

Canada- United States Relations

VOLUME III Canada's Trade Relations with the United States

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THE STANDING SENATE COMMITTEE ON FOREIGN AFFAIRS

Chairman: The Honourable George C. van Roggen

Deputy Chairman: The Honourable Martial Asselin, P.C.

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March 1982

8/1001

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Relations

VOLUME III
Canada's Trade Relations
with the United States

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Cat. No. YC 23-321/1-01-3E

ISBN 0-662-11988-6

*On peut se procurer des exemplaires, en français, du présent rapport auprès
du greffier du Comité sénatorial permanent des Affaires étrangères, Sénat
du Canada, Ottawa, Canada K1A 0A4*

Membership of the Committee

The Honourable George C. van Roggen, *Chairman*

The Honourable Martial Asselin, P.C., *Deputy Chairman*

and

The Honourable Senators:

Bélisle, Rhéal

Bird, Florence B.

Bosa, Peter

Buckwold, Sidney L.

Cameron, Donald

*Flynn, Jacques

Graham, B. Alasdair

Haidasz, Stanley

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Smith, George I.

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**Ex Officio Members*

Note: The Honourable Senators Royce Frith, Allister Grosart, Earl Hastings, Daniel A. Lang, A. Hamilton McDonald, Robert Muir, Richard J. Stanbury, Arthur Tremblay and David Walker also served on the Committee at various stages.

Order of Reference

Extract from the Minutes of the Proceedings of the Senate, Thursday, May 1st, 1980:

“With leave of the Senate,

The Honourable Senator van Roggen moved, seconded by the Honourable Senator Asselin, P.C.:

That the Standing Senate Committee on Foreign Affairs be authorized to continue its examination of and report upon Canadian relations with the United States;

That the papers and evidence received and taken on the subject in the Twenty-Ninth, Thirtieth and Thirty-first Parliaments be referred to the Committee;

That the Committee be empowered to engage the services of such counsel and technical, clerical and other personnel as may be required for the purpose of the said examination and for the purpose of its examination and consideration of such legislation and other matters as may be referred to it, at such rates of remuneration and reimbursement as the Committee may determine, and to compensate witnesses by reimbursement of travelling and living expenses, if required, in such amount as the Committee may determine; and

That the Committee have power to sit during adjournments of the Senate.

The question being put on the motion, it was—

Resolved in the affirmative.”

Robert Fortier

Clerk of the Senate

Foreword

This report concludes the three-volume study by the Standing Senate Committee on Foreign Affairs on Canada-United States relations. Volume I, presented in December 1975, dealt with the Institutional Framework for the Relationship. Volume II, presented in June 1978, examined Canada's Trade Relations with the United States. The present report, Volume III, continues the study of the trade relationship, building on the conclusions of Volume II.

During the past three years the Committee held some 40 hearings in both Ottawa and Washington, D.C., and heard a range of witnesses, both Canadian and American, including businessmen, labour leaders, academics and provincial and federal officials and Ministers. The Committee wishes to thank all of these witnesses, not only for the time taken by them to appear before the Committee, but also for the time and effort involved in the preparation of the material required for their presentations. Their willing assistance and expert testimony was indispensable in enabling the Committee to arrive at informed opinions as contained in the report although, as is evident from the report itself, each witness will not necessarily concur in all of the conclusions or recommendations herein.

I am most grateful to all members of the Committee and I am especially indebted to my Deputy-Chairman, Senator Martial Asselin, P.C., and to the other members of the Steering Committee for their help and advice. I know that all members of the Committee will wish to join with me in making special reference to Senator Allister Grosart, P.C., the Deputy-Chairman of this Committee from 1969 until his appointment as Speaker of the Senate in 1979. His perceptive questioning of witnesses, his unerring focus on the central issues and his wise counsel have all contributed in an important degree to the Committee's study.

The work of the Committee would have been impossible without the staff support provided by the Parliamentary Centre for Foreign Affairs and Foreign Trade, its Director Mr. Peter Dobell and the Committee's most able staff assistant Mrs. Carol Seaborn, who had the unenviable task of dealing with the Chairman on a day to day basis which she did with unflinching good humour. Assistance was also provided from time to time by the Institute for Research on Public Policy. Mr. Patrick Savoie, the Clerk of the Committee, has been most diligent throughout the hearings and in the production and translation of this report.

An index of the proceedings of the Committee on which this report is based has been prepared by the Reference Branch, Library of Parliament. It is available on request from the Clerk of the Committee.

George C. van Roggen

Chairman

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Recommendations of the Committee's Earlier Report

In 1974 the Senate Committee on Foreign Affairs published the results of its first study of Canada's trading relations with the United States. The report's principal recommendation urged that "government in Canada, as well as the business and labour communities... consider seriously the option of bilateral free trade with the United States."

During these earlier hearings, evidence was taken from a broad cross-section of Canadian industry. The Committee's efforts included to examine the strengths and weaknesses of Canada's bilateral trade relations with the United States as well as to assess the prospects for the 1970s and 1980s. Among other aspects, it studied the structural problems of the post-World War II manufacturing industry, the effects of the world-wide imbalance in supply and demand, the importance of non-tariff barriers, the low level of research and development (R&D), the high import penetration and productivity rates relative to the United States prevailing in other parts and the future prospects for bilateral trade. The Committee's final conclusion was that much of the Canadian manufacturing sector was in a very vulnerable position, characterized with high costs resulting from short production runs and other factors. The disadvantages mainly identified with a lack of access to a large, tariff-free market.

Disturbed by this finding in an attempt to assist in Canada's economic welfare, the Committee concluded in 1978 that of all the possible policy responses, the one which showed the most promise was a bilateral free trade

INTRODUCTION

Recommendations of the Committee's Earlier Report

In 1978 the Senate Committee on Foreign Affairs published the results of its first study of Canada's trading relations with the United States. The report's principal recommendation urged that "governments in Canada, as well as the business and labour communities. . . consider seriously the option of bilateral free trade with the United States."*

During these earlier hearings, evidence was taken from a broad cross-section of Canadian industry. The Committee's focus had been to examine the strengths and weaknesses of Canada's bilateral trade relations with the United States as well as to assess the prospects for the 1980s and 1990s. Among other aspects, it studied the structural problems of much of Canada's manufacturing industry, the effects of the tariff, the imbalance in end products trade, the importance of non-tariff barriers, the low level of research and development (R&D), the high labour costs and low productivity rates relative to the United States prevailing at that time and the future prospects for bilateral trade. The Committee's principal determination was that much of the Canadian manufacturing sector was in a very vulnerable position, shackled with high costs resulting from short production runs and other competitive disadvantages mainly associated with a lack of access to a large tariff-free market.

Disturbed by this finding in an area so critical to Canada's economic welfare, the Committee concluded in 1978 that of all the possible policy responses, the one which showed the most promise was a bilateral free trade

* Canada-United States Relations, Volume II, Canada's Trade Relations with the United States, June 1978.

arrangement with the United States. Aware of the possible political and economic difficulties involved in this conclusion, the Committee recommended an intensive examination of the bilateral free trade idea. The Committee also hoped to provoke a broader public discussion of the future of Canada's trade policy.

New interest in Canada and the United States

The Committee was gratified that its report may have led to some reflection, or at least some thinking out loud, at the senior levels of government. Liberal External Affairs Minister Donald Jamieson remarked that no government would want to dismiss the option of free trade out of hand. Progressive Conservative Finance Minister John Crosbie said free trade with the United States was one of the options Canada should seriously consider over the next few years. A former leader of the Opposition, the Hon. Robert Stanfield, P.C., Q.C. added his voice in speeches during 1979, urging free trade with the United States and stressing the advantages of such a policy in countering regional dissension in Canada. Unfortunately the issue of free trade has not yet been officially addressed or debated by the government.

Nonetheless, the earlier report appears to have coincided with a modest but growing public interest in the subject which resulted in the Committee's Chairman being invited to speak to a variety of groups and associations and to participate in seminars both in Canada and the United States on the subject of bilateral free trade. In part, the report may have provoked discussion and built on an interest latent since the Economic Council Report "Looking Outward" of 1975. In any case it was evident that the report's conclusion evoked far less emotional and nationalist reaction than might have been expected even a few years earlier.

In the United States, part of the impetus for the increasing attention to the subject was provided by Section 1104 of the U.S. Trade Agreements Act of 1979, legislation which provided the statutory basis for U.S. trade relations. Section 1104 required the President to "study the desirability of entering into trade agreements with countries in the northern portion of the western hemisphere to promote the economic growth of the United States and such countries and the mutual expansion of market opportunities". This requirement is an addition to the existing provision (Section 612) of the Trade Act of 1974 which permitted the President to "initiate negotiations for a trade agreement with Canada to establish a free trade area covering the United States and Canada". In 1974 the Section 612 provision was not taken seriously by the Administration since it was a last minute addition to the Bill in Congress with very little discussion. In the 1979 enactment of the Trade Agreements Act, the provisions of Section 612 were repeated, voted on and endorsed by the House Ways and Means Committee. There would thus

appear to be an ongoing Congressional authority given to the President to negotiate a free trade agreement with Canada.

The recent study, mandated by Section 1104 and undertaken by the Office of the Special Trade Representative (STR), itself generated studies by other U.S. agencies such as the study of the petrochemical industry undertaken by the International Trade Commission for the STR. In Congress, the Subcommittee on International Trade of the Senate Finance Committee held hearings on North American trade during 1979 and 1980. A number of private groups including the U.S. Chamber of Commerce, the U.S. United Nations Association and the Canadian-American Committee undertook studies in this area.

Further stimulus to the idea in the United States was sparked by the 'North American accord' statement of President (then Governor) Reagan in the November 1979 announcement of his candidacy for the presidency. At the time he said:

"a developing closeness among Canada, Mexico and the United States—a North American accord—would permit achievement of that potential in each country beyond that which . . . any of them . . . could accomplish in the absence of such co-operation."

Other prominent U.S. political figures including presidential aspirants Kennedy, Connally and Brown simultaneously endorsed the 'trilateralism' concept, frequently conceiving of it as a North American resource-based or energy common market.

It was the continental energy thrust to the 'accord' proposal which undoubtedly contributed to the negative reactions from both neighbours. In a joint statement in May 1980, Prime Minister Trudeau and the Mexican President Mr. Lopez Portillo firmly distanced themselves from the trilateral concept, stating that "such an approach would not serve the best interests of their countries", Mr. Trudeau adding that Canada's interest "would be advanced by the continuing strengthening of bilateral relations with Mexico and the United States."

Meanwhile cautious discussion of the idea of bilateral free trade was taking place in Canada. In 1979 a nation-wide poll conducted by a national magazine found that two out of three Canadians favoured free trade with the United States. The strongest support came from the Maritimes and the West but a majority of those polled in every region backed the idea. It was evident that the subject was no longer taboo. In industry, the government-inspired sector task force studies showed that seven out of twenty-three sectors, including petrochemicals, urban transportation equipment, electronics and cement spoke positively about bilateral free trade for their products. Statements supporting the idea were also increasingly heard from certain Canadian producers as they recognized their longer term need for free access to a larger market.

Canada's trade and payments position—an update

In its 1978 report, the Committee drew attention to the basic facts of Canada's international trade situation as well as a more detailed analysis of the Canada-U.S. trade picture. It underlined then, and it does so again, that because of the enormous concentration of Canadian trade with the United States involving all sectors of the economy, the state of Canada-U.S. relations has a critical bearing on Canadian commercial and economic policy and on its international trade prospects as well.

On the surface, Canada's international trade situation actually looks fairly good. Despite an international recession when exports usually fall faster than imports, Canada has done well in world trade, finishing with a large surplus of \$5.2 billion in 1980 and a lower but still significant surplus of \$2.3 billion in 1981.

Looking more closely, one is faced with more sobering facts. The main reason for Canada's good overall trade performance in 1980 lay in the exports of crude and fabricated materials, commodities such as forest products, grains, natural gas and mineral products. The value of forest products exports alone was \$12.8 billion and the value of wheat exports nearly doubled in 1980 to a record \$4.1 billion. Minerals and natural gas produced a \$5 billion export surplus in these commodities. But in the end product, manufacturing sector which employs 2 million Canadians and pays \$23 billion in wages, the same old problems remain. For end products, the 1980 deficit in Canada's world-wide trade balance was over \$17 billion. This situation became even more worrying in 1981 when the value of imported end products rose much faster than the value of Canada's end product exports. The result was a huge \$20 billion deficit in Canada's end product trade.

In respect to Canada-U.S. trade only, by 1981, the value of goods trading across the border had reached \$100 billion, considerably more than between any two other countries in the world. In that year over 68 percent of Canada's total trade was with the United States (66 percent of its exports and 68 percent of its imports). The enormous flows back and forth across the border were almost in balance with a small surplus of \$1.2 billion in favour of Canada. Again, on looking closely, a strong surplus for Canada is evident in crude materials and fabricated materials trade with the United States, adding up to almost \$16 billion more in exports than in imports. But despite the advantage of depreciated dollar which assisted the competitiveness of Canadian products in U.S. markets, Canada's bilateral deficit in end product trade with United States has continued to rise, reaching over \$15 billion in 1981. This widening imbalance occurred despite a lessening in Canada's deficit in bilateral automotive trade from \$3 billion in 1979 to \$2 billion in 1980 and to \$1.8 billion in 1981.*

*Figures for 1981 are preliminary only.

Table 1

Canada's Merchandise Trade, 1978-81
(billions of Cdn. dollars)

		Crude Materials	Fabricated Materials	End Products	Total Merch' Trade
Trade with all countries:					
1978	Exports	8.8	19.2	18.9	52.3
	Imports	5.9	8.7	31.3	50.1
	Balance	2.9	10.5	-12.3	2.2
1979	Exports	12.5	24.4	20.8	64.2
	Imports	7.9	12.1	37.9	62.7
	Balance	4.6	12.3	-17.1	1.5
1980	Exports	14.8	29.3	21.7	74.2
	Imports	11.3	12.7	39.5	69.0
	Balance	3.5	16.6	-17.8	5.2
1981*	Exports	15.2	30.5	25.1	83.7
	Imports	12.1	14.5	45.8	78.9
	Balance	3.1	16.0	-20.7	4.8
Trade with United States:					
1978	Exports	5.5	13.8	15.8	36.7
	Imports	2.4	6.1	24.9	35.4
	Balance	3.1	7.7	-9.0	1.3
1979	Exports	7.6	17.0	16.9	43.4
	Imports	3.7	8.7	30.4	45.4
	Balance	3.9	8.3	-13.5	-2.0
1980	Exports	9.1	18.8	16.7	46.8
	Imports	5.1	9.2	31.0	48.4
	Balance	4.0	9.6	-14.3	-1.6
1981*	Exports	9.2	21.5	20.1	55.5
	Imports	4.5	10.3	35.8	54.3
	Balance	4.7	11.2	-15.7	1.2

Sources: *Imports by Countries*, Jan.—Dec. 1980, Statistics Canada, p. 13, *Exports by Countries*, Jan.—Dec. 1980, Statistics Canada, p. 19. Statistics Canada *Daily*, 3 February 1982. *The detailed figures for 1981 are preliminary only; Statistics Canada, *Catalogue 65-001*, 1982.

Nor has the problem of Canada's perennial current account deficit disappeared. Even with Canada's recent surpluses in its world merchandise trade account, its overall current account has remained in deficit, averaging over \$4 billion during the past five years, due to the very serious imbalance in invisible or service trade items (travel, dividends, insurance, freight charges, etc.)*. In 1980, this invisible deficit reached \$9 billion, most of it with the United States. As a result, Canada's bilateral current account deficit with

*Preliminary figures for 1981 show a record high current account deficit of over \$6 billion.

that country has expanded from \$3.5 billion in 1975 to over \$8 billion in 1980, the recent deterioration caused mainly by a rapid rise in interest payments resulting from extensive corporate and governmental borrowing combined with the depreciation of the Canadian dollar. Little improvement is seen in the bilateral travel account, a component of the invisibles account. Despite predictions for considerable gains, Canada's bilateral travel account deficit with the United States stood at \$800 million in 1980.

Table 2
Canada's Current Account Deficit with the United States
(Billions of Cdn. dollars)

	1976	1977	1978	1979	1980
Current Receipts					
Merchandise exports	25.7	31.0	37.1	44.6	48.5
Invisible earnings	4.2	4.6	5.3	5.9	6.6
Total current receipts	29.8 ¹	35.7 ¹	42.4	50.4	55.1
Current Payments					
Merchandise imports	25.1	29.3	34.9	44.4	47.7
Invisible payments	8.7	10.2	12.3	13.8	15.6
Total current payments	33.8	39.6 ¹	47.2	58.2	63.3
Current Account Balance	-4.0	-3.9	-4.7 ¹	-7.8	-8.2

¹Figures may not add exactly due to rounding.

Sources: 1976 & 1977 figures—Canadian Balance of International Payments, 1977, Statistics Canada, p. 53; 1978, 1979 & 1980 figures—Quarterly estimates of Canadian balance of international payments, Fourth Quarter 1980, Statistics Canada, pp. 46-7.

As for investment, Canadians now invest more outside Canada than foreigners invest in Canada, a remarkable change from the earlier 1970s. By 1978, Canadian direct investment in the United States accounted for more than half the total and amounted to \$9 billion by 1978, up from \$6 billion in 1976. U.S. direct investment in Canada, valued at \$31.9 billion in 1976, grew relatively more slowly to \$38.3 billion. More than half the outflow of Canadian direct investment capital can be accounted for by the manufacturing industry, such investments reflecting in part at least the desire, particularly of smaller manufacturers, to have access to a larger market.

The international scene revisited

A renewed scrutiny of the current world trading environment is not a reassuring exercise in terms of Canada's trading prospects. True that the Tokyo Round multilateral trade negotiations made progress in liberalizing

trade among member states of the GATT (the General Agreement on Tariffs and Trade). Tariff reductions of an average range of 35 percent are likely to result in increased export opportunities as long as non-tariff measures do not intrude. But, in another respect, the trading opportunities have become more constricted. The European Community (EC), originally consisting of six member countries, has now expanded to 10 countries with prospects of growing to 12 shortly. When account is taken of the EC's free trade agreements with the remaining EFTA countries, this means that virtually all of Western Europe is organized into a preferential free trade unit for industrial products. As for Japan, its continued growth and success as a major trading power has astounded and jolted the other industrialized trading countries. In effect, these developments have meant a strengthening, relative to North America, of the two most powerful trading units each with free access to large internal markets. They are not encouraging for Canadian manufactured exports and it may actually negate much of the liberalizing effect of the Tokyo Round tariff reductions. Simultaneously, a New Protectionism appears to be emerging, with the governments of trading countries giving high priority to internal economic demands. While vocally supporting trade liberalization, they frequently undermine it in practice by implementing a host of non-tariff barriers.

Competition from developing nations is also part of the problem for Canada's manufacturing sector as countries such as South Korea, Hong Kong, Singapore, Brazil, Mexico and Taiwan step up their exports of manufactured items. With considerably lower labour costs, these newly industrialized countries (NIC's) can pour out standard technology items and transport them into markets around the world at a fraction of the Canadian cost of production. Against such products, the average Canadian tariff offers no meaningful protection.

The exchange rate plays a major role in shaping Canadian trade patterns. After 1976 and until the end of December 1980 the Canadian dollar experienced a substantial depreciation relative to most other currencies. Against the currencies of the major industrialized countries of Western Europe and Japan, the Canadian dollar declined by 37 percent in this period, a major factor in the improved sale of Canadian goods to Western Europe in 1979 and 1980 and in the slowing down of imports. *Vis-à-vis* the United States dollar, Canadian currency declined 18 percent over this period, a development which improved the competitive position for exports to the United States. However, from mid-1980 to mid-1981 the Canadian dollar strengthened against Western European currencies, rising 15 percent against the British pound, 24 percent against the French franc, 23 percent against the West German mark and 18 percent against the Swiss franc, changes which have again made this market difficult for sales. Over the same time period, the dollar has continued to decline against the U.S. dollar, depreciat-

ing 6 percent, and has remained almost static with respect to the Japanese yen. These exchange rate changes make the United States, more than ever, the market into which Canada is best placed to export.

* * *

The Committee's earlier study of Canada's trade relations with the United States had taken place against a background of ongoing multilateral trade negotiations under the GATT. During Committee hearings it was evident that the GATT Tokyo Round negotiations generated a considerable nervousness among industry witnesses as to how the outcome of negotiations would affect them, conscious as they were of their competitive disadvantage. Commenting in 1978 on the possible outcome of these negotiations, the Committee was somewhat doubtful that the negotiators could achieve their objectives in tariff reductions or whether meaningful restrictions could be placed on non-tariff measures.

As it turned out, from a multilateral point of view, the Tokyo Round achievements in liberalizing international trade, specifically the gradual implementation of a 35 percent reduction in average rates of duty, may be substantial. From the point of view of Canadian industry, however, the overall impact of the GATT negotiations may not be so positive. Particular problems are emerging in respect to Canada-U.S. trade.

PART I

A. The Situation Facing Canadian Industry

1. Results for Canada of the Multilateral Trade Negotiations

After six years of hard bargaining, the GATT Tokyo Round multilateral trade negotiations (MTN) were completed in 1979. Few countries had more at stake in the outcome than Canada. Few countries have a larger range of exportable goods. Few countries have exports that constitute a higher percentage of gross domestic product (GDP) than does Canada, where it amounts to about 26 percent. Under the 1979 GATT agreement, a framework was set which will significantly affect Canada's international trade opportunities during the 1980s and well into the 1990s. Both the level of tariff protection and the use of non-tariff measures are affected.

In terms of Canada-U.S. trade, the Committee was told by officials of the Department of Industry, Trade and Commerce that when the Tokyo Round tariff reductions are fully implemented by January 1987, 80 percent of current Canadian industrial exports to the United States will actually enter duty free and up to 95 percent will be subject to tariffs of 5 percent or less. For U.S. exports to Canada, the comparable figures will be 65 percent entering duty free and another 26 percent entering at rates of 5 percent or less.

a) *Tariffs*

Under the Tokyo Round agreement, Canadian tariffs will be cut by close to 40 percent. Canada's major trading partners, the United States, the Euro-

pean Community and Japan agreed to make comparable or somewhat smaller reductions. U.S. tariffs on more than \$4 billion worth of Canadian non-agricultural exports will fall by an average of close to 40 percent; the European Community will make tariff reductions averaging about 30 percent affecting over \$1 billion worth of Canadian industrial exports and Japan will cut its tariffs by about 31 percent on \$800 million worth of exported Canadian industrial products. The reductions, to be staged in eight annual steps, began on 1 January 1980 and will be completed on 1 January 1987.

Canada may have entered the negotiations at somewhat of a disadvantage, partly because it was perceived by other major industrialized countries as having had a 'free ride' in the Kennedy Round GATT talks in 1967, and partly because Canadian tariffs were seen to be relatively high—in the 15 percent or higher range—even though many imports including sophisticated machinery not made in Canada entered duty free. By the time the agreement is fully implemented, the average rate of Canadian tariffs on industrial imports will have been lowered from 15 to between 9 and 10 percent. While this rate is high relative to the average 4 to 5 percent U.S. rate and the 6 percent rate in both Japan and the European Community, the comparative adjustment requirement, in tariff terms, will be greater. In effect, Canada's reductions represent a loss of about 5 percent in protection compared to 2 to 3 points by the other major trading countries. Looked at positively, the tariff reductions will result in lower costs of inputs for Canadian industries as well as lower costs for a broad range of consumer goods. Canada agreed to make formula reductions in the range of 30 to 40 percent on most consumer items. But Canada, like other major MTN participants, made no significant reductions in its tariff protection on textiles, clothing and footwear although some protection on footwear has been removed during 1981. While lower U.S. tariffs on dutiable forest products should stimulate exports across the border, a number of other processed resource products did not fare so well. The Canadian petrochemical industry made few gains and the U.S. tariff will actually be higher on some petrochemical derivatives.

In sum, for Canada, there are losses as well as gains, minuses as well as pluses from the Tokyo Round liberalization of tariffs. (For a more detailed analysis of the results of the Tokyo Round, see Appendix A.)

b) Free trade in civil aircraft

A major international free trade agreement was concluded at the Tokyo Round which has been hailed as a possible prototype for future agreements in other sectors. The Agreement on Trade in Civil Aircraft entered into initially by Canada, the United States, the EC, Japan and Sweden provided for the mutual elimination as of 1 January, 1980 of all duties on civil aircraft and the repair of such aircraft plus the removal of duties on between 85 to 90 per-

cent of trade in components of civil aircraft including avionics and flight simulators. As well as tariffs, the agreement restricts certain non-tariff measures including government procurement and national treatment. These non-tariff concessions, based on the principle of 'conditional' most-favoured-nation (MFN) treatment, are available to other GATT signatory countries which agree to make similar concessions.

The civil aircraft free trade agreement will enhance Canada's export opportunities to a number of countries, including the United States, for high technology aerospace products.

c) Non-tariff barrier codes

The Tokyo Round marked the first time that GATT multilateral trade negotiations endeavoured to deal with non-tariff measures in detail. In the face of the increasing use of such devices, the task to bring them under better control was formidable. Some progress was made and the codes of conduct on non-tariff measures, although very limited, have established a pattern for their regulation in the future. However, enforcement of the codes may prove difficult on a multilateral basis. Such enforcement is in the hands of committees of GATT nations and sub-committees of technical experts and these bodies will require time and experience before they can prove their effectiveness.

More specifically, no agreement was reached in Geneva on new safeguard rules on emergency action against intolerable, but 'fair', import competition, a distinct shortcoming from the Canadian point of view. The agreement on government procurement, while technically well set out, has proved a major disappointment to Canada because of its very limited coverage. The agreement on valuation will establish uniform rules to be applied by all governments in determining the value of imported goods for customs purposes, based on the 'transaction value' of the goods. Implementation of this agreement will be generally difficult for Canada which has operated under a radically different valuation system based on the price charged in the home market of the exporter. (See Appendix A for more details of the problems for Canada related to the GATT non-tariff codes).

2. U.S. non-tariff barriers affecting Canada-U.S. trade

In the context of Canada-U.S. trade, as distinct from multilateral trade, the impact of non-tariff barriers is increasing both relatively and absolutely. This reflects both the diminishing importance of tariffs and the growing recourse to non-tariff barriers as a form of protection.

The Committee heard evidence that serious non-tariff problems with the United States are likely to arise in the following areas: countervail, procure-

ment and customs valuation; U.S. safeguard actions applied inadvertently against Canadian exports; and the complex trade regulatory system spelled out in the 1979 Trade Agreements Act. In addition, DISC is a perennial non-tariff irritant.

Countervail

In respect to countervail, Mr. Rodney Grey, the former head of the Canadian delegation to the Tokyo Round, and Professor Fred Lazar of York University and Director of the Canadian Institute for Economic Policy have pointed out that the GATT agreement leaves a number of problems vis-à-vis the United States. First, although the U.S. government must now establish injury prior to imposing countervail duties, new U.S. procedure makes it easier for U.S. companies to lodge complaints and for the authorities to find 'injury'.

Secondly, as Mr. Grey emphasized a vigorously applied U.S. countervail system could have an inequitably heavier impact on the effectiveness of Canadian industrial development policies when contrasted to any parallel countervail action Canada could take against the United States. This is because such a relatively large percentage of Canadian production is exported while in the United States the major portion of production is for the internal market. Any subsidization of Canadian industry could be seen as involving an encouragement of production for export purposes and would accordingly run the risk of U.S. countervail. By contrast, subsidization of a firm in the United States would be directed mainly toward encouraging production for the U.S. domestic market and would only involve the risk of a Canadian countervail for the very small percent of products which it might export.

Third, in the GATT agreement many anomalies in what constitutes a subsidy for countervail purposes remain. For instance a DREE subsidy, although not inconsistent with the GATT code, appears to be subject to countervail. But general tax incentives or the provision by states or provinces of required infrastructure for industrial sites may not be vulnerable. Finally, the United States, in a move directed at the European Community and not at Canada, has changed its 'offsetting' rule by which the amount of the subsidy to be countervailed could be reduced by the extra amount involved in locating a plant in less than a prime location. According to Mr. Grey, this could make U.S. countervail even more threatening than before the Tokyo Round. The earlier U.S. procedure took into account that regional development grants are legitimate policies. Mr. Grey expressed the opinion that if it were possible to persuade the United States to change the 'offsetting' rule, it would be in the common interest of both countries and a bilateral agreement could be made without raising problems at the GATT.

It will be necessary for the Canadian government to negotiate bilaterally with the United States concerning countervail, specifically stressing the uneven impact of application of countervail on the two countries, the need for an agreement on what constitutes a permissible subsidy and the possibility of the United States using the 'offsetting' technique in respect to Canada.

Procurement

Procurement is the most pressing non-tariff barrier problem Canada currently has with the United States. By virtue of its geography, its economy, its requirements for national survival, Canada has developed an excellence in products such as telecommunications equipment, electricity generating and transmitting equipment, urban mass transit equipment, aircraft and aircraft parts and avionics, products which are almost always purchased by governments or their agencies. Without a domestic mass market base, the survival of these Canadian industries depends on sales to foreign procurement markets, mainly those in the United States. Yet with the exception of civil aircraft and aircraft parts, it was precisely these areas which the GATT procurement agreement failed to open up. Mr. Rodney Grey warned the Committee that the code's coverage is so limited "it may just collapse if it is not extended."

Not only did the procurement code not succeed in opening up these markets but there was a marked increase, even while the GATT negotiations were proceeding, in U.S. procurement protection mandated by Congress and at the state level. The recent proliferation of state Buy American laws and regulations has brought to 37 the total number of states with such restrictions. Congress passed the Surface Transportation Assistance Act in 1978 and has tied Buy American restrictions to other federal appropriations laws such as the Public Works Employment Act or the Clean Water Act. Under such legislation, state or local governments receiving federal funds for financing projects are required to apply Buy American restrictions to such projects. In practice, this means that more than 50 percent of the content must be American and that the final assembly take place in the United States. An even more stringent proposal to raise the content requirement from 50 to 70 percent is currently being pushed in Congress and at the state level. In addition, some states have passed their own procurement laws and regulations specifying a level of domestic preference which may range as high as 20 percent.

Such U.S. legislative actions have hit certain Canadian producers hard, particularly the Buy American provisions under the Surface Transportation Assistance Act. For example, in the structural steel sector, steel bridge exports to New York State alone fell from \$20 million in 1978 to \$1 million in 1979. Mr. Raymond Royer of Bombardier Inc. told the Committee that

the 1978 extension of the Buy American laws had hit his company just as it had expanded its urban transit equipment operations and was beginning to market in the United States. The company decided it had no alternative but to establish facilities within the United States if it wanted to circumvent state Buy American barriers to municipal markets. Mr. Ron McCallum of Hawker Siddeley Canada warned that if the 50 percent requirement for basic U.S. content were to be raised to 70 percent, it would lead to complete manufacture of his company's urban transit cars in the United States.

It is urgent that the Canadian government should deal with this situation. In the urban transit sector alone, the U.S. market is estimated at a possible \$5 billion within the next five years. Canadian producers are being obliged to establish facilities in the United States to circumvent the procurement restrictions.

Canada cannot afford to wait for further multilateral negotiations on procurement. Mr. Grey made the point that Canada could have done much better at the GATT negotiations if it had been negotiating bilaterally with the United States rather than multilaterally. The Hon. Larry Grossman, Ontario Minister of Industry and Tourism added that the U.S. Surface Transportation Assistance Act had been put in place "basically to lock out Japanese competition . . . because the Americans could not get access to the growing Japanese market."

The basis already exists for bilateral initiatives. The United States has declared itself ready for reciprocity in the Trade Agreements Act of 1979, and has made it clear that it would accord better access to its procurement market to those who offered American producers better access to their markets. In this respect, Canada undoubtedly qualifies since at least 20 percent of goods purchased by the Canadian federal government annually are from foreign, mainly U.S., suppliers. This record is more favourable, in relative terms, than even that of the United States which is considered more open in its procurement purchasing than most other countries.

Mr. Grey suggested to the Committee that the government seek a bilateral deal on procurement by which the United States would exempt Canada from the provisions of the Buy American Act. (See Appendix A for details of his proposal) However, the Committee notes that the Canadian government has twice had discussions—in 1977 and 1980—with the U.S. Administration on procurement under the Surface Transportation Assistance Act. It had no success in obtaining a procurement arrangement for Canada. Canada currently lacks a good bargaining position and its position is being made weaker by the fact that Canadian firms are establishing plants in the United States. Moreover, it is doubtful that, even if Canada convinced the U.S. Administration to agree to a waiver for Canada from the restrictive legislation, the Administration would find it easy or possible to persuade Congress to pass

the necessary amendments to exempt, specifically and exclusively, only *Canadian* exporters. Furthermore, solving the federally-controlled non-tariff barriers would not be the only problem. Downstream from that, as business witnesses pointed out, problems would emerge such as limitation on technical specifications, preferences at a local level, labour objections, and all kinds of lobbying.

Mr. Kirk Foley of the Urban Transportation Development Corporation proposed to the Committee that Canada and the United States might enter into a joint venture in urban transit products which would allow manufacture of equipment in both countries and permit Canadian producers to circumvent U.S. Buy American rules. He compared it to the Canadian participation in the U.S. space program. The idea could have advantages for Canada but it is not evident to the Committee why it should prove particularly attractive to the United States.

The issue of U.S. procurement barriers is a pressing one for Canada and will require negotiations and resolution on a bilateral rather than a multilateral basis. What is needed is a procurement arrangement between Canada and the United States which would put this country in a special category vis-à-vis the United States.

Customs valuation

Potentially, Mr. Grey told the Committee, customs valuation could be one of the most troublesome areas for Canada emerging from the Tokyo Round. Canada and the United States were the only two major trading countries at the Geneva negotiations which were not previously using the GATT system of valuation. Canada agreed to the GATT Customs Valuation Code with great reluctance as it will require drastic adjustments in its present system. The switch by the United States to the new system is likely to cause Canada problems arising from the possibility of excessive use of U.S. administrative procedures; from the use of artificially low transfer prices in transactions between related companies; and from the issue of inland freight charges. The fact that the GATT code failed to deal adequately with the issue of the artificially low transfer prices for duty valuation purposes may prove particularly troublesome to Canada and the United States in view of the very large amount of trade between subsidiary and parent companies. Finally, the revisions in previous U.S. *ad valorem* rates on specific products, such as petrochemical derivatives, are likely to impede Canadian exports, since the effect of the revisions will be to raise the effective tariff barrier on a number of these items.

It is not easy to see how many of the custom valuation problems between Canada and the United States can be settled unless the two parties bring to

negotiations a determination that particular conditions in the North American trading context warrant special bilateral arrangements to resolve them.

DISC

Since 1971 the United States has used the export subsidization device DISC, the Domestic Sales International Corporation, to stimulate exports and retain direct investment in the United States. The system grants tax incentives in the form of a deferral of taxes on income from exports to companies operating in the United States. Not only does a DISC scheme give an advantage to the U.S. company competing in the Canadian market, but it has the additional impact of influencing the production decisions of U.S. multinationals in favour of their plants located in the United States as opposed to their Canadian subsidiaries.

The Tokyo Round agreement prohibited such export subsidy schemes as the DISC, but a proviso was accepted that any signatory country was only required to make a "reasonable effort" to overcome an obstacle such as Congressional resistance. The Tokyo Round will not, therefore, result in the termination of DISC by the United States, particularly since the Reagan Administration appears ready to challenge EC Commission officials on tax-based subsidies of EC member countries.

The Committee sees the DISC as another area where Canada is inadvertently affected by U.S. policies when it is not the target. While DISC is not a major irritant, **Canada should make an effort to come to an arrangement with the United States on a bilateral basis respecting it.**

Other U.S. non-tariff measures

Another problem to which Mr. Grey drew attention was the vulnerability of Canadian exports to U.S. safeguard or emergency actions. Especially in times of an economic downturn, businessmen are more likely to seek increased protection from some sort of emergency import action. The difficulty is that, because of the non-discrimination rule of the GATT, Canada is liable to be hit unjustifiably when the United States takes action against unfair or intolerable imports from other trading partners. Examples of past U.S. punitive action hitting Canada inadvertently are U.S. safeguard measures against specialty steel and fasteners in 1974 and 1978.

