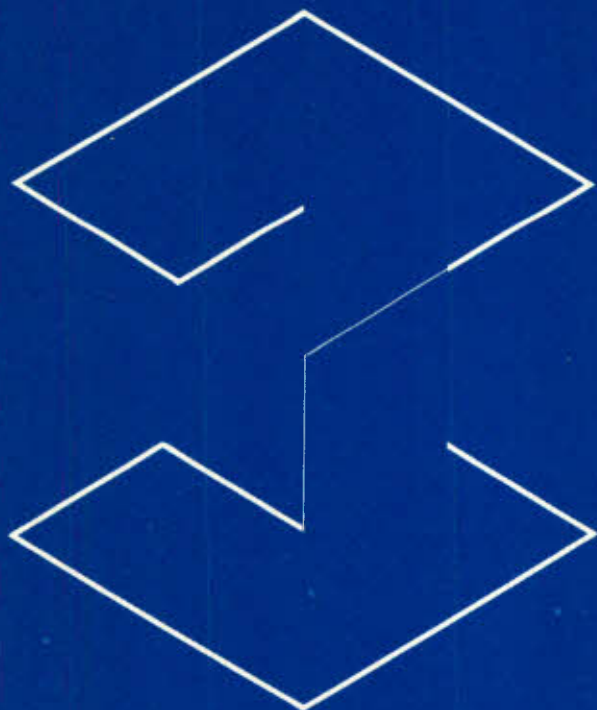


Looking Outward

Economic Council of Canada · 1975

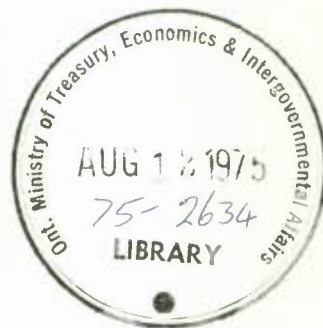
Looking Outward

A New Trade Strategy for Canada



ECONOMIC COUNCIL OF CANADA

Looking Outward
A New Trade Strategy for Canada



1975

© Crown Copyrights reserved

Available by mail from Information Canada, Ottawa, K1A 0S9
and at the following Information Canada bookshops:

HALIFAX
1683 Barrington Street

MONTREAL
640 St. Catherine Street West

OTTAWA
171 Slater Street

TORONTO
221 Yonge Street

WINNIPEG
393 Portage Avenue

VANCOUVER
800 Granville Street

or through your bookseller

Price: Canada: \$5.00

Other Countries: \$6.00 Catalogue No. EC22-27/1975

Price subject to change without notice

Information Canada
Ottawa, 1975

CONTENTS

1	The Legacy of Protection	1
2	Trade Barriers and Trade Patterns	9
	Canadian and Foreign Trade Barriers	10
	Major Dimensions of Canadian Trade	18
	Canadian Trade and the Factors of Production	23
	Conclusions	24
3	Protection, Productivity, and Foreign Ownership	25
	Productivity Growth in Canada	26
	Productivity in Manufacturing	31
	Scale and Specialization	31
	Trade Barriers and Foreign Ownership	34
	Conclusions	37
4	Commercial Policy and Regional Development	39
	Regional Aspects of Canadian Trade	40
	The Regional Impact of Trade Barriers	42
	Conclusions	45
5	The Changing World Economy	47
	Shifting Economic Status	48
	The Growth of Economic Blocs	52
	Emergence of New Growth Centres	55
	Multinational Production	56
	East-West Economic Relations	58
	Shortages of Primary Commodities	59
	Conclusions	60

6	The Case for Trade Liberalization	61
	The Canadian Economy of the Future	62
	The Impact of Trade Liberalization	66
	Reorganization of Industry	67
	Intra-Industry versus Inter-Industry Specialization	68
	Opportunities for Specialization	70
	Recent Changes in Factor Costs and Real Incomes	73
	Reorganization of Industry under Wider	
	Free Trade Arrangements	77
	The Distribution of Income among Regions and Groups	78
	The Gains from Free Trade	81
7	The Multilateral Approach to Trade Liberalization	85
	Canada and GATT, 1947-67	86
	The Prospects for Multilateral Trade Liberalization	87
	Conclusions	90
8	Regional and Unilateral Free Trade Options	93
	Regional Free Trade Options	94
	Size and Accessibility of Potential Trade Partners	95
	Trade Diversion	98
	Ranking of Bilateral Options	99
	Wider Regional Arrangements	100
	Unilateral Action	101
	Conclusions	104
9	Free Trade with the United States	107
	Other Economic Concerns	108
	Risks of Termination, Instability, and Adjustment	108
	Foreign Ownership of Canadian Industry	110
	Political Considerations	112
	The Negotiating Process	113
	Joint Administration	114
	The Spectre of Political Union	114
	Social and Cultural Concerns	116
	Conclusions	116

10	A Gradual Approach to Trade Liberalization	119
	Commercial Policy Measures	120
	Reform of the Canadian Tariff Structure	121
	A Strategy for Sectoral Trade Liberalization	124
	Economic Problems of a Sectoral Approach	124
	The Canada-U.S. Automotive Agreement	124
	The Selection of Other Sectors for Free Trade Arrangements	127
	Domestic Policies	132
	The Innovation Approach	132
	Domestic Rationalization of Canadian Industry	134
	The Textile and Clothing Industries	136
11	Special Trade Problems: Agriculture	139
	The Changing Pattern of Agricultural Production and Trade	140
	Barriers to Agricultural Trade	144
	Liberalization of Agricultural Trade	147
	Conclusions	151
12	Special Trade Problems: Energy	153
	The International Environment	154
	Canadian Trade in Energy Products	157
	Energy Issues and Canadian Commercial Policy	160
	Conclusions	162
13	Adapting to Freer Trade	165
	The Initial Impact of Trade Liberalization	166
	Specific Measures of Government Assistance	172
	The Scheduling of Tariff Reductions	172
	Assistance to Firms	173
	Manpower Assistance	174
	Assistance to Agriculture	176
	Assistance to Regions	177
	Policy Co-ordination and Advice	177
	Framework Policies	179
	The Exchange Rate System	180
	Competition Policy	180
	Foreign Investment Policy	182
	The Structure of Taxation	184
	Conclusion: An Appropriate Policy for Canada	185

	Recommendations	187
	Appendixes	
A	Nominal and Effective Rates of Protection	193
B	Ranking of Canadian Primary and Manufacturing Industries by Rate of Protection and Factor Content	199
C	The Factor Content of Canadian Trade	203
D	Project Staff and Consultants	207

Tables

2-1	Industrial Tariff Averages on Total and Dutiable Most-Favoured-Nation Imports, by Commodity Group, Canada and Major Trading Partners, 1973	11
2-2	Distribution of Imports of Industrial Products under the Most-Favoured-Nation Tariff, by Level of Tariff Rates, 1971	12
✓ 2-3	Nominal and Effective Rates of Protection for Canadian Industries, by Major Group, 1970	14
✓ 2-4	Average Nominal and Effective Rates of Protection for Canadian Primary and Manufacturing Industries, 1961, 1966, and 1970	15
✓ 2-5	Increase in Protection to Canadian Industries, 1961-66 and 1966-70	15
2-6	Tariff and Nontariff Protection Afforded Some Major Goods-Producing Sectors of the Canadian Economy, 1970	17
2-7	Canada's Merchandise Trade Balance, by Product Group, Selected Years, 1955-74	22
2-8	Relative Factor Content of Canada's Total Merchandise Trade, 1961, 1967, and 1970	24
3-1	Index of Average Plant Size, Six Industrial Countries, 1967	33
✓ 4-1	Destination of Exports from Canadian Regions, 1973	41
4-2	Share of Manufacturing Employment Dependent upon Various Markets, by Region, 1970	42
✓ 4-3	Distribution of Employment by Tariff Level of Manufacturing Industry, Canada and Its Regions, 1970	44
5-1	Export Activities of 298 U.S.-Based Multinational Enterprises, 1966 and 1970	57
6-1	Intra-Industry Trade, Selected Countries, 1959-67	69
6-2	Average Hourly Earnings of Production Workers in Manufacturing, in Current and Constant (1961) Dollars, Canada and the United States, 1960-74	73
6-3	Indexes of Labour Productivity, Average Hourly Earnings, and Unit Labour Cost in Manufacturing, Canada and the United States, 1963-74	74
6-4	Indexes of Real Net Output per Man-Hour in Manufacturing, Canada and the United States, 1963-74	75

Tables

7-1	Tariff Reductions under GATT, 1947-67	87
8-1	Market Size and Projected Output Growth in Canada's Major Trading Partners, 1970-80	96
8-2	World Trade Matrix, 1973	98
10-1	Factory List Price of a Typical Popular Model Automobile, Canada and the United States, 1965 and 1968-74	125
10-2	Percentage Distribution of Total Expenditures, Selected Canadian Industrial Sectors, 1961	126
10-3	Post-Kennedy Round Import Tariffs, by Stage of Processing	129
10-4	Percentage Distribution of Total Expenditures of the Metal-Working Sector, 1961	130
11-1	Some Barriers to Agricultural Trade, Canada and the United States, 1973	145
11-2	Ranking of the Comparative Advantage of Canadian and U.S. Agricultural Products in International Trade	148
12-1	Canadian Energy Exports, Three-Year Averages, 1961-63 and 1971-73	157
12-2	Canadian Energy Imports, Three-Year Averages, 1961-63 and 1971-73	158
13-1	Estimated Initial Impact of Canada-U.S. and Unilateral Tariff Removal on the Canadian Economy, 1969	168
A-1	Nominal and Effective Rates of Protection, Primary and Manufacturing Industries, Canada, 1961, 1966, and 1970	195
B-1	Ranking of Canadian Primary and Manufacturing Industries, by Rate of Protection and Factor Content	200
C-1	Factor Content of a Balanced Increase in Canada's Bilateral Merchandise Trade of One Million Dollars, 1967	205

Charts

1-1	Average Nominal Rates of Duty, Canada and United States, 1869-1973	4
2-1	Most-Favoured-Nation Tariff Levels on Dutiable Manufactured Imports, 1973	13

Charts

2-2	Proportion of Commodity Import Groups Subject to Nontariff Trade Barriers, Selected Countries, 1967	16
2-3	Exports of Goods as a Percentage of the Output of Goods-Producing Industries, Selected Years	18
2-4	Area Distribution of Canadian Merchandise Trade, Three-Year Averages, 1961-63 and 1971-73	19
2-5	Percentage Distribution of Canada's Merchandise Trade, by Commodity Group, Three-Year Averages, 1961-63 and 1971-73	20
3-1	Rates of Growth of Output per Person Employed, Employment, and Output, Selected Countries, 1960-70 and 1970-80	27
3-2	Crude Birth Rates, Canada and the United States, 1955-73	30
4-1	Distribution of Canadian Exports and Employment, by Region, 1973	41
5-1	Merchandise Trade Balances, Five Industrial Countries, 1963-73	49
5-2	Net Exports of Long-Term Capital, United States and Japan, 1971-73	52
5-3	The Free-Access Markets of Industrialized Countries, 1960, 1970, and 1980	54
8-1	Economic Ranking of Commercial Policy Alternatives for Canadian Industrial Trade	104
11-1	Agricultural Employment as a Percentage of Total Employment, Canada and Regions, 1974	141
11-2	Commodity Composition of Canadian Agricultural Trade, Three-Year Averages, 1961-63 and 1971-73	142
11-3	Area Distribution of Canadian Agricultural Trade, Three-Year Averages, 1961-63 and 1971-73	143
11-4	Canadian Grain Exports, 1960-74	144
11-5	Incidence of Nontariff Barriers to Agricultural Imports, Selected Countries, 1966	146
12-1	Index of Real Gross National Product and Volume of Fuel Imports, United States, 1967-82	156
12-2	Canadian Trade in Crude Oil, 1955-73	159

ECONOMIC COUNCIL OF CANADA

This report is a consensus document of the Economic Council of Canada:

ANDRÉ RAYNAULD, Chairman

GEORGE POST, Vice-Chairman and Director

JOHN DAWSON, Director

ROBERT G. ANNABLE	Chairman and Chief Executive Officer Ancore International (Canada) Limited Vancouver, British Columbia
PAUL BABEY	Chairman National Farm Products Marketing Council Ottawa, Ontario
IAN ANDREW BARCLAY	President and Chief Executive Officer British Columbia Forest Products Ltd. Vancouver, British Columbia
MARCEL BÉLANGER, C.A.	Bélanger, Dallaire, Gagnon and Associates Quebec City, Quebec
S. ROBERT BLAIR	President and Chief Executive Officer The Alberta Gas Trunk Line Company Limited Calgary, Alberta
ROY FRASER ELLIOTT, Q.C.	Partner Stikeman, Elliott, Tamaki, Mercier and Robb Montreal, Quebec
GILBERT FINN	President Assumption Mutual Life Insurance Company Moncton, New Brunswick

MRS. JEAN M. JONES	Professor of Sociology McMaster University Hamilton, Ontario
JOHN KOSTUIK	President Denison Mines Limited Toronto, Ontario
WILLIAM LADYMAN	Past International Vice-President International Brotherhood of Electrical Workers Toronto, Ontario
GILLES LAMONTAGNE	Mayor of Quebec City Quebec City, Quebec
STANLEY A. LITTLE	National President Canadian Union of Public Employees Ottawa, Ontario
ROBERT M. MACINTOSH	Executive Vice-President The Bank of Nova Scotia Toronto, Ontario
W. C. Y. MCGREGOR	International Vice-President Brotherhood of Railway, Airline, and Steamship Clerks Montreal, Quebec
JOSEPH MORRIS	President Canadian Labour Congress Ottawa, Ontario
HELEN K. MUSSALLEM	Executive Director Canadian Nurses' Association Ottawa, Ontario
CHARLES PERRAULT	President Conseil du patronat du Québec Montreal, Quebec
MISS HUGUETTE PLAMONDON	International Representative Canadian Food and Allied Workers Montreal, Quebec

LOUIS-PHILIPPE POULIN	Secretary-General, Coopérative fédérée de Québec Montreal, Quebec
RAYMOND PRIMEAU	Past Vice-President and General Manager The Provincial Bank of Canada Montreal, Quebec
ALEXANDER ROBERTSON	Past President The Winnipeg Supply and Fuel Company, Ltd. Winnipeg, Manitoba
A. M. RUNCIMAN	President United Grain Growers Ltd. Winnipeg, Manitoba
DONALD H. TAYLOR	Assistant to the National Director for Canada United Steelworkers of America Toronto, Ontario
RAY D. WOLFE	Chairman and Chief Executive Officer The Oshawa Group Limited Toronto, Ontario

WILLIAM E. HAVILAND, Secretary

1

THE LEGACY OF PROTECTION

Canada's economy has long been dependent on foreign trade, foreign investment, and immigration to an extent almost unequalled among nations. And, while there are differences of opinion about some aspects of this openness to the outside world, Canadians by and large recognize that they have prospered from this interchange of goods, money, population, and ideas. Given this position, the importance of global economic developments for Canada is undeniable, and recent profound changes in the international context should be examined with care. Some of these events, in the view of the Economic Council, call into question the validity of a long-standing feature of this country's economic arrangements: the use of a protective commercial policy to promote Canada's national development.

One of the most significant recent trends in world affairs is the emergence of an integrated international economic system. Whereas twenty years ago there were more than twenty economically advanced noncommunist countries, each with an essentially separate economy, today there are three economic superpowers – the United States, the European Economic Community (EEC), and Japan. Other economic units appear very small in comparison with these giants. The thrust of development in these affluent economies is, on the whole, towards industrial activities that are technologically advanced or in other ways skill-intensive. The key to efficiency, at least in the goods-producing sector, is a highly sophisticated organization of output, usually involving large scale and elaborate industrial plant and product specialization.

Equally significant is the emergence of a number of "new Japans" – that is, countries displaying an extensive capability for production of a range of "standard-technology" manufactured goods, such as were made in Japan in the years before the Second World War. As was the case in that country, wages paid in these industries are very low, labour is diligent, and in consequence the goods produced are extremely cheap. A large proportion of these goods is exported to the advanced countries, where they easily undersell comparable products made locally.

These developments are of particular significance to a country like Canada, which is an advanced industrial nation but a relatively small economic unit lacking the domestic scope for enhanced efficiency through large scale and specialization in the manufacturing sector. This situation limits Canada's ability to compete effectively with both the major developed countries and the newly industrializing areas of the developing world, not only in export markets but even at home. Moreover, these characteristics tend to inhibit technological and other initiatives in Canada that could offset the disadvantages of high unit costs. The competitive weakness of Canadian enterprises in turn encourages their takeover by foreign concerns more fortunately placed. Then, as subsidiaries of companies headquartered abroad, firms in Canada are operated in most cases as satellite activities outside the main areas of industrial innovation and growth. At the same time, the comparative advantage that Canada could gain through the produc-

tion of those commodities that it is potentially capable of producing most efficiently is lost because of its lack of free access to larger markets.

The problems associated with this train of events can already be observed in the rather slow rate of expansion in output per person employed in Canada. Although the overall level of Canadian output has risen quite rapidly, much of this performance can be attributed to the unusually high rate of labour force growth, derived from a high birth rate in the 1950s and a large influx of immigrants. Growth in output per person employed, which is a convenient proxy for productivity or efficiency, has compared poorly with that of other countries, and the evidence is that, unless strong policy measures are taken, it may not improve very much in the future, despite the many advantages that Canada possesses.

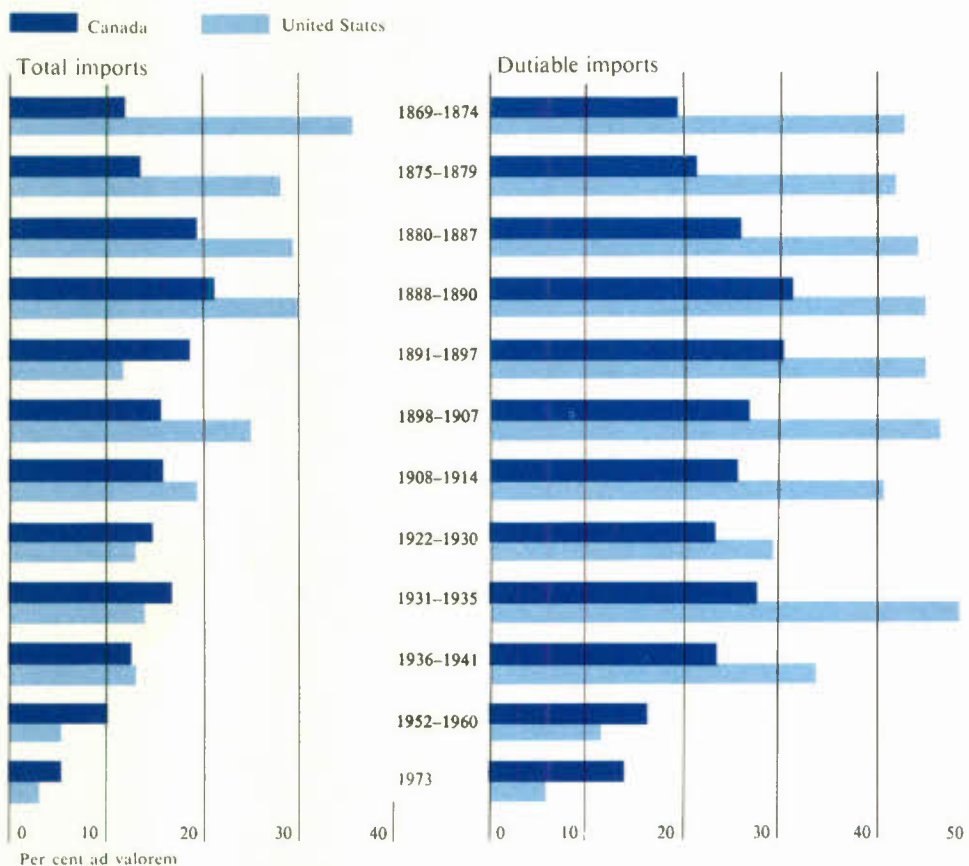
One of the basic causes of our poor productivity performance is the type and organization of manufacturing fostered by the commercial policies adopted by Canada and other countries over the years. Such measures were aimed directly at influencing the terms under which goods and services could be imported and exported and included the use of import duties (tariffs) and nontariff barriers to trade, such as subsidies to domestic firms, export and import licensing, and various quantitative restrictions.

Canadian governments have long employed the tariff as one of the main ways of furthering the attainment of national economic and political goals. This approach was embodied in the National Policy, which was introduced in 1879. The National Policy was a combination of protective tariffs and immigration and transportation policies that were all designed to foster the development of manufacturing, mainly in central Canada, and to stimulate the growth of population and resource-based industries in western Canada. It was a response to changing events in the external world—to the dynamic westward expansion of the United States and to Canada's failure to regain a preferential position for trade in either Britain or the highly protected U.S. market of the 1870s. Indeed, much of Canada's tariff history has been influenced by the level of tariffs in the United States (Chart 1-1).

The initial emphasis of the National Policy was on stimulation of east-west trade within Canada and between Canada and Europe, in order to balance the growing continental economic dominance of the United States. Around the turn of the century, for example, Canada extended unilateral tariff preferences to the United Kingdom primarily to strengthen the European orientation of Canadian trade. The east-west approach, however, did not always enjoy unequivocal support. Efforts to abandon the National Policy in favour of free trade with the United States gained a considerable following at various times, and the case for "reciprocity" was a major focus of the general elections of 1891 and 1911. These initiatives reflected the fact that, in the pre-Confederation period, a treaty for limited Canada-U.S. free trade was actually operative from 1854 to

Chart 1-1

Average Nominal Rates of Duty, Canada and United States, 1869-1973



NOTE The data are an average of duty collected divided by import value. The U.S. data have been adjusted to coincide with the Canadian time periods by using weighted averages. Data for 1973 were calculated by the Economic Council from official Canadian and U.S. figures.

SOURCE Based on H. M. Pinchin, "The Regional Impact of the Canadian Tariff," a background study for the Economic Council of Canada.

1866, when it was abrogated by the United States. But, despite periodic interest in free-trade arrangements, the concepts originated by the National Policy survived as the basis of Canadian commercial policy for more than fifty years.

In the early 1930s, Canadian protection was increased substantially, primarily in response to the violent swing towards protectionism throughout the world and especially in the United States, which had become a major market for Canadian products. While the exchange of tariff preferences with Britain and other Commonwealth countries in 1932 followed the traditional east-west approach to international trade, the major Canadian motivations were defensive. Canada sought to maintain employment and to find export markets in an otherwise depressed and protectionist world economy. Canadian tariffs had in the past stimulated foreign investment in this country's industry, but the depressed state of the economy led to an actual outflow of capital after 1932. It was not until after the Second World War, in a climate of greater prosperity, that the net inflow of capital resumed on a large scale.

Even in the 1930s, the efforts of the industrial countries to promote employment through increased protection were recognized as self-defeating, but there was no effective machinery for promoting international economic co-operation or domestic stabilization. However, some attempts were made to retreat from the costly impasse to which national measures of high protection had led. The U.S. Reciprocal Trade Agreements Program was initiated in 1934 by Secretary of State Cordell Hull, and in the latter part of the decade both Canada and the United Kingdom reduced their tariff levels and Commonwealth tariff preferences in order to bring about a reduction of U.S. tariffs.

The end of the Second World War was a turning point in Canadian international economic relations. To offset U.S. influence, strong support emerged in Canada for multilateral action to reduce world trade barriers; this was preferred over the narrower concept of a trade relationship focusing on Europe and particularly Britain. In practice, however, the United States was increasingly becoming Canada's most important trade partner and source of capital.

The multilateral approach to reduction of trade barriers came to centre around the General Agreement on Tariffs and Trade (GATT), negotiated in 1947. As one of the main initiators of GATT, Canada accepted the principle that no new preferential arrangements would be exchanged between countries, and recognized implicitly that the existing Commonwealth preferences would wither away as most-favoured-nation tariff rates were reduced through GATT negotiations.¹ In common with the other members, Canada also agreed that national commercial policy measures should be used to promote the growth of world trade, international

¹ New preferential tariffs are prohibited by GATT, save for arrangements substantially freeing trade among countries, as in a customs union (common market) or free trade area.

specialization, and efficiency of national production and *not* primarily to achieve high levels of employment in protected industries – the “beggar-my-neighbour” policies of the 1930s. All of the industrial countries developed increasingly comprehensive domestic instruments designed to maintain growth and employment.

Meanwhile, world economic conditions tended to increase the interdependence of the Canadian and U.S. economies. Canada provided a stable and attractive location for a growing volume of U.S. investment. The U.S. share of Canadian direct investment abroad also increased rapidly until the early 1950s and, although it has declined in relative importance since then, it still accounts for more than half of the total.

With respect to trade, both the Canadian and U.S. markets were relatively open in the 1950s when most other countries controlled imports – particularly those from the “dollar” countries – to conserve foreign exchange. And, in comparison with the war-shattered economies of the other industrial nations, both countries were in a good position to supply products that the other required. The European Economic Community and Japan grew faster than the United States in the 1960s, but their trade with Canada was modest and their investment in Canadian industry small. Moreover, Canada’s competitive position in the European market deteriorated with the establishment of the EEC, and it was impaired even more by British entry into the Community in 1973.

Canada-U.S. economic integration was also reinforced through bilateral policy measures. The defence production sharing program with the United States was renewed in 1959, and the Canada-U.S. Automotive Agreement, which resulted in a major expansion of north-south trade and much closer integration of a major industry in the two countries, was signed in 1965.

More recently the interdependence of the two countries has become a matter of increasing political concern in Canada. A widely quoted statement on this issue, released in 1972 by the Secretary of State for External Affairs, suggested a number of alternatives for Canadian policy with respect to the United States:

In practice, three broad options are open to us:

- a) we can seek to maintain more or less our present relationship with the United States with a minimum of policy adjustments;
- b) we can move deliberately toward closer integration with the United States;
- c) we can pursue a comprehensive, long-term strategy to develop and strengthen the Canadian economy and other aspects of our national life and in the process to reduce the present Canadian vulnerability.²

2 Honourable Mitchell Sharp, “Canada-U.S. Relations: Options for the Future,” *International Perspectives* (Fall 1972).

The Minister chose the third option as the one most likely to ensure Canadian sovereignty, independence, and distinctness. Thus in effect he reaffirmed his attachment to a policy of national consolidation along the east-west axis as opposed to an acceptance of the forces tending to bring Canada into a north-south "continental" economic system.

According to one interpretation of this option, Canada must, and in fact does, strongly support the multilateral approach to the reduction of trade barriers. Indeed, Canada participated in the six GATT negotiating rounds held from 1947 to 1967. Substantial progress was made in the dismantling of Canadian import barriers in this process, so that our economy – like those of our trading partners – is much less protected now than it was in 1945. Even so, there remains a hard core of what might be described as "lingering protectionism" in this country and elsewhere. There is no adequate system of regulating the widespread use of nontariff barriers, and there is a residue of national tariffs that still discriminate against the import of manufactured goods.

These difficult problems must be tackled in the round of GATT negotiations that began in 1975. Comprehensive and constructive negotiations on all trade barriers will be required to consolidate the gains from earlier negotiations and to prevent the world from slipping into a costly new spate of protectionism. Such backsliding would be disastrous for Canada. Without free access to foreign markets, this country cannot evolve in the direction of large-scale specialized production in the manufacturing industries, and will not be able to overcome its productivity or innovation difficulties in areas of high technology and "knowledge-intensive" endeavour.

Commercial policy is thus of paramount importance if Canada is to achieve the sort of economic growth and dynamism that will provide its population with the wealth, security, and well-being that they desire for the future. This report is devoted to an analysis of Canadian commercial policy requirements on the basis of contemporary national goals. Of these goals, the most fundamental are the same basic political imperatives that were recognized a hundred years ago when the National Policy was established: national unity and independence. Today, however, they take a different form from that underlying the development strategy of the late nineteenth century. The need for unity, which then led governments to foster the construction of railways and the settlement of land, now encourages a search for greater regional representation in national decision-making and for means of reducing the disparities in levels of wealth among various parts of the country. Similarly, the preoccupation with independence, which in earlier times was expressed in action to prevent physical occupation of Canada's empty spaces by Americans, is today manifested in a concern to limit U.S. investment and cultural penetration.

Commercial policy must also clearly be related to a number of economic goals, the most significant of which have been subject to widespread discussion and study in recent years.³ These include substantial increases in real living standards over time; full employment, including productive jobs for an increasingly educated labour force; reasonable stability of prices; a more equitable distribution of income among different groups and regions; and steady growth in the world economy, with accelerated progress for the developing countries.

Chapters 2 to 5 appraise Canadian commercial policy in the light of these broad aims and of the prospects unfolding on the domestic and international scenes. We conclude in Chapter 6 that a much more liberal trading environment would be better suited to future conditions. Various options that Canada might pursue to reach this goal are then examined in Chapters 7 to 12, and a strategy for Canadian initiatives is suggested. This is intended not as a blueprint for the impending round of GATT negotiations in Geneva, but rather as a general guide for policy in the period ahead. In Chapter 13 we look at a variety of measures that would be required to assist the Canadian economy to adapt smoothly to the increasingly competitive international environment.

3 Canada's economic goals have been set out in Canada, Department of External Affairs, *Foreign Policy for Canadians* (Ottawa: Information Canada, 1970); and various Annual Reviews of the Economic Council of Canada.

2

TRADE BARRIERS AND TRADE PATTERNS

For Canada, more than for most countries, the kind of national economy that has evolved is fundamentally related to the characteristics of commercial policy at home and abroad. This is partly because, having a relatively small domestic market yet being one of the world's major producers of primary products, we are very important traders. And it is obvious that the larger the significance of trade in any economy, the greater will be the influence on that economy of the barriers to free movement of goods.

Moreover, when an economy is not large enough to provide, within the national market, sufficient justification for world-scale production units, the very existence of some industries is dependent on the access they have to foreign markets or on protection in the domestic market. And since trade barriers are essentially selective, they have profound effects on the basic shape and structure of industry in such trade-sensitive countries. Given the relevance of these factors, our analysis commences with an assessment of the prevailing system of import barriers in Canada and our main trading partners, as well as of the pattern of Canadian trade that has developed in the presence of that system.

Canadian and Foreign Trade Barriers

Three broad points can be made about the existing structure of trade barriers as it relates to Canada. First, Canadian tariffs on those goods that are dutiable are high in comparison with the corresponding tariffs of our major trading partners. Second, both Canadian and foreign tariffs are biased in favour of domestic manufacturing. Third, Canada tends to rank rather low in the use of nontariff barriers. These three general observations can be used as a basis for our consideration of commercial policy, despite the fact that international comparisons of tariff levels have to be treated with some caution. Average tariffs may vary greatly with the particular methodology used and the commodities included in the calculation; there is also a distinction to be made between nominal and effective tariffs.¹

Canada's average tariff level compares favourably with those of our major trading partners when total industrial imports are considered (Table 2-1). On dutiable imports, however, our average tariffs are higher than those of our trading partners. Furthermore, a relatively large proportion of Canada's dutiable imports enter at rates above 10 or even 15 per cent (Table 2-2). The suggestion by some that Canada remains a high-tariff country is thus based on two grounds: we

1 A nominal tariff is the customs duty on imported commodities listed in a country's tariff schedule. For an industry, it is a weighted average of the nominal tariffs on the commodities produced by that industry. The effective tariff is a calculation of the total protection accorded an industry, which allows for the fact that the nominal tariff on its final product may differ from those on its inputs. This concept is explained in more detail in Appendix A.

have high rates of duty on a significant amount of trade, and there is a very wide dispersion of rates from low to high levels compared with the tariff schedules of most other advanced countries.

Table 2-1

Industrial Tariff Averages on Total and Dutiable Most-Favoured-Nation Imports, by Commodity Group, Canada and Major Trading Partners, 1973¹

	Total import averages				Dutiable import averages			
	1	2	3	4	1	2	3	4
	(Per cent)							
Raw materials								
EEC	1.7	0.7	0.3	0.5	3.9	3.6	3.5	3.4
U.S.	5.6	3.8	2.3	2.7	9.7	6.8	4.4	6.1
Canada	3.4	1.1	0.4	0.3	10.6	11.1	6.3	7.2
Japan	2.2	6.0	3.8	5.9	8.1	9.5	10.6	9.3
Semifinished manufactures								
EEC	8.9	7.7	5.9	8.1	9.4	9.2	9.9	9.6
U.S.	9.8	9.1	6.0	7.6	10.7	10.1	9.5	9.0
Canada	7.2	6.4	10.6	8.4	13.2	12.1	14.5	12.7
Japan	9.6	9.6	6.2	8.6	10.5	10.5	8.9	9.9
Finished manufactures								
EEC	8.3	9.2	8.9	9.3	8.5	9.4	9.2	9.6
U.S.	13.1	8.2	9.0	7.9	13.7	8.7	9.5	8.3
Canada	10.5	9.5	6.7	10.2	16.0	15.3	14.2	14.7
Japan	11.3	11.5	12.0	11.2	11.6	11.7	12.5	11.5
All industrial products								
EEC	8.1	7.0	4.2	7.2	8.8	8.9	9.0	9.1
U.S.	11.2	7.5	7.1	6.7	12.2	8.7	8.9	8.1
Canada	9.1	7.0	6.7	7.7	15.1	14.2	14.2	13.7
Japan	10.0	9.8	6.3	9.4	11.1	11.0	11.2	10.7

¹ Average No. 1 is a simple (unweighted) arithmetic average of all MFN duty rates applying to tariff lines classified in a commodity category. It was calculated directly from national tariff lines. Average No. 2 was calculated in two steps. First, a simple (unweighted) arithmetic average of tariff lines was calculated for each BTN heading in a category. Each of these arithmetic averages was then weighted by total (MFN, preferential, and intra-area) combined imports of the industrial countries covered by the study in calculating an average for a category. Average No. 3 is a weighted average of all duty rates classified under a category using MFN imports of the country concerned at the national tariff line level as the weighting pattern. Average No. 4 was calculated in two steps. First, a weighted average based on a country's own MFN imports up to the BTN heading level was calculated. The results in individual BTN headings were then weighted by the total (MFN, preferential, and intra-area) combined imports of the industrial countries covered by the study in calculating an average of each category.

SOURCE General Agreement on Tariffs and Trade, *Basic Documentation for the Tariff Study* (Geneva: GATT, 1974).

Table 2-2

Distribution of Imports of Industrial Products under the Most-Favoured-Nation Tariff,
by Level of Tariff Rates, 1973

	Duty-free imports	Dutiable imports, by tariff rate			
		5 per cent and under	5.1 to 10 per cent	10.1 to 15 per cent	Over 15 per cent
		(Per cent)			
Canada ¹	53	2	15	13	18
United States ¹	21	40	23	6	11
EEC ²	54	11	19	11	5
Japan	43	3	21	28	5

1 Canadian imports of auto products from the United States appear under the "duty-free imports" column, while U.S. imports from Canada appear in the "5 per cent and under" column, though the average rate of U.S. duties on such imports is very low. For greater comparability between Canada and the United States, the "duty-free imports" and "5 per cent and under" columns could be combined.

2 Percentage figures in this table are based on trade data that exclude intra-EEC trade.

SOURCE General Agreement on Tariffs and Trade, *Basic Documentation for the Tariff Study* (Geneva: GATT, 1974).

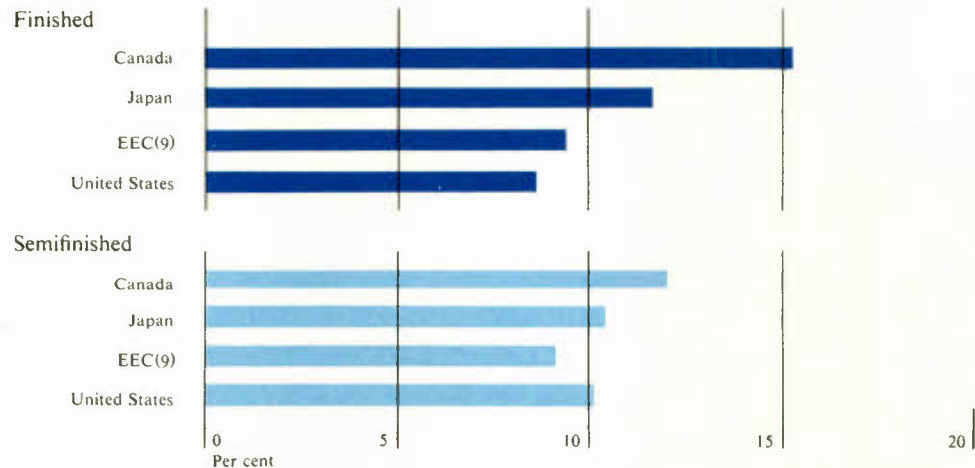
Nominal tariffs in both Canada and its trading partners tend to be somewhat higher on fully manufactured goods than on raw materials or semimanufactures (Table 2-1 and Chart 2-1). The result is that effective protection is frequently higher than nominal protection. This is what Table 2-3 and Appendix A show for most Canadian manufacturing industries. Moreover, both the average nominal and average effective tariff levels are much higher for manufacturing as a group than for primary industries (see also Table 2-4). On these grounds, it can be claimed that Canada's tariff structure is aimed at stimulating manufacturing.

On the other hand, although effective protection varies a great deal among individual manufacturing industries, the average level is often much the same for those in advanced stages of processing as for those in earlier stages.² In a few cases, such as that of mixed fertilizers (Appendix A), industries are subject to a negative effective rate, because the protection on inputs is so much greater than on end products.

2 Bruce W. Wilkinson and Ken Norrie, *Effective Protection and the Return to Capital*, Economic Council of Canada (forthcoming), Chapter 3.

Chart 2-1

Most-Favoured-Nation Tariff Levels on Dutiable Manufactured Imports, 1973



NOTE The tariff rates shown are averages calculated by the second method described in Table 2-1. For these dutiable imports, although different methods of averaging tariffs give different levels, the country-to-country patterns are similar.

SOURCE General Agreement on Tariffs and Trade, *Basic Documentation for the Tariff Study* (Geneva: GATT, 1974).

In general, average nominal and effective rates of protection declined in Canada during the 1960s as a result of international trade negotiations. However, effective tariff protection was actually increased for some industries (Table 2-5 and Appendix A). Manufacturing continued to receive greater protection than primary industry.

Other industrial countries also provide considerably more protection for manufacturing than for primary industries. It is not certain whether, on balance, the combined effects of Canadian and foreign tariffs increase or decrease total manufacturing activity in Canada. What is clear, as explained in Chapter 3, is that the overall effect is to reduce significantly the efficiency of Canadian manufacturing.

Much the same is true of protection afforded by means of nontariff obstacles to trade. The reduction in average tariff levels during the 1960s gave much greater visibility to these nontariff barriers (NTBs). Moreover, there has been increasing resort to this type of trade restriction in recent years, in some cases to offset lower tariffs. The use of NTBs raises particularly awkward problems for international negotiations. Some are hard to identify, being hidden in administrative procedures.

Table 2-3

Nominal and Effective Rates of Protection for Canadian Industries,
by Major Group, 1970¹

	Nominal Tariffs	Effective Tariffs ²
	(Per cent)	
Primary		
Agriculture	2.05	0.52
Forestry	0.01	-0.66
Fishing and trapping	0.61	-2.59
Mining, quarrying, and oil wells	0.19	-0.35
Manufacturing		
Food and beverages (excluding alcohol)	7.96	19.04
Rubber	14.36	13.17
Leather	19.23	33.78
Textiles	17.00	23.67
Knitting mills	23.08	33.73
Clothing	21.46	25.90
Wood	4.59	9.36
Furniture and fixtures	15.54	20.19
Paper and allied products	6.09	9.33
Printing and publishing	6.89	8.17
Primary metals	2.84	6.91
Metal fabricating	11.27	15.57
Machinery	5.36	4.29
Transportation equipment	3.04	2.22
Electrical products	12.43	16.54
Nonmetallic mineral products	6.24	9.47
Petroleum and coal products	7.90	44.41
Chemicals and chemical products	8.34	10.43
Miscellaneous	10.76	14.50

1 The groups are at the two-digit level aggregation of the Standard Industrial Classification. They contain all the primary and manufacturing industries listed in the 110-industry aggregation of the Canadian Input-Output Table with the exception of alcoholic beverages and tobacco products groups, which have been excluded for statistical reasons. See Appendix A for further details.

2 The effective rates presented in this and the following tables differ slightly from some earlier estimates, since they look at the percentage *decline* in value added that may occur if protection is removed rather than the increase in value added that may occur if protection is imposed. Effective rates in the source study have also been adjusted for exports, for taxes and subsidies, and for depreciation. In the interests of brevity, however, the Council's own report uses only the calculation of simple effective rates.

SOURCE Bruce W. Wilkinson and Ken Norrie, *Effective Protection and the Return to Capital*, Economic Council of Canada (forthcoming).

Table 2-4

Average Nominal and Effective Rates of Protection for Canadian Primary and Manufacturing Industries, 1961, 1966, and 1970

	Nominal tariffs			Effective tariffs		
	1961	1966	1970	1961	1966	1970
	(Per cent)					
Primary	2.01	1.09	0.37	1.66	0.34	-0.71
Manufacturing	13.57	11.94	10.31	22.53	20.09	16.37

SOURCE Bruce W. Wilkinson and Ken Norrie, *Effective Protection and the Return to Capital*, Economic Council of Canada (forthcoming).

Table 2-5

Increase in Protection to Canadian Industries, 1961-66 and 1966-70

	Industries in sector	Number of industries in which tariffs increased			
		1961-66		1966-70	
		Nominal	Effective	Nominal	Effective
Primary	11	1	3	1	6
Manufacturing	82	19	29	11	11
Total	93	20	32	12	17

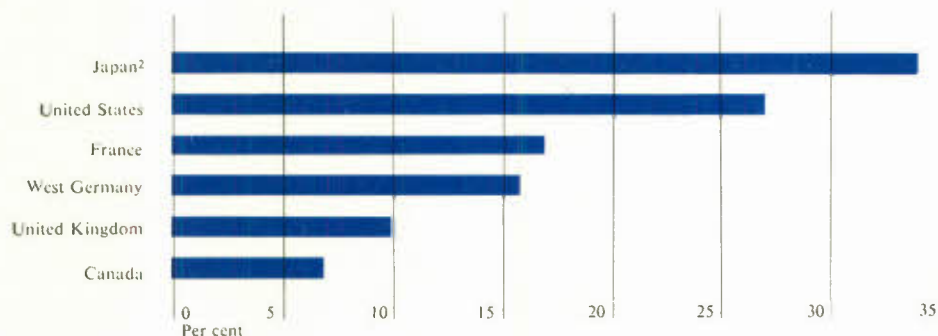
SOURCE Bruce W. Wilkinson and Ken Norrie, *Effective Protection and the Return to Capital*, Economic Council of Canada (forthcoming).

Many are closely linked to domestic economic and social objectives, such as the promotion of employment in particular areas or the protection of consumers. Finally, the effects of many NTBs are hard to quantify, so bargaining is difficult.

Some international comparisons of the impact of NTBs have been attempted, however, largely in terms of the actual numbers of such barriers, and this evidence tends to mitigate the view that Canada is one of the more protectionist industrial countries (Chart 2-2). We can be more precise about the quantitative

Chart 2-2

Proportion of Commodity Import Groups¹ Subject to Nontariff Trade Barriers,
Selected Countries, 1967



1 A commodity group consists of products aggregated at the Standard International Trade Classification four-digit level.

2 It is only fair to add that Japan, which appears in the least favourable light on the basis of past data, has since 1967 substantially reduced the number of NTBs applied.

SOURCE Ingo Walter, "Non-Tariff Protection Among Industrial Countries: Some Preliminary Evidence," *Economia Internazionale* 25, no. 2 (May 1972):350.

effects of some of Canada's own NTBs by expressing them in terms of tariff equivalents (Table 2-6). Thus, although we rank relatively low internationally in the use of such measures, NTBs add significantly to protection in some of our manufacturing industries, and they extend protection into other sectors of the economy. It is unfortunate that comparable quantitative information is lacking for other countries. Even so, the wide variety of nontariff barriers affecting Canada's exports has been well documented,³ and there is good reason to believe that their quantitative effects are substantial.

In short, we emphasize that, in considering commercial policy options, account must be taken of Canadian NTBs as well as import tariffs, and that both foreign tariffs and – perhaps even more – nontariff barriers have substantial implications for Canadian policy. Indeed, as we shall show in Chapter 3, a country like Canada, with a relatively small home market, suffers much greater losses from trade barriers than do large-market entities, such as the United States and the EEC.

3 See, for example, "Submission of the Canadian Manufacturers' Association to the Minister of Industry, Trade and Commerce with respect to Foreign Non-Tariff Barriers to Trade," April 12, 1973.

Table 2-6

Tariff and Nontariff Protection Afforded Some Major Goods-Producing Sectors of the Canadian Economy,¹ 1970

	Nominal tariffs ²	Nontariff barriers (expressed as tariff equivalents)			Total tariff and nontariff protection
		Quota restric- tions	Subsidies	Tax conces- sions	
			(Per cent)		
All agriculture	2.82		4.18		7.00
Wheat			27.50		27.50
Industrial milk			18.20		18.20
All mining	0.04	4.11	0.61	8.88	13.64
Metals	0.01		1.28	8.15	9.44
Mineral fuels	0	7.24	0.29	10.15	17.68
Other mining (including asbestos, sand, gravel, etc.)	0.48			3.18	3.66
All manufacturing	9.58	1.62	1.24		12.44
Tobacco products	24.04				24.04
Food and beverages	10.00	2.53	1.66		14.19
Dairy products	16.92	14.84	9.75		41.51
All textile mill production	16.99	9.74			26.73
Cotton yarn and cloth production	15.48	25.81			41.29
Synthetic textile mill production	19.74	11.38			31.12
Knitting mills	24.14	1.07			25.21
Clothing	22.01	4.08			26.09
Wood industries	3.80				3.80
Furniture	17.20				17.20
Rubber products	14.88				14.88
Leather products	19.59				19.59
Paper and allied industries	9.12				9.12
Printing, publishing, and allied industries	5.65				5.65
Primary metals	4.13				4.13
Metal fabricating	12.17				12.17
Machinery	6.08				6.08
All transportation equipment	2.79		4.40		7.19
Aircraft and parts	0.02				0.02
Motor vehicle manufacturing	2.95		6.13		9.08
Vehicle parts manufacturing	0.88				0.88
Ship construction	9.44		17.00		26.44
Electrical equipment	13.71				13.71
Nonmetallic mineral products	7.44				7.44
Petroleum and coal products	7.63				7.63
Chemicals and chemical products	9.21				9.21
Miscellaneous manufacturing	11.80				11.80

1 The sector detail is not designed to be exhaustive in every case but includes major recipients of tariff and/or nontariff protection.

2 Nominal tariff rates were obtained by dividing customs duties in 1970 by the value of imports that year. When several items subject to tariff appear as one group—for example, "all agriculture" or "rubber products"—a representative tariff was obtained by weighting each nominal tariff by the item's importance in Canadian production. These rates may differ slightly from those presented in Table 2-3 and Appendix A, since the weighting is different.

SOURCE Based on Roma Dauphin and Gérald Audet, "The Regional Impact of Freer Trade in Canada," a background study for the Economic Council of Canada.

Major Dimensions of Canadian Trade

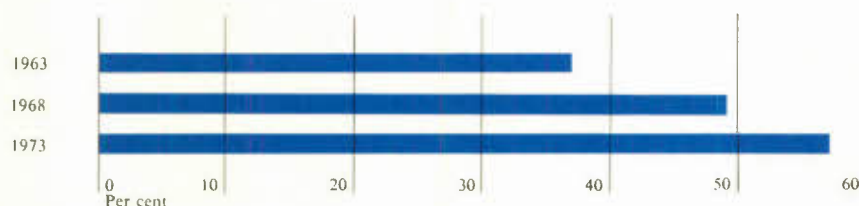
Given that the height of trade barriers in Canada and other countries varies greatly from one product to another, patterns of trade are substantially distorted from what would be the case in their absence. Much trade that might otherwise occur is prevented, and the goods that move between nations are not necessarily the ones in which they would have comparative advantage under free trade. Thus a study of commercial policy is definitely not an analysis of trade, as such. However, the existing characteristics of trade flows tell us something important about the results of commercial policies, here and among our trading partners, giving us an indication of our point of departure in any consideration of changes in policy.

Canada's foreign trade has always been large in relation to the size of the economy, and this feature has become even more pronounced in recent years. Between 1963 and 1973, for example, exports of goods rose from 17.2 per cent to 24.1 per cent of Gross Domestic Product (GDP), while imports increased from 16.0 per cent to 22.0 per cent of GDP. This expansion of trade represented, on the export side, an enlargement from the equivalent of one-third to more than one-half of the output of the goods-producing industries (Chart 2-3), at a time when the share of the goods-producing industries in GDP was declining moderately, from 45 per cent in 1963 to 41 per cent in 1973. On the other hand, imports of goods also increased—from the equivalent of 35 per cent of Canadian goods production in 1963 to 53 per cent ten years later.

