the immediate post-war period, political considerations usually favoured the integration process. In Europe there was an upsurge of interest in federalism as a means both of avoiding a recurrence of the economic nationalism of the thirties and of breaking the cycle of European wars. Concerns about the growing power and the intentions of the Soviet Union spurred the U.S. decision to mount a massive aid program and the initiatives aimed at economic cooperation through OEEC. The establishment of ECSC was seen as helping to prevent a revival of the historic conflict between France and

Germany, for it would make it easier to manage the competition between their steel industries for the iron ore of Lorraine and the coal and coke of the Saar and the Ruhr. A major factor leading the BENELUX countries to propose a broader-ranging integration of the economies of the Six in 1955 was concern over the deterioration of Franco-German relations. The French Parliament had failed to ratify the treaty for a European Defence Community which would have contributed to the rehabilitation of Germany. The two countries were also having differences over such issues as the future of the Saar (not reunited with Germany at that time), and construction of a Moselle Canal to bring Ruhr coal to French steel mills. It was hoped that working together on the "construction of Europe" would make it easier for France and Germany to resolve such problems - and this did in fact turn out to be the case.

There were, however, other situations where political factors impeded economic integration. Austria, Finland, Switzerland and Sweden could not join the Community because of their status as neutrals. (Some of them also had economic inhibitions). In the mid-fifties, Britain still saw itself as a world-scale power and was not intersted in joining an exclusively European trade grouping which would weaken its ties with the Commonwealth and the United States. Spain's internal regime was, for years, an obstacle to association with or membership in the Community.

Domestic political considerations entered in, too, at times. The left wing of the Labour Party in Britain was concerned that joining the Community would make it more difficult to maintain full employment and lead to pressures to water down the welfare state and hold off on further extension of public ownership. Thus, although it was a Labour Government that made the second, unsuccessful, bid to join the EEC, the party became distinctly ambivalent about membership when in opposition from 1970 to 1974. It called for a fundamental renegotiation of the terms of entry and a referendum to consult the British public. (It was suggested that joining without either a general election or referendum was somehow illegal and unconstitutional). The minority Labour Government returned to power in 1974 found itself stuck with carrying out this policy. It entered into a rather modest renegotiation which did not require amendment of the Treaty of Accession, the main feature being an adjustment of Britain's financial contribution. A consultative referendum was then called and the

Cabinet recommended a vote in favour of continued membership (although more than half of the Labour M.P.s took the other side). The vote went 2 to 1 for staying in the EEC. Labour went into opposition again in 1979 and moved sharply to the left. It called for Britain's withdrawal from the Community in the 1983 election. With the Party now running ahead of the Conservatives in the public opinion polls some uncertainty has once again arisen about Britain's continued role in the Community. In addition to those on the left, there are a few anti-Marketeers on the right. Their hostility to the EEC is based on a variety of things, ranging from imperial nostalgia to concern about changes in the traditional British way of life.

Miscalculations

To determine where they fitted into the process of European economic integration, therefore, countries had to weigh a complex set of considerations, political as well as economic. Inevitably mistakes were made and it is easy to see them in retrospect. This is especially true of Britain's relations with the Community. If, instead of trying to stop it, Britain had gone in from the beginning, it would have been able to influence the content of the Treaty of Rome and the early development of the Community, including the Common Agricultural Policy. If Britain had not negotiated so hard and so long in 1962 on such issues as safeguards for Commonwealth interests and arrangements for agriculture, it might have been more difficult for de Gaulle to impose his veto.

Europe and the World

Community membership has not, in fact, prevented Britain from pursuing its foreign policy interests (e.g., the Falklands, the current close relationship with the United States on a variety of issues). The same is true of other members of the EEC. Nor has economic integration in Europe prevented the EEC and other countries of the region from taking an active part in the liberalization of trade on a multilateral basis. Efforts to form customs unions and free trade areas between neighbouring countries before the Second World War often ran afoul of the most-favoured-nation principle (requiring that concessions given to one partner be extended to all entitled to this kind of treatment).

When the GATT was negotiated in the early post-war years, provision was specifically made in Article XXIV for the formation of customs unions and free trade areas, subject to certain conditions. The Treaty of Rome and the EFTA Convention were examined in the GATT and some countries questioned whether the relevant conditions had been met. However, while pressure was applied for changes in some of the features of these arrangements, no formal decision was ever reached as to whether they did or did not conform to Article XXIV.

Since the founding of the GATT, both the EEC and EFTA countries have contributed to the success of a number of major multilateral trade negotiations. It can be argued that they might have been more forthcoming if they had not been members of regional groupings. There are indications that, today, the reluctance of these countries to weaken too much the preferential aspects of the European system may make it more difficult to continue the process of multilateral trade liberalization. However, the European countries do, and will continue to, have an important stake in their trade and commercial relationship with North America, Japan and many others.

B. THE EUROPEAN ECONOMIC COMMUNITY

Expectations

While the immediate impetus for creating the Community was political, it was also expected to bring important economic benefits. Some of the objectives were set out in the Preamble to the Rome Treaty -- for example, improvements in living and working conditions, a steady expansion, balanced trade, fair competition, and harmonious development by reducing the differences between the various regions.

These were expected to be some of the main results of freeing up movements of goods, services, capital and people, within the framework of common policies and rules in some areas and harmonized national policies in others. Classic international trade theory taught that the removal of trade barriers would allow countries to specialize in the things they could produce most efficiently. But even more important, it was anticipated that interpenetration of markets in the EEC would lead to profound changes in production structures to take full advantage of economies of scale. The productivity of capital and labour would be increased; wages and profits would rise; investment would be stimulated; and the rate of growth would be accelerated.

However, all of this was seen as a long-term process. There were concerns, especially on the part of those in close touch with the business world, that, over the short term, there would be abrupt changes in trade and production patterns, bringing serious problems of adjustment for some firms and a certain amount of unemployment.

There were also some particular worries in some of the member states. France saw the Common Market as, in some degree, a trade-off, in which it would have to open up its market for manufactures to stronger German producers in return for benefits for its agricultural sector. In addition to the perceived economic weaknesses of French industry, it was feared that French social policies in such fields as overtime pay would make it difficult to compete.

There were concerns too in France, and even more so in Italy, that economic integration would increase the polarization of industry in the triangle Amsterdam - Dusseldorf - Lille, aggravating regional disparities within Europe. France and Italy were also particularly vulnerable to balance of payment problems. They could foresee the possibility that action to deal with such difficulties might conflict with their obligations to free up trade and capital movements.

Safeguard Provisions

To deal with these contingencies and other special situations a number of safeguards and transitional provisions were written into the Rome Treaty. They can be divided into those which would be in effect only for a transitional period and those which were of a continuing nature. The more important are as follows:[1]

Transitional Provisions

1. The dismantling of tariffs against the products of other member states and establishment of the Common External Tariff (CET) was to be carried out in small steps over a transitional period of 12 years.[2] There was also provision to extend the transitional period to 15 years or to adjust tariffs more rapidly if circumstances permitted. A schedule was also laid down for abolishing QRs over the transitional period.

2. If the reduction of internal tariffs gave rise to "Any special problems ....," the Council of Ministers of the Community was to settle them by directives based on proposals of the Commission. (Article 14(5)).

3. The rules for tariff reductions also applied to duties of a fiscal nature; but if the Commission found that substitution of an internal tax for a fiscal duty caused serious difficulties, it was empowered in the first year of the Community to authorize the retention of the duty for as long as six years. (Article 17(4))

4. In the event of injury caused by dumping, the Commission was to recommend the cessation of this practice and, if the situation continued, was to authorize the injured country to take appropriate protective action. Moreover, in order to discourage dumping, member states were required to readmit, free of duties or quantitative restrictions, any goods exported to other members. (Article 91)

5. The Commission was given the power to authorize protective measures in the event of discrimination by state monopolies of a commercial nature. (Article 37)

6. At the special request of France, the Commission was given the power to authorize member states to take safeguard measures in the event that industries were affected in equalities in overtime pay. (Protocol relating to certain provisions of concern to France, Part II)

7. A general safeguard clause (Article 226), which turned out to be the most important, provided that a member state might ask the Commission to authorize relief measures if there were "serious difficulties which are likely to persist in any sector of economic activity or difficulties which may seriously impair the economic situation in any region ....". The Commission was to determine the measures to be taken, which might include derogations from the Treaty. The latter were however to be limited in extent and duration, to what was strictly necessary to restore the situation and adapt the sector concerned. Priority was to be given to measures which would least disturn the functioning of the common market.

Continuing Provisions

1. The rules governing the elimination of quantitative restrictions (QRs) on exports and imports were waived for controls which were justified on grounds such as the protection of public health, morality, safety, industrial and commercial property and national treasures. However, such controls are not to constitute a means of arbitrary

discrimination or disguised restriction on intra-Community trade. (Article 36) Member states are also free to take measures with respect to production or trade in military products which they deem necessary for their security, but such measures are not to prejudice conditions of competition for items not intended for military purposes. (Article 223)

2. Procedures are laid down to deal with a situation in which a member state encounters or is seriously threatened by balance of payments difficulties. This can include mutual assistance. If aid is not granted or is inadequate, the Commission may authorize the country to take appropriate protective measures. The Council may modify or revoke this authority. (Article 108) There is provision for the affected member state to take unilateral action on a provisional basis in the event of a sudden crisis. (Article 109) Such measures are however not to exceed the minimum necessary to remedy the situation and are to be selected so as to cause least possible disturbance to the functioning of the Common Market. The power to authorize a country to depart from its obligations rests with the Commission and the power to control unilateral action with the Council. There are special provisions relating to Italy and France.

3. Where enterprises engage in such practices as discrimination, limitation of production or market sharing, the Commission may propose steps to end the situation and, if it continues, may authorize member states to take protective action (presumably tariffs, QRs etc). (Article 89)

4. The Commission may authorize protective measures if a member state alters its exchange rate in a manner which "seriously distorts the conditions of competition" and is incompatible with an exchange rate policy necessary for balance of payments equilibrium accompanied by high employment and stable prices. (Article 107)

5. Where conditions of competition are distorted by a disparity in legal and administrative provisions of member states, which cannot be resolved by consultation, it appears that one of the options open is the authorization of safeguard measures. (Article 101)

6. When diversions of trade or economic difficulties result from lack of harmonization of commercial policies and cannot be resolved through cooperation, the Commission is to authorize the necessary protective measures. There is provision for unilateral action during the transitional period in case of emergency. Again, the action chosen is to be that which will cause least disturbance to the functioning of the Common Market and interfere least with the early introduction of the Common External Tariff. (Article 115)

7. Although not strictly safeguards, the provisions relating to state aids to industry (e.g. grants, low-or nil-interst loans and tax concessions) are certainly relevant. While the Treaty set up procedures to deal with aids which were incompatible with the Common Market because they distort competition and adversely affect trade between member states, it did provide a good deal of leeway for measures of this kind. They may be used, among other things, for promoting the development of depressed regions, remedying a serious disturbance in a member state, and assisting individual consumers. Certain conditions are laid down for their use, including review by the Commission and other member states. (Article 92)

8. A European Social Fund was established with the aim of promoting employment opportunities, especially by facilitating geographical and occupational mobility. A European Investment Bank was also created and given the task of using its own resources and those of the capital markets to contribute to "the balanced and smooth development of the Common Market in the interets of the Community".

The Actual Experience

The difficulties of adaptation and adjustment were not as wide-spread or severe as some had feared. Economic conditions were generally buoyant. There was some temporary unemployment but apparently those displaced were easily absorbed elsewhere in the economy. General levels of unemployment in all member states fell from 1958/59 to 1963 and remained at very low levels until around 1974 with the exception of a slight increase in some countries in 1968. Real wages rose rapidly over these years. Regional disparities were not aggravated.

The share of the peripheral regions in the community's GDP did not change much from 1960 to 1969, while that of the triangle Amsterdam - Dusseldorf - Lille declined slightly. On a country basis, Italy continued to lag well behind the rest of the Community in GDP per capita, on account of its depressed south, but the gap was somewhat smaller in 1970 than in 1960.

Since the problems of adjustment were much less serious than some had feared it was possible to shorten the period for phasing in the internal and external tariff changes by 18 months, completing the process of 10.5 years instead of 12 years from the beginning of the transitional period. Moreover, relatively modest use was made of the transitional safeguard provisions having to do with removal of internal barriers.

In the case of industrial materials and manufactures, the general safeguard clause (Article 226) was used mainly to give temporary relief to a number of Italian producers, particularly in the southern part of the country. The items affected included silk and derived products, certain forms of lead and zinc, sulphur and its products, iodine, and two chemical products manufactured from local raw materials. The Italians brought these problems to the Commission early in the transitional period. They had been encouraged to do so during the negotiations between the Six on the level of the Common External Tariff on some of the items or on the raw materials from which they were manufactured. Their concerns related perhaps even more to competition from outside the EEC than from their Community partners. The safeguard action permitted was, in some cases, "isolation" of the Italian market through a ban or quota control on imports and, in others, delayed removal of tariffs against imports from other member states. In most cases the Italians were required to submit a program for putting the industry concerned on a sounder footing. Extensions were granted for some of the Italian safeguard measures but practically all were eliminated before the end of the transitional period.

In the early years of the Community, several other member states were allowed to take safeguard action on industrial products. The Benelux countries were permitted to maintain a quota on penicillin and its preparations, to conserve domestic production. A French request for authorization of a quota on semi-conductors was granted. Germany was given permission to set up an equalization fund to support its lead and zinc producers. The duration of these measures ranged from several months to a year.

In 1962 the Commission developed some strict criteria for considering any further applications under the general safeguards clause to ensure it was not used to circumvent the inevitable difficulties resulting from the speed-up in the dismantling of internal barriers which had been agreed upon. From this time on, it seems that the Commission was more inclined to reject requests for permission to extend existing measures or introduce new ones.

In the middle and latter part of the transitional period France sought authority on several occasions to take safeguard action. In 1962 it wanted to impose a temporary 12 per cent duty on refrigerators to counter an upsurge of imports from Italy which was causing serious difficulties for the French industry. The Commission agreed, subject to a gradual reduction of the duty to 6 p.c. and a tight deadline for its removal.

Four years later, with its white goods industry in the throes of a painful adjustment, France asked for permission to apply import quotas for two years on refrigerators, washing machines, and electric and gas stoves. The French kraft plyboard industry was also in trouble, and it was proposed to introduce QRs for that product too. The Commission decided that quotas on plyboard might lead to deterioration in the conditions of intra-Community trade and invited the French Government to come up with another solution. It rejected the application regarding white goods.

Shortly afterwards, in May and June, 1968, France found itself in a serious economic situation as a result of widespread social and industrial unrest. Permission was therefore granted for import quotas, not only on white goods but also steel, motor vehicles and textiles, under the balance of payment safeguards provisions. However, the quotas were to be allocated fairly among the member states and were to be removed by the end of the year. The Commission rejected a French request for an extension on refrigerators.

An item which gave rise to difficulties in the Netherlands, Belgium and Germany was carded wool. The first-named country was allowed to adopt safeguards but applications from the two others were rejected.

The Commission approved a number of safeguard actions to deal with deflections of trade and it made many decisions granting or denying permission to levy countervailing duties, although the latter appear to have affected mainly agricultural products.

A number of allegations of dumping were investigated. In some cases they were apparently resolved without formal action, while in others the Commission took the problem up with the offending firm. No member state was actually authorized to apply anti-dumping duties in the first 3 1/2 years of the Community's life.

There were instances of member states taking safeguard action illegally. Up to mid-1961 the Commission had taken two of these to the Court of Justice.

What happened to the industries which were granted temporary relief under the transitional safeguard provisions? The information is sketchy, but there are some indications.

Output of lead and zinc ores in Italy dropped by about 40 per cent from 1958 to 1968 and then continued on down in the early seventies. In the case of secondary lead and primary lead and zinc, production either held steady or declined somewhat at first, then recovered and started to increase. However, secondary zinc production seems to have disappeared

after 1963/64. Sulphur production in Italy seems to have declined by 1968 to only about 10 per cent of the 1961 level. Production of woven silk fabrics fluctuated considerably from 1958 to 1968 and no very clear trend is evident. Carded wool production dropped more than one quarter in Germany and over 15 per cent in the Netherlands during the first decade of the Community's existence and continued to decline to 1974. In Belgium, however, output of this product increased substantially, although that country had at one time wanted to apply safeguards.

As regards France's problems in the white goods sector, production of cookers, electric refrigerators and electric washing machines in 1968 was 170 per cent, 47 per cent and 94 per cent respectively above the 1958 levels. In the case of refrigerators there was a subsequent falling off, but in 1972 output was still about the same level as in 1958.

The data studied do not, in some cases, cover the precise items on which safeguard action was permitted, but rather relate to wider groups of products or different stages of manufacture. Moreover, they do not throw any light on the position of individual firms or regional patterns of production. A good deal more study would be needed to reach definite conclusions. Nevertheless, the analysis does seem to suggest that in some cases safeguard action may have helped in putting the industries on a sounder footing while in other cases it was a temporary palliative. It also bears noting that, for the most part, the items concerned occupied a relatively small place in the total economies of the countries concerned, even though they may have been important to specific companies and regions.

It appears that there has rarely been recourse to the continuing safeguards. The most notable cases relate to Italy, which was, in 1974 and again in 1976, authorized under the balance of payments provision to introduce a system requiring importers to consumer goods to deposit cash in advance with the Bank of Italy against purchases of foreign exchange. The amounts to be deposited were to be progressively reduced to nil. The Italian Government also took unilateral action under the balance of payments safeguards to impose a tax on the purchase of foreign currency.

It is virtually impossible to determine to what extent state aids were used to cushion the effects of dismantling trade barriers because of the lack of transparency in this area. However, the member states certainly had the means to intervene in this way. Not only did they all have programs designed to aid particular industries and regions; they also had powerful general instruments of policy at their disposal which could be used to influence the response of their firms to the problems and opportunities of integration. These ranged from relatively modest devices like special depreciation and other tax concessions to more interventionist mechanisms such as using the economic power of nationalized industries and infusing capital into certain private enterprises through control of the banking system or special investment funds.

There is not much information about the way such practices may have influenced the pace and nature of integration but there are some indications. In the early years of the Community, there were many mergers and cooperation agreements between firms. The great majority of these operations were not transnational but took place within an individual country. It is difficult to believe this was not to some extent due to the influence exerted and inducements offered by national governments.

The Commission did try to get a handle on state aids. During the first few years of the Community's existence, it started to prepare an inventory of existing measures of this kind and made decisions on the compatibility with the Common Market of various new programs. Regional aids authorized included schemes to help the economic and social development of Sardinia and to improve the balance of Luxembourg's economy. Examples of aids to specific industries which were approved were schemes for helping the German and Italian textile industries. In some cases member states were asked to modify or withdraw their proposals, but sometimes the Commission was overruled. For example, the French wanted to aid the production of certain grades of paper pulp, and when the Commission raised doubts about the proposal, they made a successful appeal to the Council of Ministers.

In addition to dealing with specific cases, the Community's institutions, from 1969 onward developed guidelines for assistance to problem industries, such as shipbuilding, film production and textiles. However, in all of this, they came up against two difficulties in particular. First there was the dilemma of how to reconcile the requirements of competition policy

(avoiding distortions of competitive conditions within the common market) with those of regional and structural policy (which was certainly recognized as legitimate under the Rome Treaty). A second problem was that examination of general schemes was often not very conclusive and it was necessary to look at the way they were being applied - something on which the member states were loath to provide information.

Ten years after the Community came into being, the Commission was well aware that there were problems in regard to state aids with which it was not yet able to come to grips. In its 1968 Report it acknowledged that member states were vying with one another to attract new investment, particularly from non-member countries. Efforts to obtain greater transparency did have some effect. From 1971 onward procedures were followed to cut down competition in regional aids. This involved setting up a coordinating committee with the member states and establishing ceilings for aid to certain regions. New and revised guidelines were issued for aids to specific industries. Also it would appear that the Commission was, in the latter 60's and early 70's taking a tougher stand on specific proposals. For example, in 1969 it took France to the Court of Justice over its schemes for aiding the textile and pulp industries.

The economic difficulties of the mid- and latter- 70's led member states to make more intensive use of state aids. On the whole, the Commission did not try to interfere with this as long as the measures were of limited duration and subject to its supervision. Moreover, there are grounds for thinking that by no means all of the assistance to industries and regions was actually notified to the Commission.

The Community's own programs for aiding regions and industries were slow getting off the ground and were not very significant in easing problems which arose in the first decade of its existence. The assistance available from the European Social Fund was meager. Over the whole period, 1960 to 1968, the amount spent was under $26 million. However, the fund does seem to have been of some help in readapting and retraining workers, such as the miners made redundant by the decline of the Italian sulphur industry. Apart from this, it was used mainly to facilitate migration of workers within the Community - especially from Italy to Germany, France, and to a lesser extent the BENELUX countries.

In the case of the coal, iron and steel industries, much more substantial assistance was available for readaptation of workers under the ECSC Treaty . Aid was also extended to firms in these industries for restructuring.

From 1958 to 1967, the loans and guarantees of the European Investment Bank were running at an average of under $100 million a year. More than half of this was channelled into investments in Italy - particularly the south. In the Community as a whole, about half of the bank's financing went for industrial development (new plants and expanded facilities) and the other half for infrastructure (mainly communications, energy and water). Among all the bodies, public and private, marshalling funds for investment, the EIB played a relatively small role.

Other Factors Affecting the Use of Safeguards

The Treaty of Rome provided not only for the abolition of internal customs duties and QRs, but also for the elimination of other measures and practices which hindered free movement of goods. This was, and is, seen as necessary to obtain the full benefits of trade liberalization. The other side of the coin is that foot-dragging by member states can be a means of shielding their firms from competitive forces. It can therefore reduce the need for recourse to safeguard provisions.

The more important steps to be taken were as follows:

- Standardization of customs procedures and simplification of customs formalities and documentation requirements.

- Approximation, or as it is more usually referred to, "harmonization" of product standards, (maintained for reasons of health, safety etc.) and systems of taxation.

- Development of rules on competition, to come to grips with such practices as collusion between suppliers and abuse of a dominant position.

- Coordination of government purchasing policies to ensure bidding is permitted on a fully competitive basis.

° Operation of the common transport policy so that supply of transportation services is not manipulated in such a way that it impedes or distorts trade.

In point of fact progress on all these issues has been slow and, in some cases, minimal. A few examples will suffice.

° While steps have been taken to simplify border routines, they are still often cumbersome and time-consuming, increasing significantly the cost of shipping goods. The European Commission estimates that the cost of getting goods across frontiers represents 5 per cent of total transport costs.

° The EEC has issued 177 directives on product standards since 1969 but it has taken an average of 10 years to get each of the last 15 directives out. Sometimes they were out of date before they were issued. Moreover new national standards have been constantly emerging.

° Road traffic, which accounts for 42 per cent of goods traded between member states, is still to a considerable extent controlled by quotas established bilaterally. The Community's Parliament took the unprecedented step of censuring the Council of Ministers for its lack of progress on the common transport policy.

° Although all member states have adopted the Value Added Tax (VAT), standard rates vary from 12 per cent in Luxembourg to 23 per cent in Ireland.

° Telecommunications, transport, water and energy - all areas where an integrated market is important - have been excluded from the Community's directives on government purchasing. It appears that, in procurement of items which <u>are</u> covered, the rules are often disregarded.

In addition to these barriers to free movement of goods maintained by governments, there are the ones for which the private sector and even the general public are responsible. Foremost among these are the business practices which restrict competition, particularly significant in Europe, where there is a long history of cartelization.

The Community initially made slow progress in developing an approach to competition policy. In the meantime, many new agreements were concluded between firms, most of them involving exclusive distribution arrangements. There was probably also a good deal of price fixing and market sharing. Under the Rome Treaty, such practices could be permitted if they contributed to improved production or distribution of goods or promotion of technical or economic progress. They must however not enable the firms concerned to eliminate competition for a substantial proportion of the goods affected or impose restrictions not necessary for achieving the prescribed objectives. Moreover the consumer must benefit and competition must not be completely eliminated. All of this was not easy to interpret and apply. For one thing it involved reconciling objectives which were partly in conflict. For another, there were so many agreements and the EEC Commission was so short of staff. Much has been done to work out principles and procedures and establish Community authority through the courts, both on collusive practices and on abuse of dominant position. However there are indications that competition is still being restricted in many fields. For example, there are substantial differentials in prices for similar products in various parts of the Community, which cannot be explained by differences in internal taxes.

One must also include, among the invisible barriers, language differences, different ways of doing business and even the national prejudices which still influence some businessmen as well as consumers. For all these reasons it has been said that while the European Community operates a tariff union, it is not really a customs union (because barriers still exist at the border) and certainly not a common market (as long as there are many other obstacles to free movement of goods within the internal market). Imperfections also exist in the free movement of persons, capital and services.

The conclusion that emerges about the adjustment process in the Community is that it has probably extended over a much longer period than might have been expected on the basis of the timetable for tariff dismantling. Indeed it is no doubt still taking place. This needs to be borne in mind in assessing the reasons why so little use was made of safeguards provisions in the early days.

Benefits of Integration

In its first decade or so, the Community experienced a remarkable expansion in trade, output and productivity, considerably exceeding that achieved by the U.S.A. and bettering U.K. performance by an even wider margin. (See Table 1)

Following are some of the salient points about the economic progress of the Community (figures are for the period 1959 to 1969 unless otherwise indicated):

- The Community's internal trade increased by 347 per cent. Its external trade rose by 136 per cent compared with 124 per cent for the U.S.A. and 77 per cent for the U.K.

- With the exception of Luxembourg, all member states achieved greater rates of growth in GDP (constant prices) than the United States.

- All of them expanded GDP per employed person at a faster rate than the United States (for Germany, France and Italy, the growth rate was more than double that of the U.S.A.).

- In 1969, industrial production was 84 per cent above the 1958 level in the Community compared with 64 per cent for the U.S.A. and 39 per cent for the U.K. There is no clear-cut difference here between the experience of the "big three" and that of the smaller member states. While Belgium and Luxembourg had the lowest growth rate for industrial production, the Netherlands had the highest.

- Average income in the Community was 1/3 lower than that of the United States in 1974, compared with 50 per cent lower two decades earlier.

There has been much debate about the extent to which these developments can be attributed to formation of the Community. Professional economists have attempted, with varying results, to estimate the amounts of new trade creation and trade diversion. Efforts have been made, on the basis of these figures, to determine what proportion of the growth of the Community's GDP should be credited to economic integration. Most of these estimates have been rather small, in the order of fractions of a per cent, and not at all in line with the perceptions of people in business and government.

It is generally acknowledged that, in addition to integration, a number of other factors contributed to Europe's impressive economic progress in the Sixties. A fast pace had been set during the post-war reconstruction period when a great deal of new plant and equipment was put in place. Interest rates were low and inflation was moderate. After the French devaluations of 1957 and 1958, the Community enjoyed a decade of exchange rate stability. (It might be argued, of course, that this was a result as well as a cause of the Community's economic success). There was the trade creation effect of reducing tariffs on a multilateral basis in a number of GATT rounds, which continued after the formation of the community, and progressively removing post-war quota controls, until they had been practically eliminated by the early sixties. There was the expansion of the industrial work force as a result of modernization of agriculture and migration from East to West Germany.

Thus, the Six had a variety of things going for them in the Sixties. Nevertheless there are grounds for thinking that conventional economic analysis has often understated the gains from economic integration. Recent studies of what has happened in certain industry sectors support this conclusion. The following examples are indicative:

Refrigerators and other White Goods

Intra-Community trade in refrigerators, washing machines, small household appliances, radios and TV's increased six-fold from 1960 to 1970.

In the late 1950's certain Italian producers installed large-scale automated plants to produce a narrow range of small-volume refrigerators. They were thus able to achieve dramatic reductions in unit costs and cut prices sufficiently to make major inroads into the markets of their neighbors. By the early 60's they had 2/3 of the French market and 40 per cent of the German market. Under pressure of this competition there was a series of mergers in France and by 1970 one sole producer was left in the industry. It had an optimally-sized plant and concentrated on larger refrigerators. In this way it was able to retain 45 per cent of the French market. The German industry was already more concentrated than the French in 1958 and this process continued. By 1970, Germany was producing the same number of refrigerators as in 1958. In the Netherlands and Belgium, production ceased.

Some of the same features were repeated in the integration of the Community's washing machine market. As was also the case for refrigerators, the Italians showed ingenuity in finding marketing channels and overcoming the handicaps of unknown or less acceptable brand names.

Trucks

It would appear that scale was the basis of the predominant positions which Daimler - Benz, Fiat and Ford carved out in European markets. They achieved the necessary volume by a change in manufacturing philosophy away from customized engineering and a shift in perspective from national to European markets.

Automobiles

While no one country emerged as the clear front-runner (contrary to the experience with white goods) there was great increase in the inter-penetration of markets. Community producers had 31 per cent of one another's markets in 1970 compared with 7 per cent in 1958. The consumer benefitted from wider choice and probably from lower prices than would otherwise have prevailed. In addition there was a trend to concentration of production. Scale proved to be a major determinant of unit costs.

The behaviour of the "national champions" (major nationally-owned auto companies in France, Germany and Italy) was different from that of the subsidiaries of U.S. producers. The former had few plants elsewhere in the Community, and in at least one case an existing assembly plant was closed down. The U.S. firms operated in several EEC countries and they took advantage of the removal of tariffs to increase the degree of specialization between their various plants.

