VENTURING FORTH

An Assessment of the Canada-U.S. Trade Agreement

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A statement by the Economic Council of Canada

1988

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A Statement by the
Economic Council of Canada
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This Statement reflects the views of the Members of the Economic Council of Canada; however, a comment by Diane Bellemare and Kalmen Kaplansky, and a dissent by Raymond Koskie appear at the end of the document.

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Foreword

This Statement assesses the Canada-U.S. Free-Trade Agreement signed by the Prime Minister of Canada and the President of the United States on 2 January 1988. The Statement reflects the views of the Council members and is based upon an in-depth analysis of the agreement by a team of Council researchers.

For just over two years, this team has been analysing the potential impact of a new trade agreement on various sectors of the Canadian economy. The technical analysis of the actual agreement is found in the Council's Discussion Paper 344. Earlier results of their work were published in our 23rd and 24th Annual Reviews (October 1986 and September 1987, respectively), and in another staff document – Discussion Paper 331. The efforts of the team were reinforced by an Advisory Committee, composed of Council members and of trade and industry specialists.

The Council is advancing its views on the free-trade agreement, for two reasons. First, through its effects on trade policy, the agreement will have an important bearing on the performance of the economy over the medium to long term. Second, the Council has been contributing to the debate on trade policy for more than a decade now – our report *Looking Outward* was published in 1975 – and it has gone on record with its views about the potential import of a bilateral trade agreement; thus it seemed only fair for us to assess whether the actual agreement seems likely to live up to the potential outlined in our earlier work.

Any evaluation of Canada's trade policy must begin in the context of a changed global economy and within the framework of this country's obligations within the General Agreement on Tariffs and Trade (GATT) – the organization responsible for setting the rules for international trade. As a medium-sized nation, Canada sets a high priority on rule-making, since rules protect us from arbitrary or unfair treatment by larger or smaller trading partners. Evaluation of the agreement must also take into account the realities of recent trends in the Canada-U.S. trading relationship and the political momentum of protectionist pressures in both countries. These broad concerns are dealt with in Sections 1 and 2 of the text. Sections 3 and 4 provide the Council's detailed analysis of the agreement, while Section 5 contains our conclusions. Dissenting opinions and comments follow.

Our analysis shows that reductions in trade barriers between Canada and the United States would give a modest, but significant, boost to the growth in incomes, output, and productivity over the longer term. In addition, the rule-making elements of the agreement, which are clearly within the GATT framework, may turn out to be as important to Canada as the explicit reduction in trade barriers. In other words, for investors and for exporting and importing firms on both sides of the border, the real (but not easily measured) gains to be derived from more-*secure* access may well match the measured economic benefits that flow from an *increase* in access to each other's market.

In assessing the potential hardships associated with adjustment to the agreement, the Council finds that the challenges posed by the accord are similar to those identified in our Statement on *Making Technology Work*, published in June 1987. The Council is very

conscious that if Canadians are to continue to enjoy high (and rising) living standards in an increasingly competitive world, they must concentrate their energies and resources in activities with high value-added, taking advantage of Canada's best manpower and entrepreneurial skills and of the most advanced knowledge available. Our corporate sector must be responsive to the process of continuous change; our markets must be able to respond to competition flexibly; and government support must be more sharply focused, so as to enable workers to become more purposefully and more productively employed.

On behalf of the Council, I would like to thank the Advisory Committee, composed of four Council members and four outside experts. Under the chairmanship of Dian Cohen, the committee gave valuable advice and guidance to the research team, particularly on matters of policy.

Judith Maxwell
Chairman

Venturing Forth

READER'S NOTE

The reader should note that various conventional symbols similar to those used by Statistics Canada have been used in the tables:

..	figures not available
...	figures not appropriate or not applicable
– –	amount too small to be expressed
–	nil or zero
e	estimated figures
x	data confidential, to meet the secrecy requirements of the *Statistics Act*.

Details may not add up to totals because of rounding.

1 Global Change

Four decades ago, in 1947, Canada and 22 other nations signed the General Agreement on Tariffs and Trade (GATT), which committed them to a process of trade liberalization. The GATT members, who now number over 90 countries, are currently engaged in their eighth round of multilateral trade negotiations. Canada, which earlier this year signed a historic bilateral free-trade agreement with the United States, is also an active participant in the so-called *Uruguay Round* of multilateral negotiations.

Since 1947, the world's population has doubled, to reach over 5 billion. Thanks in part to the liberalization that followed the previous seven rounds of GATT negotiations, world output has increased by a factor of four, fueled by a sixfold increase in world trade. As well, there have been major improvements in health care, literacy, agriculture, and industrial development on a global scale, although the distribution of these benefits among countries has been uneven. At the same time, distances have shrunk. Remarkable developments in telecommunications and space technology now link individuals, organizations, and events almost instantaneously. Increasingly, governments and businesses are making their decisions with an eye to global aspirations and opportunities.

Canadians have participated fully in this process. Since 1947 Canada's population has doubled, to nearly 26 million. Real GNP has increased by a factor of five, and Canadian exports and imports have increased sevenfold, in real terms. The nation has been transformed into a largely urban society. Real standards of living have almost tripled. Economically and socially, Canada is now a mature nation, with a mix of commercial activities and a quality of life that compares favourably with that of any other nation on earth. Both the federal and provincial governments have come to play an active role in providing national standards of opportunity, service, and care.

For most countries, the legacy of the 1930s – a period of economic depression that led governments to adopt protectionist measures – consisted in part of domestic trade barriers that had highly retrogressive effects: they diminished markets, reduced output, and destroyed employment. Business activity was inward-looking, with a focus on import substitution. Much of the foreign direct investment in manufacturing acted as a substitute for trade – a way in which to skirt high tariff barriers in order to compete in another country's domestic market.

In 1935, Canada and the United States signed a bilateral trade agreement that began the process of systematically reducing tariffs on imports. But it was not until after the Second World War and the signing of the GATT that the emphasis in the industrial countries switched increasingly to the expansion of markets and to the opportunities inherent in export-led specialization and growth. The progressive reduction of tariff barriers meant that foreign investment and trade gradually became complementary business activities shaped by global markets, global cost considerations, and global sourcing. The number of multinational corporations has grown considerably, and their national origins are now diverse: they have appeared in the United States and Canada, in Japan and Europe, and in many other countries. The multinationals have fostered the cross-fertilization of knowledge through the transfer of technological, scientific, and management know-how to affiliates around the world. The new technologies have accelerated the transfer of information and capital; as a result, financial markets are rapidly evolving into an integrated, global capital market.

Inevitably, many of the achievements over the past 40 years have entailed certain costs. The globalization of business activity, accompanied by lower customs tariffs, has set up natural tensions between established domestic producers and new competitors from abroad. The emergence of the Organization of Petroleum Exporting Countries (OPEC) as a world economic power slowed the rate of economic growth in much of the industrialized world and underlined for the West the strategic importance of stable energy supplies. By the mid-1970s, the momentum of productivity growth in North America and western Europe had begun to slacken; inflation and unemployment rates were rising; the growth momentum was shifting to Japan and southeast Asia; and other newly industrialized countries (NICs) had learned to mobilize their capital, their work force, and the new technologies into industrial successes.

The two oil price shocks of the 1970s hastened and amplified those trends. In Europe and North America, "stagflation" and rising unemployment triggered a number of adverse developments. Inflation distorted expectations and investment. Declining profit levels and high unemployment encouraged protectionist sentiments. More and more nations introduced nontariff barriers and special measures to manage trade. The highly restrictive Multifibre Arrangement (MFA) and the use of import quotas and "voluntary" export restraints are examples. Many of these new protectionist measures are at odds with the spirit of GATT principles and procedures; and whatever their rationale, they undermine the authority of the General Agreement itself, as well as the liberal and nondiscriminatory trading system that is its goal.

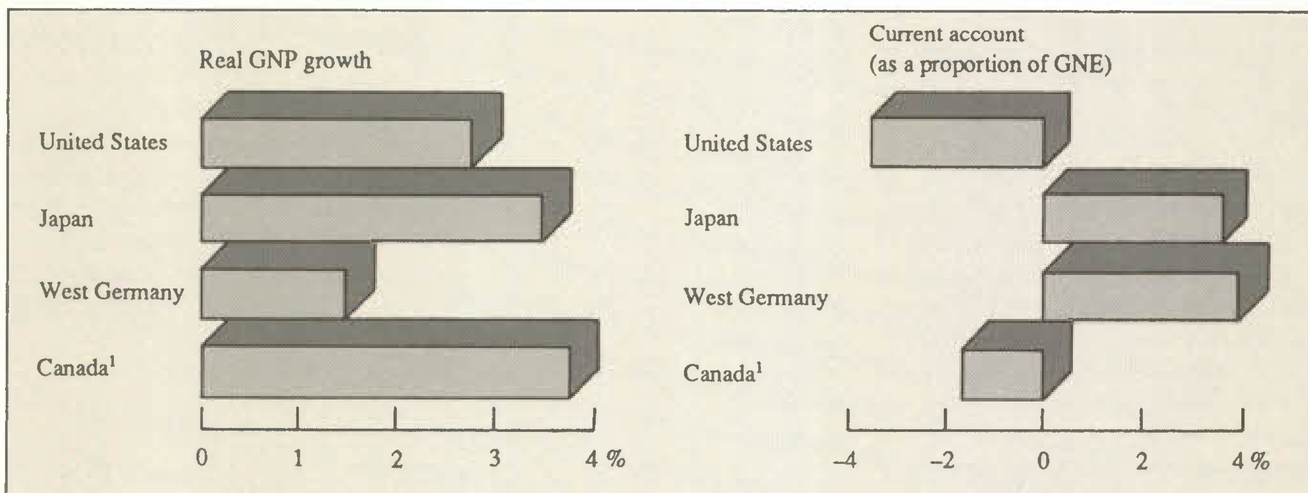
These pressures have intensified in the 1980s, largely as a result of serious trade imbalances. The United States has incurred very large current-account deficits – over $100 billion a year since 1984 – while Japan, West Germany, and some of the NICs (Taiwan and South Korea, in particular) have earned large surpluses (Chart 1). The sources of the U.S. trade deficit are complex; they include an excessively stimulative fiscal policy, an overvalued dollar, and a loss of overseas markets, among others. And, to date, the two major responses have been a depreciation of the U.S. dollar and increased lobbying by special interests in the United States for protectionist legislation. At the same time, the U.S. Administration pushed hard in the early 1980s for a new round of multilateral negotiations, to review the rules and procedures of the GATT and to strengthen its role and authority. The *Uruguay Round* was launched in September 1986.

Along with the slowdown of growth, the role and responsibilities of governments have been challenged. Governments have had to respond to high levels of unemployment and to the needs of aging populations and other vulnerable sectors with new policies designed to provide greater social cohesion. This, in turn, has contributed to rising budgetary expenditures. Concern over high budget deficits and heavy public debt has limited the power of many governments to increase spending. As economies have become more interdependent, the scope for autonomous action by individual governments has narrowed. At the same time, societies have begun to question the value of some of the less efficient forms of government intervention. In a number of areas, government policies and regulations have been seen to impede competition, destroy business initiatives, or distort commercial activities – hence the widespread interest in regulatory change and tax reform, and in measures that encourage industry and employment in modern growth activities. Tax reform, for instance, is aimed at eliminating biases that have encouraged preferential tax avoidance or investments attuned to tax advantages rather than genuine economic gain.

The globalization of world trade and investment has been accompanied by the establishment of trading alliances encompassing about 80 developed and developing countries. Economic integration through the European Community (EC) and the European Free Trade Association (EFTA) has dismantled many of the tariff barriers and some of the nontariff barriers, and opened up large markets (360 million people) for all the countries of western Europe. The EFTA is a free-trade area, broadly similar to the one established under the recent agreement signed by Canada and the United States, and it has an associated trading relationship with the European Community. Within the European Community, internal markets are fully unified: goods, labour, and capital move with relative freedom from country to country. There are 12 other trading blocks among the market economies. Many developing countries are members of some regional grouping – the Caribbean Community, the Western African Economic Community, and the Association for the Integration of Latin America, for ex-

Chart 1

Real GNP Growth and the Current Account of the Balance of Payments, United States, Japan, West Germany, and Canada, 1987 (Estimates)



1 GDP.

SOURCE Organisation for Economic Co-operation and Development, *Economic Outlook* (Paris: OECD, December 1987).

ample. All of these regional free-trade groupings have contributed substantially to the global integration of trade and investment.

Until a few months ago, Canada was the only member of the Organisation for Economic Co-operation and Development (OECD), other than Japan, that did not belong to a free-trade area or to a common-market association. The Canadian economy had nonetheless been exposed to all of these international developments: Canada's capital markets are almost totally integrated with the global market, and Canadian producers export 30 per cent of their output. The recovery that started in 1982 provided evidence of that exposure, as the slump in metal, agricultural, and oil and gas prices had aggravated economic difficulties in the resource-dependent regions of the country. Recent developments have shown how sensitive Canada's resource industries – lumber, potash, uranium, and western agriculture, for example – are to the protectionist policies and export subsidies of the United States and of other major OECD countries.

In contrast, central Canada has experienced a vigorous expansion of activity in manufacturing and services since 1982. Many manufacturers, however, have been hard-pressed by competition from the newly industrialized countries that can combine new technologies with low wage costs. This is forcing Canadian firms to cut costs, improve quality, and move production towards goods with higher value-added.

Canada has always had a strong interest in maintaining an open trading system and in renewing the authority of the GATT. Small and medium-sized countries such as Canada need internationally agreed-upon trading rules to ensure that their rights are observed by countries that enjoy greater economic power. This has become an issue for Canada in recent years, as various lobbying groups in the United States have shown increasing aggressiveness in using their country's trade laws to limit imports. Thus Canada's major concern in trade negotiations has been to uphold the GATT principles of trade liberalization while trying to limit the damage resulting from U.S. trade actions.

These developments served as background to the negotiations that led Canada to sign a free-trade agreement with the United States on 2 January 1988. From Canada's perspective, the objective of this agreement is to extend earlier initiatives, to encourage tougher competition in the Canadian market, and to open up the large U.S. market for Canadian goods and services. These goals are in keeping with the internationalization of financial activity and the global application of science, technology, and investment. At the same time, the agreement is intended to bring discipline to trade actions that could hurt producers and workers in either country and to serve as a model for the rest of the world in the development of new rules to deal with trade in agriculture, services, and investment. And by establishing agreed-upon rules of commercial conduct and a dispute-settlement mechanism to replace systems of adjudication by domestic tribunals, it strives for greater scope and security for cross-border transactions.

2 Developments in Trade Policy

Since the formation of the GATT in 1947, Canadian governments have, on several occasions, flirted with a variety of special trading arrangements. In the late 1940s, Prime Minister Mackenzie King considered, then rejected, the idea of a reciprocity arrangement with the United States. A decade later, an effort was made to develop closer trade ties within the Commonwealth, as the old system of Imperial tariff preferences was being abandoned. In the early 1970s, the Canadian government was interested in "the third option," which would have seen a strengthening of Canadian trade alliances with Britain and the European Economic Community (the EEC – now known as the European Community, or EC) as a counterweight to the growing importance of trade with the United States. In 1978 and 1982, the Standing Senate Committee on Foreign Affairs endorsed the idea of free trade with the United States, as did the Macdonald Commission in its 1985 report.

Over the years, a growing proportion of Canadian trade has been in the north-south direction. In 1947, the United States was the destination of only 38 per cent of Canada's exports; today, that figure is close to 75 per cent. Almost 80 per cent of Canada's imports are from the United States, representing 25 per cent of that country's exports. Given the importance of each country's markets to the industry of the other, the two governments have worked over the years to remove barriers that raise costs and distort bilateral trade relations. Much of this process has been conducted within the framework of the GATT; some has resulted from bilateral discussions (e.g., the *Agreement Concerning Automotive Products between the Government of Canada and the Government of the United States of America*, more commonly known as the "Auto Pact").

Several articles of the GATT are worth noting in the context of international trade liberalization. Article I prescribes unconditional most-favoured-nation (MFN) treatment. The process of tariff reduction under the General Agreement consists of both multilateral negotiations and a series of bilateral negotiations taking place more or less

simultaneously. At the risk of oversimplifying the process, the latter can be said to involve the negotiation of tariff reductions on a bilateral basis, with the results of these bilateral negotiations then being extended to all other trading partners via the MFN principle. In previous rounds, therefore, Canadian negotiators spent much of their time engaged in bilateral deals with the governments of the United States and of a few other countries.

Article XI calls for the elimination of all quantitative restrictions on trade, though there are some exceptions cited in Article XII. These exceptions have been used increasingly in recent years, as governments have sought to protect specific industries.

Article XXIV provides for the formation of customs unions and free-trade areas. This article accommodated the formation of the EEC and EFTA. The two trade alliances have undergone substantial transformation over their 25 to 30 years of existence; their membership, their trade arrangements, and their means of resolving disputes have all changed. It is likely that the Canada-U.S. agreement, once fully implemented, will also evolve through further negotiations, as the commercial considerations and concerns of the two governments dictate.