Finally, Mr. Grey emphasized that there had been a fundamental change of approach in the United States in recent years which was not at all reassuring for future Canada-United States trade relations. Parallel to its agreement to lower certain tariff rates in the 1980s, the United States has taken action to protect its imports by refining its various legal mechanisms to deal with import competition. A complex regulatory system has been developed over a

number of years and has been given full expression in the 1979 Trade Agreements Act. This new emphasis in the United States on what Mr. Grey has called a system of contingent or stand-by protection, means that U.S. domestic producers will be able to get protection when a case can be made for it. Mr. Grey suggested in a recent article that despite diminishing tariffs resulting from the Tokyo Round, the United States has not effectively lowered its barriers to imports as a result of the multilateral trade negotiations. He emphasized that, for Canada, the important objective would be "getting inside, rather than staying outside, the whole legalistic trade regulatory system now installed in Washington, D.C."

In sum, in its trade with the United States, Canada faces a strengthened array of non-tariff barriers. The GATT multilateral negotiations have failed to resolve these problems.

The Committee is convinced that the only way to deal with these problems—procurement, countervail, customs valuations, DISC, and safeguard restrictions—is through bilateral negotiations with the United States. The only way to get inside the new, potentially protectionist U.S. trade regulatory system is through a bilateral arrangement with the United States.

3. The implications of the Tokyo Round for Canadian industry

"Time is not on the side of this country's manufacturing industry," wrote the Economic Council in 1975. The prospects have not been greatly improved by the completion of the Tokyo Round negotiations, and in a number of respects the outlook is less promising than before.

In sectors where the traditional tariff protection is diminishing, increased import competition from efficient foreign producers will challenge the less-protected Canadian manufacturers who are not structured to resist such competition and whose position will be gradually eroded. At the same time, many Canadian manufacturers will not be in a position to take advantage of the increased export opportunities in the U.S. market, also less protected by tariffs. In that market they will face stepped-up competition as stronger, more efficiently structured Japanese or European competitors move in. At the same time, relatively high U.S. duties will remain on a number of items of importance to Canadian industry, most notably on petrochemicals where Canadian producers stand ready to compete internationally.

In the trading world of the 1980s, tariffs are no longer the most important influence on trade flows for most products. Much more worrying in the Canada-U.S. context are the unresolved problems related to non-tariff restrictions and particularly the U.S. non-tariff barriers spelled out above. The economic distortions to trade which arise from such non-tariff restrictions may prove to be more costly than any remaining tariffs. They could

result in higher prices, in misallocation of resources, in restricted choices, in inferior products and in the location in the United States, instead of in Canada, of important high technology producers.

The Tokyo Round has, in effect, left Canadian industry in the worst of both possible worlds—with tariffs too low to be an effective protection and, at the same time, still without free access to a huge assured market as enjoyed by its competitors, the European Community, Japan and the United States.

4. The outlook for Canadian industry

In the 10 year period to 1979, Canada's share of world trade in manufactured goods declined from 4.8 percent to 3.1 percent. Canada's trading performance world-wide and with the United States has, at best, marked time since the Committee completed its last report in 1978. In spite of strenuous efforts by the government, to be briefly reviewed in the next section, and the completion of the MTN, the deficit in end product trade continues to grow. Canada appears to be in danger of being pushed out of world markets in manufactured goods.

The problem remains, as the Committee pointed out in its earlier report, that too many fragmented and inefficient firms are producing mainly for the small Canadian market. It is important to observe that Canada is the only major industrialized country without free access to a market of from 100 to 300 million people. The manufacturing sector is, with a number of notable exceptions, producing standard technology products, using technology which has been largely imported. A high proportion (over 50 percent) of the sector is foreign-owned. R&D in Canada has been at seriously low levels. Productivity is rising relatively more slowly in Canada than in competing countries and remains markedly lower than in the United States.

The remedies are generally accepted and not particularly controversial: economies of scale are essential; the Canadian manufacturing sector must rationalize; it must specialize in particular product lines instead of a broad diversity of products; it must modernize its production processes and achieve economies of scale and higher productivity rates through long, efficient production runs; it must seek out the areas where Canada has natural advantages.

Where opinions differ is on how to accomplish these changes.

B. Actions So Far . . . And Reactions

1. Government actions

Recognizing the basic weakness in much of the Canadian manufacturing sector and its increased vulnerability in the wake of the Tokyo Round, the government has been implementing in recent years certain policies designed to stimulate and assist the necessary restructuring of this sector and to increase Canadian competitiveness.

The government has sought to gain a larger market for Canadian products through a variety of policy modifications and programs. These include an emphasis on increasing domestic import displacement through 'Shop Canadian' programs and a monitoring process on purchases in megaprojects; an emphasis on domestic sourcing under the National Energy Program (NEP); a variety of industry development programs including the Defence Industry Program (DIP) and the Enterprise Development Program (EDP); and a policy of nurturing selected high technology sectors; a review of procedures under the Foreign Investment Review Agency (FIRA) coupled with what appears to the United States to be a stronger emphasis on the "significant benefit to Canada" requirement; and a drive to co-ordinate not only federal procurement but certain provincial procurement as well as a way of promoting the restructuring of Canadian industrial sectors.

In addition, in January 1981, a special industrial and labour adjustment fund of \$350 million was announced which, over the next three years will help displaced workers and assist communities which are particularly hard hit by industrial readjustment. Special measures have been announced for the textile and footwear industry. (See Appendix B for a more detailed examination of the government's industrial development program.)

It may be premature to assess the results of certain of these measures since they have only recently been introduced. But it is clear that the strategy of 'picking winners' in the high technology sector, for example, has had mixed results. And the Committee notes that many of the measures represent extensions of policies already in place for a number of years, which have thus far failed to bring about the intended broad restructuring of Canadian industry.

2. U.S. reactions to Canadian industrial development policies

After carefully watching Ottawa's recent economic policy directions, Washington has cried "foul play!" During 1981 the U.S. Administration has publicly called for changes in FIRA's Canadian benefit requirements, in Canada's duty-remission plans to foster exports and in what are perceived to be the trade distorting effects on the sourcing of goods, equipment and ser-

VICES under the NEP. Specific Congressional hearings devoted to Canada's 'discriminatory' policies have raised calls for tough measures including a moratorium on Canadian investment in U.S. companies, tougher financing rules for Canadian companies and the exclusion of Canadian energy firms from holding mineral leases on U.S. federal lands. The U.S. Administration has set up a task force under the Office of the Trade Representative and the Commerce Department, aimed at finding effective means of pressuring Canada to change its policies.

In addition, the Administration has been strongly critical of proposed changes in Canada's import policy and it is watching closely the way Canada will handle its eventual adherence to the customs valuation code as well as the extent to which procurement preferences are being used by Ottawa to encourage high technology industries.

There is no doubt that the United States may try to retaliate in a number of damaging ways. Under the U.S. Trade Act of 1974, the President is authorized specifically to retaliate against any country that "engages in discriminatory . . . policies . . . which burden or restrict United States' commerce". Such measures might include import duties or restrictions directed specifically against Canada, an expanded use of the 'trigger price' mechanism for Canadian steel imports, or tougher conditions for Canadian banks operating in the United States or a move against forestry exports, Canada's largest earner of foreign exchange.

Reviewing these developments, the Committee is alarmed that Canadian industrial development policies are not only failing to achieve a restructuring of industry in this country, but they are also causing Canada to become a target for the U.S. Administration, for Congress and for an influential segment of the private business sector.

The Committee is concerned that the reaction of both government and industry in the United States to Canadian policies is not being adequately considered by Ottawa. Given the high degree of interdependence existing between the two countries, Canadian industrial development policies can have negative consequences for U.S. industries. Affected U.S. firms may demand that the U.S. Administration and Congress provide relief. Bilateral trade confrontations seem bound to increase and Congress, in particular, may retaliate in quite unrelated areas as it has done in the past. The Canadian economy could end up in a very much worse situation than would have occurred without some of these Canadian government's industrial development measures.

It is in light of these concerns that the Committee considers it more urgent than ever to draw attention to an alternative policy course.

PART II

A. An Alternative Approach

As already stated in its earlier study, the Committee was concerned over the competitive disadvantages of Canadian industry, particularly in the manufacturing sector. In its 1978 report, it reviewed the industrial development measures which the government had taken at that time and made a number of its own recommendations for strengthening Canada's competitive capacity. The Committee concluded then that such measures by themselves would not be enough to achieve the necessary restructuring of the manufacturing sector. Nor would they ensure the necessary access, particularly over U.S. non-tariff measures, to the U.S. market. The main recommendation of the 1978 report was to urge that the idea of a bilateral free trade arrangement with the United States be seriously studied.

Regrettably, as far as the Committee is aware, the government has attempted no analysis of bilateral free trade between Canada and the United States and its policy thrust has continued to incline in the opposite direction. Instead, the government has continued to strengthen existing programs designed to stimulate industrial development including those to encourage displacement of imports, those to spur high technology exports or those to organize a co-ordinated Canadian procurement market or those to strengthen FIRA.

The perception of the critical importance of a large market has been borne out by representatives from various Canadian manufacturing indus-

tries at the Committee's recent meetings. Companies which have good access to the U.S. market, such as is available for aerospace and related products under the new GATT agreement for trade in this sector, are successfully exporting to the United States. In certain other industrial sectors, some large companies, including Canadian subsidiaries of multinationals, are already rationalizing and are gaining access to U.S. markets for specialized products through internal arrangements such as world product mandates. But many Canadian companies, lacking this opportunity, are struggling with the restructuring problem without the guaranteed market access. A growing number of these Canadian companies rather than increasing investment in Canada, are buying into U.S. markets through acquisitions in order to gain assured access. (Canadian direct investment in the United States increased by 43 percent in 1980 over 1979, mostly through U.S. affiliates of Canadian companies). Still other Canadian companies, unfortunately, seem prepared to rely on various government industrial policies to do their restructuring for them or are seeking continued protection from tariffs or quotas or non-tariff measures.

The Committee remains convinced that what Canadian industry needs, above all else, is dependable access to the U.S. market, and better still, a preference in that market over both the advanced industrial countries of Europe and Japan and the fast-growing NICs. Canadian industry needs to know that the U.S. market will remain open to it, even if protectionist pressures mount against imports from other countries. Undeniably, the government's industrial policies are useful in helping restructure Canadian industry, but unless they can achieve reliable access to a larger market—and the United States is obviously that market—they can only be palliative. The long-term future of much of Canadian industry will remain at risk.

It is in this light that the Committee has turned to an alternative approach—the negotiation of a bilateral free trade agreement with the United States. The Committee believes that if Canada is to retain its current standard of living and its present productive capacity into the 1990s, the piecemeal approach to trade liberalization and the reliance on a series of supportive measures must give way to the forthright adoption of this broad policy initiative.

The Committee recognizes that the negotiation of such an arrangement will be an enormously complex undertaking, not without its own risks. But the risks of not moving forward are much greater.

1. Why not multilateral instead of bilateral free trade?

Arguments have been put before the Committee to the effect that free or freer trade on a multilateral basis would be preferable to bilateral free trade with the United States: the economic benefits to the Canadian consumer

would be greater; there would be less danger of being dominated by the United States; the multilateral approach to trade liberalization has been the traditional Canadian route and should continue to be so. The Committee is conscious that there would also be important benefits to Canadian consumers from multilateral free trade. Indeed, the Committee recognizes that multilateral free trade was the Economic Council's first choice in its 1975 report, "Looking Outward", although the Council recognized that practical necessities would require more limited solutions in the short-term. The Committee has noted that, for the past 35 years Canada has supported, with two exceptions, the multilateral non-discriminatory approach as being in its best interest. The two important exceptions are the bilateral arrangements between Canada and the United States related to defence production and automotive products, although even in the latter case Canada accorded MFN treatment to any firm which could meet the qualifications set down for *bona fide* Canadian manufacturers.

Nonetheless, the Committee asks how wise is it for Canada to wait for multilateral trade negotiations (MTN) to achieve better access to the necessary mass markets? How soon are such negotiations likely to be held? To what extent is multilateral free trade achievable by this approach in the foreseeable future?

Aside from certain monitoring and dispute-settlement mechanisms for the GATT non-tariff barrier codes and possibly for some extension of the codes' coverage, the likelihood is that another full-scale multilateral trade negotiation will not take place before the mid-1990s. Indeed, some observers consider the Tokyo Round may be the last such meeting. Even if there were subsequent meetings, there are doubts that they are likely to serve Canada's interests. Reflecting on the Tokyo Round in a recent article, Mr. Rodney Grey said that "the MTN showed how little we can expect from the EEC and Japan in the way of accommodating our particular interests. We got from them, and we will get from them in future negotiations, only what happens to fall out of their negotiations with the U.S.A." In short, the GATT multilateral trade negotiations have now effectively become a 'club of three,' a tripartite negotiation in which the voices of the United States, the European Community and Japan are the only ones that really count. Canada should not blind itself to the realization that it can no longer continue to play a significant role in such negotiations.

Even in the event that there are other MTNs, Professor Ronald Wonnacott of the University of Western Ontario predicted that full trade liberalization will not be achieved, only progressively smaller and smaller steps toward it. This is not what Canadian industry needs, he said.

"... we won't satisfy Canada's important requirement that we achieve essentially free access to foreign markets and, in particular, the U.S. market. That last step

is the crucial one because if you are talking about rationalizing Canadian industry, you are talking about increasing scale enormously. If you have a guarantee of access to that U.S. market, then you can engage in the large scale investment this implies, whereas if there are tariffs remaining—even though they be small—they put such enormous investment at considerable risk (18:17).”*

In fact, a strong case can be made that small, gradual tariff cuts are not only unhelpful to a country like Canada but will actually put it at a considerable disadvantage. Canadian manufactured goods tend to be high cost, for reasons mentioned earlier. Small, graduated reductions in foreign trade barriers do not give Canadian producers enough scope for the needed rationalization and specialization to reduce costs and to become more competitive. On the other hand, similar small cuts in the Canadian barriers will allow the foreign manufacturer—already more cost competitive due to economies of scale possible from his own larger market base—to make sharp inroads into Canada with his imports. It is questionable whether the GATT liberalization approach, in the long run, will provide the incentive for Canadian producers to undertake the reorganization necessary to compete internationally.

In any case the existing pattern of Canada's exports to Community and Japanese markets suggests there would be relatively little benefit to Canada's manufacturing sector even if better access were granted. **Japan and the EC take only from 3 to 10 percent of their imports from Canada in manufactured goods as distinct from raw resources, while the United States takes 68 percent of its imports from Canada in manufactured goods as opposed to raw materials.**

Moreover, Canadians have witnessed, in recent years, an evident trend to regionalism in international trading patterns. The European Community, with its common market, has grown from six to nine, then to ten, and possibly soon to twelve members. Add to this the Community's agreements for free trade in industrial products with the six remaining EFTA countries and North America is confronted by a vast sixteen-country free trade network across Europe. This situation has not been reassuring for Canada or the United States, more particularly because it seems to be accompanied by a gradual chipping away of the MFN principle of non-discrimination.

Other arguments against bilateral free trade have emphasized the benefit of the multilateral system to a smaller country by allowing it to have more leverage against a larger country. Pointing to the power disparities between Canada and the United States, the multilateralist proponents argue that not only have extra benefits accrued to Canada because it is automatically accorded the gains wrung from the United States by other trading entities

* Numbers refer to the Committee Proceedings. The first number indicates the issue number of the Proceedings and the second number indicates the page. Unless otherwise stated, all refer to the First Session of the Thirty-Second Parliament, 1980-81.

like the EC or Japan but also, in a dispute with the United States, it has been helpful for Canada to have, around the negotiating table, stronger countervailing forces with objectives similar to its own.

The Committee recognizes the benefits accorded to Canada from the GATT multilateral system over the past 35 years. But it does not see why continued support of the GATT liberalization process and a Canada-U.S. free trade agreement should be considered mutually exclusive. In a bilateral free trade area with the United States the 'most-favoured-nation' type of gains which have been achieved through the GATT will continue to be accorded to Canada. In fact, in future GATT panels, Canada could be the beneficiary of a stronger North American point of view on many issues. At the same time, Canada should remain realistic about how few new gains it can achieve in this forum and how its specific interests are more likely to be served in a Canada-U.S. arrangement.

As for bilateral disputes with the United States and the disparity-of-size question, it is interesting to note that the free trade agreements between the European Community and Austria, Finland, Iceland, Portugal, Sweden, Norway and Switzerland were negotiated on an individual country basis. In each case, the size disparity with the Community is greater than that existing between Canada and the United States. For each bilateral agreement, a separate joint committee was established and a dispute-settlement procedure was spelled out. Any bilateral Canada-U.S. free trade agreement would of course include such a dispute settlement body.

The establishment in mid-1981 of a trilateral trade consultation body comprising the United States, the European Community and Japan threatened to leave Canada 'out in the cold'. Developments such as this make it all the more important for Canada to seek a strong bilateral negotiating structure with the United States. Otherwise the United States may tend to forget the interests of its major trading partner, Canada, in its preoccupation with Europe and Japan.

Another argument which has been presented against a bilateral arrangement and which is difficult to understand is that Canada would sacrifice its existing third country markets. **But Germany and other European countries have not stopped trading with the rest of the world since they joined the European Community. Quite the contrary, their trade with third countries outside the Community has flourished.**

The Committee has concluded, therefore, that multilateral free trade is not an achievable goal in the next 20 years and that many key Canadian interests are unlikely to be served by future GATT negotiations. Moreover, the Committee asks why Canada should wait for gradual multilateral trade liberalization to attain its assured mass markets when its main competitors

already have theirs? For instance Japan has a free market of over 100 million, the European Community and the former EFTA countries have one of 350 million and the United States one of 250 million. **These are the three markets with which Canada conducts between 80 and 90 percent of its trade.**

A very important argument for taking positive action now, rather than waiting for gradual GATT liberalization, relates to the fact that Canada is actually "backing eyes shut" into closer economic integration with the United States.* The fact is that the Tokyo Round tariff cuts will mean over 95 percent of Canadian exports to the United States and 85 percent of imports from the United States will trade duty free or at duties of less than 5 percent by 1987. Whether Canada is aware of it or not, it is moving inexorably into a more interdependent trading relationship with the United States. In 1980, a joint Canadian-American study** found that each economy has become increasingly dependent on the other for a broad range of goods. Since the present tariff structure discriminates against imports of highly fabricated goods, trade in intermediate products has been encouraged with a resulting integration of production processes. Moreover, the trend by Canadian multinationals to locate within U.S. borders, in order to escape tariff and non-tariff barriers, is leading to increasing cross-border patterns of ownership, product development and design. Professor Sidney Weintraub of the University of Texas made a similar point in testimony to the Committee. Even by taking no steps at all, the two economies are integrating more and more, he said, and he could not think of another pair of independent industrial countries which were already so thoroughly economically interdependent. The point is that Canada, by maintaining bilateral trade barriers is actually unwittingly intensifying the economic integration of the two countries.

At the same time, by not recognizing the increasing trading interdependence, by not taking positive action to formalize it, and by not negotiating benefits, safeguards, adjustment arrangements and, most especially, a preferential access over non-tariff barriers, Canada confers on itself the disadvantages of an unprotected market and foregoes the positive advantages possible under a bilateral free trade arrangement. **By not facing up to the reality of the situation now, Canada will increasingly feel the costs without any of the benefits of free trade.**

Bilateral free trade offers two other important advantages over multilateral free trade. First, Canadian industry would feel less competition from third country imports because it could retain its tariffs against these competi-

* As pointed out by the *Financial Post*, 17 March 1979. "Psst-we're backing, eyes shut, into closer trade ties with the U.S."

** Peter Morici, *Canada-United States Trade and Economic Interdependence*, C.D. Howe Research Institute (Canada) and National Planning Association (U.S.A.) 1980

tors. Secondly, Canada would receive preferential treatment in the U.S. markets vis-à-vis third country imports because the United States could also retain its tariffs and/or quotas against these countries. Moreover, a multilateral free trade agreement would be much harder to negotiate than a bilateral agreement. With only one partner, Professor Ronald Wonnacott pointed out, a better set of transitional safeguards can be negotiated and the sequencing of tariff cuts and the diminution of non-tariff measures can be phased in at a rate more cognizant of Canadian requirements. The monitoring of such reductions can be effectively carried out with one partner but could well prove almost impossible with a host of far-flung trading countries.

2. Not a common market nor a customs union

It needs to be clearly understood what the Committee is recommending. **It is a free trade arrangement between Canada and the United States. It is not a common market nor a customs union.**

It has been evident from the Committee hearings, from press comments and even from academic writing that too many Canadians in government, in the media and in business fail to distinguish the important differences between a free trade area and a common market or customs union.

To begin with, a free trade area would provide for the elimination, by stages, of certain remaining tariffs. Secondly, and more importantly, a bilateral free trade arrangement would provide Canada and the United States with a mechanism for negotiating the elimination or reduction of non-tariff barriers between the two countries. A bilateral free trade agreement would have no bearing on the external tariff or non-tariff barriers which either country might wish to employ against the outside world.

The proposal for a Canada-U.S. free trade agreement is aimed at strengthening Canadian industry by helping it to rationalize in sectors where it has been losing its traditional high tariff protection without gaining the advantages of its competitors, namely the assurance of a larger market.

The Committee would like to underline what its proposal for a Canada-U.S. free trade arrangement is NOT: *

- It is not a North American common market
- It is not a Canada-U.S. common market
- It is not a proposal for a pooling of energy resources
- It is not a proposal for political integration
- It is not a proposal for 'continentalism', if that word is used in the pejorative sense rather than in the context of mutual cooperation

A common market or customs union—as distinct from a free trade area—involves free movement of goods, labour and capital between member

states which agree to be bound by a common external tariff against the rest of the world and which agree to the harmonization of non-tariff barriers and a host of other matters as between themselves and in their relations with the outside world. In addition, the best known example of a common market, the European Community, specifically contemplates a degree of political cooperation (as evidenced by the recent direct elections to the European Community parliament) even if not full political union. The hesitancy of some nations to join the European Community, as was the case with Great Britain, is related to the fact that in so doing they would indeed be gradually relinquishing a considerable degree of national sovereignty. **None of the free trade agreements entered into between Finland, Sweden, Norway, Austria, Switzerland and Portugal with the European Community have these characteristics. Nor would such an agreement between Canada and the United States.**

* A free trade agreement would have no bearing on Canadian mineral or other resources which Canada could export or not as it chose. Such resources are generally not subject to tariffs in any case, except when they are upgraded. Free trade would encourage and enhance the possibility of such upgrading by giving the upgraded resources free access to the U.S. market. Oil, natural gas and electricity are not dutiable and would continue to be subject to exactly the same regulatory authorities and permits in both countries as they are today. If Canada and the U.S. followed the European examples, agriculture and even fisheries would not be included in such an agreement even as far as tariffs are concerned (and such an exclusion is permitted under the GATT). Canadian quotas on textiles and shoes against third countries would not be affected. On the contrary, the Canadian textile and shoe industries could continue to have the same protection as they have now vis-à-vis the rest of the world and yet have free access to the U.S. market.

Bilateral free trade would not mean free movement of labour between the two countries. As far as movement of capital between Canada and the United States is concerned, there is already such a degree of free capital movements that this is not likely to be a significant issue. However, even within the European Community, there have been certain restrictions on the movement of capital. Policies which could be seen to influence the movement of direct investment flows such as Canada's FIRA would undoubtedly require examination during negotiations, and Canada would likely press for retention of the FIRA screening process during the transition period. (See page 85).

Free trade does not mean political integration between the two countries.* It is worth recalling again the examples in Europe of a free trade

* The important question of the political implications of bilateral free trade is dealt with more fully in Part VI.

arrangement—the EFTA—and of a common market—the European Community. When the six-member European Community was first formed, the other European countries, namely the United Kingdom, Sweden, Norway, Denmark, Iceland, Portugal and Switzerland and subsequently Austria and Finland formed in 1957 a free trade area (EFTA) which involved free trade in industrial goods but none of the other characteristics of a common market or customs union. When the United Kingdom and some of the other members of EFTA later joined the European Community in 1972, EFTA was effectively terminated whereupon all of the remaining smaller countries of Western Europe, including Switzerland (6 million population), Portugal (9 million), Sweden (7 million), Austria (7 million), Finland (4.5 million) and Norway (3.7 million) all decided to negotiate industrial free trade agreements with the European Community (225 million). In each case, individual free trade agreements with the EC were signed. In every instance this involved a disproportion of population substantially greater than Canada's population relationship to the United States.

As the Committee pointed out in its earlier report, Finland's case was particularly interesting. During its association with EFTA, Finland had monitored its exports of industrial goods and found that they were expanding more rapidly with the rather sluggish United Kingdom economy within EFTA's free trade arrangement, than with Germany whose economy was booming. Germany had traditionally been Finland's closest trading partner, but Finland did not have free access to its market. It was this experience that persuaded Finland to enter into the free trade agreement with the Community.

The experience of the Republic of Ireland (Eire) which has had free trade with Great Britain for many years is equally persuasive. In 1966, a free trade area, patterned after the EFTA agreement, was established between the United Kingdom and Ireland. The United Kingdom ended all protective duties on imports from Ireland immediately and the Irish Republic undertook to eliminate protective duties on most U.K. imports in 10 equal instalments over a period of nine years. A large proportion of trade in both directions had been already trading freely. The Irish government emphasized that the agreement was "a trade agreement and nothing more" with no political implications. Minimal institutional links were set up and little or no policy harmonization resulted, although a degree of policy harmonization already existed. While this agreement did not run its full course, as both countries entered the European Community in 1972, a significant increase took place in Anglo-Irish trade and the volume of Irish industrial exports to all countries expanded in the 1965-70 period.

The case of the Australia and New Zealand free trade area is also instructive. Prior to the arrangement, New Zealand had a very large trade

deficit with Australia; each country was its own best market for manufactured products but New Zealand was concerned by the greater strength and sophistication of the Australian industry. In 1966 a bilateral trade agreement created a limited free trade area for 13 million people. The agreement covered only about 50 percent of the actual trade, much of which was already trading freely and it included numerous resource products. In the first seven years of the agreement, trade between the two countries increased by 78 percent and the balance of trade in favour of Australia declined from over 4 to 1 to 2 to 1. Formal institutional arrangements were slight. The agreement appears to have been advantageous for the smaller partner.

All three examples resulted in expanded trade for the smaller partners. None of the foregoing free trade arrangements resulted in any discernible political integration. (See Part VI).

B. A Bilateral Agreement and the GATT

Having reached the conclusion that the appropriate policy for the government of Canada is to seek a bilateral free trade agreement with the United States, the Committee addressed the important question of how this should be done. Given both countries' long-standing commitment to the ideal of non-discrimination in international trade relations, it seems very desirable that a free trade arrangement should keep within the legality of the Articles of the GATT. Any other course would be likely to invite retaliation from third countries, an outcome which the United States, as well as Canada, would seek to avoid. Moreover, it is unlikely that either country would wish to see an 'unravelling' of all the solid achievements of GATT in liberalizing trade, an undoubted risk if the major trading nation, the United States, were a party to an arrangement which openly flouted the GATT Contract.

The Committee explored various policy options permissible under GATT rules in the concluding of a bilateral trade arrangement. The basic principle of the GATT treaty governing a trade agreement is one of non-discrimination, that is, each of the signatory countries must extend to all others, on a non-discriminatory basis, any concessions it may negotiate on both tariff and non-tariff barriers to trade. Article XXIV of the GATT treaty, however, permits signatories to negotiate customs unions and preferential free trade agreements as long as certain conditions are met. Alternatively in cases where these conditions are not met, limited preferential arrangements may be granted if approved by a two-thirds vote of the GATT signatories under a waiver procedure set out in Article XXV. The United States, but not Canada, obtained such a waiver for its bilateral preferential Auto Agreement in 1965.

1. A pragmatic approach

Rather than a broad free trade agreement, Mr. Rodney Grey suggested a pragmatic approach. In areas where GATT had left "unfinished business", such as procurement, petrochemicals, countervail, etc. Mr. Grey proposed that Canada and the United States should try to conclude separate issue-by-issue bilateral arrangements for freer trade. The resulting benefits of better access would be offered simultaneously to those countries which were prepared themselves to offer better access, a process known as a conditional most-favoured-nation (MFN) approach. In the case of petrochemicals, however, he told the Committee it might even be necessary to conclude a preferential bilateral agreement, "abandoning the strict rule of non-discrimination." In this fashion, said Mr. Grey "we might evolve piece-by-piece, policy area-by-policy area, a special trading regime or arrangement."

The Hon. Larry Grossman, Minister of Industry and Tourism of the Government of Ontario advocated the same approach. Making clear his opposition to general free trade with the United States and acknowledging that Mr. Grey was an adviser to the provincial government, he explained that what Ontario wanted was "in certain sectors, when it would benefit our economy, structured, carefully negotiated bilateral free access to the American market."

Initially this approach seemed attractive for two reasons: first, the objectives were simple and limited and appeared accordingly to be more likely of speedy resolution; and secondly, negotiations might be limited to selected areas where, as Mr. Grossman suggested, the benefits to the Canadian economy would be undisputed. This would have avoided the need, painful to the politician and difficult for the negotiator, of taking risks and making concessions.

It is the Committee's understanding, however, that this approach would require a series of waivers under Article XXV or risk retaliation. GATT experience shows that third countries, even if offered a conditional MFN situation whereby they could opt into a sectoral agreement if they reciprocated with equal access into their own markets, might challenge a bilateral agreement not concluded according to the Article XXIV provisions. They would be almost certain to do so if a preferential bilateral sectoral arrangement were concluded outside the GATT context. In the case of petrochemicals in particular, major petrochemical-producing countries in the European Community would likely be particularly resistant.

Quite apart from these theoretical difficulties, the Committee has failed to detect any American interest in this pragmatic approach. An inquiry by the U.S. Chemical Manufacturers Association of its members' attitudes toward a bilateral agreement in petrochemicals showed almost complete dis-

interest; the Committee was told there was less than a 10 percent response, and this in spite of the declared interest of at least one large multinational. The Canadian government has already twice initiated *ad hoc* bilateral negotiations on procurement in the urban transit industry—in 1977 and 1980—with a distinct lack of success. Although the U.S. Administration undertook in July 1979 to consider carefully Canada's request for a waiver from the Buy American provisions of the Surface Transportation Assistance Act, there has been no further response. **If, under the *ad hoc* procedure, this one problem area has proved so difficult to negotiate with so little result, the Committee asks how long would it take Canada to achieve a resolution to the whole range of bilateral issues by such an approach?**

All of the witnesses whom the Committee met in Washington advised against the pragmatic approach. Although the Canadian interest in each special arrangement was very clear, the Americans questioned where the reciprocal benefit lay for the United States; even if a mutual interest could be identified, they warned that Canada's limited bargaining position would be frittered away; they pointed to resistance in Congress to special deals with Canada based on dissatisfaction with the safeguard clauses of the Automotive Agreement. They urged avoidance of the quagmire of sectoral bargaining, which every special interest would try to exploit and which the Congressional system encouraged. **If Canada wanted a special arrangement with the United States, the unanimous advice of the American witnesses was to go the route of a broad free trade agreement. Such an approach, they said, had the potential of attracting genuine support in the Administration and in Congress.**

2. Declaration of a free trade area under Article XXIV

In authoritative testimony prepared at the Committee's request, Professor John Quinn, a legal specialist from the University of Western Ontario, indicated that in establishing a free trade agreement, two possibilities present themselves within the scope of Article XXIV of the GATT: either a declaratory approach or the conclusion of an interim agreement. Article XXIV requires that all restrictions or barriers to trade be eliminated on "substantially all" the trade of goods between the countries concluding a preferential agreement. Past experience of Article XXIV has indicated that the freeing of trade in 80 per cent of traded commodities between the two countries will be deemed sufficient to satisfy the "substantially all trade" threshold. In respect to the declaratory procedure, Canada and the United States might issue a bilateral declaration that a free trade area as defined in Article XXIV should be now deemed to exist between the two countries. From there, the two countries could proceed to liberalize trade further for particular products or sectors.

The Committee has found that, on the basis of the actual bilateral trade statistics and their projection to 1987 when the agreed-to GATT tariff cuts will be in place, Canada-U.S. trade could satisfy or be very close to satisfying the "substantially all trade" requirement laid down by the GATT for the establishment of a free trade area. With the large amount of resource-based products trading freely as well as the large free flow of products under the Automotive Agreement, almost 70 per cent of bilateral trade is at present free of tariffs. As noted earlier, by 1987, 80 percent of Canada's industrial exports to the United States will actually enter duty-free and a further 15 percent will face tariffs of 5 percent or less. On the other side, 65 percent of Canadian imports from the United States will be free of duty and a further 26 percent will move across tariffs of less than 5 percent. Furthermore, the GATT has previously acquiesced in free trade arrangements with less than this threshold of goods trading freely.*

The Committee has concluded that by 1987 a *de facto* free trade area between Canada and the United States could be deemed to exist in respect to tariffs. Under GATT rules, therefore, Canada and the United States could theoretically declare in 1987 that a bilateral free trade area already existed and then proceed on a product by product or sectoral basis to liberalize trade without recourse to further GATT exemptions.

Such a finding might lead the casual observer to ask, if a *de facto* free trade area will exist in any case by 1987, why does Canada need to pursue the matter further. The answer is that the 80 percent of bilateral trade which will be duty-free by 1987 will be composed mainly of resources and resource-based goods plus the substantial duty-free trade under the auto pact, the defence production sharing arrangement and the civil aircraft agreement. Where Canada's problem lies is in the remaining protected 15 or 20 percent, all involving its manufacturing sector which must be rationalized and placed in a world competitive mode if Canada is to redress its \$20 billion trade deficit in end products.

However, there is, in any case, a serious deficiency in the declaratory approach. The main drawback is that it ignores the degree of protection accorded by non-tariff measures. As the Committee has already pointed out, these are becoming more important obstacles to trade than tariffs. They have been recognized as such at the last multilateral trade negotiations. The degree of non-tariff protection is particularly difficult to measure in respect to countervail, customs valuation and anti-dumping procedures. Accordingly, other GATT countries could argue that a bilateral arrangement arrived at

*Agricultural trade would be excluded in a Canada-U.S. arrangement as it has been excluded from consideration in most other free trade arrangements including EFTA. Although this might be cause for complaints by GATT partners, it is doubtful a serious challenge could be mounted on this ground.

through the declaratory approach, which failed to take account of non-tariff barriers, would not fully meet GATT criteria in the present multilateral trade context. The result could be complaints and retaliatory measures against Canada and the United States. Moreover, while the GATT has acquiesced in the declaratory approach for certain other countries which had a lower existing level of duty-free trade, it is extremely doubtful that it would do so when a free trade declaration involved a major world trading entity like the United States. As Professor Weintraub told the Committee, the 'declaration' mechanism could be adversely perceived by other GATT members as being "a bit too cute." The United States would not wish to give the impression it was weakening the GATT. And from Canada's point of view the use of the declaratory approach would give no assurance of resolving Canada's main problem with the United States, that is, non-tariff barriers.

3. An interim agreement under Article XXIV

The second possibility within the GATT Article XXIV framework, Professor Quinn pointed out, would be for Canada and the United States to conclude an "interim agreement leading to the formation of . . . a free trade area". If this route were chosen, a plan and schedule for the achievement of such a free trade area within a reasonable length of time must be provided to the GATT signatories, as well as sufficient information to allow them to make recommendations. This 'interim agreement' procedure is the one which has been used for all regional arrangements placed so far before the GATT. In no case have other GATT signatories made formal recommendations. However, informal consultations may have led to modifications of proposed arrangements. Nor has "within a reasonable length of time" been defined. It would appear from precedent that under this option the two countries would be free to set a timetable of their own as well as a fairly loosely-worded schedule as to when and how the successive stages of further liberalization would take place.* Indeed, what would be involved would be little more tariff adjustment than will be in effect in any case by 1987 but with the essential additional advantage for Canada of a mechanism for negotiating the mutual reduction of non-tariff barriers.

After consideration of the three approaches, two with the objective of a bilateral free trade agreement as provided for under Article XXIV and the third a pragmatic sector-by-sector, issue-by-issue negotiating procedure, aiming only at freer trade, the **Committee recommends as the best approach that Canada and the United States choose the 'interim agreement' mechanism to achieve a bilateral free trade arrangement.** This umbrella-type approach is superior to the declaratory approach, in that non-tariff barriers would be

* There may be a possibility that under an interim agreement, liberalization could be scheduled on a sectoral basis rather than an across-the-board reduction of tariffs over a certain time period. (See page 35).

taken into account and would be included in the plan and schedule. It is also superior to the pragmatic approach which, while attractive to Canada, is open to objections by GATT members and offers insufficient benefits to the United States to be attainable.