These and other cases have underlined that the chief advantage of integration appears to have been the opportunity it has provided for achieving economies of scale. According to one of these studies, size of plant is more significant in general than that of the firm or the product line. The studies also point up the greater importance, in a group of advanced economies such as the major EEC countries, of specialization within rather than between industry sectors. This process brings improvements in efficiency, not only for the industry in the country which increases its market share, but also for the surviving industry in the country whose market share is reduced.

Based on this kind of case analysis, one recent study has estimated that the benefits of European integration, through increased trade in manufactured goods, may have been in the order of 3 - 6 per cent of GDP over the period up to 1980. This might show up as a measured increase in GDP of 10 per cent because of national accounting practices. These figures take into account the effects of industrial restructuring as well as the indirect impact on other sectors of the economy.

These figures certainly fit better than the very low earlier estimates with the perceptions of those in industry, trade and government. But they should be taken with some caution for they are based on the notable success stories of European integration - white goods and motor vehicles. While other industries do not appear to have been studied as intensively, enough has been done to suggest that the nature, pace and extent of the rationalization varied considerably from one sector to another. Government policies and measures and/or collusive business practices seem to have inhibited the process to a greater or lesser extent in important sectors like iron and steel, non-ferrous metals, processed foods, chemicals, pharmaceuticals, petroleum-refining and power-generating equipment. It would therefore probably be safer to regard the figure of 3 - 6 per cent of GDP as a potential which will be realized when the integration process has run its full course.

Multinational Enterprises and Inter-Corporate Links

The lags in integration may have been a major reason for the surprisingly large number of subsidiaries acquired or established by Community firms in other EEC countries up to 1971. From 1959 to 1971, large parent companies based in the Community established 553 manufacturing subsidiaries in other EEC countries. Moreover, there were only 35 closures of such subsidiaries from 1958 to 1971. A study carried out in 1975 indicated that some of the largest numbers of subsidiaries were established in industries where economies of scale were greatest. Certain of these were industries where intra-Community trade was expanding most slowly. This, together with examination of specific cases, led to the conclusion that many of these branch plant operations were not the result of "common market behaviour" but rather of efforts by national governments and the private sector to limit integration. But no doubt there were also cases (though they do not seem to have been as well documented) where Community firms set up, or continued to operate, subsidiaries elsewhere in the EEC for other reasons, such as the advantages of being close to a local market (e.g. because of transport costs or perishability of product) or of spreading risks (e.g. shut-downs because of strikes).

In addition to parent-subsidiary operations, there were several cases of trans-national mergers or cooperative arrangements between major firms in different EEC countries. However, such initiatives were not as numerous or as successful as had been hoped. Most have now been dissolved or have turned into straight take-overs of one partner by the other.

There were many American take-overs and new subsidiary operations in the EEC in the 1960's and early 1970's. The book value of foreign direct investment by U.S. firms in manufacturing in the Community grew from $1.1 billion in 1959 to $9.7 billion in 1972 (these figures include investment in sales operations). The number of subsidiaries established or acquired by U.S. firms in the Community was at least as great as the corresponding figure for EEC firms.

The attractions of the large, rapidly-growing Community market, in which internal tariff barriers were being removed, together with the difficulty of supplying it from the United States because of the Common External Tariff and transport costs, were obviously major factors in the upsurge of American investment. There seems to be little information on the extent to which the activities of American firms in the Community were influenced by the kind of considerations which seem to have impeded rationalization of the operations of European companies. However, in some industries, such as automobiles (already mentioned) and agricultural equipment and tractors, U.S. companies have increasingly organized the activities of their plants in the EEC on a specialized basis.

Is Integration Slowing Down?

Whatever may have been the benefits of the integration process so far, concerns have been expressed that, over the past decade or so, it has been running out of steam. The figures for the period 1973 to 1983 certainly do not look as good as those for the preceding fifteen years. (See Table 2) The main points to note are as follows:

- For the period examined, the Community ran neck to neck with the U.S.A. on growth in GDP (real terms) but lagged in industrial production. It did however, out perform the U.S.A. in growth of GDP per employed person. The U.S.A. had a greater relative

increase in foreign trade.

- Imports of member states from one another did not grow as fast as their purchases from outside countries.

- The rate of growth in GDP, in total and per employed person was much lower than from 1959 to 1969.

Soaring energy prices and the EFTA agreements probably had something to do with the failure of the EEc's internal trade to expand at a faster rate than its trade with the rest of the world.

Entry of the slower-growing British economy into the Community contributed to the slackening of the EEC's growth rate.

Notwithstanding these extenuating factors some of the blame for the less impressive performance of the Community over the past decade or so has been attributed to the slow progress in removing the hidden barriers to trade mentioned above (pp .... to ....). In the latter 70's there were indications that these barriers might be increasing and in 1978 the Commission reported it was investigating 400 of them. There has indeed been a good deal of foot-dragging, not only on these issues but also in such areas as the development of an adequately-financed industrial policy and the adoption of a statute for a European company (which would facilitate trans-national mergers).

The world economic environment was, of course, much less favorable in the seventies, with the collapse of the Bretton Woods monetary system, the two oil price shocks in 1973 and 1979, the foodstuffs and commodities price surges, "stagflation" and recession. In 1983 the economies of EEc countries were operating below the long term trend level.

There were substantial movements in the rates of exchange between the currencies of member countries from 1969 onward. Though the European Monetary System, set up by the Community in 1978, succeeded in bringing about somewhat greater stability, there were still seven realignments of central rates up to 1984, four of them being quite significant.

What is seen as the loss of momentum in the Community has led to a certain "Europessimism" and more recently to initiatives for "relaunching Europe". Foremost among these is the proposal, considered at the EEC summit in Milan last June, to hold an inter-governmental conference to amend the Treaty of Rome, so that unanimity would no longer be required on such matters as harmonization of technical standards. Though the majority favoured this, Britain, Denmark and Greece bitterly opposed any changes in the Treaty. Unless they change their minds, the proposed conference will be of questionable value. On a more practical level, the EEC Commission has produced a program for creating a frontier-free internal market for goods and services by 1992. It also has action plans in such fields as public purchasing, competition policy, industrial development and science and technology; but most of these represent an extension of existing activities and their effectiveness will depend in some cases on cooperation of the member states and in others on adequate financial resources.

In the case of science and technology, progress will also depend on breaking down the monopolies of national firms in public procurement of hi-tech goods such as telecommunications equipment, on fiscal incentives to encourage innovation, on improved training and on a better correlation of research to the requirements of the market. Most of these are areas where a good deal of the responsibility lies with the private sector and the member states.

With some justice European businessmen have, among other things, been accused of lacking entrepreneurship, clinging to antiquated structures, being weak on management and marketing and preferring associations with, or take-overs by, U.S. and Japanese firms because of intra-European jealousies. The positive side is the significant number of success stories - the firms which have made good use of the opportunities provided by European integration and indeed by markets in other parts of the world. They include Daimler-Benz (trucks), Bosch (high-technology automobile components), BSN - Gervais Danone (yoghurt and other fresh dairy products), Heineken (brewing), Tetra Pak (packaging), L'Oreal (cosmetics) and Ciba-Geigy (pharmaceuticals).

Most of the world leaders are centered in Germany and France, few in the smaller countries of the Community. On the other hand, Sweden has produced such winners as Volvo, Electrolux (electrical appliances) SKF (bearings) and Perstorp (chemicals). While that country has been part of the Europe-wide free trade zone since 1973 and of EFTA since 1960, the success of these firms goes back a good deal further than this. In recent years, they have for the most part followed the "niche" strategy - carving out small market segments where they can establish strong positions. The extent to which European integration may have facilitated this would bear further study. It would be useful too, to know more about the role it has played in the success of many medium-sized firms distributed throughout the Community and its European associates.

The London Financial Times has recently published a series of articles under the title, "Can Europe Catch Up?". As one of the articles points out, the answer will depend as much on the performance of the United States and Japan as on that of Europe. Some U.S. industries such as steel are suffering from some of the same problems as are afflicting their Euopean counterparts. Also, the extent to which European industries and markets remain divided by institutional and psychological barriers will have a bearing on whether the various parts of the continent move forward at different speeds or together. This in turn will depend to a considerable degree on results of current efforts to relaunch Europe - something which is far from clear at present.

C. BRITISH MEMBERSHIP IN THE EEC

Expectations

As it was about to begin negotiations for entry with the Community in 1970 the British Government published a detailed assessment of the benefits of membership and the problems likely to arise. On the industrial side, the benefits were along the same lines as those seen by the Six when they were negotiating the Rome Treaty - "a much larger and faster growing 'home market'", "opportunities for greater economies of scale, increased specialization, a sharper competitive climate and faster growth".

In one respect, however, the situation of Britain was quite different from that of the original Six. As the White Paper pointed out, they would be joining a market which was growing much faster than their own. This should increase the dynamic effects of membership. Moreover, Britain within the Community would, it was thought, be able to attract more overseas investment, especially from the United States. There would also be greater opportunity for British firms to grow to the point where adequate research and development expenditure would be profitable. In addition to the fact that a larger domestic market would provide a basis for British firms to expand their operations, their growth would be less inhibited by concerns about monopoly.

On the other hand there were what the White paper called the "impact" effects - the immediate changes in trade and production patterns which would result from removal of tariffs against the Six, free entry into the Community market, erection of the Common External Tariff aginst third countries and the consequent changes in access to those markets. In the latter case the authors of the White Paper were thinking particularly of the loss of Commonwealth preferences. Using some simple and rather questionable mathematics, they estimated that Britain's balance of trade for items other than food was likely to deteriorate by £125 to 275 million. (The Economist called these estimates "unadulterated rubbish"). The expected increase in food prices as a result of adoption of the Common Agricultural Policy could also lead to a rise in wages which would make it more difficult for British industry to compete. Furthermore, if the burden on the balance of payments became excessive, the British Government might not have enough flexibility to pursue economic policies which would enable full benefit to be drawn from membership.

Some of these points may have been exaggerated a little to improve Britain's bargaining position with the Six, but there is no reason to doubt that they reflected, in their essentials, the government's thinking.

The Confederation of British Industries also made some estimates. It calculated that entry into the Community would mean a loss of protection on British manufactures of 2 1/4 percent (weighted average). On the other hand there would be a net reduction of only 0.09 percent in the tariffs facing their goods abroad (because there would be higher duties in markets where they had previously enjoyed preferences). They consequently saw an increase in the total import bill which would exceed that in export receipts. Thus, like the White Paper they expected an immediate deterioration in the balance of payments. However, notwithstanding this, the Confederation supported British entry because of the anticipated longer term benefits.

Various efforts were made by the Department of Trade, private research organizations and professional economists to define which British industries would be the winners in an enlarged Community and which would be in trouble. The conclusions differed considerably.

Professional economists divided on the issue of British entry - largely along right-left lines. The latter were sometimes accused of basing their opposition less on objective economic analysis than on their ideological biases in favour of economic planning and state ownership. Yet they did back up their option, with reasoned arguments. Professor Kaldor for example, considered that the adverse static effects of entry (the expected trade deficit, the rise in domestic costs, the large net contribution to the community budget and the loss of real income) would be so severe that the dynamic effects would be in a downward direction. Those who saw this kind of process taking place predicted that Britain would be frequently facing balance of payments deficits and would be confronted with the choice of continually devaluing or reducing incomes through deflation. Instead of a lot of new investment taking place, capital would flow out to the more dynamic parts of the Community, where higher wages would be offset by a more favourable business environment and a more highly developed economic and social infrastructure. Some anti-Marketeers also disputed the economies of scale argument, claiming the most industries in Britain were already operating at the optimum level.

Economists in favour of EEC membership replied with studies aimed at showing that it would in fact not affect Britain's trade balance on industrial goods and that there was in fact scope for greater economies of scale, particularly through intra-industry specialization. There would therefore be an increase in investment. It was also argued that, once Britain was inside the Community, EEC policies, especially in agriculture, would be more responsive to British interests. No one appears to have denied, however, that there would be adjustment problems in the short term.

The Minister of Industry in the Conservative Government returned to power in 1970 predicted an appreciable down-turn followed by a marked upturn in external trade. He expected the transitional period to be "vexatious" - not because of marked recession but because there would be dissatisfaction with the growth of exports.

Transitional and Safeguard Provisions

Probably based on the experience of the original Six, the British Government decided it would like to get the short term pain over with quickly, and get on to the long term gain. It readily agreed to a five-year transitional period - less than half the time it had taken the Six to dismantle internal tariffs. Moreover it proposed somewhat higher cuts on manufactures in the earlier part of the transitional period, which would have brought internal tariffs down 65 per cent by the beginning of 1975 and 90 per cent by the beginning of 1977 instead of 60 per cent and 80 per cent respectively under the EEC proposal. However, the Six were anxious to maintain the same timetable for industrial goods as that for British adjustment to the Common Agricultural Policy.

A general transitional safeguards clause (Article 135) was included in the Treaty of Accession, practically identical to Article 226 of the Rome Treaty (see above, p.....). There was also provision, (in Article 136) for application of anti-dumping duties under certain conditions during the transitional period. However, this article for some reason did not include the requirement that goods exported from one member state to another

should be re-admitted free of duty. Another feature of the original transitional arrangement which was carried over into the Accession Treaty was flexibility in the schedule for abolishing fiscal duties or converting them into internal taxes (Article 38(3)). Article 43 was designed to meet a special British concern about the way in which removal of their QRs on iron and steel scrap might affect costs of production in the steel industry. It allowed them to retain these quotas for two years as long as they did not discriminate against other member states.

In addition to these transitional provision, the British of course had access to all the continuing safeguard arrangements in the Treaty of Rome.

The Actual Experience

No evidence has been found of serious problems of adjustment which can be directly related to British entry into the Community. Unemployment in Britain did rise from a rate of 3.5 per cent in 1972 to 5.3 per cent in 1979, but this does not seem to be attributable in any significant degree to British entry into the Community, since there were similar, and in some cases greater increases registered in jobless in other EEC countries.

The British appear to have invoked Article 135 in only one case. A sharp drop in coal and coke production resulting from the miners' strike of 1974 led to shortages of certain steel products. The British were permitted, under the general transitional safeguard provisions, to set up an export licensing system for certain steel products and later in the year to add other forms of steel and coal to the list of controlled items. However, the problem which had been anticipated regarding steel scrap exports did not arise.

It would be difficult to determine to what extent the British Government used state aids, or state ownership of industries such as steel, to mitigate the effects of EEC entry.

By the time Britain joined the Community, the resources at the disposal of the European Social Fund and the ECSC re-adaptation fund had been greatly increased. The same was true of the European Investment Bank. Moreover, in 1975 the Community set up a European Regional Development Fund - something in which the British were particularly interested. However, the assistance available from these sources was small in relation to the needs, the EEC budget and the funds at the disposal of national governments.

By the middle of 1982, Britain had received from Community sources £3.5 billion in grants and £ 4.4 billion in loans to assist and promote industrial change and stimulate investment. The annual average was thus about £ 830 million, though there was a substantial increase over the 9 1/2 year period. It is difficult to relate the projects assisted to situations resulting from British entry, except to some extent in the case of aid provided for restructuring the iron and steel industry. Much of the EIB's financing went, as in other member states, for improvement of infrastructure.

The absence of major difficulties for British industry may seem surprising in view of the pronounced deterioration in Britian's balance of trade with other EEC countries on manufactured goods (which is discussed in more detail below). By 1979, Britain had a deficit on manufactures with its Community partners amounting to $6,175 million compared with a surplus of $41 million in 1972. [3]

This was probably far in excess of what had been envisaged by the most pessimistic economists before accession, even allowing for the general rise in prices which took place over these years. Other predicitions also turned out to be wide of the mark. The initial cost of adopting the CAP was much lower than anticipated because after the boom in agricultural prices starting in 1974, it was actually cheaper to obtain some major agricultureal products inside the Community than from outside suppliers. Moreover, Britain's own exports of agricultural products to the Six developed in a way that was quite unexpected.

Some of this was due to bad forecasting. However, there was more to it than that. The fact is that the effects of British entry had been largely overshadowed by the dramatic changes in the international environment which took place in the seventies. (See pp.... to ....) Some of these completely demolished assumptions on which predictions about the consequences of joining the EEC had been based. For example, with the floating of the pound sterling, balance of payments surpluses and deficits were compensated by fairly gradual movements in exchange rates rather tan by periodic substantial devaluations or by draconian measures to deflate the economy.

Has British Membership been a Success?

Under the best of circumstances it is a complicated process to try to separate the trade effects of customs unions or free trade areas from those of other internal and external developments. When we are dealing with the world of the seventies it is particularly difficult. To the changes in the international environment already mentioned we need to add such factors as the progressive reduction of trade barriers on a multilateral basis as a result of the Toyko Round and the increasingly intense competition, in some sectors, of the newly industrialized countries (NIC's). On the British domesic front, one has to take into account factors like the labour unrest and political instability of 1974 and the development of North Sea oil (which had its negative as well as its positive side).

Having recognized the limitations of this kind of analysis, however, we can start with a few basic facts about Britain's trade. After 1973 there was a striking shift in British trade towards the EEC. From 1972 to 1980 the share of British exports going to other members of the Community rose from 30.2 per cent to 43.1 per cent. In the case of imports the EEC share went up from 33.8 per cent to 42.7 per cent. The ratio of trade to national output also rose substantially.

As already mentioned there was a deterioration in the British trade balance with the EEC on manufactures. Much of this took place from 1972 to 1976, when four-fifths of British duties against the products of the Six were eliminated. Since, at the same time Britain actually increased its surplus with the rest of the world in manufactured goods, it would appear on the surface that tariff changes had something to do with the poorer performance vis-a-vis the community. However, British manufacturers were not holding their own with their EEC competitors in the eight years before accession. Indeed their position deteriorated more in that period than in the years 1973-81. Also, in the latter 70's, Britain's export-import ratio in manufacturing trade deteriorated less with the EEC than with certain other countries, including the USA and Japan.

The trend vis-a-vis the EEC was in fact part of a general worsening of Britain's position in this sector which had been going on for a long time. A decline in the country's share of the manufactured exports of 12 major industrial countries was registered from 1955-58 to 1970-73. It has been attributed to such factors as under-investment, bad labour management relations and stop-go economic policies.

There have been indications very recently of a marked improvement in manufacturing productivity in Britain. From 1979 to 1983, real value added in British industry per person employed rose at an average annual rate of 3.8 per cent - more than double that for the Community as a whole and considerably greater than that achieved by Britain over the period 1960 to 1980. Why has this not been reflected in a strengthening of Britain's position in world markets for manufactured goods? The OECD has pointed out that, although productivity has been rising, Britain's international competitiveness in terms of labour costs and prices has actually been weaker in recent years than in the 1970's. Up to 1981, this seems to have been due mainly to such factors as the appreciation of sterling, associated with North Sea oil, and increases in wage rates. Since early 1981 the pound has been falling, though apparently not enough to bring about an improvement in Britain's trade performance on manufactures. Indeed, this trade went into deficit in 1983 for the first time since the war and the position further worsened in 1984 and early 1985. This was attributable mainly to the fact that Britain came earlier and faster out of the recession than its European partners, and to the miners' strike.

It also bears noting that the deterioration of the balance on manufactures is not an across-the-board phenomenon. It is accounted for largely by sharp increases in import penetration in several specific sectors, particularly motor vehicles, and, to a lesser extent, metal manufacturing, office machinery and data-processing equipment and electrical and electronic engineering.

It would therefore be wrong to conclude from the widening deficit on manufactures that membership in the Community is not paying off for Britain. Special circumstances have, in fact, masked a notable improvement in manufacturing productivity. Nor does the evidence so far bear out Professor Kaldor's claim that membership in the EEC has "accelerated the de-industrialization of Britain". The share of manufacturing in Britain's GDP has certainly declined from 32 per cent in 1972 to 24 per cent in 1983. However, there is scarcely a western industrialized country that has not experienced some trend in this direction - associated with the growing importance of the service sector. In Britain's case it was more pronounced than in most other countries and a major factor in this would appear to be the much greater contribution of the energy sector to GDP. The share of agriculture, forestry and fishing actually declined slightly more than that of manufacturing.

Against all of this, it has to be admitted that the predicted dynamic effects of membership on British industry have yet to show up. One study suggests there is some trend towards intra-industry specialization but that there is decreased inter-industry specialization. Another of its conclusions does not bode very well for Britain's industrial future. The country has increased its share of the European output in low-growth low-skills industries such as tobacco, clothing and footwear, rubber and leather goods, textiles and printing. The viability of industries such as these can generally be maintained only by protecting them in one way or another from the "laser beam" competition of the NIC's. It has been suggested that the growth of these industries in Britain reflects the fact that, within Europe, it has become a low-wage economy with a relatively unskilled labour force.

Turning to the performance of the British economy as a whole, membership in the EEC has not altered the country's position as the slowest-growing major industrialized nation. Its GDP rose, in volume, by only 11 per cent from 1973 to 1983 compared with a Community average of 19 per cent (which, as already pointed out, was about the same as that for the United States). The rate of growth in Britain's real GDP per employed person over the same decade was also inferior to those of its major Community partners though better than that of the United States. But if we look at the most recent period, 1979-1983, a different picture emerges. Over these three years British real GDP per employed person was growing faster than that of any other leading industrialized country except Japan. The average annual rate of increase was 2.1 per cent compared with a Community average of 1.2 percent. A report recently prepared by the European Communities Commission notes that a significant improvement has been taking place in total factor productivity in Britain, and attributes it to "shake out" (more efficient use of capital and labour). This fits in with what has already been said about the increase in productivity in manufacturing.

What about the anticipated inflow of foreign investment into Britain? Here the readily available evidence is mildly positive but not very conclusive. There has certainly not been the great flood of new investment that some had predicted. The proportion of total U.S. overseas investment going to Britain declined in the 60's and early 70's but recovered markedly after that. It is not clear how much of the increase represented investment in North Sea oil. As regards U.S. direct investment in manufacturing, Britain's share of the total increased from 12.6 per cent in 1976 to 15.7 per cent (estimated) in 1981. In 1980, Britain accounted for nearly 59 per cent of total U.S. direct investment in the Community, excluding oil. The corresponding figure for manufacturing was 34 per cent of the world total. About half of Japan's investment in the EEC is in Britain. British membership does not seem to have had a strong effect on investment flows to and from other members of the Community. Indeed, direct investment in and out of Britain grew much more with North America from 1970/72 to 1980. Perhaps this should be expected in view of the extent to which direct investment and trade are alternative ways of developing a market.

To summarize the apparent effect of British entry so far, while there is some evidence of short term adverse impact effects, and there are indications of a very recent improvement in productivity it cannot really be conclusively demonstrated that the country is now getting the benefits from membership that the original Six obtained. There are, however, a number of extenuating factors:-

1. Studies of what happened to the industries of the Six after 1958 suggest that integration is a slow process. Once economist who has looked into this experience suggests it may take 15-20 years to show measureable results and 40-50 years for completion.

2. Britain joined the Community just as it was coming to the end of 15 years of rapid growth, and thus "missed the best of the party". The British also came on the scene when EEC members were having increasing difficulty keeping up the momentum of harmonization and removal of non-tariff obstacles to trade.

3. As already mentioned, Britain went in with its manufacturing sector much weakened by developments over the preceding decade or so.

4. The economic and industrial relations atmosphere at the time of entry was not such as to encourage new investment and the inflow of foreign capital (e.g. rapid increases in wages and prices, the miners' strike which led to the fall of the Heath Government).

5. The ambivalence in Britain regarding membership in the Community may have led to the postponement of business decisions needed to take advantage of the larger market, at least until after the 1975 Referendum. In the last several years, uncertainty has again arisen about whether Britain will stay in the EEC in view of the Labour Party's official position favouring withdrawl "in a amicable and orderly way" because membership is an obstacle to the "radical, socialist policies..." to which it is committed. Public opinion polls also suggest that the British people might be persuaded to vote against remaining in the Community.

6. Government policies have not been such as to facilitate positive adjustment and restructuring. Among the main criticisms it has been pointed out that, from 1974-1979, the Government pursued policies which enhanced the bargaining position of organized workers, reduced management's flexibility on prices, wages and profits and propped up industries in trouble instead of forcing them to face the economic facts. The gains in cost competitiveness flowing from the sharp depreciation of the pound in 1976 had been completely eroded by the first quarter of 1979. More recently Britain has been making herculean efforts to get inflation down to more manageable levels and reduce government deficits. However necessary this may have been, it has been suggested that Britain went beyond what its Common Market partners were doing to reduce deficits and placed an added burden on the economy at a time when major structural changes were needed. On the other hand it appears that British efforts to upgrade the skills of workers so that they will be more on a par with those of such competitors as Germany have been inadequate. So have the incentives to invest in new plant and equipment.

7. Exchange rate changes since the pound was floated have introduced an element of uncertainty into business transactions. British producers of certain manufactured goods, including motor vehicles, have cited this as a problem they have had to contend with in selling in Community markets.

Notwithstanding the somewhat disappointing results so far, the British business community seems convinced that there have in fact been important benefits. At the very least, it is believed that Britain over the past decade has been much better off inside than it would have been outside the Community. Although the inflow of investment has not been spectacular it is thought that it would have been considerably smaller if Britain had not joined. Interviews with officers of multinational companies suggest that, should Britain withdraw now, there would be an exodus of subsidiaries. The view has been expressed that the current difficulties of certain industries, such as steel, would have been much greater if Britain had not had the protection of EEC policies and supports. This then is perhaps the bottom line in the debate about whether Britain should remain in the Community - what is the alternative?

D. RELEVANCE FOR A CANADA - U.S. ARRANGEMENT

Some caution is advisable in attempting to apply lessons from the EEC experience to the situation in North America. There are some important differences, especially the following:-

1. The EEC is a common market, to some extent still in the making, heading towards economic, and perhaps eventually political, union. Entry into the EEC entails ceding sovereignty to a much greater extent than is the case in a free trade area. EEC institutions have supra-national powers. There are no provisions in the Rome Treaty to cover a situation where a member state wishes to withdraw. Presumably in the last analysis it could do so. However, as long as it remains in, it is required to comply with the decisions and directives of community organs. All of this entails problems (and benefits) that are not met in a more limited trading arrangement. Conversely, where there is no common external tariff or harmonization of economic and social policies, there can be distortions in the conditions of competition and deflections in trade which are not found in an EEC-type system.

2. In contrast to the Canadian situation, political considerations have provided a major impetus to economic integration in Europe.

3. The EEC started with six members, the three largest having approximately the same population. The decision-making process, with unanimity required on some matters and qualified majorities on others, makes it difficult for certain combinations of countries to dominate the Community and strengthens the position of the smaller ones. This again differs greatly from the Canada-U.S. situation where we would be dealing, one on one, with a partner which has nine times our population and ten times our output of goods and services.

4. Canada-U.S. trade is much less restricted than was that between the EEC countries in 1958. Tariff levels are a great deal lower. We have the Autopact, which has brought about major changes in trade and production patterns in the important motor vehicle sector. Our trade is not limited by extensive quota controls.

Moreover, there is a much greater degree of integration in North America in transportation and communications systems, technical standards, and ownership and control of industries and intercorporate links than exists in Europe today, even a quarter of a century after the EEC came into being. National prejudices and differences in language, culture and ways of doing business are generally not such as to have a significant effect on trade and investment decisions in North America. These factors do still seem to have some influence in the European business world.

What all this adds up to is that, other things being equal, one would expect the benefits of getting rid of trade barriers in North America to be smaller than those of integration and harmonization in Europe. One the other hand, they are likely to be achieved much more rapidly (because some of the factors which slowed down the process in Europe would not be present). The other side of this coin is that safeguards might be more necessary in a Canada-U.S. arrangement during a transitional period.

Nothwithstanding these and other differences, there <u>are</u> some useful lessons to be learned from the European experience. The more important ones would appear to be as follows:-

1. It certainly illustrates that, under the right conditions, permanent dismantling of tariffs and NTBs can provide a stimulus to industrial restructuring which increases efficiency and competitiveness, through specialization and greater economies of scale. This process in turn leads to faster growth in incomes and output.

2. The restructuring which took place in Europe seems to confirm the thesis that, where there is integration between highly developed countries which have a broad range of secondary industries, <u>intra-</u> industry specialization tends to predominate. The adjustment problems this involves, while not negligible, are generally less severe than those associated with <u>inter-</u> industry specialization.

3. To the extent that inter-industry specialization does take place, it is obviously desirable to avoid, if possible, getting into the situation in which the British to some extent find themselves - expanding their share of Community production in industries which use low-skill, low-wage labour.

4. Just because the likely adjustment problems were exaggerated when the Rome Treaty was under negotiation, we cannot assume that the same is true now in Canada. However, the European experience should make us take a harder look at whether the fears being expressed are really justified.

5. Comparison of the experience of the original Six and that of Britain suggests that a generally favourable economic climate contributes to the ease and speed of adjustment. It is for consideration how far the assurance of exchange rate stability is necessary to get the full benefits from dismantling trade barriers, in view of what has been said in Britain about this.