There were also some changes in the direction and commodity composition of Canada's trade over this period, although many long-standing features remained

Chart 2-3

Exports of Goods as a Percentage of the Output of Goods-Producing Industries,¹
Selected Years



¹ Goods-producing industries include agriculture, fishing, forestry, trapping, mining, manufacturing, construction, and utilities. Output is defined as Gross Domestic Product of those industries at factor cost.

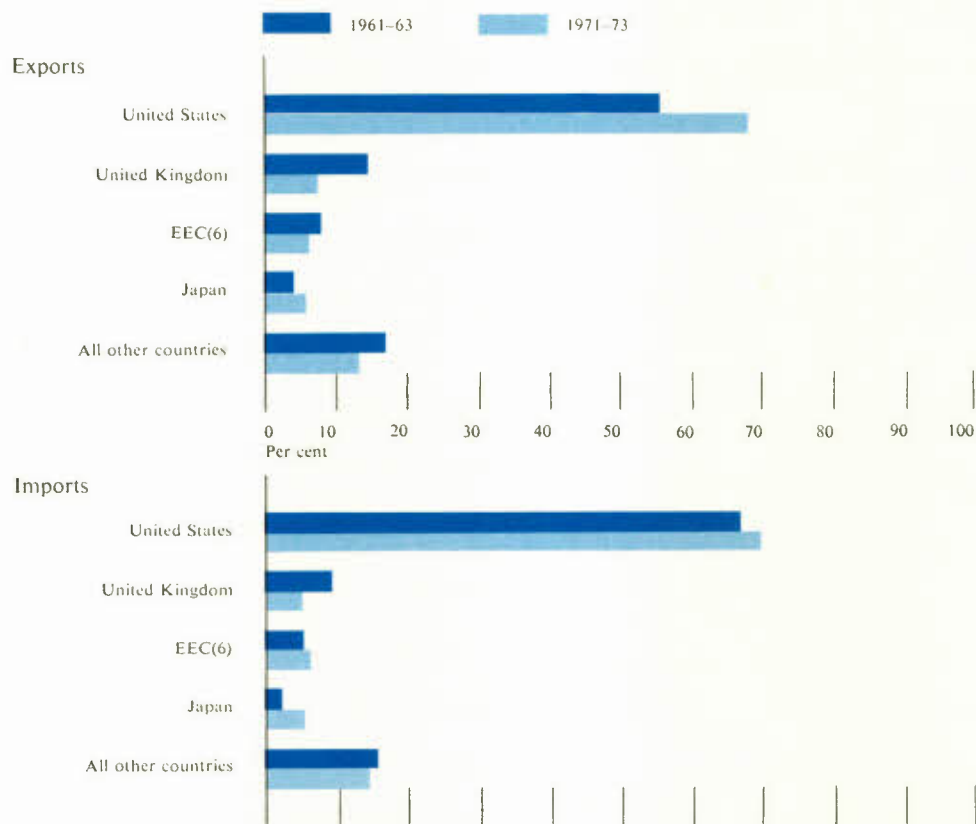
SOURCE Based on data from Statistics Canada.

the same. The United States continued to be of overwhelming importance both as a market for our exports and as a source of our imports (Chart 2-4). Highly manufactured goods became a higher proportion of both exports and imports, partly as a result of the Canada-U.S. Automotive Agreement. However, they continued to account for a much greater share of imports than exports. This is particularly apparent when automotive products are excluded from the calculation (Chart 2-5).

Exports to the United States increased over the period 1961-63 to 1971-73 from 57 to 68 per cent of the total, largely because of the massive rise in

Chart 2-4

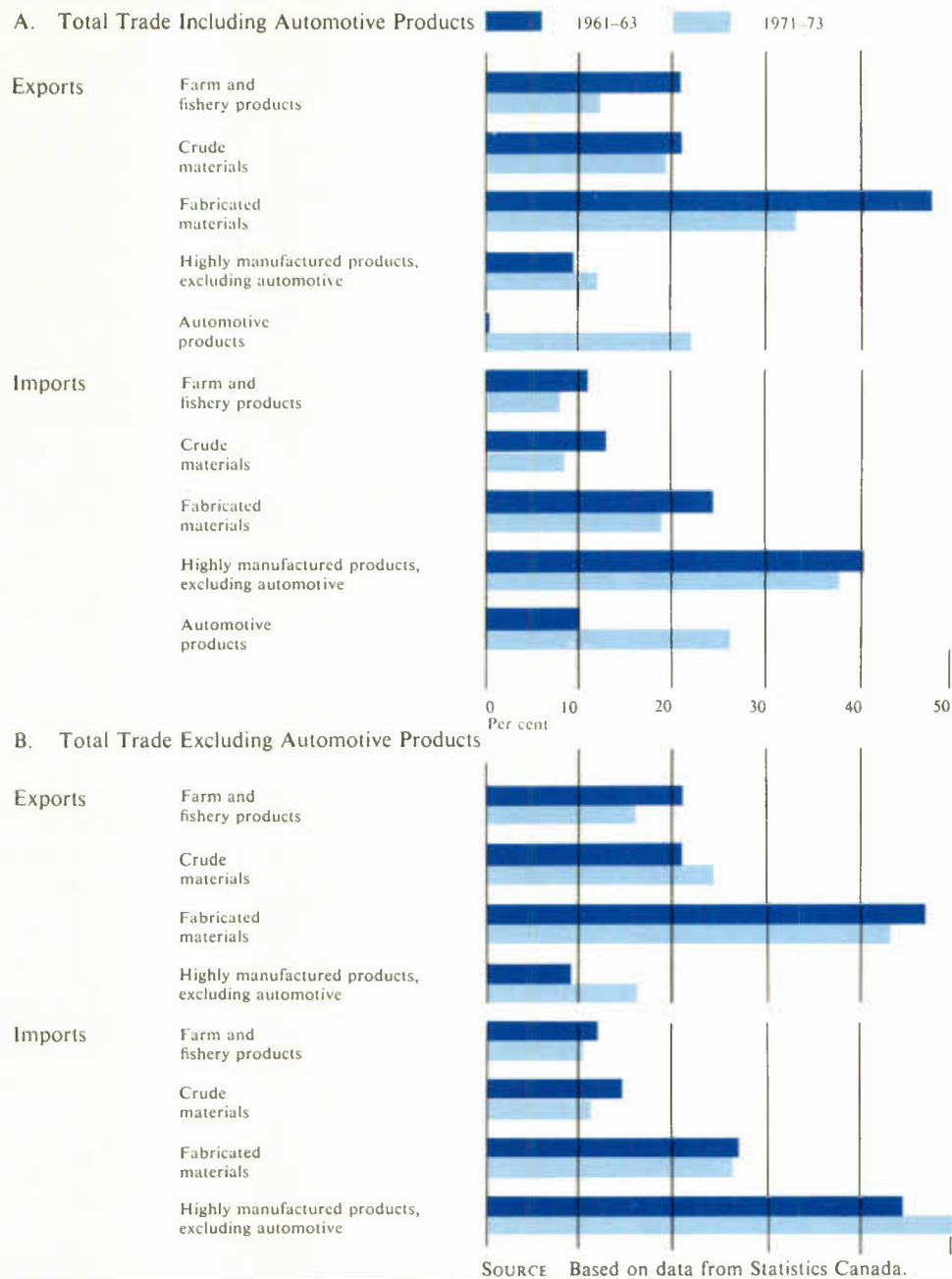
Area Distribution of Canadian Merchandise Trade, Three-Year Averages, 1961-63 and 1971-73



SOURCE Based on data from Statistics Canada.

Chart 2-5

Percentage Distribution of Canada's Merchandise Trade, by Commodity Group,
Three-Year Averages, 1961-63 and 1971-73



shipments of automotive products. The proportion of other highly manufactured goods destined for the United States also rose, as did the share of processed materials. Significant percentages of automotive and other highly manufactured goods were exported to "other" – mostly developing – countries, while such products had only a relatively small market in the overseas industrial nations. This last point must be emphasized in view of its considerable significance for the future orientation of Canadian commercial policy.

The U.S. share of Canadian imports remained roughly the same over the decade, the rise in automotive imports from that country being offset by a decline in the share of imports of all other product groups. While Japan and the continental EEC increased in relative importance as suppliers of Canadian imports, the United Kingdom declined. The composition of total imports changed as imports of automotive products rose dramatically, but other highly manufactured products continued to be by far the dominant category.

The changing size and composition of Canada's merchandise trade balance also merit careful analysis, especially in the very recent period. Table 2-7 shows the traditional export surpluses of primary and partly manufactured products offsetting trade deficits in highly manufactured items. From the mid-1950s to the late 1960s the trade surpluses in the two former groups rose, and the deficit in highly manufactured goods fell, as a percentage of GNP. Factors contributing to these changes included the long upswing in the growth of our trading partners during the 1960s and early 1970s, devaluation of the Canadian dollar in 1962, the Automotive Agreement of 1965, and the shift in Canada's status to that of net exporter of oil in the mid-1960s.

Recent experience suggests, however, that Canada's trade prospects are changing, partly at least as a result of alterations in these underlying influences. The trade balance in primary products strengthened in 1973-74 when Canadian export prices rose relative to import prices, but this improvement in the "terms of trade" cannot be expected to continue indefinitely. Moreover, the positive trade balance in these products will be adversely affected when Canada becomes a significant net importer of oil around 1977-78.⁴

The price index for goods sold by Canadian manufacturing industries rose about 47 per cent in the 1969-74 period, compared with a 32 per cent increase in the wholesale prices of U.S. manufactured goods, expressed in Canadian dollars. Much of this difference could be explained by the roughly 10 per cent appreciation

4 The Economic Council has suggested that Canada will become a net importer of oil before 1980. See its *Eleventh Annual Review: Economic Targets and Social Indicators* (Ottawa: Information Canada, 1974), p. 141. Projections by the National Energy Board indicate that Canada as a whole is likely to be a net importer of oil around 1977 and that supplies from Canadian sources will fall short of demand in the Canadian market west of Montreal by 1982 or 1983.

of the Canadian dollar relative to its U.S. counterpart in that period. Particularly in the latter part of the period, however, Canadian prices appeared to rise more rapidly than those in the United States, quite apart from exchange rate effects. Reflecting, among other things, this adverse shift in prices and the weakness of the U.S. economy in 1974, the Canadian deficit in trade in highly manufactured products has increased very recently as a proportion of GNP (Table 2-7).

It seems likely that the advantages Canada enjoyed in the 1960s will not be so favourable from now on. Prospects are, for example, that following the period of stagnation or slow growth in 1974 and 1975, economic activity in our major trading partners will remain below potential for the rest of the decade. Some adverse factors will doubtless be offset in part by the fact that Canada possesses relatively abundant agricultural and other natural resources in a world of scarcities. Canadians should not, however, allow this advantage to obscure the need to improve our international competitive position through increased productivity in manufacturing. Moreover, because of Canada's approaching need for heavy investment in energy, transport, and other facilities, it will be especially necessary to employ scarce capital with the utmost efficiency.

Table 2-7

Canada's Merchandise Trade Balance, by Product Group, Selected Years, 1955-74¹

	1957	1961	1965	1969	1973	1974	Three-year averages			
							1955-57	1961-63	1968-70	1971-73
Billions of dollars										
Farm, fish, and crude materials	0.6	1.1	1.7	1.8	4.2	5.1	0.6	1.1	2.2	3.4
Partly manufactured	0.9	1.4	1.7	2.3	4.1	4.3	1.0	1.5	2.6	3.3
Highly manufactured	-2.1	-2.4	-3.3	-3.3	-6.4	-8.9	-2.1	-2.4	-3.1	-4.9
Total trade balance	-0.6	0.1	0.1	0.8	1.9	0.5	-0.5	0.2	1.7	1.8
Balances as a percentage of GNP										
Farm, fish, and crude materials	1.81	2.73	3.10	2.27	3.55	3.63	1.76	2.67	2.76	3.20
Partly manufactured	2.73	3.54	3.02	2.93	3.41	3.12	3.22	3.45	3.31	3.14
Highly manufactured	-6.32	-5.95	-5.88	-4.19	-5.35	-6.38	-6.65	-5.63	-3.96	-4.64
Total trade balance	-1.77	0.32	0.24	1.00	1.60	0.38	-1.67	0.50	2.10	1.69

¹ Exports in each group and the total include re-exports. Balances are derived from Trade of Canada figures, since product group breakdowns are not available in the balance-of-payments accounts. A negative sign represents a deficit (imports greater than exports).

SOURCE Based on data from Statistics Canada. For the 1950s, re-exports (which are relatively small) were distributed among the product groups according to the 1961 pattern.

Canadian Trade and the Factors of Production

The goods that a country exports contain the contribution of various factors of production: labour, capital, and natural resources. Likewise, the importation of goods can be seen as the purchase of other countries' factor inputs – or, in effect, as a substitution of foreign factor inputs for the domestic factor inputs that would have been required had these items been produced at home. This exchange is affected both by trade barriers and by such influences as the relative abundance of the productive factors in each country.

In consequence, an analysis of the factor content of Canadian traded goods will permit us to draw some valuable conclusions about the economy. Allowing for the earlier caveat about the distorting effects of commercial policies on international trade, we must be careful about the use to which we apply such findings. But, as broad guidelines to the significance of different kinds of trading patterns for our own economic structure, they are decidedly illuminating.

A study prepared for the Council has examined the commodity pattern of Canadian trade in terms of its constituent elements: labour, classified by level of formal education; physical capital, in terms of both structures and machinery; and natural resource products, both renewable and nonrenewable.⁵ Using these categories, Table 2-8 outlines the "factor content" of Canada's merchandise trade. In net terms, in 1961 Canada was a relatively large exporter of natural resources and a small exporter of the services of physical capital;⁶ however, it was a small exporter of the services of labour with an elementary education and a small importer of the services of more highly educated labour. By 1970, however, we had become, again in net terms, a larger exporter of nonrenewable natural resources and a smaller importer of the services of more highly skilled labour.

The analysis also suggests how trade with particular countries or regions affects the utilization of the factors of production. For example, the same general pattern – the net export of natural-resource products and the services of fixed capital in exchange for the net import of the services of labour (particularly more highly educated labour) – holds for trade with all of our major trading partners, but to different degrees. To illustrate, a balanced shift in trade from the United States to the EEC and Japan, if it were in line with the recent commodity composition of trade, would involve, in net terms, much greater export of natural resources and the complementary fixed capital services, more employment of labour with an elementary education, and more displacement of high school- and university-educated labour by competitive imports. This kind of analysis suggests that, other

5 Harry H. Postner, assisted by Don Gilfix, *The Factor Content of Canadian Trade: An Input-Output Analysis*, Economic Council of Canada (forthcoming).

6 The capital content of Canada's manufactured imports is somewhat outweighed by the capital embodied in exports of our resource industries.

Table 2-8

Relative Factor Content of Canada's Total Merchandise Trade, 1961, 1967, and 1970¹

	1961	1967	1970
	(Per cent)		
Renewable natural resource products	29.5	25.1	25.0
Nonrenewable natural resource products	25.4	28.0	32.9
Gross machinery capital	5.6	5.4	5.0
Gross structures capital	3.8	4.8	6.2
Labour, by level of education			
Elementary school	4.2	2.7	2.3
High school	-2.3	-2.4	-2.1
University	-2.9	-1.6	-1.3
Total labour	0.6	-0.5	-0.7

1 Net trade in each factor as a percentage of availability of the services of that factor from Canadian sources that year (net factor exports, except where minus signs indicate net imports).

SOURCE Based on Harry H. Postner, assisted by Don Gilfix, *The Factor Content of Canadian Trade: An Input-Output Analysis*, Economic Council of Canada (forthcoming).

things being equal, if Canadian trade were to be expanded along the lines indicated above, the results might not be in accord with Canada's hope of fulfilling its technological capabilities by making the best use of its growing supply of highly educated labour.

Conclusions

For the past hundred years, broadly based industrialization, covering the fullest range of manufacturing activities possible, has been a major aim of Canada's national development strategy. And commercial policy has been a principal instrument of this strategy. Though not so extreme as in earlier years, our present commercial policy retains a strong element of protectionism, and Canadian exporters still face substantial trade barriers in foreign markets. Under the system of protection that has evolved, this country has remained by and large an exporter of natural resources and an importer of more highly manufactured products. This system has existed at a time when our trade has become increasingly concentrated on one major source and market – the United States.

3

**PROTECTION, PRODUCTIVITY,
AND FOREIGN OWNERSHIP**

Canadians are, in general, relatively complacent about the future of their country's economy. Although there is concern at present over inflation, the energy crisis, rather high levels of unemployment, and other problems, the long-range prospect is felt to be good. It is reasoned that Canada has ample resources, an energetic population, highly developed industry, and an advantageous position with respect to the world's richest and most advanced society, the United States. While political difficulties may exist, the typical perception of Canada's economic outlook is that of a bountiful land growing ever more prosperous.

Such optimism is not well founded. Canada's economic performance, while showing considerable strength in some respects, has long been weak in the key area of productivity growth. There is serious risk that this unsatisfactory performance will continue in future and that Canada's assets will be wasted through inefficient use. Nor is this all. Some of the factors contributing to the slow growth in productivity – especially our own and foreign trade barriers – help to explain why the Canadian economy has been increasingly subject to foreign influence. This influence has contributed to the erosion of those indigenous capabilities that lead to dynamic and innovative behaviour. In short, Canada has been placed in a position that jeopardizes both its capacity for maximizing living standards and its opportunities for autonomous and independent action as a nation.

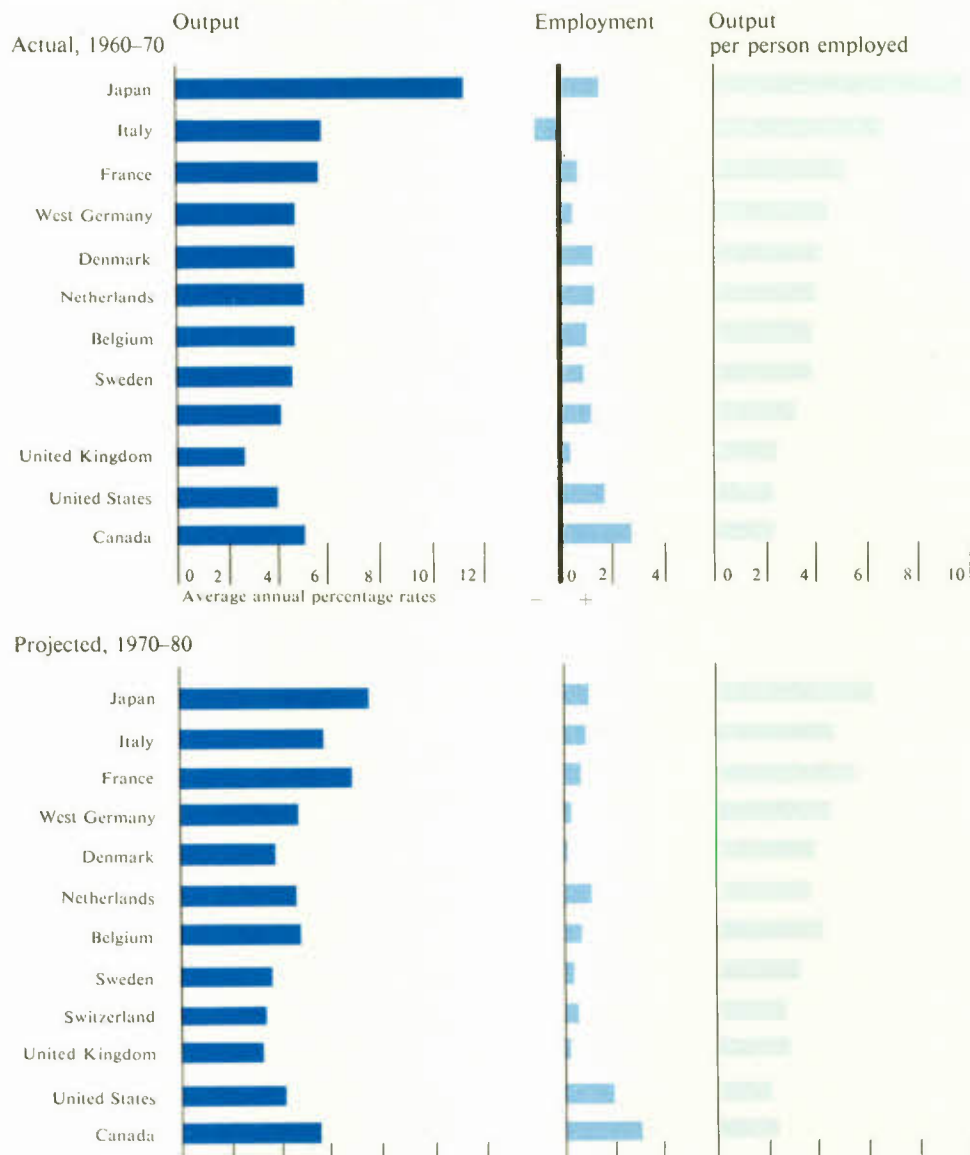
Productivity Growth in Canada

Canada's total national output has been expanding quite rapidly, but the increase is based largely on a pace of labour force growth that is among the fastest in the world, rather than on rising productivity (Chart 3-1).¹ Indeed, output per employed person has been rising very slowly. Between 1960 and 1970, for example, Canada's total output rose by an average of 5.2 per cent a year, comparing favourably with that of most other industrial countries, but the average annual increase in output per employed person was only 2.3 per cent, almost the lowest of all industrialized nations. The rest of the gain was due to straightforward employment expansion of 2.8 per cent per annum, by far the most rapid among such nations. The low rate of Canadian productivity growth is disturbing, since it implies that real incomes are not as high as they could be with more efficient use of resources at the same level of employment.

1 Output per employed person, albeit a crude measure of a country's productivity performance, provides a readily available international comparison. Moreover, the Council's previous work in this field, which focused on the combined productivity of labour (adjusted for quality) and capital, reinforces our conclusion that Canadian productivity growth has been very low compared with that of our trading partners. See, particularly, Economic Council of Canada, *Fifth Annual Review: The Challenge of Growth and Change* (Ottawa: Queen's Printer, 1968), Chapter 2, and the *Sixth Annual Review: Perspective 1975* (Ottawa: Queen's Printer, 1969), Chapter 2.

Chart 3-1

Rates of Growth of Output per Person Employed, Employment, and Output,
Selected Countries, 1960-70 and 1970-80



SOURCE: Based on data from the Organisation for Economic Co-operation and Development, *The Growth of Output, 1960-1980* (Paris: OECD, 1970), except for revisions affecting the United States, Canada, and Japan. The revisions for 1970-80 for Canada and the United States are based on data from the Wharton Annual model and the CANDIDE model. For Japan the revisions are based on data from the Japanese Economic Planning Agency.

Low productivity could continue to be a problem in Canada. Projections based on the trends of the last decade indicate that total real output in Canada will increase between 1970 and 1980 at an average annual rate of 5.4 per cent, which would be one of the most rapid growth rates of all the developed nations of the Organisation for Economic Co-operation and Development. However, such a strong expansionary trend would again derive from a high rate of growth in employment and a low rate of growth in output per employed person. While the projections may possibly be revised in due course because of the energy-cost crisis and other changes that may leave Canada better placed than these estimates suggest, at present we must assume that the prospect is as indicated. With the single exception of the United States, whose absolute productivity levels ensure better performance in this respect than Canada's for some time to come, Canada will be losing ground in terms of output per employed person to every industrial country in the OECD during the 1970s. The implications of this situation for our future prosperity are disturbing indeed.

While projections of this kind are of themselves very useful, it would also be interesting to have an up-to-date comparison of the *level* of output and real income in Canada and other countries. Unfortunately, it is much more difficult to make international comparisons of such levels than it is to compare corresponding growth rates. The use of exchange rates to convert real income per capita into comparable figures for different countries can be quite misleading, particularly in periods when foreign exchange markets are volatile. Using more sophisticated methods of calculation, a study by Dorothy Walters concluded that real income per capita in Canada was 24 per cent below the U.S. level in 1960.² The Hudson Institute later used the concept of the real purchasing power of money incomes in various countries to obtain international comparisons. On this basis, Canada's per capita income ranked eighth among seventeen countries in 1970.³

Most of the Hudson Institute's calculations for 1970 seem reasonable, although their projection of the growth of per capita incomes beyond 1970 at 1960-69 rates is not persuasive since conditions in the 1970s are so different from those in the 1960s. Its estimate that Canada is as low as eighth on a list of seventeen countries and will slip to eleventh place by 1985 may be unduly pessimistic. Even so, it is quite evident that Canadians can no longer claim to be the world's second-richest people on a per capita basis. Moreover, at least in the absence of major policy changes or huge windfall gains from our natural

2 Dorothy Walters, *Canadian Growth Revisited, 1950-67*, Economic Council of Canada Staff Study 28 (Ottawa: Queen's Printer, 1970), p. 46.

3 Hudson Institute, *France and Its Future, 1973-1985* (Croton-on-Hudson: Hudson Institute, 1973), p. 39.

resources, it is difficult to see how Canada's international ranking could rise significantly, and it may very well fall.

But more important than the question of Canada's rank on the basis of per capita income is the prospect of our wasting human and natural resources by using them inefficiently. Our concern is basically to explore the question of obtaining the best combination of returns from the potentially advantageous resources Canada possesses.

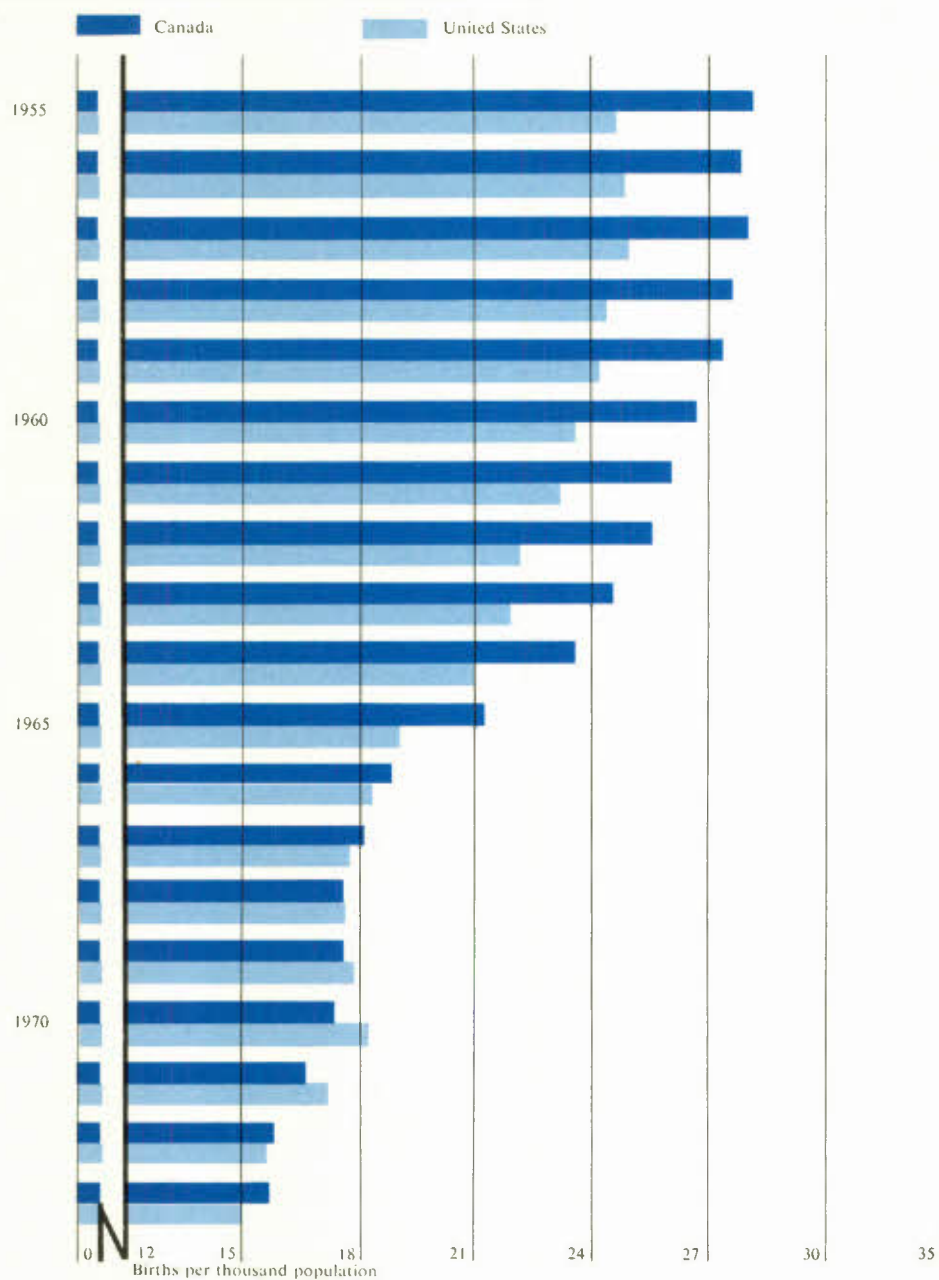
In this context, it should be noted that the labour force growth that has sustained total output over past years will shortly start to slow down because of a declining birth rate and a leveling-off, if not a decrease, in the rate of labour force participation. The Council's estimates suggest that the working-age population will increase from 15 million in 1970 to 18.6 million in 1980, a rise of about 2.2 per cent per annum. By 1985, however, this group will have climbed to 20 million, a gain of only 1.4 per cent annually from 1980. With the decline in the rate of labour force growth implicit in these figures, it is clear that Canada will not be able to rely on this source of expansion to maintain its national income growth for much longer. Unless ways are found to increase output per employed person, the growth in total output will also slow down.

Few projections of other countries' working-age populations for 1985 are available so far. Nevertheless, a fair indication of trends can be obtained by examining national birth rates year by year and then pushing the data forward fifteen years to show potential new entrants into the work force. Comparing Canadian and U.S. birth rates on this basis, Chart 3-2 shows that the Canadian figures continuously exceeded those of the United States until 1969, when the position was reversed. Canada's native-born working-age population will therefore increase proportionately more swiftly than that of the United States up to around 1984, after which the rates will move approximately into line. This shift is so pronounced that it implies a 1980-90 scenario in which differences in other determinants of labour force growth, such as net migration and participation rates, may be insufficient to alter a broadly parallel expansion in the work force and the employment of the two countries. In that event, changes in the relative levels of real national output will be decided almost wholly by differences in the rate of growth of output per employed person.

Consider what this prospect implies in terms of the goal of productivity parity with the United States — a target well within Canada's capabilities, we believe, and one increasingly to be aimed for if we are to fulfil the expectations of our population. Imagine that output per employed person in the United States rises during the 1980-90 period at no more than 1.5 per cent per annum, which is quite low by historic standards. And assume that the gap between levels of output per worker in the two countries in 1980 is about 20 per cent (it appears to be over 25 per cent now). Then, in order to catch up with U.S. productivity,

Chart 3-2

Crude Birth Rates, Canada and the United States, 1955-73



SOURCE United Nations, *Statistical Yearbook*, 1962, 1963, and 1968; and also United Nations, *Monthly Bulletin of Statistics*, various issues.

Canadian output per employee would have to increase over the ten-year period at an annual rate of 3.8 per cent – a gain that would be virtually impossible to achieve without major changes in economic policy in this country.

Some do not find these trends worrisome. They feel that increased economic growth may come only at the expense of a lower “quality of life,” whereas a slowdown in the expansion of Canada’s economy might provide a way of escaping such ills as pollution, congestion, and destruction of natural resources. However, these views, to the extent that they may be valid, are more applicable to growth in total output than to our major concern here – increasingly efficient use of our productive resources. There is no reason to suppose that, at a given level of output, efficient industries do more damage to the environment than less efficient ones.

In any event, this attitude towards growth shows little appreciation of the needs of the country in the years ahead. Tensions within the Canadian confederation remain substantial and these – as well as some of the environmental problems – will be resolved more readily in a dynamic than in a stagnant economy.

Productivity in Manufacturing

A country’s productivity performance is influenced by a wide variety of factors, such as the attitude, skills, and educational attainment of labour and management, the amount of capital per worker, and the way in which production is organized. The Council has examined all these factors from a number of viewpoints, and one feature has clearly emerged: a particularly promising avenue for improving Canada’s productivity involves increasing scale and specialization in secondary manufacturing through the removal of trade barriers and the expansion of international markets for our goods.

The fact that the service industries have become increasingly important as employers and producers reinforces this basic finding. Productivity in the service sector has tended to lag behind other areas of the economy, and large productivity gains have proven difficult to achieve. The economic problem in the long run is to create conditions that will allow people to move into the most attractive and productive occupations. The range of choice could be greatly increased if Canadian manufacturing were to achieve productivity levels comparable to those of the United States. Commercial policy initiatives could lead to productivity gains in manufacturing on a scale that could not be achieved in any other sector of the Canadian economy.

Scale and Specialization

The relation between trade barriers – both domestic and foreign – and Canadian manufacturing productivity has been well documented in recent years. In

Canada, in contrast with primary or resource industries, most of the manufacturing sector has been unable to achieve economies through access to larger external markets because both Canada and its major trading partners have provided much more protection for highly manufactured products. At the same time, Canadian protection has allowed manufacturing firms operating in Canada to increase their prices behind the tariff and so maintain otherwise uneconomic production runs.

The importance of market size in explaining the lower level of productivity in Canadian manufacturing relative to that of other major industrial countries has been brought out by a number of studies.⁴ In one of the more recent of these, E. C. West found in a sample of Canadian manufacturing industries that efficiency in the use of labour and capital was 25 per cent or more below U.S. levels in 1963.⁵ In explaining these gaps he concluded that the analysis of productivity and price differences between Canada and the United States reinforces the importance frequently attached to specialization and economies of scale. This evaluation supports the conclusion that if expansion of output were possible through access to larger markets, a substantial improvement in productivity levels could be expected.

Larger markets could stimulate productivity along two broad lines. First, they would permit firms to expand the scale of production of any particular product, either through construction of new plants with greater capacity or through expansion of production at an existing plant. If existing plants have adequate capacity, economies could be achieved by reducing the number of product lines and increasing production runs for the remaining items; economies of specialization could also be achieved in marketing. Second, productivity could be enhanced by the greater degree of competition that tends to accompany liberalized trade. Increased pressure on prices and/or profits would stimulate managers to adopt the most effective cost-reducing and marketing techniques available. Technological improvement is one way to bring down costs, and entrepreneurs could be expected to place more emphasis on their own research and development and on more rapid application of the newest techniques, wherever they might originate. Even simple and inexpensive measures, such as

4 See, for example, Dorothy Walters, *Canadian Income Levels and Growth: An International Perspective*, Economic Council of Canada Staff Study 23 (Ottawa: Queen's Printer, 1968); D. J. Daly, B. A. Keys and E. J. Spence, *Scale and Specialization in Canadian Manufacturing*, Economic Council of Canada Staff Study 21 (Ottawa: Queen's Printer, 1968); and E. C. West, *Canada-United States Price and Productivity Differences in Manufacturing Industries, 1963*, Economic Council of Canada Staff Study 32 (Ottawa: Information Canada, 1971).

5 For total manufacturing, West found that Canadian output per employed person was 31.5 per cent below the U.S. level. This translates into a gap of more than 27 per cent in terms of output per man-hour (see Table 6-4).

rearranging plant layout and changing facilities and methods to enhance worker morale, have recently been stressed as important cost-saving sources. A great many of these competition-related productivity improvements have been cited in the literature, but little quantitative information is yet available.

Work on scale economies in production, on the other hand, is both more extensive and quantitative. Evidence is accumulating, for example, that average plant size in Canada is significantly below that in other major industrial countries. A comparison of industrial plant size in six major western economies shows that in the United Kingdom, West Germany, and the United States, plant size is substantially larger than in France, Sweden, and Canada (Table 3-1).

Table 3-1

Index of Average Plant Size, Six Industrial Countries, 1967

	Mean plant size index ¹
German Federal Republic	121
United Kingdom	111
United States	100
France	68
Sweden	61
Canada	57

¹ The index for each most closely comparable U.S. industry equals 100.

SOURCE F. M. Scherer, "The Determinants of Industrial Plant Sizes in Six Nations," *Review of Economics and Statistics* 55, no. 2 (May 1973):135.

The significance of the relatively small scale of Canadian plants and, perhaps more important, the length of production runs within plants for the efficiency of Canadian manufacturing is brought out even more forcibly by specific cases. For example, the principal processes in the manufacture of refrigerators and electric ranges are well suited to large-scale methods of production, using automated assembly-line techniques. In a comprehensive examination of Canadian industrial structure and its relationship to the tariff, based on 1960 data, Eastman and Stykolt found that the Canadian market was insufficient to absorb the output of even one refrigerator or electric range plant of efficient size.⁶ Yet at that time the domestic market was served by ten plants producing refrigerators and twenty-three producing electric ranges.

⁶ H. C. Eastman and S. Stykolt, *The Tariff and Competition in Canada* (Toronto: Macmillan of Canada, 1967).

Other types of production problems also occur because of lack of specialization. For instance, one synthetic detergent producer complained that Canadian consumers demand basically the same kinds and types of products that are sold in the United States. His firm had only two installations producing four different detergents in four different colours. Constant shutdowns were necessary to allow these facilities to be cleaned as production shifted from one brand to another. In the United States, on the other hand, one item would be produced six days a week, twenty-four hours a day, thereby attaining output levels beyond which there would be no significant unit-cost reductions.⁷

In addition to the expenses incurred because of the relative lack of specialization in Canadian plants, the tariff contributes to increased costs of many inputs to the production process. Moreover, ancillary business activities such as research and development, various managerial services, and advertising and marketing are all more expensive because their cost is spread over a smaller volume of output than can be achieved in larger industrial countries. There is some evidence, too, that technological innovation in Canadian industry, measured in terms of new capital equipment, tends to lag behind other countries as a result of limited opportunities for scale and specialization.⁸ These various sources of inefficiency result directly in lower real incomes for all Canadians. Such losses reflect higher import prices and manufacturing costs as well as lower wages and salaries than would be justified under more efficient conditions.

Trade Barriers and Foreign Ownership

Many Canadians would be prepared to pay some economic cost if our commercial policy contributed to other important national goals, such as Canada's independence as a nation. As noted earlier, the import tariff was originally perceived partly as a means of fostering national autonomy, and with some justification. But we have also observed that the focus of concern with respect to the independence issue has shifted away from consolidation of Canadian territory to such matters as control of our industry by outside interests. In this light, a protective commercial policy certainly does not seem to have been beneficial to our position, since the existence of the import tariff has served to encourage foreign – especially American – capital investment in Canadian industry. Nonresident ownership and control have resulted in a substantial loss of indigenous capability, notably business decision-making authority and competence in technological and other innovations. These issues represent in large measure what the contemporary argument on questions of national independence is all about.

7 See Daly, Keys, and Spence, *Scale and Specialization*.

8 D. J. Daly and S. Globberman, "The Costs of Economic Nationalism and Its Effect on Ontario," preliminary draft (mimeo.), 1974.

Basically, the problem lies in a combination of import protection and the similarity of consumer tastes and other market characteristics in the two economies. Because of these factors, a firm in either country that has developed a good product might look upon the other country as virtually an extension of its potential sales territory. In the presence of trade barriers, however, the Canadian firm is initially limited to 10 per cent of the "natural" North American market of about 235 million people; in contrast, the U.S. firm can produce for 90 per cent of the market, obtaining economies of scale and generating other benefits from a larger operation. The lower costs made possible for the U.S. firm in satisfying its 90 per cent of the total Canadian-U.S. market give it a relative advantage when competing for a position in the remaining 10 per cent. It may, of course, simply export into the Canadian market over the tariff. Frequently, however, the relative advantages of U.S. companies have led them to establish subsidiaries instead, either by buying out a Canadian firm or establishing an enterprise in Canada to compete with it. The general result is a further consolidation of the North American market, since the product quickly becomes available in both countries.

Furthermore, investment by foreign enterprises, which is often initially a substitute for trade (producing behind the tariff wall rather than exporting over it), frequently has the effect of generating trade. A subsidiary's production naturally tends to be based on inputs similar to those used by the parent and, in many instances, they are most economically imported from the home plant or from other U.S. suppliers. This process further accelerates the consolidation of a single "continental" market and indeed of a North American corporate system. In that system the most significant difference between a U.S. corporation's Canadian subsidiary and its California branch plant is that of product specialization in California but not in Canada – a direct result of the two countries' tariffs. Indeed, Canadian subsidiaries of foreign corporations are typically less specialized than Canadian-owned firms in the same industry, although the latter are in turn less specialized than their counterparts in the United States.⁹

An all-important corollary is the almost inevitable erosion of Canada's capacity for product innovation and other business initiatives, as foreign managers have little incentive to develop a genuinely autonomous industrial capability in their limited Canadian operations. The consequences are far-reaching. For example, while a Canadian-made product might sell abroad, despite Canadian and foreign trade barriers, if its design were unique, it has little appeal if it is indistinguishable from a U.S.-manufactured item but higher in cost. This is not in any sense the fault of the foreign owner of the Canadian plant; there is simply no great incentive to

9 Richard E. Caves, *Diversification, Foreign Investment, and Scale in North American Manufacturing Industries*, Economic Council of Canada (Ottawa: Information Canada, 1975).

establish facilities for designing new products or breaking other new ground in Canadian subsidiaries when the free-access market is larger at home. Admittedly there are exceptions, but most foreign-owned companies have been modeled in accordance with the logic that such constraints impose. They are branch facilities manufacturing derivative products at higher cost than the parent firm.

Although both domestic and foreign-owned manufacturing firms operating in Canada lack adequate production specialization, the foreign-owned firms obtain economies in marketing, advertising, managerial and technical services, and other business activities. These advantages provide some of the most telling reasons for the take-over of Canadian companies by nonresident interests. Once the foreign owner has become established in a Canadian industry, he readily observes that the most profitable way to run his subsidiary may be as a "miniature branch-plant replica" of the head office. The case against such an economy was clearly expounded in the Gray Report on foreign investment in Canadian industry.¹⁰ Related arguments made by the Science Council of Canada place great emphasis on the necessity for indigenous technological innovation – allied to domestic capability in the highly professional spheres of management – if the Canadian economy is to remain viable in the future.¹¹

The world is today entering what has been called a "post-industrial" era in which the leading firms will not only be producers of goods but generators of ideas as well. Business enterprises in future will be increasingly research-oriented, and the most advanced countries will tend to develop and export technological know-how, follow-up services, and a variety of other intangible "products" in which the principal ingredient is intellectual capital. Very often, the employment of these inputs in the industrial process will occur in somewhat less advanced economies, where the costs of many key inputs – notably labour – are lower, and both the diffusion of technology and the marketing of the ultimate output will tend to take place through multinational firms. The greatest rewards will accrue to those who innovate. However, given the present organization of Canada's manufacturing sector, they will very rarely locate in this country.

10 Government of Canada, *Foreign Direct Investment in Canada* (The Gray Report) (Ottawa: Information Canada, 1972), p. 405. " 'Miniature branch-plant replica' is a term used to describe a subsidiary which adopts the same technology and techniques as the parent to turn out a virtually identical product line. The scale of operation of the Canadian subsidiary is in miniature by comparison with that of the parent, however, because its production is almost always restricted to the smaller Canadian market."

11 See, for example, Science Council of Canada, *Innovation in a Cold Climate: The Dilemma of Canadian Manufacturing*, Report 15 (Ottawa: Information Canada, 1971); and Arthur J. Cordell, *The Multinational Firm, Foreign Direct Investment, and Canadian Science Policy*, Science Council of Canada Special Study 22 (Ottawa: Information Canada, 1971).

The most vital resource of all in the economy of the future probably will be the managers, highly trained staff specialists, and other key personnel who can mobilize capital, people, and techniques (including technology, strictly defined) to the service of a profitable business venture. Already the success of many so-called "conglomerates" – in which a holding group administers a collection of widely differing commercial activities – suggests that great economies of scale are to be obtained from spreading costly management overhead. But the Canadian market is unlikely to be large enough to yield such gains either. The newer management cadres will tend to head multinational firms, and it is clear that under present conditions the head office will be located abroad, along with its managerial expertise.

Conclusions

The lingering protection in Canada and foreign countries still largely confines Canadian secondary industry to a relatively small market, and this has adverse effects on the growth of productivity and real incomes, as well as on the extent and pattern of foreign ownership, the pace of technological advance, and the development of innovative capability. In short, commercial policy has contributed to a deterioration of this country's capacity for sustained, dynamic, autonomous growth – a capacity that will become increasingly important in the future. Thus the results of a long evolution of trade policies can hardly be viewed as a contribution to independent national decision-making in Canada.

4

**COMMERCIAL POLICY
AND REGIONAL DEVELOPMENT**

If Canada's commercial policy – combined with the commercial policies of other countries – has led to a loss of efficiency and at the same time has been detrimental to this country's economic independence, what has been the effect on national unity, another traditional concern? Over the hundred years since the establishment of the National Policy, the emphasis in our continuing quest for unity has moved away from a preoccupation with settling the outlying areas of the country towards a need to reduce regional economic disparities, as well as to ensure greater regional representation in national decision-making. In this regard, the contribution of commercial policy to regional development is very important. Have import tariffs narrowed or widened regional disparities, improved the sense of shared advantage in confederation, or exacerbated perceived difficulties between one region and another? To answer these questions we must consider how the effects of commercial policy on trade, output, employment, and other economic variables are felt by the various regions.

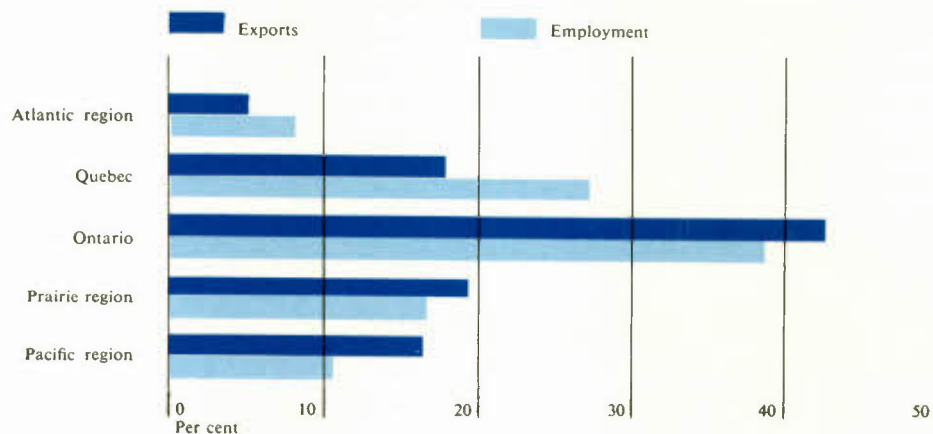
Regional Aspects of Canadian Trade

The production of goods for export to other countries makes a significant contribution to economic activity in all regions of Canada, although its importance varies considerably from one region to another. Chart 4-1 compares employment (which is a proxy for the contribution of the various regions to national output) with each region's share of total exports. This comparison indicates that exports to foreign countries are at present more important to Ontario, the Prairies, and British Columbia than to the Atlantic provinces or Quebec. These same shipments are a significant determinant of regional economic activity, and in that way they also influence interregional trade.

Relationships of Canadian regions to individual foreign markets vary because of differences in transport costs, foreign tariffs, import demand, and the regional composition of output. The United States is the most important destination for total Canadian exports. But, while each region ships more to the United States than to any other foreign destination, that proportion ranges from about 50 per cent for the Pacific region (British Columbia and the Yukon) to 80 per cent for Ontario, compared with 67 per cent for Canada as a whole (Table 4-1). On the other hand, Quebec is a more important supplier of exports to the EEC (30 per cent of the Canadian total) than is Ontario (17 per cent), and the Pacific region supplies more than half of total Canadian exports to Japan. Thus any alteration of trade flows with the United States would have a relatively greater impact in Ontario than in the other regions, and changes in the level of trade with the EEC or Japan

Chart 4-1

Distribution of Canadian Exports and Employment, by Region, 1973



NOTE Regional export figures attribute some grain and coal shipments to the Prairie region.

SOURCE Based on data from Statistics Canada.