The main advantage of the 'interim agreement' procedure is the opportunity it offers, before initial negotiations have been completed, to ascertain the degree of commitment on the part of the United States to reduce, on a bilateral basis, some of its non-tariff barriers which are causing problems for Canada. At the same time, the preliminary negotiations would reveal the objectives of the United States with regard to Canadian non-tariff barriers. In effect, under this approach each side could test the other's position before ratifying a treaty or otherwise committing itself to an agreement. In the area of non-tariff measures involving unknown elements, such a procedure would offer an important advantage.

4. Across-the-board or one issue and one sector at a time?

Under the umbrella of an 'interim agreement' to move to a bilateral free trade agreement with the United States, it might appear on the surface more advantageous from a Canadian perspective to proceed slowly to free trade, that is freeing one sector, (eg., the petrochemical sector) or one issue, (eg., procurement) at a time. Seemingly the cautious approach might permit Canada to focus on the areas of major impediments to its exports and to adjust gradually to the dislocations which would occur. It would reduce political opposition in Canada and avoid economic risk. The Committee has heard advocates of such a course and the petrochemical industry was advanced as an area where one might begin. However, there are no successful precedents for free trade areas which proceeded sector-by-sector under the GATT. Moreover, even if it were established that the two countries could, under the umbrella of an interim agreement, negotiate one issue or sector at a time to further liberalize trade, rather than present a broad plan of liberalizing trade across the board, the Committee was warned by a number of witnesses, including knowledgeable Americans, that such an approach would be inadvisable and unworkable. To begin with, the complications in negotiating a balance of costs and advantages for each country in each sector would be so great as to thwart the reaching of an agreement at all. Professor Weintraub of the University of Texas stated:

"It is much harder to reach any kind of free trade arrangement if you do it sector-by-sector. The issue is thereby complicated rather than simplified. . . We started out in GATT by negotiating item-by-item, which became so cumbersome that we had to shift to across the board negotiations, with exceptions. The European Community. . . reduced duties across-the-board, rather than negotiate item-by-item. The Latin American Free Trade Association chose a different path. It chose item-by-item negotiations and failed, and the organization no longer exists."(17:11)

The second reason to avoid the sectoral approach, he told the Committee, was that in any one sector, one country or the other would have the advantage. It would be difficult to find other industries like the automotive industry where there are mutual advantages for the two countries and even the auto pact arrangement has been the subject of constant bilateral arguments. Within single industrial sectors it would be almost impossible to ensure that, under free trade, the two countries would gain equal benefit from employment, investment or production no matter what temporary safeguards were obtained. Moreover, quid pro quos would be difficult to find. Even the petrochemical industry which had initially advocated a sectoral free trade agreement in petrochemicals has acknowledged the difficulty of negotiating an acceptable trade-off within the industry which would be attractive to U.S. producers. In testimony, Mr. Jack Dewar, president of Union Carbide Canada, told the Committee

"No matter how hard I try, I cannot think of another situation in the area of petrochemicals and their feedstocks which would be considered equitable to the U.S. yet advantageous to Canada. . . I do not want to leave the impression that the quid pro quo must be within the petrochemical industry or allied to it." (9:12).

A free trade arrangement made in one sector would have an impact on another sector not covered. It could be exceedingly difficult to separate out inputs and components used in both sectors. Finally, there would be a problem deciding which industries should benefit, and in what order, from sectoral bilateral free trade arrangements.

The Committee concludes, therefore, that under an interim agreement, the only approach likely to succeed would be one which addressed the whole spectrum of trade and set out the planned reductions staged over a transition period. However, as various witnesses have pointed out, this broad approach does not mean that longer transition periods could not be negotiated for particularly sensitive items. Nor need everything be included. **The most feasible approach, suggested by several witnesses, would be to include everything except those items which were specifically excluded, rather than excluding everything unless specifically negotiated.** As noted earlier, agriculture would not be included in the agreement. This exception accorded with the views of American witnesses and is consistent with the example of EFTA.

5. A preferential or an 'open-ended' agreement?

Having thus determined that the most appropriate mechanism for bilateral free trade would be the 'interim agreement' method, setting forth a plan or schedule for an across-the-board freeing of trade, the Committee looked into whether the bilateral free trade agreement should be on a preferential basis, as would be the normal procedure under the protection of Article XXIV, or whether it should be open on a conditional MFN basis to those countries which would care to opt in on a reciprocal basis.

A number of witnesses have urged that a Canada-U.S. free trade agreement should be 'open-ended' to multilateral extension, possibly on the basis of the conditional MFN type of clause adopted in the Trade in Civil Aircraft Agreement at the Tokyo Round. Under this agreement, free access is mutually accorded between the signatories, but the full benefits may be further extended to any other GATT member which wishes to open its markets for these products on a reciprocal basis.

In view of the February 1981 trade policy statement by the U.S. Special Trade Representative which emphasized the Reagan Administration's adherence to an "open and fair" trading system within the GATT framework, and its desire to explore possible new areas for "additional liberalization", the Administration, initially at least, may be predisposed to the option of an open-ended arrangement.

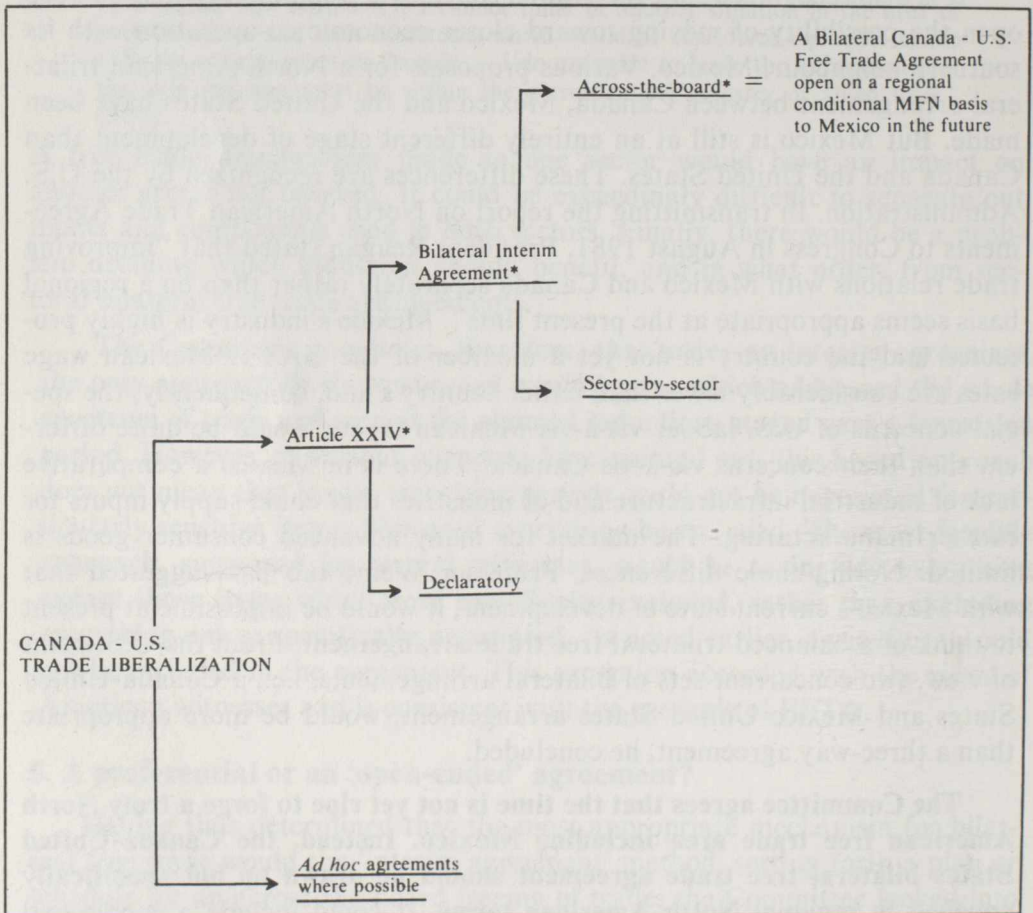
It is also recognized that the United States will undoubtedly wish to keep open the possibility of moving toward closer economic co-operation with its southern neighbour, Mexico. Various proposals for a North American trilateral arrangement between Canada, Mexico and the United States have been made. But Mexico is still at an entirely different stage of development than Canada and the United States. These differences are recognized by the U.S. Administration. In transmitting the report on North American Trade Agreements to Congress in August 1981, President Reagan stated that "improving trade relations with Mexico and Canada separately rather than on a regional basis seems appropriate at the present time". Mexico's industry is highly protected and the country is not yet a member of the GATT. Mexican wage rates are considerably lower than either country's and, consequently, the special concerns of U.S. labour vis-à-vis Mexican labour would be quite different than their concerns vis-à-vis Canada. There is in Mexico a comparative lack of industrial infrastructure and of industries that could supply inputs for further manufacturing. The market for many advanced consumer goods is limited. Noting these differences, Professor Weintraub has suggested that with Mexico's current state of development, it would be impossible at present to think of a balanced trilateral free trade arrangement. From the U.S. point of view, two concurrent sets of bilateral arrangements, i.e., a Canada-United States and Mexico-United States arrangement, would be more appropriate than a three-way agreement, he concluded.

The Committee agrees that the time is not yet ripe to forge a truly North American free trade area including Mexico. Instead, the Canada-United States bilateral free trade agreement should be drawn up but specifically couched in regional North American terms. It could include a conditional MFN proviso to the effect that whenever Mexico was ready to offer comparable access conditions it could become part of the North American Free Trade Area. While other GATT signatories such as member countries of the

European Community may not like the arrangement, there would be little cause for them to take retaliatory actions since they themselves are members of regional groupings, both the European Common Market and the free trade arrangements with former EFTA countries.

In summary, the 'decision tree' that follows attempts to present graphically the Committee's arguments for the best approach, the asterisks indicating the preferred route to follow.

The 'Best Approach' under GATT to a Canada-U.S. Trade Agreement



* The asterisks indicate the Committee's preferred approach.

C. U.S. Reaction to a Bilateral Free Trade Proposal

Reasons for U.S. interest

What interest would an economic giant of 230 million people, with an annual merchandise trade volume amounting to \$470 billion and a GNP of \$3,000 billion have in entering into a free trade agreement with a country of 24 million, an annual trade of \$148 billion and a GNP of \$290 billion? During its hearing the Committee asked this question of many witnesses including a number of knowledgeable Americans. Some interesting points emerged.

First, the concept of closer regional relations has been advocated in recent years by prominent U.S. political figures. In particular, President Reagan (then Governor), in the official announcement of his candidacy for president in November, 1979 urged "a developing closeness among Canada, Mexico and the United States—a North American accord." In addition, as mentioned earlier, the U.S. Administration was instructed by Congress in the 1979 U.S. Trade Agreements Act to study the desirability of entering into trade agreements with Canada and Mexico. (Such a study is a rare occurrence since the Executive is seldom mandated by Congress to produce a sensitive policy-oriented report. Officials admitted to the Committee in Washington that the fact that the report would be a public document limited the scope of the recommendations.)

In August, 1981 President Reagan transmitted the results of the Administration study to Congress. "The American people and our North American neighbours will benefit from reciprocal trade liberalization" wrote the President in his covering letter. The report itself spoke of "the clear economic arguments which can be made in favour of greater regional integration." It stated that U.S. industries might have "fewer reservations about trade liberalization with Canada due to a more comparable level of economic development" than with Mexico which could be seen as threatening jobs and markets with cheaper goods. One could assume, therefore, that given the Reagan Administration's known advocacy of freer trade, the President's original proposal in 1979 for a North American 'accord,' as well as the Administration report, any proposal for bilateral free trade by Canada would likely be given a fair hearing in Washington.

There is an important argument for bilateral free trade which the Committee considers would be persuasive to Washington and should be equally persuasive to Ottawa. Mr. Lawrence Krause of the Brookings Institute, suggested that the appropriate approach to Washington for Canada would be to present a projection of what would be likely to happen if the two countries maintain the status quo, without taking positive action to move to free trade. In today's very close interdependent relationship, more and more domestic

policies impinge negatively and often inadvertently on the neighbouring country. Increasing confrontations in trade are likely to arise. To forestall this growing irritation, Mr. Krause suggested the following Canadian approach to Washington.

“... The argument is that you should not believe that the status quo can be maintained; it will get worse; our difficulties bilaterally will get worse. So let us think of a scenario which says: Rather than reacting to these negatives that are clearly down the road, let us head them off by taking a positive road. That is the way we are going to offset the negatives. That will be the strongest argument, because it is always the inertia of liking the status quo that is hardest to overcome.”(7:12)

This argument raises the telling point of the increasing inevitability of bilateral clashes, a point which has become evident to the Committee as it reviewed the two countries' industrial policies. It also reflects a recognition, spelled out in the President's letter to Congress transmitting the Trade Representative's report, that some recent efforts by Canada and Mexico to reduce their dependence on U.S. trade “have conflicted with principles of liberal trade and with U.S. trade laws”. Moreover, Mr. Rodney Grey observed that trade disputes between the two countries will tend to erupt more easily without the stabilizing factor of ongoing multilateral trade negotiations to provide a forum for dialogue.

“The fact that we were negotiating, that there was ongoing discussion, that there was a working apparatus to deal in a context of problem-solving with the new problems as they arose, was a major element in the management of trade relations for most of the 1970's. Looking ahead, one factor to take into account is that there is no general negotiation taking place, and that influence on events is no longer there...” (4:6)

On the basis of such concerns, a convincing case can be made to American authorities that the ‘status quo’ will get worse and that positive action is needed to promote effective and harmonious bilateral trade relations and to avert an unwholesome drift into discord.

Another consideration, not irrelevant to the likely U.S. reaction is its own international economic position. The United States has been in the forefront of the international trade liberalization process for the past three decades. But the 1970s witnessed a decline in its leadership relative to a strengthening position of the European Community and Japan. The United States is itself becoming concerned by its current position in world trade. In his testimony before the Joint Economic Committee of Congress early in 1981, the Special Trade Representative, Mr. William Brock underlined the decline of the former “economic superpower.” From 1960, when the United States accounted for 45 percent of the market economies' output, its share has fallen to 29 percent by 1980. Its share of world exports has declined. Its productivity has declined, both “in absolute terms and relative to other major industrialized countries.” Since 1976, productivity growth in the business sector has remained flat, while hourly wages increased by 28 percent—an unfavourable

performance when compared to that of Japan, Germany or France, he said. There has been a rapid internationalization of the U.S. economy, with total trade as a share of GNP rising from 7.43 percent in 1950 to 12.3 in 1970, and 16.4 percent in the first half of 1980.

Moreover, despite the present Administration's stated commitment to preserving or strengthening an open multilateral trading system, there are signs that the U.S. psyche may be becoming bruised. Persistent U.S. attempts to persuade the Community to diminish its agricultural protectionism, or to persuade Japan to reduce its barriers to access in its internal market, have not met with any significant success. There are some indications that the United States may turn increasingly to protect itself by applying vigorously the legal and regulatory mechanisms which it now has legal recourse to. If the United States were to put up a protective dike vis-à-vis the major trading entities, it might be inclined to welcome a strengthened regional, i.e. North American, base.

While the size of the Canadian market could not be seen as a major drawing card to the U.S. negotiators for improving international trading competitiveness, it could not be considered negligible. There would be substantial economic gains for certain regions and certain sectors in the United States from a bilateral free trade area. U.S. manufacturers, including U.S. firms operating in Canada, could benefit from a larger market and improved efficiency. The President's letter to Congress emphasized this point, stating that further rationalization of companies across the border "might permit greater economies of scale and enhance North American industries' ability to meet competition from the rest of the world".

Mr. Grey summed up the U.S. economic interest in further trade liberalization with Canada when he was asked why the United States might welcome initiatives from Canada:

"The motive for the United States being willing to negotiate away some of the problems is the motive to which we have often appealed in the United States; that is their interest in Canada having a strong economy. . . they understand that they are not going to better themselves by weakening us since we are their principal customer. Senior American policymakers do adjust their policy in the light of that requirement." (4:14)

Indeed, the Committee has heard U.S. officials emphasize the U.S. concern that their major trading partner, Canada, should have a strong economy. Moreover, although it has been established that a smaller country gains most economically in a free trade arrangement with a larger country, studies have shown that there are also economic benefits for the larger country, in this case, the United States.

Some observers are of the opinion that the long U.S. devotion to the GATT would work in favour of a multilateral approach to further trade lib-

eralization rather than a bilateral or regional approach. For 35 years, they argue, the United States has played a leading role in the development of non-discriminatory trade policies and it would therefore be unwilling to arouse opposition from important trading partners which could lead to the undermining of GATT or the 'unravelling' of the liberalizing gains it had achieved. Further, the present U.S. Administration in a February 1981 speech by Mr. William Brock, the U.S. Trade Representative, has voiced its intention to "preserve and strengthen the open and fair system" constructed by GATT.

Responding to such arguments, Mr. Julius Katz, a Committee witness and until recently a senior State Department official, agreed that initially there might be a negative reaction by GATT third countries to a Canada-U.S. agreement. But he did not consider this was a sufficient reason not to proceed. While the gains of GATT had been impressive over the years, he said, unfortunately, in recent years, one form of protection has been frequently replaced by a new impediment. Therefore, "some in Canada and some in the United States seek a new approach to trade liberalization". Nor did he think a bilateral free trade arrangement would be contrary to the interests of the rest of the world. He was convinced that the trade creation effects of such an arrangement would overcome the trade distortion effects, and that the effects on the North American economy would, in the long term, benefit the larger world community. Even if Mexico came in, the trade creation effects would swamp the trade distortion effects, he added.

In arguing for a bilateral approach, a U.S. witness cautioned that it would be important for the United States not to give the impression that it wished to weaken the GATT and for this reason it would want to use the interim agreement formula sanctioned by GATT. Indeed, the Trade Representative's report explicitly discussed the requirements an agreement must fulfill in order to fall within the legality of GATT Article XXIV. Even if Japan or the Europeans expressed concern in the GATT about discrimination, Professor Weintraub said their complaints would "ring hollow given their own discrimination". In this case, the response of the United States should be that the trade diversion would be insignificant since the two economies already are substantially integrated and formalizing this fact would be unlikely to cause damage.

As long as the procedure followed was generally permissible under the Articles of the GATT, the Committee considers that the traditional commitment of the United States to a multilateral trade liberalization process should not constitute a barrier for the United States to enter a bilateral arrangement.

Nonetheless, in view of the Reagan Administration's policy to seek further multilateral trade liberalization and to work for an "open and fair" trading system, it may not wish to enter a preferential trade arrangement with

Canada alone. The Committee is convinced for reasons set out on page 37, that the United States will be more likely to accept a bilateral agreement with Canada if it is set in regional terms with provision for eventual participation by Mexico if that country should in the future wish to do so. At present, however, there would be problems with a trilateral trade liberalization arrangement. As the U.S. Trade Representative's report pointed out, while tariff barriers between the United States and Canada are moderate to low and will become even more so as the two countries continue to phase in the MTN, tariff barriers in Mexico remain relatively high. Nor would Mexico find such an arrangement very attractive, the report continued, partly because of the low rates of U.S. duty, and partly because it is extremely sensitive to competition in products where it has high barriers.

Would the United States be likely to prefer a sectoral approach or an across-the-board approach to trade liberalization? American witnesses considered it was unlikely that a series of sectoral approaches to bilateral trade liberalization would be easy for the Administration to defend politically. It would seem to smack too much of a series of special deals with Canada. There has been intermittent criticism of the auto pact in the United States, leading to the conclusion in some quarters that it has been more trouble than it is worth. While it is true that the 1981 Trade Representative's report said that the most promising sectoral arrangements would be with Canada rather than Mexico because of the extensive network of business arrangements, at the same time it pointed out the political difficulty in finding a balance of advantages in a series of sectoral agreements with Canada. "The industry being sacrificed by one country in return for benefits obtained elsewhere would try to block the agreement," stated the report. It also foresaw difficulties in a sectoral approach with respect to production safeguards and GATT waivers. Summing up the various private sector opinions on North American trade liberalization, the report concluded "these rather broad-based concerns point to the necessarily comprehensive nature of a possible North American Trade Agreement."

The United States would undoubtedly be reluctant to enter into a free trade agreement with Canada to which the provincial governments were not bound. Yet while the U.S. Constitution enables the federal government to enforce trade rules on state and municipal jurisdictions, the Canadian federal government is limited to a co-ordinating or exhorting role in respect to provincial non-tariff barriers. This has been the case not only in respect to Canada's international commitments under GATT but between one province and another. Before a Canada-U.S. free trade arrangement could be negotiated, the Canadian federal government would need to have obtained some sort of negotiating mandate from the provinces in respect to non-tariff barriers affecting access of U.S. products.

Of course, only if Canada showed itself seriously committed to the idea of bilateral free trade, would Washington want to look seriously at such a proposal. This point, raised by an American witness, Mr. Krause, probably reflects American unwillingness to repeat the experience of 1947-48, when officials of the two countries, with Cabinet approval, had worked strenuously on a plan for bilateral free trade, only to have the rug pulled out from under them by a sudden reversal of the Canadian Prime Minister's approval. It should be noted that, historically, the United States has supported the idea of free trade with its neighbour to the north.

Coverage of the agreement

As stated earlier, testimony from American witnesses, including those heard in Washington, persuaded the Committee that the United States would be far more receptive to a broad across-the-board agreement, rather than a sectoral approach, in view of the difficulties in finding *quid pro quos* and the difficulties of negotiation. Within this broad agreement the United States would, like Canada, undoubtedly wish to exclude some items, protect certain others, or phase them in gradually—all possible procedures under GATT rules. Most U.S. witnesses agreed that agriculture should be excluded, a precedent already established by EFTA, although Professor Krause thought that even U.S. farmers would support closer economic integration with Canada if it resulted in a co-ordinated marketing strategy for agricultural products in world markets.

It was generally agreed that each side could continue its own energy regulations, including controls on exports, but one U.S. witness foresaw difficulties if Canada wished to continue a two-price system, selling energy in its domestic market at a subsidized price and to the United States at a high world price. A subsidized price would constitute a non-tariff barrier to a partner country and would probably be inconsistent with a free trade area.

One other area of coverage in a free trade area was mentioned by numerous U.S. witnesses as being an important inclusion from Washington's viewpoint—that is, trade in services. It has been scarcely considered in Canada. The U.S. Administration has recently put considerable emphasis on trade in services (such as banking, insurance, transportation and communications) which it considers is among the most dynamic sectors of the economy and potentially one of the major sources of increased productivity in the coming decade. Mr. Brock has stated that exports of services now amount to one-third of total U.S. exports of goods and services and the U.S. Administration is currently pushing in the OECD and the GATT to formulate rules and procedures for liberalizing trade in services, similar to those developed for trade in goods. In Washington, American witnesses told the Committee that bilateral arrangements in trade in services could be entered into without con-

travening any GATT principles. According to several American witnesses, the United States might also consider it important to include investment flows in a bilateral arrangement. During the discussions the Committee held in Washington, there was specific mention of FIRA and the NEP with respect to the freedom of investment flows.

The U.S. legislative schedule

A bilateral free trade arrangement with Canada would inevitably require a vote of approval by two-thirds of the U.S. Senate. It would have to undergo close critical examination by both Houses of Congress. Professor Fred Bergsten, formerly Assistant Secretary of the U.S. Treasury Department, explained to the Committee that there were severe constraints on a president as to when he could deal with such a proposal. He would not be able to devote the enormous amount of time and effort necessary to get a bilateral free trade treaty through Congress until other major domestic restructuring was in place. Any trade bill was a major undertaking and would arouse all kinds of protectionist elements. In Professor Bergsten's view, the appropriate legislative 'window' to push a Canada-U.S. trade deal through would be unlikely to open until the third year of the presidency.

Professor Bergsten added a second consideration with regard to the timing of a Canadian overture. Observing in April 1981 that the U.S. dollar was overvalued vis-à-vis the major European currencies, he expressed the opinion that protectionist forces in the United States were usually strongest at times of exchange rate overvaluation. This led him to conclude that the U.S. manufacturing sector might be more responsive to a Canadian free trade proposal at a time when the U.S. dollar was not overvalued in foreign exchange markets.

Reactions of the U.S. private sector

a) Business

Mr. Julius Katz, a U.S. businessman and formerly senior economic adviser in the State Department, considered that a Canada-U.S. free trade agreement would be "generally welcomed" in the United States. Initially U.S. viewpoints on this subject were rather naive, but there are now more reasoned views that the advantages of closer trade ties would be substantial, he said. They take different forms depending on particular economic interests.

This opinion appears to reflect the results of a number of recent studies made by private U.S. associations examining the North American economic and business relationship. These studies include those by the U.S. Chamber of Commerce, the Economic Policy Council of the UNA-U.S.A., the

Canadian-American Committee, the Conference Board and the U.S. Chemical Manufacturers Association. In addition, an extensive survey of U.S. industry sponsored by the Council on Foreign Relations and the International Management and Development Institute in 1980 sought the views of U.S. businessmen on the appropriate directions for U.S. foreign policy, including trade policy.

In general, the results are in favour of freer trade. None of these studies presses whole-heartedly for bilateral free trade with Canada, but in many cases U.S. business executives appear to see advantages in pursuing closer bilateral ties. As well, there are some sectors which would be opposed or would be indifferent. There was some anticipation of competitive and adjustment problems. Most groups considered the idea of a three-country, Mexico-Canada-United States, free trade area as "premature" with the conclusion that the U.S. government would need to continue to deal with its neighbours separately on a bilateral basis at this time.

On the whole, the idea of an arrangement with Mexico raised far more apprehensive reactions in the private sector than an arrangement with Canada, mainly because of concern over cheap labour. In general, U.S. executives showed a preference for a free trade approach rather than a European Community common market-type arrangement which allows the free flow of capital and labour across the borders.

It is obvious that the idea of a bilateral trade arrangement does not arouse the same kind of interested debate in U.S. business circles as it does in Canada. On the one hand the economic benefits to the American producer are generally projected as being less than for the Canadian producer. On the other hand, the threat of dislocation is also less, so there is little need for concern. U.S. companies trading abroad, because they are larger, tend to have a wider vision than comparable Canadian companies.

Even in areas where there could be distinct mutual benefit, such as in the petrochemical sector, not much interest has been shown by the U.S. companies, a distinct contrast to the keen interest shown by the Canadian petrochemical industry in gaining access to the U.S. market. (See page 55). However, Dow Chemical, a major U.S. producer has spoken out in favour of bilateral free trade and both Dow and Union Carbide, another U.S. petrochemical company have organized agreements with Canadian companies to increase the importation and marketing of Canadian petrochemicals in the United States.

But most U.S. companies in other sectors seem not to have focussed on the question. In fact bilateral free trade is an issue many American business leaders have not thought closely about. As a result very little impetus for it is likely to come from the U.S. private sector, making somewhat more difficult

the marshalling of necessary Congressional support by the Administration if it decided to embark on this route.

b) Labour

The reaction of U.S. labour groups is likely to be more hesitant. As Mr. Krause pointed out:

“U.S. organized labour might raise some objections, even though Canadian wages are not much below those in the United States and would be expected to rise to U.S. levels fairly soon. Nevertheless, U.S. unions might recognize that with enhanced investment opportunities in Canada, a great deal of capital would be attracted northward and not be invested in the United States. Thus with less capital at home, productivity and real wages would rise less.” (7:9)

The AFL-CIO labour leaders to whom the Committee spoke in Washington had not seriously considered the idea of a Canada-U.S. free trade arrangement. Their initial reaction reflected concern that a liberal free trade pact could be used as a precedent for further liberalization with Mexico, a result feared because of the wide wage-rate differentials between Mexico and the United States. There was some speculation that, under a bilateral free trade agreement, the unions in both countries would press for wage parity with the United States, denominated in national currencies. The U.S. labour leaders however considered that the fraternal links between many unions in Canada and the United States would smooth out difficulties.

Reaction of individual States

The reaction of the States to the idea of a closer North American trading arrangement would appear to be positive according to a survey conducted by the National Governors' Association on behalf of the Trade Representative's Office for its report. There was a realization by the States, said the report, that a more formalized trade relationship with both Canada and Mexico would facilitate the States' efforts in developing trade relationships and mechanisms.

Initiative from Canada

The initiative for a free trade agreement would have to come from Canada. This was the viewpoint unanimously expressed by all the U.S. witnesses to whom the Committee spoke. The main reason was that if the United States were to suggest such an arrangement first, the response from Canadian nationalists could be so negative as to strangle such a proposal in its infancy. Mr. Lawrence Krause said:

“At the outset, it should be clear that a serious initiative can and should only come from Canada and not from the United States. . . . So, Canada must display considerable interest in promoting such a scheme to permit the United States the leeway it needs for giving it serious consideration. To reverse this process would likely kill the idea, regardless of its merit.” (7:8)

The Trade Representative's report on the subject of North American trade liberalization revealed a similar sensitivity.

"U.S. should not appear to be unilaterally stressing trade agreements since U.S. intentions might very well be misconstrued as an instrument of aggressive energy sourcing policy." (p. 83)

From the international point of view as well, it was pointed out that other GATT partners might be more inclined to interpret an initiative from the Washington side as a more threatening consolidation of North American economic power than if the proposal came initially from Canada.

Conclusion

It is evident that bilateral free trade would not come as a totally new idea to the Administration which itself appears to have been toying with the concept of some sort of broader trading arrangement with Canada. Despite the abrasive bilateral relations aroused during 1981 by certain Canadian policies as well as by Congress' failure to ratify the East Coast fisheries treaty, it might even be cautiously concluded that there already exists a receptive audience in certain Administration circles for a free trade initiative from Canada.

The argument that a bilateral free trade arrangement would avoid what appears to be the likelihood of increasingly abrasive bilateral trade confrontations with Canada could be an argument which would appeal to the U.S. Administration. Moreover, in a less eminent international economic position than previously, the United States might entertain the idea of an economic strengthening on a regional basis, particularly in the face of repeated frustration in certain of its multilateral trade liberalization moves.

A large segment of the U.S. business sector has been peppered with recent questionnaires and studies concerning their reaction to such a proposal, so they too are unlikely to be caught completely unaware. Undoubtedly there would be difficulties. Such an arrangement would create problems for particular U.S. industries and there would be difficulties in reconciling the U.S. preference for letting market forces prevail with the Canadian preference for safeguards to ensure employment and production levels. Nonetheless a considerable number of U.S. policy-makers could be expected to share the viewpoint of Mr. Julius Katz, who told the Committee that "a political and legal commitment by Canada and the United States to achieve the broadest possible free trade by a certain date, with appropriate adjustments to adversely affected interests would. . . represent an act of political vision and courage."

In balance, the evidence left the Committee satisfied that a Canadian initiative for a bilateral free trade agreement with the United States would be favourably considered by Washington.

PART III

A. The Economic Impact of Free Trade

1. General impact

What will the benefits be for Canada from free trade with the United States and what will the costs be? Contrary to what might be expected, it is the smaller country which is likely to benefit more in a move to bilateral free trade, not the larger one, according to economists on both sides of the border.* At the same time, it is recognized that the short-term adjustments will be more difficult for the smaller country.

Canada would face two types of economic impact from free trade with the United States. First is the impact stemming directly from the mutual removal of tariffs and non-tariff barriers. This would involve lower-priced goods for consumers, some gains and some costs in diversion of trade from other countries to the United States, as well as the removal of the often costly distorting effect of non-tariff barriers. When the lower consumer prices, the trade diversion and creation effects and the relief from non-tariff restrictions are added up, it has been estimated that the net effect is positive, albeit fairly small.

* The main reason why this usually happens, the Professors Wonnacott pointed out in a recent article, is that "trade allows a country to achieve gains by exchanging goods at international price ratios that differ from domestic price ratios it would otherwise have in isolation. And the larger the country, the more its domestic price will influence world price (i.e., price between partners); in other words, the less it will have to gain from free trade". Wonnacott, Paul and Wonnacott, R.J., "Free Trade Between the United States and Canada: Fifteen Years Later." March 1980. pp. 37-8.

Second, and in the long run more important for the future viability of the Canadian secondary manufacturing sector, are the gains achievable under bilateral free trade stemming from alterations in production processes. In particular, problems associated with the 'miniature replica' industrial structure built up behind protective tariffs—small plants, short production runs, managerial inefficiency and a lack of product innovation—would be reduced. With a large new market accessible to it, much of the Canadian manufacturing sector would be compelled to restructure, rationalize and specialize, thereby upgrading its efficiency to international standards to the benefit of workers and entrepreneurs alike. The opportunities seized by European companies within the European Community are an illustration of what is possible. Various estimates have been made of the gains to Canada from potential increases in productivity, and they are generally expected to be significant—up to eight percent of GNP, according to Professor Ronald Wonnacott.

It is important to note that the dislocating effect of bilateral free trade would be confined mainly to Canada's secondary manufacturing sector. For the primary and resource-related processing industries, trade is already largely free of tariffs, aside from the important exception of the Canadian petrochemical industry. In most cases, these industries are already rationalized; they are export-oriented and they have proven themselves efficient and internationally competitive. Free trade would cause few disruptions in this sector. At the same time they could enjoy additional benefits, such as increases in productivity from cheaper manufactured inputs that are still subject to tariffs. Increases in upgrading of Canada's resources could be expected as U.S. tariffs and quotas against processed primary products were eliminated. However the extent of this further processing would depend on Canadian competitiveness, additional transportation costs and the need for market proximity. Resource-related industries could also benefit from the ability of Canada to get behind the U.S. administrative wall to help deal with non-tariff obstacles to their exports. Witnesses told the Committee that the guarantee of a large internal market would reduce the risk of the huge investments needed in Canada's capital-intensive resource industries and an investment boom was predicted in this sector in a Canada-U.S. free trade area. In a bilateral free trade situation, it was suggested, output would increase in the following resource-based industries: mining, smelting, ferrous and non-ferrous metals, lumber, pulp and paper, non-metallic minerals, petrochemicals, fertilizers and some chemicals and primary and secondary energy industries.

The situation differs in the secondary manufacturing sector, however. Here the process of adjustment would generally work as follows. With the removal of tariff and non-tariff barriers to both northward and southward trade, Canadian manufacturers would be faced with not only the opportunity of greater market access to the United States, but also the threat of increased

competition from larger, typically more specialized, U.S. firms. This combination of market forces would compel Canadian firms to increase their output of each product, while narrowing the range of products produced. In order to continue operating profitably, many Canadian firms in order to survive would be forced to specialize in their most efficiently-produced products. Production costs would then decline as machinery changeovers became less frequent and employees' experience in individual tasks accumulated faster.

The significant point to note is that increased efficiency derives from product specialization, not plant size. Dr. David Dodge, the director of research, Institute for Research on Public Policy, pointed to a phenomenon which would be of benefit to Canada in moving to free trade.

"... the necessity for scale is somewhat less important to some industries today than it was even as recently as ten years ago. . . . Indeed, it is possible today to produce the same products in somewhat smaller plants than those used five years ago because of electronic controls and sophisticated servo-mechanisms."(1:10)

One of the persistent questions asked about a move by Canada to bilateral free trade with the United States is what would happen to investment decisions. Would business investment tend to take place in the United States rather than Canada; would Canadian producers not tend to locate production facilities in the larger market? The Hon. Larry Grossman, Minister of Industry and Tourism of Ontario expressed his concern in this respect to the Committee. Certainly, the spectre of Canadian companies packing up and setting off for the sunny southwest does little to enhance the political acceptability of free trade. The moves of some Canadian companies, particularly several very large developers determined to profit from new opportunities associated with the gradual move of the centre of U.S. population and industry to the south and west have dramatized a new Canadian problem which is developing whether or not Canada moves to bilateral free trade.

Corporate investment decisions involve a great number of diverse variables in addition to the specific concerns of climate and regional growth rates of population and economic activity. In practice, the fundamental investment criterion is simply efficiency, which includes in varying proportions, depending upon the industry in question, all of the following factors: availability and cost of labour, raw materials, financing and transportation services; effective rates of taxation applicable to the particular project in all its stages; education, vocational and recreation facilities; and energy supply, as distinguished from and in addition to other raw materials' availability. Overall efficiency is more important than any narrower concerns, and this is likely to prevail all the more strongly in the absence of official—artificial—barriers to trade. The effect on investment of the removal of tariff and non-tariff barriers would involve flows in both directions across the border, witnesses pointed out.

While Professor Weintraub considered that further analysis needed to be made on the question of whether investment would gravitate to certain areas of the United States or Canada, he stressed that other free trade arrangements between developed countries had not led to such a polarization of investment. Further, he pointed out, Canada has a skilled labour force able to man sophisticated industries, good transportation facilities and its main industrial capacity is close to large populations and markets in the northern United States.