6. The way in which state aids were treated in a Canada-U.S. trading arrangement could have an important bearing on its regional impact. The Rome Treaty took a particularly tolerant attitude towards measures of this kind. Moreover, such constraints as it did establish proved exceedingly difficult to enforce. It would appear that state aids and other forms of government intervention made a major contribution to the of regional development within the Community.

7. EEC experience with state aids and government procurement illustrates the kind of trade-offs involved in deciding how much autonomy to give up in these fields and the difficulty of policing any common rules.

8. Obviously integration cannot be expected to cure the long-standing weaknesses of particular industries. However, it may, as in the case of steel in Britain, make it impossible for governments and business to avoid going ahead with steps to deal with these problems which should have been taken long ago.

9. It is clear from what has happened in Britain over the past decade that the response of governments, business and even the general public to a comprehensive trading arrangement could be crucial. Just to touch on a few points, government policies should encourage investment in plant and equipment and, perhaps even more so, in human resources. Businessmen should draw the right conclusions about economies of scale - whether, in their own industries, it is the size of the firm, the plant or the product line that is important. Once having taken the step to integrate, energies should not be dissipated and uncertainties created by debating whether to undo it. If it is not possible to go ahead with a large measure of consensus, the success of the initiative will be prejudiced to some extent.

10. Because of the differences in the North American and European situations already mentioned, it would be inappropriate to try to draw firm conclusions about the implications for Canadian sovereignty and political independence. It bears noting, however, that, in spite of the much higher degree of economic integration between EEC countries and their efforts to cooperate on foreign policy, there still seems to be room for considerable differences of stance on such issues as the military defence of the West and the Falklands crisis.

11. The success of the BENELUX proposal for European economic integration in 1955 and failure of British efforts to join in 1962 and 1967 each in its own way underlines the importance of getting not only the decision but also the timing right.

ENDNOTES

[1] Provisions relating to alignment of tariffs against third countries on the CET are not dealt with here. Nor are those having to do with agriculture, which was to be subject to a system of managed markets.

[2] These changes were actually to be accomplished in 11 years, since the first adjustments were not to be made until one year after the Treaty came into effect.

[3] There were substantial fluctuations from year to year. For example the deficit was much lower in 1980. However, the general trend over the decade was towards a worsening of Britain's balance on manufactures with other EEC countries.

EFTA

While the EFTA experience was not within the scope of this study as originally envisaged, it is certainly relevant to the Canada - U.S. situation. A few facts and figures are therefore set out here to give some indication of the repercussions which EFTA had on the trade and economic development of the member countries. Some of the consequences were similar to those found in the study of the EEC - for example, faster growth in trade with EFTA partners than with the rest of the world and restructuring of industries to take advantage of new trade opportunities. But in view of the discrete and indicative nature of much of this material, it would need to supplemented by a more detailed and comprehensive analysis before drawing any firm general conclusions about the economic benefits of EFTA.

Trade Patterns

From 1959 to 1967, all members of EFTA expanded their imports at a faster rate from their partners in the trading group than from the rest of the world. In the case of Austria, Sweden and Britain, the annual average percentage increase in imports from other EFTA countries was more than half as great again as the corresponding figure for imports from all countries. For Denmark, Norway, Finland and Switzerland, the rate of growth in imports from EFTA was between one quarter and one half higher than that of total imports.

A study by the EFTA Secretariat estimated that the total increase in EFTA countries' intra-area imports, resulting from the removal of internal trade barriers, was about $2.2 billion in 1967. These "EFTA effects" on imports grew considerably from 1965 to 1967, reflecting, it was suggested, the progressive removal of tariffs and the time it takes for trade patterns to adjust fully to this. It was also estimated that about 40 per cent of the increase in imports from EFTA partners due to trade liberalization represented trade diversion and about 60 per cent trade creation.

The figure arrived at for trade creation in 1967 amounted to 7.9 per cent of total imports of EFTA countries from all sources in that year and 25.8 per cent of their imports from partners in the trading group. The corresponding figures for manufactured goods (more relevant, since EFTA was essentially an industrial trade area) were 10.3 per cent and 31.3 per cent respectively.

Industrial Structures and Productivity

The EFTA SEcretariat did not examine in detail the impact of trade creation in EFTA on specialization, scale of production and efficiency. It did, however, in another study, identify several cases where, up to 1965, some of the expected effects of trade liberalization within EFTA appeared to have taken place. These included more processing of pulp in Scandinavia, the growth of high productivity industrial sectors in Denmark, the installation of modern textile machines in Portugal and the Rationalization of the Austrian tire manufacturing industry.

NORWAY

The following deals with the repercussions on Norway of its membership in EFTA and, later, its free trade agreement with the Community:

- Trade liberalization associated with Norway's membership in EFTA is considered to have played an important role in the major transformation of the country's manufacturing industries in the sixties. (See Fritz Hodne, The Norwegian Economy, 1920-1980, p. 202). The main features were:

  - Firms were forced to seek out niches in home and/or export markets.

  - The winners (industries with expanding output and employment) included chemicals, machinery (ex. electrial), electrotechnical machinery, transport equipment, printing and publishing, basic metal industries; the losers included textiles, garments and apparel, furniture, leather products and tobacco.

  - In the engineering industry the expansion was particularly noteworthy - greater than in GNP and in manufacturing industry as a whole. Its contribution to total value added in manufacturing increased more than its share of manufacturing employment (i.e. it was improving productivity faster than was Norwegian manufacturing industry as a whole). The number of establishments was just about cut in half from 1960 to 1975, indicating a strong trend towards concentration, presumably to take advantage of economies of scale.

- It is more difficult to assess the effects of Norway's free trade agreement with the EEC, because in the seventies the development of North Sea Oil overshadowed all other economic developments. Attention is, however drawn to the following:

- In purely statistical terms, one would have the impression that Norway has taken more advantage of the link with the Community than any other EFTA country. Its exports of the EEC were up 450 per cent and imports 228 per cent over a seven-year period. In 1978, Norway had a trade surplus with the Community for the first time. However, analysis of the trade figures in detail would probably show that North Sea Oil rather than free access to the Common Market was the big factor in all this.

- Norway's real GNP rose at an annual average rate of 4.9 per cent from 1973 to 1979, a better performance than any other OECD country. The corresponding figure for 1979 to 1983 was 2.3 per cent, compared with 0.6 per cent for the EEC, and bettered only by Japan, Finland and Turkey among OECD countries. Here again, however, the credit probably should go mainly to North Sea Oil.

- A different picture emerges when one look Norwegian manufacturing output since 1973. There was practically no change from 1973 to 1982. But the machinery and industrial chemicals sectors continued to do well (as in the sixties). The poor performance of manufacturing as a whole was attributable to such sectors as textiles, apparel, leather and products, footwear and rubber products, most of which has exhibited weakness in the earlier period. It seems likely (though this would need to be confirmed by checking the trade figures) that the competition in these sectors was coming mainly from the NICs rather than the EEC. A hypothesis which might be tested is that the development of North Sea Oil, through its effect on wage rates and allocation of resources, aggravated the problems of industries which were already having some difficulty surviving.

AUSTRIA

- While the Austrian situation has not been looked at in detail, the following gives some indication of the country's economic performance since it concluded a free trade agreement with the EEC.

  - Austria's real GDP increased at an average oof 2.9 per cent from 1973 to 1979 and 1.5 per cent from 1979 to 1983. In both periods was significantly better than the EEC's performance.

  - Real value added in manufacturing grew at a considerably faster rate in Austria than in the EEC over the decade beginning in 1973. Also, Austria performed better in manufacturing producivity (as measured by the increase in real value added in manufacturing per person employed).

In order to establish what, if any, connection there is between these developments and the removal of trade barriers between Austria and the EEC, a thorough study of the trade figures and of structural changes in Austrian industry would need to be carried out.

STATISTICS

Selection of years for statistical comparisons in this study has been governed to a considerable extent by availability of data and time constraints. In some cases it may be open to criticism on such grounds as the unrepresentative nature of one of the years chosen (because of substantial year to year fluctuations) or the fact that one of the years reflected a different phase of the business cycle than the other. However such problems are not likely to have had a significant effect on the general conclusions reached.

SOURCES

A variety of sources, both primary and secondary, were consulted in writing this report.

Principal primary sources and public documents used included the files of the Department of External Affairs, the Annual Reports of the EEC Commission (later the Commission of the European Communities), reports of the European Investment Bank, OECD economic surveys by country, EEC annual economic reviews, statistical publications of the EEC and the OECD, the UN statistical year books, a number of official publications of the European Communities in the series European Documentation and European File, a report of the Commission entitled Britain and the Community, 1973-83: The Impact of Membership, a report of the Directorate General for Research and Documentation, European Parliament, entitled The Effects on the United Kingdom of Membership of the European Communities (1974), the British White Paper entitled Britain and the European Communities: An Economic Assessment (Cmnd. 4289), and a series of articles on the EEC in the London Financial Times which appeared during 1985.

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Grey, Clark, Shih and Associates, Limited

THE AUTOMOTIVE AGREEMENT IN A CANADA-UNITED STATES COMPREHENSIVE TRADE ARRANGEMENT

C.D. Arthur

Ottawa, Canada
November 6, 1985

804 -141 Laurier Avenue West, Ottawa, Canada K1P 5J3 Tel.: (613) 238-7743 Telex 053-3702

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EXECUTIVE SUMMARY

The Government of Canada has decided to enter into discussions with the United States regarding the possibility of establishing a comprehensive bilateral trade arrangement. The question has arisen as to whether the Automotive Agreement should be folded into a comprehensive arrangement with the United States or whether a separate regime for automobiles should be maintained. This paper examines the options relative to the future of the Automotive Agreement, likely United States attitudes and international implications as well as current international trade and industrial developments in the automobile industry.

Our analysis and conclusions were developed following discussions in the United States with senior officials of the Office of the United States Trade Representative, the Department of Commerce, the International Trade Commission, the Motor Vehicle Manufacturers Association, the motor vehicle companies, the union (UAW) and the National Planning Association (USA).

In Canada discussions were held with the major motor vehicle companies, the Motor Vehicle Manufacturers Association, the Automotive Parts Manufacturers Association, the union (UAW) as well as other knowledgable persons.

The world automotive scene has changed dramatically since the signing of the Canada-United States Automotive Products Trade Agreement (Automotive Agreement) in 1965. Then the world market was dominated by the North American industry. In the 1970's it became a much more competitively balanced world

industry. In the 1980's Japan has gained a significant competitive advantage among world producers particularly over the North American industry. As the tariffs and other trade barriers governing trade in automobiles and automotive products were liberalized in the 1970's it meant easier access to the major automotive consumer markets, rapidly increasing international automotive trade resulting in a major shift in the equilibrium of world automotive production.

The greatest threat to the viability of the North American automotive industry, as we know it, is the efficiency and competitiveness of its Japanese counterpart. By 1990 Japanese assembly capacity either in Canada or the United States plus imports are expected to be in excess of forty per cent of North American market demand for automobiles. Only moderately increased demand is forecast during this period. If these trends continue and the projections are realized the North American automotive industry will have considerable excess capacity and an urgent need to rationalize existing production facilities. There will be a net decline in production and employment in Canada and in the United States. Where the jobs go or stay is the paramount issue for governments and workers.

Our conclusions are as follows:

1. The issues relating to the Automotive Agreement in the context of a comprehensive trade arrangement with the United States must be measured against concerns about the viability of the automobile industry in Canada and in the United States.

2. The automobile industries on both sides of the border are preoccupied in meeting the competitive challenge of the Japanese industry in the North American market. Substantial structural changes in the production techniques employed by the North American automobile companies will occur as they adjust to new competition which will determine production, location of vehicle assembly and parts plants and employment levels.

3. The North American automobile companies will experience a declining share of the automobile market in both countries which will bring further pressure on decisions relating to the shared production objectives of the Automotive Agreement.

4. The United States, at least publicly, views the initial agenda for any comprehensive trade discussions as Canada's to put forward. If the Automotive Agreement is not included in the agenda this will be a Canadian decision. United States officials say they are unlikely to raise the Agreement unless there are political or industry pressures to do so. That such pressures may arise cannot and should not be dismissed.

5. The key questions which must be assessed relate to the potential costs, benefits and risks posed by adopting one position or another with respect to automotive trade.

6. What is to be gained by including it, if this meant re-opening the terms? The U.S. has long felt that the safeguards have outlived the transitional period and should be eliminated. It is clear that the Canadian automotive industry and the union favour excluding the Automotive Agreement from any comprehensive trade discussions because of the prospect of withdrawal of the safeguards which they consider essential to the maintenance of production and employment in Canada.

7. The risk of trying to keep the Automotive Agreement outside of any comprehensive discussions is the continuing prospect of a shift in United States commercial policy, the possibility of unexpected trade barriers against cross-border shipments, the re-emergence of U.S. concerns about the safeguards and the trade imbalance due to automotive trade or abrogation on one year's notice.

8. What is to be gained from rolling the Automotive Agreement into the bilateral agreement? Will it really safeguard our access to the U.S. market any better than the status quo? Past experience with United States attitudes should warn us that there are real risks that United States interests will try to eliminate the safeguards if the issue is re-opened. The wisdom and prudence of inviting such demands should be weighed very carefully.

9. Is it necessary to include auto trade to meet the trade coverage envisaged in GATT Article XXIV:5? It is not clear that this is necessary. Must the trade between Canada and the United States be free on a statutory or de facto basis? Surely we could argue that de facto free trade over a period of twenty years is free trade. This issue should be analyzed very carefully. We have not attempted to do it in this paper.

10. If Canada included the automotive sector in a comprehensive bilateral agreement we would almost certainly have to reduce our tariffs on a preferential basis for the United States. If we did not meet the criteria of GATT Article XXV, Canada would have to seek a waiver under GATT Article XXIV to extend these preferences. Our present system does not require a waiver. The United States has had a GATT waiver since 1965. A GATT waiver requires approval by two-thirds of the Contracting Parties. It is considered highly unlikely that Canada would obtain approval of a waiver.

11. Even if Article XXIV criteria were met, other Contracting Parties might consider that moving from a remission based system to preferential duty free access would have the effect of raising a duty inconsistently with Article II (even though the remissions are not bound) they might then pursue their perceived right to seek concessions to restore the balance under Articles XXIV and XXVIII, and possibly XXIII.

12. Also for consideration is whether the U.S. would be prepared to condone the various remission orders now in place for a number of third country producers who may obtain duty-free entry of automobiles in return for purchasing Canadian made automotive parts. United States officials consider that these arrangements are little more than subsidies to Canadian automotive parts producers. These programs which have been important to the parts industry could get caught up in "levelling the playing field."

13. Unless there is some real possibility, significantly to improve on the status quo, and there does not appear to be, the bilateral and multilateral risks of re-opening the Automotive Agreement in a bilateral context, would appear to outweigh the potential benefits by a wide margin.

THE DEVELOPMENT OF THE INDUSTRY

The 1950s and 1960s were periods of continued growth in world-wide demand for automobiles. Rising real incomes and the emergence of substantial consumer demand in Europe and later in Japan contributed to the growth of the automobile industry in these countries. Because of higher gasoline prices and lower per capita income, demand in Europe and Japan was met by more fuel efficient and lower-cost automobiles than those produced in North America. America was not much taken with these small cars, despite the popularity of the VW "Beetle" and their love affair with big cars became stronger than ever, urged on by cheap energy and rising incomes. The automobile industry in each of these major market areas operated almost entirely within their respective boundaries for assembly. The sourcing of components was largely restricted as well. Indeed the North American economies grew less by innovation during these years than by expanding basis scales of production to reduce unit costs. There were relatively few breakthroughs in new products or processes and very little real competition. But the market in North America was generally very bouyant. This was particularly true in automobile production and demand which permitted the North American industry to preserve its position as the world's leading automobile producer. It was against this positive market trend that the Automotive Agreement was negotiated.

Although Canadian demand for automobiles grew throughout the period leading up to the Automotive Agreement, automotive production in Canada was

declining. This was due in large part to the situation created by demand for a proliferation of models, the resultant short runs and higher unit production costs, a rising tide of imports, reduced economic growth, all in a period of rising unemployment. Faced with this proliferation of problems, the Federal Government, in August 1960, appointed Dean Bladen as a one-man Royal Commission to undertake an intensive study of Canada's troubled automotive industry.

In his report[1] Dean Bladen found that the Canadian industry's basic problems resulted from low volume production of a substantial number of different models at a time when the economies of scale were steadily increasing for most major automotive components. The technology of the industry at that time called for a greater degree of specialization which required expensive, dedicated equipment. Dean Bladen concluded that if the Canadian automotive industry was to become more competitive it had to have access to larger markets to take advantage of optimum scales of production. This could only be achieved if there was some form of integration between the Canadian and the United States automotive industries which could lead to a rationalization of the industry with considerable benefit to Canadian production and employment as well as to consumers. His report proposed a plan to enable automobile manufacturers to import any vehicle

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1 Report of the Royal Commission on the Automotive Industry, April 1961.

and all parts they required free of duty if they met certain Canadian content provisions calculated as a proportion of the total cost of sales by the manufacturer of vehicles sold in Canada whether there were produced in Canada or imported.

In 1962 and 1963 the government introduced remission programs designed to create an incentive for Canadian motor vehicle manufacturers to export components as a means of increasing output and employment and of providing an opportunity for Canadian producers to gain access to larger markets which in turn would enable them to lower their production costs. The success of the second plan in increasing exports of parts to the United States resulted in a petition under United States trade laws claiming that Canadian exports were benefitting from a "bounty or grant" and that a countervailing duty should be imposed. The subsequent investigation was never concluded as both the Canadian and United States governments were concerned about the possibility that an adverse ruling might seriously damage bilateral trade relations. The desire on both sides to resolve this trade dispute provided the incentive to develop a mutually agreeable arrangement covering automotive trade between the two countries.

During the period of rapid growth in world demand, barriers to automotive trade among the major producing countries were progressively dismantled. By 1973 when the "OPEC Shock" brought the trade spiral to a halt the U.S. automotive tariff had been reduced to 3 per cent, the EC external tariff to 10.9 per cent and the Canadian tariff to 15 per cent. In the Tokyo Round further reductions were

negotiated in the U.S. automobile tariff to 2.5 per cent by 1987. And the Canadian automotive tariff will be 9.2 per cent in 1987. The tariff reduction process was not viewed as threatening to any national automotive industry because the types of vehicles demanded in North America, Japan and in Europe varied markedly. Although international trade in automobiles had been substantial and was growing, most imports were in marginal market segments where domestic producers chose not to compete. Industry leaders generally considered that competition within the major automotive producing countries was reasonably balanced and that more open trade would not lead to a dramatic relocation of automotive production.

During the 1970s, the post-war economic growth slowed markedly. Worldwide automobile demand levelled off in response to broader economic problems, many of them related to energy supplies and pricing. This new situation, a worldwide slowdown of economic activity, raised additional problems for the automotive industry and for prospects for employment from automotive production. Over one million workers were employed in the United States and approximately 125,000 in Canada at the peak of automotive production in North America in 1978. By 1981 the number of directly employed autoworkers had declined to 788,000 in the United States and to 107,000 in Canada. These figures do not include the tens of thousands of workers in related industries whose employment was no doubt affected by the downturn in demand.

TABLE NO. 1

EMPLOYMENT IN THE AUTOMOTIVE INDUSTRY
1978 - 1984

Year	Assemblers	Automotive Parts Manufacturers*
1978	65,900	59,000
1979	67,400	56,400
1980	56,800	47,300
1981	55,500	51,900
1982	51,400	47,500
1983	55,900	59,700
1984	62,000	61,800

*Includes Accessories

Source - Statistics Canada

Since 1982 production and employment in the automotive industry has improved. In the United States employment in 1984 was 896,000 some 11 per cent below the 1978 peak employment year while in Canada employment was 123,800 workers some 1000 workers below the 1978 level. The consensus among industry analysts is that employment may peak in 1985 as the North American producers attempt to regain their competitiveness and the growing impact of the Japanese and other offshore suppliers. Employment reductions are expected to continue as the new automated flexible manufacturing systems now being introduced in the automotive industry start to impact on productivity. Initiatives by Japanese automobile manufacturers to establish production facilities in North America

could also accelerate employment reductions at existing plants, particularly if their operations are simply assembly of largely imported components which more than replace their direct imports. This is a major concern, particularly to the parts industry, but no less serious to workers in assembly plants that may be closed.

To improve their competitiveness, many world automobile producers are purchasing imported components for use in the final assembly of automobiles. This procedure is used most extensively by North American automobile manufacturers. Import sourcing is being used to reduce production costs, increase quality, reduce lead times for major components and to ensure more reliable service. The U.S. International Trade Commission estimated that in 1983 the major North American automobile producers together imported over 2 million engines and 1.5 million transmissions and transaxles as well as substantial quantities of components such as wiring-harnesses, radios and stampings which only five years ago were produced in North America.[2] According to the Department of Regional Industrial Expansion the percentage on a value basis of foreign content sourced by the major North American producers for incorporation in automobile assembly will increase from 6 per cent in 1985 to 16 per cent by 1990.

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2 The Internationalization of the Automobile Industry and Its Effects on the U.S. Automobile Industry, USITC Publication 1712, June 1985, p. 5.

The North American automobile producers, by making structural changes to their assembly operations and sourcing more components offshore, have lowered their breakeven points and are once again in a strong profit position. In both 1983 and 1984 the companies earned record profits. The 1984 industry profit was around $10 billion, 40 per cent more than the $6.2 billion earned in 1983. The U.S. Department of Commerce believes that current cash flows should enable the industry to finance capital expenditures, debt repayments and dividends without substantial borrowing.[3]

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3 U.S. Department of Commerce unpublished paper.

INTERNATIONALIZATION OF PRODUCT

Perceptions of the automobile industry have changed dramatically. During the 1970's it was commonly held that energy conservation and environmental concerns would make the small or light automobile the standard-size automobile in all world markets. This downsizing and standardization was to evolve what has been called the "world car". It was assumed that competition would be based on price and that high manufacturing volume would be the key to low cost. This would result in a reduction in the number of automobile companies in the Western World as highly competitive producers raced to keep ahead in economies of scale. Further many observers predicted that manufacturing would shift to developing countries from the developed countries to take advantage of lower wages to reduce manufacturing costs.

Probably the most significant factor influencing future world automotive production concepts is the new automated and robotized production machinery. Already it is lowering the minimum efficient annual production scale for individual product lines in the industry. Increased use of flexible, automated equipment in the assembly of automobiles will permit a wide range of products to be assembled on the same line. This will mean that a plant can be highly efficient if a cumulative volume of approximately 250,000 units annually is spread over several models. Previously this volume was considered to be near optimum for the production of one model. Because of the high capital cost of product design and production, equipment volumes of a half million units per

year may have to be maintained for certain power-train components such as engines and transmissions. Producers are likely to enter into joint ventures for the production of these components in order to spread costs. A range of less capital-intensive parts will be economically produced in a single plant using flexible techniques.

No longer do North American industry executives insist that production costs will only be reduced by increasing optimum scales of production through adoption of more automated equipment. Today there is broad industry consensus that production scale requirements are no longer the driving force for industry concentration that they were in the past.

The new or evolving role for the automobile assemblers is forecast to be as coordinators of the production system. There is a trend towards outside purchasing of more of the major components and sub-assemblies, reducing the extent of vertical integration. At the same time, automobile companies are working more closely with component suppliers to ensure that problems of financing, design, quality and cost are resolved cooperatively. This new approach derives many of its features from the Japanese model. There will be smaller number of suppliers for each final assembler, specific parts will be obtained from single sources, longer-term association with suppliers will be developed and efforts to bring much of the production operation as close as possible to the point of final assembly to reduce inventory and other supply problems will accelerate.

An emerging trend is to have dedicated suppliers, linked to the final assemblers although not necessarily integrated with the final assembler, supplying minor and finished parts at the point of final assembly. Senior industry executives interviewed in connection with this study predict that the development of this process is likely to take place in the medium term. Some consider that the industry may merge the system described above with the traditional North American production system because some companies may be reluctant or unwilling to abandon the more efficient manufacturing plants within the existing production system.

While no apparent locational pattern is evident as yet some recent decisions may provide an indication of the future direction of the North American industry. In addition to developing external sources for internationally competitive components, subcompact automobiles and advanced small automobile technology, the three major U.S. automakers have announced internal programs for the production of new subcompact models. These manufacturing projects are designed to revise product development practices, change component materials used and improve assembly and manufacturing procedures. General Motors has announced that its Saturn Project will be located in Tennessee. This is relatively close to the new Nissan assembly plant. Both assemblers will be able to source from parts producers locating in the area. The Chrysler Corporation's Liberty Project will use component systems or a number of component modules similar to the assembly line practice used in Japan. Ford's Alpha Project is designed to study all facets of the company's production system to create a cost competitive small automobile probably using a number of imported components.

Another factor influencing future production concepts is that the automobile markets in Europe, Japan and North America are continuing to demand a very different automobile mix. The effect of the energy shocks have been largely overcome through more fuel efficient automobiles. Consumer interest in new product concepts is strong. These factors raise questions about the level of automotive production that may be maintained in Canada in the longer term. Only the GM Oshawa complex with its two automobile plants and one truck assembly plant and in-house and independent locally positioned parts suppliers appears to have the core features of the new flexible production system being developed. Neither Ford or Chrysler have as established or positioned production facilities in Canada. According to industry analysts each company has facilities in Canada which could be integrated into a flexible production system should such production centers be located in the United States within a distance that meets the delivery requirements of this assembly technique.

COMPETITION IN THE NORTH AMERICAN MARKET

Since 1979 the types of automobiles demanded in the major world markets have converged dramatically. This is particularly true in North America where the market had so long been dominated by the large automobile. Now most manufacturers in the world are a potential threat to every other manufacturer in what is rapidly becoming a largely integrated world market. Intensifying this competitive environment and accelerating change has been a softing of demand and surplus capacity in many markets. The Japanese automobile industry has been the least affected. It has been able to produce high quality automobiles at substantially lower cost than its competitors and has experienced a dramatic export surge particularly to the North American market.

There have also been major changes in automobile buying habits in the United States and Canada. Japan has become a major automobile producing country competing directly with the North American industry. Consumers are purchasing imports from Japan in record numbers. In many cases, the Japanese cars have a perceived quality advantage over North American vehicles. In 1984 almost 2 million automobiles of Japanese origin were sold in the United States and approximately 172,000 in Canada.

The key competitive strength of the North American industry is and will continue to be the very large class of automobiles that are uniquely North American. There are indications that the Japanese will move up their challenge

into the medium size class in part as a result of the voluntary export restraints which have limited Japan's access to the United States and Canada.

A series of voluntary export restraint arrangements (VERS) since 1981 have offered a degree of protection to the North American Automotive Industry. These restraints provided a period of time to the North American industry for retooling and restructuring production to bring out smaller and more fuel efficient automobiles which were more competitive with Japanese automobiles. Since 1979 the North American automobile industry has invested more than $30 billion in new plant and equipment. This investment and the restrictions against import Japanese cars enabled the industry to generate record profits which has made it possible for the automobile companies to undertake the present investment program.

This new and more efficient production capability is not likely to overcome the intense competition which the North American automobile producers are going to face in the small and mid-size segments of the market in North America for the remainder of this decade. The Japanese are now positioned in the market to offer strong competition in the mid-size automobile market as well as having captured almost all of the small automobile market. The North American producers appear to have recognized their vulnerability in the small automobile market. Most of their recent investment has been directed to the production of mid-size automobiles.

There are also much more rigorous restrictions on Japan's auto trade with Europe. While these are not the subject of this paper they do create a spill-over effect on the relatively much more open North American markets because the Europeans are not taking their fair share. Rodney Grey has argued that the Japanese export controls to Europe discriminate against North America and are inconsistent with Japan's MFN obligations under GATT. It is our view that the unequal treatment of North America and Europe by Japan in automotive export policies exacerbates the problems of North American producers.

The North American automobile market is probably the most mature and volatile in the world. It is the easiest market for foreign producers to enter because of the organization of the retail distribution system. In Europe and Japan retailers are either owned by the automobile manufacturers or have exclusive agreements which require that a dealer may only sell a particular manufacturer's automobiles or lose its franchise. In the United States the validity of exclusive franchise arrangements have been struck down by the courts. In Canada, automobile dealerships appear to operate in a similar manner. Foreign producers can and do find well established dealers who wish to expand their business beyond their existing lines. Off-shore manufacturers therefore enjoy a cost advantage in becoming established in Canada and the United States, often through distribution systems that have been developed by local producers.

There are also differences between North American and Japanese production organization, systems, in supplier relations, financial resources and labour

relations. All of these differences pose particular problems for North American producers because long lead time is required to adjust their large organizations. Very extensive adjustments designed to improve production organizations are underway in Canada and the United States. According to the industry, a full reworking of the production system will take at least ten years. In the meantime, for quite different political and economic reasons, the Japanese are establishing production facilities in the United States and to a much lesser extent in Canada.