Table 4-1

Destination of Exports from Canadian Regions, 1973

From \ To	United States	EEC (Six)	Britain	Japan	Other	All countries
(Millions of dollars)						
Atlantic region	744	144	115	13	200	1,216
Quebec	2,637	452	371	117	673	4,250
Ontario	8,573	264	565	115	964	10,481
Prairie region	2,618	328	200	578	1,056	4,780
Pacific region	2,040	321	331	982	320	3,994
Canada	16,612	1,509	1,582	1,805	3,213	24,720

NOTE The basic figures for exports, by region of lading, have been adjusted to attribute certain grain exports to the Prairie region. This involved adding and distributing \$1.8 billion in exports to the Prairie region figures and making appropriate reductions for the other regions. In addition, \$45 million of coal exports were added to the Prairie region total and subtracted from the Pacific region total. See Statistics Canada, *Weekly Bulletin*, January 12, 1973, p. 2.

SOURCE Based on data from Statistics Canada.

would be likely to impinge more heavily on Quebec and British Columbia, respectively, than on the other areas.

Such differences should, of course, be considered in the perspective of more general regional characteristics, and particularly in terms of the variations in the industry mix across the country. The manufacturing sector is heavily concentrated in Ontario and Quebec, which together accounted for 80 per cent of Canada's employment in manufacturing in 1970. Manufacturing employment as a share of total employment is well below the national average in the Prairie and Atlantic regions and, to a lesser extent, in the Pacific region. Manufacturing in these regions tends to be heavily dependent upon a few industries. Some regions are, therefore, more dependent than others on particular markets for their goods (Table 4-2). Manufacturing employment in Quebec and the Prairies, for example, has a greater than average dependence on other regions of Canada, while Ontario and British Columbia are somewhat more dependent than average on foreign markets – although in Ontario's case this partly reflects the results of the Automotive Agreement.

Table 4-2

Share of Manufacturing Employment Dependent upon Various Markets, by Region, 1970

	Local market	Other Canadian regions	Foreign countries	Total
	(Per cent)			
Atlantic region	37.37	31.50	31.13	100.00
Quebec	43.06	37.05	19.89	100.00
Ontario	49.08	26.60	24.32	100.00
Prairie region	52.42	34.85	12.73	100.00
Pacific region	41.70	13.74	44.57	100.00

SOURCE H. M. Pinchin, "The Regional Impact of the Canadian Tariff," a background study for the Economic Council of Canada.

The Regional Impact of Trade Barriers

Canadians have traditionally been concerned with the balanced development of the country's several regions. This objective has been pursued directly through equalization payments and other fiscal measures, as well as through policies expressly designed to foster the location of industries in the less-developed areas of the nation. Other public policies have also influenced regional development, even if more indirectly. Among these has been commercial policy, including tariffs.

In Canada's case, its own tariff can be likened to a tax, which all Canadians pay when they buy either dutiable imported goods or domestically produced goods that are protected to keep their prices above world market levels. On imported goods, this tax goes to the federal government, but on domestically produced goods the equivalent of the tax is hidden in their price and goes to the producers.

As buyers of protected products, Canadians across the country bear this tax – part of the price of protectionism – more or less equally. When buyers and producers are in different regions of the country, however, the payment between them involves an interregional transfer of funds. But manufacturing, the sector most protected by the Canadian tariff, is concentrated in the urban areas of southern Ontario and Quebec, so these provinces receive a much larger share of the transfers to producers than other areas of the country. In fact, work for the Council suggests that, for central Canada, receipts by producers exceed the direct cash costs imposed by the tariff on consumers.¹

Any such estimates are based on assumptions that at best can only approximate reality. However, by and large, they confirm that the Canadian tariff of itself redistributes income from other parts of the country to Ontario and Quebec. This has contributed to a greater concentration of employment in the central provinces. About 45 per cent of the manufacturing activity in Canada is still protected by nominal rates in excess of 10 per cent (Table 4-3). Of those protected jobs, 49 per cent are found in Ontario, 37 per cent in Quebec, and only 14 per cent in all other provinces. The great bulk of employment in the automotive industries, in which nominal duties are on average about 1.6 per cent as a result of the Automotive Agreement with the United States, is in Ontario. The nominal rate tends to understate the level of protection to automotive manufacturing in Canada, because certain safeguards for this country were included in the arrangements.

This "hidden transfer" to Ontario and Quebec has long irritated other parts of the country. And, indeed, it is not the only cost the tariff imposes on the nonmanufacturing regions of the country. Since the Canadian tariff, by reducing imports, tends to raise the value of the Canadian dollar, it may also reduce the profitability of the resource industries in those regions. Thus it can be argued that the Atlantic and western provinces are worse off as a result of the tariff. According to this line of reasoning, the central provinces could be said to benefit from the tariff. However, if a dynamic view is adopted, as is done in Chapter 6, such a conclusion is erroneous. We calculate interprovincial transfers by assuming implicitly that the productivity of firms would be the same with or without tariffs. If productivity increases after a freeing of trade, all provinces would benefit, not just the Atlantic or western provinces.

1 H. M. Pinchin, "The Regional Impact of the Canadian Tariff," a background study for the Economic Council of Canada.

Table 4-3

Distribution of Employment by Tariff Level of Manufacturing Industry, Canada and Its Regions, 1970

Nominal tariff on industry output ¹ (Per cent)	Canada		Regional share as a percentage of total Canadian employment in tariff class					Total
	Employment	Percentage share	Atlantic region	Quebec	Ontario	Prairie region	Pacific region	
Over 20.0	147,229	9.2	1.1	61.5	28.8	6.4	2.2	100.0
15.1 to 20.0	109,556	6.9	2.1	43.0	48.6	4.5	1.8	100.0
10.1 to 15.0	460,276	28.9	2.9	28.5	55.1	6.9	6.6	100.0
5.1 to 10.0	459,783	28.9	6.6	27.0	50.8	8.0	7.5	100.0
0.0 to 5.0								
Excluding automotive products ²	328,843	20.6	6.5	29.7	37.8	9.5	16.4	100.0
Automotive products ³	87,122	5.5	1.1	7.5	83.9	4.1	3.4	100.0
Total ⁴	1,592,809	100.0	4.4	31.2	49.0	7.4	8.0	100.0

1 Since tariffs are measured as the average of a group of products, rather than as the duty on a single product, there is no industry with a zero nominal tariff, though some are very low. Alcoholic beverages and tobacco products have been excluded because of the difficulty of separating tariffs from excise taxes on these goods.

2 Excludes the industries that are primarily producers of automotive products.

3 Includes only the industries that are primarily producers of automotive products.

4 Excludes employment of 26,001 in the alcoholic beverage and tobacco industries as well as 29,000 workers for which there were insufficient data to calculate the employment distribution.

SOURCE Tariff data are from Bruce W. Wilkinson and Ken Norrie, *Effective Protection and the Return to Capital*, Economic Council of Canada (forthcoming). Employment figures are based on data from Statistics Canada.

It is well to remember, of course, that the Canadian tariff alone cannot be held responsible for all interregional transfers or the pattern of regional development. Moreover, its effects have been at least partly offset by other measures whose regional, as well as trade-distorting, implications have not always been recognized. Many of these measures have provided advantages to other than manufacturing industries—for example, a special tax status for the mining industry, transport subventions, a variety of supports for agriculture, and subsidies for fishing (see Table 2-6). To the degree that they have been justified as compensation for the protection of manufacturing industries, some of these policies would have been less necessary, and might have been unacceptable, in the absence of the Canadian tariff.

Foreign tariffs, and particularly those of the United States, also tend to work in the opposite direction from Canadian tariffs. Most countries' tariffs are biased in favour of greater protection for more highly processed goods while allowing easy access for raw materials (Table 2-1). Thus Canadian exports of highly manufactured goods have been discouraged, with the incidence of foreign tariffs

falling most heavily on manufacturing in Ontario and Quebec. The Canadian tariff was adopted, at least in part, to offset such effects.

Our real concern, however, is not with what has happened in the past but rather with the gains that might accrue to each region if Canada were to move now towards freer trade. Clearly, the answer to this question requires careful specification of just what kind of freer trade we are talking about – that is, whether it involves removal of Canadian tariffs alone, with foreign tariffs remaining unchanged (unilateral trade liberalization), or reduction of both Canadian and foreign tariffs (multilateral or bilateral trade liberalization).

We showed in Chapter 3 that the result of Canadian and foreign trade barriers combined was the inefficient structure of much of Canadian manufacturing. Removal of trade barriers would result, as we shall show in more detail later, not only in elimination of the transfers described above but, far more important, in the reorganization of Canadian industry towards greater specialization and higher levels of productivity. The greatest scope for reorganization would be provided by removal of both Canadian and foreign trade barriers. It would lead to substantial gains for all regions, but particularly Ontario and Quebec. In contrast, unilateral removal of Canadian tariffs, with no change in foreign trade barriers, would result in smaller gains for the country as a whole, and the implications for distribution of those gains among regions are less clear. Certainly, the western and Atlantic provinces would benefit, and Ontario and Quebec would also gain as consumers and resource-producers. What is not certain is how much scope unilateral free trade would provide for greater specialization by Ontario and Quebec manufacturing industries.

Quebec's case deserves special mention. Although it has many modern competitive firms, a high proportion of the older, more labour-intensive industries, such as textiles, are located there, and these are highly protected by nontariff barriers as well as tariffs (Table 2-6). Irrespective of the trade policy that Canada may adopt, these older industries will come under increasing pressure, partly because of the increasing competitiveness of less-developed countries in the production of standard-technology goods. But there will also be domestic pressure as labour becomes scarcer in the 1980s, and the less productive industries in Quebec – as in Canada as a whole – will find it increasingly difficult to attract the labour they require.

Conclusions

Canadian tariff protection has been a chronic source of contention in federal-provincial affairs. The Atlantic provinces and the west have never ceased to resent the price they must pay for the tariff and to suggest that its benefits accrue almost entirely to Ontario and Quebec. Despite evidence that many industries outside

these two provinces have also received various types of government support, or despite the fact that the Canadian tariff was at least in part intended to offset the effects of foreign tariffs on manufacturing in Canada, the Atlantic and western provinces feel strongly that they have paid continuously for the industrialization of central Canada. With the growing economic power of the western provinces, one can expect to see increasingly difficult federal-provincial discussions on the regional sharing of industrial development.

If Canadian economic policy has not resolved the perennial issues of balanced regional development, the onus cannot be placed wholly upon either past or present Canadian commercial policy. But its direct regional effects have often been negative. Furthermore, to the extent that it has caused inefficiencies in the economy, commercial policy has reduced the real resources available to deal with regional problems. And, while important trade measures have been adopted in response to regional needs and opportunities, it has in fact proved very difficult and costly to use commercial policy as an instrument for achieving those ends.

5

THE CHANGING WORLD ECONOMY

“Lingering protectionism” – a combination of our own and foreign trade barriers – has locked this country into a situation in which Canadians are paying considerable costs and reaping few of the benefits that are claimed for such measures. With the way the international economic scene is now developing, the costs could rise even more rapidly in future.

The most important of these international economic developments are examined in this chapter. They include major trends of historic importance: rapid economic growth in Japan and to a lesser extent in Western Europe, with a consequent relative decline in the overwhelming economic strength of the United States; creation of supranational economic blocs, notably in Western Europe but also in Eastern Europe, Central and South America, East Africa, Australasia, the Caribbean, and elsewhere; and the emergence of new economic growth centres in Southeast Asia, Latin America, and the Mediterranean region, and eventually in South Central Asia, the Middle East, and Africa. In addition, the significance of the multinational organization of corporate enterprise – either in much the present form or modified to adapt better to political requirements as well as business considerations – will increase, as will a further measure of détente between the communist countries and the West, implying growth in trade and increasing investment by U.S., European, and Japanese firms in Soviet, and possibly Chinese, industrial activity. Finally, shortages of certain industrial materials and agricultural commodities will occur, related partly to demand pressures from increasing world affluence and partly to depletion of the more readily tapped deposits of some resources.

Shifting Economic Status

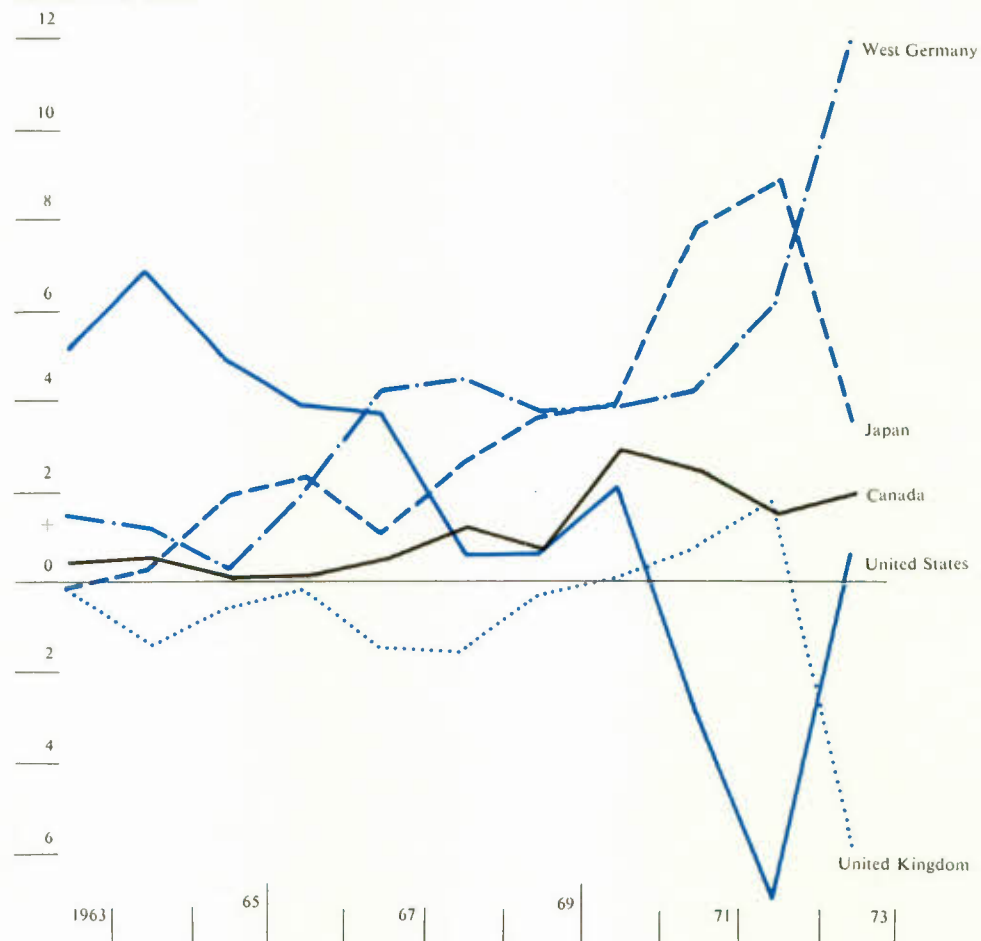
The United States still has by far the largest and wealthiest economy in the world. It is clear, however, that during the 1970s much of Europe will approach U.S. levels of income and that Japan is also catching up, albeit from a lower base. A further dimension has now been added by the special position of the oil-rich exporting countries. U.S. dominance of the international economic system is thus giving way to a changing balance of power.

Deterioration of the U.S. trade balance, a measure of shifting economic status, stemmed from several developments during the 1960s. The relative strength of the Japanese and most of the European economies increased, as reflected in their trade competitiveness vis-à-vis the United States (Chart 5-1). U.S. economic policy during the Vietnam War and the inability of the United States to devalue the dollar when necessary, under then existing rules, also contributed to this shift. Chart 5-1 shows that by 1971-72 the large U.S. trade surplus that peaked in 1964 had been replaced by substantial deficits. The United States responded to this situation in August 1971 by suspending convertibility of the U.S. dollar into gold, imposing

Chart 5-1

Merchandise Trade Balances, Five Industrial Countries, 1963-73

Billions of U.S. dollars

SOURCE: International Monetary Fund, *International Financial Statistics*, various issues.

surcharges on many imports, and introducing the Domestic International Sales Corporation (DISC) program.

These changes were more than the international monetary system, created after the Second World War, could cope with. It broke down finally in August 1971 because it was too rigid to adjust to the U.S. balance-of-payments deficit. Adjustment might have occurred if the United States had adopted tighter domestic policies or if its trading partners had pursued more expansionary monetary and fiscal policies. However, the major market mechanism for adjustment – occasional changes in otherwise fixed rates of exchange – would not, in practice, permit smooth operation of the system. This failure to ease the strain of adjustment led the United States to resort to restrictions on trade and capital movements. In this sense, the malfunction of the international monetary system has helped to blunt the move towards freer international trade. Member countries of the International Monetary Fund (IMF) have thus been attempting since 1971 to establish rules and obligations for a new world monetary system. The negotiations were already complex and difficult before the escalation of international oil prices in 1973 and 1974; the resulting rapid increase in the foreign exchange holdings of the major oil-exporting countries further complicates the task of reaching agreement on a monetary system for the longer term.

Since mid-1971 the exchange rates of the major countries have been floating, determined largely by market forces with some official management. The U.S. dollar declined sharply to mid-1973 relative to the currencies of its major trading partners; thereafter it recovered some of its former exchange value. From 1967 to June 1973 the U.S. dollar declined 17.5 per cent, and from 1967 to September 1974 about 13 per cent, in terms of the currencies of fourteen trading partners.¹ This change brought a marked improvement in the U.S. economy's competitive position, which, when reinforced by the strong world demand for farm products, was reflected in a U.S. trade surplus in 1973. A deficit in 1974 was attributable to the cost of oil imports; compared with Japan and Western Europe, however, the United States was in a good position to adapt to this energy situation. Thus these developments may indicate an improving U.S. position. Nevertheless, there is little doubt that the earlier overwhelming dominance of the United States is giving way to a more balanced distribution of strength among nations.

Europe has the potential to narrow the gap in GNP and incomes with the United States. The nine countries of the EEC, the largest trading unit in the world, have a high-income population of 256 million people. In 1973 imports from out-

¹ This is a weighted average change in the value of the U.S. dollar in relation to the currencies of fourteen industrial countries; U.S. two-way trade in 1973 provides the weights. Canada, Japan, Germany, and the United Kingdom in that order are most important, accounting for 75 per cent of the trade of the fourteen-country group with the United States.

side the Community were valued at \$U.S. 93 billion, compared with U.S. imports of \$U.S. 73 billion that year. The growth rate of the EEC from 1970 to 1980 has been projected to be faster than that of the United States (Table 8-1), though these estimates will be affected by the world oil-price crisis if it is prolonged.

Of course, it is far from certain that Europeans will maintain the momentum of their expansion over the longer haul. The extent to which their high rate of growth can be continued (or even increased) depends to a large degree on the progress made in the economic integration of the European Community and on the effect of membership on recent entrants to the group, notably Britain, which has for some years been experiencing rather slow expansion. The prognosis for the British economy on present trends is very poor, and a weak Britain must influence adversely the overall potential of Europe. On the other hand, if British performance should start to come up to that of France and Germany, Europe's rate of growth would be accelerated significantly. In any event, the likelihood is that Europe's importance in the world economy will increase over the years ahead.

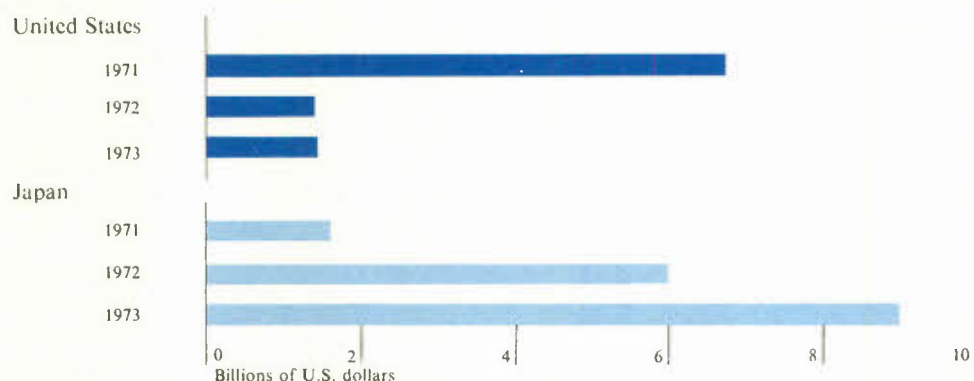
Japan's growth rate for much of the postwar period was considerably faster than that of either the United States or Europe, though by the mid-1950s Japanese real GNP had merely returned to its prewar level; in effect, the country had lost fifteen years of growth. By the end of the 1960s, however, Japan's economy was larger than that of any Western European country. Japanese output in 1973 was nearly one-third that of the United States and around 40 per cent of that of the nine EEC countries. Over the long term, under our assumptions about Japanese growth to 1980, the Japanese economy is projected to increase further in size relative to its trading partners, but rather more slowly than in the past; Japanese income per capita would continue to rise towards the U.S. level. In 1973 Japanese exports were valued at some \$37 billion and imports at \$38 billion. Japanese projections indicate a several-fold growth of imports between 1973 and 1985 and suggest that imports from Canada might rise from around \$1.7 billion in 1973 to more than \$9.0 billion by 1985.²

Japan is reshaping its economic policies. While higher priority is being given to social measures and pollution control, Japan nevertheless remains preoccupied with the economics of natural-resource scarcity. It is also more concerned than ever with its role as a major industrial nation in world affairs. That country wishes to sustain a steady export flow of long-term capital, reflecting the need to invest in capacity to produce raw materials for Japanese industry. This also indicates a desire to "export" less advanced manufacturing industries to labour-surplus areas like Brazil in order to upgrade the quality of industry at home. An integral part of this scenario is the development of major markets for capital and securities.

2 Japan Economic Research Center, *The Structure of a Three Trillion Dollar Economy* (Tokyo: Japan Economic Research Center, 1974).

Chart 5-2

Net Exports of Long-Term Capital, United States and Japan, 1971-73



SOURCE U.S. Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin* 61, no. 2 (February 1975), and *Japan Economic Journal*, April 3, 1973, April 23, 1974, and April 22, 1975.

Chart 5-2 illustrates the recent rise in the importance of Japan as a net exporter of long-term capital – another reflection of its increasing importance as a world economic power. Although there are real physical limitations to the continuation of Japan's phenomenal climb to industrial superpower status, and these may bring its economic performance more into line with U.S. rates of growth in the not-too-distant future, its new strength as an industrial power is assured.

Admittedly, because of the apparent constraints on the future growth rates of both the EEC and Japan, we must not overstress the extent to which they are catching up with the United States. Even so, the hitherto unqualified pre-eminence of the U.S. economy on the international scene is giving way to a more even balance of forces among the principal nations and blocs. The implications of this change are substantial.

The Growth of Economic Blocs

The prime mover in the development of regional economic blocs has, of course, been the European Economic Community. With the entry of Britain, Denmark, and Ireland into full membership in 1973, and with the associate status afforded other developed European countries, the whole of Western Europe has become effectively organized into a free-trading unit. Moreover, the group has established other associate arrangements with countries of the Mediterranean, Africa, and elsewhere. For the most part the external barriers to trade with countries outside

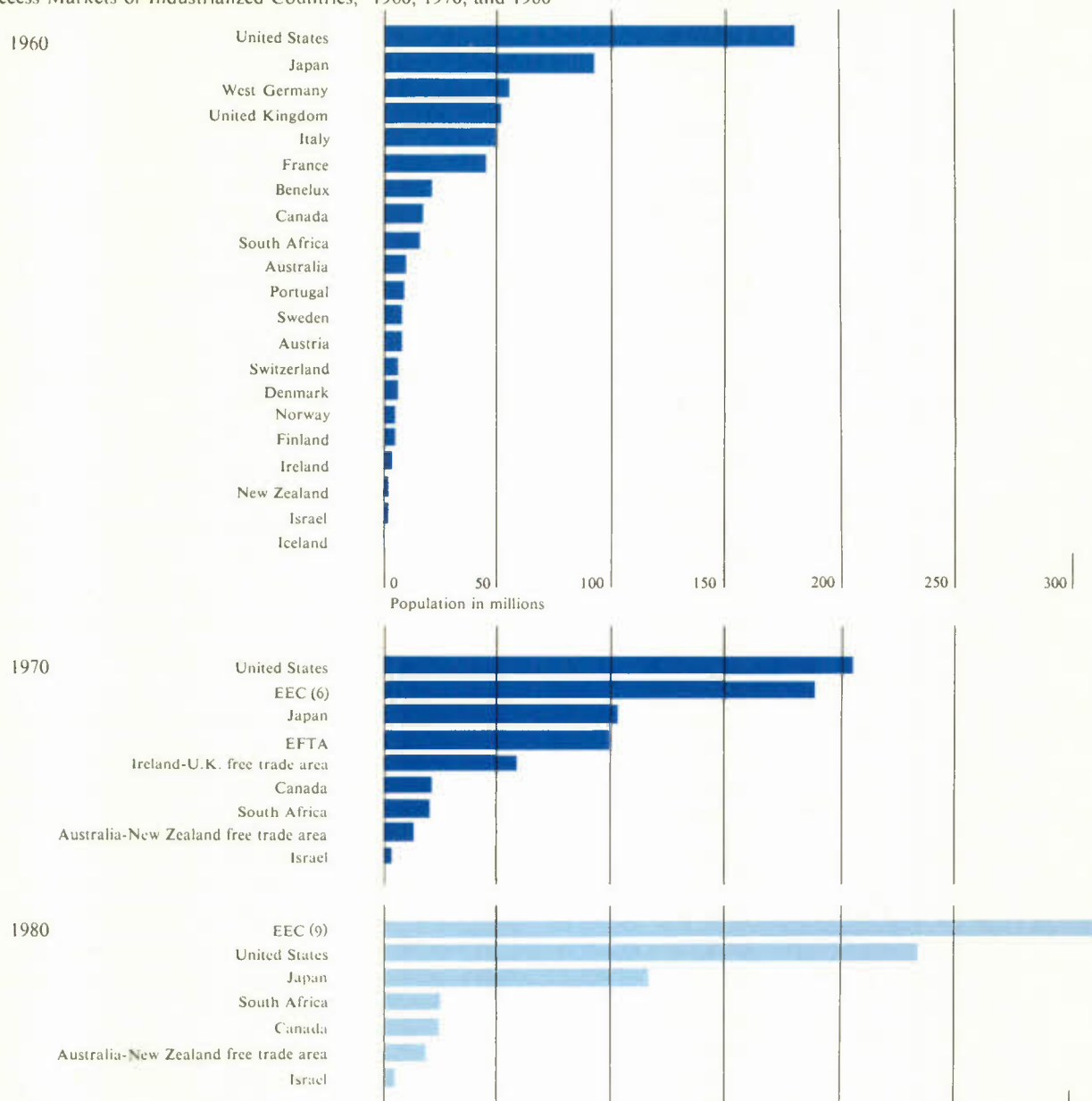
the Community are not especially high, at least on industrial goods, but they are greater than the virtually nonexistent obstacles within the bloc.

While no supranational unit comparable to the EEC has been developed elsewhere, regional experiments are being made in other places. Latin American countries have for a long time been trying to establish a free trade zone (LAFTA), but their success has been limited. Two more manageable groupings have, however, been formed in Latin America: the Central American Common Market (CACM), embracing most of the small states of the isthmus; and the Andean Group, which includes Venezuela, Colombia, Peru, Ecuador, Bolivia, and Chile. In addition, Australia and New Zealand operate a modified free trade area (NAFTA), and the islands and territories of the Commonwealth Caribbean have adopted a free trade arrangement.

From Canada's point of view, some deleterious effects are to be expected in the short run from enlargement of the European Economic Community to include Britain, because the special access to the British market that Canadian goods have enjoyed under the "British preference" tariff system has been terminated. However, any stimulus to growth that results from EEC enlargement will tend to increase Canadian exports. Exploratory analysis for the Council suggests that, on balance, exports to the EEC will be moderately depressed during the balance of the 1970s; even so, shipments to that market will rise substantially to 1980, from the level of \$3.1 billion in 1973. Thus, although there has been concern over this problem, long-term attention should focus on the more important questions of access to European markets and the future role of the EEC in shaping global economic arrangements.

The creation of economic blocs has more awkward implications for Canada in the long run. This country has generally resisted the idea – if not, in many instances, the fact – of integration into a North American regional economic bloc. Indeed, it has long been a feature of Canadian policy to use additional external links to try to counterbalance the forces that orient our economy towards the United States. Yet the extent of Canadian involvement in the continental economy is very great; some 70 per cent of both our exports and our imports are traded with the United States, and capital flows (including direct investment) are also set into a continental pattern. Moreover, development and enlargement of the EEC seem to have accentuated Canada's sense of being part of a North American economic bloc, even though no formal structure exists. There is also the growing tendency of major nations to speak of a "tripartite" organization of international affairs, consisting of a series of economic subsystems grouped around the European Community, the United States, and Japan. Such an arrangement seems to throw Canada arbitrarily into the U.S. orbit – a prospect that disturbs many Canadians.

Chart 5-3

The Free-Access Markets of Industrialized Countries,¹ 1960, 1970, and 1980

¹ Industrialized countries are those with a per capita GNP in 1970 of \$1,000 or more, or – in the case of Portugal – free access to a wider market of at least this level. Oil-exporting countries with per capita GNP of over \$1,000 whose economies are dominated by this activity are excluded.

SOURCE Based on data from National Planning Association, *U.S. Foreign Economic Policy for the 1970s: A New Approach to New Realities*, Planning Pamphlet No. 130 (Washington: National Planning Association, 1971).

The problem created for Canada by increasing international regionalization may become even more acute if some Latin American countries (which are expected by 1990 to have an average level of economic well-being comparable to Europe's today) establish the viable union (or unions) they have long been attempting. Some Latin American nations are beginning to show promise of sustained economic advance, and it is decidedly possible that within twenty-five years these countries will constitute the noncommunist world's fourth major industrial zone.

Chart 5-3 illustrates the regionalization of the rich industrial countries into trading blocs and the movement of Canada to the periphery. In 1960 Canada's domestic market was close to or larger than sixteen others among twenty-three industrial countries and not substantially below the average size. By 1980, however, the Canadian market will be less than one-quarter of the average size of the economic units into which these countries will by then be grouped. Canada will thus find itself one of the very few industrial countries without free access to a market whose population numbers over one hundred million.

Emergence of New Growth Centres

The ability to produce manufactured goods economically is spreading from the advanced industrial powers to other countries, some of which will, within a few years, join the nations and blocs that have considerable economic significance on the international scene. Although we may be into the next century before the balance of forces shifts dramatically, it seems evident that, long before then, the economic importance of several developing regions of the world will begin to rise sharply. The trend is furthest advanced at present in East Asia, where the strongest economies outside Japan are Hong Kong, Taiwan, South Korea, and Singapore.

In these countries, and in other growth centres, energetic populations have formed the nucleus of a spreading industrial boom based on low-cost production of standard-technology items for export – notably such products as clothing and textiles but also electrical appliances and equipment, engineering and metal products, and various kinds of light manufactures.³ For many standard-technology items, producers in highly developed nations cannot match the manufacturing costs of competitors in Hong Kong, Taiwan, India, Pakistan, Korea, Mexico, Brazil, Argentina, Iran, Algeria, and other developing countries that now produce these

3 The "product-cycle" theory is an attempt to describe this phenomenon. According to this theory new technology is first applied to product and process innovations in the most advanced countries, then gradually diffuses throughout the world to less and less sophisticated industrial economies, as the technology is copied and the importance of inexpensive factor inputs becomes greater than that of complex technical refinement. For a most useful summary of the theory, see Raymond Vernon, *Sovereignty at Bay* (New York: Basic Books, 1971), Chapter 3.

goods efficiently. Since many other countries in underdeveloped areas are joining the list of potential low-cost exporters of basic manufactured goods, a fundamental question for advanced nations like Canada is how quickly, and by what practicable means, they can reduce their own operations in these fields and transfer their resources into more appropriate lines of activity.

The challenge of import competition is clear. Equally important is the fact that the industrial growth of many developing countries creates opportunities for Canadian producers, provided they are competitive suppliers. Canadians could benefit from these trends, both as consumers and producers, if methods could be found to deploy efficiently our comparative advantages in resources, education, and labour skills. Growing two-way trade between rich countries and the developing countries should be welcomed as an opportunity as well as a competitive challenge to Canadians.

Multinational Production

In much of this development of important new centres of economic activity, a large role is being played by multinational enterprises (MNEs), whose capacity for mobilizing resources and knowledge of global markets gives them the unique ability to produce almost anywhere and then distribute internationally. They will not be the only mechanisms for bringing newly developing regions of the world into the economic system, any more than they have been the sole agency of integration among the existing industrialized nations, but their function in both these respects is significant enough to deserve the very closest attention on the part of policy-makers concerned with trade in the new international economy.

At present the foreign production of goods and services by multinational enterprises (that is, production outside their home bases) is estimated to be worth at least \$300 billion a year, or more than one-tenth of the combined output of all noncommunist countries.⁴ The sales of foreign subsidiaries of U.S. multinationals are valued at roughly five times U.S. exports. The real value of sales of multinational firms has been rising since the early 1950s at a rate of some 10 per cent annually or twice as fast as real output in the noncommunist world. Such enterprises are introducing new elements into world trade patterns that greatly modify some of the established notions of commerce between nations.

While not all observers are convinced that international economic affairs will henceforward be dominated by the kind of giant corporate empires that are developing today, there is little doubt that multinational business organization will be a prominent feature of the emerging global economy. Table 5-1 provides one

4 J. N. Behrman, "An Essay on Some Critical Aspects of the International Corporation," a background study for the Economic Council of Canada, Ottawa, 1970.

measure of the growing importance of multinational enterprises by showing clearly the degree to which these huge concerns dominate the international commerce of the United States. U.S. subsidiaries abroad are themselves also major exporters, both to the United States and to other markets, and their transactions add to the volume of trade that is associated with U.S. multinational firms.

Naturally, the trading activities of the subsidiaries have to be seen as part of the trade of the countries in which they are located. If these countries are also the home base to other than U.S. multinationals, as is the case in Europe, Japan, and to some extent Canada, then the interweaving of intracorporate transactions and related multinational-associated trade with more conventional commerce becomes extremely intricate. These complexities will increase with the growing size and geographic scope of large corporations based outside the United States – notably the rapidly expanding European and Japanese multinationals. Moreover, the ability of all MNEs to shift production facilities, technology, research, and management skills may tend to reduce the influence that individual governments can exercise over the development of their own economies.

Concern with this problem has been widespread in recent years, with various proposals being put forward for international regulation of multinational firms, as well as for more traditional national control of competition. Whatever

Table 5-1

Export Activities of 298 U.S.-Based Multinational Enterprises, 1966 and 1970

	1966	1970
	(Billions of U.S. dollars)	
Exports by sample MNEs to own subsidiaries	5.0	8.6
Exports by these MNEs to other than own subsidiaries	7.7	11.4
Exports by other U.S. firms to subsidiaries of these MNEs	1.0	1.2
Total MNE-associated exports	13.7	21.2
	MNE-associated exports as a percentage of total U.S. exports, by area	
To World	46.9	50.6
To Canada	48.0	54.7
To Europe	43.2	51.3
To Japan	33.8	41.0

SOURCE Based on a survey of 298 major U.S. multinational enterprises by Betty L. Barker, "U.S. Foreign Trade Associated with U.S. Multinational Companies," U.S. Department of Commerce, in *Survey of Current Business* (December 1972).

becomes of these ideas, there seems little doubt that some type of multinational enterprise will exist throughout the coming decades as a major catalyst of industrial development around the world. Thus any viable national policy for economic advancement will have to be predicated upon an effective marshalling of the resources of these firms for the service of the community concerned.

East-West Economic Relations

The past several years have seen a marked relaxation of tensions between western and communist countries; this has been accompanied by an easing of trade controls by the United States and its cold-war allies and a greater readiness by the Soviet Union and China to open their economies to commerce with noncommunist powers. In addition to the large recent exports of western grain to the Soviet Union (and, to a lesser extent, to China), trade in other goods has been growing quite significantly. Some of this trade involves increasingly sophisticated consumer products and other high-technology items, such as China's purchases of British and American jet aircraft. Westerners have recently been able to place investments in the Soviet Union; Fiat and Pepsi-Cola are two major concerns building factories in that country for local production and distribution.

On balance, the evidence suggests that these trends will continue, with the communist nations demonstrating some readiness to purchase western technology – either in the form of products, through licensing of processes, or by permitting direct investment – to keep abreast of developments in the rest of the world. The West is apparently ready to encourage this for both political and economic reasons. There has been disagreement about the conditions under which the President of the United States is empowered by the U.S. Trade Act of 1974 to extend most-favoured-nation treatment to the U.S.S.R. and other state trading economies. Nevertheless, détente still seems to be the policy of both sides.

This situation has two major implications for economic affairs in western countries: important new markets and investment possibilities are becoming available, requiring a special approach by potential exporters and investment interests; and communist nations will be able to buy large quantities of western goods and technology (as well as grains and other established trade items) only if the West makes room in its own markets for Soviet and Chinese exports.

As far as the latter is concerned, Soviet and Chinese planners have indicated that they do not feel obliged to adhere to bilateral balance in trade. The Chinese have clearly been pragmatic on this question, in effect balancing their trade with the West by means of surpluses with Asian countries.⁵ How-

5 See Claude E. Forget, *China's External Trade: A Canadian Perspective* (Montreal: Private Planning Association of Canada, 1971), p. 17.

ever, sooner or later communist nations will insist upon a rough symmetry in their trade with major western exporters, and this could pose a problem somewhat similar to that raised by the emergence into world markets of goods from developing countries. The production of the Eastern European countries, especially Czechoslovakia, Poland, and Hungary, has already created strong competition among western manufacturers of items such as bicycles. If the Soviet Union is in a position to export large volumes of goods, much of the trade will probably consist of similar standard consumer products of relatively low price. In addition, the Chinese have a vast potential for production of very low-cost manufactured items such as textiles and clothing. These factors may lead to adjustment difficulties for western countries.

Given the size and the centralized nature of the communist economies, their exports could become a powerful factor in international trade within a few years. The best response of the advanced western nations to this change and to the increasing competitiveness of developing countries is in principle very clear: they should shift resources away from labour-intensive, standard-technology production into areas in which they have greater comparative advantage by virtue of a more developed technology and highly educated work force. Here again there is a challenge to Canadian policy.

Shortages of Primary Commodities

During the last few years the world has encountered pronounced shortages of certain agricultural commodities and industrial raw materials, including energy sources, that have been responsible for sharp increases in prices not only of these items themselves but of various products in which they are important components. There is a tendency for developments of this kind to become exaggerated as a result of the prominence given them in the press and elsewhere. However, while "crisis" may be too strong a word for the present situation, concern about prospective supplies of key raw materials and certain farm commodities is justified.

If the more alarmist views of this problem are discounted, what emerges is a probability that rising affluence around the world, with consequent rapid increases in the demand for both industrial inputs and higher-quality foodstuffs, will exert increasing pressure on commodity supplies in the foreseeable future. What this implies in practical terms is a series of developments along the following lines. Existing producers of the commodities in question (such as Canada) will enjoy an improved position, not only in immediate price terms but also with respect to longer-range bargaining advantage. In addition, exploration for new resources and their exploitation will be encouraged, as will the opening-up of new farming areas in response to increased demand. In some instances, alternative materials

or foods will be used in place of commodities in short supply. Finally, other policies will be adopted that involve an economic cost but have the effect of reducing dependence on foreign supplies of crucial commodities.

In these circumstances it is difficult to foresee the implications for Canadian commercial policy. However, a country like Canada, substantially endowed with natural resources and agricultural land and well placed to supply major industrial materials, is likely to enjoy an improved situation. But this would not reduce the need to increase productivity in other sectors, notably secondary manufacturing. Trends in the demand for primary products have been exaggerated before, and some of the resources in question are depletable. Moreover, the resource industries alone are unlikely to provide sufficient high-grade employment for an increasingly educated labour force.

The situation could, however, work to Canada's long-range advantage. It creates possibilities for arrangements that would facilitate the further processing of resources in Canada whenever that was economically viable.⁶ For this to be feasible, it would be necessary to increase manufacturing productivity. To the extent that this is achieved, local processing would contribute to a basic strengthening of the Canadian economy. A growing demand for the products of primary industry would provide market support for producers, and thus it would be possible to withdraw some of the nontariff protection of these activities that has been provided at some cost to the total economy.

Conclusions

These international trends hold both challenge and opportunity for Canada. The challenge is to adjust to economic regionalism, new centres of low-cost manufacturing, growth in East-West trade, and the multinational organization of trade and investment. Opportunity lies in the rise of Europe and Japan, the prospect of large markets in developing countries, and the expanding demand for certain primary commodities. Our assessment underscores the importance of a commercial policy designed to improve the efficiency of Canadian secondary industry, upgrade the quality of indigenous technology, expand the scope for a highly educated labour force, and encourage the development of more Canadian-based multinational enterprises. Obviously, Canada must start now to respond to its changing international economic position. In some respects this will involve increased integration with our trading partners and, in others, greater autonomy for Canada both through increased prosperity and expansion of our own technological and managerial capabilities.

6 See Louis Silver, "The Pursuit of Further Processing of Canada's Natural Resources," *HRI Observations*, no. 6 (Montreal: C. D. Howe Research Institute, January 1975).

6

THE CASE FOR TRADE LIBERALIZATION

While Canada's immediate economic prospects are enhanced by its fortunate situation with respect to supplies of energy, primary materials, and basic commodities, the longer-range outlook is not so promising. With the creation of large trading blocs and the emergence of new producers of standard-technology goods in the developing world, Canadian industry seems certain to face extremely challenging competitive conditions at home and in foreign markets within the not-too-distant future. What are the implications of our analysis for Canada's commercial policy?

The results of the protective policies of the past cannot be said to argue for their continuation. Canadian and foreign import protection has contributed to our relatively poor productivity performance. Moreover, foreign control of our industry has been encouraged, and efforts to improve regional balance probably hindered, by a policy of continued import tariffs. In this chapter we argue that by far the best way for Canada to achieve its policy goals is through a significant liberalization of trade. We take this to imply not only the large-scale reduction or removal of our own and foreign tariffs but also the elimination or regulation of nontariff barriers.

If past experience is any guide, some Canadians will react very nervously to the suggestion that their government should pursue a policy of far-reaching reductions in import barriers. It is widely believed that moderate decreases in protection, accompanied by similar reductions abroad, are beneficial to our economy. But, in the view of many, deep cuts in our trade restraints would simply spell the end of the Canadian economy as we now know it. Because much of Canada's secondary industry is at present relatively high-cost, the view prevails that a sharp decline in protection would lead to the demise of large parts of our manufacturing sector, leaving us with an economic system devoted mainly to primary production. Thus it is believed that our living standards would be reduced and that there would be insufficient employment for our work force. The result would be prolonged unemployment, large-scale emigration, and a painful adjustment to the role of "hewers of wood and drawers of water."

Such fears are not well founded, in our view, since they are based on a conception of economic forces that is outdated and widely rejected by contemporary analysis. We are convinced that Canadian industry would be able to reorganize and prosper in a more freely trading environment – and in a manner that would provide very considerable long-run gains without a prolonged and painful adjustment process.

The Canadian Economy of the Future

Many of the fears about the economic impact of trade liberalization on Canada have to do with its effects on employment. Yet there is evidence to indicate that,

in the future, our preoccupation with the sheer volume of employment will increasingly give way to a concern about the kind of jobs that will meet the needs of a new type of labour force and a new type of economy. This prospect deserves some explanation.

One of the most important developments of recent times has been the drop in the Canadian birthrate. This phenomenon promises to reduce the pace of growth of the labour force attributable to the native-born population. During the period from 1982 to 1985, about 170,000 Canadian-born men and women will be entering the labour force annually, compared with an average of about 250,000 in the 1971-74 period and about 290,000 in 1974. By 1990 the rate of expansion of the ranks of workers through natural increase will be very slight indeed.

Our calculations, based upon past relationships of migration to economic activity, suggest that nearly 20 per cent of the increase in the labour force will be accounted for by immigration between 1975 and 1980, and about 27 per cent between 1980 and 1985.¹ By comparison, the proportion was 30 per cent on average in the 1946-66 period.² These figures could, of course, vary as a result of changes in immigration policy, but it would be surprising if they were substantially higher.³ Moreover, in the past, immigrants have also contributed to the educational quality of the labour force, and we do not foresee much if any dilution of Canada's existing educational endowment through future immigration.⁴

The Council's projections suggest, therefore, that the labour force, including net immigration, will grow by about 2.7 per cent per annum between 1975 and 1980 (compared with about 3.4 per cent from 1969 to 1974) and barely 2 per cent per annum from 1980 to 1985. This slowdown is likely to continue into the 1990s. The priorities of Canadian economic policy are, in consequence, also likely to shift steadily to emphasize less the number of jobs available in the economy than the quality of employment provided.

In addition, any problems associated with a move towards freer trade would be eased by the contemporary growth of employment in the service industries relative to that in manufacturing. Manufacturing, the principal sector of the economy affected by Canadian and foreign trade barriers, now accounts for only about

1 Between 1975 and 1985 the labour force is expected to increase by 2,620,000 and immigration to account for 585,000 of that number, or 22.3 per cent. For 1971-74 a comparable figure is 25 per cent.

2 Based on data presented by Frank T. Denton, *The Growth of Manpower in Canada*, 1961 Census Monograph (Ottawa: Queen's Printer, 1970), Table 29.

3 In February 1975 the government published a "green paper" on immigration as the basis for a wide-ranging policy debate.

4 R. A. Jenness, "Canadian Migration and Immigration Patterns and Government Policy," *International Migration Review* 8 (Spring 1974):8.

20 per cent of employment in Canada, and this proportion has been falling.⁵ Thus a move to liberalize trade would have significant direct effects on, at most, one-fifth of the labour force. Indeed, manufacturing industries in which tariff protection exceeded 5 per cent accounted for only 15 per cent of total Canadian employment in 1970. Moreover, any adverse effects on this minority of the working population would tend to be offset by the expansionary effects on Canadian output of reductions in other countries' trade barriers. Thus, even if one were to assume the worst consequences for some manufacturing industries, they would apply only to a relatively small number of Canadian workers.

This profound change in the traditional role of the protected sector has been almost entirely overlooked by most people contemplating the idea of trade liberalization. Coupled with the emergence of a general labour shortage in the last quarter of this century, such a change suggests that widespread unemployment is most unlikely. On the contrary, there would be excellent opportunities to absorb any labour that might be displaced – either in other manufacturing industries faced with a shortage of workers or in the burgeoning service sector, which even now accounts for about 63 per cent of all employment and by 1980 is expected to represent close to 70 per cent of the total. In short, in the next decade or so, reductions in import protection would be less likely to produce prolonged unemployment difficulties throughout the Canadian economy than at any time in recent history.

Our perception of the "employment problem" of the future is, in fact, quite different. Conventional standard-technology production is shifting from the advanced countries to other areas of the world where labour costs are lower. The corollary of this trend is the emergence in the developed nations of what has been termed the "post-industrial" economy. This means an economy in which the main emphasis is increasingly on the production of intangibles rather than on the output of goods.

A country in the post-industrial phase of development is one where basic scientific research is carried out, where technology is applied to new product ideas, where management and information systems for worldwide corporations are centred, and where major financial and other international service facilities are to be found. These functions are associated with advanced economies, and they imply the redirection of more standardized industrial pursuits to less-developed nations because of the relative costs and availability of different kinds of labour. One can, in effect, express this phenomenon in terms of comparative advantage arising from a new source. Countries with ample supplies of highly educated labour have a potential comparative advantage in the more technical and specialized activities

⁵ Some projections have indicated that, by 1980, manufacturing will account for about 17 per cent of employment. Economic Council of Canada, *Ninth Annual Review: The Years to 1980* (Ottawa: Information Canada, 1972), p. 62.

characterizing the post-industrial economy; countries without supplies of highly educated labour have a potential comparative advantage in more conventional industrial undertakings.

Clearly, Canada is a nation in the former category. Studies undertaken for the Council some years ago showed that the average level of education of the labour force was lower by about one school year in Canada than in the United States but that it was higher in Canada than in several of the leading Western European countries.⁶ Other work has indicated that Canada lags behind the United States in management education in particular.⁷ More recent calculations indicate that the general level of education in the Canadian labour force has risen in the last decade but that the gaps vis-à-vis other countries have changed very little. The average number of school years of the labour force was twelve in the United States in 1970 and close to eleven in Canada in 1971. Thus, while our labour force may not be the most educated in the world, it ranks very high.

Admittedly, we might conceivably be able to achieve an effective post-industrial economy without securing any notable proficiency in the sphere of manufacturing production. However, there is as yet no precedent for this kind of evolution, and evidence to date appears to suggest that post-industrial competence follows mostly from success in the more sophisticated areas of manufacturing activity. Thus we feel it is extremely important to stress the need of enhanced performance in this field, which we consider can best be derived from a pronounced liberalization of trade.