The Committee considers that there is no reason to expect the aggregate net flow of investments to turn southward as a result of a bilateral free trade arrangement.

The pull of the United States is there whether free trade exists or not. In 1980, Canadian companies undertook larger investments in the U.S. market than in any previous year in history. A number of successful and innovative Canadian manufacturing companies such as Bombardier, Northern Telecom and ATCO, told the Committee that they had found it necessary to establish manufacturing divisions south of the border. Like many companies they have found the Buy American legislation, the U.S. federal 'set asides' for small businesses, and the restrictions on speciality metals to be insurmountable obstacles. Far from tariffs and non-tariff barriers stopping Canadian firms from moving south, they constitute a major reason for doing so. The status quo offers no protection.

The Committee considers that a bilateral free trade arrangement to protect Canadian exporters from these U.S. obstacles to exporting should slow the current move by Canadian manufacturing multinationals to locate facilities in the United States by eliminating a major reason for doing so.

Quite apart from the 'polarization of investment' question, there is no doubt that some companies would not be able to become sufficiently efficient and would contract or disappear. Adjustment assistance would be required to ease the painful economic and social dislocations thus caused. In respect to the extent of this dislocation effect, however, the result of a membership survey by the Canadian Manufacturers Association (CMA) was of considerable interest and quite encouraging. In preparation for testimony before the Committee, the CMA asked its large membership what impact Canada-U.S. free trade would have on their companies. The results are remarkable, bearing in mind that almost 80 percent of the CMA's membership is located in Quebec and Ontario and that by far the greatest number of respondents (81 percent) were smaller companies in secondary manufacturing with sales of under \$50 million, most employing less than 100 people.

In response to the CMA questionnaire, one-third of the member companies replied that they considered they would expand in a bilateral free trade

agreement, one-third said they would register no change, and one-third said they would have to contract. Further analysis of the survey revealed that companies which do not export perceived themselves to be more vulnerable to contraction while companies with a large export orientation felt more capable of surviving. The size of the company did not appear to make a noticeable difference; both small and large companies indicated they would do well or not do well.

In the light of the survey results, the Committee and a number of subsequent witnesses were puzzled at the conclusion drawn by the CMA, namely that bilateral free trade was premature. With a one-third, one-third, one-third tally, it hardly seems justifiable to assume that the neutral one-third which said it would neither decline nor expand should be associated with the declining group. It could just as easily (but equally inappropriately) be counted with the positive expansionist group. The survey was, in effect, a draw. But, as several witnesses have since emphasized, the response to a similar questionnaire only a decade earlier would almost certainly have produced an overwhelmingly negative response. The change surely indicates a movement towards a more confident and competitive position vis-à-vis U.S. industry.

Moreover, if the 10 percent of the larger responding companies which have sales over \$50 million had been appropriately weighted as to volume of sales (justifiable in economic terms), the Committee considers the survey results might have been overwhelmingly favourable to free trade. In addition, a growing positive attitude to free trade in the small business sector was noted by the Committee as early as 1977 when the Canadian Federation of Independent Business submitted a questionnaire to its huge membership as to how small businesses would react to free trade with the United States. From over 10,000 replies it had received, the Federation reported to the Committee at the time that just under one-half supported the free trade idea. Even in 1977 this result seemed unexpectedly confident.

Indeed the Committee was impressed by the optimism and confidence displayed by Canadian businessmen responding to a policy change of this magnitude. As Mr. Laurent Thibault executive vice-president of the CMA pointed out, jumping into the very large North American market for a typically small Canadian manufacturer represents a one thousand percent decision, whereas for a typical U.S. company adding the small Canadian market is only a 10 percent decision. It seems evident from the strength of the positive replies to both questionnaires that there has been a growing appreciation by Canadian business of the realities of the international competitive outlook and of the path which Canadian business should follow.

While the Committee heard from some manufacturers, for instance furniture producers, who urged continued protection of the Canadian market, it

heard many who were positive in their reaction to bilateral free trade with the United States. Mr. C.D. Reekie, president and chief executive officer of CAE Industries Ltd., was sympathetic that some Canadian manufacturing industries would be in difficulties if all bilateral trade barriers were eliminated. But he said, "the pill will have to be swallowed eventually and better sooner than later." For his own company, his attitude was tough and unpromising.

"There are CAE divisions which export into the United States now despite tariffs, and which sell in the domestic Canadian markets which are protected by substantial tariffs . . . There is no doubt that bilateral free trade with the United States would open up additional markets in the United States to these companies, and provide additional competition for their products in Canada from American suppliers who cannot now overcome the tariff advantages we enjoy. Generally speaking, we have to contend with a five to seven percent tariff into the United States, while they must overcome a barrier of 15 to 17.5 percent . . . I firmly believe that these CAE companies, too, should be prepared to compete for the total business available in North America. If they cannot exist without tariff protection and all other factors are equal, they will likely not prosper." (15:13)

Similarly, the heads of Westinghouse Canada, Spar, de Havilland, McDonnell-Douglas, Litton Systems and Canadian Marconi welcomed the idea. Admittedly a number of the witnesses who were in support were already benefitting from free or almost free access in the U.S. market. Their message was "Come on in, the water's fine." Mr. John Simons, vice president of Canadian Marconi, put it this way:

"The experience of Canadian Marconi Company in its trade with the United States shows, I believe, the substantial opportunities which are available in freer trade between Canada and the United States . . . Canadians are all too prone to want to retreat behind protectionist walls. All this has done is to perpetuate non-competitive industries, to foster a stagnant secondary manufacturing sector, and to cause the Canadian consumer to pay more for most goods and services. Only by re-orientating Canadian thinking to an international viewpoint and negotiating opportunities for freer trade with our trading partners will we develop industries which will have the comparative advantage necessary to succeed on a world scale and redress our current horrendous imbalance in trade of manufactured goods." (12:41)

In the Committee's opinion there has been a remarkable growth in self-confidence in the Canadian business milieu in respect to the question of bilateral free trade which has not yet permeated the political scene.

2. Which industries will expand? contract?

The Committee did not make a thorough examination of the benefits and costs of a bilateral free trade arrangement in all Canadian industrial sectors. On the basis of the evidence it received, the Committee is in a position only to point to certain highlights and to comment on selected industries.

a) *The petrochemical industry*

The Canadian petrochemical industry, a subject on which the Committee received considerable testimony, has the potential to play a key economic role in Canada's future. Seizing advantage of an assured feedstock extracted from natural gas, the petrochemical industry in recent years has spent or has plans to spend \$6 billion establishing world-scale plants. In the early 1970s, prior to this enormous expansion, the average size of Canadian facilities was only one-third to one-fifth that of American, European or Japanese competitors—small scale plants built to serve the Canadian market almost entirely. The result was high prices for the Canadian industrial consumers downstream. The future looked bleak; there was little chance to export and there was an inadequate return on investment. In the words of Mr. Clifford Mort, Chairman of Dow Chemical, Canada, the companies had the alternative either to "build world-scale, world-competitive facilities, or see their existing businesses die". The companies took the major risk involved and invested heavily in new facilities designed to serve both the Canadian market and export markets.

Unfortunately the Tokyo Round did little to open up the market, particularly the U.S. export market, for derivative petrochemicals. In fact, according to Mr. B. G. S. Withers, vice-president of Petrosar and Mr. Clifford Mort, the U.S. barriers were increased rather than decreased. By 1987, under the Tokyo Round agreement, the average effective Canadian tariff on petrochemicals will be at 9.5 percent and the comparable U.S. tariff at 10.1 percent while the tariffs on certain important derivatives will be much higher.

Meanwhile the Canadian industry has geared up for the export market and by the mid-1980s it will be heavily export-oriented. What is critically important now, the Hon. Hugh Planche, Minister of Economic Development of the province of Alberta, told the Committee, is guaranteed free access to the U.S. petrochemical markets. Already in 1980, Canada had for the first time a small trade surplus in petrochemicals—a turnabout from the \$500 million deficit of 1977—as a result of a combination of a favourable exchange rate, high market demand and very competitive oil and gas prices in Canada. Currently the industry has a capacity 25 to 35 percent higher than Canadian market requirements.

Moreover, the industry itself is broadly united in its need for bilateral free trade in petrochemicals. Mr. R. L. Pierce, president, Alberta Gas Ethylene, told the Committee that, while the industry had put out "an uncertain signal" at the time of the GATT negotiations which effectively eliminated any chance of securing concessions in this sector, it is now no longer divided on the issue. Rather, it is convinced of its "unique opportunity." The Hon. Hugh Planche later stressed the considerable urgency for the Canadian

industry to use its present "window in time" to establish economies of scale at each level of upgrading before competitive Middle East installations come onstream.

The prime importance to the whole economy of an expanded petrochemical industry was emphasized to the Committee. In a written submission, Mr. T. E. Newall, chairman, DuPont Canada, stated that in the United States, studies have indicated that the U.S. petrochemical industry has an important spillover stimulus on business sales, capital investment and employment. In Canada, where oil and gas supplies are more significant, in relative terms, to the economy, the impact of an expanding petrochemical industry could be even more positive than in the United States. Mr. Withers estimated that bilateral free trade might result in double the upgrading done in Canada. Indeed, recently, Union Carbide, a U.S. company, concluded a major agreement with a Canadian company, Enesco, to purchase polyethylene resin to be produced in a large new plant in Alberta.

In elaborating on the job creation potential of upgrading petrochemicals, Mr. Mort said that if ethane, the basic feedstock of natural gas is given the value of 1, upgraded to ethylene it is 4, upgraded further to the first stage derivative it is 28, for polystyrenes it becomes 46 and by the time these products are moved to the fabricating industries, such as plastic moulders, there are 1,000 jobs created for every one job extracting ethane. If bilateral free trade resulted in this industry moving even half way up this upgrading scale, consider the huge numbers of new jobs which would be created in Canada. On the subject of further upgrading Mr. Pierce added that Canadian downstream producers in the processing and fabricating industries have been inhibited for years in their development because they have had to pay a premium price on locally produced petrochemicals. Mr. Newall said that his firm has been a world pioneer in the production of linear low-density resins and its polyethylene resin business would benefit in a major way from bilateral free trade in petrochemicals. He added that "if limited to the domestic market, we would have to sell to end-use applications where our specialty resins have no particular added value. In the huge North American market, on the other hand, the scale would be such that we could retain and develop our specialities to the fullest extent possible."

While Mr. Ian Rush, president of Polysar Limited, indicated in a written submission that his firm was favourable to the bilateral freeing of tariffs for primary petrochemicals and derivatives, he raised the additional important point that for a truly free market in petrochemicals, some arrangement would be required regarding non-tariff measures.

Canadian producers have been careful to point out that increased Canadian petrochemical exports would not undermine the U.S. industry, that it would be the late 1980s before Canada could achieve a 10 percent penetra-

tion of the U.S. market and that since that market would be growing during that period, the 10 percent would represent only about one to two years' growth in the market. The U.S. Administration for its part is sensitive to another problem, that is, the fact that the Canadian feedstock price is lower than the feedstock price available to U.S. producers, although currently the U.S. Gulf Coast states producers also have a controlled lower-than-world-market price. Most Canadian producers contend that a feedstock price at 85 to 90 percent of the U.S. price is necessary because of higher capital costs, higher distribution costs and higher construction and maintenance costs due to location and climate. However, the Hon. Hugh Planche said that studies made by the province of Alberta on petrochemicals had not been predicated on a discount price. He thought security of supply would induce long-term investment.

The benefits to the petrochemical industry of free access to U.S. markets are clear and the industry itself is prepared. The advantages to the entire Canadian economy seem equally clear. But experience to date and testimony before the Committee in Washington indicated that there is no likelihood of making a free trade arrangement in this sector alone because the benefits would accrue largely to Canada. As emphasized by Mr. Jack Dewar of Union Carbide in his testimony as quoted on page 36 there is simply no easy *quid pro quo* to be found within this single industry.

For this reason the Committee stresses that only a broad approach to free trade, with a sharing of benefits and costs across many industries, holds the prospect of success. Only this course would give the petrochemical industry the boost it needs.

b) Secondary manufacturing industries

As stated earlier, under bilateral free trade the major negative effect would be felt by the secondary manufacturing industries, not by the primary and resource-related processing industries which should expand significantly. Within the manufacturing sector, the impact would vary widely.

A divergence of views was presented to the Committee by economists as to what would happen in the secondary manufacturing sector in a bilateral free trade situation. Opinions ranged from predicting an increase in Canadian secondary manufacturing output to anticipating a small decline overall in secondary manufacturing activity, more than balanced by a large increase in resource-related activity, including further processing. Witnesses were hesitant to speculate on the prospects for specific industries. Dr. David Dodge, a proponent of the more cautious approach, considered that output would be likely to fall in the following industries: food processing, beverages, tobacco, textiles and clothing, furniture, some metal fabricating, household appliances, hardware and tools, motor vehicles and parts, paints and

household soaps and toilet preparations. But he expected that output would increase in most of the resource-based industries and in some machinery industries, in the electrical and communications equipment industries, the glass industry and in a large number of service industries. Dr. Dodge said the importance of the so-called service industries should not be overlooked as business services represented a very high skill, high employment industry and one in which Canada has developed capability. In assessing the probable expansion of primary industries and the decline of certain secondary manufacturing industries, Dr. Dodge commented:

“... The skill requirement and the technology involved in a host of the primary industries in terms of primary upgrading is very much superior to some... assembly-type operations. I would feel happy if we could find some [primary] industries to move in and some of the service industries to move in to replace the relatively low productivity industries, such as textiles which we have.” (1:20).

According to testimony from the Canadian secondary manufacturing sector itself, the consequences for specific industries would be mainly determined by two important factors: the economies of scale available and the relative transportation costs. Witnesses pointed out that when transportation costs are low—when a product travels inexpensively—and the economies of scale in production are high, production becomes centralized in the most advantageous location in relation to the total market. This could mean that certain production activity might move to the United States. On the other hand, products that are manufactured in shorter runs where economies of scale are low and where transportation costs are high might not be affected when trade is free. In between these two situations are a range of variations. Clearly, production of huge custom-made generators or turbines or other machinery with neither economies of scale nor low transportation costs would not tend to relocate; nor would metal fabrication which tends to be locally oriented and manufactured in small volumes for specific orders. Cement, notwithstanding its good levels of productivity and economies of scale, would not centralize production because transportation costs are relatively high.

In the CMA survey, the industries which were ranked the most confident of new possibilities in a free trade environment were the primary metal industry, the electrical industry, the non-metal mineral industry, the transportation equipment industry and the textile industry. They, and other industries which were satisfied they could expand, gave a variety of reasons which were summed up as follows:

“They relish their access to a larger market. They felt they would get better utilization of their facilities and, therefore, be more cost competitive; they felt they might get lower raw material prices and that would help them; they felt they could easily establish at least some kind of a little position in a huge market; they felt they might get lower machinery prices, which would lower their costs; they felt they might be able to bring in goods more cheaply to round out their product

lines; they felt they had a good geographical position; some of them felt they had better technology; and some felt they had specialized custom-made equipment and would be able to do well." (14:55)

The CMA also identified the industries having the largest number of companies which were doubtful about bilateral free trade. The reasons given to the CMA by these firms, including subsidiary firms, which feared contraction in an open trading system were:

"They generally said that the bigger, more specialized, lower-cost, high-technology plants in the U.S. would simply do them in. They also argued that they had, generally, higher running costs in terms of wages and materials in Canada. That is the predominant reason. The second most important category of reasons, quite apart from the competition issue, was that they just simply said they would be unable to make a transition because they were not capable of making an autonomous decision in Canada, that they would have financial limitations, plant facilities would not be on par, and that they had licensing limitations on exports."(14:53)

Surprisingly, under the CMA ranking system the paper industry appeared to be the most vulnerable, followed by textiles and chemicals. However, as Mr. Thibault of the CMA explained, the reason why the paper industry headed the list of doubtful industries was because the survey reflected mainly the viewpoint of numerous small paper companies, including fine paper companies, with annual sales of less than \$50 million. The major integrated paper companies which are already fully internationalized with large sales and employment would not be affected in the same way. Indeed, in the Committee's view, these large paper companies would welcome bilateral free trade. The same is obviously true of the large petrochemical companies in contrast to small chemical firms which made up the bulk of the respondents in that industry. If the replies of the respondent paper or chemical firms had been weighted by volume of sales and number of employees rather than merely by the number of companies responding, a procedure which automatically gave extra weighting to the views of the numerous small companies, a more realistic assessment of the industry reaction might have been obtained.

The CMA testified that other industries in which a significant percentage of companies responded that they would contract under a bilateral free trade regime included the textile industry, the transportation equipment industry and the electrical industry. It is clear from a comparison of the overlap of these three industries with those industries ranked by the CMA as the most confident they could expand, that a distorted impression of industry reactions results from the equal weighting accorded each firm regardless of size, sales or employment levels. In each industrial sector which feared contraction, it is evident there was a significant number of large, confident, more efficient firms which considered they could expand under bilateral free trade.

In fact, as Mr. Thibault told the Committee, a significant amount of rationalization of manufacturing is already underway in Canadian and for-

eign-controlled companies as these producers recognize it is no longer profitable to make a large number of products with short production runs.

The furniture industry is a mixed situation. In testimony before the Committee a majority of the furniture companies' representatives were fearful of bilateral free trade or of any lowering of Canadian tariffs on furniture beyond the 15 percent level scheduled for 1987. (By contrast, U.S. furniture tariffs will drop to between 2 ½ and 7 ½ percent by 1987.) Mr. K. M. Campbell, expressing the point of view of the Canadian Council of Furniture Manufacturers, emphasized the higher labour costs, higher material costs, lower productivity levels and higher freight rates in Canada than in the United States. Mr. Bernard Papineau, president of H.P.L. Cie, pointed to the special constraints affecting Quebec furniture manufacturers, such as the smallness of the companies involved, the small-sized plants with their broad diversity of product lines, the lack of economies of scale and the high dependency of small communities on the furniture industry. Mr. Joe Malko of Furniture West Inc. of Winnipeg said that in the case of the furniture industry of Western Canada, the small, family-owned furniture manufacturing facilities were already very sensitive to competition from the U.S. furniture industry. For most Canadian producers, the strongest competition was cited as coming from the U.S. South, particularly North Carolina, where the lower wages of non-unionized workers give the U.S. manufacturers a competitive advantage.

However, in the CMA survey, almost as many furniture companies expected to expand as to contract in a bilateral free trade setting. Dr. James McNiven, then executive vice-president of the Atlantic Provinces Economic Council, did not think that the specialized furniture industry in the Maritimes would be particularly affected one way or another by bilateral free trade. Moreover, because of its vulnerability to damage in transport, living-room furniture is considered to have a considerable degree of protection. In addition, transportation costs which are relatively heavy for most furniture items could be expected to protect the Canadian market somewhat from distant southern U.S. products, while allowing Canadian producers in Ontario and Quebec a degree of advantage to nearby populated markets in the northeastern United States. Some Canadian furniture producers, including office furniture producers, have already moved aggressively into the U.S. market, successfully competing over the U.S. tariff by specializing and rationalizing. It is difficult to understand why, in the face of gradually lowering tariffs and increasingly competitive imports, more rationalization and specialization is not taking place in this Canadian industry.

To sum up, bilateral free trade will undoubtedly mean some painful adjustments in the secondary manufacturing sector. But even at present, standard technology manufacturing companies, not of world scale or not tied to resource development, are finding it increasingly rough going. Many are

already being squeezed and the future outlook is not promising. **Bilateral free trade would allow Canada to concentrate more on things that it does well, including resource-based industries and certain secondary manufacturing industries where Canada has a natural advantage, to build on these areas and substitute these for goods which it produces less efficiently behind protective tariffs. The outcome could be an industrial establishment equipped to face the challenges of the 1990s. Canada would be better off in the end and certainly very much better off than if it continues its current policies.**

c) Foreign-controlled companies

In respect to U.S.-controlled companies, concern has been expressed that in a bilateral free trade arrangement, there could be significant repatriation of production to the United States, or even the outright closure of branch plants, leaving the Canadian market to be supplied from across the border. Having originally located in Canada to get access to the Canadian market behind the protective tariffs, subsidiary firms, it is argued, might consider they had no reason for staying once tariffs had been dismantled or reduced so much as to no longer constitute a barrier to imports from the parent company in the United States. This concern was mentioned in the Committee's 1978 report.

In its survey, the CMA found that foreign-controlled subsidiaries were slightly more vulnerable to contraction under bilateral free trade than Canadian-controlled companies (35 percent as compared to 27 percent). A company's reaction to free trade appeared to be more closely related to whether it exported than whether it was foreign-controlled; that is, the larger the export orientation, the more a company felt able to survive in a free trade setting.

It can be assumed that for many of these subsidiary companies, if they could not expand into export markets, survival would not be possible. Even under current conditions some subsidiaries are contracting and repatriating production to the United States, not as a result of bilateral free trade, but due to the lessening importance of the tariff and their own uncompetitive industrial organization. The Hon. Larry Grossman of Ontario, a province where half the secondary manufacturing industry is foreign-controlled, recognized this development when he told the Committee that the fact that tariffs were no longer important in many sectors, calls into question "the viability of branch plant operations... originally set up to jump the tariff walls".

A number of branch plant subsidiaries have already faced the fact of their outmoded structure. Their experience is instructive. Westinghouse Canada told the Committee that a private survey it made in 1978 of 50 U.S. subsidiaries in Canada, in the electrical and electronic industry, had revealed

that over half were increasingly concentrating on the export market. The necessary reorganization is obviously easier for a large multi-product company like Canadian General Electric (CGE) than smaller subsidiaries. Mr. L.R. Douglas, vice-president of CGE, told the Committee that his company had become a "product specialist" in 26 different products within the General Electric organization, including such major products as hydro-electric generators, jet engines, hydraulic turbines and paper-making machinery. In a bilateral free trade setting, CGE would restructure further, Mr. Douglas said. Some products now made in Canada would be supplied from the United States and the manufacture of other products would expand with tariff-free access to the U.S. market.

In 1977, Westinghouse, Canada, rationalized its Canadian production of lamp products on a North American basis. Faced with declining profits, the product lines made in Canada were narrowed down but the products still produced in Canada were now sold in the U.S. market as well as in Canada, and U.S. products were imported to Canada replacing the styles and types no longer made here. The result of this specialization, said Mr. F.H. Tyaack, president of Westinghouse, Canada, was increased efficiency, lowered unit costs and better total factory capacity in both countries. Although the duty on lamps coming into Canada is double what it is going into the United States, the company was determined to "blast through" the tariff to make its rationalization strategy work. This North American rationalization averted any thought of closing down the Canadian lamp products operations, Mr. Tyaack said.

It appears evident from such examples that a bilateral free trade environment could make reorganization easier and more attractive for subsidiaries of multinational companies.

In the late 1970s, Westinghouse went further and prepared a long-range plan for its Canadian subsidiary based on the assumption that no form of tariff protection existed whatsoever, no non-tariff barrier protection was available and the U.S. and Canadian dollars were at par. It was, said Mr. Tyaack, a "worst-case" scenario. The plan, which placed principal emphasis on world product mandates and other rationalization schemes, envisaged the export of half of Canadian production by 1990. With this strategy, the company had implicitly answered the question, "How would Westinghouse react to a free trade agreement with the United States?"

However, Mr. M.J. McDonough, the senior vice-president of the parent Westinghouse company, who testified along with Mr. Tyaack, also gave the Committee the explicit reasons why his company would not pull its production operations out of Canada in a free trade situation: its considerable investment and large trained work force, the company's long-term strategy for mutually satisfying business arrangements, the fact that Canadian

exports can be sold in markets to which exports from the U.S. company cannot, and the company's successful decision to restructure on the assumption that free trade already existed. As a result of rationalization, Westinghouse, Canada, has become highly efficient and actually more profitable than the company's U.S. operations.

Product mandating by subsidiary companies is increasingly regarded as an important instrument for countering the risk of multinationals repatriating production facilities. Under a global or North American product mandate, a subsidiary is given total responsibility within the corporate family for developing, marketing and exporting a specific range of products.

The Committee heard excellent evidence from four very successful subsidiaries which had sought and obtained product mandates from their parent: Pratt & Whitney, one of the first subsidiaries to use this formula, now has annual sales approaching half a billion dollars, mainly from its small turbine engine; Garrett Manufacturing has its temperature-control systems on 70 percent of the world commercial and military aircraft; Litton Systems Canada has its inertial navigation system in the aircraft of 70 airlines and has recently won a very large contract for a navigation system on the U.S. Cruise missile; Westinghouse Canada has the company mandate for industrial turbines, certain electronic products and airport lighting.

Repatriation of such successful subsidiaries by the parent appears very unlikely. In these cases, although every company is different, the evidence heard by the Committee revealed a very great degree of independence by the subsidiary in handling its own mandated product. There were frequently significant benefits accruing from the parent in the form of transfers of technology and marketing expertise.

For example, Mr. Ronald R. Keating, president, Litton Systems Canada told the Committee that through product mandating his firm had established a comparative advantage in a wide range of high technology products and would benefit from a free trade arrangement—bilateral or multilateral.

“Because of the advantages we have built up, we do not believe that a free trade situation would lead the parent organization to consolidate, in the U.S., production of our important lines.” (15:25)

Mr. W.C. Tate, vice-president and general manager of Garrett Manufacturing had an interesting additional comment.

“The establishment of a highly technically oriented engineering group and facilities for production makes it far more difficult to move than it would for a branch plant operation which is not doing its own design or development or manufacturing in Canada.” (15:16)

One of the effects of product mandates would be an increase in the R&D done in Canada by foreign-owned firms. Mr. Tyaack explained the different

attitude towards R&D of a branch plant and of a subsidiary with full responsibility of product lines.

"... one of our problems in doing R&D when we were a branch plant was, all right, we did the R&D; where are we going to dump it now that we have it? Because the market was too restrictive. There wasn't the entrepreneurial drive to do that much that was new for this market... It wasn't so much a question of a subsidiary manager having problems with the parent as it was an opportunity problem. Once you get into that hot competition in your world charter areas, then you have a worthwhile place to dump your R&D. We do not necessarily recommend that you crank up and do a lot of R&D and then let that somehow push its way into markets of strength. That is a long trip, and you may guess wrong at the R&D level because you do not know what the applications are." (16:20-21)

Aware of the potential of product mandating for strengthening and transforming branch plants, the Hon. Larry Grossman told the Committee he has established a joint government-industry committee to help push multinational parents into granting product mandates to Canadian subsidiaries. This group has already established a list of about 100 subsidiary companies with full or partial product mandates. Mandated products include: computer systems, muffler parts, antenna systems, carpets and rugs, pharmaceuticals, auto radiators, mining equipment, furnaces and auto brake products. Mr. Grossman mentioned that he was considering using provincial procurement preference and perhaps incentives to encourage product mandates in Ontario.

The Committee welcomes the current emphasis on product mandating insofar as it reflects increased awareness of the need for manufacturers to rationalize production in order to improve efficiency. But the Committee is concerned that the assignment of product mandates is being regarded in government quarters as a panacea, to be secured through offering sticks or carrots to Canadian subsidiaries of multinational companies. Not only is this potentially costly, but the approach implies that the achievement occurs in a static environment, like winning a race which ends. But the trading world is dynamic and the assignment within a group of companies of product mandates is a rational response to a market situation. Many of the successful instances of product mandating—Pratt & Whitney, Garrett Manufacturing, and Litton Systems—have occurred in the aircraft industry, where free trade already effectively exists. Or like Westinghouse, some companies have decided to act as though free trade exists, even though difficulties with tariffs and non-tariff barriers are present, as Mr. Tyaack explained.

"While we have decided to proceed with our plans, which are based on a total absence of protection, the fact is that tariffs and non-tariff barriers do exist. If anything, in terms of whether one perceives it from Canada looking at the U.S. or from the U.S. looking back at Canada, the latter seem to be increasing. Many of those can be a hindrance to us. Concerning tariffs, for example, as we increase north-south trade between parent and subsidiary, even if the trade is balanced we have to pay an increasing amount of tolls at the border, which diverts moneys we would rather have for investment. For those products that get involved in government procurements, we can actually be blocked from rationalization schemes due

to non-tariff barriers having to do with content or what have you . . . We see a tendency to proliferate these kinds of subtle barriers which do block such schemes as we have." (16:16).

The conclusion seems inescapable. Product mandating assignments and rationalization schemes within transnational firms are easier in a free trade setting, where tariffs would be eliminated and the application of non-tariff barriers mutually agreed to and enforced. However, a number of the success stories in world product mandating have resulted from federal financial assistance provided through PAIT (the Program for the Advancement of Industrial Technology) or DIP grants. It would be important to ensure that, under the terms of a bilateral free trade arrangement, subsidiary firms with potential would not be deprived of this type of assistance initially from the Canadian government, particularly since counterpart U.S. firms are also recipients of a variety of assistance in developing new products.

Repatriation and contraction of subsidiaries is an ongoing possibility, both at the present time and potentially under a free trade regime. **But to the extent that North American rationalization and product mandating are vigorously pursued by subsidiaries, the likelihood of repatriation is lessened.** As executives told the Committee, a parent company is much less likely to repatriate a technically-oriented engineering group with an efficient facility producing a successful product than to close down a branch plant operation manufacturing a similar product for a small adjacent market. Moving to freer trade in North America would create a dynamic new environment in which the potentially strong producers could and would grow and some of the weak would fall by the wayside. Subsidiaries would not wait to be assigned product mandates but, like Canadian Marconi, develop their own products in Canada regardless of the location of their ownership.

While the large foreign ownership component of the Canadian secondary manufacturing industry has been looked on by many nationalists as a disadvantage in the struggle to promote industrial development in Canada, in terms of restructuring it could actually be an advantage. Indeed, as Mr. Tyaack pointed out, rationalization schemes and product mandates are easier when the subsidiary is wholly-owned or almost wholly-owned, by the parent.

"Suppose . . . we were only 50 percent owned. In that case, if I propose to the parent that we produce something in an alternate plant site in Canada for sale in the North American or world market, rather than make the same product in the United States in an alternate plant site there, I could be at a disadvantage, because to make the product in the U.S. would avail Westinghouse of 100 percent of the fruits of such labour but to make the same product in Canada would only bring back 50 percent of the fruits to Westinghouse. We would be sharing with other owners something that historically we had developed ourselves. That could put the Canadian option at a two to one disadvantage. I bring that up only because I do not think that issue should be looked at as totally irrelevant to the issue of rationalizations and world product mandates between subsidiaries and parents." (16:17)

The Committee concludes that in a free trade environment, foreign ownership could be an asset, giving Canadian manufacturing facilities easier and more secure access to the large and competitive U.S. market. In this situation product mandating would become a rational intra-company response. Providing the Canadian economy remains generally competitive, massive repatriation and de-industrialization are not dangers.

d) *High technology industries*

Overlapping to a degree both the discussion of secondary manufacturing industries and foreign-controlled companies is the high technology sector, but its importance is such as to warrant separate consideration.

High technology industries offer the best future prospects for the Canadian economy. Mr. David Mundy, former senior trade official and past president of the Air Industries Association of Canada, drew the Committee's attention to a government study which has shown that high research intensive industries in Canada have out-performed, by a wide margin, those of low research intensity—higher employment by 50 percent; higher output by 23 percent; improved productivity by 29 percent; lower growth in prices by 57 percent. The viability and growth of this sector is critically important. What are the chances that this dynamic sector would move into the United States in a free trade situation? To what extent would it tend to gravitate toward clusters of 'high tech' industries south of the border?

To compete internationally in advanced technology is costly and it involves big risks. Innovative technology is enormously expensive to acquire, whether it is imported or developed in-house. Competitors in other countries are usually supported by massive government funding or other types of assistance. The most advanced technology and production methods are prerequisites. Concerned by the need for more innovative products, the Canadian government has been pumping out financial assistance through various programs to assist key high technology firms to do R&D in Canada.

Yet, by and large, the sectors which have produced the most fruitful results to date have been those which can sell their products in other markets, particularly the United States. The aerospace and avionics sector is the prime example. While government assistance in innovating has been important, the essential component in their success has been market access. Mr. John Simons of Canadian Marconi told the Committee:

"In those market segments where free or nearly free trade exists, Canadian Marconi has been able to compete, grow and prosper. In those areas where free trade does not exist, Canadian Marconi has made no significant sales." (12:41)

The same approach was stated by the president of Pratt & Whitney, Mr. E. L. Smith when he asserted that "there is no possibility at all of surviving based on the Canadian market alone". The Defence Production Sharing

Arrangement (DPSA) and the GATT Trade in Civil Aircraft Agreement have permitted the success of many of Canada's foremost aerospace firms. Companies such as Canadian Marconi have flourished in Canada, selling more than twice as many avionics products in the United States as in Canada. A multi-product company like CAE can sell flight simulators and magnetic detection equipment under the DPSA or the civil aircraft agreement. It can also, under the auto pact, export duty free its advanced technology parts to the United States. In each case the key to the success of innovative products has been free access to the U.S. market.

The Hon. Patrick McGeer, Minister of Universities, Science and Communications for the province of British Columbia, told the Committee that he has had direct experience with international high technology firms which decided not to establish a facility in Canada because they did not have the whole North American market base in which to operate freely; that is, no guaranteed free access to the U.S. market from Canada. Mr. McGeer also cited the case of a thriving Canadian pharmaceutical firm which had built its plant in the United States because of U.S. tariff barriers in order to exploit its Canadian discovery. The U.S. part of the Canadian company soon became dominant and sold out to a U.S. firm. Had it not been for the U.S. tariff, the company would have remained in Canada. In addition, some of Canada's successful high technology companies, such as Northern Telecom, have established manufacturing divisions south of the border in order to get assured market access around non-tariff barriers such as Buy American legislation, small business 'set asides', restrictions on the import of specialty metals, etc.

Far from fearing the massive relocation south of the border of Canadian high technology manufacturers, the Committee is convinced that such firms would do more R&D in Canada and would be more likely to flourish in a free trade setting which eliminated the tariffs, limited the application of non-tariff barriers and removed the inducement which now exists to locate manufacturing facilities in the United States.

B. Regional Economic Impact

1. Political perspectives

The tariff has been a source of regional friction in Canada for 100 years. For most of that time, free trade with the United States has been strongly supported by Canadians in the West and the Atlantic provinces and just as strongly resisted by Canadians in the central provinces. The rationale has been that with free trade, people in the extremities would benefit from cheaper imported consumer goods and find a readier market for their own

products—which in the case of resources, could be upgraded prior to export—while people in Quebec and Ontario were concerned to establish a protected market for their manufacturing industries.

This historical pattern was, to a certain extent, borne out by the viewpoints of the regional representatives who testified before the Committee. For example, the Hon. Patrick McGeer of British Columbia told the Committee that Canada has been pursuing a foreign trade strategy that has caused the country to forego significant economic opportunities. He said Canada's "manufacturing strategy is particularly disadvantageous to the wings of the country—by that I mean the West and the Maritimes." He continued:

"The defensive strategy is one that accepts or encourages reciprocal tariffs as a means of isolating Canada from foreign competition. . . in the name of nationalism. The other side of that coin is the one that traditionally has been so hard for westerners to accept, namely the denial of opportunity to Canadian manufacturers, because of the reciprocal tariffs, to penetrate the much more lucrative markets which exist in the United States, traditionally, and now in Japan and the European Economic Community." (20:7)

And he argued further:

"How then do we offset the foreign deficit that we have in manufactured goods? We offset it because of our surplus in the area of unprocessed natural resources. These come in disproportionate measure from the West. So here you have the source of historic western alienation. Westerners are obliged to buy their manufactured goods from eastern Canada, where the prices are above world market prices, because the branch plants cannot operate here as efficiently as they can in other parts of the world. So westerners buy Canadian manufactured goods at high prices. At the same time, they sell their resources, always unprocessed, often non-renewable, at world market prices." (20:7)

All in all, an excellent expression of the classic Western position on tariffs and the protectionism of the central provinces.

Alberta's position was similar. Alberta was seeking "general trade liberalization with the United States," said the Hon. Hugh Planche. He continued:

"We are a relatively strong and rapidly expanding economy. In order to achieve world scale economies we must pursue the most lucrative volume markets available to us. This requires that Alberta have free access to the large U.S. markets for its products. Therein is the basis for our objective of free trade." (21:11)

Moreover, while Mr. Planche did not explicitly endorse a broadly-based bilateral free trade agreement, his attitude was positive.