Among analysts there is the view that the recovery of the North American industry over the past three years may have peaked and that current levels of production and employment may never again be achieved. The industry's profile is changing rapidly with an ever increasing foreign presence. New production is flowing out of Honda in Ohio which will reach 300,000 units annually by 1988; Nissan in Tennessee with annual production capacity of 115,000 automobiles and a similar number of trucks; Mazda in Michigan with planned annual automobile production by 1988 of 240,000 units; Mitsubishi in a joint venture with Chrysler planned for somewhere in the midwest with annual automobile capacity of 200,000 units; and Toyota in joint venture with General Motors at Fremont, California to produce a subcompact automobile with 250,000 annual unit volume by 1988. In addition Toyota recently announced that it will start building mid-size automobiles in the United States by 1988 in annual volumes of 200,000 units at a location to be announced. In the meantime it will have 50,000 Toyota automobiles built in the Fremont plant to be marketed in North America under

the Toyota name. Toyota has also announced that it will begin assembling automobiles in Canada at an annual volume of 50,000 units. Thus by 1988 Japanese companies will be producing some 1.5 million units in North America either in joint ventures or in their own plants. Hyundai has announced that it will establish a plant in Canada to assemble 100,000 automobiles annually.

Also of significance to the activity of off-shore producers in North America are the investments by United States vehicle manufacturers in foreign firms. Nearly all United States manufacturers own a substantial share of one or more automobile companies in Pacific Rim Countries. General Motors has a strong interest in Isuzu and Susuki as well as the joint California venture with Toyota. In addition, General Motors owns a fifty per cent interest in Daewoo Motors in South Korea. Ford owns a twenty-five per cent interest in Mazda Japan and has a considerable interest in Hyundai in South Korea. Ford owns seventy per cent of Ford Lio Ho Motor Company Limited of Taiwan. Mazda announced recently that it will design a small car for Kia Motors of Korea and Ford (U.S.) would take charge of marketing particularly to the United States.[4] Chrysler will have a 24 per cent interest in Mitsubishi by 1986. As further evidence of the internationalization of the industry American Motors Corporation is 46 per cent owned by Régie Nationale des Usines Renault of France. All four United States companies, as well, have interests in automobile or truck producing companies in other parts of the world.

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4 Business Korea, August 1985, Vol. 3 No.2, p.55

NORTH AMERICAN-JAPANESE PRODUCTION COSTS

The international competitiveness of North American producers vis-a-vis their Japanese counterparts and other off-shore suppliers remains the most critical issue. Unless North American producers overcome the present cost disadvantage they will suffer further erosion of their market share and manufacturing base. But assessing comparative costs is a complex task made more difficult by problems of product comparability, degrees of capacity utilization, exchange rate fluctuations and the lack of adequate detailed information. According to many automobile analysts, the Japanese enjoy a landed cost advantage of approximately $1,500 to $2,000 per automobile when compared to a North American built automobiles.

Despite major gains in productivity, large fixed cost reductions and more efficient controls over variable costs in recent years North American automobile producers will continue to face a substantial Japanese cost advantage of the above magnitude in the production of small cars. This will limit the ability of North American producers to generate increased small car sales through major price reductions. A recent study[5] suggests that the differential may have widened rather than narrowed as the Japanese have also been improving their production efficiency. The Japanese production cost advantage has been an

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5 Joint United States - Japan Automobile Study. University of Michigan, Ann Arbor, Michigan, February 1984 p. 151-52.

important factor in causing North American producers to obtain significant numbers of small cars from off-shore sources while they attempt to develop new approaches to lowering the cost of producing small cars in North America. This situation may be further aggravated by the entry of newly industrialized countries such as Korea and Taiwan in automobile production.

Both the automobile producers and the UAW consider that an important factor favouring the Japanese is improperly aligned currencies (the yen is too weak and the dollar is too strong). While the yen has strengthened in recent weeks, it is not clear how far the realignment may go or how much it may help. Industry representatives consider that the basic structure of the North American industry is a more important factor in creating cost differences.

The "voluntary" restraint arrangements which limit imports of Japanese automobiles and pressures in the Congress to limit trade with Japan have been viewed by Japanese producers as risks, making their access to the North American market less than certain. The establishment of the Japanese assembly plants in North America is a response to restraints on exports and according to analysts will not substantially alter Japan's cost advantage. Initially over 50 per cent of the value added components will be imported from Japan. In recent remarks in Toronto[7] Ambassador Kiyoaki Kikuchi of Japan is reported to have

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7 Toyota's Auto Pact Role Questioned, The Globe and Mail October 29, 1985 Section B.

said that neither Toyota or Honda would be able to obtain enough parts in Canada to meet the minimum content requirements of the Automotive Agreement. "Toyota and Honda won't be part of the auto pact. They would like to be but they can't". The Japanese Ambassador also indicated that Canada might see more automotive investment but not because of any restrictions on imports from Japan. Japanese automobile assemblers "are investing in all foreign markets because there is no room to expand in the mature Japanese market". There also would be little incentive for Japanese companies to meet the conditions of the Automotive Agreement because to export automobiles to the United States market will mean overcoming a U.S. tariff of only 2.5 per cent by 1987. These moves into the Canadian and United States market should be viewed as the next step in increasing the Japanese industry's earnings and will in turn increase Canada and United States automotive trade deficits with Japan.

Japanese producers have obtained concessions from the UAW which will add to their cost advantage. Also because the Japanese in North America have recruited production workers in their early twenties they will delay for many years payment of pensions to retired workers. According to industry executives and analysts, current pension payments by the established North American producers to retired workers adds about seven hundred dollars to the average cost of an automobile.

PRODUCTION AND TRADE

In 1984 over 30 million automobiles were produced in the world, a one per cent increase over the 29.7 million produced in 1983. Truck and bus production in 1984 was almost 11.5 million units up 15 per cent from the approximately 10 million units produced in 1983. Production of automobiles in Canada and the United States in 1984 was nearly 8.8 million units the highest since 1979 and a 13 per cent increase over the 1983 output. Passenger automobiles assembled in the United States accounted for 88 per cent of the total production in North America and in Canada automaking surpassed the one million mark for the first time since 1978.

There was also sizeable growth in truck and bus production on both sides of the border. In the United States 3.1 million trucks and buses were made in 1984 for a 27 per cent gain over 1983 and the best production year since 1978. Truck and bus production in Canada was up with 262,192 more units manufactured than in 1983 for a total of over 800,000 units — the best year ever. Combining all motor vehicle production — automobiles, trucks and buses — showed that the United States and Canada built nearly 12.7 million vehicles during 1984 up 18 per cent over 1983. This was a dramatic turn around from the recession year 1982 when 8.2 million units were produced.

In 1984 the combined Canada/United States percentage share of world production was 30.5 per cent up from 27 per cent in 1983. Japan's percentage

share of world production in 1984 was 27.5 per cent down from 27.9 per cent in 1983. Japan, though hampered by voluntary restraints on exports of its automobiles to Canada, the United States and other countries remained the world's leading exporter of motor vehicles during 1983. The Japanese exported 3.8 million cars and nearly 1.9 million trucks for a total of 5.7 million vehicles, more than twice its nearest export competitor. In 1984 United States imports of Japanese automobiles represented 2.7 million units or 18.3 per cent of market demand while Japanese exports of automobiles into Canada were 138,677 units or 17.6 per cent of Canadian demand in that year. Projections are that 1985 market demand in both countries will increase modestly while Japanese imports will capture 22 per cent of the United States market and 18 per cent of the Canadian market. Automobile demand in the North American market is expected to grow at less than 2 per cent annually over the next five years.

PROSPECTS FOR THE NORTH AMERICAN INDUSTRY

Producers in all producing countries face many challenges in the years ahead. None more than the North American industry. While progress is being made and North American producers have succeeded in lower their breakeven points, lead times to adopt more competitive production systems and redirecting production workers and management are considerable. New designs and manufacturing techniques are being developed to reduce the minimum economic scale and the manpower requirements of automobile production. Although the automobile industry will continue to be a dominant factor in manufacturing in North America it may have peaked as a producer and employer of labour. The North American industry's future competitive position is jeopardized by the growing presence of the Japanese automobile in the North American market.

The future size and strength of North American automobile producers will be influenced by the total level of North American automobile sales, the competition of North American producers, the degree of import penetration and the extent of participation by Japanese and other off-shore producers in the mid-size and large car markets. There will also be a challenge from the North American subsidiaries of Japanese and other off-shore suppliers whose output is expected to supplement rather than replace imports.

Despite major gains in productivity by North American producers since 1981, Japanese automobile producers appear to have maintained or increased their

previously reported landed cost advantage in the North American market. Although detailed supporting data is not readily available, the Japanese manufacturing cost advantage, lower worker compensation rates, lower capital and material costs, and higher productivity continue to be moving targets. In recent years movements in the dollar/yen exchange rates have aggravated the competitiveness by partially neutralizing the favourable impact of recent efficiency improvements by the North American industry. Based on studies of the U.S. and Japanese automobile industries, the United States Department of Commerce estimates that U.S. firms require at least twenty per cent more hours to produce a small automobile than Japanese companies. Even with a stronger yen, the competitive strength of Japanese producers suggests only a gradual reduction in their manufacturing cost advantage is likely to occur in the next five years. While a higher yen can increase their sticker price it also makes imported raw materials cheaper.

The termination of the "voluntary" restraint arrangement between the United States and Japan on March 31, 1985 raises the question of how the North American industry is likely to fare during the next few years. Although the Japanese have agreed to contain imports to 2.3 million units in the following twelve months the prospects for the North American industry will depend on the growth in sales of Japanese automobiles and the future level of total North American demand for automobiles. Canada and Japan have recently agreed that Japanese shipments of automobiles to Canada in the twelve month period from March 31, 1985 will not exceed 18 per cent of market demand. Japan

Automobile Manufacturers Association of Canada argues that they cannot meet this target because of unhindered Korean competition in the Canadian market.[8]

There are a number of variables that could influence the market outlook to 1988 and there are a number of assumptions that could be made regarding various potential import penetration levels. For the purposes of this analysis forecasts made by Data Resources Inc., the U.S. Department of Commerce and the Department of Regional Industrial Expansion have been utilized. These forecasts exhibit a range of pessimism or optimism which reflects assumptions respecting GNP growth and inflation during the period as well as the extent of the slowdown in economic activity in 1986. These forecasts track closely the 1985/88 sales projections of the Motor Vehicle Manufacturers Association.

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8 News from JAMA Canada Japan Automobile Manufacturers Association of Canada, October 22, 1985.

TABLE 2

NORTH AMERICAN PASSENGER CAR MARKET
(Millions of Vehicles)

	1984	1985	1986	1987	1988
Total Sales					
North American	11.383	11.857	11.645	12.007	12.121
U.S.	10.402	10.808	10.641	10.975	11.100
Canadian	0.981	1.049	1.004	1.032	1.021
Total Imports					
North American	2.656	3.010	3.434	3.783	4.101
U.S.	2.409	2.720	3.119	3.443	3.737
Canadian	0.247	0.290	0.315	0.340	0.364
Total Domestic					
North American	8.727	8.841	8.211	8.224	8.020
U.S.	7.993	8.088	7.522	7.532	7.363
Canadian	0.734	0.757	0.689	0.692	0.657
Total Foreign Plants					
North American	.240	.366	.422	.596	.912
U.S.	.230	.357	.412	.586	.902
Canadian	1.000	.900	.900	1.000	1.000
Traditional Domestic					
North American	8.488	8.424	7.779	7.623	7.109
U.S.	7.466	7.434	6.760	6.609	6.053
Canadian	1.022	1.043	1.029	1.014	1.046

Source: Data Resources Inc. (DRI) Department of Regional Industrial Expansion.

This table shows that the total level of import penetration in the North American market is expected to be about 34 per cent compared to 23.3 per cent in 1984. Total off-shore company plant production will increase to 7.5 per cent

of the North American market in 1988 compared to just over 2.0 per cent in 1984. Combined North American production and imports by these off-shore companies will account for approximately 42 per cent of the total North American market in 1988 compared to 25.4 per cent in 1984.

The United States Department of Commerce forecast which is given in Table 3 also predicts growth in Japanese automobile sales, including U.S. assembled models from just over 2 million in 1984 to 3.7 million units (34 per cent) in 1987. This forecast assumes an increase of 500,000 units in total U.S. demand between 1984 and 1987. It should be recognized that the forecast was also based on the assumptions that there will be no major appreciation of the yen against the United States dollar and the manufacturing cost advantage of the Japanese automobile producers will continue to be roughly at its current level throughout this period.

TABLE 3

U.S. AUTOMOBILE MARKET DEMAND 1984-87
(Millions of units)

	1984	%	1985F	%	1986F	%	1987F	%
Total Sales of Japanese Imports	1,906	18.3	2,275	21.3	2,675	25.2	3,025	27.7
Sales of U.S.-Built Japanese Cars	133	1.3	275	2.5	525	5.0	675	6.2
Total Japanese Car Sales	2,039	19.6	2,550	23.8	3,200	30.2	3,700	33.9
Total Sales of European Imports	534	5.1	530	5.0	480	4.5	474	4.4
Total Sales of U.S./ Canadian-Built Cars	7,818	75.3	7,620	71.2	6,920	65.3	6,725	61.7
Total U.S. Car Sales	10,391	100.0	10,700	100.0	10,600	100.0	10,900	100.0

Source: U.S. Department of Commerce

The United States automobile producers are expected to experience about a 1.1 million unit drop in sales between 1984 and 1987 despite a 500,000 unit increase in total market volume. This decrease will occur in the small car segment (subcompacts) as a result of imports by U.S. and Japanese automobile companies and sales of U.S. built Japanese vehicles. Increasing Japanese competitive pressure will also be felt in the mid-car segment (compact, intermediate) and could minimize growth opportunities for U.S. automobile manufacturers in that market.

United States imports of Japan automobiles will rise from just under 2.0 million units in 1984 to an estimated 3 million units in 1987 or from 18.3 per cent to 27.7 per cent of the market. Japanese automobiles assembled in the United States and Canada will also become a factor during this period and by 1987 shipments are expected to be 675 thousand units or 6.2 per cent of the North American market. Together Japanese produced automobiles will represent almost 34 per cent of North American demand in 1987 while imports from Europe, Asia (other than Japan) and Mexico will capture 5.4 per cent of demand.

Many North American industry executives and the United States Department of Commerce predict that by 1988 the split between North American producers and Japanese producers of North American automobile demand will be not less than 60/40 while other predictions show a more even split. In testimony before the U.S. Subcommittee on Trade, Productivity and Economic Growth on June 24, 1985, Maryann N. Keller, noted automotive industry analyst, stated that the Department of Commerce study implies "that sales of foreign sourced cars are a function of supply and that U.S. manufacturers' volume is the residual of total sales less foreign brand cars."

PRODUCTION AND EMPLOYMENT

Some industry analysts forecast that shipments from North American companies in Canada and the United States will decline from 76 per cent of total demand in 1984 to approximately 55 per cent of estimated total demand in 1988. All forecasts are that there will be a decline in production and employment among the North American producers.

Based on the preceeding market projections there will be considerable excess capacity in automobile production by 1988. Overall shipments from North American automobile producers are also expected to decline which will result in over-capacity and employment losses. Shipments from North American producers are expected to decline by 15 per cent from 8.4 million units in 1984 to 7.1 million units in 1988 resulting in a net excess capacity of about 1.3 million units. Most of the loss in sales by the North American industry is expected to occur in the small car segment which is principally located in the United States.

The United States Department of Commerce estimates (Table 4) that total North American automobile production capacity will approach 11.5 million units by 1990. Of this total Canada would have a production capacity of approximately 1.2 million units.

TABLE 4

NORTH AMERICAN PASSENGER CARS' EXISTING AND PLANNED PRODUCTION CAPACITY BY 1990

Manufacturers	Small Cars	Mid-Size Cars	Large Cars	Total Cars
General Motors	1,600,000	3,050,000	1,150,000	5,800,000
Ford	930,000	850,000	950,000	2,730,000
Chrysler	375,000	950,000	-	1,325,000
AMC/Renault	250,000	50,000	-	300,000
Volvo Canada	-	50,000	-	50,000
VW-U.S.A.	250,000	-	-	250,000
Sub-Total	**3,405,000**	**4,950,000**	**2,100,000**	**10,455,000**
U.S. Based Joint U.S. - Japanese Production				
Honda	300,000	-	-	300,000
Nissan	100,000	-	-	100,000
GM/Toyota	250,000	-	-	250,000
Mazda	240,000	-	-	240,000
Mitsubishi	150,000	-	-	150,000
Sub-Total	**1,040,000**	-	-	-
Total Capacity	**4,445,000**	**4,950,000**	**2,100,000**	**11,495,000**

Source: U.S. Department of Commerce

Approximately 39 per cent of total North American capacity would be in small automobile production, approximately 43 per cent in mid-size automobile production and some 18 per cent in large automobile production. To date all of the existing or planned Japanese capacity will be in small car production although there is evidence that the Japanese are planning to move into the mid-car segment.

The estimates in Table 4 indicate that by 1988 North American automobile producers are expected to lose approximately 1.9 million units of sales to offshore imports and offshore companies production capacity based in North American despite modest growth in the North American market during this period.

TABLE 5

NORTH AMERICAN (CANADA & U.S.) AUTOMOBILE DEMAND AND PRODUCTION CAPACITY (MILLION UNITS) BY MARKET SEGMENTS 1988

	Market Size (1)	N.A. Capacity (2)	Imports & F. Capacity (3)	Excess Capacity (4)	Excess Capacity as % of Domestic Capacity (5)
Sub-Compact	3.93	1.80	3.08	.96	53.3
Compact	2.07	1.50	.88	.31	20.7
Sporty	.87	0.65	.35	.13	20.0
Large	5.32	5.05	.79	.52	10.3
Total	12.19	9.00	5.10	1.92	21.3

Source: DRI & DRIE

Note: Excess capacity = Col. 2 + Col. 3 - Col. 1

Depending upon market growth most of the excess capacity will be in the small car segment with more modest excess capacity in mid-size automotive production as a result of increased imports and the sales of United States built Japanese cars. Most of this over-capacity is located in the United States and at least in the next two years the decline in production and employment is likely to

take place to a greater extend in the United States than in Canada because of present mix but it will impact on both sides of the border. The demand for large size cars is expected to remain at approximately present levels as the supply and price of oil is expected to remain relatively stable. Production in Canada is largely geared to mid-size and large automobile production and the downturn in demand for North American automobiles should not impact on production levels to the same extent as in the United States at least in the near term. This is not to suggest that certain plants in Canada are not likely to be vulnerable to the downsizing of capacity due to political and industry pressures in the United States, the utilization and age of the plants. What effect, if any, the safeguard provisions of the Automotive Agreement are likely to have on the downsizing of production facilities forecast for the North American industry and on the adjustment decisions to meet the decline in demand for North American automobiles will vary from company to company.

THE CANADIAN AUTOMOTIVE INDUSTRY UNDER THE AUTOMOTIVE AGREEMENT

To position the Automotive Agreement and the industry in Canada in the context of discussions of a comprehensive trade arrangement with the United States it would seem appropriate to examine briefly the terms of the Agreement and the perceptions of its objectives and provisions.

The Agreement provides essentially for free trade between the two countries in automobiles, trucks, buses and original equipment parts. Excluded from the Agreement is trade in aftermarket parts and accessories, tires and tubes, batteries and used vehicles. No attempt has been made to assess the effect of including these additional items in any comprehensive trade arrangement. Duty free entry of the vehicles and parts covered by the Agreement are subject to a number of conditions, particularly relating to importation into Canada. There are five conditions applying to entry into Canada three are incorporated in the Agreement and two are contained in undertakings by the motor vehicle companies in Letters of Commitment to the Canadian Government.

The Agreement stipulates as a first condition that only a Canadian manufacturer of automobiles, trucks or buses may import products duty free provided the manufacturer in the year of importation maintained a production to sales ratio equal to that achieved in the base year and Canadian value added equal to that obtained in the base year. Canada implemented the Automotive Agreement on a

Most-Favoured-Nation basis which allows only motor vehicle manufacturers to import complete vehicles and original equipment parts duty free from MFN sources provided the production share conditions are met. The United States obtained a waiver under the GATT and restricts duty free entry of motor vehicles from Canada provided the motor vehicles have fifty per cent North American content.

The second provision was designed to maintain the proportion of vehicles assembled in Canada in relation to vehicles in each class sold in Canada. The third condition was designed to establish a floor under the amount of Canadian value added in absolute terms (1964 model year) achieved by each vehicle producer and has been largely eroded as inflation has diluted these fixed amounts.

In the letters of commitment the motor vehicle manufacturers undertook two additional commitments. They undertook to ensure that in each model year the value added in Canada would amount to at least 60 per cent in the value of automobiles sold in Canada and 50 per cent of the growth in the value of commercial vehicles sold in Canada. Further the Canadian vehicle manufacturers collectively agreed to increase the amount of CVA being produced in Canada by the 1968 model year by a further $260 million annually. The Canadian industry executives are unanimous in their view that the production to sales ratio and the CVA provisions in the Automotive Agreement and the undertakings in the Letters of Commitment continue to influence

production location decisions by their companies and have contributed to the present high level of production and employment in Canada.

There are several other features of the Automotive Agreement that are relevant to our study which may arise in discussions of its future in any context or form. The Agreement is unlimited in duration but Article VII stipulates that it can be terminated on a year's notice by either country. It also stipulated that by January 1, 1968, the two governments would undertake a comprehensive review of the progress being made toward the achievement of the objectives of the Agreement in order to consider what further steps should be taken in pursuit of these goals.

From the time of its signing there have arisen differing perceptions of the Agreements objectives and provisions and differing views of actual results. Of particular importance is the ambiguity of the objectives which reflect the different emphasis and perceptions of the two governments. During the negotiations there was acknowledgement by the United States of the perceived need of Canada for assurance that there would be a minimum Canadian value added level and provision for growth in production to assist the automotive industry in Canada to adjust to competition from the United States industry. From the beginning the United States contended that these production assurances or safeguards should be for a limited time only or "transitional". At the end of the transitional period in the United States view "market forces" should determine patterns of investment, production and trade.

Canada's concern was reflected in the second objective which called for the liberalization of trade to enable the industries in both countries "to participate on a fair and equitable basis" in an expanding North American market. This preoccupation reflected a concern for the oligopolistic North American industry, dominated through ownership and control by three large United States corporations. In the Canadian view, ownership and control were "institutional barriers" which could impair the prospect of "market forces" operating in a "fair and equitable manner" to the benefit of the automotive industry in Canada. It was therefore necessary to have safeguards to ensure a minimum level of automotive production in Canada and to maintain the prospect of investment in Canada.

The 1968 review of the Agreement was completed with no resolution of the various issues. On the Canadian side the review consultations were announced as being "successfully completed". In a special report to Congress President Johnson indicated that no decision had been reached with regard to changes in the Agreement including liberalization of conditions on duty free entry into Canada as possible means of progressing toward full achievement of the Agreement's objectives.

During the early 1970s the trade balance under the Automotive Agreement swung in the United States favour ($401 million in 1973 against a deficit of $45 million in 1972). This tended to ease some of the pressure from the United States for the removal of the safeguards. However the safeguards continued to

be an issue. Between 1968 and the end of the 1970s the United States Administration, the Senate and various Congressional committees demanded that the safeguards maintained by Canada in the Automotive Agreement be terminated. In the recently released Eighteenth Annual Report of the President to Congress on the operation of the Automotive Agreement, Mr. Reagan in referring to certain Letters of Undertaking to increase Canadian value added noted that "Although the letters were exchanged between the companies and the Canadian Government they were signed with the tacit approval of the United States Government. This approval was withdrawn in 1970 after the passing of the July 31, 1968 deadline."

President Reagan's reference to "the passing of the 1968 "deadline" had to do with the removal of the safeguards from the Automotive Agreement. The President's statement is consistent with the United States position since the inception of the Agreement that it is fundamentally a free trade arrangement that contained transitional production safeguards for Canada in the 1965 -1968 period. These safeguards were not a permanent feature of the Agreement and the apparent unwillingness of Canada to contemplate their removal has remained an irritant. What has contributed to this variance of view is the different perception of the Agreement which has existed since it was negotiated and the fact that it is vague on the subject of the life of the safeguards.

A widely held view in the automotive industry in Canada is that the safeguards are important to ensure a "fair share" of production and investment in Canada

and are necessary as long as ownership and control of the major elements of the industry rest in the United States. Others believe that the existing safeguards do not adequately provide for participation in the North American automotive market. The Automotive Parts Manufacturers' Association (APMA) and the Ontario Government have contended that the measure of success or failure of the Agreement should be judged by whether or not Canada achieves production equal to consumption in Canada. The United States administration rejects this production sharing concept as an objective of the Automotive Agreement. In a report to the United States Senate Committee on Finance, the United States Administration re-asserted its basic position:

> "The United States has rejected the "fair share" concept on the grounds that the Auto Pact is a limited free trade arrangement, not a market sharing agreement, or a mechanism to manage an industrial strategy for the auto industry".[9]

The United States administration in any subsequent discussions on the Automotive Agreement is not likely to change its traditional posture of viewing the Agreement as essentially a free trade arrangement. The United States administration will continue to argue against the existence of the production safeguards and may be expected to take a more aggressive position against Canadian initiatives either to increase the safeguards as proposed in the 1983

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9 Report on the North American Trade Agreements Office of the United States Trade Representative, (Washington, D.C.: US Trade Representatives Office 1981) p. 54.

Report of the Federal Task Force on the Canadian Motor Vehicle, and Automotive Parts Industries[10] or any other measures to extend benefits to increase automotive production in Canada.

There is a view within the automotive industry on both sides of the border that the Automotive Agreement has been an important factor in the development of the industry on a North American basis. Mr. Roger B. Smith, Chairman, General Motors Corporation, in a speech in Toronto said:

> "This agreement has been called --- "the largest and most comprehensive trade agreement between any two countries in the world." It is assuredly the most successful trade policy in the history of our industry. And despite some shortcomings, it remains - in my mind at least - an excellent example of a rational and responsible way to resolve thorny trade issues between nations.[11]

This general acceptance may contribute in part to the apparent absence of industry pressure for change on the U.S. administration at this time.

Are the safeguards economically important to the maintenance of production and investment in Canada? Are they likely to be in the future? The Automotive Agreement in its present form has been central to the development of the automotive industry in Canada. It has reinforced the nature and structure of the Canadian automotive industry, as an adjunct of the United States industry. In the early years of the Agreement rationalization of production took place and there were substantial increases in output, employment, investment and improvement in productivity in the automotive industry in Canada. Today the motor vehicle producers assemble substantially more automobiles than are

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10 An Automotive Strategy for Canada Report of the Federal Task Force on the Canadian Motor Vehicle and Automotive Parts Industries, May 1983 p. xvii.

11 Automotive Products Trade Agreement, Roger G. Smith, 20th Anniversary Dinner, January 16, 1985, Toronto.

consumed in Canada. Original equipment parts production is at a record high. The level of overall value added in vehicle assembly and original equipment parts production substantially exceeds the minimum levels established by the safeguards in the Agreement. According to the Department of Regional Industrial Expansion total Canadian value added as a percentage of cost of sales was 83 per cent in 1984.

On the assumption that the total Canadian value added as a percentage of cost of sales committed to by all qualified producers was estimated to be 60 per cent, the same as in 1983, the total achieved Canadian value added in 1984 was substantially greater than the minimum required under the Automotive Agreement. Since 1982 high levels of Canadian value added has been achieved in each model year in relation to cost of sales in Canada which may be attributed to the increasing North American demand for medium and larger automobiles that are being assembled in Canada and other factors such as labour productivity, wage rate advantage and the exchange differential. The economic importance of the safeguards in maintaining production and employment in the present buoyant market situation is less of a factor as other considerations tend to have a more important bearing on the level of production in Canada.

The increasing presence of Japanese and other off-shore automobiles in the North American market and the projected decline in demand for North American type automobiles may increase the economic relevance of the safeguards in the future. The projected decline in demand is expected to begin in 1986 but is not

likely to affect Canadian production levels at least initially because of the product mix of automobiles assembled and the influence of other factors mentioned earlier. As the contraction in demand for North American type automobiles deepens automobile producers and their parts suppliers will be consolidating production facilities and adopting new production techniques which will impact on the level of production on both sides of the border. The safeguards may serve to impede disinvestment in Canada although their effectiveness may be influenced by other variables.

Declining demand for North American automobiles in the Canadian market will reduce the number of automobiles required to be assembled in Canada to meet the ratio to sales requirement and the absolute dollar amount of Canadian value added will also be reduced as the total cost of North American type automobiles sold in Canada declines. This will lessen the pressure on the companies to maintain production and employment in Canada and reduce the effectiveness of the safeguards as an impediment to disinvestment. Other factors may also influence the effectiveness of the safeguards. Canada's labour cost advantage is likely to be reduced over time and the exchange differential will fluctuate and the gap narrow as the United States takes measures to cause the dollar to fall in value in relation to other currencies.

The level of the Canadian tariff on motor vehicles and original equipment parts could influence decisions by companies on the importance of meeting the safeguards. In 1965 the Canadian tariff on motor vehicles was 17.5 per cent

under the MFN and in 1987 the rate will be 9.2 per cent. This reduction in rate has placed continuing pressure on the industry to improve its efficiency and has had a salutary affect on the price of automobiles to the consumer. This reduction in the tariff has affected the vehicle producers differently. Initially Ford and Chrysler experienced the most cost benefit under the Automotive Agreement through rationalization of production on a North American basis. These companies, however, continue to experience relative cost penalties in meeting their production requirements in Canada. The incentives to maintain production may be increasingly marginal against the level of the tariff as the companies experience downturns in automobile demand and find it more difficult to justify meeting the production safeguards. The balance of advantage will vary from company to company. In a declining market environment any further reduction in the tariff could reduce the incentive to maintain production in Canada.