In 1983, the U.S. and Canadian governments initiated negotiations aimed at sectoral free trade in a number of specific areas – textiles and apparel, urban mass transit, computer services, and steel. The discussions foundered, however. According to the recent report of the House of Commons Standing Committee on External Affairs and International Trade:

> It proved difficult to establish any reasonable balance of advantage for the two sides in particular sectors – either one side or the other stood to gain. The process tended to bring out opponents of trade liberalization in the sector under discussion without attracting a counterbalancing influence. It also became evident that the two countries would have to seek a series of waivers from the GATT contracting parties and that these would likely be contested. Sectoral arrangements fall short of the kind of comprehensive free trade arrangements called for by the rules in GATT Article XXIV.[1]

At least three attributes of the negotiating process that led to the present free-trade agreement were missing in the sectoral approach. First, an across-the-board agenda enabled negotiators to take an overall view of the net benefits to be achieved mutually in order to balance gains and losses among sectors. Second, both countries wanted a free-trade arrangement that would fall within the rules of Article XXIV of the General Agreement. Third, the negotiations have set a pattern for further MFN trade liberalization under the General Agreement, which allows individual countries to negotiate bilaterally with a view to extending the agreed-upon benefits more generally in return for improved access to other markets. The Canada-U.S. agreement reflects a process whereby an industry-by-industry examination of the implications of trade liberalization is conducted within each country; this process has already facilitated the pursuit of Canada's negotiating goals in the current GATT negotiations: Canada is now in a better position to determine whether other GATT members are prepared to offer improved access to Canadian goods, in return for similar treatment on specific items that have been the object of its negotiations with the United States.

The Canada-U.S. agreement is thus an extension, not an alternative, to Canada's commitments within the GATT. It strengthens Canada and the United States in pursuing the three main objectives of the *Uruguay Round*: the widening of the GATT's surveillance over a larger span of trading activity, including agriculture, investment, and services; an increase in the transparency of the trade policies of member countries; and a strengthening of the rules of the General Agreement with respect to the plethora of protectionist measures that now contradict its basic objectives.

Pressures for Change

The negotiations between Canada and the United States were undertaken at a time when both Houses of the U.S. Congress had before them the most blatantly protectionist trade bills of any major industrial country since the 1930s. In their original form, the bills would have forced upon the world's trading nations a set of unilateral definitions of what might or might not have coincided with U.S. commercial interests, whether or not they met the international obligations long established under the GATT. For example, they would have amended the U.S. *Trade Act* of 1974 in order to expand the definition of subsidies subject to countervailing action; they would have removed the President's discretionary powers to prevent abuse of emergency "safeguard" duties or quotas; and they would have lengthened the "safeguard" period from five years (with a possible three-year extension) to 10 years. The Congress is now in the process of putting together an "omnibus" trade bill for consideration by the President this spring.

The shock generated by the October 1987 stock market crash, the marked decline in the exchange value of the U.S. dollar, and the recent evidence of increased export sales by U.S. industry have eroded support for some of the more

extreme protectionist measures contained in the two earlier bills. Many Americans want to move forward with further trade liberalization under the GATT. The U.S. Administration has indicated that it would veto any omnibus bill that would likely lead to retaliatory protectionist responses abroad. Nevertheless, until the U.S. trade deficit is significantly reduced, there will continue to be strong voices seeking to use U.S. trade laws to restrict imports and to subsidize exports. Even if Canada is not singled out as an "unfair" or offending party, protectionist trade sanctions or import quotas are often applied across the board, thus "sideswiping" Canadian exports.

If the Canada-U.S. agreement is ratified by the legislators of both countries, its provisions will help to shield Canada from the worst elements of the omnibus trade bill. If the agreement is not ratified, Canada will be fully exposed to the omnibus bill's provisions, and that could lead to a host of new trade disputes. Indeed, whether or not the agreement is implemented, Canada and the United States cannot return to the "status quo ante." The agreement itself has resolved a number of potentially divisive issues that would have had to be dealt with in its absence. For example, it was clear that U.S. auto producers were not going to sit idly by while Canada used duty remissions as incentives to secure new Japanese or South Korean investment, thus expanding auto-production capacity in North America at a time when auto sales are expected to decline. Had the agreement not provided for the elimination of these measures, the U.S. Congress would probably have sought major revisions to the Canada-U.S. Auto Pact.

Objectives and Outcomes

At the outset, Canada had four major objectives in the bilateral negotiations with the United States:

- to seek *more-open access* for Canadian exports flowing into the United States;

- to seek *more-secure access* as "Canadians wanted to be sure that when they invested to serve the North American market they would not be subject to the whims of American courts and regulators. They complained that U.S. trade laws were being used capriciously to harass them";[2]

- to secure a special provision for sensitive sectors; and

- to set an example to the world of reciprocal trade liberalization and to offer a model for the multilateral negotiations under the *Uruguay Round.*

More-Open Access — On tariff issues, success was achieved. By 1 January 1998, all tariffs between the two countries will have been eliminated; indeed, many will be gone within the next five years. This will effectively increase the competitiveness of Canadian exports and, thanks to greater competition from the United States, lower prices to Canadian consumers. The tariffs and related programs on trade with other partners will, of course, continue to be governed by the GATT rules. Since each country's tariff structure differs, strict "country of origin" rules will apply on goods that have significant third-country content.

With respect to nontariff barriers, the gains were disappointing. Canada had hoped to benefit from the massive expenditures that the U.S. government directs to research and development and to other high-technology items. Canada did not, however, obtain full access in nonmilitary government procurement, nor did it get the freer access that it sought in the area of transportation. Little progress was made in eliminating the other U.S. trade restrictions that we identified in our 24th Annual Review. The temporary safeguard duties on shingles and shakes and on specialty steels will not be renewed when they expire, but the increase in Canadian stumpage fees on lumber will remain permanent in order to forestall a U.S. countervailing duty.

More-Secure Access — Gains were made with respect to the security of access, and new rules to that effect were introduced in a number of areas – trade in services, investment, and energy, for example. In addition, more-general rules to govern the conduct of trade and to help settle disputes were developed.

Specifically, the agreement establishes the first comprehensive bilateral understanding on the service industries among OECD countries. Each government grants "national treatment" – i.e., treatment that does not discriminate between domestic and foreign-owned businesses – to the other's citizens with respect to all *new* measures affecting most commercial services. The agreement provides for the right of establishment (i.e., firms can start up affiliates in the other country). In addition, the agreement provides separate undertakings covering enhanced telecommunications and computer services, tourism, and architectural services. It also eliminates the barriers that previously restricted the access of individuals selling goods and services and supplying after-sale service to customers. Business personnel providing professional services, for example, will be able to work in the other country on temporary assignments. For many Canadian firms, the temporary-access rule is regarded as a major breakthrough.

On investment, each party to the agreement will provide national treatment to investors of the other country, subject to certain qualifications: the Canadian government explicitly retains the right to review the acquisition of large Canadian firms by U.S. investors; and the present rules with respect to energy, broadcasting, and transportation continue to apply. Moreover, Canadian investments in the United States will be protected from any future discrimination or review.

On energy, except under circumstances permitted under the GATT or those involving national security, neither nation will restrict imports from, or exports to, the other. This assures continued access for Canadian energy exports to the United States.

The more general rules do not provide blanket relief from the forthcoming omnibus trade bill or from the protectionist trade actions awaiting consideration by the U.S. International Trade Administration. Each country retains the right to apply its own domestic antidumping and countervailing duties and to impose temporary safeguard tariffs under Article XIX of the GATT. But limits have been placed on each country's use of bilateral emergency safeguard actions against the other. In global safeguard actions aimed at other trading partners, each country will be excluded from "sideswipes" unless its contribution to the injury is substantial. The establishment of a bilateral tribunal with the power to override U.S. and Canadian domestic administrative rulings on Canada-U.S. trade issues breaks new ground. A mutually acceptable system of North American rules for dealing with unfair pricing, subsidies, and antidumping and countervailing duties is to be negotiated over the next five to seven years. This is a crucial element of the agreement, for until such a system is put into place, Canadian (and U.S.) industries will remain subject to the uncertainties and costs of potentially harmful trade actions.

In addition, the two countries have agreed to a "standstill" provision: after the signing of the agreement, each government will refrain from trade actions that could jeopardize its ratification by the legislators of either country.

Sensitive Sectors — Special provisions apply in a number of areas – agriculture (including wines and spirits), energy, the automotive trade, the service industries, and investment. These will be discussed in more depth in Section 3.

GATT Trail-Blazer — The Canada-U.S. Free-Trade Agreement uses GATT rules as its framework; for example, the agreement's "national treatment" obligations and definition of a countervailable subsidy are identical to those under the GATT. But the Canada-U.S. accord breaks new ground in spheres not yet covered by the General Agreement. While the design of the dispute-settlement mechanism is similar to the GATT provision for panels to deal with disputes, the major innovation in the Canada-U.S. agreement is that the bilateral panel can make binding decisions, whereas GATT panels must report their findings to the main body for arbitration. The only provision of the Canada-U.S. agreement that does not follow GATT principles (in that it clearly discriminates against producers in other countries) is the limitation of Auto Pact status to those who now enjoy such status – principally the Big Three U.S. producers.

Conclusion

The Canada-U.S. Free-Trade Agreement does three things:

1 It eliminates all tariff, and some nontariff, barriers within the North American context. These barriers to trade reduce the real incomes of consumers, increase production costs, and distort the use of resources away from their most efficient allocation. The fact that many U.S. tariffs rise with the amount of manufacturing content has restricted and discouraged Canadian manufacturers. The removal of that limitation is of great importance to the future restructuring of Canadian industry.

2 The agreement establishes trade rules that will ensure a more predictable climate for commercial decisions on both sides of the border. As one observer has noted: "Trade rules are rules about investment. What a business wants to know when it builds a new plant is what size plant to build, what size market it is going to have."[3] The agreement sets the stage for increased business activity and investment on both sides of the border.

3 While the agreement does not by itself eliminate trade disputes, it will forestall, or provide joint adjudication on, minor irritants. And if comprehensive bilateral North American trade rules are ultimately worked out, that should further improve commercial relations between the two countries.

3 Areas of Special Attention

Before turning to an overall assessment of the economic impact of the agreement, we examine some of the details with respect to: 1) the removal of tariffs; 2) sectors for which the agreement includes special arrangements; 3) rules cov-

ering services, investment, and government procurement; and 4) the new rules for resolving disputes.

Tariff Reductions

Historically, nations have used tariffs and trade restrictions either to raise revenues or to encourage local production. While these barriers to trade may be effective in the short run, over the longer term they encourage inefficiencies and slow down technological adaptation and growth. There are several reasons why this is so:

- Trade restrictions against, or tariffs levied on, consumer goods add directly to the prices of the latter, thereby reducing the real incomes of purchasers.

- Tariffs levied on imported intermediate goods add to the costs of production.

- As a protective barrier, tariffs or restrictions are usually highest in industries that are the least competitive – often where production is labour-intensive and where machinery and equipment are outmoded. Thus trade barriers perpetuate industries in which Canada is at a comparative disadvantage. This effectively lowers standards of living because firms and workers are encouraged to stay in less-productive activities.

- As a source of revenue, tariffs are highly selective and discriminatory, being applied with different degrees of incidence and at different rates to different types of goods. As such, they distort the pattern of purchases by Canadian consumers.

- When quotas or voluntary export restraints are applied – e.g., on automobiles, shoes, or clothing – foreign exporters tend to ship the items with the highest quality/value-added combinations, leaving Canada to produce at the lower quality/price end of the scale.

About 70 per cent of Canada's exports to the United States and 65 per cent of U.S. exports to Canada are already exempt from tariffs. Canadian duties on those items to which tariffs currently apply are nearly twice as high as those of the United States. Canadians now pay over $2 billion a year in customs duties on imports from the United States. Roughly one-third of those imported goods subject to tariffs are finished goods for sale directly to consumers; the balance are intermediate goods or parts and equipment that enter into Canadian production of finished goods. The agreement will phase out this extra cost of U.S.-made goods to Canadian consumers and producers.

Over the 10-year period ending on 1 January 1998, virtually all remaining tariffs on trade between the two countries will be eliminated. The reductions will be implemented in three stages, following a new set of harmonized

A Three-Stage Program of Tariff Elimination in the Canada-U.S. Free-Trade Agreement

Stage and scheduled date for removal of tariffs		Proportion of Canada's dutiable imports from the United States	Examples of current tariffs		
			Imported goods	Canada	United States
		(Per cent)		(Per cent)	
A	1 January 1989	15	Skis	11.4	5.1
			Skates	22.5	5.8
			Fur garments	25.0	5.8
B	1 January 1993	35	Subway cars	12.5	6.3
			Paper	6.5	2.4
			Wooden office furniture	15.0	6.6
C	1 January 1998	50	Steel	12.5	11.6
			Appliances	12.5	4.0
			Tires	10.2	4.0
			Railway freight cars	17.5	18.0

SOURCE Canada, Department of External Affairs, *The Canada-U.S. Free-Trade Agreement: Tariff Schedules of Canada* and *Tariff Schedules of the United States* (Ottawa, 1987).

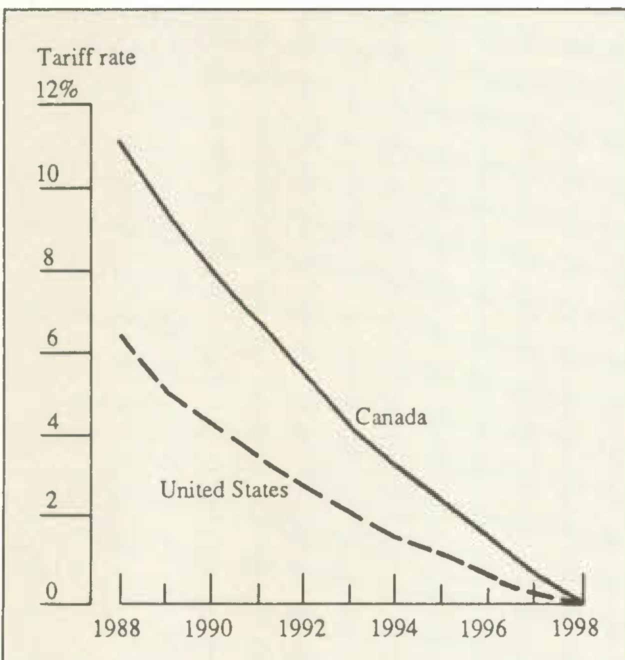
schedules for over 7,000 tariff items in Canada and over 9,000 tariff items in the United States (see box).

Chart 2 shows the path of tariff reduction over the next 10 years. By 1993, 63 per cent of Canadian tariffs will have been eliminated. Since Canadian tariffs are generally much higher than those of the United States, Canadian producers will face significant adjustments to their removal. On the other hand, Canadian consumers, as well as Canadian producers who import parts and equipment subject to tariffs, will, on average, benefit more than their U.S. counterparts.

There are two important qualifications to the tariff-cutting formula in the agreement. First, both countries agree that the stages of tariff cuts can be accelerated by mutual agreement, as has been done by the EC and by EFTA. Second, specific "rules of origin" are set out to ensure that neither country will simply pass along third-country imports with limited North American content. This has particular relevance to clothing and textiles, because many manufacturers rely on imported material from the Third World. It is crucial for some other sectors as well.

Chart 2

Path of the Aggregate Tariffs on Dutiable Imports under the Canada-U.S. Free-Trade Agreement, 1989-98[1]



1 The base tariff rates for 1988 are 11.2 and 6.5 per cent, respectively, for Canada and the United States.

SOURCE Estimates by the Economic Council of Canada, based on Canada, Department of External Affairs, *Canada-U.S. Free-Trade Agreement: Tariff Schedules of Canada* and *Tariff Schedules of the United States* (Ottawa, December 1987), with the assistance of the Trade Negotiations Office, Ottawa.

In addition to eliminating tariffs, the United States has agreed to phase out customs user fees by 1 January 1994, thereby saving Canadian exporters several million dollars a year.

Sectoral Impact

Agriculture

The extensive regulation and protection of the agri-food sector in Canada and the United States make it difficult to reconcile trade issues in this area between the two countries. Nonetheless, the free-trade agreement is a first step in liberalizing and harmonizing agricultural policies. It embodies three broad objectives:

- to maintain farm incomes in the face of unbalanced world agricultural production;

- to open borders between the two countries' agricultural sectors; and

- to serve as a precursor to multilateral trade negotiations within the GATT.

Both Canada and the United States sell most of their agricultural exports outside North America. But total trade in agriculture between the two neighbours is currently over C$6 billion; in 1986, Canada exported $2.7 billion in agricultural products to the United States, and it imported $3.6 billion. Canada enjoys a trade surplus in beef, pork, and live animals but runs a deficit in fruits, vegetables, nuts, oil seeds, and some other products. Of concern to Canada has been the uncertain access to the U.S. market of Canadian red meats and live animals, as a result of the sporadic application of U.S. nontariff barriers.

Generally, tariffs in agriculture are already low in both countries; thus the effects of the agreement on Canada's exports to, and imports from, the United States are not expected to be either significant or disruptive. As of 1 January 1989, tariffs on live animals, some animal feeds, and yeast will be eliminated. By 1 January 1998, all remaining agricultural goods will be tariff-free, subject only to the tariff "snapback" provision for fresh fruits and vegetables (which temporarily restores tariffs, under depressed market conditions, in order to give the affected producers a longer period for adjustment).

The agreement dismantles some nontariff barriers: it eliminates export subsidies in bilateral trade, provides for reciprocal exemptions from meat-import laws for beef and veal, and harmonizes some technical regulations. These initiatives do not, however, eliminate most of the existing nontariff restrictions imposed by each country, even after the agreement is fully implemented (see box).

Five specific provisions deal with subsidies:

- neither party is to subsidize, directly or indirectly, exports to the other;

- neither party is to sell to the other at prices below the costs of production, storage, handling, and so on;

- each party is to take the export interests of the other party into account when subsidizing exports to third countries;

- Canada has agreed to eliminate the rail subsidies granted under the *Western Grain Transportation Act* (WGTA) for products shipped through West Coast ports for consumption in the United States; and

- Canada has agreed to eliminate import licenses for wheat, barley, and oats (and their products) when U.S. aggregate levels of support for those grains become equal to Canadian levels.

The elimination of rail subsidies for grains shipped under the WGTA through Canadian West Coast ports will marginally affect Canadian exports; we estimate that fewer than 100,000 tonnes of canola meal and millfeeds will be affected, compared with the over 30 million tonnes of all grain products that currently benefit from WGTA subsidies on shipments to all destinations.