"We are unable to see anything that would be troublesome in terms of opening free trade with the U.S. . . . Almost all sectors of our industry—in fact without exception—would benefit from economies of scale and market access." (21:12-13)

The Hon. Robert Stanfield, a former premier of Nova Scotia, reaffirmed the opinion that bilateral free trade would be of benefit to the Atlantic region, and as he stated "the evidence suggests that we are having difficulty

competing because of the size and scale our competitors are able to operate on owing to the size of the markets they have access to".

A more muted viewpoint was expressed by the Hon. Roland Thornhill, Minister of Development in Nova Scotia who, while acknowledging the historic Atlantic viewpoint that the Canadian tariff nullified the advantages of geographic proximity of the Maritimes to major U.S. centres of population, went on to say that "factors including international trading patterns and cost competitiveness, reduced tariffs, fluctuating exchange rates and technology are making the advantages of the Nova-Scotia-New England economic link much less clear-cut and constant both for the consumer and the exporter". Further, he considered the benefits to the consumer could not be considered "in isolation from the domestic industrial base from which the consumer derives his livelihood and purchasing power". He expressed concern for the small to medium-sized provincial industries "which have declared themselves vulnerable to import penetration in the event that import barriers were lifted." He mentioned particularly companies specializing in paperboard, linerboard and moulded pulp products, as well as the textile and clothing sectors.

Dr. James McNiven, at the time of his testimony executive vice-president of the Atlantic Provinces Economic Council, said that many of the smaller businesses in the region have been created and maintained by "a combination of tariff factors, distance-related costs and a cheap dollar." These might disappear with free trade, he warned, and small engineering firms and consumer product manufacturers could be adversely affected. Further, he was concerned as to how free trade might affect the region's non-tariff measures to protect local industries. Dr. McNiven went on to say, however, that his overall assessment of the impact of bilateral free trade in economic terms was "the potential benefits to be gained . . . appear to be larger than the risk of what might be lost." He recognized that certain large manufacturers in the region could be helped by free trade and he doubted that the area's furniture producers would be negatively affected. Some moderate expansion could be expected in the resource sector, largely fish and forest products, with some increased upgrading. In this respect, Mr. Hal Connor, former chairman of National Sea Products of Halifax, testified in 1980 that bilateral free trade would be likely to lead to expansion of the market for prepared fish products.

The central Canadian position toward freeing of trade as expressed by the Hon. Larry Grossman, Minister of Industry and Tourism of Ontario was extremely cautious. Mr. Grossman attached importance to Canada remaining competitive and an attractive location for investment; he readily agreed that "non-tariff barriers are the fundamental issue"; he admitted that "the practical, realistic absence of tariffs . . . is calling into question the viability of branch plant operations" and that "the challenge then is to restructure

those plants"; he indicated that his "preferred route" was for cross-border rationalization in specific sectors and he urged Canadians to come to grips realistically with the fact that in certain sectors or industries, the idea of trying to build "world class industries based only on the Canadian market will not succeed and in those sectors we must seek other alternatives."

Mr. Grossman was opposed to an 'across-the-board' approach to bilateral free trade with the United States favouring instead the "attempt to reach bilateral agreements on the use of procurement practices in particular sectors. Urban transit equipment would be a good place to start." However he appeared to overlook the fact that two efforts since 1977 to interest the United States in such arrangements have provided no results.

The Committee noted that Mr. Grossman's rejection of bilateral free trade was based on a perception that this would involve "drop(ping) all rules and have(ing) a total unrestricted, unfettered, unstructured free trading area with the United States." No wonder Mr. Grossman is opposed to bilateral free trade. And while this is not the place to question Mr. Grossman's understanding of what free trade would involve, the Committee must restate that a major reason for its support of free trade is precisely because this approach offers the most promising avenue for negotiating mutual exemption from each other's non-tariff barriers which Mr. Grossman says are a principal concern. Nor would the agreement be 'unstructured' or 'unfettered'.

In sum, the Committee observed that although there has been some shift in position, traditional attitudes of provincial spokesmen have not changed all that much. And regional tensions relating to them still exist.

The Hon. Robert Stanfield, apart from his testimony as quoted above, had a broader approach. As one highly qualified to assess the problem both from a regional and a national perspective, he looked at the issue from all sides—the regional disparities, the competitive disadvantage of the Atlantic region and the West, the undersized Canadian market, the lack of economies of scale, the need for access to the U.S. market and the shortcomings of GATT solutions in this situation. He told the Committee that a reciprocal tariff-free arrangement with the United States "could not only open up new opportunities for Canadian manufacturing but could significantly reduce regional tensions in Canada". In view of the serious difficulties facing the Canadian manufacturing industry, he considered that access to the larger market "seems to offer the only hope of reducing one basic cause of economic disparity in the Atlantic region, and perhaps, one grievance . . . in the west—the definite disadvantage in competing in Central Canada in the Canadian market". In a larger trading area, he said "the western provinces and the Atlantic provinces might well be in a much better competitive position, and be at less competitive disadvantages compared to central Canada . . ."

essed products (such as non-ferrous metals, newsprint, pulp and paper, veneers, chemicals, etc.). Strong Quebec-based resource companies could be expected to welcome the idea of bilateral free trade and expanded opportunities for further processing of resource exports would be likely to occur. Certain end product industries such as the transportation equipment industry would clearly benefit from easier access to the U.S. market. Some large rationalized Quebec textile producers would have possibilities of expanding into a duty-free U.S. market while being still protected from low-cost third country competition.

Professor Wonnacott has estimated that the gains from bilateral free trade could be larger for Quebec than for any other Canadian region except Ontario. Moreover, in a bilateral free trade arrangement, certain Quebec industries such as clothing, food and beverages, tobacco, leather and fixtures—industries which are currently well protected by tariffs—might not require as widespread restructuring or rationalization as would many Ontario-based manufacturing industries involving more advanced technology. Many of these Quebec industries would be much harder hit if Canada decided to go to multilateral free trade. The reason for this distinction is that many of Ontario's industries would need to compete unprotected against aggressive high technology U.S. products whereas many Quebec industries would find that U.S. competitors in their product lines, which are similarly protected from cheap off-shore imports by U.S. tariffs, do not represent a threat. Quebec producers of these items would therefore have an opportunity to increase sales in the nearby larger U.S. market, while remaining protected from third country competition there, as well as in the domestic Canadian market. In a North American free trade arrangement it is argued, Quebec's clothing, food and beverage industries would have the potential to expand. On the other hand, it should be kept in mind that Quebec has an unusually high dependency on the markets of other regions of Canada, especially in Ontario, for the sale of many of its manufactured goods. If the Canadian tariff were reduced, Quebec could suffer from competition in Canadian markets from nearby U.S. producers. The competitiveness of Quebec manufactured goods would, in the end, depend on the level of its unit labour costs which, in turn, would depend on higher productivity levels and comparative wage rates. In any case, in view of Quebec's enormous dependence on the North American market, a Canada-U.S. free trade arrangement would clearly be in Quebec's best interest.

Residents in both Ontario and Quebec, like those in other provinces, would enjoy the gain in real income due to lower prices associated with the removal of the Canadian tariff. They would also benefit, according to Professor Wonnacott, from the elimination of the U.S. tariff—both because of the recapture of the duty revenue on current exports of their local industries and

because of the new exports produced by more efficient, rationalized and specialized industries.

Overall, the evidence points to economic gains for all regions in Canada from bilateral free trade, with the biggest dislocation affecting and, at the same time, the biggest gains accruing to the two central provinces. The rationalization of the manufacturing sector in the two central provinces under bilateral free trade would reduce that sector's drain on Canada's balance of payments, a development which would be of benefit to the whole country.

PART IV

Areas of Special Concern

1. Competitiveness

A major trading nation like Canada cannot fail to be concerned about its international competitiveness. Canada's record is, in fact, spotty: strong in freely traded resource products, in processing and in a few manufacturing sectors, but relatively weak in most areas of secondary manufacturing. In its 1978 report, the Committee expressed its concern both over the persistent low level of competitiveness in Canadian manufacturing (with notable exceptions) and the rapidly growing deficit in trade in end products.

This contrast between high productivity in the resource and processing sectors and low productivity in many areas of manufacturing is to some degree self-reinforcing. During periods of strong demand for natural resources, such as occurred during the 1970s, Canada faces a form of the 'British disease.' Mr. Fred Bergsten, a former Assistant Secretary of the U.S. Treasury, pointed to a Canadian policy dilemma similar to, though less severe than, that which Britain and Mexico now face as a result of their oil and gas revenues. For Canada, the strong resource sector has given an upward momentum to the exchange rate, resulting in a non-competitive price structure for the manufacturing sector, which in turn generates pressure for additional protection. Rather fortuitously in 1981, significant outward capital flows, due in large part to increased Canadian investment abroad, exerted an opposite pressure, leading to a decline in the Canadian exchange rate

which was further exacerbated by the purchases of energy companies under the Canadianization program. This lower dollar, to some degree, shielded the manufacturing sector.

By most of the traditional criteria for measuring Canada's relative competitiveness vis-à-vis the United States, i.e. comparative wage ratio, productivity rates, unit labour costs, work stoppages etc., the situation has remained static or has even deteriorated somewhat since the slight improvement manifested in 1978. (For a more detailed look at Canada's competitiveness see Appendix C.) Dr. James Frank of the Conference Board in Canada warned the Committee that the decline since 1975 in the number of Canadian industries at or above parity with comparable U.S. industries was not a reversal of a long-run trend leading to wage parity across the board. The apparent improvement merely reflected the continuing devaluation of the Canadian dollar over these years.

Statistics in 1979 and 1980 indicate that, after the one-year reversal in 1978, wage settlements in Canada are rising at a slightly higher rate than they are in the United States. Canada's record in work stoppages is also inferior; in only two years since 1970 have industrial disputes in Canada not led to more days lost per thousand employees than has occurred in the United States. Although there has been a modest narrowing of the gap in rates of productivity over the past decade, the improvement has been insufficient to compensate for the increases in comparative wage rates. As a result, unit labour costs are once again increasing faster in Canada than they are in the United States.

The relative decline in Canadian competitiveness during the last decade has been compensated for and, to some degree, masked by the devaluation of the Canadian dollar. On an exchange rate adjusted basis, Canadian wage rates now stand at approximately 95 percent of those in the United States. But had the devaluation of the Canadian dollar not occurred, Canadian wages would be at considerably higher levels than those of the United States.

The Committee believes a decision to move to bilateral free trade could provide the shock necessary to increase competitiveness. As this report has shown, a growing number of witnesses from the private sector have recognized that bilateral free trade could offer manufacturing industries opportunities to specialize and achieve economies of scale, which could be translated into higher rates of productivity. Canada has a trained and effective work force capable of doing better if given the opportunity. According to testimony given by Mr. J. D. Frank, of the Conference Board in Canada, the only sectors where the levels of Canadian productivity have been able to equal or surpass those in the United States are precisely those which have free or almost free access to the U.S. market, namely wood products, metal products, motor vehicles and parts. (See table 5, Appendix C, page 139).

While the resource sectors have certain natural advantages, the Committee is persuaded that a key factor determining the level of productivity in many areas of manufacturing appears to be the size of the market.

Witnesses who claim to accept the need to move to free trade are nevertheless divided on how best to proceed. Some argue that the competitiveness of Canadian industry must first be improved before it faces free trade; otherwise they fear it would lose ground to stronger American competition. Their emphasis on the time needed by industry to adjust leaves the impression that they would not be ready for free trade until Canada's competitiveness has been re-established. Others, perhaps more genuinely persuaded of the benefits to be gained, maintain that only the shock of a commitment to move to bilateral free trade and a firm timetable can force on industry as a whole the restructuring necessary to achieve higher productivity.

The Committee considers the debate to be in some degree spurious. If the government were to set the goal of achieving free trade with the United States, and the U.S. Administration were to respond with a show of interest, companies would immediately begin to calculate the impact and adjust to the potential new market situation. As the CMA pointed out to the Committee, most businesses would try to adapt as quickly as possible to a free trade environment if they thought it was coming. However, moving toward bilateral free trade would not be an instantaneous or abrupt change-over, since it would take time to negotiate a free trade arrangement and any agreement would provide a reasonable transition period to permit firms to adjust. (See page 90).

The Committee recognizes the need for Canadian industry to become more competitive and is persuaded that this objective is more likely to be achieved if a clear decision is taken to seek free trade with the United States.

2. The technology race

Free access to the larger North American market would open up broad avenues of opportunity for Canadian technological and innovative capabilities. It could do much to stimulate increased research and development in Canada. But it would also present major challenges. United States companies are extremely competitive in high technology fields, usually world leaders. If Canada is to 'place' in the world technology race, government and industry must improve their performance in the risky and expensive business of expanding Canadian innovative capacity and implementing it commercially.

In relative terms, the United States spends much more on R&D than does Canada, 2.5 percent of GNP as compared to about 1 percent. The lower Canadian level is both in government support and private sector spending.

The problem of Canada's dismally low level of R&D spending has gradually been recognized by the government over the past decade. But despite incentives in the form of tax write-offs, investment tax credits and a variety of grants programs, the government has been unable to turn the situation around. At best, Canada could be said to have arrested the dramatic decline of R&D spending of the early 1970s and to be holding its own. Hardly good enough.

In January 1981 the government reiterated its aim of raising Canada's R&D expenditures to the equivalent of 1.5 percent of GNP by 1985.* To meet this new objective, federal spending will have to rise from \$973 million in 1979 to \$2.52 billion by 1985, while industry's spending will need to rise even faster, from \$875 million to \$3.78 billion. According to OECD statistics, R&D spending by Canadian industry is significantly below that of industry in Canada's major competitors. Reflecting this fact in its program, the government intends to increase its R&D expenditures by 17 percent per annum over five years, but has said it expects industry's spending to rise by 27 percent.

During the hearings, the Committee probed business witnesses as to the relative usefulness of the two principal approaches to stimulating R&D in Canada—tax incentives and grants programs. As in the earlier hearings, there was general support for tax incentives from large and established companies such as Canadian General Electric and Alcan, two of the largest R&D spenders in Canada. But it was also evident that tax incentives failed to help small, medium-sized or new companies which, lacking profits, do not qualify for tax benefits. Moreover, there was criticism of the incremental aspect of the R&D incentive.**

Mr. C.D. Reekie of CAE Industries Ltd. explained:

"... it is not at all clear that unless you keep on spending more than you have spent you will get any advantage. You have to continue on with increments each year in R&D spending or you do not get the benefit. So then, at some point, you are just not going to keep on spending." (15:44)

As for the grant programs, high technology firms in defence-related fields bestowed high praise on the government's Defence Industry Productivity (DIP) program. The support was essential, it was reiterated, to compete internationally in advanced aerospace products. Mr. E.L. Smith, president of Pratt and Whitney, attributed his firm's success "very directly to the financial support we have received from the federal program under the DIP program." Mr. John Sandford, president of de Havilland, called the DIP pro-

* The same objective was announced first in 1979 to be realized by 1983.

** In addition to the 100 percent write-off for current and capital expenditures on R&D, firms may qualify for a supplemental 50 percent deduction for incremental R&D (defined as R&D expenditures in excess of the previous three-year moving average).

gram "a very vital and effective program . . . Every \$1 invested . . . is estimated to yield \$28.3 in sales." Mr. John Simons, vice-president of Canadian Marconi, said that without a doubt the DIP program has been "the most successful government economic development program" and called it "the essential link in the continued export success of Canadian firms." He was critical, however, that the level of DIP funding had not kept pace with inflation and that, for a time, the program had been discontinued, a fact which had cost Canadian industry many new opportunities and a loss of momentum.

The other grant program in support of innovative manufacturing is the Enterprise Development Program (EDP). Replacing seven earlier programs, it is focussed on helping medium to small manufacturing and processing companies to generate industrial innovation and adapt operational methods. Among business witnesses there was support for the EDP program, but it was tempered by their criticism of the tight administrative control and review procedures, which left decisions to be made by bureaucrats as to how the funds should be spent. Business was better able to do this itself, private sector witnesses maintained. Other critics have pointed to the difficulties officials naturally have in assessing which ideas and which firms to give the grants to.

The Committee concludes that grants and tax incentives are both necessary in assisting companies in Canada to undertake R&D. In defence-related fields, the DIP grants are clearly necessary to compete with the rich funding of the research efforts by defence departments of competitors in other countries. However, the Committee heard some critical comments from Mr. David Mundy with regard to the levels of R&D undertaken by Canadian firms in the defence production field. He maintained that Canada had been "chiselling" its way into U.S. programs under the defence production sharing arrangement, trying to get contracts awarded to Canadian firms without paying the R&D costs. Canada had been operating on a shoestring and it was not working, he said. He suggested that the way to get better access to this all-important technology was for Canada to offer to make a long-term funding commitment to a major U.S. project—as it did with the space arm—on the condition that Canadian industry could participate in the technological mainstream of the program.

A related point by Mr. Simons concerned the disadvantages of offset procurement arrangements made as part of defence equipment purchases. He maintained that Canadian companies learn little from producing from established designs and the Canadian taxpayer suffers by paying the cost premiums associated with small production runs in a second location. To increase Canada's technological capability, he urged that the premiums be invested in R&D of *new* products and their purchase by the U.S. Defense Department negotiated as offset. A small move in this direction was made with a 6 per-

cent requirement for advanced technology offset opportunities as part of the fighter aircraft offset program. While there was evidently some difficulty initially in filling this 6 percent, the Committee agrees that such a thrust makes sense. Short-term employment objectives should not obscure the longer lasting benefits from new product technology.

The Committee went into the question of why the Canadian R&D performance in the manufacturing sector has been so dismal. Many in Canada blame the high levels of foreign ownership and assume that the remedy lies in 'Canadianization'. This is, of course, an oversimplification. But it is true that while certain foreign-owned firms do some of the highest levels of R&D in Canada, many subsidiaries, particularly of the branch plant 'miniature replica' variety do very little. They have no incentive to do so.

The Committee has concluded that there is an essential ingredient which such firms look for before they commit money to R&D. Market size is the critical factor. In every instance which the Committee examined of private firms which engage in significant R&D expenditures, they had access to a market larger than that which Canada alone offers, whether it was through a duty-free trade arrangement, as for aerospace and defence production, or as the subsidiary of a large U.S. company, through an established U.S. source of technological and engineering advice and marketing support. The point was put succinctly by Mr. Simons, whose high technology company, Canadian Marconi, spent \$10 million on R&D in 1980. He told the Committee:

"It is almost self-evident from the level of R&D funding required that the Canadian domestic market is too small to support anything developed solely for Canadian use. Thus access to a larger market is a necessary condition before R&D investment can pay off." (12:39)

This situation, in the Committee's opinion, accounts for the high levels of R&D undertaken by a number of multinational companies in Canada. Some critics argue from the experience of the auto industry under the auto pact that, with free trade, all R&D would be moved abroad and Canada would become a technological parasite. This analysis is valid for the traditional branch plant which is making carbon copies of the parent's production. The auto industry fits this model. Production lines are readily interchangeable from Windsor to Wichita and all draw on a single pool of R&D.

By contrast, subsidiaries which undertake extensive R&D in Canada such as CGE, Canadian Marconi, Pratt & Whitney, Litton Systems or Garrett Manufacturing, are usually specializing in a limited range of products for the North American or world markets. They need their own R&D and naturally are quick to take advantage of the support available from the Canadian government. U.S. subsidiaries of Canadian multinationals, such as Moore Corporation and Northern Telecom, have themselves done the same thing in reverse in the United States.

Market access is important because the total cost of developing and successfully marketing a new product is enormous. Research costs are only the first step in a long and costly process, which includes engineering, start-up manufacturing and market development phases. The way a businessman looks at the problem was graphically expressed by Mr. M. J. McDonough, vice-president of the parent Westinghouse company.

“If one looks at a new business based on designing and building a product, the front end R&D is less than 10 percent of the cost of embarking on and fulfilling a project. One could do all the R&D in the world . . . and have only done 10 percent of what is needed . . . and that is not the tough part. The tough part is the 90 percent. So when one embarks on an R&D program, one had better think about how that R&D is going to be implemented. To subsidize and stimulate R&D alone, without looking at the mechanism required to employ that R&D, would be a waste of money.” (16:35)

This comment by Mr. McDonough, whose Canadian subsidiary has a good record of R&D undertaken in Canada, may be one of the explanations as to why so many companies in Canada do not take advantage of the R&D support which the government offers. They lack a large enough market to cover the full cost of developing, launching and selling a new product; and the profit to be gained from the Canadian market, even if they are successful, usually does not justify the risk inherent in high development costs for a new product. It is not that Canadians are less innovative, or even that they are afraid to take risks, as is so often alleged. An important explanation is the restricted market which ensures that the spectacular successes of a Polaroid or a Xerox can never be duplicated in Canada and makes even the recovery of development costs a dangerous gamble.

Canadians have, indeed, been successful innovators, but too often their ideas have had to be executed abroad in larger markets. Sadly, this has brought little benefit to Canada. The example cited earlier by the Hon. Patrick McGeer is again relevant here. The B.C. Minister referred to a Canadian pharmaceutical company which decided that, in order to exploit its discovery, it had to establish a production facility in the United States. It was so successful that the American part of the company became predominant and eventually the company was sold to a large U.S. corporation. Had there been no tariff or non-tariff barriers to block the company's exports from Canada, no doubt this company would still be producing in Canada.

Conversely, Canada has benefitted from imported technology developed by others. It has been suggested that, in order to stimulate R&D expenditure in Canada, imported technology should be screened by FIRA or imported by independent Canadian firms via arm's length licensing agreements. The Committee completely disagrees. Canada has profitted substantially from R&D imported through subsidiaries, subsequently adapted by them and exported. Canadian firms frequently find it easier and cheaper to buy technology and modify it than to develop it in Canada. The outstanding success

of the Japanese in adapting imported research findings gives convincing support to this procedure. Canadian industry must hone its ability to adopt and adapt innovative technology as well as develop it. It should be ready to import knowledge in order to create new technology.

Efforts by the government, as now provided under the EDP, to get around this problem by offering grants to support later phases in product development, carry their own risk. One such action which attracted considerable public attention involved a grant* to Honeywell Limited of Toronto to develop a liquid level sensing system. In 1978, the U.S. Treasury responded to a complaint from an American competitor by imposing a countervail duty, on the grounds that part of the grant to Honeywell was not to support R&D, but to subsidize the successful marketing of the product in the United States. This was a problem that officials of the Department of Industry, Trade and Commerce were reluctant to talk about before the Committee. They left the impression that it was a grey area which they thought it wise to leave in obscurity; publicity would only attract undesirable U.S. attention. Even so, the Honeywell experience frightens other companies from going the same route.

This report has stressed the theme that the Canadian market is often too small to justify the development of many specialized products; if a manufacturer cannot anticipate sales in the United States or abroad, he will not proceed. In the United States, government assistance is justified to develop products for the huge domestic market. In Canada, a company with an idea for a product which could not generate sufficient sales in the small home market to cover development costs either admits that it is aiming at the foreign market, in which case, some government support may attract countervail, (i.e. Honeywell) or it dissimulates. As has been noted earlier, this is a problem which would have to be dealt with in the free trade negotiations. It would be necessary as part of the agreement to reach an understanding as to which development costs the two governments would mutually accept and which would be unacceptable. The aim should be to reduce to the minimum the uncertainty faced by the private sector.

In conclusion, the Committee is concerned above all that Canadian industry be able to compete in the technology race of the 1980s and 1990s. The essential and to date neglected factor needed to stimulate increased R&D is a free trade agreement with the United States, thereby securing for Canadian entrepreneurs access to a market large enough to support the full range of development costs involved in getting new products to market. Indigenous R&D should continue to be encouraged by a mixed system of tax

* Under the Program for the Advancement of Industrial Technology (PAIT), a program which was subsequently melded into the EDP.

incentives and grants. But expensive R&D should not be pursued as a goal in itself, particularly when it might be cheaper to import technology and adapt it.

And, as part of a bilateral free trade agreement, an understanding should be sought as to which forms of development support would be mutually acceptable, in order to reduce uncertainty and limit the already high risks faced by the private sector in product innovation.

3. Canadian non-tariff measures

This report has emphasized throughout that one of the major benefits for Canada of a bilateral free trade agreement would be the possibility of getting a handle on U.S. non-tariff barriers—the trade obstacles which are almost certainly going to loom increasingly large for Canadian exporters. But a bilateral free trade agreement is a two-way street. What about Canadian non-tariff barriers?

The United States is not unaware of Canada's non-tariff barriers. Nor are U.S. industries. For example, a recent study for the American Iron and Steel Institute examined, at both the federal and provincial level, how Canadian procurement laws and practices discriminate against foreign materials and suppliers. It set out in considerable detail its case that, although largely unlegislated and out of public view, Canadian procurement favoured domestic procurement through unpublished administrative policy and informal practice. Canada's import displacement programs, including its monitoring of the purchasing activities of private companies involved in energy megaprojects, its expanding aid to the 'picking winners' program, or the proposed import policy involving a 'basic price system', all fall within the definition of non-tariff barriers. So do provincial monopolies over wines and spirits.

In respect to Canadian procurement, Canada is in a weak bargaining position to negotiate against U.S. procurement policies, given the current state of federal-provincial relations. While preferences exist in the United States in at least 37 states, in Canada, protective provincial preferences result in the fragmentation of Canadian production facilities which itself decreases Canadian cost competitiveness in foreign markets. In this regard the Committee views with approval the recent efforts of the federal government and the Ontario government to co-ordinate and strengthen the Canadian procurement market.

That said, however, the Committee disagrees with the policy approach urged by economic nationalists when confronting U.S. non-tariff barriers, namely to increase Canada's industrial strategy measures designed to protect the domestic base and to formulate and legislate new Canadian non-tariff barriers paralleling those in the United States.

The Committee asks where such a policy would lead. As has been stated earlier in the report, the Committee completely rejects the argument that such a protective strategy will render the Canadian manufacturing sector internationally competitive. On the contrary the Committee is convinced that this goal can best be achieved through free trade; it is also convinced that the surest and perhaps only way for gaining exemption from, or achieving some control over, punitive U.S. non-tariff barriers is through a bilateral free trade agreement.

Nonetheless, it is only realistic to recognize that in bilateral free trade, Canada will have to 'give' if it wants to 'get'. For instance, in order to open U.S. procurement doors for their industries, Canadian provinces are going to have to open their own procurement. But not all non-tariff barriers need be of concern in a free trade agreement—only those established for purely protectionist purposes. Those which are essential in controlling the circumvention of accepted trade practices, such as anti-dumping procedures etc., could be expected to be retained, as would those such as product and safety standards which had incidental non-tariff side effects.

Finally, because the Canadian federal government has limited jurisdiction constitutionally in many areas where provincial policies have been particularly active in recent years, the government would undoubtedly need to have obtained some sort of agreement on overall policies and also a negotiating mandate from the provinces prior to undertaking a bilateral agreement.

4. FIRA and the control of foreign investment

The extent of foreign and particularly U.S. ownership and control of Canadian industry has been a controversial issue in Canada for two decades. The role of FIRA (the Foreign Investment Review Agency), the agency created to monitor and pass on new investment proposals by foreign interests, has been a subject of particular concern to the business community in the United States and elsewhere. The coincidence of the declaration in the speech from the Throne of 4 April 1980 that the government intended to strengthen and extend FIRA's powers with the Canadianization features of the National Energy Policy announced in the October, 1980 budget have alarmed United States authorities and aggravated relations between the two countries.

Not surprisingly, in this environment, many witnesses appearing before the Committee in Canada and the United States assumed that a condition of U.S. participation in a free trade agreement would be some check on FIRA's powers and possibly even its termination. Only one American witness questioned this view, claiming in a colourful analogy that FIRA was of no more concern than a California zoning law.

The Committee appreciates that FIRA is too important to be ignored in negotiations on bilateral free trade. The question of FIRA must be faced, but it does not follow that the United States would insist on its being closed down. Sweden had foreign investment controls when EFTA was formed, and it was permitted to retain them. This is an important precedent. During the transition period which would lead to free trade, Canada could claim the need for regulations to ease that process. A good case could be made that, without some sort of screening process during the transition period particularly, small dislocated Canadian firms previously dependent on the Canadian domestic market and faced with the need to restructure would be "easy picking" for the stronger foreign corporations with both the necessary financing and established markets available. It would seem reasonable to include foreign investment controls in the agreement for the transition period. Once the transition phase had been concluded, Canadian industry should be sufficiently rationalized to be competitive and FIRA's review processes should be less necessary.

Even in the absence of free trade negotiations, Canada cannot ignore U.S. concerns about FIRA's powers as the current situation reveals. Washington reacted strongly against the announcement in the 1980 Speech from the Throne that FIRA would be strengthened. Nor has this negative perception been fully assuaged by the policy change announced by the Finance Minister, the Hon. Allan MacEachen in the November 1981 budget that no amendments would be made to the Foreign Investment Review Act for the time being.

5. The exchange rate

The Committee reached the conclusion in its 1978 report that, should Canada and the United States enter into a full bilateral free trade arrangement, "the exchange rate would become the principal equilibrating mechanism". (p.114) As this was an important point, the Committee devoted some time during its current hearings to examining the implications of bilateral free trade for the exchange rate.

While the exchange rate reflects in part competitive differences between the two countries, expressed in terms of wages, productivity and so on, it also reflects a host of other factors—capital flows, dividend payments, monetary policy, etc. In very broad terms, the exchange rate is indeed an important adjusting mechanism. But the picture is extremely complex and testimony was divided as to how bilateral free trade would influence the exchange rate.

The extent of the initial effect on the exchange rate, witnesses claimed, would depend to some degree on the scope of the free trade agreement, and ultimately on the resulting balance of trade. In the short run, the Canadian dollar could be expected to weaken, owing to the greater structural adjust-

ment costs, to be borne in Canada. Over the long run, however, the Canadian dollar would probably strengthen as Canadian manufacturers begin to switch to longer production runs and reap the benefits of greater economies of scale. Of course, this outcome would depend heavily upon the relative levels of productivity, wage rate differentials and comparative inflation rates between the two economies.

Professor Robert Dunn Jr., of George Washington University told the Committee that he expected the financial impact of a bilateral free trade agreement on the exchange rate and on cross-border capital flows would be marginal. His conclusion was based on the premise that any bilateral free trade agreement would be negotiated so as to yield a rough balance of advantage to both sides. Professor Dunn supported the continued use of a flexible exchange rate policy under a free trade regime, especially during the transition period. He argued that attempts to gain competitive advantages by either government by pegging the exchange rate artificially low would undoubtedly cause problems, especially in terms of the Canadian reserve requirements to undertake foreign exchange market intervention. Mr. Lawrence Krause of the Brookings Institute added that, if the exchange rate were left largely free to do the adjusting, gross distortions could be avoided or minimized.

Dr. David Dodge, a Canadian economist, approached this problem from a different perspective and reached a contrary conclusion. He assumed that Canada would be "driven to think very hard about pegging the exchange rate" between the two countries, to overcome U.S. concerns that the Canadian authorities could use "monetary policy . . . to depreciate our currency and hence gain a competitive edge on American firms".

The Committee cannot anticipate how the U.S. government would respond on this point if negotiations on bilateral free trade were to commence. The European Community, with a much more integrated structure than that being proposed for Canada and the United States, has learned from painful experience that a degree of exchange rate flexibility between members is necessary. The Committee is of the view that a flexible exchange rate could cause the least difficulty, and it takes comfort from the fact that U.S. witnesses on this point thought a flexible exchange rate would be preferred by the U.S. authorities. Accordingly, the Committee concludes that the flexible exchange rate policy could and should be maintained under a free trade arrangement.

Increased bilateral trade flows resulting from a free trade arrangement would generate some increase in cross-border capital flows, reinforcing the already close integration of Canadian and U.S. capital markets. The result might be a greater speed of equalization between the interest rates charged in both national capital markets, although these markets are so highly inte-

grated already that the Committee doubts whether such a change would be significant.

As a medium-sized trade-dependent economy bordering upon the large metropole of the United States, the Committee recognizes that Canadian monetary and exchange rate policy choices have been and will continue to be, to a large degree, responsive to the policies adopted in the United States. The floating exchange rate has helped to some extent to insulate the Canadian domestic policy milieu from such external pressures. Nevertheless, during 1981, for example, the 'tight' U.S. monetary policy has forced Canada to accept a higher level of domestic interest rates than would appear to be warranted by purely domestic economic factors. With differing policy approaches towards the control of inflation in Canada and the United States, it is likely that problems in this area will continue to cause concern for Canadian central bankers. However, the Committee received no evidence that such problems would be aggravated under free trade between the two countries.

6. Tax harmonization

The Committee received conflicting testimony with regard to the degree of tax harmonization necessary under bilateral free trade. Dr. David Dodge said he thought "it is inevitable that, as we move towards freer trade in the sense of the removal of tariffs and non-tariff barriers, we would be forced towards a standardization of tax and subsidy arrangements". Later he acknowledged that "further integration did not take place in, for instance, the European Free Trade Association", but he speculated that "circumstances are unique in each case, and the unequal nature of partners in the Canada-U.S. free trade area probably means that Canada would have to adapt its micro-economic policies to those of the U.S."

Professor Weintraub, an American witness, adopted a rather different stance, looking on tax harmonization not as a necessary condition for a free trade arrangement, but rather as a potential and perhaps desirable outcome. He said:

"...that tax structures and fiscal policies could remain as they are, and the differences (between Canada and the U.S.), as they affect trade, would come out in the exchange rates. Just how serious the difficulties would be, I do not know. Having said that, I suppose that if you wanted to take this one step further and make the whole system somewhat more efficient, you could seek to harmonize taxes, particularly with regard to indirect taxes, but I do not think it is required."(17:30)

The Committee did not examine the tax changes which might be contemplated in order to enhance possible gains from trade and specialization of production. A cursory inquiry indicated that there was sufficient similarity between the two tax structures to offer favourable prospects for tax harmoni-

zation if the government wished to proceed along this route. Furthermore, the Committee concluded that tax rationalization was a goal which could be pursued subsequent to agreement on a free trade arrangement and on an *ad hoc* basis.

Whether or not Canada moves to free trade, the government has no alternative to responding to changes in U.S. policy. The Committee did agree whole-heartedly with the assertion of the Hon. Larry Grossman, that "on a longer term basis Canada will have to ensure that its own treatment of investment income and regulatory policies remains competitive". The Committee further concluded that there is no requirement under free trade that Canada harmonize its tax policies with those of the United States.

PART V

Conditions of the Agreement

It is not practical at this stage to make detailed proposals as to what a free trade agreement with the United States should contain. A comprehensive examination of the affected industries, their tariff levels and the necessary adjustments would need to be made first by officials on both sides. Extensive negotiating would be required on the definition and ways of restricting certain non-tariff barriers. The Committee is limiting itself at this point to some general observations on the terms of such an agreement.

1. Timing and scope

In moving to a bilateral free trade agreement by means of the Committee's recommended 'interim agreement' procedure, the two countries would only be required to file with the GATT their plan and schedule for eliminating "substantially all" tariffs within a "reasonable" length of time. There is no established GATT precedent as to what the transition period should be. In order to protect its industries as much as possible and help them adapt to a less protected position Canada could, if it wished, negotiate a long adjustment period.

Academic witnesses have suggested transition periods ranging from 5 to 15 years. In proposing the longer period, Professor Weintraub argued that just as the Tokyo Round tariff reductions are undertaken gradually over eight years to avoid sudden jolts, so the remaining bilateral tariffs could be

gradually phased out over 10 to 15 years. Further, it would be prudent to request the longer rather than a shorter period and, if the process could be speeded up, so much the better.

On the other hand, Mr. Thibault of the Canadian Manufacturers Association, argued that the impact would probably occur much more rapidly than anticipated. Once a firm policy decision to go to bilateral free trade became known, Canadian companies would be unlikely "to sit around ten years waiting to make a fundamental decision. The production would be allocated . . . it would be a relatively short period of time in which . . . all the essential decisions would, in fact, occur." Major adjustment decisions could take place in as short a period as two years, he said.

The Committee considers that Canada should try to negotiate a period of 8 to 10 years as the transition stage to the achievement of a free trade area. It could begin in 1987 when the Tokyo Round cuts would be all in place. However, in requesting this medium to long transition period to protect weaker companies, the Canadian government should be aware that it could frustrate the relatively stronger companies or industries which would be able to adjust more easily. Pressure could come from these stronger industries to speed up the process and give them full tariff-free access quickly. If the accelerated dismantling of tariffs in EFTA and in the European Community—tariffs which were higher and more disparate than Canada-U.S. tariffs—is any example, the time frame could be considerably compressed. But these European adjustments took place in the 1960s—a period of dynamic growth unlikely to be paralleled in the foreseeable future—and it seems safer to provide for the longer period in the 1980s and 1990s.