There are potential costs and risks and no discernible benefits from rolling the Automotive Agreement into a more comprehensive trade arrangement. There is the risk that if the Agreement should become an element in the discussions of a comprehensive trade arrangement that the United States would seek removal of the safeguards. The United States is certain to be unwilling to consider any proposal to improve Canada's access to the United States automotive market. The United States has taken the decision to remove any impediments to entry into its automobile market and would not look favourably on any attempt by Canada to gain more favourable access to the United States market or to take

any action that is likely to direct production away from the United States. Canada could be under pressure to abandon the status quo. Past experience would suggest that there is a real risk that United States interests would try to eliminate the safeguards if the Agreement is included on the agenda of more comprehensive trade discussions. The wisdom and prudence of inviting such demands should be weighed very carefully.

There is the prospect that if the Automotive Agreement is raised the United States will seize the opportunity to draw attention to the current favourable Canadian trade balance in the automotive sector and to the need to redress the automotive trade balance given Congressional concerns about the growing overall unfavourable United States trade balance. In 1984 Canada had a favourable trade balance of almost $6 billion in automotive trade with the United States the highest annual surplus recorded by either country under the Automotive Agreement. Motor vehicle trade was in surplus by $10.8 billion in that year and automotive parts in deficit by $5.1 billion. Canada's automotive trade with the United States has been in surplus since 1982 although with the exception of a three-year period in the early 1970s the United States has had an annual favourable trade balance in automotive products with Canada. The United States continues to experience a small overall trade balance in this sector. The balance in automotive trade has been the most visible and ready symbol of relative economic activity in the automotive industry. Movement of the balance in favour of either Canada or the United States had tended to raise the interest and intensity of concern of the side experiencing the deficit.

Also for consideration is whether the United States would be prepared to condone the various remission orders now in place for a number of third country producers who obtain duty-free entry of autos in return for purchasing Canadian made auto parts. United States officials consider that these arrangements are little more than subsidies to Canadian auto parts producers. These programs which have been important to the parts industry could get caught up in "levelling the playing field."

There is a view that the Automotive Agreement was an agreed basis for meeting a growing trade dispute, is unique to the automotive industry, and is working to the benefit of both countries. Trade under the Automotive Agreement represents 35 per cent of total merchandise trade between the two countries and, as a minimum, in any comprehensive trade discussions there would be need to reach an understanding on the positioning of the Agreement in relation to the broader trade arrangement.

NEED FOR A CONSULTATIVE MECHANISM?

There is no structured procedure under the Automotive Agreement for assessing whether the full objectives are being achieved. The only provision for review covered the period to January 1, 1968, when the two Governments were to have jointly undertaken "a comprehensive review of the progress made towards achieving the objectives ... ." (Article IV (c)). This review was approached by each side differently with respect to measuring progress towards "achieving the objectives" and no clear assessment was possible and no agreement on its progress was reached.

There is provision for consultation. Article IV (a) provides that the two Governments shall "consult with respect to any problems relating to the Agreement." This subparagraph would appear to relate to the working of the Agreement. More specifically subparagraph (b) provides for consultation "with respect to any problem which may arise concerning automotive producers in the United States which did not have facilities in Canada ..." in the base year designated in the Agreement or new entrants which established facilities in Canada after the Agreement came into effect. There is no clear evidence that subsequent discussions between the two sides were held under the provisions of Article IV. These discussions did not appear to have appeased one side or the other and this may have contributed to the apparent reluctance of either side in recent years to seek further discussions on outstanding issues. If the Agreement had a dispute settlement mechanism there may have been less acrimony on

either side but the lack of such a mechanism may have been of benefit to Canada given that in the twenty years of the Agreement its provisions remain intact.

In this respect the Automotive Agreement has not lived up to its earlier expectations of contributing a strong and positive influence on Canada-United States relations in this sector or on our economic relationship more generally. The Agreement has been of substantial economic benefit to both countries and to the industry on both sides of the border. But throughout its history the Automotive Agreement has been accompanied by continuing complaints in the United States and Canada. On occasion, these disputes have threatened its existence. The Agreement is vague on how its success or failure should be measured. As a result the flow of trade between Canada and the United States has been one of the principal measurements adopted by governments and the media to measure the health of the industry and its competitiveness. The extent to which the trade in automotive products moves away from being roughly in balance in either direction has in the past determined the dissatisfaction - or satisfaction with the Agreement although this may have very little bearing on the actual condition of the industry on either side of the border.

Today the Automotive Agreement remains virtually as originally drafted although there have been important changes in the industry which could be accommodated by modification to the Agreement. In the 1968 review one of the areas that was considered as a possible means of progressing towards the full achievement of the objectives of the Agreement was through amendment to

encompass additional products. Nothing was accomplished as the United States administration was not prepared to reopen the Agreement with Congress unless Canada agreed to the withdrawal of the safeguards. If there be fault it is that the Agreement has not provided a flexible framework within which important issues could be considered or resolved.

Important provisions of any comprehensive trade arrangement between Canada and the United States will relate to review, consultation and dispute settlement procedures and there may be merit in extending this institutional framework to encompass the functioning of the Automobile Agreement. This would provide a more stable and secure basis for the Agreement. It would bring a large segment of trade between the two countries under the same joint management as would apply to the trade covered by the new comprehensive arrangement. This would ensure that any issues relating to the Automotive Agreement would be viewed in the context of overall Canada-United States trade relations. It would be seen as managing trade issues in the automotive sector and should reduce the political and public attention that has tended to inflate issues arising from the working of the Agreement. There would be advantage in having an established consultative procedure to examine the impact of change now that the North American industry is facing the prospect of declining demand for its automotive products and the resultant downsizing of production capacity on both sides of the border. It could be viewed as a positive attempt to provide a consultative mechanism to discuss the future prospects for the industry and possibly what collective steps might be taken to ensure its future as a viable industry in North America.

It may be difficult to confine consultation or other related procedural provisions to matters relating to the vagaries of the market without reference to the structure of the Agreement particularly if it was an impediment to the ability of the automobile producers to meet reduced demand by restructuring or rationalizing their production facilities in Canada and the United States. There is likely to be strong political and industry pressure on the United States administration to negotiate changes that would enable the maximum prospect for production being concentrated in the United States. That this situation may arise whether or not the Automotive Agreement is included in the broader consultative procedure is distinctly possible. There may be prospect of managing these discussions more effectively under formally established procedures in a comprehensive trade arrangement but it is difficult to envisage how this might be achieved without opening up the prospect of the economic provisions of the Agreement being included.

CANADIAN INDUSTRY VIEWS

Parts Producers

The Automotive Parts Manufacturing Association (APMA) has claimed over the years that the parts sector has not fared well under the Automotive Agreement. The APMA has argued that the "fair share" commitments under the Agreement have not worked equally to the benefit of all segments of the industry. As evidence the APMA has claimed that Canada's trade balance with the United States in original equipment parts has risen every year. In 1984 the parts imbalance under the Arrangement was $5.1 billion although Canada had an almost $6 billion favourable balance in automotive trade with the United States. Simon Reisman in his Inquiry into the Automotive Industry[12] concluded that "the figures indicate clearly that the growth in Canadian value added from the production of parts for incorporation in Canadian-made vehicles and for export has far exceeded the increase in CVA contributed by vehicle assembly". A very substantial portion of original equipment parts imported into Canada are assembled into vehicles which are shipped to the United States. Reisman concluded "in no sense can these components be said to have been consumed in Canada."

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12 The Canadian Automotive Industry Performance and Proposals for Progress, Commission on the Automotive Industry SS Reisman October 1978, p. 83.

In more recent times the APMA have urged the government to expand the Agreement or to put in place arrangements that would require all vehicle manufacturers selling vehicles in Canada to achieve a certain amount of Canadian value added preferably through the purchase of Canadian produced parts. The Association has also suggested that the Canadian valued added requirements should be increased for all manufacturers selling in the Canadian market. The APMA in its presentation to the Special Joint Committee on Canada's International Relations on August 18, 1985, stated that:

> "Rapidly rising Japanese imports in the United States as a result of the ending of quotas last March are likely to cause a fall-off in U.S. vehicle production by the end of the year, precipitating more unemployment among autoworkers. This is not the environment in which to raise the prospect of ending the Canadian safeguards in the Auto Pact and we can no longer count on the UAW in the United States to support continuing employment for their former colleagues in the United States.
>
> To date, the government has not dealt with these issues. . . .We have urged the government to leave the Auto Pact out of any trade discussions with the United States. To do otherwise poses a very serious threat to the stability to the largest area of trade between the two countries."

AUTOMOBILE PRODUCERS

The Canadian automobile companies have identified increasing participation in the market by Japanese producers as the most immediate threat to the automobile industry in North America. The companies also consider that the safeguards play an important role in sourcing of production in Canada. They

point to the relative buoyancy of the Canadian industry during the 1981-82 downturn in the market as compared to the industry in the United States in support of their claim.

The Motor Vehicle Manufacturers' Association in its statement to The Special Joint Committee on Canada's Trade Relations on August 18, 1985 stated that "Canada's best, indeed only, automotive export market is the U.S. and vice-versa. Hence the importance of the principles of the A.P.T.A. — and the reason for its continuation as the keystone of Canadian automotive policy."

The Canadian automobile producers are also concerned that if the Automotive Agreement was rolled into any comprehensive free trade arrangement that this would enable Japanese automobile manufacturers with production facilities in the United States to ship automobiles duty free into the Canadian market. This would give these automobiles a further competitive advantage in the Canadian market at the expense of production and employment in Canada.

The potential shrinkage in demand for North American industry produced vehicles in the Canadian and United States market and the 1987 level of the Canadian tariff may create a situation that will cause the automobile producers to bring more into question whether there is a balance of advantage to continuing production in Canada.

THE UNITED STATES ATTITUDE

Officials in the United States do not appear inclined to suggest that the Automotive Agreement should form part of any such discussion. Should they change their position, we should expect they will propose that as a condition of acceptance of a more comprehensive package that the various safeguards in the Automotive Agreement be withdrawn. Indeed, if the Automotive Agreement is not put on the agenda by Canada because there is no disposition to discuss the removal of the safeguards our interviews suggest that this would be unlikely to cause surprise to the United States.

The U.S. Commerce Department and the Motor Vehicle Manufacturers Association (U.S.) consider that as there are no apparent serious issues on either side there would be advantage to leave the Automotive Agreement out of any comprehensive trade discussions but possibly to use it to illustrate the gains that can be achieved through freer access and rationalization on a Northern American basis. The Automotive Parts and Accessories Association (U.S.) has taken the position that U.S. aftermarket producers want no part of any arrangement that would extend free trade to aftermarket parts (Appendix A).

The United States approach to removal of the safeguards is likely to be guided in large measure by the position taken by the United States industry should the issue be raised. There has been no apparent approach by United States officials to the industry on issues arising from the operation of the Agreement in the

context of preparations for discussions on a possible comprehensive trade arrangement. Nor does there appear to have been any industry view expressed about the desirability of including the Automotive Agreement on the agenda in the public hearings convened by the US ITC or by USTR. Our discussions suggest that it is unlikely that the United States side will press for the inclusion of the Automotive Agreement in a comprehensive trade arrangement.

During our discussions in Washington other concerns were expressed which, while not directly bearing on the United States attitude, provide an insight into matters which may influence the subsequent benefits for Canada under the Automotive Agreement. The recent split in the United Auto Workers Union (UAW) and the creation of an independent Canadian UAW adds a new dimension to the labour scene which could have far-reaching consequences for the Canadian industry. This view is shared by the motor vehicle industry and the UAW (U.S.). Prior to the 1982 round of union negotiation there was a fairly uniform approach by the UAW to each of the motor vehicle companies on both sides of the border. This created a fair degree of certainty as to the longer term labour environment for the industry. It was not a compelling factor in locating production. Recent changes in production techniques and the emergence of larger more sophisticated parts suppliers and the single sourcing of certain components has made the motor vehicle companies more conscious of the need for labour predictability and a continuous supply of parts to maintain the most cost effective production process.

The recent successfully completed round of negotiations between Chrysler and the unions on both sides of the border is viewed as a positive indication that the two unions have not chartered a separate course in reaching settlements with Chrysler. Although details of these settlements are not available it is understood that the benefits obtained maintain equivalent wage and benefit provisions of the previous agreements. This should help to overcome some of the apprehension in the industry over having a separate union on each side of the border particularly as the settlement in Canada was concluded first with minimum disruption to production. The Chrysler settlements may also influence the pattern of contract negotiations in the automobile industry in the future.

This labour scene should be viewed against projected demand for North American type vehicles by 1990 and the resultant overcapacity of assembly and parts production facilities. An increasing share of total North American demand will be met by imports from Japan or other off-shore sources or from production in North American facilities of the Japanese automobile companies. It is likely in this market situation that the UAW in the United States will have less allegiance to the Canadian union than in the past and will no doubt bring pressure on the U.S. administration and the motor vehicle companies to maintain maximum production facilities in the United States.

The Motor Vehicle Manufacturers' Association (U.S.) point to the apparent growing disparity between the approach to equal pay for equal work provisions between the United States and Canada and cite recent proposed legislation by

Ontario. The Association is undertaking a review of the effect of the recent Canadian budget and the proposed changes in the United States tax system to determine the effect on the industry doing business in both countries. The Association tends to view these disparities as potential impediments to investment in Canada.

GATT IMPLICATIONS

Is it necessary to include auto trade to meet the trade coverage envisaged in GATT Article XXIV:5? It is not clear that this is necessary. Must the trade between Canada and the U.S.A. be free on a statutory or de facto basis? Surely we could argue that de facto free trade over a period of twenty years is free trade. Very careful analysis should be given to this issue, which we have not attempted to do in this paper.

If Canada included autos in a comprehensive bilateral agreement we would almost certainly have to reduce our tariffs on a preferential basis for the United States. If we did not meet the criteria of GATT Article XXIV, Canada would not seek a waiver under GATT Article XXV to extend these preferences. Our present system does not require a waiver. The U.S. has had a GATT waiver since 1965. A GATT waiver requires approval by two-thirds of the Contracting Parties. It is considered highly unlikely that Canada would obtain approval of a waiver.

Even if Article XXIV criteria were met, other Contracting Parties might consider that moving from remissions to preferential duty free access had the effect of raising a duty inconsistently with Article II (even though the remissions are not bound) they might then pursue their perceived right to seek concessions to restore the balance, under Articles XXIV and XXVIII, and possibly XXIII. Experts we have consulted suggest they would not have a substantive case.

CONCLUSIONS

The automotive industry on both sides of the border is preoccupied with attempting to meet the competitive challenge of the Japanese intrusion into the North American market. It is difficult to predict whether the North American industry will remain viable. There will need to be substantial structural changes in the North American industry if it is successfully to adjust to the new competitive environment.

The North American market demand for automobiles is forecast to grow moderately over the next five years while the market share held by the domestic manufacturers will decline sharply. This will result in plant closures and substantially lower production and employment levels. Sales of Japanese automobiles in North America will increase rapidly in this period with demand being met by imports and from North American situated assembly facilities. These assembly operations will use a high percentage of imported components and the employment effect will be a net loss in Canada and the United States.

The Automotive Agreement has been of benefit to both countries and there is no pressure on either side to have it included in any comprehensive trade discussions. If Canada does not propose that the Automotive Agreement be included on the agenda it is unlikely to be raised as an issue by the United States. If it was included in the decision there is the risk that the United States would be seeking the removal of the safeguards which could adversely affect the level of

production and employment in Canada. If the safeguards and the tariff are removed Japanese automobiles assembled in the United States would have more favourable access to the Canadian market. If the Automotive Agreement is raised it should be to determine how it might be positioned in relation to any comprehensive arrangement.

The danger of retaining the Automotive Agreement outside any comprehensive trade arrangement with the United States is the risk, which has always existed, of a substantial shift in United States commercial policy. This is a disincentive to the automobile companies investing in Canada as they must always hedge against the possibilities of unexpected tariff or non-tariff barriers against cross-border shipments. A change in United States laws or rulings could affect the profitability of the Canadian operations. The possibility of abrogation of the Agreement on one year's notice is an important consideration to future investment and production planning in the automotive industry.

There could be some advantage to Canada in this period of structural adjustment and down-sizing of the industry if the Agreement had a greater perceived degree of permanence and there was an established monitoring organization to oversee actions under the Agreement. This must be weighed against the international and bilateral risks in re-opening the agreement and/or including it in a comprehensive agreement.

Unless there is some real possibility, significantly to improve on the status quo, and there does not appear to be, the bilateral and multilatural risks of re-opening the Automotive Agreement in a bilateral context, would appear to outweigh the potential benefits by a wide margin.

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APPENDIX I

5100 FORBES BLVD., LANHAM, MD 20706, 301/459-9110, TELEX: 4990739–APAAI (VIA ITT)

AUTOMOTIVE PARTS & ACCESSORIES ASSOCIATION

September 30, 1985

Honorable Malcolm Baldrige, Secretary
U.S. Department of Commerce
Washington, D.C. 20230

Dear Mr. Baldrige:

Now that Canada's Prime Minister Mulroney has formally asked President Reagan to explore Congressional interest in negotiating a bilateral free trade agreement, the Automotive Parts & Accessories Association (APAA) would like to link our knowledge of the U.S. automotive aftermarket industry's needs to the skills of our negotiating team to ensure that our industry is not imperiled by any new pact.

Not only is the free trade proposal the centerpiece of the Macdonald Commission Report on Canada's economic future, but the concept also has many backers in the Administration and Congress who wish to eliminate tariff barriers between principal trading partners. We believe that the proposal warrants serious study, and we recognize that there are sure to be some industry sectors in both nations where a free trade agreement would prove mutually beneficial.

We do not believe this would be the case for the automotive aftermarket industry. We contend this because Canada has introduced a new twist into our bilateral automotive trade -- the lure of Japanese suppliers to use Canada as a springboard to launch duty free original equipment exports into both domestic and Japanese car assembly plants in the U.S.

Of course, both Canadian and Japanese parts makers view the U.S. aftermarket as the major prize in world parts trade. The minimal degree of tariff protection now afforded aftermarket products must remain intact to absorb some of the shock of the price advantage that the exchange rate alone guarantees aftermarket exports of Canadian firms and a growing number of Canadian-based Japanese firms.

We note that Canada has a longstanding commitment to a national policy for its automotive industry. Concern for its supplier base spurred the 1975 implementation of a duty remission program for imported vehicles. The objective was to induce foreign-based

auto makers to buy Canadian content, by netting out the value of that content from the dutiable value of the car maker's shipments to Canada. The 11 percent plus Canadian tariff makes this a valuable incentive.

In a 1981 spin-off of this program, Canada offered Volkswagen (VW) duty free importation of cars into Canada in exchange for their manufacture of parts in Canada for export to VW's U.S. assembly plants. That plan was cut short by the auto making depression and the deep plunge in VW's equipment demands.

Finally, Canada's 1983 Private Sector Task Force on the Motor Vehicle and Parts Industries named a domestic content requirement as the cornerstone of its recommendations to the federal government. The task force proposal effectively would broaden the Auto Pact content stipulations to apply to Japanese and other foreign vehicle producers who market cars in Canada.

In the U.S., APAA has worked with the Department of Commerce (DOC) and the Office of U.S. Trade Representative (USTR) to begin development of our own program for the aftermarket. While we have joined Administration ranks in denouncing domestic content as bad economics that would threaten both short-term and long-term industry vitality, we still hope to gain Administration support for the Automotive Products Export Council (APEC)-developed Parts Purchase Incentive Plan, tailored after the Canadian duty remission program.

The linchpin of the U.S. parts program is the industry/government Japan Initiative to crack Japanese car company-controlled markets. Through the exchange of buying and selling missions, already begun at the recent APAA Show, and the creation of a bilateral Trade Facilitation Committee (TFC) to help smooth the rough edges in private contract talks, we have a program to build American supplier opportunities wherever Japan builds and sells cars.

Clearly our policy objectives differ -- Canadian industry support of domestic content versus the U.S. industry/government market opening initiative, preferably assisted by the leverage that our Parts Purchase Incentive Plan would provide. The bottom line is the same, however, as both industries work feverishly to develop new customers -- namely Japanese car makers -- to supplant the sagging parts demand of traditional Big Four customers.

While we have no quarrel with healthy competition, we must object to the playing field being tipped to Canada's advantage. We cite the well-reported Canadian government bounties to lure new Japanese supplier investment to Canada. In fact, it was Canadian government seed money that helped found Pacific Automotive Co-operation, Inc.

(PAC) in 1984, for the purpose of stimulating both the Canadian and Japanese parts industries. Staffed by Japanese auto executives and directed by officials of the Japanese Automobile Manufacturers Association (JAMA) and the Japan Auto Parts Industries Association (JAPIA), PAC is waging an ambitious campaign to entice Japanese suppliers to take some of the sting out of U.S. political frustration with the mounting parts trade deficit, by entering the U.S. through the back door. Perhaps this fits the letter of the Auto Pact, but it clearly does not conform with the spirit. Moreover, it seriously undermines our market opening initiatives.

But, Japan is reacting to political pressure from both countries. Its chief response is to move more of its vehicle production to North America. Reluctant to choose from U.S. suppliers who are capable of supplying the entire gamut of Japanese auto manufacturing needs, Japanese car makers prefer to establish their own supplier families nearby. Faced with U.S. industry resistance to a network of new plants setting up next door to underutilized American plants, Japanese firms are finding PAC's sales pitch most appealing. Not only will Canada welcome their suppliers, but the Japanese can locate close enough to the U.S. assembly plants for just-in-time delivery. All is done duty free and in full compliance with the Auto Pact.

Obviously, Canada offers advantages beyond a receptive climate. The strong U.S. dollar, that has hampered our firms' access to foreign markets, becomes a potent club against us as our chief trading partner offers a built in 25 percent plus discount on every component and car shipped to the U.S.

Add to this the lure of government grants and lower operating costs in the key areas of wages, utilities, and materials, and it is easy to see that our parts trade deficit with Canada could mount swiftly as Japanese suppliers exploit the Auto Pact to sidestep U.S. political pressures.

To reiterate, it is imperative that we not aid this onslaught by making our aftermarket industry more vulnerable. Even with the status quo, we know that Japanese suppliers to American OE markets will enter our aftermarket with the same competitive advantages cited above. Moreover, their OE production base will help lower the cost of the extra units produced for the U.S. aftermarket, making their price competitiveness even more formidable.

As a member of ISAC-16, I look forward to discussing this issue with fellow council members. More importantly, APAA wishes to work with trade negotiators from your department and the USTR. Please let me know how and when we can help at each stage of the negotiating process.

Sincerely,

Julian C. Morris

Julian C. Morris
President

JCM/lk/dp

cc: Mr. Bruce Smart, Undersecretary, International Trade, DOC
Mr. Robert Watkins, Deputy Assistant Secretary, Automotive Affairs and Consumer Goods, DOC
Mr. Robert Reck, Division Director, Parts & Suppliers Division, DOC
Mr. Thomas Brewer, Director, Office of Canada, DOC
Mr. William S. Merkin, Deputy Assistant U.S. Trade Representative, Canada and Mexico

TABLE 6

Retail Sales of Motor Vehicles in Canada and the United States
1965 and 1970-84 - (Thousands of Units)

	Automobiles			Trucks			
Year	North American Type	Overseas Import Type	Total	North American Type	Overseas Import Type	Total	Total Vehicles
1. Canada							
1965	634	75	709	120	2	122	831
1970	497	143	640	125	9	134	774
1971	592	188	780	147	13	160	940
1972	654	205	859	190	17	207	1,066
1973	783	188	971	235	20	256	1,227
1974	797	146	943	288	19	307	1,249
1975	836	154	989	310	17	327	1,317
1976	793	153	946	331	14	345	1,291
1977	798	194	991	338	16	354	1,345
1978	816	173	989	364	13	377	1,366
1979	863	140	1,003	381	12	393	1,396
1980	741	191	932	312	22	334	1,266
1981	647	257	904	251	36	287	1,191
1982	489	224	713	167	40	207	920
1983	625	218	843	193	45	238	1,081
1984	725	246	971	274	39	313	1,284

Source: Statistics Canada

Retail Sales of Motor Vehicles in Canada and the United States
1965 and 1970-84 - (Thousands of Units)

	Automobiles			Trucks			
Year	North American Type	Overseas Import Type	Total	North American Type	Overseas Import Type	Total	Total Vehicles
2. U.S.							
1965	8,763	569	9,332	1,539	44	1,583	10,915
1970	7,120	1,285	8,405	1,746	65	1,811	10,216
1971	8,681	1,570	10,251	2,011	85	2,096	12,347
1972	9,327	1,623	10,950	2,486	143	2,632	13,575
1973	9,676	1,763	11,439	2,916	228	3,144	14,583
1974	7,454	1,413	8,867	2,512	171	2,683	11,550
1975	7,053	1,587	8,640	2,249	231	2,480	11,120
1976	8,611	1,498	10,109	2,944	237	3,181	13,290
1977	9,109	2,075	11,184	3,353	323	3,676	14,860
1978	9,312	2,000	11,312	3,776	337	4,113	15,425
1979	8,328	2,300	10,628	3,000	500	3,500	14,128
1980	6,578	2,398	8,976	2,002	484	2,486	11,462
1981	6,206	2,324	8,530	1,852	448	2,300	10,830
1982	5,757	2,222	7,979	2,151	410	2,561	10,540
1983	6,795	2,386	9,181	2,588	464	3,052	12,233
1984	7,951	2,439	10,390	3,484	607	4,091	14,481

Source: Motor Vehicle Manufacturers' Association and Ward's Reports

TABLE 7

CANADIAN SALES OF NEW PASSENGER CARS BY ORIGIN
1964 - 1984 CALENDAR YEAR (Units)

Year	Total Sales Volume	Domestic Volume	Domestic Per cent	Total Imported Volume	Total Imported Per cent	Japanese Volume	Japanese Per cent
1964	616 759	550 823	89.3	65 936	10.7	- -	
1965	708 716	633 641	89.4	75 075	10.6	2 834	0.4
1966	694 820	626 986	90.2	67 834	9.8	2 742	0.4
1967	679 435	605 049	89.1	74 386	10.9	5 617	0.8
1968	741 915	637 393	85.9	104 522	14.1	15 859	2.1
1969	760 803	638 270	83.9	122 533	16.1	39 033	5.1
1970	640 360	497 185	77.7	143 175	22.3	65 569	10.2
1971	780 762	592 319	75.9	188 443	24.1	106 552	13.7
1972	858 959	653 933	76.1	205 026	23.9	116 860	13.6
1973	970 828	782 914	80.6	187 914	19.4	111 467	11.5
1974	942 797	796 840	84.5	145 957	15.5	87 609	9.3
1975	989 280	835 679	84.5	153 601	15.5	95 772	9.7
1976	946 488	793 201	83.8	153 287	16.2	101 558	10.7
1977	991 398	797 752	80.5	193 646	19.5	134 900	13.6
1978	988 890	815 994	82.5	172 896	17.5	113 166	11.4
1979	1,003 008	863 554	86.1	139 454	13.9	79 879	8.0
1980	932 060	740 767	79.5	191 293	20.5	138 107	14.8
1981	904 195	646 942	71.6	257 253	28.4	207 639	23.0
1982	713 481	489 435	68.6	224 046	31.4	178 174	25.0
1983	843 318	625 088	74.1	218 230	25.9	176 525	20.9
1984	971 210	724 932	74.6	246 278	25.4	171 204	17.6

Source: Statistics Canada

TABLE 8

NORTH AMERICAN PRODUCTION OF MOTOR VEHICLES ('000 UNITS)

Year	Canada		U.S.A.		North America Total	
	Volume	Per cent	Volume	Per cent	Volume	Per cent
1965	846	7.1	11,114	92.9	11,960	100.0
1966	902	8.0	10,363	92.0	11,265	100.0
1967	947	9.5	8,992	90.5	9,939	100.0
1968	1,180	9.8	10,794	90.2	11,974	100.0
1969	1,353	11.7	10,182	88.3	11,535	100.0
1970	1,193	12.6	8,263	87.4	9,456	100.0
1971	1,373	11.4	10,650	88.6	12,023	100.0
1972	1,474	11.5	11,297	88.5	12,771	100.0
1973	1,575	11.1	12,663	88.9	14,238	100.0
1974	1,564	13.5	9,984	86.5	11,548	100.0
1975	1,442	13.9	8,965	86.1	10,407	100.0
1976	1,647	12.5	11,486	87.5	13,133	100.0
1977	1,775	12.3	12,699	87.7	14,474	100.0
1978	1,818	12.4	12,895	87.6	14,713	100.0
1979	1,632	12.4	11,475	87.6	13,107	100.0
1980	1,374	14.6	8,010	85.4	9,384	100.0
1981	1,280	13.9	7,941	86.1	9,221	100.0
1982	1,236	15.0	6,985	85.0	8,221	100.0
1983	1,502	13.9	9,226	86.1	10,728	100.0
1984	1,830	14.4	10,924	85.6	12,754	100.0

Source: Ward's Automotive Reports

TABLE 9

MOTOR VEHICLE PARTS AND ACCESSORIES PRODUCTION
CANADA AND THE U.S.
($ millions Canadian)