The estimated aggregate levels of support for wheat and barley are lower in Canada than in the United States, but they are roughly equivalent for oats. The free-trade agreement establishes formulas for calculating levels of government support for grains.

Canada's supply-management system for poultry, eggs, and dairy products remains intact. The elimination of tariffs will not result in increased imports of supply-managed products that are subject to the import-control regimes. The principal determinant of imports continues to be the level of domestic production, which in turn depends on Canadian sales.

Some Canadian food processors who use supply-managed poultry products may be at some cost disadvantage relative to their American counterparts, since U.S. prices for poultry products are considerably lower than Canadian prices. The products at issue (TV dinners, for example) account for about 2 per cent of Canada's total production of poultry products. Processors of these products will be given priority in the allocation of import permits. If this should prove insufficient, an accommodation might be possible, perhaps through some kind of two-price system of relief or through a change in import controls. For Canadian food processors who use domestic wheat and flour, which are higher-priced in Canada than in the United States, the Canadian government has announced its intention to discontinue the two-price wheat policy and compensate wheat growers in some other way. In addition, there may well be

Nontariff Barriers Remaining in Agriculture after the Implementation of the Canada-U.S. Free-Trade Agreement

	Nontariff barrier	Canada	United States
Wheat	Subsidies	x	x
Unprocessed milk	Prohibition and standards	x	
Poultry (eggs, chicken, and turkey)	Quotas	x*	
Hogs	Countervailing duties		x
Dairy products	Import controls and standards	x	x
Corn	Countervailing duties	x	
Sugar	Quotas		x*
Meat products other than red meats	Health standards	x*	x*

x Existing nontariff barriers will remain.

* Nontariff barriers will be changed slightly as a result of free trade.

SOURCE S. Magun, S. Rao, B. Lodh, L. Lavallée, and J. Peirce, "Open borders: An assessment of the Canada-U.S. Free-Trade Agreement," Economic Council of Canada, Discussion Paper 344, Ottawa, 1988.

adjustment problems for farmers in the major fruit- and vegetable-growing regions. In providing for a 20-year tariff "snapback" for these crops, both governments recognize the special characteristics of the farm sector.

Finally, the two parties have agreed to establish a series of working groups (eight in all), designed to achieve reasonable uniformity – or to recognize the equivalence – of standards, inspection measures, and so on, on a range of items such as animal health, pesticides, and packaging and labeling.

The Automotive Industry

The Canada-U.S. Auto Pact was signed when the U.S. auto industry was pre-eminent in the world and was expected to remain so. The Auto Pact eliminated the tariffs of either country on imports of completed vehicles and of original equipment and parts from the other. The elimination of tariffs was conditional on manufacturers being able to maintain certain minimum levels of production in Canada and of domestic content in North America. Thus the Auto Pact provided a mixture of trade liberalization and protection.

In 1986, the automotive trade between the two countries was valued at $61 billion, or 36 per cent of total bilateral trade, compared with 8 per cent in 1964. That year, the Canadian automobile and parts industry employed over 130,000 workers, about 70 per cent of whom were in the parts industry.

Canada has enjoyed a surplus in the automotive trade since 1982. Its exports of motor vehicles and motor vehicle parts have doubled, mainly as a result of the modernization and improved competitive position of the Canadian automotive industry vis-à-vis that of the United States. One measure of that improved competitiveness is labour compensation costs. For motor vehicle and equipment manufacturing, Canadian costs (including their nonwage components) are estimated to be about 70 per cent of those in the United States. In fact, the safeguards providing for minimum levels of Canadian production have proved to be largely unnecessary. In most cases, Canadian manufacturers have exceeded the minimum requirements by a wide margin.

The emergence of competition from Japanese and other foreign automobile manufacturers complicates the administration of the Auto Pact. Under the GATT, Canada's tariff on autos and original equipment is 9.2 per cent, while the U.S. tariff is 2.5 per cent. Canadian Auto Pact producers can import assembled vehicles or parts duty-free, provided they meet overall Canadian production and value-added requirements. In addition, foreign producers in Canada can import parts from third countries duty-free, provided they increase the value added here (by using Canadian labour and material inputs) and they export in amounts at least equal to the value of the imported parts. Both the U.S. government and U.S. parts producers have objected to this duty-remission program on the grounds that it acts as an export subsidy to parts producers by encouraging more assembly work in Canada than would otherwise occur.

The new Canada-U.S. arrangements on automotive trade (see box) diffuse a number of irritants between the two neighbouring countries:

- Canadian duty remissions offered to foreign producers in consideration of Canadian value-added in their Canadian production will terminate by 1996 at the latest, after the present agreements with those producers expire;

- Canadian export-based duty remissions with respect to automotive exports to the United States will be eliminated when the agreement comes into effect; with respect to exports to other countries, they will disappear on 1 January 1998; Canadian production safeguards in the Auto Pact will remain intact, but the tariffs to enforce the safeguards will be eliminated gradually;

- both countries agreed not to allow any more auto companies into the Auto Pact; and

- the trade agreement requires all auto manufacturers to incorporate 50-per-cent (direct costs) North American content for parts and materials (equal to about 70 per cent of the value-added) if their products are to move duty-free across the border.

Critics point out that the gradual elimination of tariffs on automotive products will also eliminate one of the two penalties for failing to meet the production safeguards and that, over time, production could move to the United States. Thus the agreement could reduce the commitment to jobs and investment in Canada by overseas producers; and the Big Three (General Motors, Ford, and Chrysler), who already have more than 50-per-cent North American content, could bring parts from Mexico and Japan and still meet the new requirements.

Our analysis indicates that the bulk of the industry (including car and light-truck assembly) and the larger parts manufacturers will be relatively unaffected by free trade. Some small parts-manufacturing firms will likely have to

Free Trade in Automotive Products

The Canada-U.S. Free-Trade Agreement provides for:

- The elimination of tariffs on original equipment and tires over 10 years, and of tariffs on replacement parts over five years;
- the phasing-out, over a five-year period, of the embargo on the importation of used cars into Canada;
- the termination of Canadian duty waivers linked to exports to the United States when the agreement takes effect;
- the termination of Canadian production-based duty waivers (duty-remission programs) by 1996 or according to the schedules negotiated between the companies concerned and the Government of Canada, whichever is sooner;
- a new 50-per-cent North American (U.S. and Canadian) rule of origin, based on the direct costs of manufacturing (materials plus labour), in order to stimulate increased use of U.S. and Canadian automotive parts and materials by foreign producers;
- a commitment by Canada and the United States that no additional companies may qualify as eligible manufacturers of vehicles under the provisions of the Auto Pact;
- changing the duty drawbacks and "foreign trade zones" of the United States to make them consistent with the general provisions of the agreement; and
- the creation of a select panel to assess the state of the North American automotive industry and to propose public policy measures and private initiatives aimed at improving its competitiveness in domestic and foreign markets.

restructure as a result of tariff reductions and of the phasing-out of the duty-remission schemes. Several of Canada's heavy-truck facilities may shift to the United States; these latter producers account for only a small proportion of industry value-added, however.

Market conditions in the industry are changing rapidly. The depreciation of North American currencies since 1985, together with the introduction of joint ventures and more quality-oriented production techniques, makes it possible for U.S. and Canadian auto makers to market their products abroad. The current provisions of the agreement with respect to automotive production would then be beneficial. Indeed, in creating the blue-ribbon panel of experts to assess the state of the North American industry, there was an expectation that in the years ahead there would be significant export opportunities for North American automotive products.

Market conditions, especially relative production costs, will continue to be the major factor determining the location of North American auto plants. Future trends in the Canadian share of North American production will be influenced mainly by wage and other cost developments in the two countries and by the value of the Canadian dollar. As long as Canadian plants maintain their record of good quality and competitive costs, they seem likely to retain a significant share of North American automobile production (the current share is 14.5 per cent). Whatever the outcome of the trade debate, an expected slowdown in North American automobile demand will lead to fiercer competition over the next five years.

Energy

Canada produces about 4 per cent of the world's supply of primary energy. About 14 per cent of total Canadian investment is in the energy sector. Gross revenues of over $60 billion are generated in this sector; 70 per cent of that amount derives from oil and gas; 26 per cent, from electrical power generation; and 4 per cent, from coal mining, uranium, and other energy sources (see box).

Canada is currently the most important supplier of oil and gas to the United States, providing about 13 per cent of its imports of crude oil and petroleum products, and close to 100 per cent of its natural gas imports. Because oil and gas production in the United States is falling, U.S. imports are likely to increase substantially if present trends continue. Much of this increased supply could be shipped from Canada. The U.S. demand for electrical energy from Canada is also expected to grow substantially.

Canada's Energy Situation

Canada is a major exporter and importer of energy: in 1986, its energy exports amounted to over $12 billion (or about 10 per cent of all Canadian exports); imports, to over $5 billion. Since 1983, Canada has been a net exporter of all energy commodities.

Oil — Oil is the most important source of energy in Canada. Current production is about 1.8 million barrels of crude oil per day, of which about 45 per cent is exported. The fastest-growing source of oil supply in Canada is found in bitumen, which is recovered from oil sands and transformed into heavy crude; the latter is not upgraded but, for the most part, is shipped to the United States to be used as asphalt. The pools of conventional light crude oil in Alberta are declining, and it is estimated that about 70 per cent of the remaining reserves of crude oil are in offshore and frontier regions and would require high-cost development. Eastern Canada imports and refines most of its oil supplies. Over the longer term, the Canadian tar sands offer tremendous energy potential, equivalent to the combined reserves of Saudi Arabia, Kuwait, and the United Arab Emirates, if economic techniques can be found to exploit them.

Gas — Though gas is much more plentiful than oil in Alberta, it is six times more costly to transport; consequently, it is important that markets be as close as possible to the source. Thus the United States is the only practical export market for Canadian gas. In recent years, overcapacity has developed in the oil and gas industry, and mounting competition between the two sources of energy has resulted, particularly in the United States. There are signs, however, that the surplus domestic gas supply in the United States is finally beginning to shrink. Canadian natural gas sales to the United States rose by 20 per cent in 1987, reaching an estimated 950 billion cubic feet. Exports are expected to exceed 1.3 trillion cubic feet annually by the mid-1990s. New pipeline capacity is now planned, especially to serve the large U.S. Northeast market.

It is estimated that Canada's gas reserves are twice as large as the oil reserves in both conventional and frontier regions, with Alberta and British Columbia accounting for 84 and 12 per cent of the gas reserves, respectively. Canada is, therefore, in a very strong export position in the North American context.

Hydro-electricity — The use of electricity in Canada has been increasing over time; it now stands at about 20 per cent of all energy use. Canada is the largest hydro-electric energy producer in the world, with hydro accounting for over 65 per cent of its supply of electric power. Hydro-electricity is particularly important to Quebec, British Columbia, and Manitoba. Coal is also important for the generation of electricity, with most of it being mined in western Canada. Coal reserves are estimated to have a supply capacity of over 100 years at today's rate of production. Canada is a net exporter of coal, principally to Japan and South Korea for use in steel production. Coal is an important source of power generation in Alberta, Saskatchewan, Nova Scotia, and Ontario, where it competes mainly with nuclear power.

With respect to future demand, with the development of new conservation technologies it is anticipated that energy demand in Canada will not grow as rapidly as the economy and that the shift away from oil will continue to favour natural gas and electricity. The demand for heavy crude oil in Canada is not expected to grow much in the 1990s; hence Canada will likely become increasingly dependent on light crude oil imports into eastern Canada. Much, of course, will depend on the course of world oil prices.

Under the trade agreement, almost all bilateral barriers to energy trade are to be eliminated. Canada gains secure access for exports on a nondiscriminatory basis; the United States gains more-secure access to energy supplies in the event of world shortages. While Canada is entitled to restrict the *amount* of energy exports to the United States in times of shortage, it must continue to allow U.S. energy importers to buy up to their traditional *proportion* of the reduced Canadian supply. Both countries have agreed not to impose special export or import charges.

A concern of some Canadians is that the provisions jeopardize Canadian sovereignty and that sharing the shortages will effectively undermine Canada's ability to achieve self-sufficiency in energy. That argument ignores the fact that Canada is already committed to an emergency oil-sharing system as a member of the International Energy Agency. The federal government's position is that the IEA's procedures override those of the Canada-U.S. agreement and require that in times of shortage each member country restrain its demand and share the available oil with the other members. The agreement extends the commitment to include the sharing of natural gas and electricity with existing customers in the event of a shortage. Canada has ample reserves of both natural gas and hydro-electricity until well into the next century.

There is the possibility that the requirement for energy sharing may, at some future date, exacerbate a tight supply situation within Canada. The likelihood of such an event

occurring frequently is not great, however, so that the potential disadvantages that it might entail would be limited to relatively brief periods. Conversely, the benefits of secure access to the U.S. market will be continuing ones and will lead, over time, to advantages that considerably outstrip any potential disadvantages.

The most important issue with respect to the security of supply lies in Canada's ability to influence the pace of development of new energy reserves. In the past, natural gas reserves were formally set aside by the National Energy Board, and producers held reserves idle to meet forthcoming needs. In 1987, however, the NEB decided not to dictate what reserves had to be set aside, and Canadian gas distributors now have to negotiate long-term contracts with producers to ensure that future supplies are adequate. In effect, producers and consumers (as represented by the distributors) will jointly carry the responsibility of achieving the security of supply. (Provincial agencies – the Alberta Energy Resources Conservation Board, for example – will continue to regulate such technical matters as the appropriate rates of production for conservation purposes.) As for electricity, a provincial utility is now compelled to offer power to neighbouring provinces before it can make long-term commitments to U.S. customers. In contrast, oil supplies have never been sold on long-term contract; the security of oil supply is based on stockpiling and on international transactions endorsed by the IEA.

By guaranteeing the continuity of Canadian energy supplies to the United States, Canada has paved the way for expanding its own oil, gas, and hydro-electric development – projects that are usually large in scale and expensive. This is particularly important in the oil sector, because Canada's conventional sources of light crude are rapidly declining and the new-found security of access will facilitate investments in the high-cost energy projects in the Beaufort Sea and on the East Coast. It should also accelerate exploration work in traditional oil and gas reserves and foster further development of the Alberta oil sands.

As far as pricing is concerned, the agreement does not eliminate the opportunity for Canadian electricity-exporting firms to strike a more favourable price for Canadian-exported energy than they could get in Canada. Canadian utilities are free to obtain the best contractual price that they can get for their exports. What has changed is that governments can no longer intervene directly to set export prices.

Finally, the provision that the United States will remove its restrictions on the enrichment of Canadian uranium and that Canada will eliminate the requirement that the uranium be processed before being exported to the United States will likely have modest benefits for Canada, particularly in the producing regions of Saskatchewan and northern Ontario.

Over the longer term, then, the agreement will reduce some of the market risks that tend to impede large-scale development. But, in our opinion, the demand for energy, not the trade agreement or the National Energy Board, will remain the main factor determining the timing of new energy megaprojects.

Special Rules

Services (Including Financial Services)

The service sector in Canada accounts for about 65 per cent of output and 70 per cent of employment. There are no tariff barriers to service flows between the two countries. Most of the barriers to service trade are nontariff barriers, primarily of a regulatory nature. The Canada-U.S. Free-Trade Agreement recognizes all existing practices; the new principles, such as national treatment, apply only to new measures. Neither government is under any obligation to harmonize its licensing procedures, health and safety standards, consumer protection laws, or commercial regulations; rather, both governments agree not to discriminate between Canadians and Americans with respect to any new regulations that may be adopted.

Canada will exempt the subsidiaries of U.S. banks from the existing limit on foreign assets. U.S. residents may acquire more than 25 per cent of the shares of a federally regulated, Canadian-controlled financial institution, but the present rule that no single non-resident may acquire more than 10 per cent of the shares of a Schedule A bank remains in effect. Change has already occurred with respect to provincially regulated securities, trusts, and insurance companies, as Ontario, Quebec, and British Columbia have effectively opened their borders to U.S. acquisition and ownership.

The United States agrees to allow Canadian banks and other financial institutions to underwrite and deal in securities of Canadian governments in the United States. They will be treated as U.S. financial institutions with respect to any changes in U.S. legislation. In this connection, it is worth noting that the Glass-Steagall Act, which effectively separates banking from securities functions, is now under review.

In summary, the Canada-U.S. agreement on trade in services, including financial services, is likely to have a minor impact on the flow of business services between the

two countries. By providing national treatment for new regulations and by guaranteeing reciprocal access to service and sales personnel, it will likely improve competition, lower prices, and give some stimulus to employment and output. Perhaps more important, the bilateral agreement on services could lay the foundation for new multilateral initiatives under the GATT.

Since the bulk of employment in services occurs at the point of delivery to the customer, we do not foresee any significant gains or losses in employment as a result of the trade agreement. On the contrary, the increase in competition is likely to ensure that Canadians can buy their services at lower prices.

Investment

Canada agrees to raise the review thresholds for direct acquisitions of Canadian businesses by U.S. firms from their present level of $5 million to $150 million by 1992 and to phase out the review process for indirect acquisitions. Canada retains the right, however, to review U.S. applications to acquire control of oil, gas, and uranium enterprises, as well as transportation services and cultural activities. Other existing laws and practices are "grandfathered." Both countries agree to materially reduce the performance requirements related to foreign investments, such as local-content and export or import requirements. Nothing will inhibit the right of either government to nationalize or expropriate an investment, but any action of this type must be on a nondiscriminatory basis and must be based on fair market value.

Two-thirds of all Canadian-controlled nonfinancial assets will still be reviewable if acquired by U.S. firms – down from about 75 per cent currently.[4] In recent years, the flow of Canadian direct investment to the United States has exceeded the flow of U.S. direct investment into Canada, and there has been a material reduction in the proportion of Canadian commercial assets under U.S. ownership. Since the early 1970s, the presence of foreign-owned enterprises in Canada has declined: their share of total Canadian corporate assets has dropped from approximately 37 to 23 per cent; and in oil and gas, the proportion has fallen from roughly 80 to 50 per cent of Canadian assets.