There is, of course, no guarantee that a liberalized trading environment would, of itself, lead to a concentration of knowledge-intensive endeavours. The point is that it would open up the inherent possibilities, enabling competition to do the rest. Up to now, comparatively poor use has been made of skills derived from education and training, partly because of the structure of our industry and the pattern of trade with which it is associated.⁸ In manufacturing, for example, the levels of output per employee and per man-hour are still significantly lower than in the United States. Skilled labour represents an important element in Canada's productive potential and, given sound policies, the returns on the employment of these resources could be a prime source of future economic efficiency and growth.

6 Dorothy Walters, *Canadian Income Levels and Growth: An International Perspective*, Economic Council of Canada Staff Study 23 (Ottawa: Queen's Printer, 1968). See also Economic Council of Canada, *Fifth Annual Review: The Challenge of Growth and Change* (Ottawa: Information Canada, 1968), Chapter 2.

7 D. J. Daly and Rein Peterson, "On Bridging the Gaps," *Management Science* 20 (December 1973): 550-69.

8 Harry H. Postner, assisted by Don Gilfix, *The Factor Content of Canadian International Trade: An Input-Output Analysis*, Economic Council of Canada (forthcoming).

The Impact of Trade Liberalization

In analysing the potential of Canadian industry under liberalized trade, one very important point should be noted at the outset. This is the elementary economic principle of comparative advantage expressed in this simplified form by David Ricardo:

Two men can both make shoes and hats, and one is superior to the other in both employments; but in making hats he can only exceed his competitor by one-fifth or 20 per cent and in making shoes he can exceed him by one-third or 33 per cent; will it not be for the interest of both that the superior man should employ himself exclusively in making shoes and the inferior man in making hats?⁹

What this principle implies is that this country's ability to prosper in a liberalized trading environment does not depend on whether certain industries enjoy *absolute* cost advantages over those in other nations. Even if Canadian factor costs were found to be generally out of line with those of our trading partners, the corrective forces of international trade and payments would eventually exert pressures leading to a shift in the exchange rate and/or internal prices and costs; such a shift, or shifts, would tend to bring about a new equilibrium position in which Canada would specialize in those goods in which its *comparative* efficiency was greatest. But just which goods it would export and which it would import at a given rate of exchange would depend upon the relative domestic factor and output prices. In brief, the levels of absolute costs and prices are important in determining how the economy would adjust to freer trade, but they do not determine the long-run pattern of trade.

With this broad proposition in mind, we can go on to consider how benefits would accrue from freer trade. They would derive from several sources. Economies would result from increased specialization; that is, industries would concentrate their production on goods in which Canada had a comparative advantage internationally. These gains would accrue even if there were no economies of scale in production, but such economies would also come into play. This means that, over and above the benefits from specialization as such, costs would fall as production runs were lengthened to meet expanded domestic and foreign demand. There could also be other economies of market size, including increased efficiency in selling, servicing, and distribution, as well as other scale-related factors such as opportunities for development of entrepreneurial skills and capacity to bear risks.

The achievement of these benefits would quite clearly imply a considerable reorganization of Canadian manufacturing. For this reason, it is useful to think of the effects of trade liberalization in three parts: the initial impact, assuming no

9 David Ricardo, *The Principles of Political Economy and Taxation* (Homewood, Ill.: Richard D. Irwin, 1963), p. 72.

change in the structure of production with its protection-induced inefficiencies; a period of reorganization to meet international competition; and the long run – the period after reorganization has been completed. The first two of these comprise what we frequently refer to as the transition period.

We have already pointed out that, because of protective policies, present costs and prices in many Canadian industries – particularly in the secondary manufacturing sector – are higher than those of their counterparts in the United States and other countries. Consequently, it should come as no surprise that if markedly freer trade were introduced before affected industries and firms had a chance to adjust to the new situation, the impact on output and employment would be adverse in many cases. The rationale for a rather lengthy tariff-reduction period is that reorganization would go hand in hand with liberalization. The initial effects could also be mitigated by appropriate complementary policies (see Chapter 13), and the temporary costs associated with shifting Canada's productive resources into new activities could quite properly be considered as an investment in new long-term economic viability. We now look at how these long-range gains would be achieved.

Reorganization of Industry

The impact of freer trade would be confined largely to secondary manufacturing. Canada's primary and related processing industries are already export-oriented and internationally competitive. They might benefit somewhat from cheaper imports, and they would be able to increase production of some processed products that have had to contend with higher tariffs than the primary forms. However, in this sector there would be no more than a modest increase in production and employment without, in most cases, the necessity of any large-scale reorganization.

The service industries are only slightly affected by existing trade barriers because their output consists largely of nontraded products and because many of their inputs come from within the sector itself.¹⁰ They could benefit slightly from cheaper imports, and they would tend to expand as real income rose through increased efficiency of the economy. But the direct impact of a marked liberalization of trade would be minor in this sector too.

Deep cuts in Canadian and foreign trade barriers would, on the other hand, have complex effects on this country's secondary manufacturing sector. Some industries would expand and new ones would appear; others – or at least parts of them – would decline relatively or absolutely. Responses would vary depending upon the particular trade option followed and the ability of particular firms to exploit the advantages that they might have under free trade.

10 Bruce W. Wilkinson and Ken Norrie, *Effective Protection and the Return to Capital*, Economic Council of Canada (forthcoming).

Some Canadian manufacturing industries are, of course, already well able to compete internationally. There are others – the manufacture of fertilizers is a good example – where a higher present Canadian price may reflect negative effective protection. With the adoption of much freer trade, their average costs would fall more than the prices of their products because of lower prices for inputs that are currently protected. Of more general importance, however, is the now extensive evidence suggesting that only rarely would the dropping of import barriers result in the displacement of whole industries by import competition. In the great majority of instances, what could be expected is a shift to more specialized lines of production *within* industries. This type of reorganization would not necessarily be a painful or costly process.

Intra-Industry versus Inter-Industry Specialization

On the basis of experience in free trade areas, it is hard to understand how the idea is perpetuated that Canada would be incapable of adjusting to much freer trade. In Europe, small nations like the Netherlands, Belgium, Denmark, Norway, and Ireland have joined the freely trading communities of the EEC and EFTA, and their adaptation to these new environments is one of the greatest economic success stories of the past quarter century. How is it that Canada is thought to be unable to reorganize its industrial system for competition under liberalized trade conditions with larger countries, including the United States, when Belgium, for example, is evidently thriving in a customs union with much stronger powers like West Germany and France?

The fact is that trade liberalization in the EEC, EFTA, and such other free trade arrangements as the Central American Common Market (CACM) and the Australia–New Zealand trading scheme have resulted in far greater trade expansion and fewer adjustment problems than had been anticipated.¹¹ The reason for this is that much of the adjustment took place not in terms of expansion or contraction of whole industries but by virtue of increased specialization within individual industries, resulting in expansion of both exports and imports of the items they could produce. This kind of intra-industry specialization and trade has occurred elsewhere too, partly at least as a result of the general lowering of trade barriers.

Table 6-1 illustrates the growth in intra-industry trade in a number of industrial countries in the 1959-67 period. For Australia, the increase in the total was very small, but detailed examination reveals that intra-industry trade with New Zealand was much larger than that with any other country.

11 Herbert G. Grubel and P. J. Lloyd, *Intra-Industry Trade* (London: Macmillan, 1975), pp. 9-10 and Chapter 9.

Table 6-1

Intra-Industry Trade,¹ Selected Countries, 1959-67

	Percentage of total trade			Change	
	1959	1964	1967	1959-64	1959-67
	(Per cent)				
Canada	28	35	48	25.0	71.4
United States	40	40	49	0.0	22.5
Japan	17	21	21	23.5	23.5
Belgium-Luxemburg	53	60	63	13.0	18.9
Netherlands	55	58	56	5.5	1.9
Germany	39	42	46	7.9	17.9
France	45	60	65	11.1	44.4
Italy	35	44	42	25.7	20.0
United Kingdom	32	40	69	25.0	115.6
Australia	14	17	17	21.4	21.4
Mean	36	42	48	16.7	33.3

1 Intra-industry trade is defined as the value of exports of an industry that is exactly matched by imports of the same industry. For comparing various industries, this value can be expressed as a percentage of each industry's total trade (exports + imports). For comparisons among countries, as in the table above, total intra-industry trade is expressed as a proportion of a country's total commodity export plus import trade adjusted for any trade imbalance.

SOURCE Herbert G. Grubel and P. J. Lloyd, *Intra-Industry Trade* (London: Macmillan, 1975), p. 42.

The Canada-U.S. Automotive Agreement played an important role in the very large increase in Canada's intra-industry trade. Prior to the Agreement, Canadian automotive subsidiaries produced a full range of cars to serve the small domestic market. After the Agreement came into effect, they specialized in a smaller number of models for the whole North American market. The increase in specialization was most marked in automobile assembly, in which productive efficiency rapidly approached U.S. levels. Increased specialization and efficiency gains also occurred in automotive parts, though on a lesser scale.¹² Evidence of increased intra-industry trade and specialization in Canada is not, however, confined to the automobile industry. Intra-industry trade increased from 1961 to 1971 in other

12 Despite the very considerable reorganization that took place, government assistance to the industry was not large: loans to producers of automotive parts amounted to only \$115 million from 1965 to mid-1973. It has been estimated also that the Automotive Agreement resulted in Canadian GNP being 5.3 per cent higher in 1971 than it would otherwise have been. See David A. Wilton, *An Econometric Analysis of the Effects of the Canada-United States Automotive Agreement*, Economic Council of Canada (forthcoming).

manufacturing industries, notably machinery and chemicals, and this has been attributed to the effect of Kennedy Round tariff reductions.¹³

This type of adjustment to the lowering of trade barriers reflects the characteristics of modern industry. Most groups of production establishments that are classified as "industries," particularly in manufacturing, do not produce only a single commodity, each unit of which is a perfect substitute for the others; rather, they make a range of products, under varying cost conditions, that are commonly differentiated from those of their competitors either by style (for example, in packaging or brand identification) or quality (with different performance characteristics, such as durability). Typically, manufacturers within a given industry in one country will be more competitive, relative to other countries, in some of the goods they can produce than in others. This is reflected, for instance, in the wide range of effective protection applying to products of the same industries, as well as in the simultaneous export and import of goods produced by the same industries in different countries. International competitiveness must, therefore, be considered in terms of both production costs and product differentiation and in terms of specific commodities rather than whole industries.

Product differentiation is, of course, apparent in both investment and consumer goods. Wherever it occurs, the possibilities for specialization in production and trade are broadened in two ways. First, the more distinctive the product, the less the producer will have to compete on price alone. Second, specialization in differentiated products increases the possibility of cost savings from longer production runs, albeit perhaps in narrower lines of specialization. Even with a relatively small domestic market for a particular item, longer runs may be possible under a liberalized trade situation if the product appeals to enough buyers in other countries.

Opportunities for Specialization

Lowering Canadian trade barriers would reduce the costs of inputs and spur Canadian industry on to reorganize in order to become internationally competitive. Substantial cuts in other countries' trade barriers would open possibilities of much larger production runs with consequent cost reductions. In brief, protection-induced costs would decline or disappear.

The possibility of product differentiation greatly strengthens the argument that, under a liberalized trading regime, industrial reorganization would be feasible and could be accomplished without great difficulty. But just which product lines are suited for specialization by Canadian manufacturers, and how great the gains from this process would be, depends not only upon their ability to offer distinctive items but on a variety of other factors affecting the location of industry

13 George Lermer, "Evidence from Trade Data Regarding the Rationalizing of Canadian Industry," *Canadian Journal of Economics* 6, no. 2 (May 1973):248-56.

in Canada – factors that would remain in effect even after the reduction of trade barriers. Considerable analysis of this subject has been undertaken over the last decade, primarily in terms of the removal of trade barriers between Canada and the United States. However, since 70 per cent of our trade is already with that country, not too much modification would be required for the conclusions to apply to wider liberalized trading schemes.

Perhaps the most important feature of this recent analysis is that examination of Canada's position in an open trading environment centres on comparisons of regions rather than on national aggregates. The locational advantages of Canadian regions relative to their competing U.S. counterparts were set out in some detail in a study of free trade between Canada and the United States by Ronald and Paul Wonnacott.¹⁴ Their comparison was based on two main elements: first, on the readily measurable costs of the various productive factors, including labour, resources, transportation, and capital; and, second, on a group of intangible factors whose effects are difficult to measure in quantitative terms, such as proximity to markets and manufactured supplies, as well as other benefits that industrial concentration may provide.

Factor-cost advantages are, of course, likely to shift over time; in addition, they are interrelated with movements in the foreign exchange value of the Canadian dollar. This implies that the range of products in which Canadian manufacturers would be likely to specialize would also shift, which means that continuous, extensive, and up-to-date analysis would be needed to identify the best possibilities for specialization under freer trade at any given time.

Since the mid-1960s a number of studies have been devoted to this question. Although they do not answer all of our needs, they nevertheless illustrate the feasibility of specialization by Canadian industries in a free trade arrangement. Assessing tangible factor-cost advantages for particular industries in different regions of North America, the Wonnacotts found that in the late 1950s Canadian locations were as attractive as those in the United States for the manufacture of a broad range of goods for an integrated market, including food and beverages, machinery, transportation equipment, apparel, and books and other printed material.¹⁵ This was primarily because lower labour costs outweighed any disadvantages with respect to capital and transportation costs. The industrial belt between Windsor and Quebec City appeared especially well placed, comparing favourably with the Chicago-Boston-Baltimore triangle – the major U.S. industrial area. In only a handful of industries were southern Ontario and western Quebec clearly inferior to the prime U.S. location.

14 Ronald J. and Paul Wonnacott, *Free Trade between the United States and Canada* (Cambridge, Mass.: Harvard University Press, 1967).

15 These comparisons were based on the assumption of parity between U.S. and Canadian dollars.

The position of the Canadian industrial belt was less advantageous than the Chicago-Boston-Baltimore triangle in the Wonnacotts' evaluation of proximity to markets and other "intangible" factors. But, in comparison with U.S. regions outside the industrial triangle, southern Ontario and western Quebec had an advantage in terms of both factor costs and nonquantifiable factors. Given that the level of industrialization and the rate of economic growth in the U.S. South, the Midwest, and the Far West approximated those of central Canada, the Wonnacotts concluded that the latter's potential for manufacturing activity under free trade would be strong. For many industries specialization would be the only additional element required for effective competition with their U.S. counterparts. The Wonnacotts' work also confirmed that the gains from specialization would be very high in some industries.

Canadian regions outside the Windsor-Quebec City corridor – areas in which production tends to be resource-based – were judged to have every prospect of continued prosperity where it already existed; some gain was expected where economic standards were low. To the extent that Canada-U.S. wage parity was not fully realized or that wage and salary cost increases in these regions were more modest than elsewhere in North America, a greater proportion of the industrial expansion resulting from free trade might be expected to occur there. In the absence of such special advantages, however, the opportunities for agriculture, resource exploitation, and other primary activities would be enhanced anyway, and benefits from lower import prices would accrue to all consumers.

The Wonnacotts' 1967 book was followed by detailed assessments¹⁶ of the free trade potential of several Canadian industries. The steel industry was found to be already internationally competitive, although it has been concerned with dumping from overseas sources. Its existing level of specialization implies that it would be able to prosper in a free trading world without the necessity of any large-scale reorganization. Pulp and paper are also being produced in Canada under internationally competitive conditions. Other parts of the paper industry are now protected, but research indicates that they have prospects for effective operation in a liberalized trade environment, notably in the specialized production of items whose costs would be affected by such things as the availability of low-cost electricity. Even the furniture industry, which was chosen for analysis in

16 Jacques Singer, *Trade Liberalization and the Canadian Steel Industry* (Toronto: University of Toronto Press, 1969); W. E. Haviland, N. S. Takacsy, and E. M. Cape, *Trade Liberalization and the Canadian Pulp and Paper Industry* (Toronto: University of Toronto Press, 1968); and David E. Bond and Ronald J. Wonnacott, *Trade Liberalization and the Canadian Furniture Industry* (Toronto: University of Toronto Press, 1968). These studies were published as part of its "Canada in the Atlantic Economy" series by the Private Planning Association of Canada (now the C. D. Howe Research Institute).

trade studies because of its import vulnerability, was considered to have potential in a number of specialty items and to be protected by transport costs in the case of bulky goods like upholstery and bedding.

*Recent Changes in Factor Costs
and Real Incomes*

Since these analyses were undertaken, some of the cost comparisons underlying them have changed (Table 6-2). Average hourly *money* wages of production workers in Canadian manufacturing were more than 20 per cent below the U.S. level in the early 1960s, but by 1974 that gap had disappeared. The gap also narrowed in real terms (that is, after allowance for price changes in both countries); in 1974, real hourly wages of production workers in Canadian

Table 6-2

Average Hourly Earnings¹ of Production Workers in Manufacturing,
in Current and Constant (1961) Dollars,
Canada and the United States, 1960-74

	Current dollars			Constant 1961 dollars ²	
	Canada	Canada	U.S.	Canada	U.S.
	(\$ Can.)	(\$ U.S.)	(\$ U.S.)		
1960	1.79	1.85	2.26	1.80	2.28
1961	1.83	1.80	2.32	1.82	2.32
1962	1.88	1.76	2.39	1.81	2.36
1963	1.95	1.81	2.46	1.88	2.40
1964	2.02	1.87	2.53	1.92	2.44
1965	2.12	1.96	2.61	1.96	2.47
1966	2.25	2.09	2.72	2.00	2.51
1967	2.40	2.23	2.83	2.07	2.54
1968	2.58	2.39	3.01	2.14	2.59
1969	2.79	2.59	3.19	2.20	2.60
1970	3.01	2.87	3.36	2.30	2.59
1971	3.28	3.24	3.56	2.44	2.63
1972	3.54	3.57	3.81	2.51	2.73
1973	3.85	3.85	4.07	2.54	2.74
1974	4.39	4.49	4.40	2.61	2.73

¹ Earnings figures do not include fringe benefits.

² These are the current-dollar figures deflated by the consumer price index for each country. The Canadian figures have also been adjusted to allow for a slight difference in the average level of consumer goods and services in each country for a benchmark year (1965). See Appendix by E. C. West in Dorothy Walters, *Canadian Income Levels and Growth: An International Perspective*, Economic Council of Canada Staff Study 23 (Ottawa: Queen's Printer, 1968).

SOURCE Based on data from Statistics Canada; the U.S. Bureau of Labor Statistics; and the U.S. Department of Commerce.

manufacturing were only about 4 per cent below the U.S. level.¹⁷ These changes do not mean that Canada would no longer benefit from a further freeing of trade. They do imply, however, that the process of adjustment to a free trade situation would be somewhat different from that envisaged earlier by the Wonnacotts.

Real wage gains in Canadian manufacturing are likely to be sustainable over the long run only to the extent that they are matched by increases in productivity relative to our trading partners. Part of the closing of the gap in money and real earnings from the early 1960s to the early 1970s was associated with a narrowing of the Canada-U.S. productivity difference. Increases in output per man-hour were indeed greater in Canada than in the United States over this period (Table 6-3). The "catch-up" in productivity occurred largely in the late 1960s, however, and it resulted, partly at least, from trade liberalization. The largest gain in Canadian productivity, for example, was in transportation equipment, reflecting greater specialization under the Automotive Agreement. But, despite the gain, the productivity gap was still over 20 per cent in 1972 (Table 6-4), and preliminary evidence suggests that it had closed little further by 1974. And Canada's rate of productivity growth still remained below that recorded in a number of advanced European countries and Japan.

Table 6-3

Indexes of Labour Productivity,
Average Hourly Earnings, and Unit Labour Cost in Manufacturing,
Canada and the United States, 1963-74

	Real output per man-hour		Compensation per man-hour ¹		Unit labour cost ¹	
	Canada	U.S.	Canada	U.S.	Canada	U.S.
	(1961 = 100)					
1963	109.4	110.1	106.7	109.0	97.6	97.8
1972 ²	159.7	149.7	195.1	175.0	122.2	117.3
1974 (est.)	169.6	157.9	242.5	202.0	143.1	128.4
Percentage increase, 1963-74	55.0	43.4	127.3	85.3	46.6	31.3

1 The original data are in terms of each country's national currency; that is, the series do not reflect exchange rate changes. Compensation figures do not include fringe benefits, and they cover production workers only.

2 Subject to revision.

SOURCE Based on data from Statistics Canada and estimates by the Economic Council of Canada.

17 The gap would be somewhat greater if nonproduction workers were included in the comparison and if allowance were made for the higher fringe benefits of U.S. workers.

Table 6-4

Indexes of Real Net Output per Man-Hour in Manufacturing,
Canada and the United States, 1963-74

	1963	1972 ¹	Estimated 1974
(U.S. data for 1963 = 100)			
United States	100.0	136.0	143.5
Canada	72.8	106.3	112.9
Canada as percentage of United States	72.8	78.2	78.7

¹ Subject to revision.

SOURCE E. C. West, *Canada-United States Price and Productivity Differences in Manufacturing Industries, 1963*, Economic Council of Canada Staff Study 32 (Ottawa: Information Canada, 1971), adjusted to a man-hour basis. The data were updated to 1972 for the Economic Council of Canada and the Ontario Economic Council, using data from Statistics Canada. The 1974 figures are estimates by the Economic Council of Canada.

The fact that the Canada-U.S. wage differential has narrowed more rapidly than the productivity gap, particularly in the 1970s, is explained in part by the significant improvement in Canada's terms of trade. This has permitted a given quantity of exports to be exchanged for a larger quantity of imports, with favourable effects on real income. Furthermore, the appreciation of the Canadian dollar limited price increases for both export and import items, while domestic wages and other factor costs were increasing – supporting larger gains in real incomes in Canada than might have been anticipated from the gains in manufacturing productivity.

It seems unlikely that these rather special circumstances will continue. The competitive position of Canadian manufacturing has been eroded, particularly in the last several years (Table 6-3). Unit labour costs – a measure that combines the effects of wages and productivity changes – have risen more rapidly than in the United States, and average increases for some nonlabour costs per unit have been slightly higher still. In terms of U.S. dollars, Canadian cost increases have been even greater, because of the appreciation of our dollar after mid-1970. Part of the recent deterioration in Canada's balance of trade on manufactured goods (see Chapter 2) may be attributed to these costs, although cyclical factors have also been important. In any event, the effects of such changes on Canada's balance of payments on current account are less likely to be offset in the period ahead, since gains from sales of our resource products are already declining.

Thus measures to stimulate productivity in Canadian manufacturing are all the more important, and further substantial gains from specialization and longer

runs must be sought. Indeed, wage parity makes the need for such gains even more immediate, although it also implies that initially there will be greater problems of adjustment to freer trade.

Despite the closing of the wage gap at the national level, Canadian regions may, of course, still retain some labour-cost advantage relative to competing U.S. areas. In April 1974 the difference in average hourly money wages in manufacturing between Ontario and the Great Lakes states (Wisconsin, Michigan, Illinois, Indiana, and Ohio) stood at about 9 per cent, even after allowance for the higher value of the Canadian dollar. Quebec's manufacturing wages were about 6 per cent below those in the New England states (Maine, Massachusetts, New Hampshire, Rhode Island, Connecticut, and Vermont) and 16 per cent below those in the mid-Atlantic states (New York, Pennsylvania, and New Jersey), again after allowance for the exchange rate. Even if productivity gaps were eliminated, of course, some such differences might be required for particular Canadian industries to be able to offset the transport and other disadvantages entailed in slightly greater distances from the main industrial and market centres of the United States. The same could, of course, be said for U.S. locations outside the prime industrial area, such as Minneapolis or Atlanta.

As noted earlier, regional comparisons are the relevant ones for the assessment of locational advantages. Since they too have changed greatly since the early 1960s, however, the Council has made some evaluations of its own, based on more recent data. These studies were carried out in two stages, the first involving a recalculation of relevant costs in selected Canadian and U.S. manufacturing industries as of 1969, and the second, an updating of these results to early 1974 in the light of more recent wage changes.¹⁸

Despite the shrinking of the wage gap, the 1969 calculation revealed substantial competitive advantages for many Canadian industries in a free trading situation with the United States alone. Ontario producers of electrical industrial equipment, for example, were well placed to compete with manufacturers of comparable products in the Great Lakes states, and Quebec-based knitting mills and clothing factories had a potential cost advantage in the New York market compared with competitors in the U.S. South. The same general results held for other central Canadian industries, such as those producing tires and tubes, communications equipment, and cutlery, hand tools, and hardware. In contrast, it appeared that the metal fabricating industries would be at a disadvantage in U.S. markets, even with increased specialization under free trade, because the lower labour costs in Canada would not be sufficient to offset the high transport charges

18 This work, like that of the Wonnacotts, assumed parity of the U.S. and Canadian dollars.

incurred in shipping over substantial distances.¹⁹ When these findings were updated to early 1974, the results were still broadly the same, although the competitive advantages for Canadian locations were all somewhat reduced, and in one case – electrical industrial equipment – the advantage had turned into a disadvantage.

So far we have focused on absolute cost advantages at particular wage and exchange rate levels. However, as we pointed out earlier, under free trade a country will tend to specialize, in the long run, in those goods in which its comparative efficiency is greatest and import those goods in which it is least. Particularly because of the widespread wage advantages that existed for Canadian industry, the Wonnacotts concluded that adjustment to free trade with the United States would bring an expansion of Canadian manufacturing output, an appreciation of the Canadian dollar, and general increases in money wages. At present wage levels relative to the United States, the achievement under liberalized trade of competitive cost levels by Canadian manufacturers could be most easily brought about by a depreciation of the Canadian dollar. Such depreciation could provide more of the initial incentive required to induce reorganization of Canadian industry.

As industry reorganizes to attain greater productivity, benefits again could be realized because lower prices and higher money incomes would combine to raise real income. In present circumstances, however, it would be important that further narrowing of the productivity gap be reflected in lower prices to consumers. This would facilitate greater restraint on prices, a major public concern of recent years, and reduce the risks both of adjustment problems during the transition period and of adverse balance-of-payments developments.

Reorganization of Industry under Wider Free Trade Arrangements

We have emphasized that a good deal of the specialization that would follow a Canadian move to more liberalized trade would occur within, rather than between, industries, thus reducing the adjustment costs. Adjustment would be somewhat different, to the extent that free trade arrangements included overseas countries – especially if they involved the low-wage developing nations. In those circumstances more extensive adjustment problems could be expected to arise in the production of such items as textiles, clothing, footwear, toys, household utensils, and bicycles – all industries in which overseas sources, particularly developing countries, are highly competitive. Difficulties have already arisen in some industries, such as the automotive parts industry, because of the general preferential arrangements granted to countries classified as developing. Much of

19 The same high transport costs would, of course, provide some protection from U.S. products in local markets.

the ability of Canadian industries to prosper under these conditions would relate to their potential for taking advantage of special skills, distinctive styling, and new technology so as to affect cost differences through product differentiation and superior quality.

The experience of the textile industry is illuminating in this respect. Although most of the restructuring that has taken place in that industry in recent years has been designed to increase the share of the domestic market rather than to expand exports, some substantial improvements in efficiency and scale have in fact been achieved as a result. In synthetic textiles, for example, increased effectiveness in the face of foreign competition enabled producers to expand output markedly and to hold employment constant between 1965 and 1971, despite a 9 per cent decline in jobs in the textile industry as a whole. There is scope for further developments along the same lines in other textile items.

Nevertheless, in a liberalized trading world including the low-wage countries, more extensive adjustment would be required in some vulnerable sectors. Parts of these sectors would contract further, and this would pose problems in cases such as textiles, where a high proportion of production is centred in small communities like some of those in the Eastern Townships of Quebec and where many of the workers are relatively unskilled and lack mobility. These difficulties could, however, be dealt with by other measures (see Chapter 13). We should not allow the legitimate concerns over particular cases to obscure the main findings of our analysis – that trade liberalization would, with rather few exceptions, be readily accommodated by Canadian industry through increased specialization of operations, largely within individual industries.

The Distribution of Income among Regions and Groups

Given time for industry to reorganize, real income in Canada would rise with the elimination of Canadian and foreign trade barriers.²⁰ But, as the previous section suggests, this does not mean that the various regions or income and occupational groups would necessarily share equally in the increase. The most obvious effect of removing the Canadian tariff would be to reduce the prices all consumers pay for internationally traded goods. Removal of our own tariff – and even more so, foreign tariffs – would also involve net gains for producers. But, since industry is not evenly distributed across the country, the prospective gains could differ substantially among the various regions.

20 The impact of unilateral removal of Canadian trade barriers is discussed in Chapter 8.

The Atlantic and western provinces could expect substantial gains with relatively little adjustment and reorganization.²¹ They are considerably more dependent upon primary industries than the central provinces, and such industries could expect moderate expansion without any restructuring. There would be opportunities for secondary industry to increase modestly in these provinces, too, mainly because of improved access to neighbouring foreign markets, particularly in the United States. The need for reorganization would, at least for the present, be confined mainly to a small group of industries, such as manufacturers of clothing in Manitoba and textiles in Nova Scotia.

Ontario would face a good deal of industrial reorganization because of its greater dependence upon manufacturing, but by the same token it would have opportunities for much greater gains than the Atlantic and western provinces. Ontario manufacturing is already considerably more export-oriented than its Quebec counterpart, partly because of the increase in automotive exports in recent years. Moreover, it is less dependent upon manufacturing industries that are highly protected and, in particular, upon industries that are subject to competition from "low-cost" imports. The removal of trade barriers, particularly between Canada and the United States, could be expected to result in much greater manufacturing specialization, especially through reorganization of individual firms. Extension of free trade arrangements to other countries would involve less additional reorganization in Ontario than Quebec. Ontario would also gain by virtue of its position as a primary producer.

Quebec would be in a somewhat different position, since its industrial structure is not the same as that of Ontario. The primary sector, which is considerably more important in Quebec, would experience greater growth under free trade conditions, and the province's strong resource base would supply large opportunities for further processing. In addition, Quebec has a number of manufacturing industries – transportation equipment, some paper products, and chemicals, for example – whose profitability would be greatly enhanced by access to large nearby markets. Such sectors would undergo reorganization like their counterparts in Ontario. And the rapid increase in industrial skills in the province, as well as its stronger orientation in recent years towards technological and entrepreneurial activity, would favour these industries and the development of firms in new lines.

On the other hand, a large share of Canadian production of textiles, shoes, and other labour-intensive manufactures is located in Quebec. Under free trade with

21 It has been estimated that North Atlantic free trade involving both Europe and the United States would have resulted in a gain of 5.5 per cent of personal income for British Columbia in 1963. See Ronald A. Shearer, John H. Young, and Gordon R. Munro, *Trade Liberalization and a Regional Economy: Studies of the Impact of Free Trade on British Columbia*, Private Planning Association, Canada in the Atlantic Economy series (Toronto: University of Toronto Press, 1971), p. 202.

the United States, they could deliver their output to the major U.S. markets at prices relatively competitive with similar industries in the southern United States. However, if they had to face competition from low-wage economies in the developing world, they would experience much more severe adjustment problems. But this competition will increase in any event. The real question is whether adjustment will be carried out in a planned and orderly manner or through a series of ad hoc responses to a worldwide trend.

In brief, for Quebec as for Ontario, the elimination of Canadian and foreign trade barriers offers the possibility of greater ultimate gains than would accrue to the Atlantic and western provinces. However, achievement of these gains would involve greater adjustment costs in Quebec than it would elsewhere.

The question of the effects of free trade on the distribution of income among income and occupational groups is even more complicated, and we cannot claim to have examined it intensively. Nevertheless, our work does provide some indication as to how distribution might be affected.

Although all Canadians would gain as consumers, we have not been able to determine which groups of consumers spend the largest proportion of their income on tariff-protected goods. However, it may be interesting to note that, in the United States where the tariff structure is roughly similar to that in Canada, there is evidence to suggest that tariff reduction would provide the greatest benefit to low-income consumers.²²

The effect on incomes would be much more complex. Removal of Canadian tariffs alone might provide larger income increases in resource industries, but it could involve lower returns for some manufacturing industries, particularly those that are now most highly protected. Removal of foreign tariffs would, however, tend to raise incomes in the Canadian manufacturing industries that could become internationally competitive. On balance, there would be an overall gain.

At present, labour-intensive industries that employ many workers with elementary and high school education receive the highest protection from the Canadian tariff.²³ Those industries that are heavy users of university-trained labour receive relatively little protection. Removal of the Canadian tariff alone would mean that a somewhat greater-than-average share of the overall gain would probably accrue to the more highly educated groups, particularly those employed in the natural resource intensive industries. Even greater premiums for educated workers would result from removal of foreign tariffs, since that would stimulate expansion of the specialized manufacturing industries that are relatively heavy users of their skills.

These same effects would hold for management skills. The Canadian tariff can provide protection for inefficient or poorly trained management. Its removal

22 See Norman S. Fieleke, "The Cost of Tariffs to Consumers," *New England Economic Review* (September-October 1971):13-18.

23 Postner and Gilfix, *The Factor Content of Canadian International Trade*, Chapter 7.

would tend to favour highly trained, efficient managers, and the scope for such people would be further enhanced if removal of foreign trade barriers gave their firms access to much larger markets.

Clearly, changes in commercial policy could of themselves have a significant impact on the distribution of income among various regions and groups in Canada. Far more important, however, is the fact that income distribution can be even more readily affected by changes in the fiscal system. Shifts in income could be offset, if necessary, by changes in government taxes and expenditures, so that the overall gains from free trade could be retained without unfavourable effects on particular groups or regions. It is worth recalling that Canada already has a number of programs for improving regional balance, upgrading manpower skills, and re-distributing income to disadvantaged groups; further measures are proposed in Chapter 13. Free trade could provide increased resources for these and other programs.

The Gains from Free Trade

Under free trade with the United States, Canadian manufacturing productivity could move up to U.S. levels. Given manufacturing's present share in GNP, elimination of the gap shown in Table 6-4 would imply an increase in this country's GNP of about 5.7 per cent. But this would be due in considerable part to the lengthening of production runs. Even apart from scale economies, however, some gains could accrue from Canada's greater specialization in items in which this country has a comparative advantage. These have been estimated at 4 per cent of consumer expenditure, or about 2.3 per cent of GNP.²⁴ Wider industrial free trade arrangements would not likely result in further substantial gains from scale economies, although they could lead to further benefits from specialization in accordance with Canada's comparative advantage. Small additional gains of this nature might also accrue from the inclusion of agriculture in a free trade arrangement. Thus we conclude that total gains from free trade would amount to at least 5 per cent of GNP and perhaps somewhat more.²⁵

24 James R. Williams, "The Canadian-U.S. Tariff and Canadian Industry," 1974 (mimeo.) Chapter 1, p. 46.

25 By way of illustration, using the assumptions about population and GNP growth incorporated in our *Eleventh Annual Review*, an increase of 7 per cent in per capita incomes would give the average Canadian nearly \$650 more income in 1985 (in terms of 1974 prices). Of course, not all of this would really be more disposable income in the hands of individuals since, for one thing, some part of the increment would presumably accrue to governments to spend on public consumption and investment. There would, nevertheless, be 7 per cent more real income for the country as a whole. In this same sense, there would, on average, be extra income of \$1,950 per family of three (in terms of 1974 prices) in 1985.

Such estimates are necessarily imprecise, but it seems clear that substantial results could be achieved from a freeing of trade. In a single step our living standards would be raised permanently to a new level, which would become the base on which future increases could be developed. And the prospect of future increases would be enhanced, because industrial free trade would have increased the efficiency of an important sector of the Canadian economy partly by opening up fresh opportunities for effective development and innovation, thereby improving our growth performance. Multilateral free trade would provide the most remarkable improvement in the economic well-being of Canadians that could result from a single step by a government today – or at any time since the Great Depression.

However, gains of this magnitude would hold only if trade were completely freed. It must be emphasized that the extent of the benefits from any trade liberalization would depend on the size of the cuts in import barriers at home and abroad and on the range of countries included in the arrangement. Post-war experience has shown that the results of the gradual reduction of obstacles to trade have not been very satisfactory from Canada's point of view; by and large, productivity growth has not been rapid enough. The gradual approach has also resulted in a very uneven application of trade barriers – measured in terms of effective protection – to various Canadian industries. Indeed, it is difficult to perceive a continuing and consistent economic philosophy that has shaped this outcome. Rather, the evidence may be interpreted as implying that, once an industry has come into existence, the government has been concerned to provide it with sufficient protection to keep it in operation.²⁶ Although efficiency has sometimes been a consideration, this rationale could well be pushed far enough to perpetuate uneconomic methods of production, especially since it is applicable industry by industry. Also the effects on other industries are often obscure and are not easy to take into account.

In addition, for a country like Canada, small tariff cuts have unequal effects on exports and imports. Canadian goods manufactured behind protective barriers in a relatively narrow market tend to be high-cost, and minor reductions in foreign trade barriers may not provide our manufacturers with sufficient scope for lowering costs through specialization and longer runs. On the other hand, a similar reduction in our own trade barriers allows foreign manufacturers who already have advantages of scale and specialization to become more competitive here. This is the dilemma of a too-gradual approach. What is required is a reciprocal reduction in import restraints deep enough to promote a basic re-

26 This hypothesis would at least partly explain the dispersion of effective rates of protection. See James R. Melvin and Bruce W. Wilkinson, *Effective Protection in the Canadian Economy*, Economic Council of Canada Special Study 9 (Ottawa: Queen's Printer, 1968). Also Wilkinson and Norrie, *Effective Protection and the Return to Capital*.

organization of manufacturing in Canada, so as to eliminate the gap between production costs here and in competing countries. If Canadian businessmen feel that remaining barriers are significant and likely to remain in effect for some time, they have little incentive to undertake the thorough reorganization required to compete internationally.

Thus it is that a totally free trade situation has to be seen as the best answer to Canada's industrial concerns. While practical necessities may require that we look for more limited short-term measures, multilateral free trade alone has the capacity to remove completely the constraints on our manufacturing sector and induce the type of reorganization of production that will make Canada truly competitive. This is the policy that must be our ultimate goal in all discussions of this subject and the fundamental basis of any initiative we may contemplate to improve this country's economic performance through changes in commercial policy.

7

**THE MULTILATERAL APPROACH
TO TRADE LIBERALIZATION**

Since multilateral free trade would best serve Canada's long-run purposes, it is natural to think first of the possibilities of achieving it directly through GATT negotiations. Two immediate practical questions arise: How much progress can be achieved through existing procedures in GATT? And how long will that take? The object of negotiations would be to obtain the widest free trade conditions as soon as possible, perhaps even by 1980, rather than sometime in the distant future. In this chapter, we review international experience with the multilateral (GATT) approach and assess the near-term prospects for multilateral trade liberalization.

Canada and GATT, 1947-67

Canada has been deeply committed to the multilateral, nondiscriminatory approach to trade liberalization ever since GATT was adopted after the Second World War, and it participated in each of the six negotiating rounds held between 1947 and 1967. Of the agreements resulting from these meetings, those concluded in 1947 and 1967 were by far the most important in terms of the number of tariff cuts and the value of trade affected (Table 7-1).

Under the 1947 agreement, tariffs erected by Canada during the 1930s were sharply reduced in return for substantial cuts in U.S. and other foreign tariffs. From then until the mid-1960s, however, the multilateral negotiating process moved quite slowly, and there was even some backsliding into protection against imports both of farm produce and of low-cost goods from developing countries. In contrast, trade liberalization proceeded quite rapidly within Europe.

The momentum of the multilateral approach picked up again during the Kennedy Round of 1964-67, and extensive tariff reductions were negotiated.¹ Europe, Japan, and the United States agreed to staged reductions of their duties on most manufactured goods to levels of 10 per cent or less. Canada did not reduce its tariffs across the board in the same way as the large industrial countries. Because of this country's special trade and economic structure, the government felt that linear cuts would be inappropriate, and this position was accepted by GATT. Rather, some excessively high rates were scaled down, and attempts were made to reduce tariffs on intermediate products and capital equipment.

The difference between the linear approach of the big countries and Canada's approach to tariff-cutting in 1967 can be exaggerated, since the larger countries in fact made notable exceptions to the linear rule in practice. For example, the United States reduced tariffs on 64 per cent of all its dutiable imports, while Canada agreed to lower duties on 56 per cent. The value of bilateral U.S.-Canadian trade influenced by these reductions was about \$2 billion each way at the time.

¹ The agreements also included an antidumping code, a new basic international agreement on grains, and a multilateral food aid program. On the last two of these, it could be argued that Canada gave up more than it received.

Table 7-1

Tariff Reductions under GATT, 1947-67

	Value of trade affected		Number of tariff cuts by GATT members
	Billions of U.S. dollars	Percentage of world exports	
Geneva, 1947	10.0	21.3	45,000
Annecy, 1948	n.a.	n.a.	5,000
Torquay, 1951	n.a.	n.a.	8,700
Geneva, 1956	2.5	2.4	n.a.
Geneva, 1960-61	4.9	3.7	4,400
Geneva, 1964-67	45.0	21.0	n.a.

n.a.—not available.

SOURCE Based on data from Gerard Curzon, *Multilateral Commercial Diplomacy* (London: Michael Joseph, 1965), p. 81, and from the Secretariat of the General Agreement on Tariffs and Trade. The required world export figures are from United Nations, *Statistical Yearbook*, various issues.

Yet, from the viewpoint of the ultimate objective of multilateral free trade, a great deal remained to be done. In brief, there were still sizable impediments to trade after the Kennedy Round, particularly for exporters from a country like Canada with its relatively small domestic market. Moreover, the issue of nontariff barriers remained largely unresolved. In Canada a rather high level of tariffs on dutiable goods was retained, and the complex reductions in various Canadian duties appear, on balance, to have only modestly reduced effective protection available to industry. Indeed, for some Canadian industries, effective protection actually increased.

The Prospects for Multilateral Trade Liberalization

In 1973 the GATT countries agreed to enter a major new round of comprehensive trade negotiations, with the intention of concluding an agreement to achieve "the progressive dismantling of obstacles to trade and the improvement of the international framework for the conduct of world trade."² Broad guidelines were adopted for various aspects of the negotiations:

Tariffs: employ appropriate formulas of the most general application possible.

Nontariff barriers: reduce or eliminate such measures, or at least their trade-distorting effects, and bring them under more effective international discipline.

2 Declaration of GATT Ministers, Tokyo, September 14, 1973, p. 1.

Sector negotiations: examine possibilities for reduction or elimination of all barriers to trade in selected sectors, as a technique to complement the more general formulas.

Safeguards: in order to further trade liberalization and to preserve its results, examine the adequacy in GATT of provisions against the disruption of markets by imports.

Agriculture: ensure that the approach is in line with the general objectives of the negotiations, yet takes account of special characteristics and problems in this sector.

Tropical products: treat as a special and priority sector.

The purpose of these general formulas is to reduce the need for detailed negotiations and to broaden the scope and depth of agreed tariff cuts to the maximum extent possible. Precise procedures for reducing tariffs had not been worked out at the time of writing, but many general formulas are conceivable. One would be to reduce all high tariffs to a common ceiling rate, with remaining duties cut by an agreed percentage and very low duties removed altogether. Then there is the precedent set during the Kennedy Round of an equal percentage cut in all tariffs with a minimum of exceptions, although Canada would again find this approach difficult. Moreover, any movement simply to reduce tariffs rather than eliminate them multilaterally would be far less beneficial to this country.

At present, there is no visible intention of negotiating full tariff-free industrial trade on the part of any country capable of exercising leadership. The influential negotiators in GATT – the EEC, the United States, and Japan – are already highly competitive exporters of manufactured goods. In contrast with Canada, their trade in such products is not much inhibited by current tariff levels in other industrial countries, so they give priority to special problems including NTBs, agriculture, safeguards, and the position of developing nations.

The Japanese have recently proposed free trade as a long-term goal, but they apparently have no intention of pursuing it during the current GATT round. The EEC's overall priority is to establish itself as a distinct identity in world affairs.³ In pursuit of this goal, the EEC has emphasized freer trade and the problems of agriculture but has made no reference to multilateral free trade as an objective. The present mandate given the EEC Commission by ministers suggests tariff cuts ranging from 25 to 50 per cent and an emphasis on harmonization of tariff structures.⁴ The Community may also regard the maintenance of some level of common external tariff as an essential ingredient of its distinctiveness.

In the United States, the Williams Report urged the removal of all barriers to trade and capital movements within twenty-five years and the elimination of most

3 See the EEC's "Proposal on Relations with the United States," in *New York Times*, September 24, 1973, p. 16.

4 Reported in the *Journal of Commerce*, New York, February 12, 1975.

tariffs within ten years.⁵ However, the negotiating authority provided to the President by Congress does not go that far. Under the Trade Act of 1974, which became law early in 1975, he can reduce U.S. tariffs by up to 60 per cent and can eliminate tariffs of 5 per cent or lower. He also has authority to raise tariffs under certain conditions, in order to align them with tariffs of other countries. The Act emphasizes reduction, elimination, or harmonization of the various national nontariff barriers, with U.S. agreement subject to approval by Congress under a special procedure. The goals of the Act include trade liberalization, expansion of U.S. exports, agreement on access to supplies in international trade, and acceptance of safeguard rules covering temporary responses to excessive import competition. There is also discretionary power for the President to enter into bilateral agreements, if these promise to be more effective than multilateral agreements from the U.S. viewpoint. Specifically, the President is empowered to begin negotiations with Canada for a bilateral free trade agreement.

The GATT countries are also concerned with the International Monetary Fund's efforts to develop a financial system that will protect the world economy against disruptions. The problem of monetary reform has been greatly increased by the international oil-price crisis and the huge build-up of liquid funds in the hands of relatively small countries that export oil. Although trade and monetary negotiations are conducted separately, they are interdependent; a successful outcome in one area depends upon similar progress in the other.

Current GATT negotiations are unlikely to result in complete elimination of tariffs or satisfactory control of all NTBs; they are nevertheless very important. One major objective, for example, is to prevent a general backsliding into protectionism, a development that would harm Canada. But it remains true that the priorities of the countries that will most influence these talks are not tailored to the full resolution of long-term productivity problems of countries like Canada.

Our assessment is that the likelihood of realizing world free trade in the near future is small. To the extent that attention is focused on industries that are efficient in industrial countries, the GATT negotiators are likely to give priority to the nontariff distortions of international commerce. Here the problem is one of obtaining a sufficient community of political will among GATT countries to bring about the abandonment or control of nontariff barriers that have been erected as part of the national policies of individual countries. The GATT arrangements do not presuppose strong co-ordination of members' internal policies towards some common aim as, for example, in the EEC's Treaty of Rome. How rapid progress will be on the NTB issue is, therefore, an open question.

5 Commission on International Trade and Investment Policy, *United States International Economic Policy in an Interdependent World* (Washington: U.S. Government Printing Office, 1971), pp. 10 and 14.

The Canadian government has tacitly recognized these difficulties by urging the adoption of a sectoral approach to the negotiations.⁶ The possibility of reducing trade barriers among certain industrial sectors, rather than for all commodities, was a technique implicit in the "dominant supplier authority" included in President Kennedy's Trade Expansion Act of 1962. If broader options are not feasible, this approach does offer a way of cutting negotiations down to more manageable proportions. For a particular sector, it would be possible, for example, to deal concretely with all types of measures that influence trade. The method is attractive to governments since it seems to offer limited commitments with reasonably clear implications.

The sectoral approach could be used to supplement other negotiating strategies. If carried far enough to include a number of important sectors – and fast enough – it could offer an answer to Canada's present dilemma. But there are grounds for believing that this will not be the case. For one thing, this approach reduces the scope for balancing concessions – unless, again, it is applied simultaneously to a wide variety of industrial sectors at the same time.

Progress may be made in carefully selected industries during the current GATT negotiations, although relatively few industries to which the technique would be applicable have been identified.⁷ There are, however, definite limitations inherent in using the sectoral approach as the sole method of effecting the restructuring of Canadian industry. In Chapter 10 we discuss how Canada could make the most of the benefits that might nevertheless be available from the sectoral option.

Conclusions

Few countries could be more interested than Canada in a significant breakthrough in the current multilateral negotiations. Thus, whatever else may be considered, the difficulties facing the present GATT round should spur us to even greater efforts towards this objective. Therefore,

Recommendation 1

We recommend that the current GATT negotiations on international trade liberalization be vigorously pursued and that every effort be made by Canada to eliminate its own and other countries' trade barriers.

6 The Canadian government has stated that "in carefully defined and selected sectors" there should be "a comprehensive attack on all barriers to trade especially where these impede the processing and upgrading of resources in the country of origin." *Canada Commerce* (January 1974), p. 40.

7 Trade Policy Research Centre, *Towards an Open World Economy* (London: Macmillan, 1972), p. 65. See also Gerard and Victoria Curzon, "Options After the Kennedy Round," in *New Trade Strategy for the World Economy*, ed. Harry C. Johnson (London: Allen & Unwin, 1969), pp. 59-68.