Year	Canada	U.S.	Canadian as a percentage of Total North America
1972	2,106.0	27,765.3	7.1
1973	2,533.8	32,919.8	7.1
1974	2,510.0	32,231.8	7.2
1975	2,552.9	34,035.4	7.0
1976	3,417.8	43,271.2	7.3
1977	4,138.8	57,017.0	6.8
1978	5,119.7	68,345.5	7.0
1979	4,897.4	69,833.6	6.6
1980	4,034.2	58,119.3	6.5
1981	4,879.3	66,527.6	6.8
1982	5,538.9	44,642.0	11.0
1983	6,544.4	58,785.0	10.0
1984	10,231.8	74,012.0	12.1

Source: Statistics Canada and the U.S. Department of Commerce

TABLE 10

EMPLOYMENT RELATED TO AUTOMOTIVE MANUFACTURING IN CANADA
1964 - 1984
(Thousands)

Calendar Year	Motor Vehicle Assembly (SIC 323)	Truck Body & Trailers (SIC 324)	Automotive Parts & Acc. (SIC 325)	Automobile Fabric & Acc. (SIC 188)	Total
1964	34.3	4.4	30.5	1.3	70.5
1965	39.8	5.8	35.3	1.9	82.8
1966	40.7	6.3	37.6	2.7	87.3
1967	38.7	6.7	37.7	2.6	85.7
1968	39.6	6.8	37.3	3.1	86.8
1969	42.3	8.2	40.4	4.1	95.0
1970	37.5	8.4	36.4	3.7	86.0
1971	41.0	10.1	41.3	4.3	96.7
1972	41.9	14.2	41.4	5.2	102.7
1973	45.2	14.8	48.8	5.8	114.6
1974	47.1	15.2	45.9	5.7	113.9
1975	43.4	14.4	41.2	4.8	103.8
1976	46.6	14.0	46.2	5.6	112.4
1977	50.6	12.6	48.6	6.5	118.3
1978	52.3	13.6	52.1	6.9	124.9
1979	52.6	14.8	49.8	6.6	123.8
1980	43.9	12.9	41.0	6.3	104.1
1981	43.4	12.1	44.7	7.2	107.4
1982	42.7	8.6	41.1	6.3	98.7
1983	44.4	11.5	55.2	4.5	115.6
1984	49.5	12.5	56.9	4.9	123.8

Source: Statistics Canada

TABLE 11

CANADA - UNITED STATES TRADE IN AUTOMOTIVE PRODUCTS
1967 - 1984

	1976	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
									$ MILLION									
United States Imports from Canada*																		
Cars	748	1,204	1,662	1,538	1,943	2,046	2,272	2,540	2,858	3,430	4,032	4,723	4,345	4,452	5,145	7,170	8,973	13,085
Trucks, etc.	247	399	605	589	593	706	789	868	932	1,344	1,964	2,364	2,218	3,142	3,946	4,437	5,880	
Parts	512	846	1,037	1,127	1,495	1,778	2,172	1,963	2,045	2,942	3,721	4,753	4,489	3,405	4,151	4,902	7,056	10,287
Tires & tubes	13	9	5	15	8	23	68	64	68	163	144	192	234	231	286	406	419	598
Total	1,520	2,458	3,309	3,269	4,039	4,553	5,301	5,435	5,903	7,879	9,861	11,993	11,432	10,306	12,724	16,424	20,885	29,850
Canadian Imports from United States																		
Cars	588	809	792	659	960	1,056	1,439	1,621	2,183	2,317	2,834	3,038	3,747	3,388	3,710	2,875	4,886	6,085
Trucks etc.	132	189	263	275	361	495	643	896	942	970	1,118	1,322	1,952	1,217	1,347	873	1,129	2,039
Parts	1,314	1,820	2,307	2,107	2,485	2,907	3,528	3,829	4,425	5,473	6,848	8,092	8,666	7,600	9,230	9,676	11,359	15,446
Tires & tubes	8	29	37	24	36	50	92	218	174	115	153	130	155	146	165	147	225	345
Total	2,042	2,847	3,399	3,065	3,842	4,508	5,702	6,564	7,724	8,874	10,953	12,582	14,520	12,351	14,452	13,571	17,599	23,915
Balances																		
Cars	160	395	870	879	983	990	833	919	675	1,113	1,198	1,685	598	1,064	1,435	4,295	4,087	7,000
Trucks etc.	115	210	342	314	232	211	146	-28	-10	375	846	1,003	412	1,001	1,795	3,073	3,308	3,841
Parts	-802	-974	-1,270	-980	-990	-1,129	-1,866	-1,866	-2,380	-2,531	-3,127	-3,339	-4,177	-4,195	-5,079	-4,774	-4,303	-5,159
Tires & tubes	5	-20	-32	-9	-28	-27	-24	-154	-106	48	-9	62	79	85	121	259	194	253
Total	-522	-389	-90	204	197	45	-401	-1,129	-1,821	-995	-1,092	-589	-3,087	-2,045	-1,728	2,853	3,286	5,935

*A more accurate measurement of trade in automotive products is obtained by comparing the import statistics of each country. Accordingly, Canadian exports are derived from the counterpart United States statistics of imports.

TABLE 12

Relationship Between Canada/U.S. Auto Pact Trade Imbalance and Canadian Value Added in Automotive Production as Percentage of Canadian Cost of Sales

Year	Canadian Value Added as Percentage of Cost of Sales in Canada	Canada Auto Pact Trade Imbalance as Percentage of Total Canada/U.S. Auto Pact Trade
	(model year)	(calendar year)
1966	69	-24.7
1967	69	-15.8
1968	72	-7.8
1969	81	-1.4
1970	92	4.4
1971	95	3.5
1972	90	1.5
1973	79	-1.5
1974	71	-7.0
1975	66	-11.1
1976	67	-3.0
1977	72	-3.2
1978	74	-1.4
1979	64	-11.0
1980	53	-8.6
1981	62	-6.0
1982	91	9.1
1983	87	6.5
1984	83	n/a

Source: Department of Regional Industrial Expansion

TABLE 13

Overall Net Production to Net Sales Value Rations* Achieved by Auto Pact Companies in Canada 1971-1984

	MODEL YEARS													
	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Passenger Vehicles														
(Required ratio: range 95-100)														
Net Sales Value Ratio Achieved (All companies)	149	125	121	122	122	122	125	130	130	106	123	202	196	173
Commercial Vehicles														
(Required ratio: range 75-100+)														
Net Sales Value Ratio Achieved (All companies)	142	122	115	98	101	113	132	155	127	115	140	238	272	231
Buses														
(Required ratio: range 85-100)														
Net Sales Value Ratio Achieved	120	119	97	102	114	98	105	163	183	199	273	213	243	312

* Net production to net sales value ratio is the ratio of the total value of Canadian vehicle production to the total net sales value of vehicle sales for all Auto Pact companies.

Source: Compiled from Company Auto Pact Reports to Department of Regional Industrial Expansion.

An Overview of Harmonization Issues

Richard Lipsey and Murray Smith

C.D. Howe Institute

October, 1985

Contents

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? Will the forces that are set loose by a free-trade agreement with the United States destroy, seriously erode, slightly influence, or leave unaffected Canada's political and cultural sovereignty and social integrity? More specifically, will these forces impel Canada to harmonize its policies with those of the United States in ways that seriously reduce Canada's policy independence?

Any international agreement constrains the signatories' independence in some way. A free-trade agreement 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, central governments.

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 or the small countries of Central America. Finally, this sense of cultural fragility is, in part, irrationally based on the lack of Canadians' 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 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 tax and subsidies 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 whether the negotiation of a free-trade area (FTA) with the United States would reduce Canada's policy independence. 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 tradeable 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 tradeable 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 captial 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 European Community (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, not matched by perceived differentials in benefits from government expenditure, 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 legislative 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.[1] 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.

Regulatory issues in particular sectors: 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 1985 — 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 General Agreement on Tariffs and Trade (GATT).

An interesting example of how those 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 accorded "national treatment" — that is, treatment no less favorable than that accorded products of the home country. In addition, efforts continue toward achieving voluntary standardization of U.S. and Canadian technical standards with respect to quality, performance, and safety of manufactured articles. Problem areas remain, however, and include health and safety inspections — especially for food and agricultural products — and medical supplies.

U.S. certification procedures and product-testing methods also may create trade barriers to the import of foreign manufactured products.

Although the GATT Standards Code and national-treatment principle apply in these areas as well, problems still arise when the United States refuses to accept another country's test data.

Yet another source of pressure for harmonization arises in Canadian trade with third countries. U.S. pressures exist in the application of U.S. export controls to high-technology goods for reasons of national security (Canada already restricts technology licensing and the export of technologically sensitive products that are associated with Canadian participation in NATO); and in the extraterritorial application of U.S. laws to U.S. subsidiaries or licensees operating in Canada.

Imagined Forces

A second set of motivations behind political and legal arrangements inducing policy harmonization under the status quo are "imaginary forces". These are particularly important and troublesome; we need to be concerned about them because policymakers may react to imagined advantages and disadvantages by introducing policies that have real effects. Furthermore, pressure can be placed on one country to harmonize its policies with those of 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.[2] 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.[3]

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?

The General Case that Harmonization Pressures Will Not Be Increased

There is a prima facie case that the proposed changes in the trading regime will set up few new harmonization pressures. The suggestion is that Canada and the United States 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 is unlikely to involve the negotiated commitments on internal tax-subsidy policies or fiscal transfers among members 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.

As the late, great Canadian economist Harry Johnson has eloquently stated,

> 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.[4]

The experience of the European Free Trade Association (EFTA) bears out Johnson's contention:

> 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.[5]

Assessment of the FTA

Notwithstanding these 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. In some areas at least, there could be a tradeoff between reducing the risk that U.S. contingent-protection mechanisms would be applied to Canadian exports and limiting the types of policy commitments made by Canadian governments. In addition, harmonization of regulatory, subsidy, or other economic policies could be a political quid pro quo for reaching an agreement.

Harmonization 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. We call them "post-agreement pressures". They can be studied rationally, since it is a matter of predicting the new economic forces set in play by an FTA.

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

The first 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 second source of negotiating pressures is a correct appreciation of the economic forces set up by an FTA, followed by political pressure at the bargaining table on Canada to harmonize some aspects of its policies based on this correct appreciation. These can be rationally anticipated and analyzed. 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 third source of negotiating pressures is an incorrect appreciation of the economic forces set up by an FTA and 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 just too "specialized", and so on. In such cases, it could put pressure on Canada to abandon these systems just because it did not like them.

Now that we have examined how pressures might arise at the bargaining table, let us extend this examination to specific policy areas where pressures for change as a result of an FTA can be anticipated.

Commercial Policy

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.

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 is also 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 would then 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.

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 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 result in major changes in these pressures. There are forces pulling in either direction, and 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.

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; and

o seeking to maintain the status quo with respect to the generally available subsidy; by application of the border-tax-adjustment principle, Canada could seek agreement that general subsidies are not countervailable.

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 broadly 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. Making it available to seasonal workers, rather than on an experience-related basis, could be seen to constitute a differential subsidy to seasonal industries. Competing U.S. seasonal industries, which do not have this subsidy, 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 such broadly based policies are not aimed at distorting trade and that any such effects are incidental;

o that virtually any broadly 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 broadly based social policies where they belong: outside of the scope of negotiations.

Cultural-Support Policies

Pressures can be anticipated from the Canadian side to request blanket exemption in FTA negotiations for all policies falling under the generic title of "cultural support". It seems unlikely that any country bargaining for an FTA could, or should, 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.

If this principle seems too open ended, a second possibility could be to allow trade-restricting exemptions to one country only when the other country could not suggest an alternative with the same support effect, but fewer trade-restricting effects. (Disagreements might be referred to a dispute-settlement body.)

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 willing to grant exemptions to measures that significantly increased the amount of Canadian activity while denying exemptions that merely raised profits for owners of facilities that would exist in any case.

We see a number of possible negotiating positions:

o Exemptions could be sought for all existing policies without attemping to evaluate their success.

o Such a general exemption could be advocated, while at the same time Canadian policy attempted to replace specific 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.[6] This is a more-flexible position and the United States might be more willing to accept it.

o 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 could well be arranged in other sectors. This would give Canada much room for maneuver, and since the United States would want 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 dropped and exemptions obtained for only those policies that really were 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 nonaudience television programs -- as cheaply as possible.

o Canada could accede to pressures in certain contentious areas. One such practice is the substitution of Canadian for U.S. commercials on cable television.

Policy-harmonizing pressures certainly will exist in the cultural area. The above list -- which is only illustrative of some possible Canadian positions -- is enough to establish two basic points. First, 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.

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 has, however, sometimes 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. Very probably the United States 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.[7] At the same time, key

sectors might be designated where foreign investment is restricted or precluded. If Canada were to agree to such commitments in some sectors, then it would have to cease screening only foreign acquisitions of firms in those 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.

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,

the two countries' price-support mechanisms are remarkably similar. In this case, although freer trade might not cause many problems at the outset, it might eventually increase Canadian producers' exposure to U.S. policy changes. Finally, 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.

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 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 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.

Conclusion

The overall conclusion that emerges from this study is that a free-trade arrangement with the United States 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. 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 trading 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 only a few 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 could also 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, broadly 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 U.S. policies. The view that such programs constitute subidies 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 would 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 of screening mergers and acquisitions, 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.

NOTES

1. "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.

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

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

4. 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.

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

6. 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.

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

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

prepared for the C.D. Howe Institute

by Debra Steger

McCarthy & McCarthy, Toronto

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Introduction

Reduction in tariffs since the negotiation of the General Agreement on Tariffs and Trade (GATT) in 1947, has coincided with gradually accelerating recourse by the United States to other measures for restraining foreign imports. The major trade acts of 1962, 1974, 1979 (the Trade Agreements Act of 1979 which implemented the Tokyo Round), and 1984 (the Trade and Tariff Act of 1984) demonstrate the growth of a legalistic and complex governmental system for import regulation. A dozen different procedures and processes now exist which a private citizen can invoke to seek relief from imports. To counter growing protectionist sentiments in Congress in 1985, it appears to be emerging Administration policy to initiate more unfair trade actions on behalf of the government. The system of remedies includes countervailing duty and antidumping procedures, unfair trade practices such as patent, copyright, or antitrust infringement under Section 337 of the Tariff Act of 1930, 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.

This paper examines the implications for Canadian economic policies of U.S. legal remedies against unfair trade. The U.S. Congress has become increasingly adept at exploiting the ambiguities of multilateral agreements in order to redefine unilaterally what constitutes unfair trade. Under the status quo the threat of U.S. restrictions is an important constraint on discretionary Canadian economic policy. After analyzing these constraints suggestions are offered as to how the impact of U.S. trade laws on Canadians might be limited by bilateral trade negotiations. In 1984 Canada shipped 78 percent of its exports to the United States; the elaborate U.S.

contingency-protection system, therefore, has profound effects on exporters' business activities and Canadian government policymaking.[1] Rodney de C. Grey has characterized contingency-protection systems as "power-oriented".[2] Only a large industrial state can effectively operate the large bureaucratic establishment and the mass of detailed legislation required to maintain it. The impact of countervailing duty and antidumping actions, he argues, will be greater on a smaller, trade-dependent economy. 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. A plant in a large economy, on the other hand, sells most of its production in the domestic market and thus is not as vulnerable to unfair trade actions taken in other countries. The 1983 U.S. countervailing duty action against Canadian softwood products is a case in point. Canada exports 76.5 percent of its softwood exports, worth approximately $3 billion, to the United States. If countervailing duties were levied against those exports, the Canadian softwood lumber industry virtually would be crippled.

In discussions of new trade arrangements with the United States, the Canadian government might want to assess the relative effects of the U.S. and Canadian contingency-protection systems on business and government activities in the two countries. If the U.S. trade regulation system (and Canada's practice of subsidizing business) are, in effect, nontariff barriers, then those practices should be included as issues in the negotiations.

The most significant irritants in the U.S. trade arsenal from Canada's perspective are the countervailing duty and antidumping procedures. Proceedings for imposing countervailing duties or antidumping duties are not new to U.S. trade law, but before 1979 they were only selectively applied. As a combined result of the Trade Act of 1974 (which severely limited the U.S.

Treasury's discretion by imposing time limits on investigations and making judicial review available to domestic petitioners) and the Trade Agreements Act of 1979 (which implemented the results of the Tokyo Round of multilateral trade negotiations, including the Subsidies Code and the Antidumping Code), countervailing duty and antidumping laws now offer a fully-integrated, mandatory, quasi-judicial administrative system for investigating, hearing, and determining complaints from private industries seeking redress against injurious import competition. Contrary to the intention of the multilateral codes, the United States has established a complex set of procedures which guarantee private rights to domestic industries to protect them from vigorous import competition.

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 International Trade Administration in the Department of Commerce (ITA) finds that a foreign exporter is dumping a class or kind of merchandise in the U.S. and the International Trade Commission (ITC) determines that an industry in the U.S. is materially injured, or threatened with material injury, by the imports of that merchandise, then an antidumping duty shall be imposed on the imports. Dumping occurs when a foreign exporter sells his merchandise in the U.S. 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 to domestic firms against the unfair trade practices of foreign firms.

Countervailing Duty Laws and Subsidy Practices

Canada's practice of subsidizing industries and U.S. countervailing duty countermeasures are undoubtedly the most important trade irritants between Canada and the United States. Domestic countervailing duty laws are expressly authorized by Article VI of the GATT and the Subsidies Code as a procedure by which an importing country may levy duties to counteract the unfair trade practice of a foreign country subsidizing the exportation or production of a product. Although U.S. countervailing duty law dates back to 1890, it is only since the enactment of the Trade Agreements Act of 1979 that cases have been brought 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 duty countermeasures. Between 1980 and 1984, the United States initiated 123 actions as compared with 8 by Canada and Australia, 6 by the European Community, and 1 by Japan.[3]

The greater emphasis placed by the United States on countervailing duty procedures reflects its philosophical commitment to free market principles. The whole question of subsidies and countervailing duties to discipline their use has been pioneered by the United States both in its own trade legislation and in multilateral negotiations. The United States approached the Tokyo Round of multilateral trade negotiations with the objective of strengthening the GATT rules concerning subsidy practices. Most of the other participants viewed the use of subsidies, with the exception of export subsidies, as strictly a question of national or internal policy.[4] While the goal of the United States was to submit the other countries to discipline in their use of subsidies, the objective of the other participants was to have the United States adopt an injury test in its countervailing duty actions.

The 1979 Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the GATT (the Subsidies Code) contains a two-track procedure. Track I of the Subsidies Code regulates the imposition of countervailing duties by a signatory on products imported from another signatory. Article 2 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 thereof 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 recognize that subsidies are used by governments 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 acknowledges the right of member countries to use domestic (non-export) subsidies to promote social and economic policy objectives such 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.

The United States and Canada, as a result of their unique histories and political cultures, have developed different philosophical views on the use of subsidies as an instrument of government policy and the international discipline of them through the use of countervailing measures. Of the "Big

Seven" countries, the U.S. has persistently, since 1952, exhibited the lowest ratio of subsidies to gross domestic product (GDP). 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 has risen from a low subsidy/GDP ratio of 0.39 in 1956 to 0.87 in 1968 to a high of 2.34 in 1980.[5]

Current U.S. Procedures

The current U.S. countervailing duty laws, contained in Title VII of the Trade Agreements Act of 1979 and Section 301 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 the imports of subsidized products from another country.[6] Section 701 stipulates that where the International Trade Administration in the Department of Commerce (ITA) finds that 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" and the International Trade Commission (ITC) determines that "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, then 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."[7] [emphasis added]

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 whether there is a reasonable indication of material injury or threat thereof to a U.S. industry. If it makes a negative determination, the investigation ceases. The ITA has 85 days from the date of filing the petition to make a preliminary determination of whether there is a reasonable basis to believe that a subsidy is being provided with respect to the merchandise being investigated. If the ITA makes an affirmative preliminary determination, all entries of 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 in the U.S.[8]

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 to a U.S. industry by reason of the imports.[9] Where the ITA and ITC both make affirmative final determinations, the ITA must order that customs officials assess countervailing duties equal to the net subsidy provided on the imports of merchandise.[10] "Net subsidy" means the gross subsidy adjusted for deferral of receipt from or special charges by, the foreign government.

The 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 Executive intervention in the process. These mandatory, quasi-judicial procedures, 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.[11]

Definition of Subsidy

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

1. the existence of a subsidy,

2. 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,

3. a causal link between the subsidized imports and the alleged injury.

Material injury, in U.S. law, means "harm which is not inconsequential, immaterial, or unimportant." It is to be assessed in terms of (i) the volume of imports of the merchandise, (ii) the effect of the imports on prices in the U.S. for similar products, and (iii) the impact of the imports on domestic producers of similar products.[12] Generally speaking, injury will be found where 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 the U.S. jurisprudence administrative 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." "This defect in the international system", he argues, "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."[13]

Determination of the existence of a subsidy is, given the recent cases, the more significant issue. Subsidy is defined in Section 771(5) of the Trade Agreements Act of 1979 as follows:

> (5) SUBSIDY - The term 'subsidy' has the same meaning as the term 'bounty or grant' as that term is used in section 303 of this Act, and includes, but is not limited to, the following:
>
> (A) Any export subsidy described in Annex A to the Agreement (relating to illustrative list of export subsidies).
>
> (B) The following domestic subsidies, if provided or required by government action to a specific enterprise or industry, or group of enterprises or industries, whether publicly or privately owned, and whether paid or bestowed directly or indirectly on the manufacture, production, or export of any class or kind of merchandise:
>
> (i) The provision of capital, loans, or loan guarantees on terms inconsistent with commercial considerations.
>
> (ii) The provision of goods or services at preferential rates.
>
> (iii) The grant of funds or forgiveness of debt to cover operating losses sustained by a specific industry.
>
> (iv) The assumption of any costs or expenses of manufacture, production, or distribution.[14]

There are basically two categories of subsidies as recognized by the Subsidies Code and U.S. law. First, there are export subsidies which are prohibited by the Code except on certain primary products. Second, there are domestic production subsidies which 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 have been treated as inherently bad by the Subsidies Code and U.S. law. They have been countervailed consistently by the

Department of Treasury and the ITA. 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 Subsidies Code specifically incorporated into U.S. law, lists some examples:

> (a) provision by governments of direct subsidies to a firm or industry contingent upon export performance,
>
> (b) currency retention schemes or any similar practices which involve a bonus on exports,
>
> (e) full or partial exemptions, remission or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises,
>
> (j) provision by governments (or special institutions controlled by governments) of export credit guarantee or insurance programs, or of exchange risk programs, at premium rates, which are manifestly inadequate to cover the long-term operating costs and losses of the programs.

Canada's Export Development Corporation grant to Bombardier Inc. of a loan of $563 million at 9.7 percent interest over 15 years, was clearly an export subsidy and was determined countervailable by the ITA and ITC in 1983.[15]

Although countervailing duties were levied on some foreign domestic subsidies in the 1920s, it was not U.S. trade policy until the 1960s to countervail domestic subsidies. With increasing trade deficits in the 1960s, the Department of Treasury began to apply the countervailing duty laws more aggressively against imports bearing production subsidies. In 1973, countervailing duties were imposed in the first case involving domestic subsidies, Canadian Michelin Tire. As a result of an intense North American

competition for location of a Michelin tire plant to manufacture steel-belted radial tires, in 1967 the government of Nova Scotia won with a package of DREE grants and special accelerated depreciation from the government of Canada, grants and low-interest loans from the government of Nova Scotia, and concessions on property taxes from the municipalities involved. In 1973, the Department of Treasury issued an affirmative countervailing duty order based on the theory that the subsidies had an export stimulative effect since 75% 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 to specifically include a definition of domestic subsidy. Countervailable domestic subsidies include:

(i) The provision of capital, loans, or loan guarantees on terms inconsistent with commercial considerations.

(ii) The provision of goods or services at preferential rates.

(iii) The grant of funds or forgiveness of debt to cover operating losses sustained by a specific industry.

(iv) The assumption of any costs or expenses of manufacture, production, or distribution.[16]

There are currently numerous bills in Congress which would add more practices to the definition of countervailable subsidy. 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. Two bills before Congress, Congressman Gibbons' bill, HR2451, and Congressman Bonker's bill, HR1648 would make government natural resource pricing policies countervailable subsidies.

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.[17] It has long been administrative practice in the United States not to countervail generally available subsidies because they do not have demonstrable trade distorting effects. Prior to the Trade Agreements Act of 1979, the Department of Treasury refused to countervail programs generally available to more than a limited number of producers or industries. The Trade Agreements Act of 1979 imposed a "specificity" test. Since then, the ITA has imposed countervailing duties only on programs targeted to specific enterprises, industries, or regions.

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."[18] Article 11.3 of the Subsidies Code refers to "subsidies granted with the aim of giving an advantage to certain enterprises...either regionally or by sector."

The ITA has had to defend its interpretation of Section 771(5)(B) as containing a specificity test in two recent appeals before the Court of International Trade. In a 1983 decision, Carlisle Tire and Rubber Company, Maletz, S.J. held that two accelerated depreciation programs for equipment available under 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 Korea.[19] The court agreed with the ITA's interpretation of "bounty or grant" as connoting some special or comparative advantage conferred upon an industry or group of industries and not available to all manufacturers and producers within an industry. Maletz found some support in previous case law for his interpretation but he also agreed with the ITA's submissions that to countervail widely available subsidies would lead to an absurd result and that Congress had meant by its

use of the word "specific" in Section 771(5)(B) to limit the term subsidy to those which are preferential in nature.

The ITA based its interpretation on the economic theory that a widely available benefit does not usually distort comparative advantage within a country and any advantage would be washed out by floating exchange rates. Furthermore, they 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. If the United States were to countervail generally available subsidies, contrary to the admonitions of the signatories to the Subsidies Code that "countervailing measures...[should]...not unjustifiably impede international trade" and that the objective of the Code is "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," other countries would very likely retaliate against U.S. programs.[20]

In a 1984 case in the same court, Watson, J. emphatically rejected a broad rule that generally available programs are not subsidies. He 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."[21] Although Watson's comments on the broad rule of general availability or specificity are dicta -- not binding precedent -- 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 of International Trade to accept the ITA's

interpretation of Section 771(5)(B). His views, expressed in Bethlehem Steel Corp. v. United States and Highveld Steel and Vandium Corp., create some uncertainty about the strength of the specificity test in U.S. countervailing duty law.

Recent Cases Involving Canada

The ITA, in its recent decisions, continues to countervail only those subsidies which 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 Certain Softwood Products from Canada (Softwood Products).[22] The other was Live Swine and Fresh, Chilled, and Frozen Pork Products from Canada (Hogs and Pork).[23] In Softwood Products, numerous federal and provincial programs were found to confer subsidies because assistance was made available only to certain industries or to certain regions, however, they were not countervailed because the net ad valorem subsidies were de minimis.

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 DREE to create stable employment opportunities in underprivileged regions because the benefits were limited to companies in specific regions, and the federal employment program -- the Community-Based Industrial Adjustment Program -- created to alleviate distress in Cabinet-designated communities by large-scale permanent industry dislocation.

Federal/provincial Agriculture and Rural Development Agreements (ARDA) and DREE's General Development Agreements with the provinces were found to confer subsidies because their assistance was limited to companies in specific regions, generally rural, economically depressed regions within a province. Several provincial programs were deemed to provide subsidies including: Alberta's Stumpage Payment Deferral, B.C.'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, Aide à la Promotion des Exportations, Société de Récupération, d'Exploitation et de Développement Forestiers du Québec (REXFOR), FRI Tax Abatement Program and SDI Export Expansion Program. Particularly interesting was the ITA's handling of REXFOR, a Quebec crown corporation which owns sawmills and pulp and paper mills, manages provincially-owned forest lands, and invests in the Quebec forest industry. DREE grants to REXFOR and government of Quebec assistance in the forms 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 potential impact on the Canadian economy, the most important finding in Softwood Products was that the stumpage programs of the federal and provincial governments do not confer subsidies. The ITA held that stumpage programs do not confer an export subsidy because they do not stimulate export rather than domestic sales and are not offered contingent on export performance. They 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". Stumpage programs are available within Canada on similar terms regardless of industry or enterprise of 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. The determination that stumpage programs are not targeted to specific industries has met with some criticism.[24]

Even if stumpage is provided to a specific group of industries, the ITA reasoned, it is not a domestic subsidy within Section 771(5)(B)(ii) in that stumpage programs do not provide goods at preferential rates, i.e. rates more favorable to some within Canada than others within Canada, and (iv) stumpage programs do not assume a cost of production because "assumption" refers only to government activity which relieves an enterprise or industry of a pre-existing statutory or contractual obligation.

Generally available federal and provincial programs such as the federal Income Tax Act's Deductible Inventory Allowance and Capital Cost Allowance, federal employment programs, enterprise development programs and rail freight rates were deemed not to confer subsidies because they were not targeted in their enabling legislation, regulations or administration to specific regions or industries. Furthermore, loans and loan guarantees provided by DREE at above average interest rates were determined not to provide subsidies.

In the 1985 case, Hogs and Pork, the ITA found that many federal and provincial agricultural assistance programs conferred subsidies. 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.[25] Countervailing duties thus will be levied on imports of Canadian hogs but not on Canada's U.S.$248 million pork products industry.