In short, given the extent of foreign-owned or -controlled activity in Canada, the Canadian government wanted to retain a screening mechanism for major acquisitions of Canadian assets by foreign interests. And it succeeded. At the same time, it secured Canada's exemption from any restraints on foreign investment that the U.S. government might impose.

Government Procurement and R&D

The free-trade agreement commits both Canada and the United States to broadening and deepening their obligations within the framework of the multilateral liberalization of government procurement. Those commitments are symbolic rather than substantive, however: 1) the threshold level of government procurement accessible to exporters in the other country is reduced to US$25,000 from the GATT Code restriction of US$171,000; and 2) provisions are made for more-transparent procedures, including bid-challenge systems to ensure the equitable treatment of potential suppliers. Under the procurement clauses, 11 out of 13 government departments and 42 agencies (including NASA) in the United States, and 22 government departments and 10 agencies in Canada, are included.

The lower threshold provides additional access for Canadian and U.S. suppliers in the other's country. Government procurement of defence, transport, and telecommunications goods remains closed to foreign bidders. This is unfortunate, given that the U.S. Department of Defense spends billions of dollars on research and development through university and other contracts and that Canada was hoping to benefit.

Thus, while the agreement has cracked opened a new window to government purchases in Canada and the United States, the actual trade effects are likely to be small. Our estimates suggest that Canada may expect about $141 million in additional sales and additional imports of about $128 million. Perhaps the most important effect will be the new institutional framework of bid-challenge procedures, whereby complaints regarding discrimination against potential suppliers are dealt with by an impartial reviewing authority.

Dispute-Settlement Mechanisms

The implementation of the free-trade agreement and the ultimate resolution of disputes are under the general supervision of a Canada-U.S. Trade Commission. Broadly speaking, there are two avenues of dispute settlement – one dealing with issues of general application, such as institutional irritants or safeguards in the event of import surges; the other dealing with antidumping and countervailing issues. In matters of general application, either party may request consultations regarding any actual or proposed

measure or any disagreement. If the commission cannot resolve a dispute, the latter may be submitted either to binding arbitration or to an advisory (nonbinding) decision. However, binding arbitration is to be used only when both parties agree to it. In other cases, either party may refer the matter in question to a five-member, binational panel; the panel may then submit a (nonbinding) recommendation to the commission, which must then agree on a resolution of the dispute. If the "offending" party does not then comply, the injured party may suspend equivalent benefits.

There are two situations where disputes will be subject to binding arbitration. The first pertains to the provisions on safeguards – restrictions against "surges" of imports that cause serious injury to domestic producers. These are especially important for Canada, since the United States has resorted to safeguards with increasing frequency in recent years. On a bilateral basis, such actions will be limited to the restoration of the most-favoured-nation (MFN) tariffs, for a period not exceeding three years. The MFN tariffs will be eliminated completely after 1998. In cases where global restrictions are applied, as indicated earlier each country will be exempted unless its exports are contributing significantly to the serious injury; and even then each will be entitled to its traditional amount of unrestricted exports.

The second situation where binding arbitration may apply involves the application of antidumping and countervailing duties.The two governments will continue to enforce their own domestic laws, but these must be consistent with the GATT Codes on antidumping and subsidies and with the terms of the free-trade agreement.

In both cases, either party may appeal to a five-member binational panel, following an initial decision in the country in which a complaint is launched. Based upon the administrative record, the panel will apply the appropriate standard of judicial review applicable under the domestic law of the party whose antidumping or countervailing-duty order is being challenged. That is to say, if Canada challenges an American countervail order, U.S. law will be the standard applied; and vice versa.

Critics of the agreement argue that use of the "offending" country's law as the standard for final review provides a less than truly impartial forum for the resolution of disputes over safeguard and antidumping and countervail matters. Supporters maintain that the new binding dispute-settlement mechanism, although it is not perfect, does represent a significant improvement over the present system while preserving the sovereignty of both governments. Similarly, the strict time limits for each stage of the process will mean a much speedier resolution of those cases than was generally possible in the past. This speed-up in trading actions is considered a valuable asset by both firms and government agencies that have had to deal with long drawn-out cases in the past.

What is most important, however, is that further negotiations are planned in order to replace these procedures (in whole or in part), within seven years, with mutually accepted North American trade rules by which both countries will abide.

Other Issues

Apart from relatively minor irritants having to do principally with the "theft" by Canadian cable-television stations of U.S. programs, the entire culture issue was removed from the bargaining table. A discriminatory tax advantage for printing or typesetting in Canada was eliminated – a relatively trivial item, consistent with the view that the printing industry is not in fact a cultural activity. Canadian cultural development is neither more nor less secure with the agreement than without it.

In certain areas, the effects of the agreement remain unclear. With respect to alcoholic beverages, for example, the agreement calls for the gradual elimination of differential pricing of wine over a seven-year period; in the case of spirits, the differential is to be eliminated upon implementation of the agreement. The latter also "grandfathers" existing practices, subject to the GATT rules, governing beer sales. But its precise effect on the Canadian wine and spirits and beer industries depends on the results of a pending GATT Council decision on a complaint made by the European Community that existing provincial liquor regulations constitute discriminatory trade barriers. A preliminary decision by a GATT panel went against Canada. Should it be confirmed by the full GATT Council, the Canadian government, together with provincial governments, will face the difficult choice of accepting that decision – and the competitive harm that could result for Canadian industries – or rejecting it and having sanctions of equivalent value imposed on Canadian exports. At the same time, the federal government has indicated that it will introduce specific measures to ease adjustment in the Canadian grape-growing industry.

The elimination of tariffs and the establishment of an agreed-upon North American system for dealing with subsidies, antidumping, countervail, and other trade disputes will not, by themselves, prevent specific firms, industries, or interest groups from seeking some form of national protection in order to gain a specific market advantage.

Some companies are likely to seek protection through domestic regulations covering such issues as content, health, packaging, and so on. This in turn will put additional pressure on, and add importance to, the process of regulatory harmonization. In most cases, that is probably good. Historically, Canada has benefited by being able to draw on U.S. scientific research and standards – particularly in such areas as toxic chemicals and other health contaminants. In some cases, however, the interweaving of commercial interests and government lobbying is based on self-interest; there will likely be instances where Canadian negotiators will have to defend Canadian standards vigorously against U.S. pressures. Examples of where such action has already been taken include standards covering acid rain and Canada's conservation-based renewable-resource management practices.

4 The Future Impact of the Agreement

In our 24th Annual Review (*Reaching Outward*), we reported on simulations of the medium-term impact of a postulated Canada-U.S. free-trade agreement using the Candide Model 3.0 and Statistics Canada's Input-Output Model of the Canadian economy. That simulation was undertaken before the signing of the actual agreement, and consequently – as we indicated at the time – the results applied to a hypothetical agreement. At the same time, we promised that when the actual agreement was signed, we would undertake additional simulations to determine its potential impact on output and employment in Canada.

Econometric simulations, of course, involve the use of assumptions about market behaviour, expressed through mathematical calculations. In the case of the trade agreement, some issues have been left for subsequent negotiation, and some elements have created constraints on future actions. Thus there are still many unknowns that the model cannot capture. For that reason, we present, in this section, alternate cases that show the upside and the downside sensitivities of the estimates.

In the Appendix to this report, we compare the net effects of the negotiated free-trade agreement on Canada's major economic indicators with those of the earlier hypothetical trade deal, analysed in the 24th Review. The core of that analysis was reported in a technical document – Discussion Paper 331 – authored by Messrs. Magun, Rao, and Lodh of the Economic Council. The same authors, with Messrs. Lavallée and Peirce, have since prepared an updated document – Discussion Paper 344 – in which they analyse the impact of the actual agreement signed on 2 January 1988. (The figures in this section are based on the latter analysis.)

As we did last year, we base our analysis on the expectation that the trade agreement will have two major consequences. First, there is the direct impact of removing tariff and nontariff barriers. Here, the stimulus to output and employment comes from the increases in consumer expenditure and investment that result from lower prices and lower production costs. Second, there is the rationalization of Canadian manufacturing in response to U.S. competition and a more open and secure access to the U.S. market. By modernizing their facilities, attuning plant size to expanded sales, and finding appropriate specialized product niches, Canadian firms can substantially increase their productivity.

Our new simulations indicate that there will be gains in output and employment. These are more modest than the simulations in the 24th Review suggested, because the actual agreement is not as all-embracing as the hypothetical deal that we simulated in 1987. For example, last year we assumed that the agreement would include complete mutual access to federal government procurement in all areas except strategic military hardware. We also postulated that all existing nontariff barriers would be removed and that there would be mutually open access in transportation. The actual agreement excludes access to transportation and, in the other two areas, encompasses far less than we assumed in the 24th Review.

The scope for productivity enhancement is substantial. It is estimated that, on average, Canadian manufacturers are about 25 per cent less efficient, in terms of output per person-hour, than their U.S. counterparts. Canada offsets this disadvantage with a favourable exchange rate and by being more productive in some other areas, such as primary resource extraction, construction, and utilities. In last year's Review, we examined all the major manufacturing sectors and noted that close to 70 per cent of manufacturing plants were of a less-than-efficient scale for the North American market. The potential productivity gain from industry restructuring and plant rationalization is estimated to be in the order of 6 per cent in output per person-hour over 10 years, with variations from industry to industry. Since productivity growth in any normal year in the manufacturing sector averages about 3 per cent, this trade-induced gain would be equivalent to an annual increase in productivity levels of about 3.6 per cent. It would be achieved gradually through new management systems, new technologies, mergers, new investment, and expanded sales. The early stages of such corporate revitalization have been quite evident from news reports since the agreement was signed earlier this year.

The Simulations

In the simulations that follow, we distinguish between two types of investment – "induced" and "autonomous." Induced investment is associated with normal increases in final demand that result from population growth, rising living standards, increased export sales, and the need to replace worn-out machinery and equipment. It is the investment required to provide the working capital for new workers entering the labour force and for the unemployed who find jobs; overall, the stock of capital per worker does not change. Autonomous investment is more or less independent of current habits of consumption and production; it is investment in new products and new processes that occurs in response to new markets and often results from new discoveries and innovations. With autonomous (or additional) investment, the stock of capital per worker increases. In our simulations, we assume that the new investment that accompanies the free-trade accord is induced – i.e., no more than what might normally be expected. Then, to put these simulations in perspective, we provide the results of additional scenarios – two showing the impact of any additional or autonomous investment that might accompany free trade, and one showing the possible impact of not implementing the agreement. In all the simulations, the federal revenues forgone through lowered customs duties are offset by increased revenues from taxes on higher personal and corporate incomes.

Simulation 2: The Most Likely Outcome

Simply removing the tariff and nontariff impediments to trade identified in the agreement – as we do in new Simulation 1 – would, by itself, create about 76,000 new jobs, net of job losses; it would also raise Canada's real GNE in 1998 by 0.7 per cent above the level projected in the base case, which is based on the assumption that no change will occur in the trade relations between Canada and the United States. Also, inflation and the unemployment rate would be lower than in the base case. These results are shown under SIM.1 in Table 1. When one takes into account the induced investment that leads to industrial rationalization and enhanced productivity – our new Simulation 2, which we consider the most likely outcome – the results show that total potential employment in 1998 will be 1.8 per cent higher than in the base case – a net gain of 251,000 jobs. In this scenario, real GNE is about 2.5 per cent higher than its base-case level, and the unemployment rate is lower by 0.9 percentage points; the inflation rate is lower, and real wages are higher. There is also some modest appreciation of the Canadian dollar. While these numbers may seem impressive at first, they are, in fact, moderate when averaged over 10 years. In short, viewed in terms of annual changes or rates of change, the impact of the agreement is small but positive.

Simulations 3 and 4: Additional Investment

Over the long term, the benefits flowing from greater security of access and from an agreement on rules of commercial conduct – benefits that are not easily quantified – could be much higher than those in Simulation 2. The provision of national treatment to investors who establish or acquire business enterprises, the new regulations governing services, and the commitment to remove disguised barriers to trade will greatly reduce the economic and commercial risk of undertaking a new venture. The energy provisions ensure the continuity and expansion of Canadian exports to the U.S. market. And the provisions covering business travel mean that Canada's sales and service personnel may enter the United States on business, free of harassment. Already there have been substantial inflows of European and Asian capital, as well as other new "autonomous" investments funded domestically, that appear to anticipate the implementation of the treaty; these are likely to continue.

Accordingly, we undertook two additional simulations designed to capture the effects on the economy of additional autonomous investments. Normally, gross investment in Canada accounts for about one-fifth of GNE, or between $100 and $120 billion annually (in 1987 dollars). In Simulation 2, the "induced" investment accompanying the lowering of trade barriers turned out to be about $6 billion annually. To that figure, we added an extra $3 billion annually of "autonomous" investment after 1989, principally in the manufacturing sector, and a second injection of $3 billion annually after 1993, to take into account the increasing reliance of the United States on Canadian energy and the need for several energy megaprojects as a result. In the first additional run (Simulation 3), we postulated that the autonomous investment is financed entirely from abroad; in the other (Simulation 4), the investment is assumed to be financed completely from domestic savings (see Table 1). This injection of new autonomous investment increases gross investment in the economy by about 5 per cent overall – well within the bounds of investment variability and growth each year.

The choice of a 5-per-cent increase in investment was based on the following logic. As part of our work for this report, we commissioned a survey of major multinational firms with establishments on both sides of the border, asking how a Canada-U.S. free-trade agreement would affect their business plans. Most respondents indicated that

Table 1

Estimated Impact[1] of the Canada-U.S. Free-Trade Agreement on Selected Economic Indicators, Canada, 1998 (Five Scenarios)

	SIM.1	SIM.2	SIM.3	SIM.4	SIM.5
			(Per cent)		
GNE (1981 dollars)	0.7	2.5	3.2	3.3	–0.2
Employment	0.5	1.8	2.6	2.7	–0.2
Consumer price index (1981 = 100)	–3.3	–5.5	–4.7	–2.7	–0.1
Output per person employed	0.2	0.7	0.6	0.6	– –
Exchange rate[2]	3.2	4.0	5.9	2.5	–0.4
Real disposable income	0.7	2.3	2.8	2.5	–0.2
Investment (1981 dollars)	2.2	5.0	10.4	10.5	–0.5
Exports (1981 dollars)	0.9	2.2	1.1	1.5	– –
Imports (1981 dollars)	2.3	3.9	5.5	4.2	–0.4
			(Thousands)		
Employment	76	251	370	384	–22
			(Percentage points)		
Unemployment rate	–0.3	–0.9	–1.4	–1.5	0.1
			(Billions of dollars)		
Total government account	–0.9	2.5	5.3	7.3	–0.8

1 Measured as the change from the levels estimated for the base case, which describes what would happen if there were no change in the Canada-U.S. trading relationship. Four scenarios (SIM.1 to SIM.4) are based on the assumption that free trade will occur, while the fifth (SIM.5) is based on the negative impact that could result from a worsening of Canada-U.S. trading relationships in the absence of the free-trade agreement:
SIM.1: Removal of trade barriers
SIM.2: SIM.1 plus productivity gains
SIM.3: SIM.2 plus autonomous investment, financed abroad
SIM.4: SIM.2 plus autonomous investment, domestically financed
SIM.5: Potential U.S. trade actions plus increased outflow of direct investment.
2 The Canadian dollar in U.S. currency.
SOURCE Magun, Rao, Lodh, Lavallée, and Peirce, "Open borders."

they would benefit directly from national treatment and the harmonization of technical standards and other rules; most of them expected their sales and exports to increase, and most expected to increase their investment in Canada by 10 to 20 per cent, as a direct result of the agreement (Chart 3). These were large firms, but there is clear evidence that many small and medium-sized firms in both Canada and the United States expect to increase their sales and to invest in Canada as a result of the agreement. In a poll conducted in May 1986 by the Canadian Federation of Independent Businesses, for instance, most member firms saw clear benefits from the agreement; many are already retuning their production plans and developing sales strategies to access, or expand in, the U.S. market. The removal of U.S. tariff barriers, which rise with the amount of manufacturing content, will encourage more value-added processing in Canada for export to the U.S. market.

What the results indicate is that the additional investment will impart an extra stimulus to GNE that will be equal to 0.7 or 0.8 per cent in 1998 and will result in lower unemployment rates and – depending on whether the investments originate externally or in Canada – between 119,000 and 133,000 extra jobs.

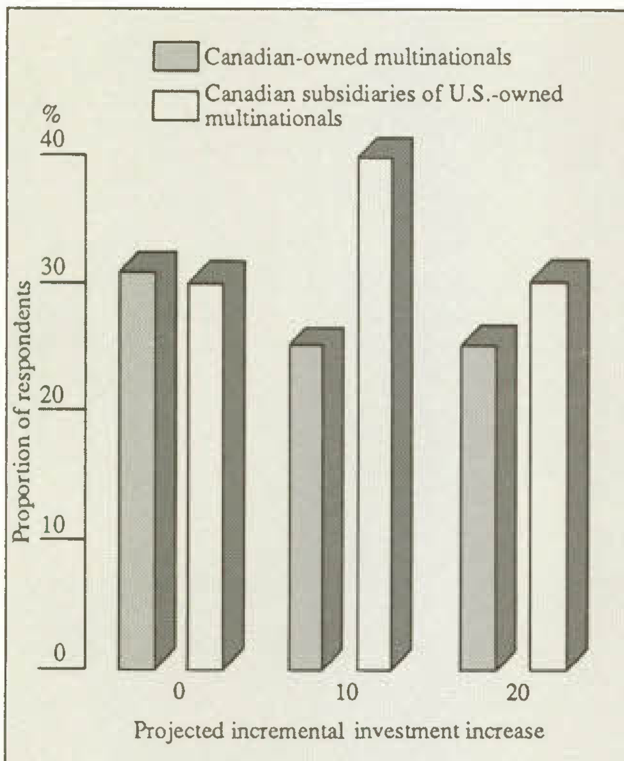
In combination with Simulation 2, this could mean that by 1998 Canada's gross output could be about 3.3 per cent, or over $20 billion, higher, in real terms, than in the base case. Real wage rates would be higher; prices would be slightly lower; and employment could rise by 370,000 jobs or by over 380,000 additional jobs, depending on the source of financing. Under this favourable scenario, the total government account would improve, assuming no major shifts in fiscal policy.