To demonstrate our readiness to move to free trade, it would be desirable for Canada to make some unilateral gestures involving substantial cuts in protection. The most appropriate would be an offer to reduce a number of peak Canadian tariffs; the binding of such cuts should, however, be linked to further progress in negotiations. Therefore,

Recommendation 2

We recommend that Canada declare its readiness to make initial reductions in a number of high Canadian tariffs, the permanence of which would be conditional upon further substantial progress in negotiating these and the appropriate foreign tariffs down on a multilateral basis.

Such action could move Canada closer to an overall level of protection that would not be too far out of line with the tariffs of other industrial states and that would provide a better point of departure for multilateral negotiation and a subsequent move to multilateral free trade. It would demonstrate Canada's strong interest in maximizing trade liberalization without necessarily forfeiting any bargaining strength. Agreement to bind such initial reductions would itself constitute a trade concession. Thus a unilateral initiative of this kind would not commit Canada to maintain the lower rates of duty under GATT rules, unless the other member countries were willing to negotiate appropriate trade concessions with this country. The concessions we have in mind would be deep cuts in foreign tariffs in return for Canada's agreement to bind its initial reductions and to make further substantial cuts in its own tariffs.

The multilateral achievement of free trade, even with respect to tariffs alone, will require a systematic and determined effort by all countries to reach accord on a wide range of intricate questions, such as timing, special phasing, and adjustment mechanisms. For Canada, an agreement on tariffs must be a high-priority item not only because of the need for free access to other countries' markets, but also because failure of the international community to move sharply towards free trade makes both Canadian businessmen and negotiators cautious. Small tariff cuts and the prolonging of tariff-protected trade encourage the continuation of these attitudes with the risk of perpetuating inefficient production and postponing indefinitely the widespread rationalization of Canadian manufacturing industries. There is, of course, nothing in the international rules to prevent Canada from unilaterally removing its tariffs. But the economic benefits of multilateral free trade would be much greater, and the adjustment costs much less, than those of unilateral free trade.

Canada is equally concerned about nontariff barriers. Meaningful trading access to international markets can be assured only if import obstacles of all kinds are reduced to a minimum. However, the greater adjustment required by industries in the smaller economies is likely to call for a variety of adaptive programs during

the restructuring period. Some of these measures, even though temporary, may be regarded as NTBS. They could be very difficult to negotiate because of the large number of countries involved.

The danger is that these many complicated issues will not easily be resolved in the present or even ensuing GATT negotiations. In this situation, prudence demands that Canada explore other possible ways within the GATT framework of reaching the desired goal more quickly. One such avenue is the elimination of trade barriers on a regional basis. GATT permits such arrangements, and experience indicates that they can quickly yield many of the benefits of multilateral free trade. For example, both the European Economic Community and the European Free Trade Association have shown how tariffs may be abolished quite effectively over a period of a few years; the members of these groups also appear to have found ways to resolve numerous nontariff issues. We have also referred to the possibility that Canada could abolish its own trade barriers unilaterally. And, even if these options proved, for some reason, to be closed to this country, there might be ways to improve upon the present gradual process of trade liberalization.

The next five chapters attempt to gauge the relative merits of a variety of options. In moving on to those possibilities, we are not abandoning the multilateral approach; far from it. We are seeking additional measures to supplement the present multilateral route, not to replace it. Accordingly, such measures should not be considered only if the current GATT round fails. On the contrary, there are good reasons for considering promising initiatives in parallel with the multilateral approach, as long as these are consistent with the principles of GATT.

8

**REGIONAL AND UNILATERAL
FREE TRADE OPTIONS**

We have suggested that one of Canada's more obvious additional avenues to free trade is a regional arrangement. Less obvious, perhaps, is the possibility of unilateral Canadian action. And there are other routes as well. The course actually followed will depend upon a variety of economic and political considerations, some of which are very much subject to change. What is necessary now, therefore, is that Canadians get their own priorities straight so that they can respond quickly and imaginatively to emerging opportunities.

This chapter discusses the ranking of various free trade options below the multilateral level – mainly on the basis of the economic benefits they would provide Canada in terms of increased industrial efficiency and higher real income. Admittedly, even the economic ranking can be only approximate, since the ultimate outcome in many cases would depend upon negotiations with our trading partners. However, such an approach could help to establish guidelines for these negotiations.

Chapter 6 stressed that only multilateral free trade would provide Canada with all the gains possible from trade liberalization, and it set out the sources of those gains. Now we must ask to what extent they would be available under various other trade options. The answer to this question rests heavily on sometimes conflicting effects that economists call "trade creation" and "trade diversion." Trade creation occurs when a participant in a customs union or free trade area replaces high-cost production from domestic sources with lower-cost goods imported from its new trading partners. Apart from transitional adjustment costs, it is beneficial from every viewpoint. Trade diversion occurs when participants in a free trade area buy goods from their new partners that they previously bought from outsiders. (Of course, under multilateral free trade there are no outsiders; trade diversion cannot exist and thus the only effect is trade creation.)

Trade diversion typically involves a complicated mixture of benefits and costs. By way of example, if a free trade area were formed between Canada and the United States, U.S. importers might divert to Canada the purchase of some goods formerly bought in other countries. While this might involve either a net benefit or a net cost for the United States, such "partner's diversion" would generate a net benefit for Canada. At the same time, it might raise a longer-term difficulty if it brought initial expansion to certain Canadian industries that would later face contraction under wider free trade arrangements – a problem we refer to later as one of "double adjustment."

Regional Free Trade Options

Canada's opportunities for trade creation under a regional arrangement would depend mainly on the size and accessibility of the market in the partner country or countries. For practical purposes, this means that such arrangements would

be feasible only with the EEC, Japan, and the United States. Clearly, many Canadians would be less apprehensive about arrangements with countries other than the United States, or with other countries and the United States. A Canada-Europe trading zone or some wider scheme might be felt, for example, to offer a countervailing influence to the United States and pose much less of a threat to Canada's scope for independent decision-making. But there are trade-offs to be considered here, since economic benefits differ substantially among the regional options. This chapter first discusses the benefits that might accrue from free trade arrangements with any one of the EEC, Japan, or the United States and then looks at how some combinations of these basic arrangements could provide even greater gains.

Size and Accessibility of Potential Trade Partners

Although the population of the United States is somewhat less than that of the EEC, its market remains the largest in the world (Table 8-1). In 1973, the combined GNP of the EEC was about 83 per cent of that of the United States. But European growth both in total and on a per capita basis is expected to exceed that of the United States from 1970 to 1980 and the gap, in terms of the size of GNP and of material living standards, is expected to narrow during this decade. Japan, on the other hand, is a considerably smaller market than either the EEC or the United States. Although it is closing the gap in real output per capita more rapidly than Europe, its total output cannot be expected to approach that of the United States since its population is so much smaller. On size alone, therefore, the EEC market could offer Canada substantial opportunities for gains from specialization and economies of scale second only to the U.S. market. Japan would rank a good deal lower, but with rapidly rising potential.

The ranking of the EEC and Japan drops somewhat when "accessibility" is taken into account. Access to markets is restricted by both policy and natural obstacles to trade. The former include tariffs and nontariff barriers and the latter the costs of transportation, communications, and servicing customers at a distance, as well as the costs inherent in differences of language, consumer tastes, and customs.

Canada's geographic trade pattern, with its heavy concentration on the United States (Table 8-2), has been influenced much more by natural obstacles than by policy obstacles.¹ Trade with the United States has, by and large, been subject to the same most-favoured-nation tariff that has applied to all our major trade partners; moreover, the duties applied by these countries to imports from Canada have

¹ This is in sharp contrast to the commodity composition of trade, which, as was indicated in Chapter 2, is heavily influenced by policy obstacles.

Table 8-1

Market Size and Projected Output Growth in Canada's Major Trading Partners, 1970-80

	1973			Projected average annual rates of growth of output, 1970-80	
	Population	GNP	Per capita GNP	Total	Per capita
	(Millions)	(Billions of \$U.S.)	(\$U.S.)	(Per cent)	
United States	210	1,295	6,155	4.0	3.2
EEC	256	1,071	4,180	4.9	4.3
Japan	108	418	3,860	7.5	6.2

SOURCE European projections are based on Organisation for Economic Co-operation and Development, *The Growth of Output, 1960-1980* (Paris: OECD, 1970). The U.S. figures were estimated by the Economic Council on the basis of revised data from mid-1974 projections of the Wharton Annual and Industry Forecasting Model. The original OECD projection for Japan has been revised downward by 2.5 percentage points per annum because of less optimistic prospects in the 1970s. See also International Monetary Fund, *International Financial Statistics*, November 1974. The GNP figures for the EEC countries and Japan have been converted into U.S. dollars at 1973 average rates of exchange. Results based on such a conversion cannot be considered precise but are suggestive of orders of magnitude.

not differed a great deal.² Even when some geographical discrimination has been applied, such as the Commonwealth Preferences, the proportion of trade conducted with the United States has not been greatly affected. And, while the Automotive Agreement led to additional trade between the two countries, a high proportion of Canadian trade was with the United States even before the pact took effect. Free trade would remove many of the policy obstacles, but the natural

- 2 It has been suggested that the GATT negotiating process results in sufficient "commodity discrimination" to influence the direction of trade flows significantly. By way of illustration, two countries may originate negotiations in GATT by selecting for tariff cuts only those products - for example, automobiles over a certain size - in which their trade with one another is large and with other GATT members small. Under the MFN rule, the other GATT countries are entitled to the reduced tariff rates agreed upon by the original negotiators. But, since existing trade is conducted mostly by the two original negotiators, the theory is that the other GATT members may not benefit much from the MFN rule.

Such "commodity discrimination" can occur. The real question, however, is whether it is likely to have a long-lasting effect on the direction of trade. To begin with, even before negotiations are initiated, the two original negotiators by definition already have a preponderance of trade with one another in the selected products. Moreover, the "across-the-board" tariff-cutting technique of the Kennedy Round substantially reduced the scope for commodity discrimination. Finally, there is nothing to prevent GATT countries that were originally small exporters from building up a competitive line in the items on which tariffs were reduced, as Japan often did during the 1960s. The ability of a modern industrial state to produce imitations of, or substitutes for, foreign products quickly tends to limit the effectiveness of commodity discrimination to the short run or to a few products that are unique but do not constitute a significant percentage of trade.

barriers – including powerful economic, cultural, and institutional forces that have worked against expansion of this country's trade overseas and towards an integrated industrial system in North America – would remain.

A study of one natural barrier – transport costs – sought to determine whether freight charges across the Atlantic added an element of protection to North American trade.³ It concluded that the costs of transporting manufactured goods with a high value-to-weight ratio by sea from Canadian to European *ports* often do not differ much from the costs of moving comparable goods by road or rail to U.S. points. However, the comparison must be modified to take account of additional delivery costs, which may be greater in Europe because of transshipment charges, plus the fact that the extra time involved in ocean transportation can be a significant cost factor in many cases. Moreover, the finding rests on the costs of transport with existing facilities and trade volumes; such facilities would more readily support expansion of shipments to the United States than to Europe.

Another important natural barrier is the extra cost of providing rapid delivery and service. In a Canada-EEC free trade arrangement, Canadian firms would have to set up an elaborate distribution and after-sales service network, as well as market intelligence, merchandising, and advertising programs. In a Canada-U.S. scheme, these requirements could often be satisfied within existing corporate relationships, and in any case such facilities would be much more readily created by Canadian firms in the U.S. market than anywhere else in the world. This is simply a matter of the relative availability and cost of information: Canadians are better able to develop systems of business operations in the United States than in Europe, because they are more attuned to U.S. institutions, practices, and even habits of thought. This factor, essentially the result of geographic and historical circumstances, is a powerful force influencing the relative costs of servicing markets.

These same considerations would apply with even more force to Canada-Japan free trade. Except for British Columbia, and perhaps some other parts of the west, transport costs from Canada to Japan are higher than those to major European markets. And it would be more difficult to establish effective distribution, merchandising, and other services in Japan than in Europe, since the Japanese business environment is still more unfamiliar to Canadian firms.

Such arguments do not rule out the possibilities for increasing trade with Europe and Japan or the ultimate great value of free trade arrangements with those areas. What they suggest, however, is that Canada's longer-run strategy for trade expansion and diversification will need to focus on a number of factors, including the development of stronger transportation and distribution links with overseas countries.

3 JoAnne Raynes, "Transport Costs as a Barrier to Trade," a background study for the Economic Council of Canada.

Trade Diversion

While trade creation would not be as great according to our analysis under free trade with the EEC or Japan as under a Canada-U.S. arrangement, the possibility of losses from diversion of Canadian imports to more expensive sources could be very much larger. Table 8-2 indicates that roughly 70 per cent of Canada's imports come from the United States, 10 per cent from the EEC, and about 5 per cent from Japan. Assuming that this pattern is not much affected by trade barriers, such figures imply that only some 30 per cent of total Canadian imports would be subject to possible diversion under Canada-U.S. free trade, about 90 per cent under free trade with the EEC, and 95 per cent under free trade with Japan.

Table 8-2

World Trade Matrix, 1973¹

Exports to → from ↓	Canada	United States	EEC(6) and Britain	Japan	Rest of world	World
(Billions of \$U.S.)						
Canada	—	17.1	3.1	1.8	3.2	25.2
United States	14.8	—	15.8	8.2	31.4	70.2
EEC(6) and Britain	2.4	15.2	—	2.8	80.9	101.3
Japan	1.0	9.6	4.2	—	22.2	37.0
Rest of world	3.1	25.2	69.4	20.0	—	117.7
World	21.3	67.1	92.5	32.8	137.7	351.4

1 Exports within the EEC (6) plus Britain, and exports from the "rest of the world" to the "rest of the world," are excluded; trade totals have been adjusted accordingly.

SOURCE Based on data from United Nations, *Monthly Bulletin of Statistics*, June 1974, and International Monetary Fund, *International Financial Statistics*, November 1974.

Import diversion by Canada's free trade partners could, of course, increase the demand for Canadian products and so cushion this country's short-run adjustment problem. Both the EEC and the United States now import very large amounts from countries other than Canada (Table 8-2), so the prospects for such diversion in Canada's favour would appear substantial in both cases. However, again because of the presence of natural barriers to Canada's overseas trade, we believe that free trade with the United States would have the edge in this respect as well.

Of course, from the viewpoint of multilateral free trade as the ultimate goal, this "partner's diversion" may not be an unequivocal benefit because it introduces the problem of "double adjustment." Partly for this reason, we later recommend that, if Canada were to enter into any regional free trade arrangements, it should be prepared at the same time to lower somewhat its most-favoured-nation tariffs against imports from all sources.

Ranking of Bilateral Options

On the basis of the potential for trade creation and trade diversion, the economic benefits of free trade with the United States would rank well above an arrangement with the EEC and even more above the advantages of one with Japan. The ranking of Europe and Japan drops even more, however, when the possibilities of negotiating each option are considered. Questions arise, for example, about how the United States would react if Canada were to join bilaterally with Europe and how the Europeans would accommodate the idea of a non-European industrial state joining the Community. Similar uncertainties would exist with respect to negotiation of the Canada-Japan option.

A bilateral free trade arrangement between, say, Canada and the EEC would be in accordance with the rules of the GATT. Such an arrangement would, however, discriminate against the United States in practical terms, and it would thus be unrealistic to assume a benign U.S. response. At a minimum, the U.S. attitude towards trade co-operation would inevitably change; at a maximum, there could well be a resurgence of the latent U.S. forces that favour a return to protectionism. In this sense the U.S. response, whether overtly retaliatory or not, would reduce the gains Canada could expect from a bilateral arrangement with another major partner and would also reduce potential European advantages from a free trade scheme with Canada. In any event, such an undertaking would be alien to the concept of European union.⁴

Much the same would be true for a bilateral Canada-Japan free trade agreement. The United States would likely react adversely. And, although some Japanese groups have expressed an interest in a Pacific free trade area, there has been no interest in strictly bilateral arrangements with Canada. Japan, like other countries, appears to be interested in trade liberalization arrangements involving several nations, usually including the United States.

4 A study prepared for the Economic Council of Canada suggests that the idea of bilateral free trade between Canada and the EEC is "totally unrealistic." See Gerard and Victoria Curzon, *Coping with the Community: Issues and Alternatives for Canada*, Economic Council of Canada (forthcoming).

Wider Regional Arrangements

So far we have tried to establish the ranking of free trade areas with our major trading partners individually. That basic ranking allows us to look now at wider regional groupings involving various combinations of the EEC, Japan, and the United States.

A Canadian free trade agreement with the EEC and Japan, for example, would represent a wider political design than the bilateral associations just discussed. Moreover, the economic benefits would be greater than under free trade with either of these areas alone. But the risk of U.S. retaliation would be high. Thus it appears unlikely that the EEC and Japan would be interested – except, perhaps, in the unlikely event that the United States became isolationist. What emerges from our analysis, then, is the conclusion that no regional trading community would be feasible and economically worthwhile for Canada unless it included the United States. And this leads to consideration of a multisided free trade agreement including Canada, the United States, and either or both the EEC and Japan.

These multisided options are all very attractive. The political merits of being able to offset, through the membership of other countries, fears about being a dependent partner in a Canada-U.S. association would be combined with greater economic advantages. The threats of trade diversion from the United States and of U.S. retaliation would be removed, and the participation of other countries in the scheme would undoubtedly add to the economic benefits. Moreover, such an agreement would be attractive to Japan and would be taken very seriously by the EEC.

A free trade arrangement consisting of Canada, the United States, Japan, and the EEC would, in fact, come close to giving this country the benefits of complete multilateral free trade. Its major disadvantage from an international viewpoint would be the exclusion of the developing countries and some developed countries like Australia. However, even this could be greatly reduced if the partners agreed to an open-ended free trade area and to special provisions for the developing countries.⁵

A free trade area that included Canada, the United States, and either one of the other two economic units – the EEC or Japan – would also yield substantial, though somewhat smaller, economic benefits. And it might well be more feasible and more quickly negotiated than a four-way pact or a wider arrangement for multilateral free trade.

Any move towards multisided regional free trade would, of course, be confronted by practical difficulties. But, in terms of Canada's industrial needs,

⁵ It must be pointed out, however, that as a result of the recent Lomé agreements, some thirty-five countries of the underdeveloped world now have associate status with the EEC.

the prospects for early success appear to be brighter than those involving the multilateral approach to trade liberalization. Accordingly,

Recommendation 3

We recommend that, parallel with its participation in the current multilateral trade negotiations, the Canadian government actively explore the conditions under which Canada might join an open-ended free trade area with other interested countries. To this end, discussions should be held initially with the United States, the EEC, and Japan, with a view to establishing, before the end of this decade, an arrangement under which the barriers to trade in industrial products might be eliminated over a ten-year period – in accordance with an agreed method and schedule.

In Chapters 11 and 12, we propose that any free trade arrangements include special provisions for agricultural and energy products. These provisions would, however, bear on only a small proportion of Canada's trade with any of our potential free trade partners, so they would not appear to violate the GATT requirement that any preferential trading arrangements cover "substantially all" trade among participating countries. Precedents also exist: the former European Free Trade Association (EFTA) found it necessary to make special arrangements for a wide range of agricultural products;⁶ and the EEC countries also have special arrangements in the agricultural sector.

To the extent that basic problems in some rural areas of Canada would limit the scope for rapid adjustments in parts of the agricultural sector, they might in turn retard Canada's timetable for liberalizing trade in certain food and beverage manufacturing industries, such as dairy products. It would not be desirable to saddle any industry with high-cost protected inputs while subjecting the output of that industry to free trade competition. Such anomalies already exist for a few nonagricultural industries as a result of the structure of the Canadian tariff, and it would not be appropriate to add to their number. Rather, the fact that the pace of trade liberalization for agriculture will affect the arrangements necessary for some food industries under industrial free trade underlines the urgent need for co-ordination and rationalization of provincial and federal farm policies.

Unilateral Action

The options set out above hinge on joint action with other countries. Canada could, however, undertake far-reaching policy changes on its own. A nation does not have to exact a quid pro quo from others in order to reap benefits from

⁶ The EFTA arrangements excluded almost all of the commodities listed in Chapters 1 to 24 of the Brussels Tariff Nomenclature from the free trade agreement. These tariff chapters cover both primary and manufactured agricultural products.

trade liberalization. Unilateral action to eliminate trade barriers could lead to gains from increased productive efficiency. Imports would increase, but they would be displacing relatively high-cost domestic production. Under a flexible exchange rate, gains could even accrue on exports, since the foreign exchange value of the Canadian dollar would decline and bring about an increase in other countries' purchases of our goods. In other words, unilateral free trade would involve some increased specialization and beneficial trade creation, although not as much as under multilateral free trade or any free trade area that included the United States. Moreover, since there would be no excluded countries, there could be no costs from trade diversion.

But the unilateral approach is not without substantial drawbacks. In the first place, many Canadians would be understandably reluctant to abandon this country's tariff as a device for negotiating the removal of foreign import barriers. Second, substantial movements of the Canadian dollar in the face of a massive unilateral shift in commercial policy would increase uncertainty and inhibit Canadian businessmen from restructuring their operations on the scale that could be expected in the event of removal of foreign as well as domestic import barriers. Third, a number of serious problems arise from the fact that a unilateral freeing of trade would subject Canada, in a direct and major way, to the influence of other countries' commercial policies. For example, since import tariffs are usually designed to promote employment in manufacturing, elimination of Canadian tariffs – while other nations maintained their employment-oriented systems of protection – would discriminate against manufacturing employment in this country and would probably involve increased reliance on our resource industries.⁷ By the same token subsequent changes in import barriers abroad could cause dislocations throughout Canadian industry.

As a consequence, the possibilities for gain are not nearly as great under unilateral free trade as under the Canada-U.S. or wider regional options.⁸ And, since these regional groupings cover 70 to 85 per cent of Canada's existing trade, our ranking of net benefits is not significantly changed when allowance is made for the fact that they, in contrast with the unilateral approach, may involve some trade diversion. Furthermore, the unilateral option would lead to higher adjustment costs than would Canada-U.S. or wider free trade (see Chapter 13). How-

7 This implies, too, that in contrast with multilateral or regional free trade options, the benefits from unilateral reductions in trade barriers would accrue more to the resource-producing areas of the country.

8 Some of the implications of unilateral free trade for the Canadian economy have been examined in greater depth in Roma Dauphin and Gérald Audet, "The Regional Impact of Freer Trade in Canada," a background study for the Economic Council of Canada. See also R. J. Wonnacott, *Canada's Trade Options*, Economic Council of Canada (Ottawa: Information Canada, 1975).

ever, because under unilateral free trade there is no risk of U.S. retaliation, it would be superior to the EEC or Japan options.

Although unilateral free trade does not rank as high as many of the other options, unilateral initiatives do not have to be a pure alternative to other approaches. If Canada were to join in a regional arrangement, and so gain better access for its exports to major industrial countries, certain additional actions of a unilateral nature would not only be feasible but helpful in minimizing possible problems of trade diversion and double adjustment. Therefore,

Recommendation 4

We recommend that, to avoid distortions in our trade with nonmembers of any free trade area that might be negotiated, Canada be ready to reduce import duties in excess of 10 per cent to a level of 10 per cent ad valorem.

Such a reduction would accelerate the adjustment of highly protected Canadian industries to greatly increased and highly competitive manufacturing in developing countries. It would not only benefit Canadian consumers but also serve the objectives of Canadian aid policy. Moreover, it could provide the "fair" compensation required by GATT rules for member countries not party to the free trade group. However, in the absence of similar action by other countries, reduction of Canada's trade barriers against developing nations would have only a small impact on their economies, and it would unduly concentrate competition on some Canadian industries.

Since mid-1974, this country has been participating in the GATT system of generalized preferences towards developing countries. But this is, after all, a modest program.⁹ Accordingly, Canada should join in any international program designed to accelerate and extend the progressive elimination of barriers to imports from developing countries. More generally, Canada shares the desire of the western countries to help raise living standards in the developing nations. Yet the special trade diversion. Furthermore, the unilateral option would lead to higher adjustment that tends to reduce the effectiveness of foreign aid programs. With these considerations in mind, we believe that further steps should be taken to open the Canadian market to more competition from the developing world. Therefore,

9 Although the lower duties granted by the affluent GATT members to developing countries are called "generalized," the practice is in fact quite selective. In Canada's case, agricultural products are excluded from the scheme, unless otherwise specified. The rule is the reverse for industrial products: they are included for preferential treatment unless otherwise specified. Canada's formula is to grant to developing countries either British preferential tariff rates or two-thirds of the most-favoured-nation rate, whichever is lower. In contrast to this system of generalized preferences offered to all developing countries, the EEC has abolished all tariffs on manufactured products for a group of some 35 of them.

Recommendation 5

We recommend that, contingent upon negotiation of a regional industrial free trade arrangement, Canada consider offering free entry to imports from those countries of the Caribbean area with which we have historic or cultural connections. In these same circumstances, Canada should also contemplate giving free entry to imports from Latin American countries to the extent that the United States is prepared to take similar action and, in the same way, extending such access to goods from the developing countries of Asia and Africa insofar as the United States, the EEC, and Japan are prepared to do likewise.

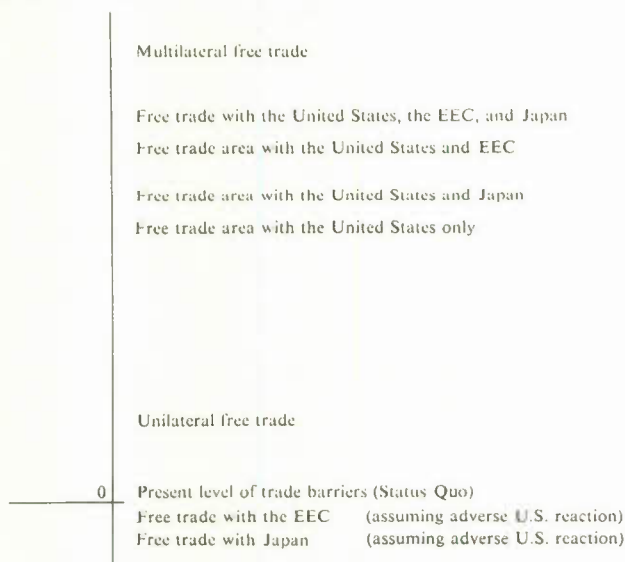
Conclusions

Summing up our analysis of economic benefits and costs from the various possibilities yields a ranking of Canada's commercial policy options for trade in industrial goods as shown in Chart 8-1.¹⁰

Chart 8-1

Economic Ranking of Commercial Policy Alternatives for Canadian Industrial Trade

Potential gain in real income



SOURCE Based on R. J. Wonnacott, *Canada's Trade Options*. Economic Council of Canada (Ottawa: Information Canada, 1975).

¹⁰ The special cases of agriculture and energy are discussed in Chapters 11 and 12.

The ranking is arranged in rough correspondence with the level of relative advantage provided by each option. Retention of the present level of trade barriers is, of course, one of the available options, and it is used here to define the "status quo." As negotiations proceed under GATT, this level of protection would presumably be reduced, resulting in a new "status quo" involving higher real incomes for Canadians. But the ranking of the other options relative to this new level of protection would remain the same. That is, if multilateral free trade in industrial products could be expected to bring, say, a 10 per cent increase in real income, a Canada-U.S. free trade arrangement might bring well over half, and a Canada-U.S.-EEC grouping, perhaps more than three-quarters of this gain.

9

FREE TRADE WITH THE UNITED STATES

In reviewing the range of trading options that Canada might consider, we have stated our belief that this country's interests would best be served in the widest possible free trade environment. But since this may well prove unattainable in the near future, Canadians must consider the possibility of reinforcing the basic multilateral approach with additional measures below the multilateral level.

In our ranking of economic benefits, free trade areas composed of the EEC and Japan, or at least one of them, in addition to the United States were considered the next best options. But circumstances may not permit even these arrangements to be negotiated. In their attempts to establish a regional free trade system, Canadians could in the end be confronted with the necessity of considering a bilateral arrangement with the United States alone – not as a matter of first choice, but as the only option available that would, at least within the coming ten to fifteen years, provide opportunities commensurate with the vast requirements for restructuring Canadian industry.

So far, however, we have focused largely on the implications of various trading options for Canada's industrial efficiency and real income. But serious consideration of any possible Canada-U.S. arrangement clearly involves a variety of additional economic and, even more important, political and social concerns.

Other Economic Concerns

Increased specialization within industries, firms, and plants is essentially what is required to improve the efficiency of Canadian manufacturing. Such structural reorganization would be a natural result of free trade with the United States and it would lead to higher real incomes for Canadians. The problem remains, however, whether the gains could be achieved without adverse consequences for other economic objectives, such as the stability of the Canadian economy or those relating to foreign ownership and control of Canadian industry.

Risks of Termination, Instability, and Adjustment

There is first the question whether the Canadian economy would be impaired if, at some future date, the U.S. government terminated the agreement. In this connection, it is worth reminding ourselves that the U.S. record in sustaining treaties is a good one. Furthermore, the best defence against termination would be the fact that in a free trade scheme U.S. business interests would be heavily involved in Canadian-American production and trade patterns, so that they would also stand to suffer if the arrangement were terminated. Termination could, however, occur. But the likelihood is that Canadian manufacturing, once rendered far more efficient through regional free trade, would be better able to readapt than if it

had never achieved such efficiency in the first place. Moreover, in the event of termination, Canada could, as a last resort, retain some of its original gains by unilaterally reducing import barriers against all countries.

Some Canadians have suggested too that under Canada-U.S. free trade there would be a risk of increasing this country's vulnerability to cyclical fluctuations and that diversifying our export markets overseas would produce the opposite result. However, other industrial countries are also susceptible to the business cycle, and it is not clear that there would be a major decrease in Canadian economic instability if the direction of our trade were changed.¹ It would be far more realistic for us to design our own stabilization policies to offset, or at least compensate for, cyclical instability transmitted from any external source. Retention of a flexible exchange rate would enhance the possibilities for such compensation.

In any event, there are large and growing markets for the products of our resource industries in overseas countries, so that diversification is increasing and will continue to increase for these industries. If a policy of further diversification is deemed to be desirable, it must focus on more highly manufactured exports. As previously stressed, however, the problem in this sector is caused by a relative lack of specialization and scale. Solving this problem depends essentially upon increasing the competitiveness of Canadian manufacturing. Indeed, one of the main reasons for seeking to upgrade the productivity of Canadian manufacturing at an early date through regional trade liberalization is to take advantage of the long-term growth of opportunities in world markets. And if, as we have recommended, there were also some unilateral reduction of this country's trade barriers, Canadian industries and consumers would have access to offshore supplies at lower prices; this would tend to maintain the flow of imports from overseas.

Another type of risk is connected to what we term "the double-adjustment problem." We have emphasized that regional arrangements should be viewed as stepping-stones to multilateral free trade. This raises the danger that the type of specialization resulting from the first step might not be consistent with that required by the second. Some Canadian specialization might occur in the "wrong" industries, in terms of the capacity of those industries to compete later in a wider free trading environment. For example, to the extent that Canadian manufacturers retained a labour-cost advantage relative to their U.S. counterparts, industries such as textiles, clothing, and shoes could be expected to expand under a Canada-U.S. free trade scheme. However, when low-wage countries subsequently entered the arrangement, Canada might well find that these industries had lost their labour-cost advantage. In short, there would be two opposing adjustments: the first involving

¹ The case for diversification of Canadian exports on cyclical grounds rests largely on the assumption that recessions in overseas countries would not occur at the same time, or with the same amplitude, as recessions in the United States.

expansion of such industries when trade was freed with the United States; the second, their contraction when wider free trade arrangements were achieved.

Bilateral free trade – partially insulated from third countries – would, indeed, be a useful transitional device for those industries. But it would be essential to ensure that they were striving to become viable in terms of world competition. Thus there is much to be said for combining regional elimination of trade barriers with unilateral lowering of such obstacles against outside countries; this accords with the basic intent of the recommendations in Chapter 8.

Foreign Ownership of Canadian Industry

Among the questions raised by the Canada-U.S. free trade option are several that concern Canadian reliance on U.S. investment capital and the heavy foreign ownership and control of Canadian business. First, would U.S. firms close their Canadian operations under free trade? Second, to what extent would Canada-U.S. corporate links prevent this country from realizing the full potential of removal of trade barriers? Third, would Canada's reliance on foreign capital increase or decrease with free trade?

In the short run, U.S. firms would maintain production in Canada, both because it would provide them with some return on invested capital and because any large-scale repatriation of investment would, under a flexible exchange rate, involve losses. More important, the fear of widespread shutdowns of Canadian operations over a longer period is not borne out by our discussion in Chapter 6. The evidence of intra-industry specialization as the general response to free trade implies not a termination of operations but a reorganization of production in subsidiaries, at least within certain limits of changing factor costs.

There is, however, a more complex related problem. Increased penetration of each other's markets by Canada and the United States might argue for a more unified North American corporate strategy, with the result that some Canadian subsidiary managements would be withdrawn to U.S. head offices. In certain instances, when production in Canada became a significant part of the total, there would doubtless be the need for a separate Canadian-based management. However, it is unlikely that this would be the case in smaller firms – or, indeed, in many larger ones. Transfer of administrative authority, and some personnel, from subsidiary managements to head offices in the United States would probably be one of the results of free trade.

Whether this would entail considerable costs to Canada is a moot point. Real managerial and technical effectiveness is more likely to be developed in Canadian-based multinational enterprises than in the present truncated offshoots of foreign-owned enterprises. And free trade, with its scope for increased efficiency in

Canada's manufacturing sector, would remove past impediments to the creation of Canadian multinational firms.²

This leads to the second issue raised above: To what extent would Canadian firms, whether foreign or domestically owned, be constrained in supplying U.S. markets by "corporate nontariff barriers" put in place to protect the particular interests of U.S. enterprises? The experience of Canada's producers of automotive parts under the Canada-U.S. Automotive Agreement suggests that the incidence of private nontariff obstacles did not inhibit expansion in Canada. With open access to the U.S. market for Canadian automobiles and parts, the sales of both foreign-owned and independent parts manufacturers to the auto companies in the United States increased considerably. Certainly, it is always conceivable that U.S.-owned subsidiaries might be prevented by their parents from taking full advantage of free trade opportunities – especially, perhaps, if the parents were under pressure from trade unions in the United States to avoid the "export of jobs" to Canada. We can only say that where conflicts between market considerations and factors such as these have arisen in the operations of foreign-owned firms to date, the former seem generally to have prevailed. But since it is not possible to be certain about such matters in the future, any free trade agreement would have to provide for complaint procedures.

The third issue is whether foreign ownership and control would rise or decline with Canada-U.S. free trade. Here a distinction must be made between the period of transition to free trade and the longer run. During the transition period, Canadian mergers or joint ventures with U.S.-owned corporations could be an important device for penetrating the U.S. market, and the possibility that foreign ownership would temporarily increase must be faced. Procedures for dealing with this are, however, already in place in Canada (see Chapter 13).

Over the longer run this situation would change. The rise in Canadian incomes that would follow from free trade would increase the supply of domestic savings by at least the same proportion. Indeed, given higher levels of income, Canadians might be inclined to save a larger proportion of their earnings – although much would depend on a variety of other factors, including government tax and expenditure policies. On the demand side, free trade would influence the capital-output ratio in Canadian industry. At present this ratio is substantially higher than that in the United States, essentially because of the limited and relatively inefficient scale of production in much of Canada's manufacturing sector. Removal of trade barriers would make possible a reduction in the capital-output ratio, probably bringing it close to U.S. levels. Thus Canada's demand for new capital would rise less rapidly than output. Given an increase in savings at about the same rate as output, free trade would put Canada in a position to finance a higher proportion of

2 It is noteworthy that existing Canadian multinationals are usually found in industries in which foreign trade barriers are low or zero.

domestic investment out of domestic savings, thereby permitting this country to rely less heavily on foreign capital. Alternatively, or more likely in combination with this result, Canada could repurchase its industry from foreigners or build up its holdings of assets in other countries.

Political Considerations

Our analysis of the economic implications of regional free trade arrangements leads us to the conclusion that there is little reason to fear the economic effects of a Canada-U.S. free trade area. Such a bilateral agreement could provide a large proportion of the economic gains that this country might expect from multi-lateral free trade, or from a regional arrangement involving the United States and either or both the EEC and Japan. But questions like foreign ownership and control of Canadian industry are really linked to a broader set of political and social issues. Nationalist pressures focusing on these issues are most sharply manifested in the Canada-U.S. relationship, and they have already played a significant role in a number of areas of public policy. However, nationalism can take many different forms. Basically, a nationalist is one who strives to strengthen his country's independence. While such a general objective would probably receive considerable public support, there would be many different views on how it could be achieved. There are those who contend that to rank Canada-U.S. free trade as a serious option – even in “second best” or “less-than-ideal” terms – is to be completely out of line with the realities of contemporary Canadian political life. But there are also nationalists who feel that Canadian independence has more to do with decision-making than with the free exchange of commodities with a neighbouring country. We are concerned here less with who is right or wrong than with the fact that these positions may be dismissed outright either for emotive reasons or through failure to set out the issues in terms appropriate to today's circumstances.

One of the things that Canadians may wish to consider is our judgment that persistent import protection – foreign as well as Canadian – has greatly weakened this country's capacity to develop efficient, dynamic, Canadian-controlled manufacturing industries. In our view, it would be difficult to conceive of an approach to commercial policy more detrimental to future national unity and independence than protectionism.

What, then, are the basic Canadian political concerns? Typically, they are articulated in a variety of broad questions. Would free trade make Canada more vulnerable to policies adopted by the United States in pursuit of its own national objectives? Would government decision-making machinery have to be co-ordinated or harmonized and, if so, would the United States predominate in any such

arrangements? Would a free trade area tend inevitably to become a customs union, and would a customs union contain the seeds of ultimate political union?

These are complex matters. At the risk of oversimplification, we suggest that they can be treated in three parts: first, the difficulties believed to arise from the process of negotiating a free trade arrangement; second, the problems associated with implementing and sustaining any particular scheme; and, third, the threat to Canada's survival posed by continuing free trade with the United States.

The Negotiating Process

There is, of course, the possibility that the United States might attempt to use its considerable leverage to extract harsh terms from Canada as the price of industrial free trade. U.S. agreement would not, after all, be an act of altruism. But for cogent economic and political reasons – especially the desire to have some of its major Canadian links secured by mutually acceptable rules of conduct – the United States is likely to prefer a harmonious relationship with its largest and most accessible trading partner.

Canadians cannot, however, expect to know the U.S. position until the process of negotiation is well under way. Thus it is important for Canada to order its own priorities regardless of the U.S. stance. In any event, no responsible Canadian policy-maker would, or should, consider entering a free trade arrangement whose terms imposed severe constraints on this country's freedom to pursue basic national goals. On the contrary, given the relative economic strength of the prospective partners, it would be crucial for Canada to obtain U.S. acceptance of whatever conditions are necessary to ensure a dynamic and resilient Canadian economy.

In our view, the first requirement would be that the Canada-U.S. arrangement take the form of a free trade area rather than a customs union, and that its membership be open to other countries willing to adhere to the conditions established by the founding members. A free trade area, in contrast with a customs union, permits the partners to maintain their own commercial policies vis-à-vis nonmembers; this would obviously reduce the scope of policy harmonization needed to operate the scheme. An open-ended arrangement could lead to early diversification of membership, with a consequent diffusion of decision-making power.

A second requirement would be precise definition of the range of commodity coverage. In Chapters 11 and 12 we argue that Canada's agricultural and energy sectors should not be fully governed by the rules of any free trade system, whether regional or multilateral. These special cases would have to be clearly recognized by the United States.

A third requirement would be provision for the use of a flexible exchange rate to ease the process of adjustment to free trade. This would be most significant in relation to the restructuring of Canadian industry for expanded competition

in world markets. In the same vein, there would have to be mutual exemption from trade restrictions introduced for balance-of-payments reasons. And there would have to be wide scope for domestic adjustment measures – especially direct assistance to workers, firms, and regions – that did not result in the imposition of countervailing duties by the United States.

Joint Administration

All of these conditions – and more – would in turn necessitate the adoption of appropriate institutional machinery.³ The approach could be quite pragmatic. Certainly the system need not be elaborate; for example, the European Free Trade Association (EFTA) set general guidelines and left their specific application to be settled if and when any conflicts arose.⁴ However, the institutions would have to be strong enough to make the agreement work as planned. In particular, they would have to provide for prior consultation on changes in trade and balance-of-payments policies, for joint surveillance of nontariff barriers and periodic review of efforts to lower them, and for continuing adjudication of disputes arising from the application of the scheme. Any new institutions required to implement these provisions could be built on already established co-operative mechanisms, such as the International Joint Commission.⁵

The Spectre of Political Union

The deepest of all Canadian concerns is, of course, the fear that a Canada-U.S. free trade arrangement would ultimately lead to political absorption by the United States. This is the heart of the matter. The fact is, however, that Canadians have been slow to subject this concern to critical examination. For a start, they must ask if free trade would result in substitution of Canadian dependence for autonomy or if instead it would involve replacing one type of Canada-U.S. interdependence with another? Would not the change be from a largely unplanned North American economic relationship to a system based on agreed rules of conduct? There is no *a priori* reason to believe that the act of structuring an already vast array of trade links would increase the danger of political union. Indeed, it might be more

3 Detailed discussion of the provisions of a free trade treaty is presented in Sperry Lea, *A Canada-U.S. Free Trade Arrangement: Survey of Possible Characteristics* (Montreal: Private Planning Association of Canada, 1963); and *idem*, *A Possible Plan for a Canada-U.S. Free Trade Area* (Washington: Private Planning Association, 1965).

4 See EFTA Secretariat, *The Stockholm Convention Examined* (Geneva: EFTA, 1963); also F. V. Meyer, *The European Free Trade Association* (New York: Praeger, 1960).

5 The case for joint administrative and consultative mechanisms between the two countries is well made in Maxwell Cohen, "Canada and the United States: Possibilities for the Future," *Columbia Journal of Transnational Law* 12, no. 2 (1973).

realistic to argue that Canada's capacity for survival would be strengthened by accepting the fact that our unique trade relationship with the United States is irreversible. It would be better to deliberately define, in accordance with clear national objectives, the direction in which this relationship should develop, rather than to cope, after the fact, with the consequences.

A common view, however, is that a free trade area would inevitably evolve into a customs union and eventually into a form of political integration. But this view receives little support from the available evidence.⁶ In fact, some recent research suggests that transnational trade schemes may actually enhance the self-awareness of participants, further retarding integration even when it was originally intended.⁷ All things considered, there appears little reason to assume that a free trade area whose members wish it to remain so need become anything else.

The concern over ultimate political union has other strands as well. Perhaps the most serious one is the argument that a Canada-U.S. free trade arrangement – of whatever kind – is bound to erode Canadian independence by causing a very substantial increase in U.S. ownership and control of Canadian industry. As noted earlier, we share the view that continuing expansion along these lines would not be consistent with Canada's long-term political objectives. In Chapter 13, accordingly, we touch on the role that the Foreign Investment Review Agency could play in keeping direct investment inflows under constant review throughout the transition years. We also recommend exploring the possibility of adopting a joint code or set of guidelines on the behaviour of multinational enterprises. In this connection, it is important that Canada mobilize its own capital resources for the more effective development of opportunities opened up by free trade. The fundamental purpose of all such efforts would be to prevent any increase in foreign ownership and control and possibly to reduce it.

At the same time, our sense of perspective compels us to re-emphasize some of our findings on this particular issue. For example, it is Canadian tariff protection – not trade liberalization – that has provided a powerful stimulus to U.S. ownership and control. Second, a tariff-free U.S. market would give ample scope for accelerated development of Canadian innovative and managerial capacity and

6 See Peyton V. Lyon, *Canada-United States Free Trade and Canadian Independence*, Economic Council of Canada (Ottawa: Information Canada, 1975).

7 Naomi Black found that "though close and enduring interactions exist between pairs of nations of vastly unequal power, such interactions seem unlikely to lead to a fusion of the two units. Furthermore, such interactions will tend to make merger increasingly less . . . likely. Nor are such interactions likely to increase indefinitely . . . even for a single aspect of economic or cultural life. . . . Neither absorption nor sector take-over seem to be important threats." See "Absorptive Systems Are Impossible: The Canadian-American Relationship as a Disparate Dyad," in *Continental Community? Independence and Integration in North America*, ed. W. Andrew Axline, James E. Hyndman, Peyton V. Lyon, and Maureen A. Molot (Toronto: McClelland & Stewart, 1974), p. 94.

Canadian-controlled multinational enterprises. Third, the long-run prospect, if free trade were adopted, is for a richer Canadian economy, less reliant on foreign capital and know-how to meet its investment needs.

Social and Cultural Concerns

If the political implications of Canada-U.S. free trade are hard to analyse, the social and cultural elements are more difficult still. But for some Canadians they are even more fundamentally linked to the issue of independence. There is, for example, an understandable concern to avoid the spread to Canada of social tensions that are particularly strong in the United States. More important, Canadians are uneasy about their ability to develop and sustain a culture distinct from that of the United States.

We recognize that geographic and cultural proximity create a strong potential for the transmission of U.S. ideas and life-styles – both negative and positive – to Canada. However, the pertinent question in this chapter is whether Canada-U.S. free trade would significantly weaken the social and cultural underpinnings of Canadian nationhood, compared with the present situation.

Of the many different types of flow across national boundaries – goods, investment capital, people, ideas – the exchange of goods seems least likely to influence the individual countries' social organization or cultural milieu. Trade liberalization, with its institutional mechanisms, is sure to have some side effects. But we would be surprised if their impact on Canada's social system were large, given the already close interdependence between this country and the United States.

There is, nevertheless, the possibility that a Canada-U.S. free trade arrangement might directly restrict the flow of information and ideas from third countries to Canada. For example, a tariff preference in favour of the United States could place other suppliers of books and similar materials at a disadvantage in the Canadian market. However, the problem need never arise. In a free trade area, as opposed to a customs union, Canada could handle this situation by unilateral tariff action. In addition, rich nations can obviously afford to spend more than poor ones on their social and cultural betterment. The economic gains derived from Canada-U.S. free trade would mean a major expansion of the base on which a viable Canadian independence must be built.

Conclusions

How to increase this country's economic welfare without eroding its political or social strength vis-à-vis the United States has long concerned Canadians. For the 1970s and beyond, the economic challenge is particularly great, because other countries are moving so rapidly to develop new technology and better ways of

organizing industrial activity. But the sociopolitical uncertainties are no less real than they have ever been.

This is undoubtedly why most Canadians would rank Canada-U.S. free trade well below such options as multilateral free trade and regional free trade involving the United States and the EEC. The wider options clearly offer a more potent combination of economic gain and diversity of international links. But the logic of our economic analysis suggests that a Canada-U.S. free trade arrangement is the only other option offering economic benefits roughly commensurate with the gains that would accrue from multisided free trade.

We have, of course, developed our case primarily in Canadian terms. If commercial policy is to be positive rather than simply a reaction to other countries' initiatives, we must first establish whether and how much Canada would gain from any particular option. With this question answered, it is worth asking why the United States in particular would be amenable to a free trade arrangement with this country, as was indicated in the Trade Act of 1974.

Without being presumptuous about U.S. attitudes, several reasons for their interest can be advanced. Canada is the largest U.S. trading partner, a favoured location for major U.S. investments, and an important and nearby source of many of its raw materials. It would be useful to the United States, as well as to Canada, to have its very large Canadian interests secured by mutually acceptable rules of conduct. Such rules could also remove a number of sources of friction for both countries and allow them to concentrate much more effectively on their frequently mutual interests in the wider multilateral sphere. Finally, since the United States regards multilateral free trade as a desirable long-term objective, a Canada-U.S. free trade arrangement that recognized this goal would be consistent with U.S. aims. Indeed, it might well stimulate other countries to join in a wider free trade scheme, and this could accelerate achievement of the longer-run multilateral goal. For all these reasons, we do not find it surprising that the United States would be prepared to explore the possibilities for Canada-U.S. free trade – particularly if viewed as part of a larger design.

We have tried to show here that the sociopolitical issues that must be taken into account in a Canadian re-examination of this option are far more complex than is generally assumed, and that they *may not* run counter to the positive effects of Canada-U.S. free trade. Canadians should probe these issues more deeply than ever before. Meanwhile, they will have to recognize that time is not on the side of this country's manufacturing industry and that, if wider options turn out to be unfeasible, it could be very costly in economic terms to forgo a free trade arrangement with the United States.

Some time will, however, be required to explore fully the wider and more beneficial arrangements set out in our ranking. And Canadians must be given an

opportunity to reassess the political and social implications of Canada-U.S. free trade. For these reasons, the Council does not propose that the government initiate formal negotiations at this time for such an association with the United States alone. Rather, we stand on the recommendations presented in earlier chapters.