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. Programs deemed not to confer subsidies included federal financing programs 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, and provincial programs such as grants and low-interest loans provided under the Quebec Act to Promote the Development of Agricultural Operations, the Quebec Industrial Assistance Act, the Quebec Act to Promote Farm Improvement, the Ontario Farm Adjustment Assistance Program, the Ontario Beginning Farmer Assistance Program, the Ontario Young-Farmer Credit Program, the New Brunswick Farm Adjustment Act, the Newfoundland 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.

The distinction the ITA made between those programs determined to confer subsidies and those deemed widely available was based on a narrow interpretation of the specificity test. 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 it were found to be subsidies because the legislation establishing the ASA program specifically listed "named 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 there were different formulae 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 was deemed not to be a subsidy because numerous agricultural products were similarly graded under this federally-funded grading program.

The Ontario Farm Tax Reduction Program which provides for the 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 Canada's 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,

the New Brunswick Farm Adjustment Act, the Alberta Agricultural Development Corporation, and the B.C. 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 Hogs 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, therefore, has some discretion to determine how specific a benefit must be before it constitutes a subsidy.

The Trade and Tariff Act of 1984 specifies the circumstances under which the ITA may determine an "upstream subsidy" countervailable. Section 613 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, i.e. 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 it has a significant effect on the cost of manufacturing or producing the merchandise.[26]

Regional development programs are 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 section 771(6) of the Trade Agreements Act of 1979.

Generally, the ITA treats research and development subsidies the same as any other subsidies. The problem is in quantification of 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.[27]

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

There are currently two bills before Congress that would make the sale of a government-owned resource at a price lower than the price of a comparable resource in the United States a countervailable subsidy. Congressman Bonker's bill, HR1648, 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".[28] Chairman Gibbons' (of the Trade Subcommittee of the House Ways and Means Committee) bill, HR2451, would add a category of "resource input subsidy" to the current definition . Included would be a resource product or a 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. "Fair market value" would mean for an input product, "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", and for a removal right, "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).[29]

Congressmen Bonker's and Gibbons' 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.[30] In these cases, U.S. domestic producers complained that their foreign competitors had lower production costs because the foreign 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. 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 in Congress 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 possiblity 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 its 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 "fair market value" of a resource input owned by the government in a foreign country as the same as the price of a comparable resource input in the U.S. 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. contingency protection system include unfair trade practices such as patent, copyright, trademark,or antitrust infringement under Section 337 of the Tariff Act of 1930, unfair foreign government practices affecting U.S. exports or other trading actions under Section 301 of the Trade Act of 1974, and the escape clause, Section 201 of the Trade Act of 1974, which provides import relief to U.S. domestic industries burdened or threatened with serious injury from increased imports.

Section 337: Unfair Practices in Import Trade

Section 337 of the Tariff Act of 1930, as amended by the Trade Act of 1974, provides that imported goods tainted with unfair trade practices, such as patent, copyright or trademark infringement or unfair methods of competition, can be refused entry at the border. The ITC, upon receiving a private complaint or upon 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.[31]

Any such acts are unlawful, and if the ITC determines that there is a violation of Section 337, it shall order either that the goods concerned be refused entry into the U.S. or that the importer or owner cease and desist from engaging in the unfair acts or methods. After the ITC submits a report of its determination to the President, he has the discretion to disapprove of the ITC's finding. If the President does not intervene, the ITC's determination is final. Section 337 does not apply to claims involving U.S. patents on goods procured by the government of the United States. In the period from 1980-85, there were 14 Section 337 cases involving imports of Canadian goods. Exclusion orders were made in 3 cases and settlement agreements were reached in 5 cases.[32]

Section 301: Retaliation Against Unfair Trade Practices of Foreign Governments

Section 301 of the Trade Act of 1974, as amended by Title IX of the Trade Agreements Act of 1979 and Title III of the Trade and Tariff Act of 1984, provides the President with broad powers to enforce the rights of the U.S. 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."[33] Where one of those conditions exists, the President is obligated 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 President independently of the GATT or any other trade agreement. Wherever U.S. commerce is burdened or restricted by an "unjustifiable, unreasonable or discriminatory" practice of a foreign government, he may take action. In contrast to the GATT and the multilateral codes, this provision applies to services as well as products.

Section 301 actions are commenced 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 is Canadian Border Broadcasting. 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 in 1980 recommended to President Carter that mirror tax legislation be enacted by Congress. Section 232 of the Trade and Tariff Act of 1984 is that response. It denies a deduction to U.S. companies for foreign advertising expenses in countries which deny similar deductions for U.S. advertising.

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 U.S. "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."[34] Section 201 is not designed to provide relief against foreign unfair trade practices. Safeguards 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 MTN agreements.

The ITC conducts an investigation upon receipt of a petition, upon its own motion, upon request of the President or the USTR, or upon a resolution of the House Committee on Ways and Means or the Senate Committee of

Finance. It must consider all economic factors in its inquiry into the questions of serious injury to a U.S. industry and an increase in imports being a substantial cause of the serious injury. After holding public hearings, the ITC reports its findings to the President.

Upon receiving an affirmative finding from the ITC, the President must provide import relief for the industry unless he deems it not in "the national economic interest of the United States". He may order that adjustment assistance be provided to the industry. To provide import relief, the President may proclaim an increase in duties on the article, impose tariff-rate quotas, modify or impose quantitative restrictions, negotiate orderly marketing agreements (or voluntary export restraint agreements -- VERs) with the foreign government involved, or any combination of the above. Any order for import relief that the President makes under Section 201 is technically subject to Most-Favored-Nation (MFN) treatment under the GATT, Article I. Therefore, all GATT countries exporting that article to the U.S. must be treated alike. Futhermore, if sanctions or restrictions are imposed upon a foreign country under Section 201, it has the right to retaliate with compensatory measures against the U.S. pursuant to GATT, Article XIX.

The President has the absolute discretion to decide whether he will take action and what type of import relief he will impose. 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.

Recent Administration Policy

In resisting 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 this year, directed the USTR to "initiate investigations to root out any unfair trade practices that may be harming U.S. interests."[35] The ITC, at the urging of the Senate Finance Committee, had recommended that shoe import quotas be imposed because the domestic industry was seriously hurt by imports. The President, in his policy statement, spoke out strongly against protectionism. It is new Administration policy that the U.S. government will use Section 301 to open up foreign markets to U.S. producers.[36] At the same time, we can probably expect more active government initiation of other unfair trade cases, namely countervailing duty, antidumping and Section 337 actions in the President's bid to stem the growing protectionist tide in Congress with more active Administration enforcement of the unfair trade laws. Senator Dole announced recently that the Senate is considering "fairness legislation" to be voted on this fall.[37]

Conclusion

The House of Representatives and the Senate are currently in a dangerous protectionist mood. The Administration, which 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), may be powerless to defend against the latest onslaught. The Presidential veto can be defeated by a two-thirds majority of both Houses. The President's current strategy is to step up government enforcement of the unfair trade laws in order to placate domestic complainants and slow the protectionist tide.

The complex U.S. contingency system, when activated, can present a substantial non-tariff barrier to Canadian trade. As such, it places considerable constraints on Canadian domestic policymaking. Since the Trade Agreements 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. In the U.S. law there is no room 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. countervailing duty system raise particular concerns for Canadian business and government. First, the process, with its strict time limits and mandatory, legalistic, quasi-judicial procedures, is a source of harassment for Canadian exporters. By its very diversity and complexity, the U.S. contingency-protection 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 lobby the President, the USTR, the ITC, and individual Congressmen on all the 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 countervailing duty system is the substantive issues. The ITC determination of material injury to a domestic industry as a result of the 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 an unfair government practice. Unfortunately, the U.S. definition has become so broad in recent years that there is virtually no government policy, with the exception of universally available tax advantages or social benefits, which 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. At risk, when U.S. administrative, judicial and legislative authorities can decree any form of government involvement in the economy countervailable, is the sovereignty of a foreign government. The U.S. definition of subsidy now exceeds the intentions of the signatories to the Subsidies Code. With its domestic countervailing duty laws, the U.S. is imposing 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 contingency protection arsenal. He has shown a reluctance lately to use the escape clause to impose quotas, enter voluntary export restraint agreements with foreign governments, or 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. A new emphasis 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.

As a result of the rounds of multilateral tariff negotiations since the GATT was signed in 1947, the U.S. has evolved a complex system of contingency protection mechanisms to safeguard U.S. domestic industries from injury resulting from increasing trade liberalization. Pronouncing as "unfair trade" many of the internal activities of foreign businesses and governments, the U.S. has developed privately-initiated, quasi-judicial, legalistic procedures for providing U.S. industries with redress against vigorous import competition and retaliatory measures to open up foreign markets to U.S. exporters.

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

One option in the negotiation of a bilateral free trade agreement (FTA) would be for each country to exempt the other from the application of its countervailing duty and antidumping procedures. Canada and the United States could follow the example of the European Community and create a bilateral agency which would make rulings on countervailing duty or antidumping complaints against imports from outside countries and which would regulate domestic subsidy policies and administer price discrimination laws within the two economies. The European Community has an internal regulation which lists the types and amounts of subsidies permitted within the Community and there are EC administered competition laws. Within the European

Community, there is free movement of labor, goods and capital unencumbered by domestic countervailing duty or antidumping countermeasures.

It is very unlikely 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. The U.S. system, since 1979 at least, 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 Macdonald Royal Commission proposed binational administration of these procedures for bilateral trade.[38] Both countries would retain their own procedures for imports from third countries. 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 would likely be more fruitful for Canada to propose some specific, incremental changes to the current U.S. trade regulation system. The Canadian negotiators should focus on features of the U.S. trade laws that are particular irritants for Canadian business and government policymaking. One such issue is the definition of subsidy in U.S. countervailing duty law.

A useful starting point for negotiations is the Agreement on Interpretation and Application of Articles VI, XVI, and XXIII of the General Agreement on Tariffs and Trade (the Subsidies Code). The preamble states that the objective is to "reduce or eliminate the trade restricting or distorting effects" of subsidies. In the preamble and Article 11, the signatories recognize "that subsidies are used by governments to promote important objectives of national policy" such as the elimination of economic and social disadvantages of regions, the alleviation of unemployment, the promotion of worker retraining, the encouragement of research and development, and the facilitation of adjustment and restructuring of industries. The signatories also recognize, however, "that subsidies may have harmful effects on trade and production". Thus, in Article 9, the member countries are enjoined from granting export subsidies on "products other than certain primary products". In Article 11, they are instructed to seek to avoid causing injury to a domestic industry of another signatory, serious prejudice to the interests of another signatory, or nullification or impairment of benefits accruing to another signatory under the GATT. In particular, domestic subsidies which "would adversely affect the conditions of normal competition" or which would have "possible adverse effects on (world) trade" are to be avoided.

In accordance with the Subsidies Code, the GATT and the U.S. Trade Agreements Act of 1979, export subsidies (as defined in the Illustrative List of Export Subsidies, Annex B of the Subsidies Code) should be prohibited in a bilateral trade agreement. Domestic subsidies should be permitted where they serve important economic, social, or industrial national policy objectives and do not adversely affect trade. To make determinations of the administrative agencies easier, the member countries could each negotiate a list of current assistance programs or, alternatively, general categories of domestic subsidies which are to be exempted from countervailing duty procedures. The

lists for each country would be different and could reflect government policy priorities. The lists could be specific and capable of amendment by application to a binational commission or more general and delineated by categories such as regional development, natural resource, environmental, health and safety, agricultural, and cultural programs. The lists would be negotiated and, when agreed to, appended to the agreement.

Concerns about abrogation from an agreed-upon definition of domestic subsidy and specific lists of excepted government programs are exaggerated. If a definition and lists of exceptions are included in a bilateral agreement which is subsequently accepted and implemented in domestic legislation, it is unlikely that Congress will tinker with it. There are, of course, no guarantees. The President cannot bind Congress and Congress would surely refuse to implement any international agreement which attempted to constrain its future actions. Experience with the U.S.-Canadian auto pact has demonstrated Congress' respect for, and reluctance to tamper with, international economic agreements.

NOTES

1. Statistics Canada, Exports: Merchandise Trade, catalogue number 65-202

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17. I am heavily indebted throughout this discussion of current subsidy issues to Gary N. Horlick, O'Melveny & Myers, Washington, D.C., formerly Deputy Assistant Secretary of Commerce for Import Administration, and Judith Hippler Bello, O'Melveny & Myers, Washington, D.C., formerly Deputy for Policy, Office of Import Administration, U.S. Department of Commerce, for three unpublished papers:

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

by

Murray G. Smith

Senior Policy Analyst

C.D. Howe Institute

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Introduction

Although a free trade area agreement (FTA) between two countries should leave both free to pursue their own commercial policies toward third countries, negotiating issues can be expected to arise with respect to the application of such policies towards each other. Both parties will have to identify where such pressures may arise and how to deal with them at the negotiating table.

Definition of pressures that are likely to arise can be achieved in two steps: first, by examining harmonization pressures that exist in the status quo; second, by defining additional issues that could arise during negotiations.

This paper is organized in that way. First, it examines some of the economic and political pressures that currently operate to promote harmonization of Canadian and U.S. commercial policies with respect to both bilateral trade and their trade relations with third countries. Commercial policies include border measures, such as tariffs and quotas, and domestic policies that can operate as nontariff barriers. It then focuses on some of the issues that could arise from the negotiation of a comprehensive trade agreement between Canada and the United States. These issues include added harmonization pressures on tariffs and nontariff barriers; possible implications for the application of export controls; the possible development of common systems of contingent protection; and longer term strategic implications for the conduct of future Canadian trade policy.

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 non-tariff measures concluded during the Tokyo Round of multilateral trade negotiations.[1] These GATT agreements -- supplemented by other forums such as the Organization for Economic Cooperation and Development (OECD) -- provide the basic framework for the conduct of commercial relations between the two countries and for their commercial relations with third countries. The GATT framework provides rules and procedures governing tariffs and quotas, remedies against import competition; GATT rules also apply with varying degrees of effectiveness to nontariff measures, such 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 the 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. Similar concerns about the effects of import competition on labor intensive industries such as apparel and textiles and the impact on both of the GATT negotiating process account for this similarity in pattern.

GATT negotiations have influenced a pronounced convergence in each country's trade legislation which provides regulatory regimes to remedy injurious import competition with domestic industries. For example, after the Kennedy Round negotiations, Canada introduced the requirement that there be an injury finding before antidumping duties are imposed. The United States introduced the requirement for an injury finding before levying countervailing duties after the Tokyo Round.

There has also been a tendency to emulate each other's procedural protectionism. As Rodney Grey has argued, the process of codification of the import regulatory procedures of different countries may have made it more acceptable for countries to imitate protectionist features of the import regulatory systems of their trading partners.[2] Regardless of which of these two factors may explain the phenomenon, the import regulatory procedures of the United States and Canada have evolved into very similar systems.

The trade legislation in each country has two elements. The first consists of remedies including antidumping and countervailing duties and other remedies against practices such as copyright or patent infringement, that are intended to limit unfair trade practices. Both countries require 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 other element, sometimes referred to as the "escape clause" or as "safeguards", is intended to provide temporary relief to domestic industries who are suffering from surges in imports. If industries can demonstrate "serious injury" from imports -- which is 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

Although the GATT process has been more successful in negotiating limitations on the use of tariffs, than with domestic policies that may constitute nontariff barriers to trade rules nevertheless exist. The key GATT provision is Article III whereby signatories must grant national treatment to imported goods (treatment no less favorable than that accorded products which originate in the home country); for example, countries are not permitted to have discriminatory commodity taxes which may have protectionist effects similar to tariffs. Although the obligation to provide national treatment imposes constraints on domestic policies, 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 which may act as nontariff barriers to trade 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 effort to limit the potential effects of standards as nontariff barriers to trade, which build 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, that is, treatment no less favorable than products which originate in the home country. Thus, Canada can require bilingual labelling or have stricter safety standards for products than does the United States, as long as both domestic and imported goods are subject to the same requirements.

In addition to the mechanism of the Standards Code, there are continued efforts to achieve voluntary standardization of technical standards with respect to quality, performance, and safety of manufactured articles between Canada and the United States. Problem areas that remain include health and safety inspections, especially for food and agricultural products, and medical supplies.

Certification procedures and methods of testing products may create trade barriers for the export of manufactured products. Under the Standards Code, buyers of imported products are to be accorded ready access to procedures for testing and certification on conditions no less favorable than products of national origin or from another country. Nonetheless, problems still arise in areas such as in the acceptance of another country's test data. Regardless of whether an FTA agreement is negotiated, there is scope for more cooperation between Canada and the United States in accepting each other's test data.

Commercial Policies Towards Third Countries

At the present time, pressures exist to harmonize Canadian commercial policies for trade with 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 currently imposes restrictions on the export of technologically advanced or sensitive products as a result of Canadian participation in NATO commitments and monitoring processes. In addition to this consensus framework within NATO, there is the extraterritorial application of U.S. laws to U.S. multinational companies or subsidiaries, or their licencees operating in Canada.

Aside from national security objectives, pressures also exist for Canada to adopt U.S. trade policies in sectors characterized by managed trade. Recently Canada has acted to impose origin marking requirements on steel imported into Canada. The reason Canada has implemented this administrative requirement is to reassure the United States that offshore steel is not entering Canada and being processed or fabricated here for reshipment to the United States.

These examples are least suggestive of some of the pressures that currently operate to promote harmonization of Canadian with U.S. commercial policies. There can be no doubt, however, that Canada and the United States pursue their own separate commercial policy objectives, both in trade negotiations and the day-to-day administration and conduct of trade policy. A crucial question to be considered is how a comprehensive trade agreement between the two countries would alter their economic relations with third countries.

Effects of a Comprehensive Trade Agreement

For the purposes of this discussion, a comprehensive trade agreement is understood to mean the elimination of substantially all bilateral barriers to trade between Canada and the United States. Thus, such an arrangement would meet the formal requirements for a free trade

area (FTA) under GATT Article XXIV 8(b). Such an arrangement is quite distinct from any proposal for a customs union, which would involve common external commercial policies for both countries.

Each country would 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 an FTA would involve each country maintaining its own independent commercial policies and trade relations with third countries, there remains the question of whether such an arrangement 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 problem that might arise in a free trade area can be called "pass-through" trade. If there are substantial discrepancies in the level of protection afforded particular products in the member countries, then there is an incentive for third countries 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 would create pressues to harmonize the import barriers of members of the FTA. As a result, there could be a tendency for an FTA to eventually evolve into a customs union.

In principle at least, the problem of pass through trade can be solved relatively easily. When the particular product in question moves from the member of the FTA with the lower external barrier into the territory of the FTA member with the higher external barrier, then the difference in the tariff duties would simply have to be paid at that point. In fact as Ad paragraph 9 of Article XXIV points out this type of treatment would be required by Article I of the GATT.

The example of pass through trade does illustrate the general problem of what products qualify for duty free access between the members of the FTA. 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 disparity in import barriers when the product in question enters the other member country with the higher external duties.

Rules of Origin

To prevent these problems of trade deflection, virtually all free trade areas impose rules of origin criteria before products can qualify for duty free access under the terms of the FTA. These rules of origin criteria set minimum levels of value added by member countries according to the type of product involved. Thus primary products such as fresh fruit would simply 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 for FTA treatment.

The purpose of rules of origin is to avoid the need to have to harmonize import restrictions, but if the discrepancy in import barriers is very large then there might still be incentives for deflections of production. Deflection of production involves a significant relocation of production relative to that which would occur in the absence of the anomaly in external trade barriers. Such anomalies in external trade barriers can create an incentive to locate production in the country with the lowest import barriers in order to capture the benefits of the pass through effect.

At least in terms of average tariffs, the pattern of tariffs across industries is broadly similar in Canada and the United States (see Table 1). But, it may well be the case that particular features of the tariff structure as applied to particular products or production activities could create significant incentives for deflections of production.

Since production deflection 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, it is potential anomalies in the entire structure of effective protection between the two countries.

Effective Protection

The issue becomes one of differences in effective protection rates, not just nominal import barriers. Effective protection rates calculate the advantage afforded a particular production activity through a tariff on its output adjusted for the effects of tariffs upon its

inputs. The effects of a tariff upon the incentives to relocate a particular production process can greatly magnified by the interaction of input and output tariffs.

Consider the following examples. A manufacturing industry assembling a consumer durable has an output tariff of 10 percent. Compare the following two situations:

	No Input Tariff	Input Tariff of 10 percent
Price of Components on world markets.	$ 50.	$ 50.
Duty paid on components	0	$ 5.
Cost of inputs	$ 50.	$ 55.
Cost of Assembly	$ 55.	$ 55.
Total Cost	$105.	$110.

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 the case where the consumer product must pay an import duty of 10 percent on the input, the domestic manufacturer can have costs 10 percent higher than the foreign manufacturer and still be competitive in the domestic market. In the case where there is no import duty on the input, than the domestic manufacturer could have costs as high as $60 and still be competitive. In this latter case the domestic manufacturers cost of production could be as much as twenty percent higher than the foreign producer's cost.

The magnification of rates of effective protection 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 the 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 the foreign manufacturer. With no input tariff, the domestic firm can have costs of assembly as high as $38, or 27 percent higher than the foreign firm.

Consider the situation in a free trade area. Suppose both countries have the same tariff of 10 percent on the final good, but country A levies a tariff of 10 percent on the components, while country B does not. If the rule of origin criteria requires 50 percent value added then the manufacturer in country B can have assembly costs as high as $60 and still supply the product to country A. By comparision assembly costs in country A can be $55, while offshore producers will have costs of $50. Consequently, country B's costs can be 20 percent higher than those of offshore producers and up to 8 percent higher than the costs of domestic producers in country A, while remaining competitive in the domestic market and exporting to country A.

If the rule of origin criteria is 30 percent then the discrepancy in costs of production within the FTA can potentially be greater. In the situation just described -- where Country A has an input tariff of 10 percent while Country B has no input tariff, country B's costs could be $38 compared to $33 Country A and $30 in third countries. Thus country B's costs could be 15 percent higher than producers in country A and still remain competitive.

Of course if the input tariff, as well as the output tariff is the same in both countries then there would be no difference in the rates of effective protection for manufacturers in either country. When both input and output tariffs are similar (and in particular when input

tariffs are low or zero in both countries) then there will be no trade deflection even with a low value added requirement in the rules of origin.

The issue is whether the quantitative discrepancy in effective protection rates across different economic activities is sufficient to distort significantly the incentives to locate the production in Canada or the United States. If the discrepancy in effective protection rates is low then very liberal rules of origin could be implemented.

Duty Drawback

A related issue to the criteria for rules of origin is the question of whether duty drawback provisions are applied to trade between the FTA partners. The rationale for duty drawback is that by remitting duties on imported components when products incorporated the components are exported, drawback permits an exporter to have costs that more closely correspond to world prices. In this context duty drawback is not an export subsidy but is simply removing an impediment to trade. Following this reasoning, the drawback of duties on imported components is excluded from the illustrative list of export subsidies included in the Subsidies Code.

The effects of duty drawback are potentially different within a free trade area. Under these circumstances the application of duty drawback on imports from third countries could be perceived as having the effect of an export subsidy into other FTA members. Thus, duty drawback provisions within the FTA could substantially increase the potential for deflections of production. In effect duty drawback provisions imply that input tariffs will be zero for export industries. There is a tradeoff between having relatively liberal rules of origin criteria and permitting duty drawback.[3]

Of course domestic producers of raw materials or components may resist the application of duty drawback within the free trade area for reasons other than efficiency objectives. The application of duty drawback in conjunction with an FTA 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 there are combinations of both quotas and tarriffs applied to particular products. In sectors like textiles or apparel, 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 sectors such as textiles and clothing.) 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 the potential deflection of production. Imposing stricter rules of origin upon sectors characterized by managed trade, could help resolve these difficulties.

Administration of Rules of Origin

The administration of any system of rules of origin will require coordination of customs administrations in both countries and the retention of customs points between Canada and the United States. Although any system of rules of origin will impose a compliance burden upon firms, a system analogous to that used by EFTA is likely to be less costly to administer, then a more cumbersome and complicated system similar to that used in the agreements between the European Community and the former EFTA countries.[4]

In this discussion we have been examining the basic mechanics of commercial policy in a free trade area and considering some of the possible effects of the basic rules, upon the administration of import controls. Issues also arise in administration of export controls.

Export Controls

We have already discussed the issues associated with export controls applied to technology related goods and services. Although national security considerations seem likely to loom large in the years ahead, it is difficult to see how a comprehensive trade agreement between the United States and Canada will have any substantial effect on what is likely to be a difficult and contentious set of issues between the two countries.

Other types of export controls will raise particular issues in the context of a comprehensive agreement. The first and most important question is whether each country would retain the right to export

controls over resource products. At the present time the GATT is remarkably silent on the question of export controls.[5] At the present time, neither country has obligations to the other with respect to export controls on raw materials or other basic products.

There are two sorts of issues that arise in the application of export controls to resource products. One issues involves the problem of emergencies or supply disruptions. The other problem involves a more permanent concern about the use of resource pricing as an instrument of industrial policy.

Although there might be some divergence of view, between the United States and Canada on the applicability of export controls in emergencies, it is likely that these divergent views could be reconciled.

Much more contentious is the issue of permanent export controls on primary resource products. Canadians perceive this as an essential element of their sovereignty in order to protect their ability to manage their resource base. Americans perceive any disparities between domestic and world resource prices as 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 tenure or management policies between the two countries, if the primary resource product can trade freely between them, then little or no advantage will be conveyed to the processing industries except for modest differences in transport costs.

There are some problems that must be considered if bilateral export controls are to be removed. 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 Canada-U.S. border does occur on an arms length basis. Third, the obligations should be reciprocal.

Although these concerns could be easily remedied or addressed in a bilateral arrangement, some 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, allowing free trade in logs between the two countries would likely have negligable economic affects, but would deflect many of the allegations by U.S. producers that Canadian sawmills or pulp mills 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 the free trade in logs between the two countries — Canada and the United States — creates the potential for logs to flow out of Canada into the United States and then perhaps be re-exported to Japan. This problem is analogous to the problem of pass through trade with imports discussed above. Freer bilateral trade between Canada and the United States could allow Japanese purchasers of logs to circumvent Canadian export controls.

In principle this 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 import control regimes.

Contingent Protection

There are two questions about contingent protection in any comprehensive trade arrangement between Canada and the United States. The first question would be whether there was any additional limitations upon or perhaps bilateral exemption from the application of contingent protection mechanisms. The second question is 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 at customs points between the two countries and the same administrative arrangements involving rules of origin would apply to goods that were subject to anti-dumping and countervailing duties or other contingent protection remedies. Thus, even if there was bilateral exemptions in the application of contingent protection devices, each country could still retain separate external systems. Not only would it not be necessary for Canada and the United States to merge their contingent protection regulatory apparatus for dealing with third countries, it is very unlikely that either would ever want to do so.

The Conduct of Trade Negotiations

An essential feature of a comprehensive trade agreement of the free trade area type 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 which 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 the locus of tariff negotiations would shift for Canada. Other countries would now become the principal suppliers of products which were previously the focus of Canadian-U.S. negotiations. Thus Canada could then focus its tariff negotiating strategy upon its trade with these other countries.

The general situation would be analagous to that which prevailed on tariff negotiations with respect to automobiles during the Tokyo Round. The United States was 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 principle focus of negotiations with respect to the automotive tarriff was with other countries, notably Japan. Since Canada would no longer be

conducting its principal tariff negotiation with the United States and then making this tariff offer available to other countries under the GATT Most Favored Nation (MFN) rule, the effect could be to enhance Canada's negotiating leverage in tariff negotiations with third countries.

Either Canada or the United States might attempt to exert subtle influence over the other country's tariff negotiations. Canada might lobby the United States to retain particular U.S. tariff barriers which have the effect of creating preferential treatment to Canadian producers who would have duty-free access under the FTA. At the same time 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 would likely 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 the United States and Canada. One result of this process would be that the margins of preference that each would have into the other market under the FTA agreement, would progressively be reduced. Although the margins of preference would be reduced, the direct improvements in access achieved on a bilateral basis would not be eroded through subsequent negotiations with third countries with either country.

The situation with an FTA would be quite different than that which characterized the bilateral reciprocal arrangements during the nineteenth century. Under those types of bilateral agreements an improvement in bilateral access that was obtained under a particular

treaty could subsequently be completely dissipated as a result of trade negotiations of one of the parties with a third country. The reason that impairment of bilateral market access could occur was that tariffs with a third country might be reduced below those available to the country party 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 free trade area agreements was recently considered by U.S. Secretary of State, George Schultz:

> 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. [6]

Elaborating on this theme, the Report of 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...."[7] The Council argues that the preferred access available to members of a 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. Threatened protectionist

measures would impose costs on the home country, and thus the threats lack credibility. Furthermore, if the threats were implemented this would invite retaliation.[8]

Conclusion

The essential feature of a free trade area 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.[9]

This discussion of some of the effects of a free trade area upon trade flows suggests two quite contradictory influences upon commercial policy of the member countries. On the one hand, one member of the FTA is likely to urge the other member to harmonize its external commercial policies to prevent increases in trade deflection or trade diversions. In part this problem could be solved by the rules of origin criteria. However, there may be significant enough discrepancies in import barriers given the structure of effective protection in the two countries, that

incentives for deflections of production would remain. Indeed, far from harmonizing their external trade barriers, members of the FTA may attempt to tinker with their import barriers to inputs in a way that will promote deflections of production and will use their external trade barriers as bargaining chips in multilateral trade negotiations.