Simulation 5: Assuming the Agreement Is Not Implemented

The simulations described above are based on the premise that the agreement will be approved by both the Cana-

Chart 3

Average Investment Increase Projected by Multinationals with over $1 Billion in Assets, Canada[1]



1 Respondents were asked to estimate by how much investment by their company following the implementation of a bilateral free-trade agreement between Canada and the United States would, over a five-year period, be higher or lower than normal investment increases. The questionnaire was sent to 21 Canadian-owned multinationals and 22 Canadian subsidiaries of U.S.-owned multinationals. Four Canadian multinationals did not answer the question considered here.

SOURCE A. Rugman, "Trade liberalization and international investment," Economic Council of Canada, Discussion Paper (forthcoming).

dian Parliament and the U.S. Congress. But approval awaits an ultimate resolution of the debate between those for and against the present agreement, as well as consideration of appropriate legislation by both bodies. The agreement itself was designed to deal with a host of trade irritants on both sides of the border, while others were left pending. Through an exchange of letters, both sides reaffirmed their intention to exercise discretion during the period prior to implementation, "so as not to jeopardize the approval process or undermine the spirit and mutual benefits of the Free-Trade Agreement." But if the agreement is not implemented, those irritants, and others as well, will undoubtedly re-emerge for resolution and government action.

In our 23rd and 24th Annual Reviews, we expressed concern about the growing strength of U.S. protectionist sentiment, as reflected in the proposed omnibus trade bill or in the pressures to impose a tariff surcharge on imports (as the United States did in 1970), and about the possible implications of such moves for Canada. The mood in the U.S. Congress today appears somewhat less protectionist. The Congress is therefore unlikely to apply an across-the-board tariff surcharge on imports from all of its trading partners, right in the middle of the GATT negotiations. But it is quite likely to regard favourably new actions of some kind – countervailing duties, quantitative restrictions under the *Trade Expansion Act*, or negotiated voluntary export restraints.

A number of actions against Canadian exports have been envisaged in the United States should the free-trade agreement be rejected (see box). If undertaken and approved by the U.S. government (or renewed, in the case of shakes and shingles and steel), such initiatives could mean a loss to Canada of close to 450 million dollars' worth of exports. We realize that Canada would not be likely to lose in all of these particular cases, but we expect that, over time, other actions would be initiated.

In this more hostile trading environment, there is likely to be some increase in the outflow of equity capital from Canada and a slowing of the inflow, as firms decide to locate new investments in the United States, where there is less risk of harassment under U.S. trade laws. In recent years, Canada has been a net exporter of equity capital, with direct inflows averaging about $800 million and direct outflows ranging between $2 and $4 billion per year. We estimate that failure to ratify the agreement could increase that annual outflow by between $500 million and $1 billion. On the strength of this estimate, and taking the lower figure, we ran another simulation (Simulation 5), which combines a $500-million capital outflow with the effects of the U.S. trade actions. In comparison with the base-case projections for 1998, the results show a decrease in Canadian output and a loss of jobs. This simulation is, of course, indicative only, since the Congress has yet to act on the omnibus trade bill and since it is too soon to identify what other protectionist trade actions might be introduced in the coming years. Simulation 5 does illustrate, however, the downside risks if the agreement is not implemented.

The Effect of Exchange-Rate Changes

In all the cases simulated here, we have allowed the value of the Canadian dollar to respond to the events taking place within the model – that is, to changes in interest rates, in the

Potential U.S. Trade Actions against Canada, as of March 1988

Product:	Type of barrier expected from the United States	Potential loss of Canadian exports to the United States (Millions of C$)
Beef and veal	Global quotas	20
Fall-harvested white potatoes (Atlantic provinces)	Health standards (from Maine farmers)	5
Processed fish (Atlantic and Pacific regions)	Quotas	30
Potash (Saskatchewan and northern Ontario)	Pressure on Canada to further increase export prices (over and above the current agreement of 8 February 1988)	50
Uranium (processed)	Restrictions on enriched Canadian exports	20
Copper	Quotas and increased duties	3
Millfeeds and canola meal (exports to the U.S. Pacific Northwest)	Quotas	20
Cedar shakes and shingles	U.S. duty to be continued after expiry of current duty in January 1991	50
Electricity	Quantitative restrictions (under Section 232 of the U.S. Trade Expansion Act through petition by U.S. mideastern coal interests)	40
Specialty steel	Voluntary export restraints to be continued after 1 October 1989	200
Automobiles	Countervailing duties against Canadian duty-remission programs to third countries	10
Total		448

SOURCE Magun, Rao, Lodh, Lavallée, and Peirce, "Open borders."

relative rates of inflation, and in cross-border capital and trade flows. In our most likely case (Simulation 2), the net effect of the free-trade agreement is to increase the value of the dollar over the base-case estimate in 1998 by about 3 cents (because Canada's inflation rate falls by more than the U.S. rate, and capital flows increase). The current strength of the Canadian dollar probably already reflects the market's anticipation of benefits from the agreement.

We have tested the sensitivity of all of our results to either an appreciation or a depreciation of the exchange rate, caused by factors other than the trade agreement – for example, an anticipated rise in commodity prices or changing expectations in financial markets. These sensitivity tests indicate that fluctuations in the value of the dollar have a strong effect on the rate of inflation and on the fiscal position of governments. Over the longer run, the impact of these fluctuations on the levels of overall employment and real disposable income is limited, but their effect on the distribution of income and on the mix of employment is significant. For example, a strong appreciation of the Canadian dollar puts a competitive strain on Canada's export indus-

tries, but by lowering the price of imports it increases real incomes, which tend to be spent domestically. The result of such a favourable shift in the terms of trade is a reduction in manufacturing activity and employment, which is more or less offset by increases in the service sector. Unfavourable shifts in the terms of trade and a significant depreciation of the dollar reverse the process, increasing the price of imports and encouraging import substitution and domestic manufacturing activity and employment, at the cost of lower real incomes and reduced service-sector activity and employment.

How helpful these additional simulations really are depends on how they are used and interpreted. While we have confidence in the econometric tools that our researchers have used, we share the general misgivings about the apparent precision and accuracy of econometric projections. Mathematics cannot fully capture reality; nor can today's analyst foretell the future in all its complexity. Nevertheless, the simulations tell a consistent story. The implementation of the free-trade agreement will encourage increased economic growth and employment in Canada. If business responds by increasing autonomous investment, the gains from trade will be substantially higher. In contrast, failure to ratify the agreement would have a dampening effect on the economy. Just how negative that impact would be would depend on the strength of U.S. protectionism and the trade frictions that could potentially follow.

Industry Implications

To examine the effects of the agreement on Canadian industry at a more disaggregated level, we relied on what we described as the most likely outcome, derived from Simulation 2. A comparison of that estimate with Simulation 1 underlines the importance of industry specialization and rationalization. It indicates clearly that, without improvements in Canadian manufacturing productivity, increased U.S. competition could result in a net decline of output and employment in 17 of the 36 industries studied, virtually all of them in manufacturing (Table 2).

And while the losses in manufacturing output and employment are more than balanced by projected increases in other sectors, the figures show clearly that if Canadian manufacturing firms are to prosper in a free-trade environment, they must be prepared to modernize their plants and to upgrade the skills of their work force. Some firms will have to merge; others will have to close. As projected in Simulation 1, for example, one industry – the electrical products industry – would account for 40 per cent of all the job losses in manufacturing: the output of electrical products is projected to fall by 15 per cent, and employment by 8 per cent. As shown in our 24th Review, 76 per cent of the more than 1,000 plants in this industry are operating at less than the minimum efficient scale. The industry is being severely tested by imports and by technological change; already, there have been a number of mergers and plant reorganizations and closures. Indeed, employment projections for the period 1981-95, which we published last year in *Innovation and Jobs in Canada*, showed the industry's work force dropping by half, quite independently of the trade accord. This suggests that if electrical-goods producers make effective use of new technologies, the trade agreement will help them to meet the competition that is threatening their future: the agreement will increase domestic demand for electrical products and create new opportunities in the U.S. market.

Simulation 1 shows which industries will have to adapt in response to the trade agreement, while Simulation 2 shows what the impact could be, once firms have reorganized and/or modernized their operations. With the appropriate adjustment and rationalization assumed in Simulation 2, most Canadian industries (29 out of the 36 that we studied) are expected to benefit from bilateral free trade. The service sector, the primary industries, and construction are likely to account for over 90 per cent of the gains in employment. Indeed, in response to increased domestic demand, five service industries alone – retail trade; wholesale trade; finance, insurance, and real estate; personal services; and business services – are projected to contribute close to 54 per cent of all the new jobs. Manufacturing will probably account for only one-tenth of the increase in real output and for less than 8 per cent of the increase in employment resulting from the agreement. Within the manufacturing sector, 13 out of the 20 industries are likely to enjoy increases in output and employment, once firms have geared up to take advantage of the deal.

The wood, primary metals, and printing and publishing industries are prominent among those in manufacturing which would benefit the most from free trade. Wood and primary metals would benefit from the removal of U.S. nontariff barriers on Canadian exports of shakes and shingles and of steel products. The printing and publishing industry would receive substantial benefits from the positive indirect effects of free trade on real incomes and consumer expenditure.

Although nondurable manufacturing industries would, on average, benefit more from bilateral free trade than the durable manufacturing industries, six of the seven manufacturing industries that could be adversely affected by increased U.S. imports are in the nondurable segment (rubber

Table 2

Estimated Impact[1] of the Canada-U.S. Free-Trade Agreement on Output and Employment, by Industry, Canada, 1998

	Output				Employment			
	Amount in millions of 1981 $		Percentage change		Number in thousands		Percentage change	
	SIM.1	SIM.2	SIM.1	SIM.2	SIM.1	SIM.2	SIM.1	SIM.2
Primary sector:								
Agriculture	124	327	0.8	2.2	2.0	7.2	0.5	1.8
Forestry	8	35	0.3	1.1	0.1	0.7	0.1	0.5
Fishing, hunting, and trapping	6	10	0.7	1.2	0.1	0.3	0.4	0.9
Mining	120	433	0.4	1.6	1.8	5.0	0.6	1.7
Total	258	805	0.6	1.8	4.0	13.1	0.5	1.5
Manufacturing sector:								
Food and beverages	145	376	1.2	3.2	2.1	6.4	0.7	2.0
Tobacco products	–5	1	–0.7	0.1	– –	– –	–0.4	0.1
Rubber and plastics	–364	–95	–9.4	–2.5	–4.5	–1.6	–4.7	–1.7
Leather	–40	–16	–8.4	–3.4	–1.0	–0.6	–3.7	–2.1
Textiles	–281	–76	–12.2	–3.3	–3.5	–1.3	–5.6	–2.1
Knitting mills	–57	–16	–12.6	–3.5	–1.4	–0.5	–7.1	–2.6
Clothing	– –	47	– –	2.2	– –	1.6	– –	1.7
Wood	78	113	1.5	2.2	1.0	2.0	0.8	1.6
Furniture and fixtures	–44	15	–3.3	1.1	–1.0	0.5	–2.0	0.9
Paper products	–103	86	–1.0	0.8	–1.0	1.0	–0.6	0.6
Printing and publishing	178	421	3.3	7.8	2.6	8.4	1.9	6.1
Primary metals	434	337	6.7	5.2	4.6	5.0	2.7	2.9
Metal fabricating	–224	85	–3.6	1.4	–2.9	1.4	–2.1	1.0
Machinery	–235	66	–3.3	0.9	–2.0	0.8	–1.6	0.7
Transportation equipment	–177	36	–1.6	0.3	–1.2	0.6	–0.6	0.3
Electrical products	–870	–268	–14.6	–4.5	–10.7	–4.5	–8.0	–3.4
Nonmetallic minerals	–45	79	–1.6	2.7	–0.6	1.1	–0.9	1.6
Petroleum and coal	–2	9	–0.3	1.3	– –	0.1	–0.2	0.8
Chemical products	–422	–50	–5.4	–0.6	–2.8	–0.4	–2.6	–0.3
Miscellaneous	–187	–31	–9.7	–1.6	–3.7	–0.9	–5.8	–1.4
Total	–2,221	1,119	–2.4	1.2	–26.0	18.9	–0.1	0.9
Construction	1,159	2,070	3.8	6.8	15.0	37.5	2.0	5.1
Service sector:								
Transportation and storage	315	708	0.9	2.1	3.0	8.8	0.6	1.8
Communications	–162	28	–1.1	0.2	–0.8	1.2	–0.3	0.4
Utilities	180	406	1.0	2.2	0.6	2.0	0.4	1.3
Wholesale trade	463	790	1.7	3.0	6.7	15.7	1.0	2.3
Retail trade	1,003	1,357	2.9	4.0	32.1	59.6	1.7	3.1
Finance, insurance, and real estate	963	1,801	2.1	3.8	12.7	30.3	1.3	3.0
Business services	305	656	1.4	3.0	6.9	20.0	0.4	1.2
Health and education	186	306	1.8	2.9	2.5	5.9	1.5	3.5
Amusement and recreation	126	171	3.7	4.9	2.4	4.6	0.9	1.7
Food and accommodation	401	586	2.8	4.1	11.8	23.6	1.1	2.1
Personal and other services	82	126	0.5	0.8	5.1	10.3	0.3	0.7
Total	3,862	6,935	1.4	2.6	83.0	181.8	0.8	0.2
All sectors	3,060	10,930	0.7	2.5	76.0	251.3	0.5	1.8

1 Measured as the change from the levels estimated for the base case, which describes what would happen if there were no change in the Canada-U.S. trading relationship. The two simulations are defined as follows:
SIM.1: Removal of trade barriers
SIM.2: SIM.1 plus productivity gains.

SOURCE Magun, Rao, Lodh, Lavallée, and Peirce, "Open borders."

and plastic products; leather products; textiles; knitting mills; chemicals and chemical products; and miscellaneous manufacturing). Because these industries now enjoy substantially higher protection than their U.S. counterparts, they would face important structural adjustments. The furniture and fixtures, metal fabricating, and machinery industries also get more trade protection in Canada than in the United States, but the stimulus of industrial rationalization and heightened domestic and foreign demand would more than offset any negative direct effects.

Overall, the net increase in manufacturing output and employment of the 13 industries favourably affected by the Canada-U.S. Free-Trade Agreement outweighs the losses of the seven that are adversely affected. Net employment gains in the former are expected to number around 30,000 (spread over the 10-year period), while net employment losses in the latter will probably be around 10,000 (out of their current work force of about 600,000).

These aggregate industry impacts do not, of course, provide a detailed view of the winners and losers in the new trade environment. Within each industry there are various segments, many of which produce a variety of products; some of them will be favourably affected by the agreement, while others may have to retrench. Within the leather industry, for example, Canadian producers of cross-country ski boots, women's winter boots, workers' boots, and high-priced casual shoes will likely do well in a free-trade environment. Similarly, Canadian high-fashion textile and wool producers will benefit from free trade, whereas producers of man-made fibres and cotton will be at risk. In the chemical industry, producers of petrochemicals and fertilizers (including potash) are expected to perform well, whereas producers of organic and inorganic chemicals will likely experience severe adjustment pressures.[5]

In a similar vein, there are potential losers within some industries that are projected to benefit from free trade, such

Table 3

Difference in Projected GDP between the Base Case and Simulation 2, Canada-U.S. Free-Trade Agreement, Canada, by Province, 1998

	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia	Canada[1]
	(Millions of 1981 $)										
Primary industries	12	3	14	8	62	99	29	96	377	84	805
Manufacturing											
Durables	1	--	4	6	89	201	16	8	41	99	463
Nondurables	15	4	16	23	173	249	37	15	39	86	656
Construction	40	8	49	49	473	607	68	96	395	264	2,070
Services	78	20	154	132	1,595	2,574	295	260	985	821	6,935
Total difference	146	35	236	218	2,392	3,731	445	474	1,837	1,354	10,930
	(Percentage points)										
Contribution of:											
Primary industries	0.22	0.25	0.15	0.09	0.06	0.06	0.17	0.55	0.56	0.16	0.18
Manufacturing											
Durables	0.02	--	0.04	0.07	0.09	0.12	0.09	0.05	0.06	0.19	0.11
Nondurables	0.28	0.33	0.18	0.27	0.18	0.15	0.22	0.09	0.06	0.17	0.15
Construction	0.74	0.66	0.54	0.58	0.49	0.38	0.40	0.55	0.59	0.51	0.47
Services	1.45	1.65	1.70	1.56	1.64	1.59	1.75	1.50	1.47	1.60	1.59
	(Per cent)										
Total difference	2.71	2.89	2.61	2.57	2.46	2.31	2.63	2.73	2.74	2.64	2.50

1 Includes the Yukon and Northwest Territories.

SOURCE Magun, Rao, Lodh, Lavallée, and Peirce, "Open borders."