What about a faster elimination of U.S. tariffs than Canadian? Could the United States be persuaded to phase out its tariffs in half the time, for example? Academic witnesses, including Professor Wonnacott, considered that it would be possible. If both sets of tariffs were cut by the same absolute amount, he pointed out, the U.S. tariff would be eliminated sooner since U.S. barriers were smaller to begin with. On the grounds that affected Canadian industry will be faced with a major reorganization—which is not the case for U.S. industry—**Canada should press for a faster elimination of U.S. tariffs than Canadian tariffs as part of the agreement.**

Traditionally, Canadians and Americans have generally preferred a fairly informal approach to their bilateral commercial arrangements, with general principles stated and much of the interpretation and adjustment left to be settled through normal established channels. It is true that such an approach permits more flexibility in coping with unexpected developments than rigidly specified rules and procedures. The Stockholm Convention establishing EFTA lacked detailed rules and definitions in several areas and this fact has since been considered to have promoted an effective and flexible

approach to problem-solving. The rules were interpreted and regulated by *ad hoc* committees of representatives of the member states reviewing the issues and reaching negotiated settlement. EFTA's pragmatic handling of non-tariff barrier problems in this fashion has been termed "pioneering" and "innovative" and as having made a significant contribution to international trade practices.

On the other hand, because the auto pact was not explicit on whether the safeguards were transitional or permanent, Canada and the United States have had serious bilateral disputes which both governments would rather avoid. Industry too would likely prefer succinct guidelines. Professor Peyton Lyon of Carleton University argued that as the nation that had most to gain from free trade and most to lose if the other participant were to change its stand, Canada had a strong interest in a precise detailed agreement.

"The more precise and permanent the treaty and the more effective a regulatory mechanism, the more confidence industry would have in that arrangement; and only if entrepreneurs had confidence in the agreement's permanence and effectiveness would industry be likely to make the necessary adjustments and long-term plans that would maximize the economic benefits of the expected free trade." (2:11)

The Committee completely agrees with this approach. **Free trade would be of such major importance to Canada that every attempt should be made to anticipate potential problems and spell out as fully and precisely as possible the scope and terms of the agreement.** Businessmen must be sure that the rules are there and that they will stick.

2. Rules of origin

In contrast to the common external tariff characteristic of a customs union, **a free trade area between Canada and the United States would retain differences in tariff levels and in tariff policies with third parties.** The GATT definition of a free trade area requires only that the duties be eliminated between the two countries on products originating in each country. **For all other trade the two countries could maintain their separate tariff rates and/or quotas.** This raises the problem of 'trade deflection', which may occur when goods from third countries enter the free trade area via the country with a lower tariff on that particular product. If the product were then re-exported to the other member of the free trade area at zero tariff rate, it would provide an unfair benefit to the country with the lower external tariff. When further processing of resource products or manufactured goods with imported components are considered, the distorting impact quickly becomes significant. For this reason, any free trade area must establish 'rules of origin' for intra-member trade and, in fact, such rules of origin have been established in all preferential trade arrangements. Although there are no specific

provisions laid down by GATT concerning rules of origin, certain precedents exist, the most relevant being those adopted by the EFTA.

It is important to note that if strict rules of origin are applied, the larger country will have a greater capacity to source requirements internally. Thus, if the U.S. exempted from duty the U.S.-made components in goods imported from Canada, but imposed strict requirements on externally sourced inputs, then Canada would be forced into increased sourcing from the U.S. market for semi-processed and raw material inputs. If such U.S. sources were not the least-cost suppliers of such inputs, the trade diversion effects would become disadvantageous for Canadian exporters, particularly so in respect to those products which are not only exported to the U.S. market, but to overseas markets as well. Manufacturers would resist the costs involved in maintaining two inventories of materials, one qualifying for exemptions and the other for materials which did not qualify. Canadian exporters in such a situation could find that they had priced themselves out of third country export markets.

An origin system may be liberal or strict. A liberal system allows a substantial proportion of 'free trade area' products to originate in non-member countries and it is likely to result in the least trade diversion effects in terms of existing patterns of supply of raw materials or semi-processed goods.

The 1965 Canada-U.S. Automotive Agreement imposed a rules-of-origin condition for duty-free access to the U.S. market, aimed specifically at preventing trade deflection by third country automotive producers using Canada as a channel to circumvent the U.S. tariff. Under the pact, imports from Canada must contain a minimum 50 percent North American content, on a value basis, in order to qualify for duty-free treatment in the United States.*

The EFTA adopted a liberal set of origin rules under which a product qualified for duty-free treatment if up to 50 percent of its export price originated in the free trade area. In EFTA, it was initially feared that sizeable deflections of trade to lower-tariff members of EFTA would occur, or that uneconomic structures of production would result, if manufacturers whose products depended heavily on imported inputs shifted their operations and investments to the lower tariff countries. **In actual fact, however, the EFTA rules of origin appeared to work surprisingly smoothly with no visible deflections of trade or production.** One factor considered important in this success-

* Both Canada and the United States also have rules of origin, somewhat differing, associated with their arrangements under the Generalized System of Preferences (GSP) for 'developing country' exports. Under the GSP arrangement, Canada accorded easier access to products originating in a preference-receiving country as long as not more than 40 percent of the value was due to imports from outside the preference-receiving country or from Canada itself. In the U.S. system, at least 35 percent of the value must represent content from the preference-receiving country in order to benefit from the easier access (or 50 percent if there were a designated association of countries treated as one country for purposes of the Generalized System of Preferences).

ful result was the fact that, in EFTA countries, tariff levels on raw materials and semi-processed goods were, with few exceptions, low or non-existent, and that external tariff disparities between the member countries were relatively small. Since the same situation pertains to Canada and the United States, it may optimistically be predicted that a liberal origin system would suffice to restrict trade deflection in a Canada-U.S. free trade area.

The Committee concludes therefore that, while Canada must protect itself from harmful trade deflection, particularly in view of the fact that U.S. tariffs are generally somewhat lower, the rules of origin should be liberal, to give Canadian manufacturers the possibility of continuing to source imports from the least-cost supplier, with the least detrimental effect on Canadian exports going to a duty-free U.S. market.

3. Exceptions and safeguards

Exceptions to free trade agreements and escape or safeguard clauses are normal features in free trade treaties. The most notable exception in a Canada-U.S. agreement would be agriculture. Standard reservations are usually made relating to the protection of health, morals and national security. **Each country would retain full sovereignty over all matters relating to customs administration and to the imposition of their individual tariffs against third countries. In addition, certain escape or safeguard clauses would be in order, permitting member countries faced with disruptions in particular sectors due to tariff cuts to impose quantitative restrictions, providing rigid requirements are met.**

A temporary protective device referred to by Professor Wonnacott—the system of trigger points used in the Swedish-EC trade agreement—is a possible procedure. The idea is to have a temporary restraint available if imports flood in over a brief period during the transition in such quantities as to reach a trigger point. Another device used in the EFTA tariff-eliminating process which could serve as a possible model is the system of 'décalage' whereby a country which felt it was suffering considerable strain on a sensitive item due to tariff removal would be allowed to get out of step temporarily and delay a tariff cut—usually only for a few months—until its industry could catch its breath.

It might also be politically necessary to negotiate guarantees for Canadian employment during the interim period, perhaps along the lines of the auto pact safeguards. However, in order to be acceptable to the United States, which has long argued that the auto safeguards had been intended as transitional, it would be essential to set a rigid time limit on such guarantees. They would be short-term transitional safeguards only. In addition to annoying the Americans, the fact that employment in the auto industry in Canada

has been safeguarded with no terminal date has, as Professor Wonnacott pointed out, eliminated a natural moderating influence on the wage rates.

"I believe it is very important to specify [a] time period, so that the labour force and the industry realize that there is a day of reckoning when they have to be world competitive." (18:24)

An escape clause which has been used in other free trade agreements, including the EFTA agreement, relates to the use of quantitative restrictions in the face of a balance of payments emergency. Canada may consider that this would be useful insurance. On the other hand, Canada may prefer to try to negotiate an exemption from a future imposition of a U.S. surcharge, as occurred in 1971. At that time, the United States exempted all goods trading duty-free from its 10 percent surcharge. This automatically exempted exports from Canada's automotive and defence production industries, as well as exports of crude and some processed goods. If such exemption for all tariff-free trade could be negotiated, Canada would be protected from future U.S. actions against other trading partners. But it could not have it both ways. If it obtained this exemption, Canada would have to relinquish the possibility of using quantitative restrictions against U.S. duty free imports when it had a balance of payments problem of its own.

4. Adjustment assistance

Most of the burden of adjustment resulting from a decision by Canada and the United States to move toward bilateral free trade would fall on Canada. The reason for this is quite straightforward: the significance of U.S. competition to Canadian industry is much greater than vice-versa. Hence, a change in the North American competitive environment caused by a move to free trade would be reflected, in a proportional sense, to a much greater degree in Canada than in the United States. While Canadian adjustment costs would, as a result, be proportionally greater than those borne by the United States, it is important to note that Canada stands to gain more from free trade. A well-prepared program of adjustment is therefore directly connected to the realization of Canadian benefits from bilateral free trade.

Representatives of the Canadian Manufacturers Association expressed the view that there is, at present, no well-defined program of adjustment assistance in place in Canada. This could be important if the scenario suggested by Mr. Thibault of the CMA is accurate. As already noted, he anticipated that corporate decision-making would begin to be influenced even before a final agreement on free trade was reached. Such a reaction is to be expected of the more forward-looking Canadian companies, if not the entire business community. The Canadian government would therefore be wise to present an overall adjustment assistance strategy well in advance of the conclusion of a free trade agreement. The date of implementation of the strategy

and the duration of the assistance to be provided should also be made public as soon as possible. Firms anticipating their position in a future free trade environment would then be able to take into account, at an early stage, all the implications of such a strategy relevant to their particular short-term and long-term plans.

The provisions for adjustment assistance contained in the federal government's policy for the clothing and textile sectors are, to a degree, illustrative of those contemplated by the Committee as part of a bilateral free trade agreement. The major adjustment program announced on June 19, 1981 allocated \$250 million over 5 years to establish new employment opportunities in communities affected by textile and clothing industry restructuring and to assist in the modernization of viable firms. The labour adjustment component emphasizes training and other labour development programs and extends measures such as portable wage subsidies to textile and clothing workers moving to alternative occupations. The increase in efficiency required of Canadian producers, as import barriers are reduced, will be facilitated through grants for modernization and funding for equipment purchases or plant layout changes. Low interest loans will also be made available for mergers and acquisitions. Private sector participation in these programs is possible through the Canadian Industrial Renewal Board (CIRB). While the textile and clothing industry is not at all typical of Canadian industry, the temporary measures used to help this very protected sector adjust to the gradual removal of trade barriers are useful examples of adjustment assistance.

One of the methods of adjustment assistance most frequently discussed by economists is the encouragement of specialization agreements, defined by the Economic Council of Canada as follows:

"A temporary agreement between firms to accomplish a restructuring of production and distribution with a view to increasing the scale and specialization of Canadian output and, in this way, reducing costs." (*Interim Report on Competition Policy*, 1969, p. 119)

The encouragement of such an agreement could be effected in a number of ways. For example, capital for reorganization could be provided in the form of government-backed loans, corporate income tax cuts, or accelerated depreciation allowances during the transition period. A specialization agreement itself could also take many different forms. The number of variations on the basic theme are only as limited as the collective corporate and academic imaginations of Canada and the United States. For example, does the agreement cover potential production as well as actual current production? Both goods and services? Clearly, specialization agreements are a very flexible method of response to competitive pressures.

As for their effectiveness in aiding adjustment to free trade conditions, it must be recognized that, irrespective of policy inducements, the removal of

trade barriers itself creates an incentive to specialize. This incentive is strongest when there are significant economies of scale yet to be achieved, as is the case in Canada. Aside from unit cost savings, the specialized firm is also more efficient in terms of management decision-making. As Dr. Fred Lazar of the Canadian Institute for Economic Policy said to the Committee:

"The more product lines you introduce, the greater the problems arising in managing the operations, the more decisions have to be made and the more decision modules in the corporate structure. [With specialization, you] have rather simple product lines, fewer decisions, and less complications and that makes for efficient management." (10:37)

Having described, in general, the need for adjustment assistance and some of the routes which might be taken to achieve it, the Committee emphasizes that government aids designed to further this objective must be part and parcel of the larger free trade agreement. Just as the variety of possible mechanisms of adjustment is virtually unlimited, so too is the number of policy options to encourage industry to make use of those mechanisms: government-backed loans or corporate tax credits may be given during the transition period; accelerated depreciation may be allowed, according to various formulas on certain types of capital expenditure; direct R&D grants and subsidies, or improved private sector access to specialized government research personnel and facilities—all of these could conceivably come within the ambit of an adjustment assistance program. It is, therefore, imperative that both parties to a bilateral free trade agreement be aware of and agree upon the specific policies open to each in providing industrial adjustment aid. These policies must not be allowed, unintentionally or otherwise, to act as instruments of protectionism in their own right as the United States now regards the safeguard clauses of the auto pact. One method of avoiding this possibility is to include 'sunset clauses' or limits to the duration of individual adjustment assistance measures, as part of the agreement establishing a free trade area.

Clearly, the issue of adjustment assistance will require detailed and complex negotiations if it is to be resolved in a manner which will both satisfy the parties and ensure that trade barriers are not permitted to persist in disguised forms. **However, in the Committee's opinion, the informed and intelligent implementation of an adjustment assistance strategy is a feasible and essential element of a Canada-U.S. free trade agreement. The Committee strongly recommends the formation of such a strategy, well in advance of the conclusion of bilateral negotiations, to facilitate both the conduct of the negotiations themselves and the planning decisions of Canadian industry.**

5. Subsidies

The Committee recognizes that the political and economic importance of many government subsidy programs would not vanish with the removal of

barriers to trade. Indeed, as has been noted above, they would become more important as part of an adjustment assistance program. But the provision of government subsidies to industry is a potential difficulty in any trade negotiation, particularly with the decline in the relative importance of tariffs. In the Tokyo Round negotiations, the participants found it impossible even to write a generally applicable definition of 'subsidy.' Over the years, in the Canada-U.S. trade context, there have been a number of disputes in this area, involving grants through the DREE and the PAIT programs by Canada and the DISC program of the United States.

In a free trade agreement, the question is, to what extent would Canada be compelled to accept standardization of subsidy arrangements? To what extent would Canada be able to keep its different forms of government aids to Canadian industry?

Opinions vary on the issue. Dr. David Dodge thought that with tariffs and non-tariff barriers removed, some degree of harmonization of the two countries' subsidies programs would probably be inevitable. The Hon. Larry Grossman was convinced this would happen. He was particularly concerned that, in order to stay competitive for investment purposes, Canada would have to adopt U.S. types of incentives and subsidies. Both Mr. Keating of Litton Systems and Mr. Tate of Garrett Manufacturing were apprehensive that, in a free trade agreement, other younger companies might not be able to benefit from the type of "financial leg-up" which they received from the government to launch their successful products.

The Committee is satisfied that neither harmonization of subsidies or an elimination of certain types of government aid need occur in a free trade setting. Other free trade areas such as EFTA have recognized that sovereign member states require different tools for their internal economic interventions. In this respect the testimony of Mr. F. H. Tyaack, a businessman with experience on both sides of the border, was instructive. He observed that each country had special problems and special needs. The United States protected small and minority-owned businesses; Canada had its DREE funding, and both countries supported R & D, although in different ways. He stated,

"I would not expect that you could write a practical bilateral agreement unless the other party recognizes your need. It is not just a matter of wiping out practices, but a matter of understanding what kinds of practices can be mutually tolerated under what sort of agreement. I think we underestimate the degree to which the original European Economic Community had all of those little matters in the background. They did not just wade into free trade. All their worries and concerns were documented and each knew its escape valve.

... If the other party has a strong need to do something then the other must allow him to do that within limits and according to agreements. . . . That is an approach which recognizes needs, but says that they should be described and a boundary put around them. . . . Having those things might be better than the impractical thing of trying to eliminate all to make a pure relationship, or having no agreement at all, because then one is constantly surprised." (16:27, 29)

Exactly. The Committee recommends that a free trade agreement should include a fairly explicit understanding of a balance of mutually tolerable subsidy programs, which could be retained without unduly frustrating the objectives of the agreement itself. Surely Canada and the United States need be no less flexible than European countries in free trade situations, in providing for special situations and anomalies which will naturally arise in an agreement of this kind.

6. Competition Policy

If Canada were to decide to move to free trade with the United States, small and medium-size Canadian firms would feel the need to merge in order to survive. At the time of this restructuring, an adjustment in the application of Canada's competition legislation would appear to be necessary.

Recent proposals for reform of Canada's competition policy would, if implemented, have the effect of bringing Canada's competition law much closer in line with that of the United States. The U.S. anti-trust enforcement is generally conceded as being much tougher than the present Combines Investigations Act. However, as the Committee warned in its earlier report, it is unwise for Canada to model its competition policy on U.S. laws. In the United States, while every industry is different, a yardstick used by many anti-monopoly advocates is that a company should not occupy more than 15 percent of the market of a given product. It is only necessary to point out that 15 percent of the U.S. market equals 150 percent of the total Canadian market to realize how inappropriate it is to base Canadian competition policy on U.S. policy. Application of the U.S. type of anti-trust policy in Canada would result in the continuation of inefficiently small firms, unable to compete with their much larger U.S. counterparts.

In the move to bilateral free trade, it would be important not to discourage rationalization through mergers of smallish Canadian producers. Even if the merging of several Canadian firms implied a monopoly position, there would be no difficulty in keeping the rationalized Canadian producer honest with the competition from U.S. producers across the border. Free trade would produce the necessary competition and protection for the consumer.

That being said, it is relevant to note that, in the past, competition policy has provoked disputes between Canada and the United States, particularly in respect to the extraterritorial impact of U.S. law north of the border. The suits filed in the United States regarding certain practices in the potash industry are a case in point. However, as an indication of the similarity of their respective legislation, the two countries were able to develop a comprehensive agreement on anti-trust modification and consultation procedure, the so-called Basford-Mitchell agreement. Nonetheless, U.S. firms with Canadian subsidiaries which would contemplate rationalization in the transi-

tional period could face prosecution under U.S. anti-trust laws as well as Canadian legislation. To avoid this danger, **the Committee suggests that the bilateral free trade agreement should contain provision that, during the transitional period, U.S. competition laws, as well as those of Canada, should be relaxed.**

A similar compromise would be necessary on the issues of conspiracy, monopoly, and other restrictive trade practices. Specialization agreements are in conflict with the legislation covering these issues at present. Although a transitional period for such agreements may not prove to be as easy to negotiate as for mergers, the imposition of a five to ten-year time limit on the duration of specialization agreements could greatly facilitate U.S. acceptance of the concept. By the time such specialization agreements came to an end, Canadian companies should have realized sufficient economies of scale to allow them to compete in the international markets. With the return to full enforcement of monopoly, conspiracy and restrictive practices legislation, Canada would have—for perhaps the first time—both competition and efficiency.

The Committee concludes that agreement on competition policy should be relatively simple to negotiate and would also prove to be a useful instrument of transitional adjustment.

7. The institutional structure

Very little testimony was taken on this subject but, because of its earlier study on the institutional framework of the Canada-U.S. relationship*, the Committee considers itself qualified to make several general points.

Neither the auto pact nor the defence production sharing arrangement provided for the establishment of a formal joint institution to be the custodian of the arrangements. As it turned out, particularly in the case of the auto pact, this was a mistake.** Serious confrontation, threats of abrogation and a series of industry inquiries could have been avoided if a mechanism had been established to monitor the performance of the pact, to recognize growing imbalances and distortions and to speak out on the counterproductive competition in respect to incentives for locational purposes.

Unquestionably a permanent joint monitoring mechanism would be required for a bilateral free trade arrangement. The Committee is doubtful that such a monitoring agency could be modelled closely on the International Joint Commission (IJC) with its collegial decision-making process in the face

* Canada-United States Relations, Vol I, *The Institutional Framework for the Relationship*, 1975.

** In its 1978 report, the Committee recommended the establishment of a Joint Automotive Monitoring Commission, to monitor the performance of the agreement, to modify procedure in minor ways and to help smooth and reconcile the differences between the two countries which have frequently been caused by unrealistic expectations of what the pact could do.

of the more complex and more confrontational nature of trade and investment issues. In the case of the IJC, both countries share a common goal even though priorities for achieving it may differ. The same is not true in respect to trade, where identity of interest will be rarer and each side would seek to maximize its own trade performance. These differences would render the establishment of a mutually agreeable mechanism more difficult. But a balanced monitoring agency would be fundamental to the successful operation of a free trade arrangement.

Any joint monitoring mechanism which is set up would be obliged to establish the facts. In this respect, the Committee suggests as a possible model, the Consultative Committee set up under EFTA. This group, composed not only of officials, but of representatives drawn from business and labour acted as a two-way channel of information between industry and labour on the one hand and the joint EFTA Council on the other.

In addition, it will be important to set up an appeal mechanism, a tribunal to rule on complaints and violations under the bilateral free trade agreement. Professor Lyon has pointed out that to attain the maximum degree of permanence, authority and effectiveness, a certain limitation on national autonomy, both American and Canadian, would be required. However, he considered that the United States would be unlikely to agree to a tribunal giving equal weight to both parties and having the power to make rulings which were in all cases binding. Instead, what would likely be attainable would be a joint body on which the two nations are equally represented, but whose important rulings would be taken as recommendations to the two governments, rather than binding rulings. Again, the Committee considers this is a realistic assessment.

PART VI

The Political Implications: Myth And Fact

The Committee is convinced that, economically, bilateral free trade is viable, that it would be of real benefit to all regions of Canada and that these advantages are widely recognized. What appears to deter many Canadians from the idea is a deep-seated fear of an erosion of Canadian sovereignty or eventual political integration. This ancient fallacy has dominated Canadian political life since the country was founded.

The government's 1972 'Third Option' paper represented a typical expression of the "inevitability of political union" point of view. It asserted that "free trade areas. . . tend towards a full customs and economic union" and that probably in a Canada-U.S. free trade area Canada would be obliged to seek political union. The claim was baldly stated and on this simple proposition the argument for closer economic ties was rejected. There was no analysis or examination of past experience in other parts of the world. A major Ontario government paper, *Interprovincial Economic Co-operation. Towards the Development of a Canadian Common Market* went even further:

"... the pursuit of free trade with the United States at the expense of an erosion of our ties to the rest of Canada would inevitably lead to the disintegration of our nation." (p. 13)

The Committee recognizes how widespread the misconception is. During the hearings, regional political representatives expressed these concerns about

diminished sovereignty and increased vulnerability to the U.S. giant. The Hon. Larry Grossman of Ontario was the most vocal of regional representatives in his reactions but the Hon. Roland Thornhill of Nova Scotia and Dr. James McNiven of the Atlantic Provinces Economic Council also expressed concern for the country's political sovereignty and suggested that the east-west ties in the country would be diluted in a free trade arrangement. The Hon. Hugh Planche of Alberta was cautious about a one-to-one situation and the implications it would have on the integrity of Canadian decision-making. Similar apprehensions seemed to be a central element in the preference of certain other witnesses for a multilateral rather than a bilateral approach to trade liberalization. It is an "in bed with the elephant, it is safer to have supporting friends with you" type of argument.

What are the facts? Having studied past international experience in free trade areas, Professor Peyton Lyon told the Committee that both **"history and logic refute the claim that free trade areas inevitably unleash economic forces that drive the participating nations, against their will, on to tighter forms of economic and political union."** Documenting his case, Professor Lyon concluded that **"far from being typical there is no single, solitary case of this ever having happened."**

Free trade areas do not tend to become customs unions; they do not become politically integrated. On the contrary they are "characteristically established by governments determined to achieve gains while retaining as much national sovereignty as possible," said Professor Lyon. Moreover, even countries which have organized into the much more tightly structured arrangement of a customs union or a common market, with the expressed aim of some degree of political integration, have met with frustration and difficulties in achieving their aim. Some scholars even argue that economic integration may impede political integration, Professor Lyon reported.

The Hon. Robert Stanfield also disagreed with the perception that Canada's sovereignty would be diminished in a bilateral free trade situation, although he recognized it has been dangerous, politically, over the years to propose reciprocity with the United States. He told the Committee he believed a shared market between the two countries would help strengthen Canadian national feeling and reduce regional tensions. But in view of the common Canadian misconception on the sovereignty question, and the fact that Canadians have been slow to examine it carefully, Mr. Stanfield urged its active debate.

"Some people who are strong economic nationalists will dismiss it immediately on, perhaps, emotional grounds; others who are traditional free traders will accept it on their faith and principles; but my belief is that most Canadians are not sufficiently informed on the subject today to have any firm opinion or be at all certain as to what the indications are. I think there is a lot of educating and a lot of thinking to be done . . ." (5:23)

Both Mr. Stanfield and Professor Lyon made the point that Canada is already dependent on the United States in the sense of concentration of sales to one market, an inescapable result of a geographic fact of life. Consequently, Canada is even now vulnerable to policy changes by the U.S. government in import regulations, quotas, tariffs, non-tariff measures, etc. Canadian decision-makers are at present constrained to a considerable degree by this reality whether they like it or not. Former political leaders have acknowledged it. To reduce the existing dependence, Mr. Stanfield said, would only result in a far lower standard of living in Canada and in a diminishing opportunity for national prosperity. Most Canadians appear ready to accept the current degree of economic dependency.

Contrary to the popular myth, it is precisely a free trade arrangement which could give Canada a lessening of this kind of constraint. With a carefully defined and structured free trade arrangement with Canada, the United States would be much less likely to hit its partner with sudden reversals of trade policy. If Canadian policy makers are worried about a tightening up of procurement rules, for example, what better way to get at it than through the mechanism of a free trade agreement and the appeal mechanism provided therein? A good case can be made that Canada would actually have more influence in Washington and more independence of policy under a free trade agreement than it currently has without it. Recalling the abrupt imposition in 1971 by President Nixon of a 10 percent surcharge on all dutiable imports to the United States, an American economist told the Committee that Canada would have been exempted had it been a free trade partner. Nor did he think that U.S. government procurement could be as discriminatory as at present against a free trade partner.

It is difficult for the Committee to understand the viewpoint that the removal of the remaining tariffs could have such momentous political effects as its critics claim. It is, after all, only a small part of the total economy which would be affected—namely a part of the secondary manufacturing sector, badly in need of assistance. Almost 80 percent of Canada-U.S. trade will soon be free of tariffs in any case. Canada has gone this far toward tariff free trade without any awful consequence to its independence and sovereignty. Why would the freeing of the last 10 to 20 percent have such disastrous effects? Where is the evidence that, as Mr. Grossman put it, “Canadian cultural values, traditions and social and political choices would disappear and be swallowed up”? The Committee wants to see these values protected and enhanced. Is there not more basis for saying that an improved economic situation resulting from a successful bilateral free trade arrangement would give Canadians more confidence, more strength to resist pulls from the United States including those of Canada’s educated youth migrating south to more interesting job opportunities. **The strongest industrial areas in Canada, both in resource-based and manufacturing sectors, are those with no tariff**

protection; it is only the weaker manufacturing areas which are protected and if these industries are restructured and strengthened through free access to the U.S. market it could only strengthen the Canadian social and political fabric as well as its economy. Would anyone suggest that Ireland (Eire) had lost any of its political or cultural independence after it joined the United Kingdom in a bilateral free trade arrangement? It certainly became economically stronger.

Another concern which has been raised is the fear of abrogation by the United States of a bilateral free trade agreement. The argument goes that since, under free trade, the concentration of Canadian trade in the U.S. market would be greater than it is now, the reintroduction of tariffs or other trade restrictions would be dangerously costly to Canada whereas the United States would hardly notice it. This 'irreversibility' of the arrangement for Canada, the fact that the United States holds Canada's main markets as 'hostage', it is maintained, would give the United States potent leverage in bilateral negotiations.

First, as Professor Lyon pointed out, the U.S. record of adherence to treaties is relatively good. Secondly, a bilateral agreement could explicitly spell out that any intention to terminate the agreement should necessitate a specified warning period and this should be long enough to ensure there would be no sudden shock of termination. Third, even in the unlikely and unfortunate event that the United States did terminate the agreement, how vulnerable would Canada actually be? Most proponents of bilateral free trade consider that one of the most important reasons to go this route is the need to jolt the vulnerable secondary manufacturing sector into reorganizing and restructuring. Once this adjustment had taken place under a Canada-U.S. agreement, the Canadian manufacturing sector would have been forced to rationalize and would thus have strengthened itself. Even if the United States were to reimpose its tariffs (and they would be the MFN tariffs lowered meanwhile under the GATT agreement by as much as 40 percent), Canadian industry should be better able to compete than it is now. Thus, even in the 'worst scenario' case and no matter what the final outcome, the Canadian manufacturing sector would be stronger than it is today and with a better future outlook.

Finally, the United States has a major stake in Canadian prosperity. Currently it is very angry at certain Canadian policies which it sees as 'discriminatory' and is threatening to retaliate. But it is finding it quite difficult to do so. Like Gulliver, the United States is constrained by a network of strings—links which weave its own economy to that of Canada. Retaliation risks inflicting damage on itself since almost 25 percent of its exports go north to Canada. With free trade, this constraint on U.S. retaliatory action

would be strengthened, making abrogation of a treaty a very unlikely development.

Nor is Canada without some leverage of its own. U.S. industry is highly dependent on a wide range of Canadian resources. Canada's control over future sales of such resources is in itself a strong bargaining counter. Moreover, as Professor Wonnacott has pointed out, the extent of U.S. direct investment in Canada gives Canada the power to retaliate swiftly—with a tax on U.S. subsidiaries for example—if the United States arbitrarily and unilaterally reimposed the tariff which Canada would view as a tax on its industrial output.

What about the concern that foreign ownership would increase under bilateral free trade—that the stronger foreign corporations with better financing possibilities and established markets would be able to survive the rationalizing moves of the Canadian manufacturing sector and would consolidate smaller unviable Canadian firms during the initial adjustment period? Most economists agree that indeed this could be a short term danger and that it would be reasonable to negotiate short term controls into the agreement for the period immediately following tariff reform. As noted on page 99, it might be necessary to modify competition rules and allow greater freedom for Canadian firms to merge during the transition period. Concerns over competition would be diminished since the Canadian consumer would be protected from a Canadian monopoly situation by the availability of duty free imports. The Economic Council has also suggested that, because influences such as emotional nationalism might possibly adversely affect the location decisions of U.S.-owned firms under bilateral free trade, some form of review procedure could be justified for the transition period.

Over the long term, however, the prospects for strengthened Canadian ownership look good as multinationals would feel free to choose to service the whole North American market from Canada. At present, it is mainly the successful Canadian multinationals in the resource sector or in certain high technology areas already benefitting from special tariff-free access which have remained in Canada. For many others, the U.S. tariff has prompted a move southward.

Finally, any discussion of the free trade and foreign ownership issue necessitates setting the record straight. **It has been, after all, the Canadian tariff which has resulted in the high degree of U.S. ownership in Canada's manufacturing sector and the creation of 'branch plant' companies. Had free trade been adopted much earlier, the story could have been quite different.**

The necessity for harmonization and co-ordination of policies of the two countries in a free trade arrangement was another concern broached during Committee hearings. The Hon. Larry Grossman argued that in order to

ensure that the investments of multinationals came to Ontario or Quebec and not to the north-east United States, it would be necessary to adjust Canadian standards or policies to conform with those of the United States; for example in respect to minimum wage rates, environmental standards, revenue bond financing, etc. To what extent, asked the Hon. Roland Thornhill of Nova Scotia, could Canada's policies on regional development subsidies be maintained? What about Canadian content requirements, FIRA, industrial incentive programs? Other witnesses were worried as to whether corporate taxes would need to be the same in both countries in order to avoid taxation levels being a factor in plant location or to avoid giving an unfair competitive advantage to one country? Would Canada be forced to have the same unemployment insurance and workmen's compensation schemes as the United States? Would U.S. 'set-asides' for small businesses be maintained? Would Canada be able to maintain an independent foreign policy?

Many of these points are well taken and the Committee heard a variety of opinions on them from expert witnesses. The balance of evidence was that the two countries' taxation and fiscal policies could remain as they were and the differences, as they affected trade, could come out in the exchange rate. Professor Lyon stated that only a modest amount of policy co-ordination had been found desirable in most free trade areas. Dr. David Dodge considered there might well be some pressure for Canada to standardize its subsidy and tax arrangements with those of the United States. In Washington, while Professor Robert Dunn told the Committee that even FIRA would not constitute a major problem in a free trade arrangement, other American witnesses expressed concern that it could cause problems.

In actual fact, relatively little policy harmonization has been required in EFTA or in other free trade areas. Even the small European countries like Sweden and Norway, which have free trade agreements with the huge European Community, show little evidence of conformity to it either in matters of economic or foreign policy. Even within the Community itself, which as a common market, not a free trade area, has sought policy harmonization, there is not a high degree of uniformity. That free trade is not dependent on taxation conformity is evident from the differing tax systems within the individual states of the United States. But even to-day Canada cannot allow its competitive position, with all its different components including wage and productivity rates, taxation rates, etc., to vary too much from that of the United States without suffering the consequences of a falling dollar and falling investment. A free trade arrangement would not substantially alter this situation.

The most sensible approach to the issue of policy harmonization was one suggested by a businessman familiar with the situation on both sides of the

border. Mr. F.H. Tyaack of Westinghouse, Canada said that in negotiations, both sides would be worried about the other side's existing policy on this or that. But he said:

"Each country has certain problems, economically and in other respects . . . In recognizing the needs of the other party you can have a reciprocal agreement which recognizes needs and condones practices. This is another avenue than just assuming that they must be eliminated. You cannot eliminate needs. . . Therefore, I would not expect that you could write a practical bilateral agreement unless the other party recognizes your need. It is not just a matter of wiping out practices, but a matter of understanding what kinds of practices can be mutually tolerated under what sort of agreement." (16:27)

As to whether bilateral free trade would diminish the independence of Canadian foreign policy, it must first be noted that Canada's present foreign policy formulation is constrained, as is that of all the countries of the western industrialized world, by their existing economic and military interdependence. As one witness said, existing precedents do not lend support to those who fear a diminished independence. Under a free trade agreement Swedish foreign policy has been quite different from that of other EFTA members for example. Even with 70 percent of its exports and imports tied to the United States, Canada has differed from the United States on many issues in NATO and in the United Nations. Canada has pursued policies toward Cuba and China which were not to the United States' liking. Professor Lyon pointed out that Australia, which is much less dependent on the U.S. market than Canada, has had a less independent foreign policy than Canada, perhaps because of its different strategic position. Australia may consider it should try to align its policies with those of the United States in view of its defence dependency, whereas Canada assumes that, as a close neighbour, it will continue to benefit from joint defence agreements. The Committee finds it difficult to understand why the lifting of remaining tariffs should make a difference to Canada's foreign policy stance. On the contrary, a persuasive case can be made that, if a formal bilateral free trade agreement strengthens the Canadian economy, Canada's ability to pursue an independent foreign policy would be strengthened, not weakened.

To sum up, the Committee is convinced that a hard-headed assessment is needed for this emotionally-charged issue. A great deal of educating needs to be done. That Canada's prosperity and standard of living are dependent to a very great extent on U.S. markets, no one can deny. For the majority of Canadians, this appears to pose no problem even though it may concern Canadian, and even American, decision-makers from time-to-time. But to jump from this to the conclusion that the removal of the remaining tariffs and the increasingly troublesome non-tariff barriers would lead to political integration with the United States is totally unwarranted by the facts.

In the Committee's opinion, a far more potent threat to Canada's political and social strength would come from a continued weakening of its indus-

trial performance and a decline in its economic stability in the face of the challenge of the 1980s and 1990s. It is precisely at the strengthening of the national fabric, both political and economic, that a Canada-U.S. free trade arrangement is aimed.

PART VII

Summary

Background

Among the recommendations made by the Committee in its 1978 report (Volume II) on Canada-US trade relations was one which urged the governments in Canada as well as the business and labour communities to examine seriously the option of bilateral free trade with the United States. In its more recent study, the Committee has held a series of hearings with businessmen, academics and trade negotiators, both Canadian and American, as well as representatives in various regions of Canada, in order to examine reactions to such a policy course and to determine what the best approach to achieving such an objective would be.