10

**A GRADUAL APPROACH TO
TRADE LIBERALIZATION**

The preceding chapters have reviewed a variety of approaches that Canada might take towards substantially freer trade over some reasonably short and well-defined time period. However, we must face the possibility that none of these options may turn out to be open – either because they would be difficult or impossible to negotiate, or because they would be politically unacceptable to a large number of Canadians. Canada would have little choice in such circumstances but to accept a continued gradual approach to multilateral trade liberalization and to look for ways of improving or supplementing the contributions of this approach to productivity improvement. There are, of course, many ways to increase productivity,¹ but here again we focus on those (both commercial policy and more purely domestic measures) that would bear directly on what we consider the major problem of Canadian manufacturing – the lack of scale and specialization.

Clearly a more gradual approach to trade liberalization would have a certain appeal. For example, if mistakes were made, they might be corrected before any great damage was done. Moreover, in the short run, fewer disturbing adjustments are likely to occur than under some of the other options. But there is another side to the story. Adjustments cannot be viewed in isolation; they are part of the costs of achieving longer-run gains. Under gradualism, the greater uncertainty about the size and timing of reductions in trade barriers will impede the reorganization of production, implying a loss in terms of real income forgone and, perhaps, greater adjustment costs.

This chapter is concerned with how the net benefits of a gradual approach might be maximized, lower though they may be. In this connection, it is well to remember that the economy is an interdependent system. Measures designed to help one industry or sector may lead to unexpected or even unfortunate results in others. Thus gradualism will involve more government intervention, a more complicated decision-making process, and concern with the sequence of changes undertaken.

Commercial Policy Measures

Gradual elimination of trade barriers would result in a much more difficult and complex situation than would free trade, since not all protection-induced costs would be removed simultaneously.² For example, reduction of the Canadian tariff on an end product could seriously jeopardize production of that item if producers still had to incur high costs for protected inputs. In addition, partial

1 See, for example, Economic Council of Canada, *Fifth Annual Review: The Challenge of Growth and Change* (Ottawa: Queen's Printer, 1968), Chapter 2.

2 The complexity of the problems involved is brought out very clearly in James R. Williams, "The Canadian-U.S. Tariff and Canadian Industry: A Multisectoral Analysis," 1974 (mimeo.).

but close to equal reductions in the protection accorded a product here and in our major trading partners could, because of disparities in the size of the home markets and related economies, allow penetration of the Canadian market by foreigners without compensating advantages for Canadian exporters.

For these reasons, it is simply not possible to say that, under a gradualist approach, a 20 or a 50 per cent reduction in all tariffs would achieve one-fifth or one-half of the gains that would accrue from tariff-free trade. In fact, the gains from trade liberalization could be considerably less than proportional to the size of the tariff cut if the path towards free trade were not selected very carefully.

Reform of the Canadian Tariff Structure

Complete elimination of the Canadian tariff, as under unilateral free trade, would present a major difficulty: it could wipe out some lines of manufacturing that might ultimately be profitable if all tariffs – foreign as well as Canadian – were removed. However, reform of Canada's tariff structure, in a way that recognized the importance of foreign trade barriers to Canadian industry, could provide a useful way of preparing for eventual multilateral free trade.

Under the existing system, Canadian tariffs escalate in the sense that manufacturing industries generally receive more protection than primary industries. Moreover, there is a distinct tendency for industries that use a lot of agricultural inputs and unskilled labour to receive high rates of protection in comparison with other manufacturing industries. Thus there is great variability in the rates of protection to different industries, even when they are within the same broad industrial group or at approximately the same degree of processing.

For example, in 1970, effective rates of protection in the food and beverage industries ranged from a low of – 1.4 per cent for flour mills to a high of 49.1 per cent for dairy factories.³ The high effective rates for dairy factories and poultry processing plants reflect, at least in part, policies directed at ensuring a domestic market for certain agricultural products. A high percentage of the costs of these industries is for direct purchases of agricultural inputs produced at relatively high cost in a protected Canadian environment. As a second example, the average effective rate of protection in the primary metals group⁴ in 1970 was 6.9 per cent (Table 2-3), but this masked effective rates of protection ranging from a low of

3 The food and beverage group includes industries 12 to 27 in Appendix A; distilleries, breweries, and wineries have been excluded.

4 The primary metals group includes industries 59 to 65 in Appendix A. Tariffs for the individual industries have been weighted by value of output to calculate the average for the group.

2.6 per cent for smelting and refining to a high of 32.3 per cent for copper and alloy rolling, casting, and extruding.

Similar variability is observed among the tariffs for industries whose levels of processing are roughly the same. There is very little relationship between an industry's use of natural resources – a proxy for the degree of processing – and the height of its tariff. The processing level for the carpet, mat, and rug industry is, for example, approximately equivalent to that for refrigeration, office, and store equipment industries (Appendix B, industries 41 and 74). However, in 1970, effective protection for the former group was 35.4 per cent and for the latter, only 5.7 per cent.

If the objective of Canada's tariff system is to permit a variety of industries to earn a "normal" profit, then such wide variations in rates of protection would indeed be necessary. They simply recognize the fact that differentials in cost between Canadian and foreign producers are not the same for all industries. But, if the objective is to move towards more efficient production, then it is important to look closely at the reasons for those cost differentials and to begin reducing the variation in protection in line with Canada's long-run comparative advantages.

Some of the cost differentials offset by Canadian tariffs arise from factors that would remain even under free trade. For example, industries such as textiles, clothing, and knitting mills are highly protected in Canada, primarily to offset the wage-cost advantages of the developing countries.⁵ As these countries become even more competitive over time, the industries cited will only be able to survive in their present form in Canada by means of still higher protection and greater costs to consumers. For other industries, such as petrochemicals, protection may be required because foreign trade barriers have precluded the greater scale and specialization that would lower unit costs of production to the level that this country's endowment of human and physical resources would make possible in a free market.

Canada's longer-run interests would call for reductions in its own trade barriers in the first case, while maintaining some protection to enable the second group to survive in the face of other countries' trade barriers. These interests might be met by starting with reductions in unusually high Canadian tariffs unless the industry concerned could demonstrate that, while it is capable of sufficient economies of scale under complete free trade, it is prevented from attaining such economies by particularly severe trade barriers elsewhere and therefore requires a protected Canadian market so long as these barriers remain. Exceptions might also have to be made for some of the food processing industries until a lasting solution to Canada's problems of agricultural adjustment could be achieved.

⁵ Even with protection, these industries have not always been able to obtain all the domestic labour they require. They have, at times, been compelled to import low-wage labour from developing countries.

Where adequate economies of scale cannot be obtained now because of barriers abroad, a tariff lower than the present level might suffice in some cases, especially if there were a general decrease in the level of Canadian tariffs and a consequent reduction in input costs. In industries that depend heavily on protected inputs, such a general policy may be all that is required for improvement in cost-effectiveness and reduced dependence on the domestic market. Indeed, a carefully selected path of tariff reductions, such as we describe later for the nonferrous metal and iron and steel industries, could facilitate expansion of some industries and would help to absorb the factors of production released by less competitive producers.

The measures we have in mind for a gradual approach would reduce the present wide variation from the average of the tariff protection within each industry group, though perhaps not as rapidly as would follow from implementation of our Recommendation 2 (see Chapter 7). In the process, the variation of the average from one group to another could also be reduced, subject to the proviso that no nominal tariffs were raised and that care were taken to avoid burdening any industries with negative effective protection. This approach would improve the allocation of resources among import-competing industries by reducing disparities in protection. It would provide gains for consumers and would allow better allocation of resources between import-competing and export industries, since it would also reduce the general level of protection. Moreover, the steps we are suggesting here would provide an especially strong stimulus to Canada's labour-intensive industries to adapt to the circumstances of the future. Therefore,

Recommendation 6

We recommend that, if broader trading options are not open to this country, Canada should seek generally to rationalize its own tariff structure by reducing unusually high nominal tariffs to a narrower band around the average for each industry group and by reducing the variation in average protection among industry groups. Tariff reductions in the food and beverage industries should, however, be linked, where necessary, to international progress in solving problems of economic efficiency and social adjustment in agriculture.

Some of the peaks in the tariff could be removed in the course of trade negotiations. But unilateral action might also be considered. A good argument can be made, for example, for implementing such a policy during an inflationary period to help keep prices down; it could also be useful when the foreign exchange value of the Canadian dollar was particularly high, so as to alleviate the pressure that would otherwise be felt by exporters. In addition, this approach could be taken into account in the deliberations of the Tariff Board. We will make recommendations in this regard in Chapter 13.

A Strategy for Sectoral Trade Liberalization

We suggested in Chapter 7 that a sector-by-sector approach to trade negotiations would be unlikely to provide Canada with a rapid entrée into world markets on a large scale. There is another problem. When trade in only one or a few sectors can be freed at a time, the costs involved reduce the value of the approach as a path to wider free trade. Still, it can offer certain practical advantages and some economic benefits. If other options were not available, it would be important to consider how the net benefits of a sectoral approach might be maximized by careful selection of the industries to be included and the sequence of their inclusion.

Economic Problems of a Sectoral Approach

Free trade in the end products of one or two industries could hamper such industries to the extent that they would have to rely on protected Canadian suppliers or purchase inputs over a tariff. Indeed, this would be a significant feature, because some two-thirds of the total costs of Canadian manufacturers are accounted for by purchases of materials and components, including capital goods, from other Canadian and foreign producers.⁶ Many of these inputs are themselves high-priced because of trade barriers. Conversely, if end products remained protected while inputs from another industry became duty-free, some industries might simply continue or even extend inefficient patterns of production behind a higher level of effective tariff protection. Moreover, by contrast with strategies that involve across-the-board removal of trade barriers, the sector-by-sector method would appear to exacerbate what we have referred to as the "double adjustment" problem. That is, an industry might adjust in one direction as its own trade was freed, only to be faced subsequently with the need for adjustment in the opposite direction as more and more sectors were liberalized.

The Canada-U.S. Automotive Agreement

The Automotive Agreement provides a useful illustration of some aspects of sectoral free trade. The Agreement was viewed, when it was signed, as a constructive bilateral solution to a crisis situation that was forcing Canada into somewhat less desirable unilateral action.⁷ But it never entailed complete free trade in the

6 D. J. Daly, B. A. Keys and E. J. Spence, *Scale and Specialization in Canadian Manufacturing*, Economic Council of Canada Special Study 21 (Ottawa: Queen's Printer, 1968), pp. 25-26.

7 Carl E. Beigie, *The Canada-U.S. Automotive Agreement: An Evaluation* (Montreal: Private Planning Association of Canada, 1970), p. 2 and Chapter 3.

industry, and it had some rather unique features. For example, because there were only a few automotive assembly firms, all of them subsidiaries of U.S. corporations, it was possible to incorporate effective safeguards for Canadian production, thus giving the Agreement a protectionist slant. Moreover, since the United States was prepared to grant duty-free status only to imports from Canada, it had to seek a GATT waiver for its part in the Agreement.

Under the Agreement, the Canadian industry became much more specialized. Work done for the Council indicates that the result was substantially increased efficiency – about 90 per cent in vehicle assembly and over 20 per cent in parts and accessories.⁸ The benefits from these gains could be passed on in lower prices, higher wages, larger profits, and higher tax revenues.

Canadian consumers gained until 1969 but, since then, they have lost ground relative to their U.S. counterparts. The gap between U.S. and Canadian factory list prices for a typical model narrowed between 1965 and 1969, but it has widened again despite appreciation of the Canadian dollar (Table 10-1). Moreover, the gap facing the Canadian consumer became even larger than Table 10-1 indicates when the U.S. federal sales tax on cars and light trucks was removed in 1972, while the Canadian federal sales tax remained in effect.

Table 10-1

Factory List Price of a Typical Popular Model Automobile,
Canada and the United States, 1965 and 1968-74¹

Model	U.S. price	Exchange rate	U.S. price	Canadian price	Gap as percentage of U.S. price in \$ Cdn.
	(\$ U.S.)		(\$ Cdn.)	(\$ Cdn.)	
1965	2,565	1.0780	2,765	3,040	+ 9.9
1968	2,799	1.0775	3,016	3,213	+ 6.5
1969	2,868	1.0768	3,088	3,272	+ 6.0
1970	2,969	1.0440	3,100	3,381	+ 9.1
1971	3,000	1.0098	3,029	3,297	+ 8.8
1972	3,413	0.9905	3,380	3,784	+12.0
1973	3,704	1.0001	3,704	4,120	+11.2
1974	3,852	0.9780	3,767	4,209	+11.7

1 Prices are those of a four-door, eight-cylinder sedan with comparable standard equipment.

SOURCE *Annual Reports of the President of the United States to the Congress on the Operation of the Automotive Trade Products Act of 1965*, and *Bank of Canada Review*.

8 David L. Emerson, *Production, Location and the Automotive Agreement*, Economic Council of Canada (forthcoming). The effects of the Automotive Agreement are also discussed in David A. Wilton, *An Econometric Analysis of the Canada-United States Automotive Agreement*, Economic Council of Canada (forthcoming).

For wages, the results have been different. There has been nominal wage parity in automobile assembly since 1970, while in auto parts and accessories the average hourly wage in the Canadian industry rose from 77 per cent of the U.S. level in 1966 to 84 per cent in 1971 and close to parity in 1974. The pressure to close the wage gap in the auto sector was probably reflected in other industries to some extent also, thus tending to inflate their prices and reduce their competitiveness. However, even the dramatic increase in the efficiency of auto assembly in Canada may not be enough to overcome natural disadvantages (e.g., transportation costs) and, at the same time, to sustain wage parity if, for example, the right to import duty-free were extended to Canadian consumers or if Canada's relatively high automotive tariff against third countries were reduced to the level imposed by the United States against overseas producers.

One particular problem of sectoral free trade – that of higher-cost protected inputs – was eased somewhat in the automotive industry because it buys a relatively high proportion of its inputs from other firms within the same group (Table 10-2). However, the parts industry used substantial quantities of production machinery imported from the United States over the Canadian tariff. In this case, provision was made for a tariff rebate on imported machinery not available in Canada.

Table 10-2

Percentage Distribution of Total Expenditures, Selected Canadian Industrial Sectors, 1961

	Materials and components		
	From own sector	From other sectors	All other inputs ¹
Motor vehicles	34.8	33.9	31.3
Chemicals	22.1	36.3	41.7
Forestry ²	30.4	26.2	43.4
Nonferrous metals ³	47.1	16.8	36.1
Iron and steel ⁴	19.8	34.9	45.3
Other metal-working	6.8	51.2	42.0
Textiles	32.0	25.5	42.5
Knitting	4.8	60.2	35.0
Rubber	2.6	47.9	49.5
Food and beverages			
(excl. agriculture)	15.8	56.7	27.5
(incl. agriculture)	35.1	24.6	40.3

1 These include expenditures for labour services, returns to capital, indirect taxes, and noncompeting imports.

2 Includes forest products.

3 Includes base metal mines.

4 Includes iron mines.

SOURCE Based on Dominion Bureau of Statistics, *The Input-Output Structure of the Canadian Economy, 1961*, vol. 2 (Ottawa: Queen's Printer, 1969).

*The Selection of Other Sectors
for Free Trade Arrangements*

The features that made the automotive industry particularly appropriate for a sectoral trade arrangement are unlikely to be present, at least to the same degree, in many other Canadian industries. But this difficulty could be alleviated if any further sectoral arrangements could be negotiated as part of a more general strategy for minimizing the distortions that may arise under this approach.

The strategy that we have in mind would call for focusing negotiations, at least initially, on selected sectors embracing closely related commodities up to the semiprocessed stage rather than on highly fabricated end products. Such an approach would offer advantages both to manufacturing countries and to natural resource producers. We noted earlier the difficulty of removing protection on particular products when a producer must still pay for protected inputs. But reduction of trade barriers "from the bottom up" – that is, by starting at the earlier stages of processing – would offer the possibility of lower costs on a variety of inputs into more highly fabricated goods.⁹ And sectoral negotiations would be a particularly attractive way of doing this, since tariffs and, perhaps even more important, nontariff barriers could be dealt with simultaneously.

Negotiating sectoral arrangements in this way would be consistent with the recent emphasis in this country and others on further domestic processing of natural resources. It would allow the resource-producing countries to exploit more fully the cost and bargaining advantages accruing to them as a result of rapidly increasing demands for key raw materials and certain farm commodities. And the growing awareness of the problems of pollution in more densely populated countries like Japan may well reduce their enthusiasm for expanding their own processing facilities.

Canada's bargaining edge, such as it is, will have to be used carefully, in part because competing sources of raw materials are already being developed. For example, the rise of laterite production in Australasia and the Caribbean has ended Canada's dominant position in the world nickel market. Indeed, it is probably true to say that, with the possible exception of asbestos, Canada no longer enjoys a totally unchallenged position as a world producer of any item. In any event, substitution is a real possibility; for example, rubber and nitrates have been replaced in many instances by synthetic products. Thus our bargaining leverage should not be used as a basis for setting up new trade distortions but to eliminate the existing barriers that prevent Canada from exercising its real, long-run comparative advantage.

9 Gerard and Victoria Curzon, *After the Kennedy Round, What Trade Policies Now?* (London: Committee of the Atlantic Trade Study, 1968), pp. 44-45.

The fact that a country possesses a comparative advantage in the production of a raw material is, of course, no guarantee that similar advantages will be present at further stages of processing. In some cases, technical factors may preclude them. For example, coke – the more highly processed form of coal – tends to break down in transport and so lose value. Moreover, lower costs for bulk transport of raw materials or combinations of such factors as higher labour and capital costs may make a Canadian location uneconomic. Thus any “blanket” policy of further processing would be undesirable. However, the approach we suggest here could result in somewhat more upgrading of Canadian resources and, at least after a time, greater use of such commodities in highly fabricated products of Canadian manufacture.

Gradual trade liberalization in this context implies a program for *progressive elimination* of trade barriers by sectors. Quite clearly, such a process will require the exercise of a good deal of judgment, particularly on the part of those skilled in trade negotiations. To assist in making such judgments about the industries to be included, several criteria could be established. The industries should draw heavily on raw materials in which Canada already has a comparative advantage. They should be industries in which foreign trade barriers are, at present, a major impediment to efficiency gains. They should also provide inputs for a wide range of other Canadian industries and yet be relatively “self-contained” – in the sense that they buy relatively less from other industries and more from within their own group.

Table 10-2 illustrates the wide variation in the extent to which industries are self-contained. The knitting, rubber, and food and beverage industries, for example, would be poor candidates for sectoral free trade because so many of their inputs come from other sectors. The textile industry fares better in this respect; however, it is still an unsuitable candidate because foreign trade barriers are not the major impediment to its competitiveness. The chemical and forest products industries might be considered more suitable; they purchase a relatively high proportion of inputs from within their own sector, and trade barriers inhibit full efficiency on the part of Canadian producers.

Our examination suggests that the nonferrous metals, iron and steel, and other metal-working sectors, especially when taken together, possess a particularly good combination of characteristics for initiating a strategy of sectoral trade liberalization. One might start with nonferrous metals. For this group (including base metal mines), additional processing would largely involve the application of energy to inputs of minerals and crude raw materials, and Canada already has a comparative advantage in many of them. A high proportion of their inputs come from within the sector (Table 10-2), and even a cursory look at interindustry relationships reveals that they are important suppliers of inputs (some of them now protected) to a wide variety of Canadian industries, particularly in the iron and steel and other metal-working sectors. Moreover, existing barriers are evidently one of the principal distortions to trade in the more processed forms of these commodities. In Table 10-3 it can be seen that the U.S., Japanese, and EEC tariff structures discriminate against

the prior processing of such exports by resource-producing countries. Moreover, their tariffs are reinforced by a wide range of nontariff barriers, including import licensing and quotas, state trading, quality standards, and credit restrictions for imported goods. Canada, too, has some trade barriers that affect resource producers. For example, the Canadian tariff structure provides rather high effective protection for copper and alloy rolling, casting, and extruding (Appendix A).

Table 10-3

Post-Kennedy Round Import Tariffs, by Stage of Processing

	EEC	United States	Japan
	(Percentage)		
Iron and steel			
Ores and concentrates	0.0	0.0	0.0
Unworked	3.7	3.6	5.5
Semimanufactured products	6.7	7.8	10.2
Aluminum			
Bauxite	0.0	0.0	0.0
Alumina	8.8	0.0	0.0
Unwrought	3.6	4.5	6.8
Semimanufactured products	10.9	7.7	14.9
Nickel			
Ores and concentrates	0.0	0.0	0.0
Unwrought	0.0	2.4	13.4
Semimanufactured products	5.1	8.7	12.3
Copper			
Ores and concentrates	0.0	1.4	0.0
Unwrought	0.0	3.9	6.6
Semimanufactured products	7.4	8.0	16.5
Zinc			
Ores and concentrates	0.0	9.0	0.0
Unwrought	2.3	11.2	3.3
Semimanufactured products	9.2	7.9	10.4
Lead			
Ores and concentrates	0.0	7.6	0.0
Unwrought	2.7	9.0	8.4
Semimanufactured products	9.2	7.8	15.6
Wood			
Wood and cork in the rough	1.7	2.1	0.3
Wood-based panels	12.7	12.6	18.0
Semimanufactured products	4.4	2.3	5.4
Pulp and paper			
Paper pulp and paper waste	1.0	0.0	3.6
Paper and paperboard	10.1	5.5	9.2

SOURCE Based on data from GATT.

Bearing these factors in mind, therefore,

Recommendation 7

We recommend that Canada devote particular attention in the GATT negotiations to the removal of barriers affecting trade in raw and semiprocessed nonferrous metals within the stages of fabrication where their identity as products of that sector is maintained.

The immediate gains available from negotiating sectoral arrangements for the nonferrous metal industries should not be exaggerated. Further processing can be considered to involve two main stages: the conversion of concentrates to metal, and the conversion of metal to more fabricated forms. In the first of these stages, many of the opportunities for expansion of Canadian processing would be limited to copper, lead, and zinc, which are all mined domestically. But, in the aluminum and phosphate industries, for example, Canada depends entirely on imported ore. Even in the second stage, the opportunities might be more limited than popularly supposed. Zinc and lead, for example, already have duty-free access to the U.S. market, since significant quantities are used in production of automobiles and parts; thus the additional gains from sectoral free trade in these products may not be very large.

Nevertheless, free trade in nonferrous metals could lead to somewhat greater access to foreign markets; it might also reduce some of the costs of inputs to other

Table 10-4

Percentage Distribution of Total Expenditures of the Metal-Working Sector, 1961

	Purchase of materials and components from:						Total
	Mining products ¹	Non-ferrous metals	Iron and steel	Other metal-working	Other sectors	All other costs of production	
Nonferrous metals ²	39.9	28.2	1.3	0	10.9	19.7	100
Iron and steel ³	13.3	5.9	14.4	0.3	23.1	43.0	100
Other metal-working ⁴	0	5.0	23.2	6.8	33.0	42.0	100

1 Includes iron ores; metal ores, n.e.s.; radioactive ores; gold ores; and coal.

2 Includes smelting and refining; aluminum rolling, casting, and extruding; copper and alloy rolling, casting, and extruding; and metal rolling, casting, and extruding.

3 Includes iron and steel mills, steel pipe and tube mills, and iron foundries.

4 Includes boiler and plate works, fabricated structural metal; ornamental and architectural metal; metal stamping, pressing, and coating; wire and wire products; hardware, tool, and cutlery; miscellaneous metal fabricating industries.

SOURCE Based on Dominion Bureau of Statistics, *The Input-Output Structure of the Canadian Economy, 1961*, vol. 2 (Ottawa: Queen's Printer, 1969).

Canadian industries. And, since these products are widely used in other industries, it would provide a good base for moving ahead later with other sectoral arrangements, most notably for the iron and steel industry. That industry uses a relatively high proportion of inputs from within its own sector and from nonferrous metals producers (Table 10-4). Moreover, it too is a supplier of inputs to a very wide range of other industries. We suggested earlier that this sector could do well under complete free trade. At present, Canadian steel prices are among the lowest in the world. Yet foreign tariffs and especially nontariff distortions, including dumping, have frequently hindered the performance of the industry. Therefore,

Recommendation 8

We recommend that Canada seek to negotiate the removal of trade barriers on raw and semiprocessed iron and steel products to follow as closely as possible the proposed elimination of those on the nonferrous metals group.

Although these arrangements would immediately benefit natural-resource producers like Canada, it is difficult to say where the balance of advantages would ultimately rest. Foreign consumers would certainly profit and, unless further action were taken, reducing trade barriers on semiprocessed materials would increase effective protection on end products, perhaps to a greater extent in our trading partners than in Canada. It would therefore be necessary to consider carefully how a "balanced" package of reciprocal concessions could be worked out.

It is worth noting, too, that both the other metal-working industries and those involved in the manufacture of machinery and equipment use very large inputs of iron and steel. Free trade in these products, along with nonferrous metals, would therefore provide a better base in turn for liberalizing trade in these two additional sectors. The consequent reductions in the cost of fabricated metal products and machinery and equipment would be of assistance in many other industries.¹⁰ These additional industries are mentioned here mainly to illustrate how freeing trade "from the bottom up" would open successively wider possibilities. They contain a number of products that go well beyond the semifabricated stage. Other sectors, such as forest products and chemicals, also exhibit many of the features that would qualify them for relatively early inclusion in sectoral negotiations. For this reason, as well as the possibility that it may be less difficult to liberalize trade in semifabricated products than in more fully manufactured goods, these industries too should be examined closely as possible candidates.

Many suggestions have been made for the promotion of further processing of Canadian resources by more direct methods, including subsidies, tax incentives,

10 Some progress in this respect has already been made through the Machinery Program (MACH) of the Department of Industry, Trade and Commerce.

and two-price systems, implemented by export taxes or direct controls. But few of these approaches would be in line with our GATT commitments. Moreover, in contrast with removal of trade barriers, such approaches would lead to other risks. For example, if two-price systems or export taxes were instituted, other countries might be encouraged to use similar measures on raw materials that Canada needed. In Canada, consumption of the scarce product could increase; yet supply could well be reduced. Moreover, a two-price policy would very possibly be viewed as a subsidy to more highly processed Canadian products, and this could invite the imposition of countervailing duties on such products by other countries. Export controls may, however, be justifiable on conservation grounds.

Domestic Policies

So far we have focused on the direct use of various commercial policy measures to increase the efficiency of Canadian industry. Of these, Canada could proceed on its own only with unilateral reductions in trade barriers. However, there have also been proposals for more domestically oriented policies that might be employed to overcome the disadvantages of a small home market even in the absence of major changes in trade barriers. One group of these is directed largely at stimulating innovation in Canada. A second and more comprehensive approach is concerned with rationalization of Canadian industry on the basis of the domestic market.

The Innovation Approach

The idea of stimulating technological innovation as a means of improving industrial performance is far from new. High-technology industries may offer opportunities to reduce or eliminate the constraints on Canadian efficiency imposed by foreign trade barriers, since the products of such industries tend to have special characteristics that may be more important to a foreign purchaser than price. With a well-educated and skilled labour force, Canada is in a position to share in the trend towards developing technology-intensive industries within affluent countries.

Public programs already exist to promote the upgrading of industrial technology and to support relevant research in universities and other institutions. In addition, the Science Council of Canada has proposed a significant expansion of the public role that would involve greater spending on research and development, especially on applied research; the improvement of Canadian financial markets; measures to upgrade management capabilities; and a "major programs" approach designed

to capitalize on Canada's resource endowment and labour skills.¹¹ This kind of government sponsorship contains elements of what might be called a "pick the winners" approach to the question of what are the industries of the future – although the broad definition of "winners" as those with a high technological content no doubt reduces the risks of error and misallocation of resources inherent in that strategy.

The Economic Council considers that the idea of seeking to use our human capital more effectively should not be tied to improvements in technology, narrowly defined. There are many "intellectual industries," such as business administration, product design, merchandising, and the development of computer software systems. Their profitability depends upon expertise – a combination of education and experience. We believe that the concept of technological innovation should be widened substantially to include all economic activities in which a major component is educated labour. Therefore,

Recommendation 9

We recommend that efforts to develop increased innovation be more intensively pursued and that they be widened to cover all types of activity that capitalize on Canada's investment in education and skill.

It is important, however, that such public policies do not increase protection in another guise. Public procurement, for example, may be used to assist Canadian industries in the early development of innovations. But it would also be necessary to have precise guidelines and to maintain surveillance over the practice so that an assisted industry was not merely stimulated to become permanently dependent upon government preferences or subsidies. Canadian exporters already have ample experience of long-lasting trade restrictions arising from "buy national" policies of foreign governments – and can indeed see that these are often costly to the importing country concerned as well as to potential exporters. We believe that Canada should not build up similarly uncompetitive industries here. Therefore,

Recommendation 10

We recommend that Canada take an initiative in GATT negotiations to formulate an international code on government procurement policies. Before doing so, the federal government should invite the provinces to establish a federal-provincial task force to advise on the formulation and implementation of such a code across

11 Science Council of Canada, *Towards a National Science Policy for Canada* (Ottawa: Queen's Printer, 1968); *idem*, *Innovation in a Cold Climate* (Ottawa: Information Canada, 1971); and Andrew H. Wilson, *Governments and Innovation*, Science Council of Canada (Ottawa: Information Canada, 1973).

Canada. In the event that the international community should fail to establish a multilateral code, Canada should seek to negotiate reciprocal purchasing agreements with other countries.

The GATT Secretariat has worked on identifying and analysing the effects of NTBs on trade, including government procurement policies, since 1968. The technical data necessary to formulate an agreement are now ready, and it remains for member governments to agree on a code. The objective would be to define acceptable government procurement practices with a view to promoting the open conduct of business and an increase in international competition.

Domestic Rationalization of Canadian Industry

Domestic rationalization of Canadian industry may entail net costs or net benefits, depending upon the specific commercial policy measures accompanying it. At best, the net benefits will approach only the limited gains of unilateral free trade; at worst, domestic rationalization could reduce the gains provided by the present level of trade barriers.

Those who favour domestic rationalization begin with the same premise as those who favour trade liberalization; that is, they believe that unexploited economies of scale or specialization exist in Canadian manufacturing. The proponents of domestic rationalization then argue that, for many products, the Canadian market alone is large enough to support at least one firm of the most economic size. They argue too that economies of scale and specialization could be obtained by inducing or requiring industries – through more intensive encouragement of price competition, cartelization agreements, or (the most common suggestion) mergers – to specialize in fewer product lines.

We do not think that forcing either mergers or rationalization will produce an economic environment conducive to increased efficiency in manufacturing. Opinions are also divided about how rapidly costs in Canadian manufacturing industries would fall with increased output. The great attraction of free trade is that it offers possibilities for such a large increase in the available market and in the output of specialized products that this issue is not important. However, if Canada were to consider relying on the domestic market, the question of how far costs would fall with rationalization would be crucial. Success of domestic rationalization would depend on an affirmative answer to three questions:¹² Will it be institutionally feasible? Will the larger sales volume in Canada actually materialize? Will cost reductions result in price reductions?

12 R. J. Wonnacott, "Industrial Strategy: A Canadian Substitute for Trade Liberalization?" University of Western Ontario Research Report 7409 (London 1974).

In answer to the first question, mergers or a market-sharing policy could presumably be forced by public authorities – although we do not agree with this approach – without too much legal difficulty in an industry characterized by a high degree of Canadian ownership, but this would be far more difficult in the case of industries dominated by foreign subsidiaries. If American companies were affected, for example, U.S. statutes could well be violated; and subsidiaries of U.S. companies would be placed in a difficult position because their parent firms might be prosecuted. Even in the case of Canadian-owned firms, problems would arise because much more government intervention in the economy would be necessary than under any of the other options we have touched on. Moreover, federal and provincial governments would have to agree on where the rationalized industries would expand, and this could lead to controversy – as illustrated by the present disagreement over the location of petrochemical complexes in Canada.

It is not clear that the answer to the second question would be “yes,” even if the price of a product were substantially reduced at the outset through rationalization. There would be no problem if most Canadian consumers were sufficiently attracted by lower prices to switch to the more specialized output of the domestic industry. If, however, many of them preferred variety to reduced prices, that could only be supplied through imports. In turn, the importation of competing products would erode the volume of production necessary to allow the Canadian industry to maintain a low price. Thus there would very likely be pressure for increased protection to induce consumers to accept the domestic product and so preserve the necessary volume of production in Canada.

Finally, if cost reductions resulted from domestic rationalization, they would not necessarily be passed on to consumers, since a comprehensive merger or cartel arrangement is tantamount to creating a monopoly. Consumers could be protected against this if prices were regulated as in public utilities industries, but there would then be administrative costs as well as other difficulties.¹³ A far better alternative would be unilateral reduction or elimination of Canadian tariffs. This would induce producers to reduce prices to meet import competition, and it would ensure a variety of goods for consumers at prices they were willing to pay. But, as noted above, there would then be the risk of eroding the Canadian market base. This dilemma could be resolved if exports from the rationalized industry could be increased. However, a domestic rationalization policy does not, in itself, provide one of the major advantages of multilateral or regional free trade – the removal of foreign trade barriers that discriminate against Canadian manufactured goods. In this respect, it is similar to a policy of unilateral free trade.

In brief, a domestic rationalization policy cannot be considered in isolation from commercial policy. It could offer some economic benefits, particularly if its

13 The problems the government has had with monitoring pricing practices in the automobile industry show how difficult it might be to follow this course.

disadvantages (or costs) could be offset by the reduction or elimination of Canadian – and, one would hope, foreign – trade barriers. If the much larger benefits of greater international specialization could not be obtained at an early stage, it might be useful to move towards domestic rationalization. Judicious examination would be required to specify the industries that might be selected for such measures and to determine the conditions that would have to be met to achieve a successful outcome.

The Textile and Clothing Industries

The textile and clothing industries provide illustrations of some of the difficulties that may be faced by a rationalization program when export expansion is difficult and when foreign competition is strong despite the existence of substantial barriers to imports into Canada. By the latter part of the 1960s, producers indicated that they could not invest any further or maintain employment without a guarantee of security in the domestic market. When the federal government stepped in, these industries were still large employers of relatively unskilled and immobile workers (such as married women), and the preservation of employment was a key factor in the textile policy adopted in 1970. However, the need to modernize and improve the efficiency of the industry was also considered. The concepts of phasing out uncompetitive lines, and concentrating upon other areas in which technology and fashion were at least as important as price, underlay much of the policy.¹⁴

The Textile and Clothing Board – the agency established to administer the policy – is empowered to recommend special and temporary protective measures to stabilize the domestic market. If a firm is in difficulty, it may present an adjustment plan. Technical help is made available to aid in the preparation of adjustment proposals, and the firm may be assisted by means of government-insured loans. The Board is an experimental body that might serve as a model for other industries affected by low-cost imports and limited export opportunities. Since it was established, the Board has conducted inquiries into nine textile and clothing products and has found injury, or threat of injury, from imports in six cases. As a result, it recommended protective measures, but some of this special protection was removed after review by the Board. Rationalization plans have certainly influenced the Board to recommend temporary protection, but it is difficult at this time to assess efficiency gains.

A major obstacle to rationalization, on the basis of the domestic market, is the demand by important customers for a wide variety of products. The variety of fabrics available from a supplier may be just as important to buyers as price. As a

14 Statement by the Minister of Industry, Trade and Commerce on textile policy (Canada, House of Commons, *Debates*, May 14, 1970).

result, textile producers sometimes plan to broaden their product lines when they seek special protection. But this results in short runs that retard the reduction of unit costs. Nor is it easy to meet this problem by allowing duty-free imports of some lines while stimulating the Canadian industry to specialize in a few protected lines. For one thing, existing foreign barriers would still inhibit export expansion, whereas the rapid growth of imports would reduce the size of the market available to the Canadian industry.

Extensive rationalization has already occurred in the synthetic textiles industry. But further rationalization is inhibited by the small size of the market and the need to maintain product variety. However, there is evidence that this industry could compete in the North American market under Canada-U.S. free trade, especially since this would create scope for further rationalization. The synthetic textile industry in these respects is comparable in important ways to the automobile industry before the 1965 Agreement was concluded.

The difficulties of rationalization faced by individual firms that serve the domestic market suggest the need for publicly supervised mergers or market-sharing arrangements as ways of achieving efficiency gains. In fact, there has already been a good deal of integration in these industries, but producers are reluctant to go any further. U.S. subsidiaries, for example, are wary of antitrust action against their parent companies. Restrictive trade practices legislation might be modified to allow Canadian firms more leeway to rationalize, but only under the eye of an agency responsible for consumer interests as well as industrial efficiency. This arrangement would be difficult, although perhaps not impossible, to operate.

The protection of these industries imposes very substantial costs on the Canadian economy, some of which may be justified at the present time because of the immobility of some of the labour force. But signs of change in the labour force supply are now visible – a fact that is bound to undermine such traditional considerations. This suggests that the priorities of the Board, and of the industry itself, should be increasingly directed towards plans for further rationalization.

11

SPECIAL TRADE PROBLEMS: AGRICULTURE

The main purpose of this report has been to explore the ways in which changes in commercial policy might improve the productivity performance of Canadian manufacturing. But Canada has also a vital interest in the liberalization of agricultural trade. This country is an important producer and trader of farm products, and freer trade in them could provide some gains in addition to those that would accrue from industrial free trade. Moreover, progress in the liberalization of industrial trade is closely linked with the prospects for agricultural trade. Some manufacturing industries are, of course, large users of agricultural products. Equally important, the United States in particular has indicated that the degree to which it is prepared to grant concessions on industrial products in the current GATT round will be strongly influenced by progress in liberalizing trade in farm products. Canada, however, like many of the other GATT members, faces certain problems that suggest a rather different approach to commercial policy-making for the farm sector than that proposed for manufacturing.

The Changing Pattern of Agricultural Production and Trade

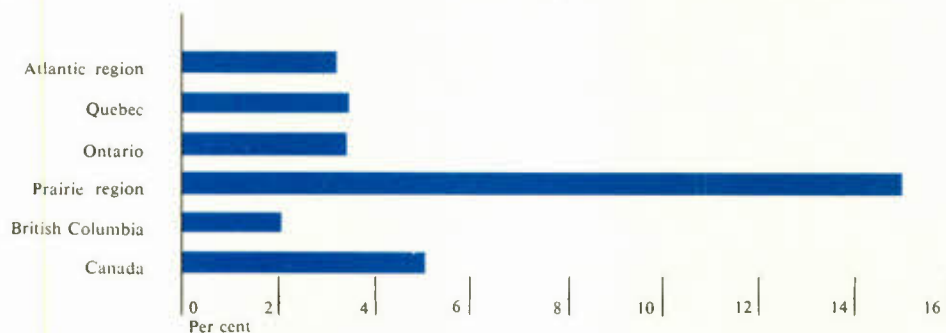
Canadian agriculture has undergone a long-term process of change and restructuring in response to developments in both domestic and foreign markets. In the 1949-51 period, employment in agriculture amounted on average to 20 per cent of Canadian total employment; in 1972-74 the figure had fallen to 5.4 per cent.¹ Over the same period, however, substantial improvements in productivity, reflecting increasing capital intensity, consolidation of farms into larger units, and technological improvements in seeds and crop management, resulted in increased agricultural output in absolute terms.² Thus agriculture remains a major industry whose share of Gross Domestic Product is currently approximately 4 per cent. Agriculture is also particularly important for some regions, notably the Prairies where it accounts for about one-sixth of total employment (Chart 11-1).

It is worth noting too that the movement of workers out of agriculture was an important source of labour for other sectors of the economy in the decade or

1 Over the past quarter century, the number of people employed in agriculture has declined by more than 50 per cent, from over one million in 1950 to less than half a million in 1974.

2 Canadian consumers benefited from this productivity growth between 1960 and 1971 when farm product prices increased less rapidly than the consumer price index. Since then, however, the rise in the selling price of farm products has generally exceeded the increase in the consumer price index.

Chart 11-1

Agricultural Employment as a Percentage of Total Employment, Canada and Regions, 1974SOURCE Based on data from Statistics Canada.

two after the Second World War. Now its relatively small size and the preponderance of older people in the farm labour force mean that skilled agricultural labour may soon be in short supply, especially if farm output is expanded in response to current world shortages. This will aggravate the prospective general tightness of the labour supply to which we drew attention earlier.

Canadian agriculture, which embraces several diverse sectors such as cereals and food grains production and livestock, dairy, and fruit and vegetable farming, has tended to become increasingly specialized both by region and by commodity. Roughly 45 per cent of farm output in Canada originates in the Prairies, about the same proportion in Ontario and Quebec combined, and about 5 per cent each in the Atlantic provinces and British Columbia. Grain and oilseeds, which are grown mostly in the Prairie provinces, account for about 25 per cent of farm receipts. Livestock and hogs, raised largely in the Prairies and Ontario, account for about 35 per cent of receipts. Dairy and poultry products yield a further 25 per cent, mainly to central Canada. Fruit, vegetables, and miscellaneous products, principally from Ontario and British Columbia, provide roughly 15 per cent of receipts.

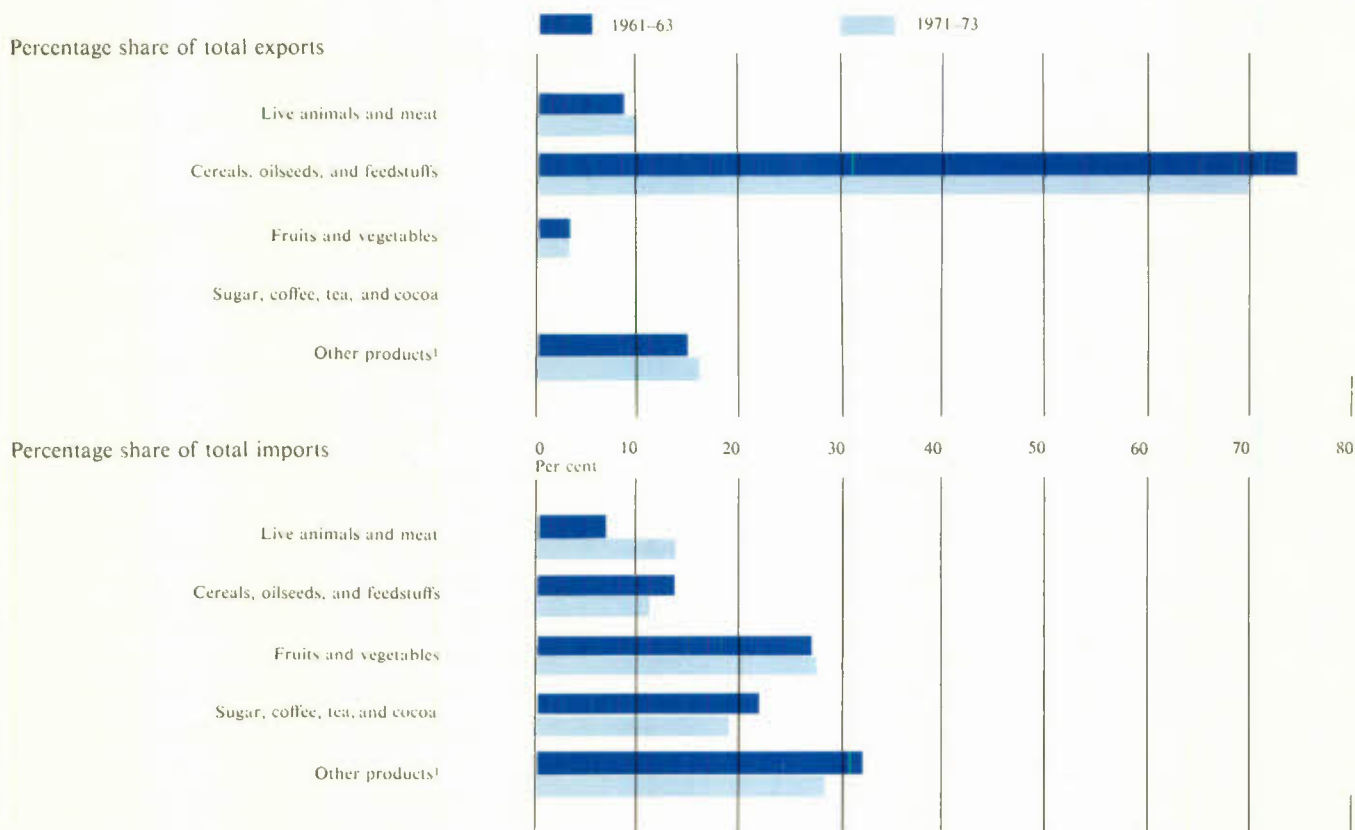
Agriculture takes on even greater importance when it is viewed in the context of Canada's international trade. The value of agricultural exports averaged \$1.3 billion in 1961-63 and \$2.4 billion in 1971-73. The price upswing brought exports up to about \$3.8 billion in 1974, or to 11.8 per cent of Canada's total exports of goods. Imports of agricultural products averaged \$.9 billion in 1961-63

and \$1.7 billion in 1971-73. In 1974 they were valued at \$2.8 billion or 9 per cent of Canada's total imports of goods. Canadian agricultural exports are concentrated in cereals, oilseeds, and feedstuffs; imports are somewhat less concentrated by commodity (Chart 11-2).

Geographically, markets for Canada's agricultural exports are more diverse than are the sources of our farm imports (Chart 11-3). While the largest market for our exports in this category is the EEC (including the United Kingdom), followed

Chart 11-2

Commodity Composition of Canadian Agricultural Trade, Three-Year Averages, 1961-63 and 1971-73

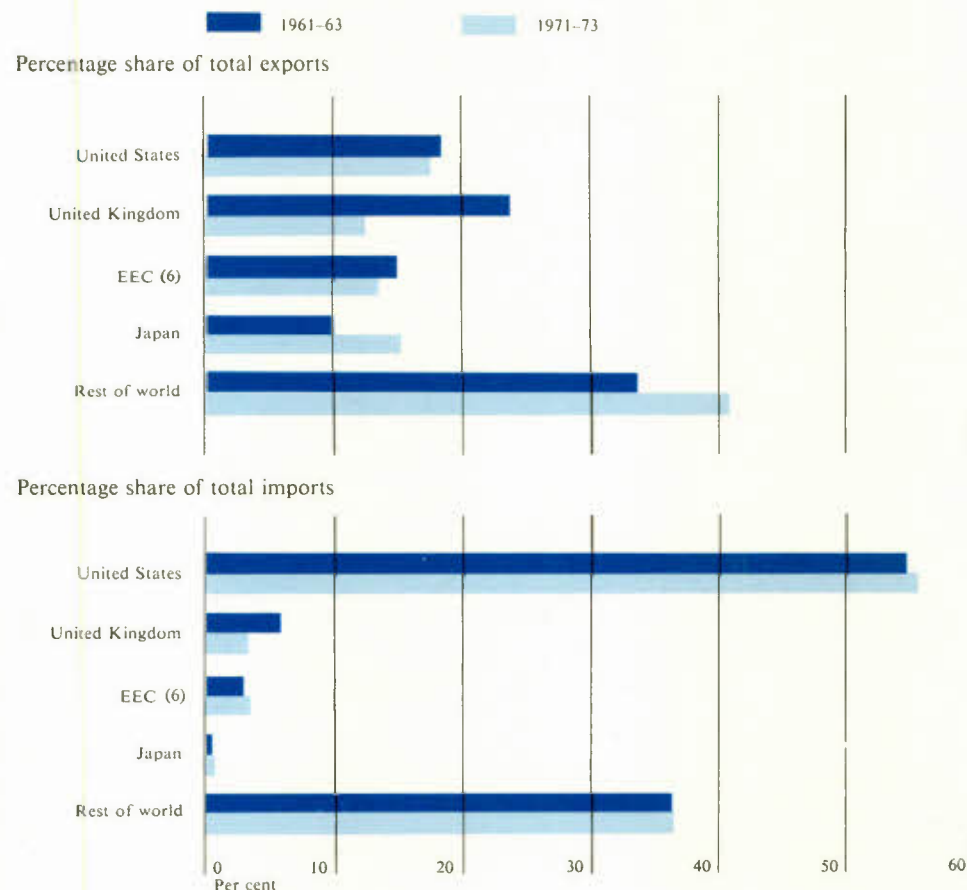


¹ Other products consist mostly of dairy produce and eggs, hides and skins, textile fibres, oils and fats, and crude animal and vegetable materials.

SOURCE Based on data from Statistics Canada.