Table 4

Difference in Projected Employment between the Base Case and Simulation 2, Canada-U.S. Free-Trade Agreement, Canada, by Province, 1998

	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia	Canada[1]
	(Number of persons)										
Primary industries	230	115	554	246	1,532	2,918	504	1,013	3,996	1,672	13,107
Manufacturing											
Durables	12	--	124	181	1,545	2,456	205	86	416	1,702	6,727
Nondurables	399	81	253	373	3,046	4,728	733	329	892	1,268	12,208*
Construction	872	218	1,145	1,036	8,668	11,176	1,581	1,527	7,142	4,034	37,454
Services	2,517	484	4,605	4,258	43,286	73,569	8,725	5,624	18,140	20,208	181,805
Total difference	4,030	898	6,681	6,094	58,077	94,847	11,748	8,579	30,586	28,884	251,301*
Contribution of:	(Percentage points)										
Primary industries	0.11	0.26	0.16	0.08	0.05	0.05	0.08	0.23	0.27	0.11	0.09
Manufacturing											
Durables	0.01	--	0.03	0.06	0.05	0.04	0.03	0.02	0.03	0.11	0.05
Nondurables	0.19	0.18	0.07	0.12	0.09	0.08	0.12	0.07	0.06	0.08	0.09
Construction	0.42	0.49	0.32	0.33	0.26	0.20	0.27	0.34	0.49	0.26	0.27
Services	1.22	1.09	1.30	1.35	1.31	1.32	1.46	1.26	1.23	1.28	1.30
	(Per cent)										
Total difference	1.95	2.02	1.88	1.93	1.75	1.70	1.97	1.93	2.08	1.83	1.80

* Includes 106 persons employed in the petroleum and coal products industry for whom the provincial allocation could not be determined.
1 Includes the Yukon and Northwest Territories.
SOURCE Magun, Rao, Lodh, Lavallée, and Peirce, "Open borders."

as the food and beverage industry and the furniture industry. In the food and beverage group, some segments of the food-processing industry (particularly fruit, vegetable, and confectionary processors) and wineries are expected to face tough competitive pressures, as tariffs and nontarriff barriers are eliminated.[6] Similarly, manufacturers of household furniture are likely to experience more difficulty than those who specialize in office furniture.

Provincial Impact

The impact of free trade on individual provinces is largely shaped by the profile of their industrial activities. In fact, according to our most likely estimate, all provincial economies will experience increases in output and employment under the Canada-U.S. Free-Trade Agreement. Most of the employment gains are expected to occur in the service sector, where activity and employment are distributed fairly evenly across the country (Tables 3 and 4).

In relative terms, the eastern and western provinces will probably gain more than Quebec and Ontario. This reflects the importance of the primary industries that will benefit from the removal of U.S. trade barriers (especially the NTBs on shakes and shingles, and on the products of agriculture and fishing); strong gains are also expected in construction and in energy and other industrial projects. On the other hand, as we have seen, the picture for manufacturing, while positive overall, is mixed, owing in part to the failure to get broad access to U.S. government procurement. As a result, the relative output and employment gains for Quebec and Ontario, where much of manufacturing is concentrated, are likely to be slightly below the national average.

Employment and Adjustment

The occupational distribution of the potential employment gains follows from the industrial split. Under the most

likely scenario, a number of major occupations in the service sector – clerical; sales and services; and managerial and administrative – will dominate, accounting for close to 148,000 new jobs. Free trade will add about 37,500 jobs in the construction industry, with the rest split mainly between manufacturing and the primary industries. As for the difference in impact between men and women, quantitative estimates become more precarious, especially at the occupational level, since they apply today's employment gender split to the future. Nonetheless, it appears from Table 5 that the job gains will be divided between men and women in roughly the same 60/40 ratio that is found in the labour force today.

Adjustment to the agreement will take time. The extra potential employment amounts to a net average gain of 25,000 jobs to the economy in each of the next 10 years. This compares with the increase of 250,000 to 350,000 jobs that normally occurs annually. The overall figures, of course, mask a process of layoffs in some sectors or communities and of re-hirings or hirings elsewhere.

Table 5

Projected Net Jobs Created as a Result of the Canada-U.S. Free-Trade Agreement (Simulation 2), by Occupation and Sex, Canada, 1998

	Both sexes	Female	Male
	(Thousands)		
Managerial and administration	16.7	4.4	12.3
Natural sciences	4.3	0.7	3.6
Social sciences	1.8	1.0	0.8
Religion	0.4	0.1	0.3
Teaching	5.9	3.5	2.4
Medicine and health	6.6	5.0	1.6
Art and literary	4.4	1.7	2.7
Clerical	51.8	41.6	10.2
Sales	43.2	18.5	24.7
Service	36.5	22.0	14.5
Farming	8.4	1.7	6.7
Fishing	0.4	--	0.4
Forestry	0.6	--	0.6
Mining	2.1	--	2.1
Processing	6.8	1.2	5.6
Machining	3.5	0.1	3.4
Product fabrication	12.4	0.8	11.6
Construction	28.1	0.4	27.7
Transportation equipment	5.7	0.3	5.4
Materials handling	4.0	0.8	3.2
Other crafts	4.5	1.1	3.4
Not classified	3.0	0.4	2.6
All occupations	251.3	105.5	145.8

SOURCE Magun, Rao, Lodh, Lavallée, and Peirce, "Open borders."

Job-turnover rates vary quite significantly depending on the activity. Drawing on past experience, we have nonetheless estimated the numbers of jobs that will be created and lost as employers adapt to the new circumstances (Table 6). We emphasize *job* turnover as distinct from *labour* turnover, since in certain types of jobs – particularly those in which students and young people are employed – worker turnover is common. Our calculations suggest that the estimated net gain of 251,000 jobs results from about 439,000 jobs being created and 188,000 jobs being destroyed over the 10-year span. Set against the number of jobs that appear and disappear each year under the impetus of competitive realities, technological shifts, changes in consumer taste, and so on – or against the 3 million new jobs that will be filled during the same period, as the labour force grows – these are not large numbers.

In our Statement, *Managing Adjustment*, for example, we found that roughly 8 per cent of all jobs in the manufacturing sector disappear each year because of plant closure or rationalization. These losses are offset by job creation in other businesses that are just starting up or expanding. The annual job-loss rate derived from Table 6 would add 0.5 percentage points to the normal rate of job loss in manufacturing.

That is not meant to suggest that losing one's job is a painless experience. Some of the people displaced will be those with years of experience, with families and homes, and with pension entitlements and skills that may or may not be easily transferable.

Conclusion

In this section we have presented new simulations based on the free-trade agreement signed a few months ago. Then, we considered its industry and provincial implications and its employment effects. In all four of the cases presented, the impact of the Canada-U.S. trade agreement is positive for output, employment, and the incomes of Canadians. In our "most likely" case (Simulation 2), we anticipate that real activity in 1998 could be 2.5 per cent higher than the figure projected in our base case, in which there is no change in Canada-U.S. relations.

We recognize, however, that without a trade agreement, Canada would be vulnerable to a setback in exports and in

Table 6

Projected Employment Flows Resulting from the Canada-U.S. Free-Trade Agreement (Simulation 2), by Industry, Canada, 1998

	Jobs created	Jobs lost	Net job gains
	(Thousands)		
Primary sector:			
Agriculture	10.9	3.8	7.2
Forestry	6.8	6.2	0.7
Fishing, hunting, and trapping	1.6	1.3	0.3
Mining	10.4	5.5	5.0
Total	29.8	16.7	13.1
Manufacturing sector:			
Food and beverages	13.0	6.6	6.4
Tobacco products	--	--	--
Rubber and plastics	2.4	4.1	-1.6
Leather	0.2	0.8	-0.6
Textiles	0.7	2.0	-1.3
Knitting mills	--	0.5	-0.5
Clothing	4.4	2.8	1.6
Wood	8.3	6.3	2.0
Furniture and fixtures	2.2	1.7	0.5
Paper products	5.4	4.5	1.0
Printing and publishing	10.7	2.2	8.4
Primary metals	9.4	4.4	5.0
Metal fabricating	7.9	6.5	1.4
Machinery	8.2	7.3	0.8
Transportation equipment	14.2	13.7	0.6
Electrical products	1.0	5.5	-4.5
Nonmetallic minerals	2.7	1.7	1.1
Petroleum and coal	0.4	0.3	0.1
Chemical products	2.5	2.9	-0.4
Miscellaneous	1.4	2.3	-0.9
Total	95.0	76.1	18.9
Construction	39.6	2.2	37.5
Service sector:			
Transportation and storage	16.2	7.4	8.8
Communications	2.9	1.7	1.2
Utilities	4.6	2.6	2.0
Wholesale trade	25.7	10.0	15.7
Retail trade	68.2	8.6	59.6
Finance, insurance, and real estate	38.1	7.8	30.3
Business services	60.4	40.4	20.0
Health and education	6.1	0.3	5.9
Amusement and recreation	5.7	1.2	4.6
Food and accommodation	27.8	4.1	23.6
Personal and other services	19.0	8.7	10.3
Total	274.7	92.8	181.8
All sectors	439.1	187.8	251.3

SOURCE Magun, Rao, Lodh, Lavallée, and Peirce, "Open borders."

capital flows as a result of new trade actions by U.S. firms or of more-protectionist legislation adopted by the U.S. Congress. This could well impair Canada's growth prospects and at least temporarily sour relationships with our neighbour.

The dislocation and adjustment set in train by the trade agreement will certainly be important for the people involved. But that impact is rather modest when compared with that of other shocks that have hit the economy over the past 15 years. The energy price shocks of the 1970s, the decline in commodity prices since 1981, and the depreciation of the Canadian dollar from 1982 to 1987 all caused upheavals for particular industries and communities that easily surpass the year-to-year effects that we have identified in our simulations.

Thus, from our calculations it certainly appears that the net effects of the agreement with the United States are on the positive side of the ledger. We do acknowledge, however, that the ultimate judgment on the trade agreement should be based on an evaluation of a broader set of issues – its impact on institutions, on trade laws, and on Canada's ability to cope with the broader aspects of international competition. These are issues that we examine in the final section of this Statement.

5 Assessing the Agreement

An American poet, Cid Corman, has written:

It is hard to be anywhere once
And twice is a dream.

Indeed, history seldom offers more than one time and one place. Canada and the United States have negotiated what, in our view, is a timely, historic, and mutually beneficial treaty. Once ratified and implemented, it will encourage a process of industrial adaptation, resource allocation, and investment in infrastructure that will not easily be reversed. It will likely lead to further developments in trade rules and, potentially, to initiatives at the multilateral level to promote further trade liberalization.

The Council's Criteria

In our 24th Annual Review, we identified four criteria for assessing the agreement (p. 61). We said, first, that *in providing freer access to U.S. markets, it must take account of state and local barriers, as well as federal* – and, by

inference, provincial and local barriers in Canada. In the actual agreement, tariff barriers at the federal level are to be eliminated fully in both countries; and some nontariff barriers – fewer than we had hoped for – are also to be dropped. In retrospect, however, our expectations for the provincial/state and local restrictions were somewhat unrealistic, for each country naturally had to adapt its negotiating agenda to its own jurisdictional situation. But there is no question that the negotiators took at least some of these barriers into account. Indeed, the agreement has already given some impetus to action, at least in Canada; and provincial Premiers recently acknowledged the need to lower interprovincial barriers.

Second, we said that *it must clearly identify areas of policy, trade, and investment that are non-negotiable, as well as domestic institutions, laws, and regulations that are beyond the reach of countervailing action.* By that, we had in mind Canada's social policies, as well as the cultural institutions and programs used to promote regional growth and opportunity. These were, in fact, excluded from the agreement.

Third, *it must contain clear definitions of subsidies that are countervailable, and of those that are not because they fall under the present GATT definitions of noncountervailable subsidies.* The agreement requires that each party abide by the GATT Subsidies Code, and it commits both countries to negotiating an agreement on new, mutually acceptable trade rules within five to seven years.

Fourth, *it should contain a dispute-settlement mechanism that would deal with trade irritants quickly and impartially.* That objective has largely been met.

In short, the document goes a long way towards achieving Canada's major objectives. On tariffs, it follows a continuum of reductions to the point where they are finally eliminated; on rule making, it goes far beyond previous agreements of this sort – primarily because of pressure from Canada to protect its interests as the smaller partner.

Canadian Concerns

In our view, both Canadians and Americans will be well served by the agreement. The tariff barriers between the two countries will be eliminated, and national treatment will be provided in investment, in traded goods and a range of services, and in some limited areas of federal procurement. Each government has preserved its right to regulate in prudential and fiduciary matters, as well as in the areas of health and safety and of environmental and consumer protection, among others, provided only that domestically owned and foreign-owned enterprises are treated equally. This means that investors may undertake their long-run investment strategies in each country without risk of discriminatory treatment.

We recognize that many Canadians have deep reservations about the agreement. Some have expressed concern that it could lead to the exodus of many Canadian subsidiaries of U.S.-owned corporations, which originally established themselves in Canada to avoid Canadian tariff barriers but which could, under free trade, profitably supply the Canadian market from the United States. Our research shows that the agreement is unlikely to trigger the departure of many subsidiaries. Some will leave if it is more efficient to do so, but because most of them have various sunk costs in this country, they will rationalize their Canadian production to focus on one or a few North American or world product lines. Indeed, a review of what took place after the *Kennedy* and *Tokyo Rounds* suggests that the decisions to maintain, expand, or contract production are shaped more by market opportunities, technology changes, and the relative prices of the factors of production than by tariff barriers or their reduction. The conclusion of our recent Statement on *Managing Adjustment* was that

> in industries experiencing rapid trade growth . . . the affiliates of U.S. multinationals in Canada have grown (in terms of exports and employment) relative to those in other developed countries. . . . Often, these are R&D-intensive industries . . . that many hope will provide the high-quality jobs desired by Canadians. At the same time, Canadian affiliates of U.S.-owned firms have become less important in industries experiencing slower trade growth. [p. 17]

In fact, employment by U.S. multinationals in Canada has been the strongest in those industries where trade barriers have been falling. In short, there is little evidence to support the idea that the agreement will lead to the "de-industrialization" of Canada or to the exodus of manufacturing and other jobs from this country.

Others are concerned that easing Investment Canada's threshold-review powers could unleash a wave of U.S. take-overs and investments in Canada that could undermine Canadian sovereignty. That is the other side of the fear that Americans may close down their Canadian branch plants and repatriate their capital: the worry is that U.S. investors may be just waiting to acquire control of Canadian firms and to invest in a whole variety of enterprises that contribute to Canada's output and employment growth. For the past decade, however, the net flows of equity investment have been from Canada to the United States.

Investment Canada may have been perceived by some U.S. investors as a barrier to direct investment in Canada. But even at the lower review thresholds that now exist, that agency has never rejected a proposed investment. Under the trade agreement, with the exception of certain performance requirements (with respect to local content and exports, for example), the present criteria for evaluating large acquisitions can still be used. In addition, Investment Canada retains its existing full right to review acquisitions in the sensitive investment areas of energy, transportation, and culture.

We expect to see a continuing two-way flow of direct investment, based on potential rates of return offered by specific investment projects. The longer-term prospects for expanded U.S. purchases of Canadian energy suggest strong investment – Canadian, foreign, or both – to expand Canada's bitumen and frontier oil and gas reserves and hydro-electric potential, with accompanying investments in supporting industries. As well, the guarantee of national treatment for Canadian investments in the United States will facilitate a continuing flow of Canadian capital towards our neighbours to the south.

A third area of concern is that the agreement will give rise to pressures that could eventually reduce or alter Canada's social and regional development policies, in order to bring them into line with U.S. practices. Both countries were at pains to remove their social programs from the negotiations and to grandfather the various consumer-oriented or socially focused legislation and regulations governing commercial transactions. As a nation with a long tradition of working for social and regional balance, Canada must always ensure that its trade policy does not diminish its ability to assert a unique Canadian concern for all of its citizens.

There is, therefore, no reason to think that free trade can be used to alter or undermine Canada's unemployment insurance, medicare, or other programs fundamental to the social safety net. Rather, by strengthening economic growth and employment in Canada, the free-trade agreement will increase government revenues and improve the ability of governments to address social issues. Canada also resisted U.S. efforts to bring culture, regional incentives, or intellectual property into the negotiations, just as U.S. negotiators were careful to guard their own sensitive areas, such as transportation and fisheries.

Of course, individual U.S. firms or lobbies may continue to claim trade injury because of one or another of Canada's social programs. But this is not a new phenomenon, and for the most part the resulting cost differentials form a minor component of the competitiveness of firms on either side of the border. The agreement alters the situation in two ways: first, it provides a relatively impartial dispute-settlement mechanism; second, until new trade laws are worked out, the present GATT definitions of subsidies, which explicitly exclude social policies, will continue to apply.

Issues where the actions or omissions of one government offend the other (in areas such as acid rain or the compulsory licensing of drugs, for example) will continue to be the focus of bilateral discussion, free-trade agreement or no agreement.

Indeed, the historical record shows no support for the view that increasing trade interdependency calls for the elimination or harmonization of social policies. Canada-U.S. trade interdependency has grown rapidly over the past four decades, but the differences between the two countries with respect to social programs and to their treatment of the unemployed, the poor, the sick, and the elderly have, if anything, increased. Nor has the growth of commerce within the European Community and the European Free Trade Association led to harmonized social policies. Rather, the heightened prosperity resulting from increased trade and specialization has allowed governments more flexibility in how they design and deliver social programs.

Another strongly held concern is that the trade agreement may limit Canada's (or the United States') national sovereignty, particularly in the ability of its government to adopt industrial strategies that steer the economy in a new direction. A number of clauses in the agreement are seen as reducing the degree of freedom of the two governments. Among them are the provisions

- to guarantee national treatment;
- to remove impediments to private investment;
- to eliminate certain performance requirements for foreign investors;
- to commit both countries to removing agricultural licensing and import restrictions;
- to eliminate export taxes or licensing on energy products and to ensure continuity of energy supply; and
- to establish a variety of working groups to harmonize standards and competitive arrangements.