While there is general awareness of the importance of trade to the Canadian economy, with exports alone constituting 26 percent of the Gross National Product, what is sometimes lost sight of is that, of Canada's total trade, almost 70 percent, or \$100 billion, is with the United States. The Committee wishes to stress that if there is a problem—and surely there is, with a deficit of trade in end products of \$20 billion—it is in the United States market that the solution to the problem must be found.

In its review of ground covered in Volume II, the report briefly notes what the Committee considers to be the main problems besetting Canadian industry, particularly the manufacturing sector, in the present international

scale MTN is not likely before the mid-1990s, and in any case, Canada's interests are unlikely to be served by what has become a 'club of three,' that is the European Community, the United States and Japan.

9. **The Committee concludes that any arrangements for a free trade area between Canada and the United States should comply with GATT rules and precedents.** Under GATT rules there are various policy options for entering into a bilateral free trade agreement:

a) A 'pragmatic' approach by Canada and the United States to specific bilateral issues under the GATT conditional most-favoured-nation (MFN) procedure; that is, the resulting benefits of freer access concluded by the two countries would be accorded automatically to those other countries which were themselves prepared to offer the same benefits.

The Committee rejects the 'pragmatic' approach because it appears difficult to achieve under GATT rules and is unlikely to interest the United States.

b) A 'declaratory' approach under Article XXIV of the GATT whereby the two countries would issue a declaration saying that a free trade area as defined by the GATT should be now deemed to exist between Canada and the United States. From there they could proceed to further liberalize trade by sector or product.

In respect to the declaratory procedure, the Committee noted that, by 1987 when the agreed GATT tariff cuts will become fully effective, a *de facto* free trade area between Canada and the United States in respect to tariffs could be said to exist.* This would mean that the two countries could, within the meaning of the GATT definition, declare they already qualified as a free trade area, as far as duty-free trade was concerned, and proceed to liberalize trade further at their own pace. However, since non-tariff barriers, which are now an even more important determinant of trade than tariffs, would not be taken account of, the declaratory approach would not serve Canada's best interests.

The Committee rejects the 'declaratory' approach.

c) An 'interim agreement' approach under Article XXIV, under which the two countries would submit to the GATT a plan and schedule for the formation of a Canada-U.S. free trade area. Such a procedure would deal with non-tariff barriers as well as tariffs. Further,

* The GATT has previously acquiesced in the formation of free trade areas with a lower level of freely traded goods than would actually exist between Canada and the United States by 1987.

protective measures which will not be easy to overcome. The Committee considers that Canada must find some way of "getting inside" the whole legalistic trade regulatory system now in place in Washington.

The Committee is convinced that the only way to deal effectively and soon with these and other serious U.S. non-tariff barrier problems is through a bilateral arrangement with the United States.

3. The Committee considers that the achievements of the Tokyo Round in liberalizing trade appear unlikely to provide sufficient stimulus to bring about the necessary restructuring and rationalization of much of Canadian industry, particularly the vulnerable manufacturing sector. **The Committee concludes that the Tokyo Round has, in effect, left Canadian industry in the worst of both possible worlds—with tariffs too low to be an effective protection and, at the same time, still without free access to a huge assured market as enjoyed by its competitors, the European Community, Japan and the United States.**
4. The Committee considers that government measures to strengthen the position of Canadian industry are not generally having the desired effect of stimulating the growth and competitiveness of the Canadian manufacturing sector and are having the added disadvantage of arousing strong critical reaction from the United States. **The Committee therefore reaffirms the conclusion reached in its Volume II report that the desired restructuring, growth and competitiveness of Canadian industry can best be achieved by the negotiation of a bilateral free trade agreement with the United States.**
5. The Committee concludes that there has been a remarkable growth in self-confidence in the Canadian business milieu in respect to the question of bilateral free trade which has not yet permeated the political milieu.
6. **The Committee emphasizes that what it is recommending is a bilateral free trade agreement, not a common market or a customs union.** There are important differences which many Canadians fail to recognize.
7. The Committee considers that what Canadian industry needs above all else is dependable access to the U.S. market and with preference in that market over both the advanced industrial countries of Europe and Japan and the fast growing, newly industrialized countries.
8. **The Committee concludes that a bilateral free trade approach is preferable to a multilateral approach** because, among other reasons, multilateral free trade is clearly not achievable in the near future. Another full-

scale MTN is not likely before the mid-1990s, and in any case, Canada's interests are unlikely to be served by what has become a 'club of three,' that is the European Community, the United States and Japan.

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The Committee rejects the 'pragmatic' approach because it appears difficult to achieve under GATT rules and is unlikely to interest the United States.

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- c) An 'interim agreement' approach under Article XXIV, under which the two countries would submit to the GATT a plan and schedule for the formation of a Canada-U.S. free trade area. Such a procedure would deal with non-tariff barriers as well as tariffs. Further,

* The GATT has previously acquiesced in the formation of free trade areas with a lower level of freely traded goods than would actually exist between Canada and the United States by 1987.

the 'interim agreement' procedure is the one used for all previous regional free trade arrangements under the GATT.

The Committee recommends the adoption of the 'interim agreement' approach.

10. The Committee concludes that the free trade agreement should be drawn up initially only between Canada and the United States, but that it could be couched in North American terms so that if and when Mexico is ready to offer comparable access conditions, it could become part of the North American free trade area.
11. The Committee concludes that there is a growing receptive audience in the United States to such an initiative from Canada for bilateral free trade.
12. In respect to the economic impact of free trade, there would be substantial benefit to the resource and resource-based industries. The initial dislocating effect of bilateral free trade would be confined mainly to Canada's secondary manufacturing sector. Some companies would contract and others would expand. **The most important and basic economic benefit of bilateral free trade would be to assist industrial restructuring in Canada, which would result in an industrial establishment equipped to compete effectively, not only in the United States but also in world markets and in the Canadian home market.**
13. As far as foreign-controlled firms are concerned, the Committee considers that the bilateral free trade environment would make rationalization easier and more attractive for foreign-owned subsidiaries in Canada. Product mandating assignments would also be easier where tariffs are eliminated and the application of non-tariff barriers mutually agreed and enforced. To the extent that rationalization and product mandating are pursued by subsidiaries, the likelihood of repatriation of such plants to the United States is lessened.
14. **The Committee is convinced that, in a bilateral free trade setting, Canadian manufacturing firms, particularly in high technology, would be less likely than at present to locate branches in the United States, would do more R&D in Canada and would be better able to serve the U.S. market from Canada.**
15. In the report, the Committee has pointed to **areas of special concern** to which particular attention should be paid if Canada is to enter a bilateral free trade agreement with the United States. These areas are: the level of Canadian competitiveness, the question of Canada's place in the world technology race, Canadian non-tariff measures, foreign investment, the exchange rate and tax harmonization. In each of these potentially difficult areas, the Committee has commented on how Canada's

interests could be affected and in some cases suggested courses of action which could be followed.

16. In the report, the Committee has commented on a number of conditions which it considers should be included in the bilateral free trade agreement with the United States. These are:

- a) **Timing and scope:** The Committee recommends that Canada should endeavour to have as many non-tariff barriers as possible eliminated forthwith and should endeavour to have tariffs eliminated over a transition period of 8 to 10 years. In addition a faster rate of elimination of U.S. tariffs than of Canadian tariffs should be sought.
- b) **Rules of origin:** While Canada must protect itself from trade diversion, in view of the fact that U.S. tariffs against third countries would be generally lower than Canada's, the rules of origin written into the agreement should nevertheless be fairly liberal, in order to give Canadian manufacturers the possibility of continuing to source imports from the least-cost supplier.
- c) **Exceptions and safeguards:** The most notable exception in the bilateral agreement would be agriculture. Safeguard clauses should be included to permit either country, when faced with disruptions in particular sectors, due to tariff cuts, to impose quantitative restrictions, provided rigid requirements are met. It might also be necessary to negotiate guarantees for Canadian employment during the interim period, with a rigid time limit set on their duration.
- d) **Adjustment assistance:** The Committee considers that a well-prepared program of adjustment assistance to affected industries would be an essential element of a Canada-U.S. free trade agreement.
- e) **Subsidies:** The two countries should come to a fairly explicit understanding of a balance of mutually tolerable subsidies which answer each country's needs.
- f) **Competition policy:** The Committee suggests that the agreement should contain a provision that the enforcement of both Canadian and U.S. competition laws should be selectively relaxed during the transition stage.
- g) **The institutional structure:** The Committee considers that a joint monitoring agency would be fundamental to the successful operation of such a bilateral free trade arrangement. In addition, it would be important to have an appeal mechanism, to rule on complaints and violations.

17. The Committee found that regional reactions to the idea of bilateral free trade varied, with considerable caution being expressed by regional politicians—a caution seemingly based less on a negative economic assessment than on the fear of a possible erosion of Canadian sovereignty. In fact, overall, the evidence pointed to some economic gains for all regions in Canada from bilateral free trade. The biggest dislocation would affect and, at the same time, the biggest gains would accrue to, the two central provinces.
18. **The Committee concludes that the widespread fears among Canadians that bilateral free trade with the United States would lead to an erosion of Canadian sovereignty, or eventual political integration, are based on misconceptions and a lack of facts as to what constitutes a free trade area. The Committee is convinced that a hard-headed assessment is needed for this emotionally-charged issue. (Part VI of the report deals specifically with this problem)**

A great deal of educating needs to be done. No one can deny that Canada's prosperity and standard of living are dependent to a very great extent on U.S. markets. For the majority of Canadians this appears to pose no problem, even though it may concern Canadian, and even American, decision-makers from time-to-time. But to jump from this to the conclusion that the removal of the remaining tariffs and increasingly important non-tariff barriers would lead to political integration with the United States is totally unwarranted by the facts.

In the Committee's opinion, a far more potent threat to Canada's political and social strength would come from a continued weakening of its industrial performance and a decline in its economic stability in the face of the challenge of the 1980s and 1990s. It is precisely at the strengthening of the national fabric, both political and economic, that a Canada-U.S. free trade arrangement is aimed.

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free trade varied, with considerable caution being exercised by regional
politicians - a caution certainly based less on a negative economic
assessment than on the fear of a possible erosion of Canadian sovereignty.
In fact, overall, the evidence points to some economic gains for
all regions in Canada from bilateral free trade. The worst distinction
would appear to be at the same time, the largest gains would accrue to
the two central provinces.

A very preliminary finding was that the Committee found that the widespread fear among Canadians
that bilateral free trade with the United States would lead to an erosion
of Canadian sovereignty or eventual political integration, are based on
misconceptions and a factual basis as to what constitutes such a trade
agreement. The Committee's conclusions (which should be made) are that
it is not necessary for the national political system (that is, of the report deals
to specifically with the provisions of the proposed free trade agreement on the
scope of government to be exercised by the participating countries.)
A great deal of educating needs to be done before one can deny that
Canada's prosperity and standard of living are dependent to a very
large extent on U.S. markets. For the majority of Canadians the
prospect of loss of jobs is not a problem, even though it may create a problem, and
in some cases, economic matters from time to time. But to jump from
this to the conclusion that the removal of the remaining tariffs and
tariff reductions would lead to political integration with the United States is totally unwarranted by the facts.

In that committee's opinion, a far more potent threat to Canada's political
and social structure would come from a continued weakening of its
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(1) Canada's political and social structure would be threatened by a continued
weakening of its industrial performance and a decline in its economic standing in the
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weakening of the national fabric, both political and economic, that a free trade
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economic system.

APPENDIX A

The Impact of the Tokyo Round on Canadian Industry

a) Tariffs

One of Canada's main objectives at the MTN had been to gain the elimination of duties on its more processed exports from the forest products, petrochemical and non-ferrous metals sectors. To this end it had proposed across-the-board sectoral negotiations encompassing both tariff and non-tariff barriers. Even though Canada tried to use the idea of security of supply as a leverage, its sectoral initiative was rebuffed. Part of the problem may have been unlucky timing, since the negotiations took place during a period when raw material supplies seemed readily available. Canada's bargaining power might have been stronger had there been a strong world market demand for resources or resource-based products.

In the resource sector, only minor concessions were gained for non-ferrous metals, apart from the elimination of the U.S. duty on aluminum ingots. Nor was much progress made in obtaining easier access to markets in the United States for Canadian specialty steels on which there is a U.S. import quota. On most asbestos products, the United States agreed to eliminate duties. In the forest products sector, however, Canada had more notable success in gaining improved access for a wide range of processed exports, particularly to the United States, but to a lesser extent also to Japan and the European Community. For example, U.S. tariffs on dutiable wood products will fall from an average of 6.2 to 0.8 percent; its tariff on waferboard and

particleboard from 10 to 4 percent, on hardboard and birchfaced plywood from 7.5 to 3 percent. The U.S. tariff on stained and pre-finished lumber and on birch and maple wood veneers will drop to zero. The duty-free U.S. access currently granted to newsprint and several other papers will be extended to certain other paper products, including an important kraft paper item, and the average U.S. tariff for paper and paper products will fall from 3.8 to 0.8 percent. On the whole therefore, access to U.S. markets should be easier for processed forest product exports, subject only to the possibility of increasing use of non-tariff barriers by the United States.

On certain manufactured products, Canada made significant concessions. While the domestic appliance industry will still retain a protective tariff in the range of 12.5 percent, down from 15 to 20 percent, the Canadian rates on imports of electrical and electronic office equipment such as cash registers, adding machines, typewriters, dictating systems will drop to zero from 10 to 20 percent. Computers and related products now protected by duties ranging up to 17.5 percent, will have duties of from 3.9 percent to zero, roughly parallelling U.S. tariffs in these items.

For furniture, the United States made substantial concessions in tariffs on both metal and wood furniture which may benefit the Canadian furniture manufacturer. Canada also agreed to reduce its furniture tariffs, down to the 10 to 15 percent range, a level still well above the U.S. rates.

In the transportation sector, the MTN could result in stimulus for automotive parts companies when market conditions improve. Both Canada and the United States agreed to tariff reductions which will affect aftermarket parts outside the auto pact. Significant cuts on auto parts duties were also agreed to by Japan and the Community. No reduction by Canada or the United States was made in their high tariffs on rail cars.

For the Canadian machinery industry, the United States is a major market, accounting in 1978 for 41 percent of sales and 72 percent of exports. Under the MTN, the United States will provide duty free access for a broad range of machinery for the pulp, paper and paperboard industry, for ingot moulds and casting machines and for fork-lift trucks and platform trucks. Duties on a number of other machines will be reduced. Some important Japanese and EC tariff reductions were also made on a number of machinery items. The United States agreed to open wider its agricultural machinery market for Canadian exports. Canada currently provides duty-free entry for a much broader range of U.S. agricultural equipment than the United States provides for Canada. At the Tokyo Round, the United States agreed to establish an 'actual use' provision in the U.S. tariff which will ensure that most Canadian exports of agricultural machinery and equipment will enter free of duty provided they are for agricultural use. In the past, the restrictive

application of this provision has constituted a considerable non-tariff barrier for Canadian agricultural machinery exports.

Canada made a major concession in respect to its Machinery Program which was an important factor in reaching an agreement with the United States concerning access for farm machinery, a long-standing trade irritant between the two countries. Under the existing Machinery Program, Canada makes a distinction between machinery imports which compete with Canadian products and those which do not. The former imports faced a duty in the 15 percent range; the latter came in free. Canada has now agreed to reduce the tariff on many items of machinery available in Canada to 9.2 percent from 15 percent and to bind the average incidence of duty on imports under the Machinery Program at 5.25 percent. In addition, for a significant number of machines which have been entering Canada free, but unbound, for many years, Canada has agreed to bind these zero rates.

In the chemicals sector, a Canadian objective had been better access to the U.S. petrochemical market for its burgeoning petrochemical industry. This objective did not succeed and, in general, both Canada and the United States retained a high degree of protection in this sector, with some U.S. tariffs on petrochemical derivatives moving even higher.

In the agricultural sector, concessions from the major trading partners will affect \$1 billion worth of Canadian exports and considerable benefits were achieved for fisheries and alcoholic beverages, particularly whisky in the U.S. market.

In sum, for numerous sectors, the lowering of Canadian tariffs will mean that consumer goods and industrial products will flow in more easily and cheaply. But the traditionally protected Canadian manufacturing sector will be rendered more vulnerable to import competition. The most sensitive industries, such as textiles and shoes, are still heavily protected.

In respect to the agreement on Trade in Civil Aircraft, there will be little adjustment required by Canada since existing tariffs on most aerospace products have not been applied for many years. Considerable stimulus for the Canadian aerospace industry is expected therefore from the duty free access provisions. At the same time, the non-tariff provisions of the agreement will allow a continuation of the government's program of support for the industry and the opportunity to seek reasonable offsets in major civil aircraft purchasing contracts. Production and trade in military aircraft are not covered by the agreement.

b) Non-tariff barrier codes

The non-tariff barrier arrangements concluded at the Tokyo Round included agreements on subsidies and countervailing duties, technical barriers

ers such as product standards to trade, government procurement, import licensing, and customs valuation; a revised agreement on anti-dumping duties; and a framework of understanding covering ways in which certain GATT obligations should be applied and a strengthened dispute settlement procedure.

(i) *Countervail*

The new GATT subsidies/countervail agreement recognized that subsidies are a legitimate tool for the promotion of such national objectives as regional development, research and development and industrial restructuring. It also introduced better international discipline in the use of subsidies which affect trade and production.

In respect to the United States, the new agreement is unlikely to solve Canada's bilateral countervail problems despite the U.S. acceptance, at the Tokyo Round, that it will henceforth conform to the GATT procedure of establishing whether or not 'material injury' has been done to a domestic producer before imposing countervail duties. Formerly, the U.S. government could, under a U.S. law which preceded the GATT procedure, arbitrarily impose duties against exports from Canadian firms benefitting from government-funded programs whether or not they had caused injury to domestic producers. Two notable examples in the 1970s which caused considerable bilateral strain concerned Canadian exports to the United States by the Michelin and Honeywell companies. An important Canadian objective in the Tokyo Round negotiations had been to gain U.S. conformity regarding the finding of 'injury'.

Professor Fred Lazar of York University told the Committee that the new U.S. conformity could be "a hollow victory" since the U.S. Trade Agreements Act of 1979 was amended simultaneously to make it much easier for U.S. companies to lodge complaints and for the International Trade Commission (ITC) to find injury. The ITC can now find injury from foreign export subsidies and order countervail duties or tariff quotas as long as there is even a marginal relationship to the fact that a U.S. producer's performance has deteriorated, he said. Similarly, Professor Lazar made the point that the revisions to the existing GATT dumping code, while including the same injury test as the subsidies code, has been watered down by the United States. It no longer requires sales at less than fair value to be the principle cause of poor performance of firms in the country in which the goods are being dumped. Instead, the U.S. legislation only requires the establishment of "a weak and perhaps indirect link between dumped goods and poor market performance". Whether the Administration will apply these rules strictly remains to be seen.

Another concern in respect to countervail, emphasized by Mr. Rodney Grey, involves the asymmetry of the impact of countervailing action by the two countries. In Canada, because of the high cost of capital and serious regional disparities in income and employment, there is a continuing need for both federal and provincial assistance to industrial development. But since a large percentage of the Canadian production must be exported, and as by far the largest market is the United States, the risks of running into U.S. countervail action, if rigorously applied, are great. For the United States, on the other hand, subsidization of industry, done via methods such as tax-free municipal industrial revenue bonds or tax-free land, is directed mainly at production for the internal domestic market, rather than for export to Canada or elsewhere. Thus, although Canada now has a countervail law, it is not likely to be frequently used, nor will it constitute much of a threat to U.S. industrial development.

In contrast, vigorous application of the U.S. countervail law against Canada could have a very serious impact, not only on industrial production by requiring producers to try to rely on a protected Canadian market, but on location of production in Canada. For example, any firm accepting a subsidy and locating in Canada with the intention of producing for the North American market runs the risk of U.S. countervail on about 80 percent of his output. However, for a similar firm also subsidized, located in the United States, there is a risk of possible Canadian countervail on only about 10 percent of its output. In the face of this risk, Canada can lose industry. Canadian subsidiaries of U.S. multinationals may choose to locate new production in a corporation's U.S. plants rather than in Canadian locations. From Canada's point of view, the GATT countervail code appears inequitable in its application.

Although the GATT prohibits export subsidies, the Tokyo Round did not succeed in defining what constitutes a subsidy, although it gives some examples. As a result, many anomalies remain. Mr. Grey has pointed out*, a Canadian DREE subsidy, while not inconsistent with the GATT code, is nevertheless vulnerable to countervail. But general tax incentives applied across the country, or the provision by a province or state of required infrastructure for an industrial site, or subsidies to an industrial project which are fully repaid do not appear to be subject to countervail. On the other hand, tax incentives for location in designated regions, or extension of credit at less than the going rate of interests, or the financing of industrial R&D if it appears to help the commercial production and marketing of a product would seem, by precedent, to be subject to countervail.

* Rodney C. Grey: *Trade Policy in the 1980s: An Agenda for Canadian-U.S. Relations*, C.D. Howe Institute, 1981, p. 56-7

Mr. Grey has pointed to another retrograde step involving U.S. countervail law occasioned by the Tokyo Round. Earlier, the U.S. Treasury had developed, partly as a result of discussions on the Michelin case, the concept of 'offsetting' in calculating the amount of countervail duty. That is, it would consider as a subsidy only that amount in excess of the higher cost involved in locating a plant in less than a prime location, thus taking into account the fact that regional development grants were legitimate national policy actions. Had this method been applied, for example, in the Michelin case, and the extra costs involved in establishing a plant in Nova Scotia rather than in Ontario or Quebec been deducted from the DREE subsidy, the net subsidy might have been calculated as very much lower or perhaps not even subject to countervail. Unfortunately, the Congress in passing the 1979 U.S. Trade Agreements Act, aiming at the European Community and not at Canada, outlawed the 'offsetting' concept, a move which makes U.S. countervail potentially much more punitive for Canada.

(ii) Procurement

From the Canadian perspective, the agreement on government procurement, while technically well set out, proved a major disappointment because of its very limited coverage. As Mr. Grey admitted to the Committee, "the procurement code does not cover very much procurement".

What the procurement code **does** cover is purchasing by major U.S. and Canadian federal government departments as well as a range of other agencies and commissions for goods valued above approximately Cdn. \$220,000. (This represents some control on only about five percent of the Canadian government's purchasing and probably the same amount in the United States.) An attempt has been made in the code to ensure more "transparency" in procurement procedures and bidding techniques. There is also a provision in both the code and the U.S. Trade Agreements Act for further multilateral negotiations to take place before the end of 1983 in respect to procurement.

What the code **does not** cover includes state and provincial purchasing, purchases by commercially-operated crown corporations and comparable arm's length corporations, government agencies in the United States, and purchasing subject to national security considerations. Important U.S. government purchasing entities, such as the Tennessee Valley Authority and Amtrak are not covered. These would normally be the prime market for the sort of products Canada excels in, namely, heavy electrical generating equipment, rapid transit and railroad equipment, etc. Telecommunications equipment is not covered. Purchases of items under Cdn. \$220,000 or U.S. \$190,000, are not covered, nor are construction or service contracts. The U.S. set-asides for small and minority-owned businesses are exempt. Nor does the

code provide an effective set of rules to preclude government procurement from imposing any kind of price preference or absolute preference for domestic goods (such as domestic content rules) over and above the preference accorded by the protective tariff. The agreement does not deal with governments' purchases of goods for resale, but only with purchases for their own use.

There was a marked increase, even while the GATT negotiations were proceeding, in U.S. procurement protection measures in Congress and at the state level. Commenting on the growing tendency in the United States to more protectionist pressures, Mr. Ron McCallum of Hawker Siddeley, Canada, told the Committee:

"Every new restrictive U.S. measure, be it legislative or procedural, appears to be regarded as a new negotiating base to determine what concessions are required on our side to recover some of the status quo on any particular issue." (11:11)

The Surface Transportation Assistance Act has seriously affected some Canadian producers, particularly in the urban mass transit industry. Mr. Kirk Foley, President of the Urban Transportation Development Corporation (UTDC) of Ontario, told the Committee that this industry has "no customers other than governments anywhere in the world", and that the average bid size in a project was from \$50 million to \$150 million and more if a whole transit system were involved. In the face of the restrictions under the Surface Transportation Assistance Act and at the state level, there is, as the Committee heard from Bombardier Inc. and other witnesses, a strong incentive for Canadian producers to establish facilities in the United States.

Mr. Grey pointed out that U.S. procurement rules are not always in the best interest of the United States and of U.S. component suppliers who sell to Canadian producers. For example, Canadian manufacturers of urban transit cars are heavy users of U.S.-made components, yet when these components re-enter the United States in finished Canadian exports, these components are not counted as U.S. content for procurement purposes. For tariff purposes, however, they are allowed duty-free re-entry as U.S.-made components. This can lead to a situation **where a French, German or Japanese firm which has established assembly facilities in the United States, using many components from their own countries, would be able to meet the U.S. preference list, whereas a Canadian-produced vehicle with higher actual U.S. content, would not meet the content requirements because of its heavy use of imported U.S. components.** In the urban transit industry, most buses in Canada are at least 50 percent U.S. content. If there were no orders from Canadian producers, U.S. suppliers would be the first to suffer.

Other sectors of Canadian industry are also adversely affected by U.S. procurement laws and regulations. In an earlier set of hearings, companies such as Northern Telecom, Wajax and ATCO told the Committee how they

had set up facilities in the United States in order to gain access to U.S. procurement markets. In a survey of its membership, the Canadian Manufacturers Association found that U.S. procurement rules were considered to be an impediment to growth by a significant number of industrial sectors, among these the transportation equipment, electrical machinery, rubber, clothing and metal fabricating sectors. Mr. C.D. Reekie, president of CAE pointed to the loss of Canadian jobs involved when Canadian companies found it difficult to sell Canadian-made products to U.S. federal departments or subcontractors of federal agencies because of the Buy American legislation. He also described the trade impediment involved in the federal set-aside provisions whereby the U.S. government sets aside 5 to 15 percent of its total contracts for small U.S. businesses, minority-owned businesses or businesses located in high unemployment areas. Once a product has been secured as a set-aside, said Mr. Reekie, it is always procured as a set-aside as long as there are two qualified U.S. bidders in the running.

In considering the policy alternatives open to Canada in dealing with this problem, it is clear that Canada cannot expect to gain much in further multilateral procurement negotiations. From the experience in the Tokyo Round, the major European countries and the Japanese will strongly resist multilateral negotiations concerning access to their procurement markets.

Mr. Kirk Foley of the UTCD proposed that Canada should try to expand its technology agreements, similar to the 1972 Jamieson-Volpe arrangement with U.S. agencies to provide access for products under technology programs similar to the waiver provided for the joint North American space program. The North American transit market could then be jointly exploited by producers in the two countries through joint research and development programs and bilateral offset arrangements. The integration of the North American market could be extended by joint ventures and cross-licensing arrangements with U.S. companies, he suggested.

Mr. Rodney Grey's proposal was that Canada should seek a bilateral deal on procurement with the United States along the lines of the 1938 Defence Production Sharing Arrangement, which exempted Canada from the Buy American Act and from U.S. tariffs for defence supplies and equipment. In his proposed procurement arrangement, however, Mr. Grey suggested that tariffs could be left as they were or addressed later as a separate issue relative to procurement; the important aspect would be the mutual elimination of non-tariff barriers.

(iii) Customs valuation

The GATT agreement on valuation will establish uniform rules to be applied by all governments in determining the value of imported goods for customs purposes, based on the 'transaction value' of the goods. Mr. Grey

considers that the decision by Canada to adopt the new GATT agreement on customs valuation "will be the most important and most troublesome change in the Canadian commercial policy system" resulting from the Tokyo Round. The adherence and adjustment to the new system by the United States will also cause problems for Canada.

Canada agreed to the GATT Customs Valuation Code with great reluctance. Because more adjustments will be required by Canada than any other major trading country, Canada insisted on a reservation qualifying its agreement. It will bring its valuation system into conformity with the code on the understanding that it will be free to raise its tariffs to offset any significant loss of protection that might result. Canada is still negotiating such understandings bilaterally with its trading partners. The United States has agreed to this condition. In addition, Canada will not adopt the new code until 1 January 1985.

The new valuation system will require drastic changes in Canada's current 'fair market system' of valuation. Under the 'fair market value'* system, duty is based on the value at which goods are sold at arm's length by the exporter in his domestic market. The fair market value must not be less than the selling price to the Canadian purchasers exclusive of all charges on the goods after they leave the point of direct shipment to Canada, for example, ocean freight or insurance. The system, like that in the United States, has offered domestic producers an added measure of protection by frequently valuing goods at prices higher than those actually paid.

Under the new GATT 'transaction' system, valuation of goods will be based on the value at which goods move in international trade. Normally, this will be the selling price to the importer in Canada as long as the exporter and importer are dealing at arm's length. Extensive research is being undertaken by the Canadian government to determine the extent of the decline in protection resulting from adoption of the GATT system. In addition, as detailed in the section above on Canadian industrial strategy, the government has proposed, in its discussion paper on Import Policy, certain contingency protective procedures which could be put in place in order to deal with unexpected injury from lower protection.

Mr. Grey has warned that Canada will have certain problems with the United States as a result of the United States switching to the new system. While the new system will present fewer internal U.S. administrative difficulties than the nine different systems it had when the Tokyo Round began,

* This valuation basis uses the price charged in the home market of the exporter. The 'transaction value' system differs in that it sets the value for duty on the basis of the market conditions in the import market that is, usually, the selling price to the importer in Canada if the exporter and importer are at arm's length.

it could well open the way for harassment of legitimate import trade by resort to excessive administrative discretion or detailed enquiries if a domestic producer complains.

Furthermore, under what was called 'the old value law,' the United States had a Final List of about 1000 products on which significantly higher duty was retained by valuation on the basis of its export or foreign value, whichever was higher. This list adversely affected Canadian exports. The United States also had a protective device for benzenoid chemicals, called the American Selling Price (ASP) system of valuation. In abandoning the Final List and the ASP at the Tokyo Round, the United States secured agreement to a revised schedule of ad valorem rates for the products covered by the two systems. As a result, the level of protection will not be reduced. In fact for some products it will even be increased. For example, Mr. Clifford Mort of Dow Chemical of Canada, told the Committee:

"As a direct result of the U.S. switching from specific and ad valorem tariffs to ad valorem tariffs only, as part of the Tokyo Round of negotiations, together with the base that was used for establishing the ad valorem tariffs, the absolute level of tariffs for most major petrochemicals by 1985 will be higher than the tariffs that would have existed had the Tokyo Round of negotiations not taken place." (9:10)

Another important problem arising from the GATT valuation code which Mr. Grey has pointed to concerns Canadian import transactions not at arm's length, but between related companies. A large amount of Canada-U.S. trade is between Canadian subsidiaries and the U.S. parent, and the temptation to charge artificially low transfer prices for duty valuation purposes is great. The code deals inadequately with this problem, and with other categories of imports frequently found in bilateral trade with the United States, such as end-of-line, used capital equipment, seconds, etc.

(iv) DISC

Another non-tariff barrier not settled by the GATT codes is the U.S. export subsidization device DISC. The Domestic International Sales Corporation has been used by the United States since 1971 to stimulate exports and retain direct investment in the United States. It is not easy to assess the impact of DISC on Canadian investment levels or on Canadian exports. Canadian corporation taxes have been adjusted somewhat in compensation and nine out of ten Canadian companies surveyed by the Canadian Manufacturers Association said they were not affected by DISC.

Because of a proviso in the GATT agreement to the effect that any signatory country was only required to make a "reasonable effort" to overcome an obstacle such as Congressional resistance, the United States will be unlikely to dismantle DISC in the near future, even though such a scheme was clearly prohibited by the Tokyo Round. Moreover, because the Reagan

Administration wishes to challenge European Community officials on their tax-based subsidies, it appears to be hardening the U.S. position and will force a full scale GATT council procedure. The Committee sees the DISC as an area where Canadian interests are inadvertently affected when they are not the target. While DISC is not a major bilateral irritant it should not be overlooked.

c) Conclusion

While not wishing to diminish the accomplishments of the Tokyo Round, the Committee agrees with Mr. Grey that "there is a lot of unfinished business", which will leave a legacy of bilateral trading problems for the 1980s and 1990s in respect to both tariff and non-tariff problems. In particular, countervail and procurement problems may well prove critical for Canadian high technology producers. The risk of encountering these U.S. non-tariff barriers has a direct impact on whether these Canadian producers decide to locate their production facilities in Canada or the United States. There is an urgent need for Canada to resolve these issues.

APPENDIX B

Government Industrial Development Policies

In recent years, certain policies designed to stimulate necessary restructuring of Canadian manufacturing industry and to increase Canadian competitiveness have been implemented by the Canadian government. The attempt has been made to gain a larger market for Canadian products by import displacement programs; by industry development policies; by co-ordination of government procurement; by the use of FIRA; and by stimulating research and innovation, especially in high technology areas.

Import displacement

A growing emphasis in government policy is being put on trying to displace imports. The value of end product imports reached \$45 billion in 1981, over \$35 billion of which was from the United States. Various pronouncements and publicity drives have been aimed at encouraging the private sector to 'Shop Canadian.' The Department of Industry, Trade and Commerce has an import analysis unit which surveys customs data in an attempt to pinpoint products imported in sizeable quantities which might constitute an area for new Canadian industrial development. In 1980, the message to 'Shop Canadian' was spelled out more explicitly in the National Energy Program, which urged the domestic sourcing, wherever possible, of the equipment, technology and engineering requirements of the major resource-based megaprojects coming onstream. In August 1981, in order to monitor the sourcing of such purchases in megaprojects costing \$100 million or more, the govern-

ment established a new office in the Department of Industry, Trade and Commerce to ensure that Canadian companies had "timely access to full information on project requirements and early participation in the bidding process." Under this program, co-operation in trying to find Canadian suppliers will be mandatory for the oil and gas projects, but voluntary elsewhere in the economy. The objective of this program is to reduce the enormous Canadian deficit in bilateral machinery and equipment trade with the United States which, it is estimated, will amount in 1981 to \$14 billion; up from \$6.4 billion in 1976. Changes are also being made in Canadian import policy, and the 1980 government discussion paper on import policy contains several controversial proposals respecting emergency import safeguards and a possible 'basic price system' to cope with large-scale dumping problems. These proposals have not yet been acted upon.

Industry development

A keystone of the present industrial development policy is a program which has come to be known as 'picking winners.' Because standard technology industries are increasingly threatened by competition of low-cost imports from newly-industrialized countries (NIC's), the concern is that Canadian industry should move aggressively into high technology areas and areas where Canada has a comparative advantage. During 1980 and 1981 an industry development policy was planned with a proposed budget of \$2.75 billion (\$1 billion of which has already been budgeted) but the November 1981 budget transformed these plans of massive economic intervention to a more modest development strategy. The government is actively promoting a videotex system (Telidon) which it helped nurture, and through various programs, i.e., the Special Electronics Program, the Canadian Space Program, an office communications program, etc., it has sought to stimulate innovation and development in new areas of high technology which would allow Canadian firms to compete with innovative products in world markets. It has announced it will establish six micro-electronic centres across the country. Other sectors which have been mentioned as the focus of the government's high technology policy are aerospace, telecommunications, biotechnology, data processing, electronics, nuclear generation and urban transit.

Hand in hand with the 'picking winners' strategy has been the relaunching of the Defence Industry Productivity (DIP) program* and the Enterprise Development Program (EDP). The original objective of the DIP program is "to develop and sustain the technological capability of the defence industry for the purpose of generating economically viable defence exports and related civil exports arising from that capability". Much of the assistance it provides

* Because of budgetary restraint and an evaluation study, the DIP program was stopped for 1½ years and was re-opened in 1981.

is designed to assist in expensive innovative R&D necessary for successful exporting. DIP funding was increased by 100 percent during 1981. As an example of this type of financing, grants of \$50 million have gone to Pratt and Whitney for a new turbine engine, the PT-7, and \$450 million to de Havilland for development of another commuter aircraft, the DASH-8.

The EDP, established in 1977, encompasses seven earlier programs including the Program for Advancement of Industrial Technology (PAIT). The purpose of EDP is to supplement the financial resources of small and medium sized manufacturing and processing industries in undertaking higher risk projects which might otherwise be left dormant. Under this program, grants for the research, development and even production and marketing of new products are possible and loan guarantees are also available. EDP approvals for grants have risen rapidly from \$18 million for 1977-78 to \$84 million for 1979-80 and loan guarantees have doubled.