Chart 11-3

Area Distribution of Canadian Agricultural Trade, Three-Year Averages, 1961-63 and 1971-73



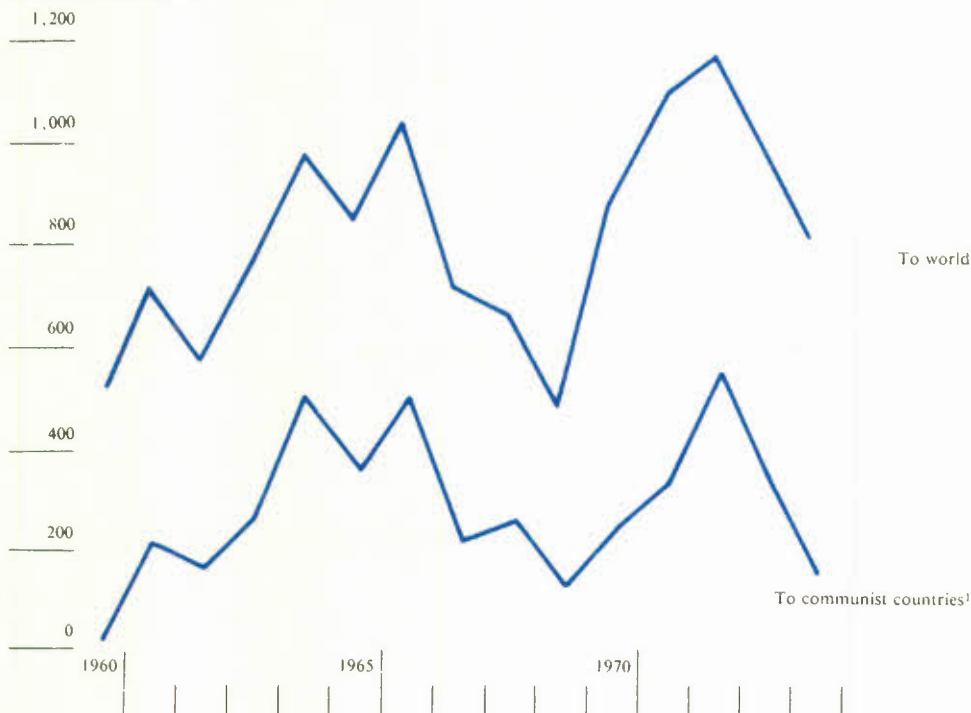
SOURCE: Based on data from Statistics Canada.

by the United States and Japan, more than half of the relevant imports came from the United States alone. Nearly two-thirds of Canada's agricultural exports are shipped to the noncommunist industrial countries, and one-third or so go to communist and developing countries. The share of the latter two groups increased during the 1960s, largely reflecting the growth of wheat exports to communist countries. Much of the volatility in shipments of grain – the largest Canadian agricultural export – has originated with sales to these countries (Chart 11-4).

Chart 11-4

Canadian Grain Exports, 1960-74

Millions of 1961 dollars



¹ Communist countries include China, the Soviet Union, and East European countries.

SOURCE Based on data from Statistics Canada.

Barriers to Agricultural Trade

The pattern of agricultural trade has been strongly influenced by trade barriers here and abroad. World trade in manufactured goods has been greatly liberalized during the past twenty-five years through reductions in tariff levels. In contrast, the industrial countries, including Canada, have tended to increase agricultural protection by systems of market intervention as well as by the use of tariffs. Both Canada and the United States employ a mixture of tariff and nontariff barriers against imports of agricultural products (Table 11-1). Extensive barriers have also been set up under the Common Agricultural Policy (CAP) of the European Economic Community. This is a Europe-wide protective scheme that tends to subsidize internal farm production and to eliminate external price competition

Table 11-1

Some Barriers to Agricultural Trade, Canada and the United States, 1973

	Entering	
	Canada ¹	United States ¹
Wheat	12¢ per bushel licensed	21¢ per bushel and small quota
Barley	7.5¢ per bushel licensed	7.5¢ per bushel
Oats	4¢ per bushel licensed	4¢ per bushel
Corn	8¢ per bushel	25¢ per bushel
Grain sorghum	8¢ per bushel	.4¢ per lb
Breeding cattle	Free	Free
Cattle		
Under 200 lbs }	1.5¢ per lb	1.5 to 2.5¢ per lb
200-700 lbs }		
Over 700 lbs }		
Beef and veal, fresh	3¢ per lb	3¢ per lb
Pork, fresh and processed	.5 to 1.25¢ per lb	.5 to 3¢ per lb
Soybeans	Free	1¢ per lb
Flaxseed	Free	50¢ per bushel
Butter	12¢ per lb and licensed	Seasonal duties 7 or 14¢ per lb and under quota
Apples (fresh)	Free	Free
Potatoes	37.5¢ per 100 lbs	37.5¢ per 100 lbs up to 45 million lbs; 75¢ over

1 "Licensed" means subject to restrictive import-licensing arrangements. A bushel of wheat is set at 60 pounds; barley, at 48 pounds; oats, at 32 pounds; corn, at 56 pounds; and flaxseed, at 56 pounds.

SOURCE U.S. and Canadian tariff schedules, 1973.

through a system of support prices and variable levies on imports. There are analogous problems of stable access for Canadian farm exports to markets in communist countries, since these nations do not allow competition between domestic production and outside suppliers.³

- 3 The communist countries are centrally planned economies and hence there is little scope for real competition between domestic output and imports. The less-than-affluent circumstances of the developing countries have led to the creation of special trade rules for them under GATT, and they are allowed to shield domestic output from import competition so long as they remain within the "developing" category.

Chart 11-5 provides some idea of the nontariff barriers applied to imports of live animals and food, beverages, and tobacco in 1966. It is only illustrative, since it is difficult to compare one NTB with another in terms of their actual restriction of trade. Moreover, Japan has reduced the number of NTBs in force since 1966. Nevertheless there is no doubt about the restrictiveness of agricultural trade barriers. In general, Canada employs NTBs less extensively than other large importers, although some Canadian NTBs are highly restrictive (for example, butter quotas).

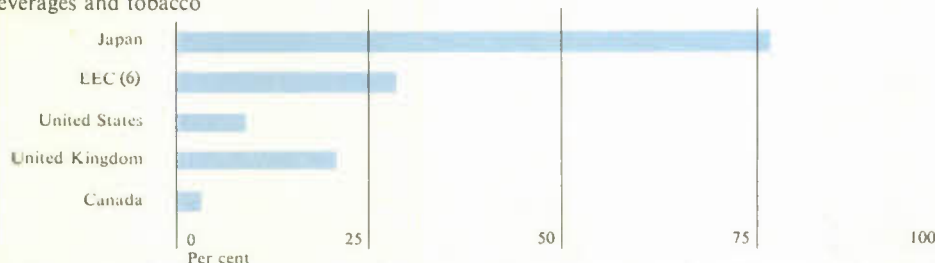
Chart 11-5

Incidence of Nontariff Barriers to Agricultural Imports,¹ Selected Countries, 1966

Food and live animals



Beverages and tobacco



¹ The number of export groups subject to NTBs has been expressed as a percentage of all import groups within each of the major categories shown. An import group under this definition includes all commodities grouped by the Standard International Trade Classification (SITC) at the four-digit level. The NTBs covered here include quantitative restrictions, licenses, tariff quotas and variable levies, domestic content regulations, and many others. A number of agricultural products which are classified in SITC as raw materials, such as cotton, natural rubber, and oilseeds are not included in the above measures.

SOURCE Ingo Walter, "Nontariff Barriers and the Free Trade Area Option," *Banca Nazionale del Lavoro Quarterly Review*, 22 (March 1969):35.

Many of the restrictions on agricultural trade arise out of the nature of the industry. Agricultural sales volumes and prices are prone to wide fluctuations because of changes in crop conditions. Most farmers have great difficulty in coping

with the resulting "boom-to-bust" cycles in agricultural markets, particularly because the industry is divided into a large number of independent production units. As a result, governments virtually everywhere in the world have become involved in extensive activities to stabilize farm output and trade through marketing boards and similar institutions.

Canada is typical in this respect. In 1972 there were more than one hundred marketing boards of varying degrees of significance in this country.⁴ Only the Canadian Wheat Board is a federal organization. Provincial efforts are co-ordinated under the federal Farm Products Marketing Agencies Act of 1972, and the Canadian Egg Marketing Agency was set up under this legislation. Free trade would entail international agreement on the operation of such boards. In Canada this would require co-ordination between the federal and provincial governments.

Trade liberalization would be complicated in this country by the fact that, although a considerable part of the farming industry, such as the cereals and feed grains sectors, is export-oriented and has already undergone a long process of adjustment to international markets, some segments of the industry are still very poorly organized and extremely vulnerable to competition. In the export-oriented sector, the main goal is to reduce the adverse impact on farm incomes of high foreign barriers to our products. The more domestically oriented sector involves farms that are typically small undertakings of marginal profitability whose operators eke out a precarious living. Because the nature of rural occupations makes it difficult to provide alternative employment for many of these individuals, except over long periods of time, governments in Canada and abroad have tended to support certain weak areas of agriculture as a kind of social policy. There is certainly an economic and social case for income stabilization policies, but it can be argued that price supports and the proliferation of marketing boards are inefficient methods for achieving the desired objectives.⁵ Over the longer run it would be desirable to place more emphasis on direct income payments to disadvantaged farmers than on price supports.

Liberalization of Agricultural Trade

Canada could certainly expect some gains from freer trade in agriculture, not so much through economies of large-scale production, as in the case of manufacturing, but simply by virtue of greater specialization in products in which our

4 It has been suggested, however, that the operations of marketing boards could be improved and that effective consumer representation should be established. See J. D. Forbes *et al.*, *A Report on Consumer Interest in Marketing Boards*, no. 1 (Ottawa: Consumer Research Council, 1974), pp. 67-69.

5 *Ibid.*

farmers possess a comparative advantage (Table 11-2). Freer access to the markets of Europe and Japan would be highly beneficial to Canadian producers of grains, oilseeds, and perhaps some livestock, particularly with rising world demand for protein. There would also be benefits for some potato and fruit producers. Freer access to the United States would likewise provide substantial gains, probably as a result of a complicated interaction with wider world markets.⁶

Table 11-2

Ranking of the Comparative Advantage of Canadian and U.S. Agricultural Products in International Trade

	Canada	United States
Clear comparative advantage	Wheat Barley Oats Rapeseed Flaxseed	Wheat Corn Barley Grain sorghum Soybeans Tobacco Poultry
Uncertain	Tobacco Poultry Pork Beef	Rice Oats Flaxseed Pork Beef
Clear disadvantage	Manufactured dairy products Sugar Wool Lamb and mutton	Manufactured dairy products Sugar Wool Lamb and mutton

SOURCE D. Gale Johnson, "The Impact of Freer Trade on North American Agriculture," paper prepared for the joint session of the American Economic Association and the American Agricultural Economics Association, Toronto, December 1972. See also Gerald I. Trant, David L. MacFarlane, and Lewis A. Fisher, *Trade Liberalization and Canadian Agriculture*, Canada in the Atlantic Economy, Study 4, Private Planning Association of Canada (Toronto: University of Toronto Press, 1968).

6 For example, the United States could enter into world markets for lower-quality food grains under free trade conditions, while a significant part of Canada's higher-quality food grains could move to the United States. The fact that both Canada and the United States are net exporters of food grains does not preclude such a rational pattern of trade. See Alex F. McCalla, "Implications of a North American Common Commodity Market," *A North American Common Market* (Ames: Iowa State University Press, 1969), pp. 129-45.

But the gains from agricultural trade liberalization would accrue to many other countries too. It has been estimated that world income in 1980 would be increased by 1.7 per cent (and value-added in agriculture by 15 per cent) if international trade in farm products were completely freed.⁷ And, in view of the recent world-scale shortages in food supplies, this figure may well be an underestimate.

Until mid-1972, the problems of agricultural trade were related to surpluses that arose from import restrictions and price supports or other subsidies and led to dumping and the disruption of world markets. During 1973-74, however, critical shortages of grain, animal feeds, and sometimes meat emerged, and prices rose to record levels. By 1973 the surpluses of grain, especially those in North America which had constituted a de facto world reserve, had disappeared. Furthermore, 1974 grain harvests were reduced below expected levels by adverse weather conditions, and the threat of famine or intensified famine in countries such as Bangladesh and India, as well as areas of Africa, became an international issue. Indeed, in the past several years, weather conditions of various kinds have had an extraordinary impact on world food production. Such conditions included severe winters in the Soviet Union, the drought that enlarged the Sahara Desert in Africa, and untimely floods and droughts in Southern Asia and North America. Some scientists believe that world weather conditions are undergoing a long-term change that will make a desirable expansion of food output more difficult to achieve.⁸

The heavy demand for meat in rich countries, including Japan and the Soviet Union, increases the quantity of feed grains required for a given population, and population is increasing in both rich and poor countries. On the supply side, more resources can be devoted to farm production, particularly in the United States, which has the potential to increase croplands by many millions of acres above the 1973 level. Canada can, no doubt, also increase farm output.

Over the long run, reductions of both foreign and Canadian barriers to agricultural trade would lead to increased stability for the exports of all countries, especially if there were a long-run trend towards recurrent surpluses and shortages. To the extent that efficient producers would be allowed to compete in foreign markets in terms of price, quality, and service, the uncertainties inherent in supplying protected markets with their marginal requirements of farm products would be removed. Furthermore, international agreement to refrain from export

7 See T. E. Josling, "Expansion of Commercial Trade in Agricultural Products," *Towards an Open World Economy*, Trade Policy Research Centre (London: Macmillan, 1972), p. 74.

8 See the views of Dr. Wolfgang Baier, president of the U.N. Technical Commission on Agricultural Meteorology, reported by Peter Cook in the *Financial Times of Canada*, Montreal, November 18, 1974, p. 3. Estimates by the United Nations suggest that a one-third increase in world food production is urgently needed by 1980.

subsidy programs would be helpful in stabilizing prices during periods of surplus. Thus the level and stability of farm output and trade would increase, and the pattern of production would be more closely related to consumer requirements.

However, for Canada as for other countries, these benefits could not be achieved without some temporary costs. In this country, gains would accrue to the export-oriented farm sectors and to consumers, but rapid reduction in trade barriers here and abroad could lead to substantial problems of adjustment for some producers. These adjustment problems would probably be most severe in the dairy industry, particularly in Quebec. Others who might find it difficult to adjust include poultry producers, as well as some fruit and vegetable growers now receiving protection from "seasonal" tariffs.

Given the relative immobility of resources in such sectors, what would be sensible would be a pragmatic approach towards improving incomes while gradually moving towards more efficient operations or more viable lines. As older people retired, younger farmers might be encouraged to produce goods that would require less protection in the long run. The worldwide trend towards an increase in the demand for farm products would facilitate such long-term adjustments. But producers would still have to be underwritten by public support measures, and a recommendation on this matter is made in Chapter 13. Adjustment assistance could include measures for retraining, support for the acquisition of land and capital, and temporary income supports.

The real cost of adjustment support for Canadian agriculture should not, however, be overstated. There are already support programs of considerable size in operation, and part of the problem is to ensure that these expenditures are employed increasingly for the purpose of moving farm resources into higher-income pursuits within agriculture. It should also be noted that over one-fifth of agricultural imports do not compete directly with Canadian farm production and that some significant imports (such as certain feedstuffs) could be appropriately regarded as complementary to Canadian farm production.

As Table 11-2 suggests, Canada and the United States are broadly interested in trade liberalization for a similar list of agricultural products. Both have argued, during the current GATT negotiations, in favour of moving steadily towards freer trade in agricultural products and a better allocation of farm resources around the world. While Canadian bargaining power alone is not strong, the addition of Canada's voice to that of the United States might make a difference in the final outcome.⁹

⁹ This consideration was stressed by A. F. W. Plumptre while speaking to the Canadian Export Association. See "Canada's Approach to Multilateral Trade Negotiations," papers of a symposium, Toronto, February 21, 1973, p. 18.

However, it is generally concluded that "any conceivable agreement on agricultural trade will be based on gradual change."¹⁰ Because of the nature of barriers to trade in farm products, it would be difficult to include agriculture fully within the ambit of a free trade arrangement, assuming one could be negotiated. Consideration of special rules would be necessary for those agricultural sectors, both foreign and Canadian, for which the rapid elimination of trade barriers did not prove feasible. The general objective of such rules would be to promote trade increases on an orderly basis as the protected sectors succeeded in adjusting over time, perhaps through greater use of direct income supplements.

Our ranking of commercial policy options (as summarized in Chapter 8) was based on the gains to Canada from industrial free trade. Special arrangements for farm products need not much reduce the beneficial impact of free trade on manufacturing productivity apart, perhaps, from the food processing industries.¹¹ On the other hand, even if Canadian agriculture were included entirely in free trade arrangements, the basic ranking of our trading options would not be likely to change. There would be some additional gains in real income, but they would be much smaller than those from industrial free trade. Moreover, the gains from including agriculture would apply to free trade with all of our major trading partners, although producers might gain more from an arrangement with Europe and Japan, and consumers from one with the United States.

Industrial free trade would, of itself, benefit Canadian agriculture. Farmers would gain from lower prices in the same way as any other group of consumers. As producers, they would enjoy gains from reductions in the costs of some inputs that are now protected by the Canadian tariff.

Conclusions

Several difficult problems, facing both Canadian and foreign agriculture, militate against a rapid move to free trade for farm products. If Canada found it feasible to negotiate free trade arrangements for industrial products, the exclusion of agriculture would retard trade liberalization for processed foods but would create few other problems. This is so because all our potential partners in a free trade arrangement would have similar farm problems to resolve. Thus special rules for agriculture could be negotiated on the principle that adjustment in this particular industry requires a longer-term approach. Given gradual trade liberalization, the existing programs for agricultural adjustment could be modified and

10 *Toward the Integration of World Agriculture*, a report by fourteen experts (Washington, D.C.: Brookings Institution, 1973), p. 16.

11 The former European Free Trade Association (EFTA) countries found it expedient to exclude the bulk of agricultural trade from their arrangements.

expanded with a view to minimizing conflicts that might arise between economic and broader social goals. In export-oriented sectors of Canadian agriculture, however, it would be beneficial to negotiate free trade as rapidly as the bargaining process permitted. Therefore,

Recommendation 11

We recommend that liberalization of agricultural trade be initiated as soon as possible and that trade barriers be removed gradually by major product group, keeping in mind the especially serious social and economic adjustment problems facing some rural areas.

12

SPECIAL TRADE PROBLEMS: ENERGY

As in the case of agriculture, trade in energy resources gives rise to rather different concerns than those that influence overall commercial policy. Energy products include crude oil, natural gas, coal, coal and oil products, uranium, and electricity. They are the outputs of a varied group of industries in the mining, processing, and manufacturing sectors. The energy-products industries have almost always been heavily regulated by governments, which often operate facilities such as hydro-electric utilities and which control production, pricing, and exports to a great extent. Moreover, in the past few years international developments affecting trade in petroleum have so transformed the world situation generally that governments have become even more involved in the energy arena. National policies are now increasingly oriented towards ensuring security of energy supplies and stability of prices, and any idea of a free international market for energy has just about disappeared. This trend suggests that Canada, like other countries, will have to fashion a strategy for its energy sector – and particularly for crude oil and natural gas, the sources of a high proportion of our energy requirements – that may not fit directly into arrangements made for trade in more conventional goods.

The International Environment

World developments have long affected Canadian decision-making in the energy field. The Suez crisis of 1956-57, for example, led the United States to rely mainly on domestic oil and to place oil imports under quota. These U.S. measures, in turn, influenced Canada's decision to adopt a National Oil Policy (NOP) in 1961.

More recently, energy problems have become a preoccupation of the larger industrial countries, and they will affect this country's decisions for many years. Several factors have contributed to these problems. The consumption of energy in final form has for some time been rising between 50 and 60 per cent per decade in the noncommunist countries. This rate implies that consumption will quadruple over the course of thirty years – say, between 1950 and 1980. Industrial countries have become lavish users of energy products, notably oil, partly because during the 1960s the price of crude petroleum remained relatively stable, while prices for most other goods and services rose. Because consumption in these countries has now outstripped domestic supplies of low-cost fuels, imports are required. Supply problems have been aggravated by the need to control pollution, and this has raised the cost of new plants to generate electricity or to refine oil.

Late in the 1960s, prospective bottlenecks in supply were of increasing concern even before the Arab states moved overtly to restrict output and to embargo exports to the United States. Then, in the 1970s, members of the Organization of Petroleum Exporting Countries (OPEC) began to exercise their market power to increase revenue from petroleum resources and to further their own economic development. Their policies have led to rising prices for oil and other basic energy materials.

These countries seem prepared to limit their output of oil in order to obtain what they consider a fair return for their nonrenewable resources over the long run. In addition, there is a major noneconomic factor: much of the world's oil supply is controlled by Arab governments that are prepared to interrupt supplies to further political goals.

A further problem is that the United States has now joined the group of countries dependent upon imports to supply a significant part of their consumption requirements for basic fuels. Since the beginning of the 1970s, the volume of U.S. fuel imports has been rising faster than real GNP. This trend will continue into the 1980s if the United States relies on imports to offset the growth in consumption and if the required level of imports is available (Chart 12-1).

In these circumstances, it is clear that the international market for crude oil will be highly regulated for the next decade or so. Importing countries, including Canada, have begun to respond to pressures on supplies by intervening in the market to promote a shift to domestic sources where possible. For example, steps to promote greater self-sufficiency in energy supplies for the United States were announced by President Ford early in 1975. At the same time, higher price levels should give rise to economies in the use of fuels and reduce the rate of growth of demand.

With respect to potential supplies of energy in relation to needs, Canada is in a relatively favourable position among the industrial countries. The United States is not so well placed in the short run, but it has considerable scope to employ advanced technology in the long run, to increase energy supplies from coal, nuclear power, oil shales, solar heat, and other natural sources. Western Europe and especially Japan appear to be at a relative disadvantage, as they lack sufficient indigenous supplies of energy materials. However, both have considerable technological resources, and Europe has prospects of major new sources of oil and gas, such as the North Sea.

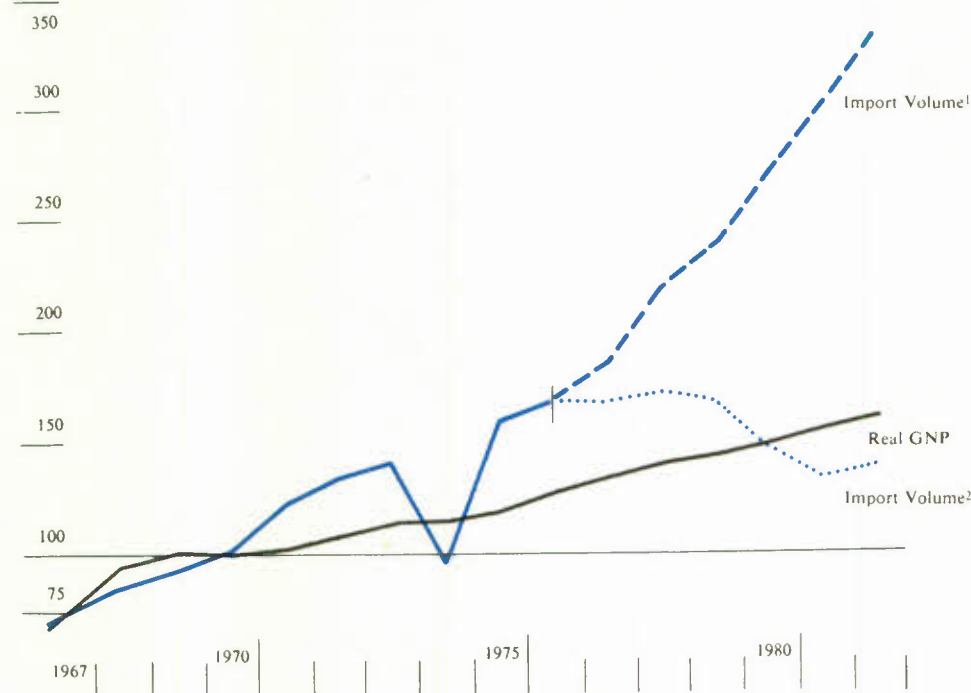
The necessity for the industrial countries individually to ensure continuity of energy supplies cannot be considered an isolated subject. Factors such as management of the financial aspects of petroleum supply in the 1970s and 1980s will tend to increase the need for co-operative international measures.¹ In the long run, the prosperity of the other industrial countries, which is intimately geared to an adequate energy supply, is essential to the prosperity of the Canadian

1 In September 1974, eleven industrial countries formulated an agreement to set up an International Energy Agency within the OECD. The objects of the agreement are to promote security of oil supply, to plan for supply emergencies, to increase co-operation with producing countries, to set up an information system, to undertake conservation measures, and to accelerate the development of alternative sources of energy supply. The text of the agreement was tabled in the House of Commons on October 25, 1974. The deadline for country signatures was May 1, 1975.

Chart 12-1

Index of Real Gross National Product and Volume of Fuel Imports, United States, 1967-82

1970 = 100



1 Assuming that the United States relies on imports to fill the increased demand for crude oil.

2 Assuming that the United States begins additional investment in domestic sources of energy supply in 1974, so as to realize the equivalent of eight million barrels of crude oil per day by 1982.

SOURCE Based on data from the Wharton Annual and Industry Forecasting Model, December 1973.

economy. Beyond these economic considerations, there is an additional need to stabilize relations with the Arab and other member countries of OPEC so as to ensure continuity of energy supplies at the levels at which they are willing to produce on economic grounds. The more secure the import supplies for industrial countries, the more flexible are the energy trade and development options available to Canada.

It is worth noting, too, that the oil-rich countries could offer expanding markets for other Canadian products and technology. The more populous of these coun-

tries could become substantial industrial buyers and suppliers in world markets. The development of countries like Mexico and Brazil could also be enhanced if their potential in energy resources were realized. In addition, it is important that the funds accumulated by OPEC members be directed to serve the investment needs of developing, as well as industrial, countries.

Canadian Trade in Energy Products

In the decade of the 1960s the total value of Canadian exports of energy products rose from over \$450 million to approximately \$1,800 million (Table 12-1). The United States has always been by far our largest market for these products, although the United Kingdom was an important market for uranium in the early 1960s. Exports of uranium declined, however, from their peak level in 1959 until recently when commercial, as distinct from military, markets became important. A long-term market for western Canada's coal has emerged in Japan, stimulating substantive developments in mining and transport activities in British Columbia and Alberta.

In value terms, Canada's imports of energy products rose during the same period from around \$500 million to \$1,100 million. About half our imports of energy products come from Venezuela and other South American and Caribbean countries. Roughly one-quarter of our imports originate in the United States – mostly coal and some petroleum products (Table 12-2).

Obviously, oil is now the most crucial of all of Canada's energy products. During the 1960s trade in crude oil was strongly influenced by the National Oil Policy

Table 12-1

Canadian Energy Exports, Three-Year Averages, 1961-63 and 1971-73

	1961-63		1971-73	
	(\$Million)	(Per cent)	(\$Million)	(Per cent)
Exports to all countries ¹	459	100.0	1,756	100.0
To United States		92.6		91.4
To United Kingdom		5.6		1.0
To Japan		1.5		7.0
Other		0.3		0.6

¹ Includes crude oil, natural gas, coal and briquettes, uranium, oil and coal products, and electricity. Virtually all of the oil and gas is exported to the United States. Japan is the major market for coal. Japan and the United Kingdom are markets for uranium.

SOURCE Based on data from Statistics Canada.

Table 12-2

Canadian Energy Imports, Three-Year Averages, 1961-63 and 1971-73

	1961-63		1971-73	
	(\$Million)	(Per cent)	(\$Million)	(Per cent)
Imports from all countries ¹	508	100.0	1,115	100.0
From United States		26.8		23.1
From Venezuela and other Western Hemisphere sources		53.5		48.4
From Arab countries		12.6		17.2
From Iran		6.2		7.9
From other countries ²		0.9		3.4

1 Includes crude oil and natural gas, coal, coal and oil products, and electricity.

2 Mostly Nigeria and western Europe.

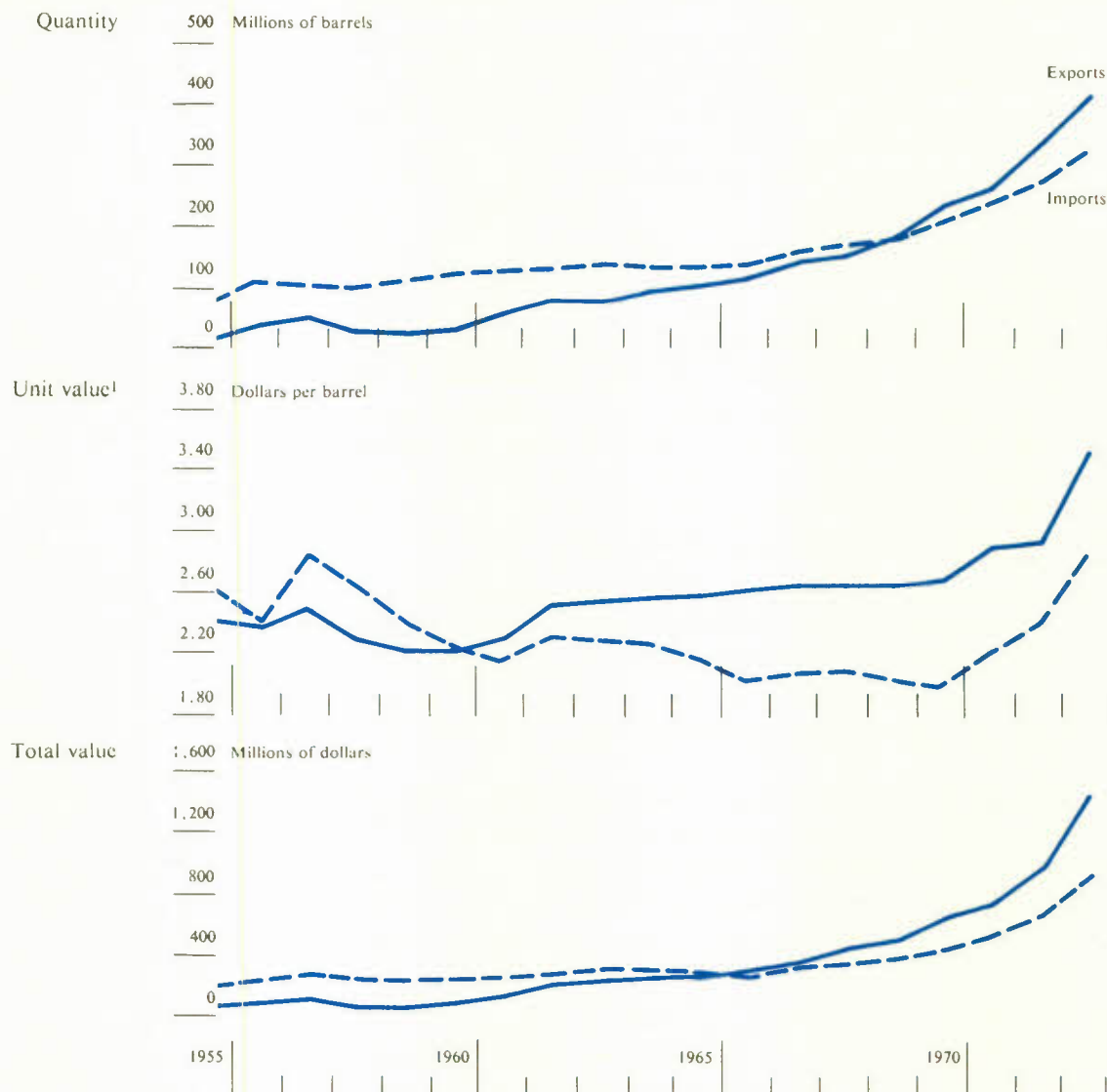
SOURCE Based on data from Statistics Canada.

and by U.S. import policies. Global import quotas in the United States at first created an export market for this country, since Canadian oil was exempted from these restrictions. Later, however, the U.S. quotas were also applied to Canadian oil, although the western states continued to buy Canadian crude at a price that was then above the international price. The significance of the NOP increased as the Canadian petroleum industry expanded and as the importance of oil relative to coal and water rose in the energy supply picture. The objective was to develop a large Canadian crude oil industry in western Canada. It secured a large protected market within Canada by excluding foreign crude oil, as well as most derivatives, from the market west of the Ottawa Valley. Under this policy Canada allowed market forces to determine the origin of oil supplies to the country east of the internal dividing line – eastern Ontario, Quebec, and the Atlantic provinces – and oil for those regions has been largely imported since then.

In effect, relatively cheap foreign oil was imported into eastern Canada, and relatively expensive Canadian oil was exported from the west to the United States. Whereas in the 1950s imports of crude oil exceeded exports in quantity (upper panel, Chart 12-2), in the 1960s exports rose rapidly and, in the latter part of the decade, the quantity of exports exceeded that of imports for the first time. At the same time, crude oil declined in price on the international market, and despite devaluation of the Canadian dollar in 1962, the average f.o.b. price of imports fell in Canadian-dollar terms. In sharp contrast, the price of Canadian exports rose in the 1960s, influenced by the level of oil prices in the protected U.S. market. As a result of these movements of quantity and price, the balance

Chart 12-2

Canadian Trade in Crude Oil, 1955-73



SOURCE Based on data from Statistics Canada and estimates by the Economic Council of Canada.

1 Calculated by dividing the value of exports (imports) by the number of barrels exported (imported). For exports, the result is an approximation of average export price f.o.b. over the year, and for imports, it reflects an average of f.o.b. prices from all the sources of Canadian oil imports. Since transport costs are excluded, these prices are not a complete measure of the cost to the buyer at the refinery. However, imported oil was cheaper than Canadian oil during the 1960s, even after allowing for transport costs and import duties.

of merchandise trade in crude oil (bottom panel, Chart 12-2) became positive around 1965. Thus they contributed to the improvement during the 1960s in Canada's total merchandise trade balance.

The external events described in the previous section have been decisive in initiating further changes in Canadian oil policy. To protect its own supplies, Canada responded by restricting exports of crude oil (exports of natural gas being already under licence). The government also decided to build a pipeline to link the Montreal market to Canadian oil supplies and to phase out oil exports so as to limit reliance on imports. The huge increases in world oil prices in 1973 and 1974, as well as the desire to ensure security of supply, added to Canadian incentives to shift towards domestic sources of supply.

In November 1974, following a more thoroughgoing review of the outlook for production and consumption of crude oil by the National Energy Board, the federal government announced a policy that went a step further. It involves, in co-operation with the provinces, the total phasing-out of exports of oil to conserve dwindling domestic supplies from conventional sources.² The policy envisages eliminating exports as rapidly as feasible, after taking account of the dependence of some U.S. areas on Canadian oil. In view of the urgent need to economize on the use of crude oil and to promote exploration and discovery, the Economic Council of Canada has recommended:

that the federal and provincial governments allow the domestic price of oil to move to international levels over the medium term and that they inquire into, and encourage, the adoption of energy-conserving practices.³

Energy Issues and Canadian Commercial Policy

Given the international situation, the trade options for crude oil that are open to Canada in the next decade will be circumscribed by the rate of discovery of conventional resources and ability to sustain production, the rate of development and cost of synthetic oil from the Alberta tar sands, and the rate of growth of domestic consumption. Discoveries of new supplies of conventional oil have, however, fallen below production levels since 1969, so that the level of proven reserves has declined. Moreover, with production from conventional sources now declining, it will not be possible to develop the oil sands rapidly enough to maintain

2 See the statement by the Honourable Donald S. Macdonald, Minister of Energy, Mines and Resources, House of Commons, *Debates*, November 22, 1974, p. 1597, and the National Energy Board Report, *In the Matter of Exportation of Oil* (Ottawa, October 1974).

3 Economic Council of Canada, *Eleventh Annual Review: Economic Targets and Social Indicators* (Ottawa: Information Canada, 1974), p. 61.

domestic supplies equal to domestic consumption, although the size of potential output from all sources and consumption growth will depend heavily upon the prevailing or expected price of oil and substitute sources of energy. Even with the policy of phasing-out exports of crude oil, Canada will become a net importer of this energy source within a few years, remaining so until such time as large new sources of production can be brought on stream. Canada will have to sustain consumption in eastern regions by relying upon imports of crude oil and its products while using domestic supplies for this purpose in central Canada and the west.

Canada's options with respect to natural gas are similarly circumscribed. This product is in high demand as an energy source in its own right and as a substitute for high-priced oil. Imports of natural gas have not been significant in the past and do not appear likely to become so in future. Thus Canada is dependent upon domestic supplies of this depletable resource, and the extent to which exports may be permitted is determined by such factors as existing reserves and discoveries in relation to the level and growth of Canadian consumption during the next several decades.

Trade-related measures have already been employed as instruments in the evolution of Canadian energy policies to meet the new international situation. Crude oil was made subject to export licensing, and the domestic price of oil was insulated (at least temporarily) from the world price by means of an export tax and an import subvention on oil.⁴ In general, the application of controls to trade in oil and gas can be expected to extend to other forms of energy supply to the extent that these become scarce. This is especially true of uranium, where military and civil security as well as commercial issues are involved.

Canada has some bargaining power as a supplier of coal and uranium, since this country is well endowed with these materials. Its bargaining position as a supplier of petroleum products to the large U.S. market is, however, modest at present. Although the quantity of crude oil exports to that country rose by more than 20 per cent in 1973, there is little scope for further expansion for a very long time. By clearly indicating that exports to the United States will be eliminated, Canadian policy-makers have accepted the prospective trade-off between domestic considerations (supply security) and some modest bargaining leverage with the United States. While these facets of Canada's evolving energy policy may be a source of friction with our largest trading partner, the scope for co-operative endeavour in the long term remains substantial.

Looking ahead to the 1980s and beyond, it seems likely that resources as large as those in the oil sands of Alberta could figure prominently as a source of supply

4 Natural gas was already subject to export licensing at the time of the "oil crisis" in 1973-74.

in a world that will still rely upon fossil fuels and their processed products for many of its basic requirements. This would be so, even if the price of oil from OPEC countries were reduced and supplies made more easily accessible. One can expect that the industrial countries will be prepared to take out insurance against potential future interruptions of supply designed to maintain prices at very high levels or to serve political ends. Such "insurance" will take the form not only of developing domestic resources, but of exploring the availability of supplies – including those of processed products – within traditionally stable jurisdictions such as Canada.

Properly measured, the economic cost to Canada of providing such insurance to its own consumers may not be high, although this is a consideration that Canadians should weigh carefully when deciding upon the optimum degree of self-reliance for this country. First, improvements in technology may reduce the cost of producing fuel from the oil sands – or from the Canadian north. Second, countries must ask themselves what the price and supply situation would be in the absence of secure sources for a high proportion of their consumption requirements. We believe that, in the long run, Canadian fuel resources could provide an economically attractive base for increasing Canadian incomes from international trade with many other countries.

Conclusions

While Canada's long-term energy supplies can be assured provided proper steps are taken to develop the resources and the required technology, during the next ten to twenty years major economic problems will have to be resolved concerning the supply and distribution within Canada of crude oil and natural gas – the sources of a high proportion of our energy requirements. The current world bottlenecks in oil and gas supply mean that there is an external demand for these products that exceeds Canada's capacity to export, or even to maintain home consumption, unless there is also a heavy reliance on imports. Because the Arab countries have decided to limit their export volume, Canada must pay more heed to security of supply considerations in future.

Because of recent events, the international market for crude oil will be highly regulated for the next decade or two. Supplies will be controlled to some degree by OPEC members in order to influence prices and, in response, the industrial countries will feel obliged to continue their intervention in the market process. Even if the OPEC countries reduce prices and ease supply constraints, those industrial countries that can are likely to strive for a higher degree of self-sufficiency. Those industrial countries that could achieve this a decade hence include Canada, the United States, and the United Kingdom. There is need for a strong framework for international co-operation – perhaps even a petroleum com-

modity agreement – to facilitate compromises, so that the cost of serving conflicting national interests may be held to a minimum.

Accordingly, because of the present world energy situation,

Recommendation 12

We recommend that crude oil and natural gas be excluded – at least initially – from any free trade agreement that might be concluded, but that Canada be prepared to discuss energy problems with other countries and to take appropriate initiatives in the light of changing supply/demand circumstances.

13

ADAPTING TO FREER TRADE

Trade liberalization can provide major benefits to Canadians in a manner that is basically compatible with the way we live and conduct our public affairs. However, freer trade by itself cannot promote all of Canada's national objectives. Nor can its potential benefits be fully realized without a set of complementary policies to aid in adapting to the new conditions. In this chapter, we suggest ways and means to facilitate the transfer of resources towards sectors in which Canada has a comparative advantage in the long run, to minimize the cost of trade liberalization in terms of short-run unemployment and industrial dislocation, and to ensure that the gain to the country as a whole would not be achieved at the expense of injury to particular groups or regions. There are two broad categories of such policies: the first involves general and specific measures of government assistance; the second, the framework surrounding economic decision-making, including competition, foreign investment, tax, and exchange rate policies.

Many of the measures to which we refer would be required no matter which commercial policy option Canada might follow. Adjustment to change, including changing trade developments, is a continuous process in any economy. However, the mix of measures in a broad policy of adjustment assistance might vary from one commercial policy option to another, since each option could have a somewhat different impact on firms, workers, regions, and the economy in general. The reorganization and longer-run effects of trade liberalization were discussed at some length in Chapter 6 so as to place the major emphasis where we feel it should be: on its lasting benefits rather than on the costs – including public investment in adjustment assistance – that may be incurred temporarily to achieve those benefits. Since appropriate measures to deal with these costs are, however, vital to the success of any approach to freer trade, we turn now to the initial impact of trade liberalization.

The Initial Impact of Trade Liberalization

We have already pointed out that if free trade were to be introduced overnight – before affected industries and firms had a chance to adjust to the new situation – the initial impact on output and employment would, in many cases, be adverse. With the aid of the CANDIDE econometric model, the Council has analysed this impact in a manner somewhat different from that of previous studies – at least for the Canada-U.S. and unilateral free trade options.¹ Although the results

1 James P. Campbell, Peter M. Cornell, and David L. Emerson, "Trade Liberalization in Canada: An Analysis of Industrial Impacts and Economic Policies for the Transition Period," a background study for the Economic Council of Canada. For an example of earlier work see H. Edward English, Bruce W. Wilkinson, and H. C. Eastman, *Canada in a Wider Economic Community*, Canada in the Atlantic Economy series, Private Planning Association of Canada (Toronto: University of Toronto Press, 1972).

of the analysis must be used with caution, we allowed for both the direct effects of tariff removal and some of the indirect effects on the level of economic activity. This permitted a more comprehensive appreciation of the possibilities for smooth adjustment.

Table 13-1 provides a summary of the results of simulating certain trade situations with the CANDIDE model. Column A presents a control solution for 1969. This is simply the values estimated by the model for that year (they were, in fact, very close to the actual values); they reflect, among other things, the trade barriers affecting Canada's trade at that time. The model was then used to estimate how key economic variables would have changed if both Canadian and U.S. tariffs had been removed and if Canadian tariffs alone had been eliminated.

The analysis was done in two stages. In the first, estimates of the effects on exports and imports of removing the relevant tariffs were made independently of the model; that is, the impact of tariff removal was examined without taking account of changes in the level of economic activity in Canada that would follow from changes in trade. Calculations were based on the responses of Canadian trade to international price movements from 1953 to 1965, a period covering considerable changes in exchange rates and tariffs (including some of the Kennedy Round results). Not surprisingly, these first-stage estimates showed that imports, particularly of manufactured goods, increased substantially – certainly more than exports.²

However, any tendency for imports to increase more than exports would cause the level of economic activity in Canada to decline, and this would in turn act to dampen the rise of imports. To pick up this effect, the second stage of the analysis consisted in running the first-stage estimates through the CANDIDE model, with the results shown in columns B to F of Table 13-1. The increases in imports that result even when no attempt is made to compensate for the decline in the level of GNE (columns B and E) are considerably smaller than those in the first-stage estimates. The increase is lower than 2 per cent in the case of a bilateral tariff reduction (column B compared with column A); it is .4 per cent in the case of a unilateral reduction (column E compared with column A).

In several ways, our analysis is based on unreasonably harsh assumptions. For example, it does not allow for partner's trade diversion (see Chapter 8) or for the increase in Canadian real income that would follow directly from lower import prices or higher export prices. Both factors would tend to mitigate any initial adverse effects on employment and income. More important, the analysis assumes that tariff reductions would occur all at once, before any reorganization

2 The first-stage estimates for the immediate increase in manufactured imports in response to removal of all Canadian tariffs, or Canadian tariffs on imports from the United States alone, were 8.1 per cent and 4.8 per cent respectively.

Table 13-1

Estimated Initial Impact of Canada-U.S. and Unilateral Tariff Removal on the Canadian Economy, 1969

(Millions of 1961 dollars unless otherwise specified)

	Canadian and U.S. tariffs removed				Canadian tariffs only removed	
	Without trade liberalization	No compensation	Increase in		No compensation	Increase in government expenditure ³
			Government expenditure ¹	Government expenditure and private investment ²		
	A	B	C	D	E	F
Gross National Expenditure	60,879.95	60,421.95	60,871.17	62,230.57	59,157.79	60,831.13
Total exports ⁴	15,381.84	15,667.06	15,665.96	15,662.56	15,393.87	15,389.80
Total imports ⁴	15,904.52	16,197.24	16,345.74	16,841.28	15,970.04	16,493.93
Balance of payments on current account ⁵	-441.57	-428.55	-603.83	-1,193.33	-480.15	-1,097.59
Total employment in thousands	7,714.74	7,690.38	7,702.21	7,738.40	7,618.48	7,661.98
Unemployment as percentage of labour force	5.13	5.39	5.30	5.01	6.16	5.81
Investment in machinery and equipment	4,582.43	4,513.40	4,574.85	4,961.91	4,392.84	4,555.08
Real Domestic Product						
Total economy	54,583.35	54,138.56	54,544.11	55,752.99	52,895.23	54,400.78
Manufacturing	14,803.66	14,553.90	14,675.09	15,022.11	13,905.16	14,348.78
(Percentage change)						
Gross National Expenditure		-0.75	-0.01	+2.22	-2.83	-0.08
Total exports ⁴		+1.85	+1.85	+1.83	+0.07	+0.05
Total imports ⁴		+1.84	+2.77	+5.89	+0.41	+3.71
Total employment in thousands		-0.32	-0.16	+0.31	-1.24	-0.68
Investment in machinery and equipment		-1.51	-0.16	+8.28	-4.14	-0.60
Real Domestic Product						
Total economy		-0.81	-0.07	+2.14	-3.09	-0.33
Manufacturing		-1.69	-0.86	+1.48	-6.07	-3.07

1 Assumes compensating increases in government expenditure on current goods and services of \$300 million.

2 This column shows the combined effects of an increase in government expenditure on current goods and services of \$300 million and an increase in private investment of \$200 million.

3 Assumes compensating increases in government expenditure on current goods and services of \$1.15 billion.

4 National Accounts basis.

5 Balance-of-payments basis, millions of 1969 dollars.

SOURCE Based on estimates by the Economic Council of Canada.

could occur, and that all short-term effects would be concentrated in one year. It might be argued that, in the past, international price changes have not been as sharp as anticipated here, so that our estimates of the first-stage increase in imports would be too low. However, even fairly substantial price changes resulting from exchange rate fluctuations have not been associated with sudden and large-scale replacement of Canadian production by imports. Moreover, tariff cuts are normally announced in advance – some of them a long time in advance – and major reductions have usually been phased-in over several years. Thus, in terms of actual practice, it seems unrealistic to assume that the results of current tariff changes would differ greatly from those in the past. This conclusion is reinforced by the fact that the average Canadian tariff on manufactured goods is now only about 10 per cent, so that the decline in the tariff would often be restricted in any event.

For these reasons, we believe that the analysis provides a rough indication of the maximum extent to which other changes – in the foreign exchange value of the Canadian dollar, in aggregate demand policies, and in the structure of industry – might be required to offset the initial impact of free trade. In this respect, one point is particularly important. With a flexible exchange rate, a deterioration in Canada's balance of trade as a result of the removal of import barriers would, other things being equal, lead to a depreciation of the Canadian dollar that would cushion part of the initial impact. Moreover, in practice, reorganization of production could well precede the initial impact – or at least take place simultaneously – thus further dampening the possible adverse effects we describe.

Even with these rather harsh assumptions, the results of this work can be considered encouraging. Participation in a free trade area with the United States would, even initially, have increased exports as well as imports so that GNE would have been only about three-quarters of 1 per cent lower than if there were no trade liberalization – considerably less than its usual annual growth – with unemployment only one-quarter of 1 percentage point higher. By contrast, in the absence of offsetting policies, the initial impact of the removal of Canadian tariffs on all imports (column E) in 1969 would have been a reduction in GNE that year of nearly 3 per cent below the actual level, and unemployment would have risen from 5 per cent to 6 per cent. Calculation of the effects of multilateral free trade would require many more data than are now available, but they would presumably fall within the limits set by the Canada-U.S. and unilateral cases; net exports would likely be higher at least initially in a bilateral arrangement, and they would be lowest in the unilateral case.

The results also bear out the suggestion that the major impact of trade liberalization would be on secondary manufacturing. Under both free trade situations, Real Domestic Product (RDP) in manufacturing would have declined roughly twice as much as RDP for the economy as a whole. A few Canadian industries – fish

processing and alcoholic beverages, for example – would have a tendency to expand output and employment as soon as Canada and its major trading partners removed their trade barriers. But the more common result would be a tendency to contract. This would be true even in some resource industries, such as mining, if appropriate measures were not taken to stimulate aggregate demand, or if the exchange rate did not decline; modest increases in net foreign demand for their products would be offset by the lower level of aggregate domestic demand.