Some may regard these provisions as conceding too many hostages to market decisions. To others, these measures are

the very essence of a mutually beneficial trade-liberalizing agreement. They remove nationally imposed trade barriers that segment markets, shelter inefficient producers, and distort or impede investment decisions. Their elimination will promote more-efficient commercial relationships between the two countries and greater prosperity within each nation. Each government retains full control over its own political agenda and its own monetary and fiscal decisions. Moreover, in the final analysis, each nation's sovereignty is enunciated by the right to abrogate the free-trade agreement upon six months' notice or, alternatively, to continue to negotiate for changes in its structure, incidence, and application.

Finally, a major concern among many Canadians has to do with the numbers of workers who will be displaced from their current employment and with the prospect of their finding more satisfying, more remunerative alternative jobs. Such fears are natural, particularly in areas of industrial and economic vulnerability, where other job opportunities are scarce. It is important, however, to provide some perspective on this matter of adjustment. Over the past 40 years, Canada has seen its tariff levels drop substantially, and yet it has enjoyed the most rapid rate of employment growth of any OECD member country. We have seen a transformation of industrial production in Canada from traditional smokestack activities employing relatively unskilled labour (activities that are increasingly becoming the domain of the newly industrializing countries) into more-specialized, information-based, high-tech industries. True, this process will continue whether or not the trade agreement is implemented. But with the agreement in place, the opportunities made available by the larger market will hasten the transformation to a high-value-added economy.

Our research shows there will be more jobs, not fewer. Our estimates in Section 4 show that the trade agreement could add one-half of 1 per cent to the number of permanent layoffs that typically occur in manufacturing in a year. At the same time, the new jobs created through increased sales and investment would outnumber the jobs lost by a ratio of two to one. Of course, governments must be willing to support the efforts of labour and business leaders (and community groups) to work out ways to ease the adjustment and to facilitate the retraining and re-employment of workers whose jobs are at risk.

Adjustment Programs

The Council believes that adjustment programs should focus on workers. In *Making Technology Work*, we called on both levels of government to review their existing programs or, if necessary, to consider new programs to ensure that those workers who are adversely affected by technological change will have adequate access to income support and to alternative training opportunities in keeping with their years of working experience. We reaffirmed the point in *Managing Adjustment*, where we recommended

> that labour adjustment policies adopted by government to assist workers in industries suffering the adverse consequences of international competition be part of general (or framework) policies designed to facilitate the adjustment of workers to changing economic times and conditions. [p. 36]

This means, in the case of firms that are closing down, early notification and use of the Industrial Adjustment Service (IAS) of Employment and Immigration Canada, along the lines suggested in *Making Technology Work*. It is worth noting that the IAS has proved particularly effective on the upside of employment adjustment in helping new or expanding firms find suitably trained workers. Where single-industry towns are faced with closure or massive layoffs, the Community Futures program within the Canadian Jobs Strategy should come into play. And in cases of layoffs that occur gradually as firms restructure and revamp their product lines or services, there are the regular placement and training services offered by Canada Employment Centres. While we have not had an opportunity to measure the effectiveness of these programs and services, one of the tasks of the recently appointed Advisory Council on Adjustment, chaired by Mr. Jean de Grandpré, is to evaluate their adequacy in helping those who are trade-displaced.

In researching the adjustment issue, we have examined the trade-related labour adjustment programs introduced by the federal government in the past, dating back to the post-*Kennedy Round* tariff cuts in 1965. They have generally taken two forms: enrichment of existing programs targeted at the unemployed (especially unemployment insurance); and income maintenance for older workers. A few were community-based, but most were industry-based. While these programs had admirable objectives, they do not, in our view, set a good example for the adjustment problems that we now face. First, we do not think that in the current environment it is possible to distinguish the workers displaced by the consequences of the Canada-U.S. agreement from those displaced by technology or by new competition from developing countries. Second, even if we could identify the workers directly affected by the agreement, we do not believe they should be treated differently from those whose employment is disrupted by technology or by the emergence of a new competitor. All of our research leads us to believe that labour market programs should be general in their application and should be designed to meet the needs

of the workers who face the most difficulty in finding and holding a new job. The most disadvantaged workers in Canada are older workers, people with low education, and those who live in small, remote communities. These people and communities should be the main targets of government adjustment programs.

We again wish to point out what a critical role training and other labour adjustment policies will play in the years ahead. Table 7 identifies the main federal programs that were or are now available. It is significant that, when unemployment insurance is included, Canada spends more, as a percentage of GDP, on labour market policies than almost all other OECD nations. The irony is that among those countries whose expenditure commitments to labour market adjustment are comparable – West Germany, Austria, and Sweden – the predominant share goes to skill training, job creation, or other productive activity. In Canada's case, over 85 per cent is devoted to income-support payments to persons who are without work. Surely we can do better.

We also emphasize that the trade agreement should serve as a catalyst to management and labour to find new ways of dealing with adjustment problems – new models for decision making and new designs for the workplace. We are entering a period when industry will have to be both more agile and more efficient in order to cope with international competition. In *Making Technology Work,* we mentioned many aspects of organizational change that have been tested and proven by Canadian firms and their employees. Such mechanisms as the Canadian Steel Trade Conference and the new sectoral committees of the Canadian Labour Market and Productivity Centre can play a potentially important role. They can help labour and management to reach a mutual understanding of the global issues they face and to prepare for unavoidable adjustment problems.

Later this year, we expect to publish a Statement on regional development, aimed specifically at giving practical advice on how communities can cope with adjustment – how they can revitalize existing industries or replace them with locally generated economic activities that can survive in the market environment of the 1990s.

Over the Longer Term

As a small trading nation, Canada's external commercial policy must always focus on trade liberalization and on ways that will strengthen the multilateral trading system in order to ensure the best possible access to all markets. The Canada-U.S. trade agreement makes progress in this direction. It is consistent with our joint aims at the *Uruguay Round*; and in certain areas, it provides a positive example for the multilateral negotiations.

Table 7

Selected Labour Program Expenditures, Canada, 1986-87

	Annual expenditures	Per cent of total
	(Million $)	
Unemployment Insurance:		
Unemployment Insurance benefits[1]	10,159.0	85.1
Training[2]	236.9	2.0
Work Sharing	21.7	0.2
Job Creation	96.0	0.8
Less: overpayments and		
cancelled warrants	(86.3)	(0.7)
benefit repayments	(33.8)	(0.3)
Total	10,393.5	87.1
Canadian Jobs Strategy:		
Job Development	834.2	7.0
Job Entry		
– Challenge '86	117.6	1.0
– Other Job Entry	228.3	1.9
Skill Shortages	185.0	1.5
Skill Investment	48.8	0.4
Community Futures	64.1	0.5
Innovations	14.8	0.1
Other related programs	50.0	0.4
Total	1,542.8	12.9
Grand total	11,936.3	100.0

1 Including regular, sickness, maternity, adoption, age 65, and fishing benefits.
2 Income support for trainees.
SOURCE Employment and Immigration Canada, *Annual Report, 1986-1987* (Ottawa, 1987).

As an industrialized country with high living standards, Canada has to move up the value-added chain. This means taking advantage of low-cost materials and components wherever they are available and adding Canadian knowledge and expertise through effective use of an educated work force and leading-edge technologies. By improving access to the U.S. market and by exposing Canadian firms to increased competition, the agreement provides a strong impetus for the revitalization of Canadian industry. It offers

a relatively stable and secure environment for change, where firms can plan and adjust to new competition and to the new opportunities from falling U.S. barriers. The alternative is likely to be a more fractious relationship and a "bumpier" adjustment to international competition, without the stimulus of tariff reductions. As we said in our 24th Review, failure to ratify the agreement would be unfortunate but not catastrophic. "Fewer jobs," we said, "would be created than under a free-trade regime, and incomes would be lower, but the standard of living would nonetheless continue to improve." The alternative, then, "would not be the status quo but a tough and combative international marketplace." [p. 61]

Rules of Trade

The agreement makes a significant step in the direction of codifying Canadian and U.S. bilateral trade actions. The deal provides, for the first time, a mechanism for reviewing and amending domestic trade decisions and new trade laws. With the binational panels, both countries have a better chance of getting reasonably quick rulings, based on accepted international tests of trade distortions. The gains involve speed (compressing the review process from four years to less than one), reduced costs, less uncertainty and irritation, and greater fairness.

The negotiations that follow the agreement are particularly crucial for Canada. Clear, mutually accepted rules of trade will go a long way towards eliminating uncertainty and unnecessary litigation. In this respect, candour and transparency will be needed on both sides.

In previous publications – *The Bottom Line* (1983); *Minding the Public's Business* (1986); and *Managing Adjustment* (1987) – we examined in some depth the effectiveness of industrial subsidies in helping firms to get established, stay in business, modernize, promote R&D, reduce pollution, and so on. In addition, in our recent study of the taxation of savings and investment – *Road Map for Tax Reform* (1987) – we examined the adverse economic consequences of a corporate tax system that was riddled with a host of implicit subsidies in the form of tax credits, deductions, and allowances. In general, we believe that unless they are exceedingly well targeted and administered, most industrial subsidy programs (direct and indirect) provide little enduring economic or social benefit; yet they incur considerable costs to the nation. This view is widely held in the United States as well. Hence, if the agreement, as one of its ultimate accomplishments, limits the indiscriminate use of industrial subsidies that favour one country's producers over more-efficient producers in the other country, it will cause us no discomfort. We must emphasize, however, that this issue is quite different from that of the initiatives aimed at promoting regionally balanced economic growth and prosperity.

Canada's explicit policy of federal subsidies to promote regional economic and social development – a policy now being decentralized to regional agencies of the federal government – is well established. On more than one occasion, our regional subsidies have been cited in U.S. trade actions against Canada; such subsidies or grants will almost surely be included under the wider definitions that will appear in the U.S. omnibus trade bill. Yet GATT rules state very explicitly that trade-remedy laws cannot legitimately be invoked against social or industrial policies that are designed solely to cross-subsidize or redistribute income and employment among regions and citizens. They can be used only against policies in one country that discriminate against producers in another country and thereby influence the flow of international trade or investment.

On the other hand, many industrial subsidies in the United States take the form of tax incentives made available at state and local levels. Moreover, the United States uses its defence and domestic-procurement programs quite deliberately to promote industrial research and development, as well as specific state and regional objectives; indeed, it has been estimated that fully one-third of U.S. scientists and engineers are employed on military or related projects. Private corporations, particularly in the military and high-technology areas, benefit not only from having much of their initial research and development paid for by the U.S. government, but also from the commercial spinoffs that follow. This puts Canadian competitors at a distinct disadvantage. In future negotiations, getting greatly increased access to U.S.-government R&D expenditures should be a top priority for Canada.

Conclusion

At this juncture, the U.S. Congress has yet to take definitive action on either the Canada-U.S. Free-Trade Agreement or the omnibus trade bill. The House of Commons Standing Committee on External Affairs and International Trade, in its Report on the Elements of the Agreement, unanimously recommended that unless it is exempted from the application of the omnibus trade bill, Canada should withdraw its consent to the free-trade agreement. Certainly, if the omnibus bill, as eventually approved by the President, does in fact seriously impair the benefits to Canada of the bilateral accord, that would seem in order.

But if Canada were to repudiate the trade agreement, the United States would not likely renew negotiations without demanding major new concessions. Indeed, it is more likely that protectionist lobbies in the United States would succeed in having a host of trade actions taken against Canada. Many such actions are already in the administrative pipeline. Others have been called for – against Canadian farmers, fishermen, and forest and mineral producers; against our steel and energy industries; and against our textile and clothing firms.

Thus it seems fair to conclude that while Canada did not get everything it wanted from the agreement, the latter is an important step forward, provided that its benefits are not severely undermined by the omnibus trade bill. It sets the stage for more-harmonious trade relations between Canada and the United States. As time and future negotiations progress, we see scope for improvement from within the terms of the agreement itself. The track record of other trade agreements is worth observing in this respect. As the partners learned to work together, efforts were made to speed up the adjustment in tariffs and to improve the internal workings of the regional market.

The trade agreement has spawned debate in communities, workplaces, and schools, in boardrooms and union halls, and within this Council. It is natural that on these matters there are legitimate differences of view. While all the members of the Council, for example, hold that more-open borders between the United States and Canada are desirable as part of the process of global trade liberalization, some members do not approve of the agreement signed in January. They explain their views in the pages that follow. On the other hand, the majority of the members of Council are of the view that the agreement will set the framework for a stronger and more prosperous economy, and that there is still adequate room for Canadian governments to address unemployment and other urgent social issues through fiscal, regional, or other selectively targeted programs. Our analysis suggests that implementation of the accord will produce concrete economic gains; in addition, the agreement makes substantial headway in setting rules for a greatly enlarged two-way trade relationship.

Canadian enterprise has shown that it is ready to seize the challenge, to venture forth into the wider marketplaces of the United States and beyond. Canadians in general have learned a lot about themselves and about the United States in the past two and a half years, through months of negotiation and millions of hours of study, consultation, and debate. We believe that history will show that the efforts were well spent and that, in the longer run, Canada will become a stronger and more cohesive nation as a result of the trade agreement.

Note

As we go to press, we learn that the Canadian government has accepted the ruling by a GATT panel (referred to on p. 15 of this Statement) that provincial pricing, listing, and distribution practices discriminate unfairly against imported wines, spirits, and beer. The government has stated that it will commence discussions with the provinces, aimed at changing their practices with respect to wine and spirits. It will not now act upon the section of the ruling that pertains to beer.

Comment and Dissent

Comment by
Diane Bellemare and Kalmen Kaplansky

In this brief commentary, we would like to repeat the reservations we expressed at the time the 24th Annual Review was published, regarding the probable effects of a free-trade agreement with the United States.

We do not share the optimistic and confident tone of the Council's Statement, which, despite the fact that Canada has given up more in the area of tariff barriers than it has gained in terms of nontariff barriers, expresses full support for the free-trade agreement. There are many individuals and groups who oppose this agreement. Their reasons for doing so cannot all be wrong. The concerns that have been expressed deserve, in our opinion, more careful consideration than the Council has given them here.

As in the 24th Review, the economic forecasts presented in Section 4 of the Statement are based on the belief that, in a more competitive environment, Canadian businesses will be in a better position than in the past to adapt to world economic conditions. It is also assumed that falling prices for Canadian consumers will provide a boost to income and employment growth in Canada. But what about the economic impact on displaced workers whose incomes will be lower? None of the simulations presented in this document address the concerns expressed by certain groups in this regard. The scenarios all assume that investment will increase as a result of Canada's new appeal to investors because of the agreement. But what if events take a different course? What will happen if new investment declines because it is even more profitable to invest directly in the United States, for the very reasons discussed in Section 4?

In any event, the agreement, as it now stands, still seems to us fraught with uncertainties that can only be dispelled as its provisions are gradually implemented; thus we find it difficult to endorse it without reservations. First, it seems rash to state categorically, as is done on page 27, that the dispute-settlement mechanism will solve problems impartially, since conflicts in the area of antidumping and countervailing duties will be resolved on the basis of the laws of the country accused of violating the agreement. Does this not mean that a double standard will be applied? Second, since there is no clear agreement on what constitutes a legal subsidy, we are concerned that the independence of Canadian governments in the areas of social policy and economic, regional, and industrial development policy could be compromised. We cannot agree, therefore, as is stated on page 27, that these matters have been removed from the purview of the agreement.

Finally, we disagree with the argument advanced once again in this document that the free-trade agreement is the key to revitalizing the Canadian economy and that because it places Canadian businesses in a more competitive environment, it can only be beneficial to society as a whole. Even if the abolition of tariffs proves to be beneficial for certain companies in certain industries, we do not believe the free-trade agreement should be seen as a national blueprint for revitalizing the Canadian economy. It cannot take the place of a national strategy designed to encourage optimum utilization of our human resources. The role of freer trade should be to complement such a strategy in order to promote a better standard of living for all those willing to work.

Dissent by
Raymond Koskie

The publication of the Council's report, *Venturing Forth: An Evaluation of the Canada-U.S. Trade Agreement,* is politically charged and, in my view, inappropriate. The Council was established as an independent economic advisory body. Its mandate is to provide advice that may be useful in shaping future economic policy. It was not created to enter political controversies over policies already adopted by a government.

The Council has now entered the political debate about the trade deal already agreed to by the government. Any semblance of political impartiality is now gone. The endorsement of the government's trade deal leaves Canadians without an economic counsellor that is above the partisan fray.

* * * *

Not surprisingly, the Council's majority writes in support of the free-trade arrangement (FTA) with the United States.

The majority writes assuringly of more investment, more jobs, higher productivity, better-quality work, meaningful limits on U.S. protectionism, greater international and not simply bilateral trade, and improved standards of living. This wholehearted endorsement sidesteps the dangers and pitfalls of the agreement, and smacks more of a partisan campaign publication than an independent economic assessment.

The majority bases its optimism on the Council's econometric projections. Yet the majority admits to having "misgivings about the apparent precision and accuracy of econometric projections" (p. 21). Indeed, the record of econometric projections, particularly where the economy is being subjected to substantial shocks, is poor and provides no sound empirical basis for optimism. In any event, due to unknown human responses, it is difficult, if not impossible, for econometric models to predict:

- whether and how businesses and workers can increase productivity;

- whether businesses will specialize in certain goods and services;

- whether businesses will invest in modern technology; and

- how much interest rates, exchange rates, and oil prices will fluctuate.

Moreover, the Council's particular assumptions underlying its FTA projections are highly suspect. The Council sees two types of benefit from the FTA – decreased tariffs, leading to lower consumer prices; and increased manufacturing investment, leading to higher manufacturing productivity and improved exports.

The assumption that tariff reductions will be fully passed on to consumers in the form of lower prices is entirely unrealistic. Some part of the tariff reduction may be passed along, but some part will doubtlessly result in higher returns to the exporter, higher fees to the importer, and higher prices for the retailer. The assumption that reductions in tariffs will be fully passed on to consumers is naive and unrealistic. It yields projections which are misleading to the Canadian public. It cannot be relied upon.