Both these programs have as a primary objective the stimulating of innovative industrial R&D. In January 1981 the government made a new commitment promising to raise Canada's R&D expenditures to the equivalent of 1.5 percent of GNP, from the present level of about 1 percent, by 1985. Three years earlier, the government had announced it would reach this same target by 1983, but results had made the goal unrealistic.

All in all, the federal research and development expenditures, exclusive of tax incentives, will be almost \$1.5 billion in the 1981 fiscal year. In addition, the government provides tax incentives allowing 100 percent write-offs for R&D spending and the possibility of qualifying for a supplemental 50 percent deduction on incremental R&D. A 10 percent investment tax credit for R&D is also available.

As announced at the time of the November 1981 budget, the government will draw together its existing programs for industrial innovation under a coordinating Industrial Opportunities Program Board. This program is designed to provide assistance for restructuring, as well as support for all phases of the product innovation cycle including initial R&D, product and process design and innovation, prototype development, organizational change, market identification and testing.

Strengthening FIRA

In order to deal with what were perceived to be constraints on Canadian industrial development due to the high degree of foreign ownership of Canadian industry, the government announced in the 1980 Throne Speech its intention of strengthening the workings of the Foreign Investment Review Agency (FIRA), including performance reviews of how existing large foreign-owned firms in Canada were meeting the requirements of the legisla-

tion; publication of foreign takeovers before they were approved so Canadian firms could bid; and federal assistance for such counter-bids. Although no new legislation was introduced, a more stringent enforcement of the existing legislation was noticeable in 1981, with an apparent stronger emphasis on "the significant benefit to Canada" which a foreign firm must be prepared to make and a firmer commitment to performing R&D in Canada, to Canadian equity participation and to product mandating. However in the budget speech in November 1981, the government withdrew from its earlier commitment and announced it had decided not to amend the Foreign Investment Review Act for the time being. The Finance Minister said Ottawa would not extend Canadian ownership targets, as implemented in 1980 for the oil and gas industry, to other sectors. No legislative action on buy-back and pre-notification measures was planned. Mandatory performance review and reporting mechanisms for larger corporations were not proposed. An assessment of the administrative procedures is being undertaken, however, to establish what changes in procedure might be warranted.

Procurement

The Canadian government has long employed certain preferences for Canadian goods. More recently it has been attempting to co-ordinate government procurement as another instrument in the restructuring of the Canadian manufacturing industry. At the federal level, a planning system now exists so that the major 'buying' departments, when purchasing goods or services valued at over \$2 million, will source their purchases in a way which will best support domestic economic development objectives. This process is in addition to the government's policy of requiring industrial benefits and offsets, such as for the new fighter aircraft or the long-range patrol aircraft. Certain federal initiatives have also been taken to try to co-ordinate the buying of provincial governments, to which the government of Ontario in particular has given support.

In 1979, a product development fund of \$115 million was created to help companies enter new fields and make products, particularly in high technology areas, which the government wants to buy. The federal Department of Supply and Services, which accounts for about 25 percent of purchasing by all levels of governments, has a Procurement Review Committee which looks at every federal government purchase of more than \$2 million in terms of maximizing Canadian purchases. A Source Development Fund of \$30 million was established in 1981 to pay the difference between a Canadian company's higher bid and a foreign bid in certain cases, over the next three years.

Competition policy

The government's competition policy, particularly the extent to which it might inhibit the rationalization of industry, is of direct interest to Canadian

manufacturing firms. This policy is still in its formative stage, awaiting the introduction to Parliament of a new competition bill in 1982.

Other measures

The government has doubled the budget for export market promotion and provided \$900 million to the Export Development Corporation over the next three years to enable it to provide export financing at more favourable rates, but Canada may still be well behind the heavily subsidized rates of many other countries, a fact which appears to be hurting Canadian exporters badly, particularly in markets other than the United States where the dollar is over-valued. In 1979, the federal government put \$235 million in a joint federal-provincial program to help strengthen and modernize the Canadian forest products industry. In support of provincial governments seeking to influence the investment decisions of multinational auto manufacturers, the federal government has assisted with large grants to ensure new investment is located in Canada. In addition, refinancing assistance has been provided to both the Chrysler Corporation of Canada and Massey-Ferguson, which were and remain in difficulties.

In January 1981, a special industrial and labour adjustment fund of \$350 million was announced, which over the next three years will help displaced workers and assist communities which are particularly hard hit by industrial readjustment. In June 1981, the government allocated \$250 million over 5 years to establish new employment opportunities in communities affected by restructuring in the textile and clothing industry and to assist in the modernization of viable firms.

APPENDIX C

Canada-U.S. Competitiveness

Relative labour costs

The Committee's 1978 report expressed concern over the serious deterioration in Canadian competitiveness vis-à-vis the United States. One of the major elements in Canadian lack of competitiveness, which was emphasized by almost all the business witnesses, was the higher increases in Canadian wage rates relative to the wage settlements in comparable U.S. industries—a trend which was closing the traditional gap between Canadian and American labour costs.

During the more recent hearings, Dr. James Frank of the Conference Board in Canada told the Committee that his study of 84 matching Canadian and U.S. industries revealed that not only was the wage gap being closed, but in many industries there was a gap in the other direction. In 55 out of 84 industries studied, Canadian production workers were being paid as much or more than their U.S. counterparts by 1975. In response to concern at this accelerating rate of wage increases, the Canadian wage control program was introduced in 1975, a development which modified the trend for several years. Some resulting improvement was noted by the Conference Board study which showed that by 1978 those industries in which Canadian earnings equalled or exceeded U.S. earnings had dropped to 48 out of the 84 studied. But Dr. Frank emphasized that the decline in the number of Canadian industries at or above wage parity with comparable U.S. industries was not a

reversal of a long run trend which was leading to wage parity. Rather, it was the result of the Canadian dollar devaluation. If the devaluation of the Canadian dollar had not occurred, these Canadian labour costs would still stand at considerably higher levels than comparable U.S. costs.

In respect to differences in the average manufacturing wages in the two countries, data supplied by Professor Wonnacott confirmed the impact of the exchange rate. When the relative level of earnings is examined on an exchange rate adjusted basis, Canadian earnings in manufacturing had declined by 1979 to a level of about 95 percent of the U.S. rate, down from a high of \$1.12 in 1976 and \$1.06 in 1977 (See Table 3, column 4).

Table 3

Canada/U.S. Wage/Productivity/Exchange Rate Nexus, 1968-1978

Canada-U.S. Labour Cost Comparisons:						
Exchange rate (Value of Canadian to U.S. dollar) (1)	Hourly Manufacturing Wages (in Canadian dollars) Canada United States (2) (3)		Relative Wages (Can./U.S.) (4)	Relative Total Compensation (Can./U.S.) (5)	Productivity Comparison (Can./U.S.) (6)	
1968	92.8	2.58	3.24	.80	.77	.65
1969	92.9	2.79	3.44	.81	.78	
1970	95.6	3.01	3.51	.86	.81	
1971	99.0	3.28	3.61	.91	.86	
1972	101.0	3.54	3.78	.94	.88	.73
1973	100.0	3.85	4.08	.94	.88	.75
1974	102.2	4.37	4.32	1.01	.94	.80
1975	98.4	5.06	4.91	1.03	.95	.74
1976	101.4	5.76	5.15	1.12	1.03	.75
1977	94.1	6.38	6.04	1.06	.98	.76
1978	87.7	6.84	7.04	.97	.90	.78
1979	85.4	7.43	7.83	.95	.88	—
1980	85.5	—	—	.97	—	—

Sources: Professor J. Wonnacott (18A:1), and additional updated figures from J. Frank, Conference Board in Canada.

Even this comparative wage advantage due to the exchange rate is being eroded. Statistics in 1979 and 1980 indicate that Canadian wage settlements are again rising faster than U.S. rates. In the manufacturing sector for example, Canadian wage rates increased by 8.8 percent and 10.1 percent in 1979 and 1980 compared to 8.5 percent and 8.7 percent respectively, in the United

States. Mr. Frank voiced his concern to the Committee that Canadian industries, after having had the benefits of significant devaluation, will again come under pressure on the competitive front in the next several years.

The situation looks only slightly more promising when total compensation, that is, earnings plus social security benefits, are calculated on an exchange rate adjusted basis. U.S. benefit costs themselves are actually higher, averaging 21.2 percent of pay, for time worked and not worked, compared to 11.2 percent in Canada. When this considerable differential is added to wages in the manufacturing sector, Mr. Frank said, Canadian earnings plus benefits were approximately 88 percent of U.S. levels in 1979, an improvement from the 95 percent figure when earnings alone are considered. But even with this gap, Canadian labour costs would still have been 2 percent higher than in the United States had the Canadian dollar not been devalued.

The higher Canadian labour costs were commented on frequently by business witnesses before the Committee. For instance, Mr. Ron McCallum of Hawker Siddeley, Canada, said that the labour cost and productivity differential was particularly severe in their British Columbia operations where his company faced 35 percent higher labour costs in "virtually identical operations" than those available across the border. Mr. John Sandford, president of de Havilland Aircraft of Canada said his company pays from \$2 to \$3.50 an hour more than competing U.S. aircraft manufacturers. It was only the lower Canadian dollar which allowed his firm to compete successfully he said.

Work stoppages

Another factor which is frequently cited as a reason for Canada's poor competitive performance is that of work stoppages. Table 4 indicates that Canada, in 1978, had a significantly worse record in this regard than did the United States, with 840 working days lost per thousand employees in Canada, compared to 438 in the United States. In only two years since 1970 has Canada not had more days lost per thousand employees due to industrial disputes than the United States.

Relative Canada-U.S. productivity*

Canadian industry has traditionally had a significantly lower productivity level than U.S. industry, another factor affecting its weaker competitive position. (See Table 3, column 6.) This historic productivity gap between Canada and the United States has narrowed somewhat particularly in the manufacturing sector, thanks to a somewhat faster overall rate of produc-

* It should be noted that labour productivity not only reflects the output per man per hour but the range of skills and capital equipment the average worker has to work with.

Table 4

Work stoppages and time lost due to industrial disputes, 1955-79

Country and year	Number of industrial disputes	Workers involved (thousands)	Working days lost (thousands)	Days lost per thousand employees
UNITED STATES				
1970	5,716	3,305	66,414	956
1971	5,138	3,280	47,589	661
1972	5,010	1,714	27,066	374
1973	5,353	2,251	27,948	373
1974	6,074	2,778	47,991	629
1975	5,031	1,746	31,237	415
1976	5,648	2,420	37,859	485
1977	5,056	2,040	35,822	443
1978	4,230	1,624	36,923	438
1979	4,800	1,700	33,000	381
CANADA				
1970	542	262	6,540	970
1971	569	240	2,867	414
1972	598	706	7,754	1,075
1973	724	348	5,776	754
1974	1,218	581	9,222	1,131
1975	1,171	506	10,909	1,313
1976	1,039	1,571	11,610	1,388
1977	803	218	3,308	387
1978	1,058	402	7,393	840

Source: *Handbook of Labor Statistics, U.S.A.*, December 1980, Table 186, p. 478.

tivity growth in Canada in recent years. From 1947 to 1978, Mr. Frank told the Committee, Canada had a bigger improvement in its average labour productivity in the manufacturing sector (4.1 percent) than did the United States (2.7 percent). From 1971 to 1979 productivity growth in both countries slowed considerably, but Canada's 2.9 percent productivity growth was still slightly better than the 2.1 percent rate in the United States, particularly from 1976 to 1978.

From an intensive study by the Conference Board, which looked at relative Canada-U.S. productivity levels in 33 matched manufacturing industries between 1967 and 1974, Mr. Frank told the Committee that Canadian labour productivity had increased on average from 62 percent of U.S. levels to 77 percent. Gains were most pronounced for the durable goods industries such as wood products, metal products and motor vehicles and parts. By 1974 the durable goods sector was found to be 94 percent as productive as compa-

erable U.S. industries. Certain sectors showed significant performance. The wood products industries for example were estimated to have a productivity level of 117 percent of the U.S. level and motor vehicles and parts were 100 percent of the U.S. rate. However, for the non-durable goods sector the level was only 68 percent of U.S. counterparts for 1974, although there was a marked improvement over the 1967 rate of 53 percent, particularly in petroleum products. Mr. Frank estimated the relative levels in these industries would not have changed significantly by 1979. (See Table 5). The Committee notes with interest that the improved productivity levels occurred in those industries which enjoyed free or almost free access to the larger U.S. market for their products.

Table 5

**Estimated Relative Productivity Levels (Canada/United States)
Percentage 1967 and 1974 Major Industry Groups**

	1967	1974
<u>Nondurable Goods</u>	<u>53%</u>	<u>68%</u>
Food Processing	72	69
Textiles, Clothing, Knitting	70	83
Paper Products	76	77
Petroleum Products	37	70
Miscellaneous	44	53
<u>Durable Goods</u>	<u>73%</u>	<u>94%</u>
Wood Products	111	117
Metal Products	70	93
Motor Vehicles & Parts	77	100
Miscellaneous	60	68
TOTAL SAMPLE	62%	77%

Source: J.D. Frank (1979, 2:25)

It is generally agreed by business witnesses and academics alike that the greatest single reason for the lower Canadian productivity is the shorter runs and lack of specialization in production, arising from a smaller protected market with the same wide tastes as Americans. Canadian producers, responding to the protective tariffs in Canada and elsewhere as well as the non-tariff barrier obstacles have, in the past, geared their production for the Canadian market. This has caused frequent labour and machine changes resulting in higher labour costs and lower productivity. Lowering tariffs and rising costs have forced some specialization and Canadian productivity has grown somewhat faster than in the United States in recent years. However, a

substantial Canada-U.S. productivity differential still remains, estimated at 22 percent in 1978. (See Table 3, column 6). Furthermore, forecasts for future Canadian productivity growth are generally pessimistic. For many Canadian manufacturing firms, the key to whether they will survive the increased competitive pressures of the 1980s and 1990s will depend on increases in their productivity levels.

Comparative unit labour costs

With lower productivity in Canada than the United States, the relatively high Canadian wage rates continue to put upward pressure on Canada's unit labour costs, thereby lowering Canadian competitiveness.

According to Dr. Frank, Canada's unit labour costs, based on the relationship between productivity growth and increases in wage rates, increased consistently throughout the 1970s at a faster rate than those in the United States until 1978, rising particularly more quickly in 1975 and 1976. In 1978 mainly because of the slowing of the Canadian wage increases noted earlier, the Canadian unit labour costs increased less quickly than those in the United States. (See Table 6 below). Unfortunately it is becoming increasingly evident that the trend to higher Canadian unit labour costs has reasserted itself in 1979, 1980 and 1981 although comparable figures are not yet available.

Table 6

Unit Labour Costs (U.S. dollar basis) Index 1967=100.

	Canada	U.S.
1967	100.0	100.0
1970	111.7	116.5
1973	126.2	123.2
1974	146.2	143.1
1975	165.6	152.4
1976	185.7	158.2
1977	182.5	166.6
1978	174.3	179.4

Source: Table 179, p. 467 *Handbook of Labor Statistics, U.S.A.*, December 1980.

Overview of current Canadian competitiveness

There have been certain modifications in the comparative cost structures in Canada and the United States during the three years since the Committee's earlier comments. The dramatic deterioration of the mid-70s has been arrested. Nonetheless the overall competitive disadvantage of Canadian industry remains. Average Canadian wage rates now stand, at the

exchange rate adjusted basis, at approximately 95 percent of the U.S., but observers fear that the benefit of the exchange rate change is being eroded by recent high Canadian wage settlements. There have been modest gains in Canada's productivity levels relative to the United States, although both countries performed badly in comparison to Japan. The Canadian durable goods sector particularly showed considerable gains in this respect, but even so, average Canadian productivity is still estimated at only about 78 percent of the U.S. level. Work stoppages in Canada also continued to be higher than in the United States, with one exceptional year.

Classify of Terms

Balance of payments is the balancing summary of all the transactions between Canadians and people in other countries. It is divided into two sections:

1. Current account, which is, in turn the sum of:
 - (a) the balance of the receipts from Canada's merchandise exports and the payments for its merchandise imports. The difference between these determines whether Canada has a surplus or a deficit in its merchandise trade account. If the balance goes into surplus it is a monthly gain and is usually in Canada's favour.
 - (b) the balance of nonmerchandise transactions. This is frequently called trade in "invisible" or "invisibles" services. It includes receipts and payments for such things as travel, interest and dividends, royalties, patents, copyrights, freight and shipping charges, banking and insurance, etc. (Canada always runs a deficit in nonmerchandise trade.)

Current account is the sum of (a) and (b) above and when these two values together, Canada's current account, is positive, it means that payments received by Canada exceed its current account.

Capital account which reflects the movement of capital in and out of Canada, including direct investments, portfolio investments, bank loans, deposits, foreign aid, export credits, financing, etc.

exchange rate adjusted basis at approximately 92 percent of the U.S. level in 1971. This is the result of the exchange rate change which occurred in 1971. Canada's productivity level relative to the United States has been relatively stable in comparison to Japan. The 1971 productivity level is still estimated to be about 75 percent of the U.S. level. Work stoppages in Canada also continued to be a major factor in the United States with one exceptional year.

With lower productivity in Canada, the relatively high Canadian wage rates continue to put upward pressure on Canada's unit labour costs, thereby lowering Canadian competitiveness.

According to Dr. Frank, Canada's unit labour costs, based on the relationship between productivity growth and increases in wage rates, increased consistently throughout the 1970s at a faster rate than those in the United States until 1978, rising particularly more quickly in 1975 and 1976. In 1978, however, because of the slowing of the Canadian wage increases noted earlier, the Canadian unit labour costs increased less quickly than those in the United States (See Table 4 below). Unfortunately, it is becoming increasingly evident that the trend to higher Canadian unit labour costs has continued until 1979, 1980 and 1981 although comparable figures are not yet available.

Table 4
Unit Labour Costs (U.S. dollar basis) Index (1967=100)

Year	Canada	U.S.
1967	100	100
1970	111	112
1971	125	123
1972	145	141
1973	165	155
1974	183	161
1975	197	168
1976	203	173

Source: Frank (1981), p. 22, corrected by Table 4, p. 22, Table 4, December 1984

Overview of economic conditions in the 1970s

There have been major modifications in the competitive environment in Canada and the United States during the 1970s. The Committee's report on the 1970s is based on the Committee's findings on the competitive environment in Canada and the United States. The Committee's findings are based on the Committee's findings on the competitive environment in Canada and the United States.

APPENDIX D

Glossary of Terms

Balance of payments is the financial summary of all the transactions between Canadians and people in other countries. It is divided into two sections:

1. **Current account**, which is, in turn the sum of:
 - (a) the balance of the receipts from Canada's merchandise exports and the payments for its merchandise imports. The difference between these determines whether Canada has a surplus or a deficit in its merchandise trade account. (This is the figure most often quoted on a monthly basis and is usually in Canada's favour).
 - (b) the balance of non-merchandise transactions. This is frequently called trade in 'invisibles' or trade in services. It includes receipts and payments for such things as travel, interest and dividends, royalties, patents, copyrights, freight and shipping charges, banking and insurance etc. (Canada always runs a deficit on non-merchandise trade.)

Current account is the sum of (a) and (b) above and when these are taken together, Canada suffers from a serious ongoing balance of payments deficit on its current account.

2. **Capital account** which reflects the movement of capital in and out of Canada, including direct investments, portfolio investments, bank term deposits, foreign aid, export credit financing, etc.

Countervail is a duty imposed by one country to offset the lower price of an imported good, production of which has been subsidized by the producer's government.

DIP The Defence Industry Productivity program is a federal program designed to provide funding to assist Canada's high technology defence-related industries to be competitive in international terms.

DISC Domestic International Sales Corporation is an export subsidization device set up in 1971 by the United States to promote exports by deferring taxes on a firm's income derived from exports. It has the second effect of influencing the locational decisions of U.S. multinationals in favour of production for export in their U.S.-based plants as opposed to their foreign subsidiary.

EC or EEC The European Community or the European Economic Community is a common market arrangement established in 1957 under the Treaty of Rome by six founding countries in Western Europe—Belgium, France, Luxembourg, the Netherlands, Italy and West Germany. In 1973, it was expanded to include Denmark, Ireland and the United Kingdom. Greece became a member in 1981 and Spain and Portugal are scheduled to join. A common external tariff is levied on all dutiable imports from outside the EC and a Common Agricultural Policy is applied. A broad objective of economic and political integration has been enunciated. Co-operation already exists on industrial, scientific, competition and regional development policies and varying degrees of EC policy co-ordination exist in international economic matters, in monetary arrangements and in foreign policy.

Economies of scale involve the increased efficiency and reduced production costs which are achieved by increasing the volume of production of a given product, a process as possible in a small plant as in a large plant if the market is large enough.

EDP, The Enterprise Development Program is a federal government grant program to support innovative manufacturing in Canada. Replacing seven earlier programs, the EDP channels most of its grants to small and medium businesses providing funding assistance for the research, development, production process or marketing of an innovative product line.

EFTA The European Free Trade Association is a free trade area established by seven European nations in 1959 under the Stockholm Agreement as an alternative to the European Community. Its members were Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom with Finland and Iceland subsequently joining. No common external tariff was established nor was there any move by EFTA members to move toward inte-

gration of their economies. This was a classic free trade area as opposed to a common market or customs union. After Denmark and the United Kingdom left EFTA to join the European Community, all the remaining members, i.e. Norway, Sweden, Finland, Iceland, Austria, Switzerland and Portugal entered into individual free trade agreements with the EC.

FIRA The Foreign Investment Review Act or the Foreign Investment Review Agency. Legislation passed in 1973 established the agency to screen foreign takeovers and, later, new foreign investment in Canada. The task of the agency is not to block foreign investment but to negotiate with foreign firms to ensure that a significant benefit to Canada will result from their investment decisions.

GATT The General Agreement on Tariffs and Trade is an international agreement signed in 1947, initially by 23 Contracting Parties, including Canada. Its objectives include the gradual reduction of trade barriers, the promotion of international trade on a non-discriminatory basis and the prevention of a return to the protectionist and discriminatory policies of the 1930s. A secretariat in Geneva monitors trade practices and can establish panels to rule on trade disputes between GATT signators.

MTNs or Multilateral Trade Negotiations are the series of trade talks held under the auspices of the GATT from time to time. As the opening meeting of the most recent round of negotiations took place in Tokyo, this series became known as the Tokyo Round, to distinguish it from earlier negotiations such as the Kennedy Round or the Dillon Round.

NEP National Energy Program is the federal government's energy measures, the objectives of which were set out in the 1980 Budget speech.

NICs are newly industrialized countries, a term used to describe less developed countries which are industrializing rapidly. Examples of NICs include the 'New Japans' as they are frequently called such as Korea, Taiwan or Hong Kong.

Non-tariff barriers (NTBs) are government policies which make it more difficult for imports to enter a country. Clear examples of non-tariff barriers are government procurement rules favouring domestic producers; subsidies which increase the competitiveness of domestic producers; technical standards which may be written to accommodate domestic producers and to make it difficult for foreign producers. But more obscure examples are almost endless from a local government's arbitrary mark-up of foreign wine to contrived technical delays at customs.

PAIT, the Program for the Advancement of Industrial Technology was a federal government assistance program to promote new and innovative tech-

nology in Canadian industry. The program was incorporated into the more comprehensive EDP program in 1977.

Productivity refers generally to 'total factor productivity' which encompasses the use of all the factors involved in production such as capital, buildings, equipment, technology, process, workers' skills, management's skills, etc. Productivity levels are **not**, as is often assumed, a reflection of how hard an individual worker works.

Terms of trade is the ratio of the price index for merchandise exports to the price index for merchandise imports. A country's terms of trade improve if prices for its exports rise higher than for its imports.

Tokyo Round See MTNs.

Trade classifications are technical categories used by Statistics Canada in classifying exports and imports. They include crude materials, fabricated materials and end products.

Crude materials—refers to raw unprocessed products such as coal or iron ore.

Fabricated materials—refers to crude materials or other commodities which have been processed but are not yet an end product. Examples are finished lumber, newsprint or aluminum ingot.

End products—refers to fully manufactured products which are ready for use by the consumer or in the assembly of another end product.

Manufactured goods is a widely used term which includes both end products and a large number of fabricated materials. However manufactured goods is not a category for which specific statistics are kept in Canada.

World product-mandating is the assignment by a multinational company to a subsidiary firm of the responsibility for the manufacturing and marketing of a given product on an international basis.

APPENDIX E

Witnesses

1. List of witnesses who appeared before the Committee, showing the number and date of the issue in which their evidence appears.

First Session of the Thirty-first Parliament, 1979

Issue No.	Date	Witnesses
2	December 11, 1979	<i>Conference Board in Canada</i> Dr. James Frank, Director, Compensation Research Centre <i>Economic Council of Canada</i> Dr. D.W. Slater, Director

First Session of the Thirty-second Parliament, 1980-82

Issue No.	Date	Witnesses
1	May 6, 1980	Dr. David A. Dodge, Director, Institute for Research on Public Policy

- 2 May 15, 1980 Professor Peyton V. Lyon, School of International Affairs, Carleton University
- 3 June 3, 1980 Professor John J. Quinn, Faculty of Law, University of Western Ontario, London, Ontario; and Director, Canada-U.S. Law Institute
- 4 June 5, 1980 Mr. Rodney de C. Grey, Advisor to the Government of Ontario, London, England; formerly Head of the Canadian Delegation to the Tokyo Round of the GATT multilateral trade negotiations.
- 5 June 10, 1980 The Hon. Robert L. Stanfield, P.C., Q.C. Mr. Harold Connor, Halifax, N.S. Mr. James McNiven, Executive Vice-President, Atlantic Provinces Economic Council
- 6 June 12, 1980 *Department of Industry, Trade and Commerce*
Mr. Robert Johnstone, Deputy Minister
Mr. R.E. Latimer, Assistant Deputy Minister, International Trade Relations
- 7 June 25, 1980 Mr. Julius Katz, Senior Vice President, White Plains, N.Y., U.S.A.; formerly Assistant Secretary of State for Economic and Business Affairs, Department of State, Washington, D.C.
Brookings Institute
Mr. Lawrence Krause, Senior Fellow, Washington, D.C., U.S.A.
- 8 June 26, 1980 *Canadian Furniture Industry*
Mr. K.M. Campbell, General Manager, Ontario Furniture Manufacturers' Association
Mr. Gerry Cockerill, Vice-president and General Manager, Kaufman Company, Collingwood, Ontario
Mr. Claude Jutras, General Manager, Quebec Furniture Manufacturers' Association Inc.
Mr. Bruce MacPherson, President, Gibbard Furniture Shops Ltd., Napanee, Ontario
Mr. Joe Malko, Furniture West Inc., Winnipeg, Manitoba

Mr. Bernard Papineau, President, H.P.L. Cie, Arthabaska, Quebec

Mr. Norman Ricard, President and General Manager, NORCA Management Ltd., Montreal, Quebec

9 July 8, 1980

Canadian Petrochemical Industry

Mr. R.L. Pierce, President, Alberta Gas Ethylene Company, Calgary, Alberta

Mr. Clifford L. Mort, Chairman, Dow Chemical of Canada Co., Sarnia, Ontario

Mr. B.G.S. Withers, Vice President, Corporate Operations, Petrosar, Corunna, Ontario

Mr. Jack S. Dewar, President, Union Carbide Canada Ltd., Toronto, Ontario

10 July 10, 1980

Canadian Institute for Economic Policy

Dr. Abraham Rotstein, Vice-Chairman

Dr. Fred Lazar, Director

11 October 16, 1980

Urban Transportation Industry

Mr. Raymond Royer, President and General Manager, Mass Transit Division, Bombardier Inc., Boucherville, Quebec

Mr. Ron McCallum, Corporate Director of Marketing, Hawker Siddeley Canada Inc., Toronto, Ontario

Mr. Kirk W. Foley, President, Urban Transportation Development Corp. Ltd., Toronto, Ontario

12 October 30, 1980

Mr. David Mundy, Carp, Ontario

Mr. John Simons, Vice-President, Avionics Division, Canadian Marconi Company, Montreal, Quebec

13 November 13, 1980

Aerospace Industry

Mr. John W. Sandford, President & Chief Executive Officer, de Havilland Aircraft of Canada, Limited, Downsview, Ontario

Mr. E.L. Smith, President & Chief Executive Officer, Pratt & Whitney Aircraft of Canada Ltd., Longueuil, Quebec

Mr. E.A. Reece, Vice-President & General Manager, McDonnell Douglas Canada Ltd., Toronto, Ontario

- 14 December 9, 1980 *Canadian Manufacturers' Association*
 Mr. Jean-Jacques Gagnon, Senior Executive Vice-President, Aluminium Company of Canada, First Vice-president of CMA
 Mr. L.R. Douglas, Vice-President, Canadian General Electric Co. Ltd., Chairman of the CMA Trade Policy Committee
 Mr. Ron McCallum, Corporate Director of Marketing, Hawker Siddeley Canada Inc., Chairman of the CMA Export Committee
 Mr. Laurent Thibault, Director of Economics and Communications for the CMA
- 15 December 11, 1980 *High Technology Industry*
 Mr. Larry Clarke, Chairman and Chief Executive Officer, Spar Aerospace Limited, Toronto, Ontario
 Mr. C.D. Reekie, President and Chief Executive Officer, CAE Industries Limited, Toronto, Ontario
 Mr. W.C. Tate, Vice-President and General Manager, Garrett Manufacturing Company Limited, Rexdale, Ontario
 Mr. Ronald R. Keating, President, Litton Systems Canada Limited, Rexdale, Ontario
- 16 January 20, 1981
 Mr. F.H. Tyaack, President and Chief Executive Officer, Westinghouse Canada Inc., Hamilton, Ontario
 Mr. M.J. McDonough, Senior Executive Vice-President, Corporate Resources, Westinghouse Inc., Pittsburgh, Pennsylvania, U.S.A.
- 17 January 22, 1981
 Professor Sidney Weintraub, Dean Rusk Professor, Lyndon B. Johnson School of Public Affairs, University of Texas, Austin, Texas, U.S.A.
- 18 February 3, 1981
 Professor Ronald J. Wonnacott, Department of Economics, University of Western Ontario, London, Ontario
- 19 March 3, 1981 *Department of Industry, Trade and Commerce*
 Mr. B.C. Steers, Assistant Deputy Minister, International Marketing
 Mr. Percy Eastham, Director General,

- Office of General Relations
 Mr. Norman Fraser, Acting Director General, Programs Branch
 Mr. Craig Oliver, Senior Director General, Industry and Commerce Development
- 20 March 5, 1981 *Province of British Columbia*
 The Honourable Patrick McGeer, Minister of Universities, Science and Communications
- 21 March 26, 1981 *Province of Alberta*
 The Honourable Hugh Planche, Minister of Economic Development
 Mr. E.G. (Ed) Shaske, Executive Director, Strategic Planning Branch, Department of Economic Development
- 22 April 7, 1981 *Province of Ontario*
 The Honourable Larry Grossman, Minister of Industry and Tourism
2. Written Submissions
1. October 23, 1980 Mr. Ian C. Rush, President, Polysar Limited, Sarnia*
2. October 27, 1980 Mr. J.E. Newall, Chairman and Chief Executive Officer, Du Pont Canada Inc., Montreal.*
3. June 11, 1981 The Honourable Roland J. Thornhill, Minister of Development, Province of Nova Scotia, "Implications of Bilateral Free Trade for Nova Scotia".

Washington Study Trip, April 28th-30th, 1981

The purpose of the Washington study trip was to seek, at the conclusion of the Committee's formal hearings, the opinions of a selection of United States officials, academics, business and labour figures on the issues of Canadian-U.S. trade relations, investment and related bilateral problems. Of particular interest to the Committee was U.S. reaction to the idea of a bilateral free trade agreement. Spokesmen were in the following order:

1. *U.S. Chamber of Commerce, Committee on Canada-U.S. Relations:*

* These two earlier witnesses from the chemical sector who had testified at the 1977 hearings were asked to comment on or add to their earlier testimony in the light of the Committee's examination during 1980-81 of the impact of bilateral free trade with the United States and in view of the more recent testimony of other witnesses from the petrochemical sector.

Topic: Perspectives of U.S. corporate executives on aspects of the Canada-U.S. relationship including proposals for increased North American interdependence.

U.S. Participants:

Mr. William G. Phillips	Chairman of the Board International Multifoods Chairman, U.S. Section, Committee on Canada-United States Relations, Board of Directors Chamber of Commerce of the U.S.
Mr. George H. Fuchs	Executive Vice President Industrial Relations RCA Corporation
Mr. Earl Huntington	Vice President and General Counsel Texasgulf, Inc.
Mr. Clinton Morrison	Past Chairman, Board of Directors Chamber of Commerce of the U.S. Retired Vice Chairman, Now Consultant First National Bank of Minneapolis
Mr. J.R. Mullen	Vice President, Corporate Relations Johnson and Johnson
Mr. E. Leslie Peter	President Leslie Peter and Company
Dr. George W. Phillips ¹	Coordinator, International Trade Affairs Union Carbide Corporation
Mr. Dudley C. Taft	President Taft Broadcasting Company
Dr. Roger Frank Swanson	Executive Secretary, U.S. Section Committee on Canada-United States Relations
Dr. John Volpe	Director, International Research Chamber of Commerce of the U.S.

2. *U.S. officials on Canada-United States trade relations:*

Topic: Round table discussion on prospects for Canada-United States free trade or bilateral preferential trading arrangements with Canada.

¹ Dr. Phillips represented Mr. R.J. Hughes, Senior Vice President and was accompanied by Mr. James K. O'Connor, Economic Analyst and Staff Executive, International Trade Committee, North American Economic Interdependence Task Force, Chemical Manufacturers' Association.

U.S. Participants:

Mr. Ernie Johnson	Deputy Assistant Secretary for Economic and Business Affairs, Department of State
Mr. John Ray	Assistant Special Trade Representative
Mr. Bill Morris	Assistant Secretary of Commerce, Trade and Development

3. *Canadian-American Committee (National Planning Association):*

Topic: Discussion on the Committee's draft report: "A proposal for improving the intergovernmental process for dealing with Canadian-American economic issues".

U.S. Participants:

Mr. William D. Eberle	U.S. Report Chairman; formerly U.S. Special Trade Representative
Mr. Sperry Lea	Vice-President, National Planning Association

4. *Discussion with Mr. Fred Bergsten:*

Topic: Prospects for closer Canada-United States trade relations.

U.S. Participant:

Mr. Fred Bergsten	Senior Associate, Carnegie Endowment for International Peace, formerly, Assistant Secretary International Affairs, Department of the Treasury.
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5. *Discussion with officials from the Office of the Special Trade Representative:*

Topic: The U.S. Task Force Report as requested by Congress in the 1979

U.S. Trade Agreements Act.

U.S. Participants:

Mr. Harvey Bayle	Deputy Assistant U.S. Special Trade Representative for Policy Development
Mr. Andrew Stoler	STR Official with Specific Responsibility for Canada
Mr. William DesRochers	Department of Commerce

6. *Discussion with Professor Robert Dunn Jr.:*

Topic: The exchange rate and capital flow effects of a Canada-United States bilateral free trade arrangement.

U.S. Participant:

Professor Robert Dunn Jr. Department of Economics, George Washington University

7. *Discussions with U.S. Senate and House Staff Members:*

Topic: Closer Canada-United States trade relations, with particular focus on the possibility of a preferential bilateral trading arrangement.

U.S. Participants:

Mr. Ed Nef

Mr. Gary Horlick Congressional staff

Mr. George Ingram

8. *Discussions with U.S. Labour Leaders—AFL-CIO*

Topic: Canada-United States trade relations, with particular emphasis on a possible Canada-United States free trade arrangement.

U.S. Participants:

Mr. Thomas Donohue Secretary Treasurer
AFL-CIO

Mr. Henry Schechter Department of Economic Research
AFL-CIO

Mr. Stephen Coplan Department of Legislation
AFL-CIO

Mr. Mark Anderson International Department
AFL-CIO

9. *During luncheon, the Committee met the following members of the U.S. Senate:*

Senator Max Baucus Montana, Democrat
Co-Chairman, Senate Caucus Committee on North American Economic Interdependence

Senator Spark Matsunaga Hawaii, Democrat
(Sponsor of provision exempting Canada and Mexico from U.S. Convention Tax Legislation in January 1981.)

Senator Ted Stevens

Alaska, Republican
Deputy Majority Leader of the Senate, Co-
Chairman, U.S. Section, Canada-United
States Interparliamentary Group

Senator Ed Zorinsky

Nebraska, Democrat
former Co-Chairman, now Vice-Chairman,
U.S. Section, Canada-United States Inter-
parliamentary Group