Of course, 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, however, to support the contention that an FTA will inevitably 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 will eventually result in a free trade area involving most of the OECD countries.[10]

The negotiation of an FTA agreement between Canada and the United States could contribute to this process. The specific concern that an FTA agreement will imply that Canada will need to harmonize its commercial policies with U.S. policies for trade with third countries can be addressed in the negotiations. The problem can be largely avoided by careful negotiation of rules of origin criteria. There may be particular administrative difficulties posed by sectors characterized by managed trade or if export controls are brought within the scope of the bilateral agreement.

NOTES

1. The five new agreements on non-tariff 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 Intenational Economics, 1983), p.248.

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

4. See the EC 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).

5. C.F. Bergsten, Completing the GATT: Toward New International Rules to Govern Export Controls, (Washington: British North American Committee, 1974).

6. G. Schultz, "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.

7. 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.

8. Ibid.

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

10. 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.

Potential Implications of Canadian-U.S. Trade Negotiations for Canadian Cultural-Support Policies

Steven Globerman

Simon Fraser University

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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?

- 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 "tradeable" 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).

Fiscal Policy Harmonization and Negotiation of a Free-Trade Area

Donald J.S. Brean

Institute for Policy Analysis

University of Toronto

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Introduction

The proposed comprehensive Canadian-U.S. trade agreement is the latest step in an ongoing process of international economic integration. Rapid structural change and expansion of trade and investment have been spurred by advances in communications and transportation technology, better management, and declining trade barriers. But once the primary steps have been taken toward liberalization of markets, progress to remove restrictions -- such as those posed by the existing international system of taxation -- weighs all the more heavily.

Sovereign countries design their own tax systems. They choose a tax base that includes one income or a combination of incomes, expenditures, value-added or sales-tax rates, and policies to influence the mix of private- and public-sector activities. But in an integrated world economy, national tax policies are no longer made in isolation. They affect international trade and competitiveness through subsidies and preferences given to industry. Tariffs and customs duties are examples of taxes with international impact; so are taxes on international foreign investment and professional incomes earned abroad. Overlapping or conflicting fiscal and tax policies in different nations have implications for economic efficiency, for the effectiveness of tax policies, and for the gains to be realized from international integration.

As one might expect, therefore, consideration of a free-trade area (FTA) between Canada and the United States raises important questions about whether such an arrangement would bring the tax systems in the two countries into conflict and, therefore, whether it would create harmonization pressures. The purpose of this paper is to identify the harmonization pressures that already exist in the status quo, and to distinguish how such pressures might be altered by further movement towards freer bilateral trade.

We first outline the basic principles of fiscal coordination in today's international economy. We then examine how trade negotiations might affect existing pressures to harmonize indirect and direct taxes. (Indirect taxes are excise and other taxes consumers pay, while direct taxes are those levied on individual and corporate incomes, royalties, and fees levied on producers.) We conclude that although targeted tax incentives and subsidies are likely to be contentious issues in negotiations, the more important influence on tax systems in the two countries will be the recently agreed bilateral tax treaty.

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.

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.[3] 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.

Frequently, however, concerns are expressed that comprehensive harmonization of tax policies and social programs will be required in negotiating an FTA. Such is not the case. The reason is that these concerns are based on an erroneous perception that, for example, a higher average corporate-tax rate, or a higher social-security tax for workers' compensation or unemployment insurance, or a difference in wages or interest rates creates a permanent competitive disadvantage in both domestic and foreign markets for producers in one of the trading countries. The same misperception also leads to the conclusion that differences in the general level of taxes, social-security charges for unemployment insurance and workers' compensation, and other business costs lead to competitive distortions in an FTA and thus require harmonization before an FTA can promote economic efficiency. The true source of trade distortion, however, is differentials in the incidence of fiscal costs and benefits on goods and the services of capital and labor that actually are traded. Only those policies that cause substantially more or less burden than the average burden of taxation on traded goods should be the focus of concern. Fiscal harmonization addresses cases in which the incidence of domestic fiscal and other policies deviates from the norm for most 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.

Debate on "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, its effect will be absorbed in the exchange rate. However, a tax that is specific to a particular good — tradable or nontradable — or even to a factor of production — which is the case for most direct taxes — potentially will distort trade. Trade is motivated by anything that causes 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 as general as possible so as not to distort relative domestic prices. Direct and indirect taxes are also capable of creating tax wedges — artificial disparities in relative commodity prices — and, hence, 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.[4] 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.[5]

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 justified if taxes on goods and services are used to finance general government services that provide directly consumable benefits and local public goods, rather than reduced production costs that would benefit 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 not justified 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, 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. If, therefore, the origin principle is applied to goods and services, these 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 between countries in rates of tax are absorbed by producers. The origin principle, therefore, is justified 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.

The question of whether a destination-principle system or an origin-principle system is less trade distorting depends essentially on the nature of the government expenditures that indirect taxes finance. If the public expenditures are for directly consumable benefits, the destination principle produces a neutral effect; if the expenditures reduce private-production costs, the origin principle produces a neutral effect.

The relative merits of the origin and destination principles with respect to western European integration were examined in The Tinbergen Report.[6] It concluded that if indirect taxes are applied across the board at the same rate to all industries, and if complications raised by nonmerchandise payments and trade with third countries are ignored, then there is no economic difference between results under the origin principle and those under the destination principle.

This conclusion relies on the exchange rate as the adjustment mechanism, and can be illustrated as follows. Suppose a country replaces a

general indirect tax of, say, 10 percent imposed on the destination principle with a 10 percent tax on the origin principle. An immediate result is that exports in terms of that country's currency rise in price, causing an unfavorable shift in its balance of payments. With a flexible exchange rate, this pressure leads to a fall in the price of the country's currency in foreign-exchange markets — that is, currency depreciation. With a shift of a uniform 10 percent tax from the destination to the origin basis, a 10 percent currency depreciation will restore trade balance. The 10 percent depreciation offsets the 10 percent tax on exports and compensates the elimination of the 10 percent tax on imports; the tax-inclusive price of exported goods will be unchanged to foreigners, and imports will be unchanged in price to domestic purchasers.

In this example, one country is assumed to have shifted unilaterally from the destination to the origin principle. But to ensure allocative neutrality, it is not essential for all trading partners to switch from one principle to the other simultaneously, provided that exchange rates are flexible. Nor is it necessary for countries to apply all general taxes on one single principle; some general taxes may be applied on the origin principle while others are applied on the destination basis.

In North America, indirect taxes are, in large part, 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 will, in general, facilitate indirect tax harmonization, at least insofar as these are provincial or state levies.[7]

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. Accurate accounting is made difficult because of the problem of assigning indirect taxes on output and also because of a degree of 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 will give rise to accounting errors in all four forms. If the system of adjustments is properly designed, errors will be random, -- that is, they will neither penalize nor favor trade in one direction. 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.[8] 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-adjustment) 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. A more accurate view would be that Canada was taxing domestic consumption of wheat.[9]

In the next section, we briefly consider an important indirect tax that appears to violate most principles of neutrality and, thus, is an exceptional case requiring especially close scrutiny in tax-harmonization negotiations. Such negotiations are likely to occur, whether or not there are trade negotiations, but some issues might become more urgent. As one analyst stated in his study of tax harmonization within an FTA:

> It may be concluded that the tax-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."[10]

The Federal Manufacturers' Sales Tax

The federal manufacturers' sales tax, long recognized as a distorting tax within Canada, would cause two problems in negotiating an FTA. First, determining the correct (destination principle) border-tax adjustment would be difficult; 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 and, with some alterations, the tax has been in effect ever since. Collected at the manufacturers' level, it is one of the most-"hidden" federal taxes.[11] 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.[12]

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.

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 are thus relevant here.[13]

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 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.

Direct taxes are levied on the income of factors of production, unlike indirect taxes, which are levied on units of output or consumption. This distinction has become blurred, because when the effects are fully traced through an economy, direct as well as indirect taxes can be shifted either forward, to consumers, or backward, to producers, in a closed economy. 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, whereas 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, at least under the foreign-tax-credit arrangement. 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 programs 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 programs serves as an important, implicit constraint on national policies.[14]

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.[15] 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.[16] 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.[17] 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 General Agreement on Tariffs and Trade (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.[18] 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 that extent 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.[19] 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 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.[20] 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.[21]

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.

What makes U.S. attempts to reduce the use of subsidies in international commerce difficult to accept is the uniquely U.S. invention of the DISC or, in its latest incarnation, the Foreign Sales Corporation (FSC).[22] This tax-based export subsidy appears to have no direct parallel in any other industrial country. In effect, it amounts to an application 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. 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.[23]

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.[24]

Canadian-U.S. Tax Coordination: The New Treaty[25]

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.[26] 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 purposes are both to preserve the integrity of the domestic-tax system and to reconcile that system with different systems of other countries. 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 tax negotiations appears largely to have been shaped by its position as a significant importer of foreign capital. Consequently, Canadian tax negotiators have sought to safeguard Canada's revenue position and to strengthen domestic ownership.[27] 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.[28]

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.[29] 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.[30]

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".[31] 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.[32] 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."[33] 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.[34]

As in all bargaining situations, at the apparent end of the tortuous and prolonged negotiations in 1980, both sides no doubt felt they had "lost" in some respects and "won" in others but that, on the whole, they could live with the results. Why, then, was the treaty slow to be ratified? The original reasons for delaying ratification largely were not tax issues as such but, rather, such fundamentally extraneous matters as a dispute about fisheries -- the resolution of which was linked to ratification of the treaty by the U.S. Senate -- as well as the more closely related dispute on border broadcasting.[35] The U.S. political system, with its requirement for Senate approval of treaties, almost invariably results in delays of this sort as hard-won international agreements are reargued in terms of U.S. domestic political concerns, often by dragging in technically irrelevant "linkage" arguments. By now, all countries seem to recognize this fact of life in dealing with the United States.

The willingness of countries to restrict their tax jurisdiction by treaty essentially depends upon the reciprocal nature of the agreement and their desire to encourage international investment. When investment flows between countries are approximately equal, or when there is a strong desire to encourage the free movement of capital, there is a strong incentive to negotiate tax treaties. The less these conditions hold, the less strong the incentive to make a deal. In the case of Canada and the United States, the volume of trade and investment flows in effect required an international tax convention to provide a certain degree of stability to these important external relations. The lesser importance of these flows to the United States

than to Canada perhaps was offset partly by the traditionally greater desire on the part of the United States to encourage international capital flows. Canada is more dependent on such flows but, for that very reason, perhaps, is more ambivalent about them.[36] The basic imbalance in the positions of the two countries makes an acceptable division of tax bases and agreement on general rules particularly difficult, however, so it is hardly surprising that it took so long to reach even the present compromise.

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.[37] These problems are subjects of current attention of policymakers, practitioners, and analysts of international tax matters.[38]

Confrontation or Cooperation?

The positions of Canada and the United States differ with respect to international taxation in their attitudes, perceptions, and realities. The basic differences in the two countries' positions arise from distinct economic -- and to some extent, ideological -- circumstances.

Canada's traditional attitude has been that it is fundamentally a relatively small, capital-importing country, which, above all, must fight in international negotiations to maintain its right to tap the profits of foreign investors in Canada and to encourage investment by Canadians in Canada. For its part, the United States has seen itself as a major capital exporter, which can only gain by furthering the international flow of capital. To some

extent, the United States has also apparently seen itself as the "tax policeman" of the world, in the sense that, at times, it has attempted to export its domestic notions of fiscal rectitude to other countries. In short, while Canada's attitude toward international tax negotiations traditionally has been defensive and inward looking, the United States' attitude traditionally has been outward looking.

There appears to be a shared perception in both countries that each has tax measures favoring particular business groups in the interests of the one country and measures penalizing business groups against the interests of the other country. The United States, for example, through its DISC program, has attempted to favor U.S. exporters, thus offsetting what it considers to be the disadvantage suffered by this group as a result of certain features of the tax system in other countries. Similarly, Canadian nationalists have long urged increased discrimination in favor of Canadian -- that is, against foreign (U.S.) -- investors in various industries, particularly natural resource industries. Nationalists thus perceive measures favoring Canadian industry -- or at least some of it -- as favoring Canada, just as U.S. business groups see measures favoring U.S. business -- or some of it -- as favoring the United States. Both countries, therefore, have spent a lot of time and effort in attempting to offset foreign measures in support of their own interests, and in arguing in international negotiations against other countries' measures.

As might be expected, the great difference in the economic and political weight of the two countries has meant that the United States has been more successful in its efforts that has Canada. Canada has been surprisingly effective in the tax field, however, in maintaining a degree of favoritism for domestic residents through such measures as its small-business deduction and the Canadians-only dividend credit. The stubborn U.S. defense,

first, of the DISC and now, of the FSC illustrates the same forces at work in a different political context. The perception in both countries of what is in the national interest -- more U.S. exports, more Canadian domestically owned investment -- has thus been clearly manifested both in domestic tax policy and in the attitudes to international tax issues discussed above.

On yet another level, however, the reality appears to be quite different from the perceptions underlying policy. For example, the United States may make gains from the distorting impact of taxes on capital, since these taxes favorably affect the United States' terms of trade; yet, these are often deplored by business. At the same time, it appears to be a net loser through the DISC program, a favorite of business. In Canada, while much less work has been done on these matters, the indications are that Canadians gain less than they think from such measures as the interest-withholding tax and have little or nothing to gain from export subsidies.[39]

Economists have discovered that in economies that are open to the winds of international competition, the corporate tax on domestic-capital income fortuitously improves that nation's terms of trade. In a bilateral context, the corporate-tax differential is the important factor. Under certain conditions, the improvement in terms of trade is sufficient to induce gains from trade that exceed the domestic efficiency loss -- resulting from misallocation of domestic resources -- due to the corporate tax. The conclusion appears to be valid both for large nations such as the United States and, with some reservation, for smaller ones such as Canada.[40] Thus, in a sense, the taxation of internationally mobile capital causes the burden of the corporate tax to be exported as taxed capital migrates to higher, after-tax returns abroad and stops the exodus when international after-tax yields are equal.

In the past, Canada probably has gained substantially from the export of U.S. capital as a result of such basic U.S. tax provisions as deferral and the positive Canadian-U.S. corporate-tax differential, while it presumably has lost from the terms-of-trade effect of the relatively high level of U.S. corporate-tax rates. On the trade front, therefore, Canada appears likely to benefit -- through improved terms of trade -- from the recent steady decline of U.S. corporate-tax rates and the rise of subsidized U.S. exports. With respect to capital flows, however, the reduction in U.S. tax rates inevitably favors the export of capital from Canada, as has indeed been occurring.

In the end, arguments such as these come down to the basic fact that in the world of international trade and factor flows, the United States remains a pricemaker, while Canada undoubtedly is a pricetaker. A small country such as Canada is, in general, well advised not to attempt to tax international capital flows much, since by so doing it will tend to penalize the less-mobile factors in its own country, rather than to reap any national, or sectoral, gain. Since Canada has recently become a substantial net exporter of capital, however, the time is perhaps right for yet another reconsideration of Canadian-U.S. tax relations.

Although the reality of the basic asymmetry in the position of the two countries has not altered, perhaps another decade of treaty negotiation would lead to quite different conclusions than the recently agreed convention. In particular, since neither Canada nor the United States exists in the world alone, both countries perhaps would be well advised to consider much more carefully the desirability of a joint, or even multilateral, approach to international tax negotiations as a whole. Canadian-U.S. tax relations must be considered in the context of the relatively integrated nature of the world capital market. Inevitably, this will lead to a tendency toward a lowest common rate of taxation on capital to become the effective

rate as time goes on.[41] In addition to their possible common interest in this respect, Canada at least has a strong interest in working as much as possible with, rather than against, the United States in developing compatible approaches to accommodate, rather than to deny, changes in the international economic environment. Finally, since both countries have very similar problems with respect to the international impact of developing divergencies in the tax and subsidy policies of state and provincial governments, there might also be considerable room for fruitful joint discussions on common approaches to this area.

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 were 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.[42]

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.

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. Johnson, p. 7.

4. 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.

5. 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.

6. European Coal and Steel Community, Report on the Problems Raised by Different Turnover-Tax Systems Applied Within the Common Market (Luxembourg, 1953). See also C. Shoup, ed., Fiscal Harmonization in Common Markets (New York: Columbia University Press, 1967).

7. 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.

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

9. W.R. Thirsk, "Should Taxes Be Included in Trade Agreements?" (Ontario Economic Council, Toronto, May 1985, Mimeographed).

10. Shibata, "Fiscal Harmonization under Freer Trade," p. 88.

11. 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.

12. 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.

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

14. 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, 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. Brean, International Issues in Taxation: The Canadian Perspective, Canadian Tax Paper no. 75 (Toronto: Canadian Tax Foundation, 1984).

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

16. These points are developed at greater length in Thirsk, "Should Taxes Be Included in Trade Agreements?"

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

18. Brean, International Issues in Taxation, Chapter 3.

19. 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.

20. See Thirsk, "Should Taxes Be Included in Trade Agreements?"

21. 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).

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

23. 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 Economics, St. Catharines, Ont., 1983 Mimeographed).

24. 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 8, for a useful guide to this exercise.

25. This section closely follows Bird and Brean, "Canada-U.S. Tax Relations."

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

27. 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.

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

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

30. 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.

31. 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.

32. 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.

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

34. 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.

35. R.D. Brown, "The United States Turns the Heat on the Canada-U.S. Tax Treaty and Canadian Tax Planners," Canadian Tax Journal 30 (September-October 1982): 716-27.

36. As Alan Short has said, "Canada is a country which on Mondays, Wednesdays, and Fridays is very concerned with the degree of foreign ownership and on Tuesdays and Thursdays welcomes the amount of foreign investment we need" (Report of Proceedings of the Thirty-Second Tax Conference, p. 412).

37. D. Brean and R.M. Bird, "The Unitary Tax Debate" (University of Toronto, Institute for Policy Analysis, Toronto 1985, Mimeographed); D. Brean, "The Relevance of Canadian Tax Rates for Foreign Investment in Canada"

(Economic Council of Canada, Ottawa, 19--, 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.

38. Brean, International Issues in Taxation, Chapter 10.

39. D. Brean, "International Portfolio Capital: The Wedge of the Withholding Tax," National Tax Journal 37 (June 1984): 239-47.

40. See J. Whalley, "Discriminating Features of Domestic Factor Tax Systems"; and W.R. Thirsk, "The Welfare Cost of Corporate Taxation in Canada" (Paper presented to the Canadian Economics Association, Vancouver, June 1983).

41. See R. Bird, 1975.

42. Thirsk, "Should Taxes Be Included in Trade Agreements?" p. 15.

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

by Richard R. Barichello

University of British Columbia

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Contents

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. 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 -- all of which often 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, except for tax expenditures, documents most of the elements of support for agriculture, 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 and 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. In other words, once market access is achieved through liberalized border controls, the principle of a level playing field is only relevant to traded products -- that is, with respect to explicit or implicit export subsidies. Reduced income to efficient producers would not change production or supply conditions at the margin and, therefore, would not change competitive advantage or trade flows.

Let us now examine existing protectionist measures in the major agricultural sectors and assess how FTA negotiations might require Canada to make policy 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 commonlyheld 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 because marketing boards are the primary form of policy intervention in this sector. Supply-management regimes would be unable to preserve price differentials exceeding usual transportation costs, and it would no longer be in the interest of the boards or of Canadian producers to restrict Canadian production. 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. The value of production quotas would vanish.

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 quite possible, and rather ironic, that a move to free trade within Canada could provoke more farm-level resource movements and adjustments 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 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. There is, however, 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 are able to purchase quotas in the major and competitive producing provinces and whose unit costs are 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 mostly debt-financed quota purchases.

Second, there are those farmers who, while not buying quotas, are able to maintain their productivity increases 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 older, who do not purchase quotas, 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 for which he has chosen to accept a lower-than-normal return. For example, a farmer who received a 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 a 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 determining the adjustments poultry and egg farmers would face if production quotas were removed. 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 increases, and quota purchasers typically time their purchases over a number of years.

Second, farmers treat a quota investment as a very risky undertaking. There are high risks of default, of changes in marketing board policy, or that trade will be liberalized; each risk eliminates or reduces the stream of rents received. As a result, rents from the quota are heavily discounted by purchasers to the equivalent of a payback period of three or four years. With such a rapid payback period, these purchasers are unlikely to suffer financially as long as an appropriate adjustment period to free trade is incorporated in the negotiations.[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 entry and exit by many farmers. 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, there are no persuasive 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 prohibited by the United States on each liter of import, and a surcharge.

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 -- 20-40 percent, depending on the region. In the United States, the current regional pattern of fuild-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 even small volumes of cross-border trade.

The most difficult problem that an open border would create is what to do about possible production surpluses. The only solution that appears 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. To judge from quota values in Ontario, Quebec, and British Columbia, farmers who purchase quotas would still be very 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, as in the case of poultry and egg producers, it is possible that at current exchange rates they could achieve some net exports to the U.S. market.

If each country were to continue to follow its current surplus policies — quotas in Canada, government purchases in the United States — at the same time that the border was opened up, some arbitrary decisions on market sharing between the two United States 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 an 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 would necessarily 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 financial power of the U.S. government would likely dominate decisions.

If the former option were followed, a removal of Canadian industrial-milk quotas likely would require elimination of the federal direct subsidy on industrial milk. In addition, Canadian support prices for butter and skim-milk powder would have to be comparable to those in the United States.

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 on 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, 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). 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 to 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 due to the widespread anticipation of this risk in milk-quota markets, this problem would be manageable and compensation for these particular producers would not be necessary given 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, much as one finds 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 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, net exports to the United States are a possibility -- 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, perhaps as much as $1.5 billion in fluid-milk quotas and $3.7 billion in industrial-milk quotas. 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 might be necessary for political reasons. But because of the large risk premium embodied in quota prices, there is no strong economic reason why recent quota purchasers should be singled out for these payments as long as a reasonable adjustment period is included.

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. More important, however, are particular features of Canadian policies and institutional arrangements. The main elements of Canadian policy that are relevant here are:

- o import controls that restrict access of U.S. grains to Canadian markets -- thus permitting the Canadian Wheat Board (CWB) to charge higher domestic prices -- or to the Canadian marketing 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 U.S. grain; 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 only slightly higher in Canada.[17] Harmonization issues relate more to Canadian import controls, CWB powers and, to a lesser extent, subsidized freight rates and the nature of each country's stabilization or price-support programs.

On Canadian import controls, the United States will press for open-border access. Such access not only would remove the price-discrimination option of setting domestic selling prices higher than export prices, but also would allow entry of lower-quality U.S. semidwarf wheat varieties. Many believe that this would jeopardize Canada's grain-licensing system, the ability to guarantee high-quality wheat abroad, and the consequent quality premium in price.[18]

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 would likely object to this U.S. access. A possible response could be to eliminate freight subsidies for 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 would reduce the world price in years when U.S. government-support purchases would be made. 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. This could include reductions in U.S. trigger prices, and although the U.S. grain sector would still 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 modest 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 inability to price domestically used wheat above world prices would be

lost, reducing average producer prices modestly. Second, 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 perhaps outweigh -- revenue losses. This change would make lower-quality U.S. flour available to the Canadian baking industry, despite the current lack of Canadian milling capacity for these wheats. Moreover, there could be some adjustment difficulties for the baking and milling industries in the process of accommodating lower-quality wheats.

It is doubtful that with an open border, the CWB could enforce its single-seller role for export grains. Grains 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. The implications of such an institutional change are beyond the scope of this paper, but it would be perceived, particularly on the Prairies, as a major policy change.

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.

Finally, there is the issue of subsidized freight rates. As already noted, there will be pressure to remove this subsidy under the Western Grain Transportation Act for U.S.-destined grains and oilseeds. More importantly, however, 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 for U.S. grain. The obvious solution would be to pay the freight subsidy directly to the farmers instead of to the railways, and to allow the railways to charge compensatory rates. However, this form of payment would invite U.S. charges that the subsidy constituted an unfair advantage. There would be consequent pressures for removal or reduction of the subsidy, to be weighed against Canadian claims for reduced U.S. protection -- from price supports, for example.

Feed Freight Assistance would also be under U.S. pressure for removal. If this happened, feed-grain-deficit regions such as Eastern Canada likely would be supplied more by U.S. feed grains, and Prairie barley would be sold off shore.

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 lower-quality wheats into the Canadian system and by removing the export-sales monopoly of the Canadian Wheat Board. Even if the CWB were maintained, the quality premium for Canadian export wheats would be at risk, two-priced wheat would not be possible, and freight-rate subsidies on U.S.-bound grains and oilseeds might be removed. There also would be the prospect of more significant changes in freight subsidies under the Western Grain Transportation Act and Feed Freight Assistance might be removed. An increase in local cross-border trade in these products could be expected, including feed grains being imported in Eastern Canada. U.S. policies also could change, in the direction of smaller deficiency payments, smaller government grain purchases, and some reduction in average world grain prices.

For all these prospective changes that an FTA would bring to the grains and oilseeds sector, it would do little 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' market 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, subject to provincial agreement. Because it features a strong market orientation, provides no payment on export production, 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 province 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 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 would increase trade in feeder cattle and calves and decrease Canada's imports of live slaughter cattle. Feeder-cattle movements would become more north-south than east-west, and the cattle-feeding industry likely would increase in both Eastern and Western Canada. There is also the possibility that greater animal-health risks would be incurred in Canada. The impact of these changes on pork and hogs is not significant.

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 what kinds of stabilization policies are mutually acceptable. 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 should find the proposed federal stabilization policy for hogs and cattle to be acceptable because it appears to provide only market-oriented floor prices below equilibrium levels. Although it raises average returns and reduces risks, it is also partly producer financed, it provides payment for domestic production only, and it is a policy direction increasingly sought by the U.S. administration, which is trying to move away from current support prices. The debate is likely to hinge on objective measures to distinguish between acceptable -- that is, not counteravailable -- "stabilization" and unacceptable "support".

Finally, the important benefit to Canada of an FTA that includes red meats is that it would reduce present uncertainties regarding access to the U.S. market. Such an agreement largely would 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.

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. 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 10 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 purchase), and subsidies for storage construction projects. Provincial government stabilization programs provide additional subsidy support.

The major 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, many fruits and vegetables in the United States are grown with government-supplied irrigation water sold at rates much below market prices. These measures rarely turn up in the public accounts because the water systems typically were built years ago, 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 remaining, while provincial stabilization schemes could attract considerable 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, Canada has demonstrated sufficient comparative advantage to benefit from an open border. In fact, as

in red meats, the small-fruits sector has much to gain in security of market access by reducing the risk of U.S. contingent-protection measures 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, expansions of scale, and expansions 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 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 expect an FTA to reduce 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 through the large U.S. and British tobacco companies. Tobacco imports into Canada are subject to a moderate tariff -- about 9 percent in 1982 -- 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 have relatively small effects, although it would forestall the 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. 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, the federal government tried unsuccessfully to persuade the provinces to observe its obligation under the code on government procurement.

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. This is relevant not only to calculating the net benefits from freer bilateral trade but also in anticipating the industries and firms that are likely to express strong opposition to freer trade. It is also likely that a number of provincial governments would come strongly to the defense of threatened local processing firms. But some processing firms now must pay higher product prices than would be the case with an open border, and removal of this "negative protection" could stimulate Canadian food-processing competitiveness.

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 or 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. Despite similar objectives, however, different policy instruments have been used to achieve them. A better understanding of why this is so would shed much light on harmonization issues. Careful negotiations might permit both countries to pursue objectives such as farm-income support through the use of instruments that are less disruptive of agricultural trade.

A bilateral trade agreement could subject the structure, policies, and institutions of Canadian agriculture to some change. All sectors would certainly 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 fruits and vegetables sectors. Clear gains would be likely only for beef, hogs, and small fruits, which 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.

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 and for the Canadian economy at large. By focusing on adjustment costs and on disadvantages from reducing the rents farmers receive and from changing the status quo, we have mentioned only briefly the new opportunities that might arise from freer trade. Yet, a market ten times that of Canada could become more accessible, and many Canadian agricultural regions are well located to serve the large U.S. population. 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. However, specific possibilities, like most new growth opportunities, are almost impossible to predict.

Many Canadian farmers are in a position to expand if domestic-production restrictions as well as interprovincial and bilateral trade barriers are removed. Many of the adjustment pressures Canadian farmers would experience, however, would come from the removal of interprovincial barriers, rather than from a trade agreement with the United States.

Farm producers also could experience adjustment difficulties resulting from price declines in dairy, poultry and eggs, vegetables, and grains. But large consumer benefits must be considered as well. With perhaps the exception 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 could 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 some evidence, chicken exports would also 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 linear 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 adjustment process would more than compensate quota purchasers, given such a payback period.

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

16. Kapitany and Bollman.

17. C. Carter, M. Glen, and 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. These concerns may be valid, but they raise two additional questions. First, is it clear that the price-premium gains under current policy outweigh the yield advantages from lower-quality wheats? Some suggest the reverse. Secondly, given current technology, is visual inspection the only reasonable way to determine wheat quality?

19. Menzie and Prentice.