Similarly, the assumption that Canadian manufacturers will respond to the FTA through "appropriate rationalization" is unsupported. The Council simply assumes, without a shred of hard evidence, that manufacturing productivity will increase by 0.6 per cent annually under the FTA. Naturally, such a positive assumption produces highly positive results, but those results are, with respect, useless.

The Council is simply playing a game with the Canadian public. It is not demonstrating – but rather is assuming – that lower prices and increased productivity will result from the FTA. Naturally, having assumed that the FTA would bring about lower prices and higher manufacturing productivity, the Council concludes that it would also create additional employment and higher growth. Once again, the Council has made assumptions about the FTA's impact on manufacturing productivity that Canadians logically and reasonably are entitled to expect it to prove. This, it has failed to do.

Remarkably, however, even these optimistic assumptions project relatively little employment creation. The Council summarizes its findings with the conclusion that "viewed in terms of annual changes or rates of change, the impact of the agreement is small but positive" (p. 17). Indeed, Simulation 1 projects the net creation of only 7,600 jobs per year between 1989 and 1998. Under Simulation 1, total GNE would only rise at a 0.07 per cent annual average rate to 1998 because of the FTA. Simulation 2, which assumes that Canadian manufacturing will make the "appropriate adjustments" to become more competitive under the FTA, projects annual average job creation of only 25,000 per year to 1998. These numbers are well below those published earlier by the Council and substantially reduce the anticipated benefits of the FTA even under optimistic assumptions.

More seriously, the Council's optimistic assumptions ignore the substantial risks of this FTA. Some of these are as follows.

Manufacturing

The Council's report acknowledges that "without improvements in Canadian manufacturing productivity, increased U.S. competition could result in a net decline of output and employment in 17 of 36 industries studied, virtually all of them in manufacturing" (p. 21). The historical record supports the expectation that Canadian manufacturing will *not* increase its productivity because of the FTA. The Canada-U.S. manufacturing productivity gap is at about the same level as it was 25 years ago, notwithstanding significant trade liberalization under the *Kennedy* and *Tokyo Rounds* of multilateral trade negotiations and substantial increases in Canadian exports. There is no reason to believe that, left to its own devices, Canadian manufacturing will improve on its historical performance. The immediate tangible reality of free trade is that Canadian

manufacturers are relatively small, inefficient, and technologically underdeveloped. Exposure to larger, more technologically advanced and efficient U.S. producers will threaten serious and widespread employment losses in Canadian manufacturing.

Even the Council's more optimistic scenario – Simulation 2 – which assumes "appropriate adjustment and rationalization" in the manufacturing sector, promises little for Canadian manufacturing. Seven of Canada's 20 manufacturing industries are projected to decline under FTA even in Simulation 2. Manufacturing as a whole promises to account for "less than 8 per cent of the increase in employment resulting from the agreement" even under this optimistic simulation (p. 21). These relatively small employment projections, made under unrealistically positive assumptions, simply do not justify the risks posed by the FTA.

Canada's position going into the FTA would evidently be much stronger if Canadian research and development and manufacturing technology and productivity were comparable to those in the United States. But they are not, as the Council acknowledges. Wishful thinking aside, Canadian research, development, and manufacturing will not, by themselves, rise to the American level, as if by magic, as a result of increased competition. As foreign experience illustrates, improvements in these areas rely upon a complex of factors: enterprising management, cooperative government, skilled work force, substantial risk capital, forthcoming finance capital, and institutional arrangements guaranteeing market share, such as exist in vertically integrated private enterprises or through government procurement. The FTA will not enhance these factors in any material way and may limit the Canadian government's ability to play a stimulative role in these areas.

New Investments

The FTA does not enhance Canada's ability to compete for new investments. Canada will no longer be able to compete as effectively for new investment by creating tariff incentives or through government procurement policies. Access to the American market will be no reason to locate new investment in Canada rather than the United States. Firms located in Canada will have access to the U.S. market, but firms located in the United States will not only have access to its market, but will be significantly closer to it. Locating in the United States will therefore offer the advantages of the North American market *and* the lowest transportation costs to bring goods to the largest market. Consequently, Canada will have to overcome new and adverse locational reasons for not investing in Canada and will have to compete with the United States for new investment with a lower currency, lower wage rates, and a lower standard of living.

Adjustment Programs

In view of Canada's relative underdevelopment, it is essential for any FTA involving Canada and the United States to be accompanied by substantial adjustment programs. Such programs must provide retraining and income support to workers displaced because of free trade and must provide financial and technical support for the country's industrial base. The government currently proposes no such adjustment programs to be introduced in conjunction with the FTA. This is an extremely serious deficiency in a highly risky free-trade strategy. The Council has previously endorsed improved adjustment programs to be implemented in conjunction with the FTA, and its failure to insist that FTA only be introduced when adequate adjustment programs are in place is extremely disappointing.

Dispute-Settlement Mechanism

Much has been made of the "dispute-settlement mechanism" contained in the FTA. This mechanism does not, however, in any way alter or modify U.S. trade law. It simply replaces U.S. court review of the Administration's trade actions with review by a binational panel. The problem with U.S. trade law, however, has been the law itself and its application by the Administration, not the enforcement of the law by U.S. appeals courts. As the U.S. law firm of Hogan and Hartson noted in its 15 October 1987 memorandum regarding "Analyses and Assessment of the Effects of the U.S.-Canada Free Trade Area Trade Agreement on U.S. Trade Remedy Laws," submitted to the Cabinet Sub-Committee on Free Trade:

> The documents make clear that the purpose of a binational review of U.S. administrative decisions is to determine if the decisions are in accordance with U.S. law. In addressing this issue, *the binational panel will apply the same standard of judicial review that would be applied by the U.S. courts.* Given that *the law and the standard of review will be the same as that employed by the U.S. courts*, it is difficult to conclude that the two systems are likely to lead to different results. Indeed, one can reach such a conclusion only if one is prepared to assume that the binational composition of the panel will significantly affect the panel's decisions. However, it is reasonable to assume that the panel will render impartial decisions, and we are not aware of instances in which it has been widely alleged that the U.S. courts have

> failed fairly to construe U.S. law or to apply the appropriate standard of judicial review. Accordingly we can find no reason to assume that the panel is likely to render judgments markedly different from those that would be rendered by the U.S. courts.
>
> While the Commerce Department has been believed by some of occasionally construing the anti-dumping and countervailing laws in response to political pressure as well as legal principle, the binational panel mechanism does not eliminate that possibility. On the contrary, it appears designed to ensure impartiality at the appellate level, a level at which impartiality has never seriously been questioned. (Italics added.)

Trade Laws

Canada has gained some protection, from 1989 forward, from U.S. trade actions taken pursuant to Section 201 of the *Trade Act* of 1974. Section 201 permits the United States to restrict imports where the imports adversely affect U.S. industries, notwithstanding that the import is fairly priced and not subsidized. Under the FTA, Canada will be protected from trade actions under Section 201 unless its exports are "substantial" and "contribute importantly" to the serious injury or threatened serious injury. Substantial Canadian imports that do contribute importantly to serious injury or the threat of serious injury may of course still trigger U.S. actions under Section 201.

Canada's limited protection against Section 201 is the only protection it has gained from U.S. trade laws. Anti-dumping and countervailing-duty laws, used against Canadian potassium chloride and softwood lumber, remain intact. Section 301 of the *Trade Act*, under which the United States may retaliate against actions that violate international agreements or that are otherwise "unjustifiable, unreasonable or discriminatory," remains largely intact. Section 337 of the *Tariff Act* of 1930, which provides U.S. parties with redress in respect of "unfair methods of competition and unfair acts in the importation of articles into the United States," is not limited by the FTA. And of course, the FTA provides Canada with no protection against the omnibus trade bill, if such is passed before 1 January 1989.

In any event, Canada's gains under the FTA with respect to U.S. trade laws are modest at best. It gained some protection against the U.S. trade measures that sideswiped Canada where the substantial problem lies with imports from other countries. But the thrust of U.S. trade law remains intact. The substitution of a binational panel for the U.S. Appeals Court cannot be expected to have any substantial effect, since the panel will be bound to apply U.S. law and practices. If the dispute-settlement mechanism works quickly and effectively, this will benefit all complainants by reducing costs and delays, but it is too early to be confident about any progress in this regard.

Continued Threat to Canadian Social Policies

Canada has, however, committed itself to reviewing its own and U.S. trade laws with a view to harmonizing trade legislation within the next five to seven years. These negotiations will take place after Canada has already made its major concessions outside the social policy, culture, and natural-resources conservation areas.

During these negotiations, Canadian social policies will doubtlessly be on the table. The results of this process will be the most important component of the FTA. It is unacceptable that Canadians are being asked to enter the FTA and to make substantial tariff and nontariff concessions that will reshape Canada's economy without any knowledge as to what these negotiations will bring. It is of great concern that the trade-laws question has been left unresolved in order to meet U.S. legislative deadlines. Canada's accommodation of the United States leaves it in a weak position to obtain substantial progress on U.S. trade legislation without making important concessions on social policy and other matters of essential national interest.

Auto Pact

Finally, the FTA's removal of tariffs in respect of automobiles sets a dangerous precedent. The Auto Pact exempts auto producers from tariffs where they comply with minimum Canadian investment targets. Removing tariffs on automobiles eliminates the most effective sanction against auto makers who fail to comply with the pact's investment requirements. So long as the Canadian currency and Canadian wage rates remain below those in the United States, Canada will remain an attractive investment for auto makers, but Canada should not be forced to accept second-class economic status in order to maintain an equitable share of North American automobile investment.

Conclusion

For the above reasons, I am compelled to dissent from the majority's endorsement of the FTA. While I fully support the removal of trade irritants and the liberalization of trade, I do not believe that the FTA, as currently structured, is in

Canada's best interests. As a small industrialized country, Canada cannot simply drop its trade barriers and expect to compete successfully against highly capitalized, high-technology world-scale producers. Canada's progress towards trade liberalization must be accompanied by substantially improved adjustment policies that will accommodate displaced workers by providing retraining and income support and that will preserve and enhance Canada's industrial base should that base be severely threatened. The government's failure to develop and implement an adequate adjustment framework as a complement to the FTA means that the latter is incomplete and should not be introduced as is.

The Council's majority has seriously understated and ignored the major risks posed to Canada's economy by the FTA. The Council's optimism is based on the assumptions that consumer prices in Canada will fall in tandem with decreased tariffs and that Canadian manufacturers will adopt "appropriate rationalization" measures to increase their productivity. Even these assumptions, however, produce relatively modest employment-gain projections. More-realistic assumptions regarding price and productivity levels would yield even lower, or even negative, employment projections.

The risks attached to FTA are substantial. Canada's industrial base is threatened because of its inferior productivity and because of the substantial presence of subsidiaries of U.S. multinational corporations, which may find it more efficient to service the Canadian market from their world-scale locations in the United States. Without adequate adjustment policies, Canadian workers and industry cannot expect to prosper under the FTA. Rather, Canada will suffer substantial employment dislocations, for which adequate adjustment programs do not exist, and which will cause substantial hardship for many working Canadians.

Appendix

Comparison of New and Old Estimates of the Impact of Free Trade

The simulated impact of the Canada-U.S. Free-Trade Agreement on output and employment under the two scenarios, Simulations 1 and 2, are substantially lower than the results reported earlier (in S. Magun, S. Rao, and B. Lodh, "Impact of Canada-U.S. free trade on the Canadian economy," Economic Council of Canada, Discussion Paper 331, Ottawa, August 1987). In Simulation 2, for example, the new output and employment gains are only about 75 per cent of those reported in our earlier study (Table 8). These lower aggregate effects (especially in SIM.1) have, in fact, changed the distribution of gains in output and employment by industry and by province. For instance, in new Simulation 1, 17 of the 36 industries are projected to experience output and employment declines, compared with just seven in the earlier study.

What factors account for this seemingly large discrepancy between the two sets of results? Recall that in the earlier study, a hypothetical, comprehensive, bilateral free-trade agreement between Canada and the United States was simulated. In those simulations, it was assumed that all of the existing trade barriers (except subsidies) between the two countries would be removed. But under the agreement signed in January, most of the existing nontariff barriers will remain intact. Existing NTBs in agriculture and in the food and beverage industries are, to a large extent, unaffected by the agreement. As such, our calculations indicate that only about 25 per cent of the existing nontariff barriers are removed under the free-trade agreement. Similarly, the impact of the agreement on federal-government procurement is substantially smaller in scope than the one assumed in Discussion Paper 331. The new estimates of government procurement open for bidding in the two countries suggest that the agreement with respect to government purchases will only generate additional net exports of $13 million (1986 prices) for Canada, compared with $804 million (1984 prices) in Discussion Paper 331 (Table 9). Under the free-trade agreement, Canada has been excluded from

Table 8

Estimated Impact[1] of the Canada-U.S. Free-Trade Agreement on Selected Indicators, Canada, 1998: A Comparison

	August 1987 simulations	January 1988 simulations
	(Per cent)	
GNE (1981 dollars)		
SIM.1	1.6	0.7
SIM.2	3.3	2.5
Consumer price index (1981 = 100)		
SIM.1	–3.6	–3.3
SIM.2	–5.7	–5.5
Productivity (GNE per person employed)		
SIM.1	0.2	0.2
SIM.2	0.7	0.7
Real wage rate (per person-hour)		
SIM.1	1.9	1.0
SIM.2	3.0	2.3
Real disposable income		
SIM.1	1.7	0.7
SIM.2	3.1	2.3
Investment expenditure (1981 dollars)		
SIM.1	4.0	2.2
SIM.2	7.0	5.0
	(Thousands)	
Employment		
SIM.1	189	76
SIM.2	350	251
Labour force		
SIM.1	82	32
SIM.2	154	115
	(Percentage points)	
Unemployment rate		
SIM.1	–0.6	–0.3
SIM.2	–1.3	–0.9
	(Billions of dollars)	
Total government deficit		
SIM.1	3.2	–0.9
SIM.2	5.2	2.5
Current account deficit		
SIM.1	–3.0	–4.1
SIM.2	–4.0	–5.0

1 Measured as the change from the levels estimated for the base case, which describes what would happen if there were no change in the Canada-U.S. trading relationship. The two simulations are defined as follows: SIM.1: Removal of trade barriers
SIM.2: SIM.1 plus productivity gains.

SOURCE S. Magun, S. Rao, and B. Lodh, "Impact of Canada-U.S. free trade on the Canadian economy," Economic Council of Canada, Discussion Paper 331, Ottawa, August 1987; and Magun, Rao, Lodh, Lavallée, and Peirce, "Open borders."

Table 9

Trade Balance in Government Procurement under the Canada-U.S. Free-Trade Agreement, Canada, 1998

	Imports from the United States	Exports to the United States	Net exports
	(Millions of C$)		
Scenario:			
January 1988 (1986 $)	128	141	13
August 1987 (1984 $)	990	1,794	804

SOURCE Magun, Rao, and Lodh, "Impact of Canada-U.S. free trade"; and Magun, Rao, Lodh, Lavallée, and Peirce, "Open borders."

bidding for large U.S. government purchases in aircraft and components, ships, communication equipment, and electrical and electronic equipment components.

Thus the differences in the two sets of results are entirely attributable to differences in assumptions about nontariff barriers and about the federal government's procurement policies. Our calculations show that about 60 per cent of the difference in the effect of the free-trade agreement on aggregate output and employment in the new and the old simulation results is attributable to a more limited actual accord with respect to nontariff barriers. The remaining 40 per cent is caused by differences in assumptions about federal government procurement policies.

Notes

1. *The Canada-U.S. Free-Trade Agreement*, Report of the House of Commons Standing Committee on External Affairs and International Trade (Ottawa, December 1987), p. 5.

2. Simon Reisman, "The nature of the Canada-U.S. trade agreement," in *Assessing the Canada-U.S. Free-Trade Agreement*, Proceedings of a conference organized by the Institute for Research on Public Policy, ed. Murray G. Smith and Frank Stone (Toronto: IRPP, 1987), p. 44.

3. Gary Horlick, "Analysis of the dispute settlement provisions: A U.S. perspective," in *Assessing the Canada-U.S. Free-Trade Agreement*, p. 100.

4. A. E. Safarian, "Investment aspects of the Canada-U.S. free-trade agreement," in *Assessing the Canada-U.S. Free-Trade Agreement*, p. 121; and Statistics Canada, "Special tabulation of analysis of non-financial corporations," 1987.

5. Scotiabank, Economics Department, "Free trade in North America" (June 1987); and *Globe and Mail*, 26 February 1988, p. B-16.

6. Agriculture Canada, *Food Market Commentary* (March 1987), p. 20.

Background Studies Commissioned by the Council

Author(s)	Study
R. Caves	Adjustment to import competition in Canadian manufacturing industries
L. Lavallée and S. Magun	Canada-U.S. Free-Trade Agreement and labour market adjustment
B. Lodh and S. Magun	An analysis of trade barriers in bilateral trade between Canada and the U.S.A.
S. Magun, S. Rao, and B. Lodh	Impact of Canada-U.S. free trade on the Canadian economy (Discussion Paper 331)
S. Magun, S. Rao, B. Lodh, L. Lavallée, and J. Peirce	Open borders: An assessment of the Canada-U.S. Free-Trade Agreement (Discussion Paper 344)
R. A. Muller and J. R. Williams	Structural adjustment to changing trade barriers: A general equilibrium approach
J. Peirce	The Industrial Adjustment Service: An historical and quantitative overview
S. Rao	U.S.-Canada productivity gap, scale economies and the gains from freer trade
A. Rugman	Trade liberalization and international investment
R. Stern	An analysis of alternative scenarios for multilateral trade liberalization
Trade Policy Team	A sectoral analysis of Canada-U.S. free-trade agreement

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25 YEARS·ANS