This raises the question of just how much demand stimulus would be required. Table 13-1 shows that in 1969 an increase of \$300 million (1961 dollars) in government expenditure on current goods and services could have almost completely offset the loss in GNE that would have resulted from Canada-U.S. free trade, even if there had been no depreciation in the Canadian dollar (column C). And it would have reduced the rise in the unemployment rate by one-third. Particularly if fiscal measures could be directed more selectively at the goods-producing industries, it would be possible to offset the entire increase in unemployment that might initially result from Canada-U.S. free trade without going beyond the more or less normal limits of compensatory measures. Not surprisingly, the fiscal changes required to compensate for a unilateral tariff reduction would have to be very much larger (column F). It seems likely, then, that additional measures to stimulate aggregate demand would be required under any free trade arrangement and, in our opinion, they would be quite feasible. Therefore,

Recommendation 13

We recommend that particular attention be paid to the maintenance of full employment by appropriate aggregate demand policies during the period of transition to any free trade arrangement that might be concluded.

Such compensatory policies would greatly reduce the need for other forms of adjustment assistance. But more specific measures would still be necessary, because the short-run impact of free trade – even when compensated – would vary substantially among industries and among regions.

For example, even with fiscal policy operating to maintain aggregate demand in Canada, there would still be initial decreases in employment and output under Canada-U.S. free trade in such industries as textiles, machinery, metal fabricating, and electrical products. These difficulties would be greater and more industries would be affected under either unilateral or multilateral options than under a Canada-U.S. arrangement. In all cases, of course, the extent of the decline would be mitigated by any depreciation in the foreign exchange value of the Canadian

dollar. Such depreciation would also offset the tendency for fiscal compensation to increase the deficit in the balance of payments.

Because of the uneven distribution of industry across the country, the impact of these changes would also differ substantially among regions. Unfortunately, since the CANDIDE model is not disaggregated by region, it was necessary to assess this impact by other methods.³ By and large, they produced a consistent ranking of changes in regional employment, although there were differences in the absolute extent of such changes.

In the absence of offsetting changes in aggregate demand or in the exchange rate, the initial consequences of Canada-U.S. free trade would involve a larger decline in total employment in Quebec, and even more so in Ontario, than in the other provinces. In both the central provinces, the major impact would be felt by such industries as synthetic textiles; linoleum and coated fabrics; rubber goods other than footwear; hardware, tools, and cutlery; and electrical appliances. With policies designed to prevent any decrease in aggregate output or employment – fiscal stimulus or exchange depreciation or, most likely, a combination of the two – these declines would be reduced but not eliminated in Ontario and Quebec, while the other provinces and especially British Columbia would probably experience a gain in employment. Under unilateral or wider free trade options, the greatest decline in employment would occur in Quebec, followed by Ontario, again because of the preponderance of import-competing industries in Ontario and because of the importance of labour-intensive industries in Quebec. Any exchange depreciation or fiscal compensation sufficient to keep employment constant in Quebec and Ontario would produce significant expansion in employment in the other provinces. Thus, even if compensatory policies held total employment at the national level constant after trade liberalization, Quebec and Ontario would likely experience some short-run unemployment.

Our suggestion for compensatory policies to deal with these effects would apply largely, of course, to arrangements that involved a fairly rapid transition to free trade. Apart from the fact that any structural change proceeds best when times are prosperous and alternative employment opportunities numerous, additional fiscal stimulus would be less necessary under gradual liberalization because trade-related changes in output and employment would presumably be much smaller in any given year.

3 Campbell, Cornell, and Emerson, "Trade Liberalization in Canada"; Harry H. Postner assisted by Don Gilfix, *The Factor Content of Canadian International Trade: An Input-Output Analysis*, Economic Council of Canada (forthcoming); and H. M. Pinchin, "The Regional Impact of the Canadian Tariff," a background study prepared for the Economic Council of Canada.

Specific Measures of Government Assistance

Whether trade liberalization is gradual or rapid, Canada will need a broad range of measures to adapt to changing international economic conditions.⁴ The actual mix of such measures that may be required should vary with the initial impact and with the reorganization requirements of individual industries. Two broad categories of Canadian manufacturing industries should be considered: the great bulk, for which the reorganization of production, the development of new product lines, and new external marketing facilities would be the main requirements as trade liberalization progressed; and a smaller group, which faces more difficult problems because of the presence of substantial cost disadvantages that would persist even under free trade with the United States or, in the case of wider trade arrangements, because of strong competition from low-wage sources.

The Scheduling of Tariff Reductions

Under a free trade arrangement, some of the measures required could be built into the agreement itself. From the moment a clear commitment was made to remove existing levels of protection, each producer would need time to assess his prospects under the new market and competitive conditions, and to plan and execute an investment program to meet them effectively. For most industries, it is unlikely that more than about five years would be needed for such a program. However, if allowance were made for initial market penetration as well as for the required investment program, this *transition period* might have to be eight or ten years, especially if new firms, or firms operating in a new market, were attempting to become more competitive with well-established firms. We have therefore recommended (Chapter 8) that, in the context of discussions on an open-ended free trade area, Canada should seek the elimination of barriers to industrial trade over a ten-year period.

This period would set the outside limits to the transition process. Given these limits, there is the equally important question of how the reduction in trade barriers should actually take place. For tariffs, three main possibilities could be considered: they could be completely eliminated in one move; eliminated in one or a few industries at a time; or reduced in stages such as 20 per cent every second year over a ten-year period.

The last of these approaches was used by the EEC, although the transition period turned out to be shorter than originally expected. Each has advantages

4 Many such measures are discussed in Roy A. Matthews, *Industrial Viability in a Free Trade Economy: A Program of Adjustment Policies for Canada*, Canada in the Atlantic Economy series, Private Planning Association of Canada (Toronto: University of Toronto Press, 1971).

and disadvantages, and these will differ among industries.⁵ Moreover, by virtue of differences in market size and its associated economies, Canada is likely to face more extensive adjustment relative to its trading partners than was true of the larger EEC countries. What this argues for is a somewhat more flexible arrangement, so we have recommended that the method and schedule of tariff reduction be left open to negotiation (Chapter 8).

Appropriate scheduling of tariff reductions could assist individual Canadian industries to adjust to free trade. Together with the recommendation we have already made about aggregate demand and the one we make later concerning the retention of a flexible exchange rate, it would help to smooth the adjustment process and spread transitional costs more evenly throughout the economy. But whatever is done through timing, aggregate demand, and exchange rate policies, it would still be necessary to have specific programs to assist firms, workers, and possibly communities or regions to adjust to the new circumstances. Under gradual trade liberalization, these specific programs could take on even greater relative importance, since exchange depreciation in particular would be less significant, if indeed it took place at all.

Assistance to Firms

Under trade liberalization, financial and other forms of assistance would be required to help firms change to new product lines, to develop new production and distribution facilities, and perhaps even to shift to new locations. Canadian-owned firms would likely encounter greater difficulties in these respects than foreign-owned enterprises. While a large part of expected financial needs could be met through existing channels, the government might step in to help meet the peak demand for investment capital that would emerge in any major and rapid movement to free trade, especially since it would be important to ensure business support for a major restructuring program. Therefore, special arrangements – including government insurance of loans made by financial institutions – would be needed. There would also be a call for certain programs required in any case to cope with changing world economic conditions but made more urgent by trade liberalization, such as export sales promotion and improved incentives for research and development.

At present, the Department of Industry, Trade and Commerce operates a wide variety of programs designed to stimulate the productivity, output, and

5 Campbell, Cornell, and Emerson, "Trade Liberalization in Canada." Phasing arrangements might also have to allow for the differential impact of Canadian taxes on particular industries. See also James R. Melvin, *Tax Structure and Canadian Trade*, Economic Council of Canada (forthcoming), Chapter 7.

exports of the Canadian manufacturing sector. They already incorporate some of the requirements discussed above. The more important programs include measures for assisting industries affected by changes in foreign or domestic trade barriers – notably in the Automotive Adjustment Assistance Program, the General Adjustment Assistance Program (GAAP), which offers both insured and direct loans, and the provisions made in the Textile and Clothing Board Act – as well as measures directed more broadly at longer-run influences such as continuing technological change. In addition, the Regional Development Incentives Act, administered by the Department of Regional Economic Expansion, provides for industrial location incentive grants and other aids to industry. With some expansion to deal with more rapid movement towards trade liberalization, these programs could go a long way towards meeting the objectives outlined earlier.

However, our brief examination of this set of programs suggests certain weaknesses. We were struck, for instance, with the bewilderingly large variety of loans, grants, technical assistance, and eligibility conditions, which may make it difficult for individual firms to become familiar with all of the programs under which they may qualify. And there are often long delays and uncertainties between the application and actual receipt of assistance. Moreover, in the case of the Textile and Clothing Board Act, the criteria for decisions can, perhaps, too easily be used to justify continuing protection. Bearing in mind the need to strengthen and expand the existing facilities for adjustment assistance while minimizing the duplication of federal and provincial efforts,

Recommendation 14

We recommend that the wide variety of existing programs for assistance to industry be re-examined with a view to reconciling their objectives and simplifying eligibility conditions and provisions for assistance. This review should also focus on the need for increasing assistance to business firms as the country moves towards greater trade liberalization – for such purposes as the expansion of distribution networks for exports and the financing of shifts to new product lines, new facilities, and new locations.

Manpower Assistance

Extensive programs already exist in Canada to help labour deal with economic change.⁶ Workers seeking re-employment require assistance in:

finding new employment (an information service is now provided both by the Department of Manpower and Immigration through Canada Manpower Centres and by private employment agencies);

⁶ They are described in considerable detail in Economic Council of Canada, *Eighth Annual Review: Design for Decision-Making* (Ottawa: Information Canada, 1971).

retraining (the federal government now participates largely through the Adult Occupational Training Act of 1967);

moving to a place of new employment (now provided mainly under the Manpower Mobility Program of the Department of Manpower and Immigration); and

living during the adjustment period (now provided under the Adult Occupational Training Act for those undergoing retraining, to some extent under the Mobility Program, and under the Unemployment Insurance Program).

There is, of course, always a need to assess the adequacy of existing measures and to address such questions as what contributions to training programs designed to supply the range of skills needed in Canada's modern economy ought to be made by industry itself and what further contributions could be made by federal and provincial institutions, including educational establishments.

Our discussion here is intended to go beyond whatever ongoing measures are necessary or desirable in existing circumstances and to indicate the nature of additional steps that would be required under trade liberalization. For instance, training-in-industry for workers might have to be given greater emphasis relative to institutional training. Governments would probably have to share some of the additional costs of an expanded retraining program. Moreover, manpower planning practices in industry would need to be improved and better co-ordinated with government. Perhaps most important would be a requirement for adequate warning of layoffs. The GAAP includes provision for a warning (now three months) of this type, but such a requirement should be built into all adjustment assistance programs and the notice period extended.

Manpower forecasts, too, would have to be improved and related more closely to existing training programs. Previous work by the Council suggests that training programs have not been very successful in directing trainees towards projected requirements or into the most rapidly growing occupations. Special arrangements, such as those now available under the Textile and Clothing Board Act, might also be needed to provide older workers in other industries with the option of early retirement. These arrangements should include additional pension provisions and further mobility support. Mobility support, especially for moving costs, should be generally expanded in any event.

Particular attention should also be paid to management training and retraining programs. Canada has a smaller proportion of university-educated managers than the United States, and professional education in business administration and management science has received considerably less emphasis in this country.⁷ The demand for highly qualified managers is already very high, and it would expand even more rapidly under the pressure of accelerated trade liberalization.

7 D. J. Daly and Rein Peterson, "On Bridging the Gaps," *Management Science* 20 (December 1973): 560-61.

In view of all these factors,

Recommendation 15

We recommend:

- a that governments explicitly accept the principle that the economic and social costs of moving to a new situation of benefit to the whole of Canada should be borne by all Canadians rather than by particular groups or individuals; and, to implement this principle,*
- b that existing programs of assistance to workers to reduce hardship caused by economic and technological change and to retrain and relocate displaced manpower be reappraised with a view to assessing their adequacy under more liberalized trading conditions;*
- c that, insofar as this reappraisal shows these programs to be inadequate, steps be taken to improve and expand them and to ensure their co-ordination in a system whose features can be readily understood by workers in need of aid;*
- d that, more specifically, ways and means be sought to increase the effectiveness of manpower planning and forecasting in industry, and to strengthen the liaison mechanisms between industry and government in this respect so that suitable arrangements may be made in advance of any layoffs or other labour disruption occasioned by trade liberalization;*
- e that, if and when it proves necessary, consideration be given to the expansion and improvement of early retirement benefits to workers in industries adversely affected by more rapid trade liberalization; and*
- f that management training and retraining programs be examined intensively with a view to bringing them more into line with the requirements of an increasingly competitive international economy.*

Assistance to Agriculture

Canadian agriculture, as noted in Chapter 11, would face special adjustment problems under trade liberalization. Certainly this would be true of the dairy industry, particularly in Quebec. Some difficulties would also be encountered by poultry producers and growers of certain fruits and vegetables. For these reasons, among others, we have recommended a gradual approach to elimination of trade barriers on agricultural products. In Canada's long-run interest, however, it would be necessary to ensure that the support programs in this sector were increasingly associated with the transfer of farm resources into more productive lines. Therefore,

Recommendation 16

We recommend that adjustment assistance available to farmers and farm workers through existing programs be re-examined and increased, as necessary, in much the same way as has been recommended for industrial firms and workers.

Assistance to Regions

The question of assistance to regions, as distinct from firms and individuals, is the most complex of all. Where a community or a region is particularly dependent upon one industry that would be greatly affected by trade liberalization, the repercussions could be far-reaching. This would be true, for example, in certain areas of Quebec that are heavily dependent on the labour-intensive production of textile products.

The assistance measures already suggested might alleviate problems of this nature. And, of course, existing programs of the Department of Regional Economic Expansion, such as those for designated regions and special areas, could be used in such cases. The Council takes for granted that trade liberalization would involve an acceleration of area redevelopment programs. Indeed, we believe that plans should be expanded even now to phase new industries of long-run viability into regions threatened by import competition, particularly from low-wage countries. However, in our view it might well be necessary to make special arrangements involving the provincial governments in order to cope with the possible disruptive effects of trade liberalization on the economic and social life of especially vulnerable communities. Therefore,

Recommendation 17

We recommend that, where trade liberalization seems likely to have disruptive effects on local communities, the federal and provincial governments explore the possibility of creating special development boards with sufficient resources to plan and finance area redevelopment, including, where necessary, provision of alternative sources of employment.

Policy Co-ordination and Advice

So far we have mainly examined the nature of the measures needed to speed the adaptation process. However, some restructuring of the institutional framework for dealing with trade policy matters would also be necessary to implement our proposals. Most of our discussion of adjustment measures has focused on federal government programs. But there is also a wide variety of provincial programs dealing with similar problems, and our recommendations could have major implications for provincial governments. Close federal-provincial co-operation

seems essential to provide cohesion in all aspects of Canadian adjustment assistance. Moreover, within both the federal and the provincial governments, a great deal of knowledge has been built up about the impact of reductions in trade barriers – particularly, of course, in preparation for trade negotiations. Accelerating the process of trade liberalization would imply a need for continuous monitoring of this impact and for high-level appreciation of the links between trade-related programs and other policies. It would also require continuing liaison with interested groups.⁸ Therefore,

Recommendation 18

We recommend:

- a *that the federal and provincial governments establish machinery to co-ordinate programs of adjustment assistance both within and between governments, to promote public understanding of the responses that more rapid trade liberalization would require in the Canadian economy, and to seek a continuing reconciliation of the objectives of commercial and other economic policies; and*
- b *that, in the interests of effective liaison, machinery also be established to obtain the advice of industry, agriculture, and labour on a continuing basis.*

In addition, the Council believes that there is a need for an independent agency concerned with trade strategy that would function on a continuing basis to supplement present departmental activities, whether or not formal trade negotiations were in progress or in prospect. Such an agency would take on even greater importance if a more gradual approach to free trade were adopted, because information requirements become far more extensive and complex.

An independent agency would have the advantage of not being tied down by operational responsibility. It would also be much freer than a government department to hold public hearings, to publish the results of important investigations and research, and to make public its recommendations. Care would, however, have to be taken to avoid conflict between its strategic function and the ongoing implementation of government programs by departments. Such an agency might be charged with:

creating, maintaining, and publishing up-to-date measures of the protection provided to Canadian industries, so that the general public would be aware of the costs of such measures;

recommending measures, after public hearings, to shift the economy towards a more relevant tariff structure, together with supporting adjustment assistance, if required;

⁸ Some of these functions are now carried out by the Canadian Trade and Tariffs Committee (CTTC), which "has been established to receive the views of all Canadian interests regarding Canada's participation in the new round of tariff negotiations under the General Agreement on Tariffs and Trade." *Canada Commerce*, January 1974, p. 40.

examining applications for adjustment assistance and the scope for substituting *temporary* subsidies to industry as tariffs were removed; and

assessing the possibilities for reorganizing and rationalizing industries that would likely be affected by free trade, including examination of the relationship between commercial policy (for example, measures to lower tariffs) and domestic mergers or specialization agreements.

Duties similar to some of those suggested are at present being carried out by the Tariff Board. Some of the functions of the Board should, we feel, be expanded and it should be asked by the government to give high priority to the improvement of productivity when recommending changes in the tariff structure. As the Board is now constituted, it is limited largely to recommending piecemeal tariff reform, although the Tariff Board Act would appear to allow for assignment of wider responsibilities by the Governor-in-Council. The Board now has two distinct functions – one judicial, and the other to provide economic analyses and advice – each requiring a separate group of experts. Moreover, economic advisory functions in this field are also located in the Anti-Dumping Tribunal, the Textile and Clothing Board, and the Machinery and Equipment Advisory Board. It might well be possible, however, to build upon a reformulated and expanded Tariff Board as a nucleus for the more comprehensive economic advisory agency that we have in mind. Therefore,

Recommendation 19

We recommend that the Tariff Board's judicial functions be transferred to a Customs Court and that the Board be expanded and reconstituted as an independent trade advisory agency, incorporating also the present advisory responsibilities of the Anti-Dumping Tribunal, the Textile and Clothing Board, and the Machinery and Equipment Advisory Board, to analyse trade-related measures to improve the efficiency of Canadian industry and the position of the Canadian consumer. We recommend also that the reconstituted agency be empowered to offer advice to government on these matters, both on its own initiative and in response to specific official requests.

Framework Policies

We have recognized the necessity of some increase in direct government intervention in the economy during the period of transition to any free trade arrangement, but it is our belief that trade liberalization would involve less such intervention than other possible approaches to restructuring Canadian industry. Our attitude on this matter is, however, predicated on the assumption that certain measures would be adopted, setting the rules of overall economic activity so that Canadian business would be able to operate in a firmly established policy environment.

The Exchange Rate System

We have already suggested that movements in the foreign exchange value of the Canadian dollar could act to reduce the extent to which other adjustments to the impact of large-scale trade liberalization would be required. Exchange rate flexibility could help to prevent unduly large changes in employment and money wages. Moreover, the necessity of making frequent and difficult decisions about the proper level of a "pegged" dollar during a period of considerable structural change in the economy would be avoided. Therefore,

Recommendation 20

We recommend that Canada retain a flexible exchange rate as a necessary instrument of adjustment, particularly during the period of transition to any free trade arrangement that might be concluded.

Competition Policy

Few government concerns should be more closely related in a complementary fashion than their commercial and competition policies. Even with complete free trade, of course, a number of Canadian industries would not be subject to much competition from imports – for example, those that enjoy high transport cost protection (such as, to take an extreme, brickyards) or that are engaged in service activities. Without vigorous enforcement of competition policy, there would be a serious risk of resource misallocation within these industries, which would not only increase costs to the Canadian consumer directly but also affect the country's position in foreign markets by raising prices for services and other inputs of industries engaged in international trade.

However, freer trade would introduce the possibility of increased reliance on international competition for the effective allocation of resources in the economy. If Canada were to conclude a free trade arrangement, the potential for strong international competition would be quite clear and, in such circumstances, there would be the need for a more flexible approach to instruments of structural readaptation, such as mergers and export and specialization agreements. This would be particularly true in the period of transition to a free trade arrangement.

Market forces by themselves could, of course, be expected to bring about considerable change. Firms can grow and specialize without government encouragement. But some aspects of Canadian industrial organization might make government initiatives necessary even under free trade conditions.⁹ Larger enter-

⁹ See, for example, H. E. English, "Rationalization of Industry," *Canadian Perspectives in Economics* (Toronto: Collier-Macmillan, 1972), F 2.

prises with relatively few competitors in the same industry might not co-operate if that required them to give up particular product lines. Especially if they were branches of international firms, they might be accustomed to offering a "full line" of related goods in major world markets. No less important, firms contemplating rationalization by joint action might face prosecution under U.S. anti-trust or Canadian combines legislation. For such reasons, as well as the efficiency gains that could be provided, many industry spokesmen have proposed that government should remove the constraint on mergers that is incorporated in present combines legislation and should encourage agreements on specialization and export arrangements.

Nevertheless, in terms of the public interest, there has been a fear that implementation of such proposals would lead to higher concentration of economic power, without any assurance that the benefits of lower costs would be passed on to consumers. This transfer would be best guaranteed by relating proposed mergers and agreements to the reductions in tariffs and other trade barriers that would be scheduled under any free trade arrangement.

With a more gradual approach to trade liberalization, the situation would be somewhat different. We stated in Chapter 10 that, in these circumstances, domestic rationalization of industry through mergers and other agreements could provide at least some benefits in terms of increased efficiency and lower costs. Without the stimulus of large-scale and rapid trade liberalization, however, such arrangements might not be forthcoming unless governments took positive action to promote them. And it would also be necessary to take more explicit action to ensure that the benefits were passed on to consumers. We also suggested in Chapter 10 that consumers could be assured some of the gains through extensive use of price controls but that a far more preferable alternative would be the unilateral reduction or elimination of the relevant Canadian tariffs.

To meet these several requirements,

Recommendation 21

We recommend that the criteria for lawful mergers and export and specialization agreements refer specifically to the forces of international competition as one appropriate method of regulating such arrangements; and that the Restrictive Trade Practices Commission be empowered, where it thinks necessary, to recommend such arrangements contingent upon reduction (or elimination) of Canadian trade barriers sufficient to ensure adequate competition.

It should be added that, in the context of a Canada-U.S. free trade scheme, a bilateral agreement might be required to ensure that the U.S. antitrust authorities would not interfere with any arrangement approved by the Canadian government as part of the transitional adjustment process.

Whatever arrangements were contemplated with respect to these measures of structural adaptation, it would seem necessary to provide for periodic review to determine whether the expected results were being achieved. One way of facilitating this review would be to build a terminal date into export and specialization agreements, since in due course their benefits, if any, would have been achieved. Moreover, it would appear desirable to maintain review and assessment procedures strong enough to deal with potentially harmful large-scale mergers even after the attainment of full trade liberalization. The requirement might call for both national and international action to prevent the abuse of market power by multinational firms.

Foreign Investment Policy

Foreign investment in Canada has been a topic of much discussion and controversy, particularly over the past decade. Two major reports have been sponsored by the federal government – one involving an assessment of the influence of non-resident ownership on the structure of Canadian industry and the other an extensive study on the characteristics of foreign direct investment in Canada.¹⁰ The first of these placed considerable emphasis on tariffs and competition policy as factors explaining the behaviour of foreign-owned firms. The second, while recognizing these same factors, gave much attention to the cultural and political effects of foreign ownership.

From our perspective in this study, two basic questions emerge: Given the importance of the tariff in determining the structure and behaviour of Canadian industry, to what extent would there be a need for change in Canada's foreign investment policies if this country moved to freer trade, and perhaps more particularly to free trade with the United States and other countries? And, in these new circumstances, could foreign-owned enterprises be depended upon to behave in such a way as to promote the economic benefits that we have suggested would accrue to Canada from free trade? There are those who argue that such firms would reduce their Canadian production in favour of a corresponding increase outside Canada. Sometimes it is even contended that foreign-owned firms would retire en masse to their home bases if their protective support in Canada were withdrawn. This line of argument has both economic and noneconomic dimensions.

On the economic side, it implies one of several conditions: that under free trade there would be no significant advantages for Canadian locations; or that,

10 Government of Canada, *Foreign Ownership and the Structure of Canadian Industry* (Ottawa: Queen's Printer, January 1968), and *Foreign Direct Investment in Canada* (Gray Report) (Ottawa: Information Canada, 1972).

while there would be advantages, the foreign-owned firms would be incapable of identifying them; or that any gain in Canada would be outweighed by the net advantages of operating abroad – that is, by the expected revenue abroad minus the cost of abandoning production facilities in Canada. On the face of it, the second condition seems totally unrealistic. As for the other two, the available evidence strongly suggests that substantial economic advantages would, in fact, accrue over wide areas of Canadian industry.

The noneconomic aspects are more difficult to articulate or comprehend. Presumably, the argument says that, whatever the potential economic gains from locating in Canada, the foreign-owned enterprise would choose to disregard them for a variety of reasons – for example, emotional nationalism, or the wish to concentrate production in the country where the majority of key decisions affecting the firm are made. There is, of course, no way of fully establishing or refuting this kind of proposition, but such corporate behaviour would be constrained, at least to some degree, by market forces. No single firm, in any industry, could go very far in this noneconomic direction if its competitors were not prepared to do likewise. Yet there can be no denying the possibility that there would be some detrimental effects in Canada because of such noneconomic factors. This problem justifies some form of information disclosure and review procedure, particularly for the period of transition to any free trade arrangement.

In the same connection it must be recognized that, particularly under the pressures of a limited transition period, some Canadian-owned firms might have considerable difficulty penetrating international markets because of the entrenched power of large foreign-owned companies. This might lead to an acceleration of international as well as domestic mergers, which, in longer-run terms, would strengthen the case for a vigorous competition policy. In any event, continuing expansion of foreign control would not be consistent with Canada's long-term political goals. Some of these problems are already being dealt with by the Foreign Investment Review Agency, and it could be used to keep direct-investment – and particularly foreign takeovers of Canadian firms – under intensive review during the period of transition to any free trade arrangement. Further institutional arrangements would, however, be required to deal with problems of international competition and the Canadian government has for some time been participating in the work of the OECD and of the United Nations on multinational enterprises. Therefore,

Recommendation 22

We recommend that Canada continue to explore with other countries the possibility of adopting a code or set of guidelines on the behaviour of multinational enterprises.

It remains only to point out that the ultimate combined effect of our suggested trade and complementary policies would probably be to reduce the relative importance of foreign investment in Canada. Indigenous enterprise would be stimulated and higher Canadian incomes would generate increased savings to finance investment needs. In our judgment, it would be wise for Canada to frame its foreign investment policies with a view to maintaining the favourable investment climate that this country still requires – and without which the goals of liberalized trade might be very difficult to achieve.

The Structure of Taxation

The relationship between trade policy and the structure of taxation is very complicated.¹¹ For example, the effects of a country's own tariffs can be duplicated by taxes. Nevertheless, the abundant literature on the subject indicates that there is little need for extensive tax harmonization, even under the various free trade options. Certainly, this is borne out by the experience of the European Free Trade Association. In the event of free trade among industrial countries, tax harmonization could be limited to an agreement not to use taxes as disguised tariffs or export subsidies.¹²

But even to reach such a simple agreement would require some negotiation of domestic policies related to differential tax status, such as the Domestic International Sales Corporation (DISC) program of the United States. Indeed, both Canada and the United States at present operate tax incentive programs for manufacturers that could be viewed as constituting export subsidies. The Canadian Manufacturing Tax Incentives (MTI) reduce the corporate tax rate on manufacturing and processing profits to 40 per cent or to 20 per cent on similar profits that are eligible for the small business deduction. The DISC program permits U.S. manufacturers to defer income taxes on 50 per cent of their profits from exporting. Depending upon the pricing policies of U.S. firms, DISC exemptions could result in a decrease in U.S. export prices of from .5 to 2.5 per cent. It has been estimated that the Canadian MTI and the U.S. DISC are largely offsetting in their bilateral trade effects and that they represent an expensive transfer of revenue from the public to the private sector in each country.¹³

11 Melvin, *Tax Structure and Canadian Trade*, Chapter 6.

12 Hirofumi Shibata, *Fiscal Harmonization under Free Trade: Principles and Their Applications to a Canada-U.S. Free Trade Area*, Canada in the Atlantic Economy series, Private Planning Association of Canada (Toronto: University of Toronto Press, 1969).

13 Peggy B. Musgrave, "International Aspects of United States' Tax Policy," *Report of Proceedings of the Twenty-Fifth Tax Conference* (Toronto: Canadian Tax Foundation, 1974), pp. 27-28.

Quite apart from problems of tax harmonization, there is a need to ensure that the Canadian tax system does not discriminate against efficient international operation by Canadian business. Such discrimination could have serious implications in the future because of the expanding role of multinational firms. Progress has already been made to reduce this discrimination through negotiation of new international tax treaties, but a good deal remains to be done. Consequently,

Recommendation 23

We recommend that every effort be made to ensure that Canada's rules for taxation of foreign accrual property income (FAPI) of Canadian affiliates abroad do not hinder the establishment of Canadian-based multinational enterprises.

Conclusion: An Appropriate Policy for Canada

We believe that Canada could prosper in a totally free trade situation, provided the adjustment was eased by means of appropriate transitional arrangements. A move towards free trade entails a transformation of the existing pattern of production to one with greater competitive viability. There is no reason to suppose that a viable economy is not available to Canada, which has immense resources of all kinds – raw materials, capital, labour – and a sophisticated and advanced social system well-equipped to cope with change.

Thus we have suggested that a free trade policy is not only feasible for Canada but is the best guarantee of its national objectives. The aim of substantially increased living standards would be greatly advanced by a marked liberalization of trade, which would give rise to a quantum jump in the productive potential of the Canadian economy. With respect to employment, after a temporary adjustment problem, new job opportunities would arise for our increasingly educated labour force. Price stability, while not permanently affected, would be temporarily assisted by the drop in prices resulting from lowered import barriers. The distribution of income among regions and occupational groups would be affected, but if any changes were considered to be undesirable, they too could be conveniently handled by other policies. And, finally, to the extent that Canadian trade liberalization was part of a more general world movement in the same direction, international economic growth would be encouraged and the situation of the developing countries materially improved.

Furthermore, there is reason to suppose that a stimulus to efficiency and growth occurring in this way would contribute to Canada's political goals. Markedly freer trade would reduce the tariff incentive to foreign investment in Canadian industry, make more domestic capital available for development of our own enterprises, and in other ways improve the autonomy of our economic life. So far as unity is concerned, it would lessen the discrimination against

Atlantic and western Canada that is perceived in the protection afforded central Canadian industries and provide additional resources to put into stepped-up programs of regional economic expansion.

We submit, therefore, that Canada can certainly contemplate the idea of a really determined move towards trade liberalization. We would go further. We do not think that this country can afford to take any other action. Such a step is inevitable if Canada is to remain one of the world's advanced economic powers and at the same time satisfy its other national objectives. Freer trade, according to the Council's appraisal of the Canadian situation, is the policy most likely to contribute to a vital, dynamic, and growing economy in a country that remains politically autonomous and internally united.

RECOMMENDATIONS

- 1 We recommend that the current GATT negotiations on international trade liberalization be vigorously pursued and that every effort be made by Canada to eliminate its own and other countries' trade barriers.
 - 2 We recommend that Canada declare its readiness to make initial reductions in a number of high Canadian tariffs, the permanence of which would be conditional upon further substantial progress in negotiating these and the appropriate foreign tariffs down on a multilateral basis.
 - 3 We recommend that parallel with its participation in the current multilateral trade negotiations, the Canadian government actively explore the conditions under which Canada might join an open-ended free trade area with other interested countries. To this end, discussions should be held initially with the United States, the EEC, and Japan, with a view to establishing, before the end of this decade, an arrangement under which the barriers to trade in industrial products might be eliminated over a ten-year period – in accordance with an agreed method and schedule.
 - 4 We recommend that, to avoid distortions in our trade with nonmembers of any free trade area that might be negotiated, Canada be ready to reduce import duties in excess of 10 per cent to a level of 10 per cent ad valorem.
 - 5 We recommend that, contingent upon negotiation of a regional industrial free trade arrangement, Canada consider offering free entry to imports from those countries of the Caribbean area with which we have historic or cultural connections. In these same circumstances, Canada should also contemplate giving free entry to imports from Latin American countries to the extent that the United States is prepared to take similar action and, in the same way, extending such access to goods from the developing countries of Asia and Africa insofar as the United States, the EEC, and Japan are prepared to do likewise.
 - 6 We recommend that, if broader trading options are not open to this country, Canada should seek generally to rationalize its own tariff structure by reducing unusually high nominal tariffs to a narrower band around the average for each industry group and by reducing the variation in average protection among industry groups. Tariff reductions in the food and beverage industries should, however, be linked, where necessary, to international progress in solving problems of economic efficiency and social adjustment in agriculture.
-

-
- 7 We recommend that Canada devote particular attention in the GATT negotiations to the removal of barriers affecting trade in raw and semiprocessed nonferrous metals within the stages of fabrication where their identity as products of that sector is maintained.
 - 8 We recommend that Canada seek to negotiate the removal of trade barriers on raw and semiprocessed iron and steel products to follow as closely as possible the proposed elimination of those on the nonferrous metals group.
 - 9 We recommend that efforts to develop increased innovation be more intensively pursued and that they be widened to cover all types of activity that capitalize on Canada's investment in education and skill.
 - 10 We recommend that Canada take an initiative in GATT negotiations to formulate an international code on government procurement policies. Before doing so, the federal government should invite the provinces to establish a federal-provincial task force to advise on the formulation and implementation of such a code across Canada. In the event that the international community should fail to establish a multilateral code, Canada should seek to negotiate reciprocal purchasing agreements with other countries.
 - 11 We recommend that liberalization of agricultural trade be initiated as soon as possible and that trade barriers be removed gradually by major product group, keeping in mind the especially serious social and economic adjustment problems facing some rural areas.
 - 12 We recommend that crude oil and natural gas be excluded – at least initially – from any free trade agreement that might be concluded, but that Canada be prepared to discuss energy problems with other countries and to take appropriate initiatives in the light of changing supply/demand circumstances.
 - 13 We recommend that particular attention be paid to the maintenance of full employment by appropriate aggregate demand policies during the period of transition to any free trade arrangement that might be concluded.
 - 14 We recommend that the wide variety of existing programs for assistance to industry be re-examined with a view to reconciling their objectives and simplifying eligibility conditions and provisions for assistance. This review should also focus on the need for increasing assistance to business firms as the country moves towards greater trade liberalization – for such purposes as the expansion of distribution networks for exports and the financing of shifts to new product lines, new facilities, and new locations.
-

15 We recommend:

- a* that governments explicitly accept the principle that the economic and social costs of moving to a new situation of benefit to the whole of Canada should be borne by all Canadians rather than by particular groups or individuals; and, to implement this principle,
- b* that existing programs of assistance to workers to reduce hardship caused by economic and technological change and to retrain and relocate displaced manpower be reappraised with a view to assessing their adequacy under more liberalized trading conditions;
- c* that, insofar as this reappraisal shows these programs to be inadequate, steps be taken to improve and expand them and to ensure their co-ordination in a system whose features can be readily understood by workers in need of aid;
- d* that, more specifically, ways and means be sought to increase the effectiveness of manpower planning and forecasting in industry and to strengthen the liaison mechanisms between industry and government in this respect so that suitable arrangements may be made in advance of any layoffs or other labour disruption occasioned by trade liberalization;
- e* that, if and when it proves necessary, consideration be given to the expansion and improvement of early retirement benefits to workers in industries adversely affected by more rapid trade liberalization; and
- f* that management training and retraining programs be examined intensively with a view to bringing them more into line with the requirements of an increasingly competitive international economy.

16 We recommend that adjustment assistance available to farmers and farm workers through existing programs be re-examined and increased, as necessary, in much the same way as has been recommended for industrial firms and workers.

17 We recommend that, where trade liberalization seems likely to have disruptive effects on local communities, the federal and provincial governments explore the possibility of creating special development boards with sufficient resources to plan and finance area redevelopment, including, where necessary, provision of alternative sources of employment.

18 We recommend:

- a* that the federal and provincial governments establish machinery to co-ordinate programs of adjustment assistance both within and between governments, to promote public understanding of the responses that more rapid trade liberalization would require in the Canadian economy, and to seek a continuing reconciliation of the objectives of commercial and other economic policies; and
- b* that, in the interests of effective liaison, machinery also be established to obtain the advice of industry, agriculture, and labour on a continuing basis.

19 We recommend that the Tariff Board's judicial functions be transferred to a Customs Court and that the Board be expanded and reconstituted as an independent trade advisory agency, incorporating also the present advisory responsibilities of the Anti-Dumping Tribunal, the Textile and Clothing Board, and the Machinery and Equipment Advisory Board, to analyse trade-related measures to improve the efficiency of Canadian industry and the position of the Canadian consumer. We recommend also that the reconstituted agency be empowered to offer advice to government on these matters, both on its own initiative and in response to specific official requests.

20 We recommend that Canada retain a flexible exchange rate as a necessary instrument of adjustment, particularly during the period of transition to any free trade arrangement that might be concluded.

21 We recommend that the criteria for lawful mergers and export and specialization agreements refer specifically to the forces of international competition as one appropriate method of regulating such arrangements; and that the Restrictive Trade Practices Commission be empowered, where it thinks necessary, to recommend such arrangements contingent upon reduction (or elimination) of Canadian trade barriers sufficient to ensure adequate competition.

22 We recommend that Canada continue to explore with other countries the possibility of adopting a code or set of guidelines on the behaviour of multinational enterprises.

23 We recommend that every effort be made to ensure that Canada's rules for taxation of foreign accrual property income (FAPI) of Canadian affiliates abroad do not hinder the establishment of Canadian-based multinational enterprises.

A

**NOMINAL AND EFFECTIVE RATES
OF PROTECTION**

Our understanding of the impact of tariffs on a country's industries and pattern of production has been greatly increased in recent years by the development of the concept of effective protection and the distinction made between nominal tariffs (the rate of duty on imports listed in a country's tariff schedule) and the effective tariff.¹ The nominal tariff allows a manufacturer to price his product up to the price of a competing imported product, plus the tariff and the exchange rate. In contrast, the effective tariff is a calculation of the total protection afforded by the nominal tariff on the finished product together with the cost effect of other nominal tariffs on intermediate components that the manufacturer purchases; that is, the effective tariff measures the overall protection for an industry when it adds value to purchased inputs in processing its products.

Traditionally, effective protection has been taken as a measure of the percentage increase in value-added made possible in an industry by the system of tariffs, and it has been calculated in terms of the difference between value-added under protection and an estimated industry value-added in a free trade situation. Because it looks at the *increase* in value-added made possible by the tariff structure, it is expressed as a percentage of estimated free trade value-added.

The approach to effective protection in this Report is slightly different.² Because concern centres on *removal* of tariff barriers, effective protection is measured here in terms of the percentage *decrease* in industry value-added that would result from removal of tariffs. The only numerical difference is that the difference between protected and unprotected industry value-added is expressed as a percentage of industry value-added under protection.

For example, assume that the total production cost of an item is \$1.00, of which \$.60 is incurred at the intermediate stage and \$.40 at the final stage. If the import tariff on the intermediate product were 10 per cent, the manufacturer of the final product would pay \$.66 for inputs (\$.60 plus 10 per cent). Supposing that the tariff on the final product were 20 per cent, then he could sell his ultimate output for \$1.20, of which \$.14 (the \$.20 of his own protection less the \$.06 of his supplier's) would be effective protection afforded his activity. Calculating that \$.14 is a proportion of the \$.54 he contributes in value-added under the protected situation (his final price of \$1.20 less the \$.66

1 The concept of effective protection was introduced explicitly into economic literature in 1955. See Clarence L. Barber, "Canadian Tariff Policy," *Canadian Journal of Economics and Political Science* 21 (November 1955): 512-30. However, much of its development has taken place in the last decade. The source study on which the tariff rates generally used in this Report are based has also extended the concept of effective protection to allow for the proportion of an industry's output that is exported, for the effects of commodity taxes and subsidies, and for the effects of depreciation. However, in this Report we refer only to simple effective rates, which do not take these adjustments into account.

2 Bruce W. Wilkinson and Ken Norrie, *Effective Protection and the Return to Capital*, Economic Council of Canada (forthcoming).

he pays for inputs), we get an effective rate of 26 per cent. If, however, the duty on intermediate goods were raised to 20 per cent while that on the final product were reduced to 10 per cent, then the manufacturer would be forced to pay \$.72 for his inputs (or \$.12 over their production cost); yet he would receive nominal protection of only \$.10. The effective rate would be minus \$.02 on \$.38 (\$1.10 - \$.72), or a negative rate of protection of 5.3 per cent.

Effective protection rankings by industry are unaltered by the definition of effective protection adopted here and, while most magnitudes are altered slightly, a zero effective rate using the traditional definition equals a zero rate under the present definition.

Table A-1

Nominal and Effective Rates of Protection, Primary and Manufacturing Industries, Canada,¹ 1961, 1966, and 1970

	Nominal tariffs			Effective tariffs		
	1961	1966	1970	1961	1966	1970
Primary						
1 Agriculture	2.53	2.34	2.05	1.38	1.60	0.52
2 Forestry	0.00	0.05	0.01	- 0.82	- 0.73	- 0.66
3 Fishing, hunting, trapping	10.09	2.94	0.61	12.33	2.21	- 2.59
4 Iron mines	0.03	0.02	0.02	- 0.81	- 1.80	- 1.38
5 Base metal mines	0.05	0.03	0.02	- 0.50	- 0.61	- 0.52
6 Uranium mines	0.03	0.00	0.00	- 0.92	- 1.15	- 1.03
7 Other metal mines	0.07	0.01	0.01	- 1.04	- 1.22	- 0.99
8 Coal mines	4.14	3.15	0.04	3.88	2.41	- 0.32
9 Petroleum, gas, and services incidental to mining	0.99	1.10	0.28	1.18	1.37	0.13
10 Asbestos mines	0.40	0.10	0.39	- 0.60	- 0.64	- 0.57
11 Other nonmetal mines	3.73	2.25	0.62	4.17	2.25	- 0.40
Manufacturing						
12 Slaughtering and meat processors	6.06	4.21	4.72	17.21	6.45	9.76
13 Poultry processors	13.22	12.14	11.60	49.52	42.65	40.37
14 Dairy factories	8.74	12.56	14.02	33.92	44.65	49.13
15 Process cheese manufacturers	10.26	9.09	8.44	15.18	13.38	11.92
16 Fish products industry	11.73	12.66	8.07	15.89	34.29	23.25
17 Fruit and vegetable canners and preservers	14.79	13.89	12.12	21.77	24.38	20.49
18 Feed mills	11.68	8.02	6.37	32.00	22.58	16.78
19 Flour mills	10.41	1.82	0.95	45.24	6.36	- 1.37
20 Breakfast cereal manufacturers	18.36	15.89	14.32	32.40	30.04	26.49
21 Biscuit manufacturers	9.69	7.98	5.52	7.98	9.26	4.47
22 Bakeries	15.38	14.85	8.83	20.38	23.98	13.06
23 Confectionery manufacturers	13.89	12.99	11.08	19.96	20.09	15.38
24 Sugar refineries	21.80	14.55	11.50	56.15	37.35	29.49
25 Vegetable oil mills	3.03	3.18	1.99	29.26	35.19	19.56
26 Miscellaneous food industries	12.20	8.86	5.61	27.80	19.31	9.95
27 Soft drink manufacturers	2.24	6.86	3.30	- 1.27	7.32	0.41
28 Distilleries						

(cont'd.)

Table A-1 (cont'd.)

	Nominal tariffs			Effective tariffs		
	1961	1966	1970	1961	1966	1970
Manufacturing (cont'd.)						
29 Breweries and wineries						
30 Leaf tobacco processing						
31 Tobacco products manufacturers						
32 Rubber footwear manufacturers	22.15	21.77	20.38	28.59	27.32	23.96
33 Tire and tube manufacturers	18.66	18.78	15.27	28.16	30.20	14.14
34 Other rubber industries	17.08	12.86	11.88	24.17	17.55	9.40
35 Leather tanneries	11.54	8.16	6.87	37.74	23.43	18.52
36 Shoe factories	24.30	24.91	23.57	34.10	41.11	39.01
37 Glove and luggage manufacturers	19.17	17.97	18.10	29.59	27.19	27.37
38 Cotton yarn and cloth mills	20.75	18.59	16.26	33.57	29.19	25.60
39 Wool yarn and cloth mills	22.56	15.89	17.82	30.76	20.65	25.19
40 Synthetic textile mills	21.95	24.31	19.92	29.53	33.67	27.98
41 Carpet, mat, and rug industry	29.47	25.99	23.91	49.49	41.39	35.38
42 Linoleum and coated fabrics industry	21.54	20.60	18.50	35.75	35.36	20.06
43 Textile bags and canvas products industry	19.36	3.12	15.08	20.56	-24.54	17.36
44 Other textile industries	15.06	13.23	12.04	17.65	14.44	12.71
45 Hosiery mills	27.46	23.02	21.51	34.43	32.70	32.08
46 Other knitting mills	27.86	28.06	23.63	40.86	40.88	34.25
47 Clothing industries	24.05	23.42	21.46	28.29	27.13	25.89
48 Sawmills	1.25	0.77	0.22	2.91	1.48	1.14
49 Veneer and plywood mills	15.64	14.93	11.58	33.10	29.63	23.22
50 Sash and door, and planing mills	15.36	16.07	10.72	31.80	25.48	16.82
51 Other wood industries	11.36	7.30	9.89	18.91	11.74	17.50
52 Household furniture industry	20.90	20.46	16.50	27.89	27.61	21.89
53 Other furniture industries	19.90	18.08	14.49	25.76	23.39	18.30
54 Pulp and paper mills	8.20	5.73	3.42	13.95	10.34	5.46
55 Asphalt roofing manufacturers	13.10	14.48	10.58	17.74	23.19	13.98
56 Paper box and bag manufacturers	19.19	8.06	13.82	25.63	3.21	22.15
57 Other paper convertors	17.08	13.74	12.11	24.93	21.98	20.25
58 Printing, publishing, and engraving	6.91	7.83	6.89	5.39	7.93	8.17
59 Iron and steel mills	3.52	3.29	2.97	4.54	4.63	4.66
60 Steel pipe and tube mills	11.24	9.92	9.11	18.70	16.90	15.85
61 Iron foundries	10.05	9.77	7.19	15.32	14.67	10.70
62 Smelting and refining	6.12	2.19	0.89	22.01	7.86	2.63
63 Aluminum rolling, casting, and extruding	10.48	4.99	4.03	22.56	17.19	15.69
64 Copper and alloy rolling, casting, and extruding	11.63	11.74	6.65	30.81	52.56	32.31
65 Metal rolling, casting, and extruding, n.e.s.	12.15	8.76	5.24	25.94	24.25	14.94
66 Boiler and plate works	12.62	10.97	9.38	16.91	12.90	11.10
67 Fabricated structural metal industry	16.16	15.84	12.79	24.03	20.42	16.39
68 Ornamental and architectural metal industry	16.03	18.31	15.00	23.60	28.72	23.59
69 Metal stamping, pressing, and coating industry	15.94	13.83	11.89	21.98	19.84	16.70
70 Wire and wire products manufacturers	14.52	10.70	9.02	21.31	14.75	11.90
71 Hardware, tool, and cutlery manufacturers	14.10	14.86	12.00	19.53	20.57	16.28
72 Other metal fabricating industries	12.99	11.54	9.77	18.01	15.68	13.60
73 Machinery and equipment manufacturers	7.53	6.96	5.25	7.54	5.95	3.80
74 Refrigeration, office and store machinery manufacturers	7.61	6.90	5.76	7.99	6.77	5.70
75 Aircraft and parts manufacturers	0.98	1.81	1.15	- 2.10	0.36	- 0.41

(cont'd.)

Table A-1 (concl'd.)

	Nominal tariffs			Effective tariffs		
	1961	1966	1970	1961	1966	1970
Manufacturing (concl'd.)						
76 Motor vehicles and trailer manufacturers	10.81	2.74	2.50	16.37	- 0.23	1.62
77 Motor vehicle parts manufacturers	7.93	2.97	1.90	8.36	- 0.67	- 1.78
78 Other transportation equipment industries	7.64	10.96	8.81	6.72	12.75	10.32
79 Manufacturers of electrical appliances	17.50	17.20	15.37	27.79	27.66	25.76
80 Manufacturers of communications equipment, including wire	13.21	13.66	11.18	15.37	16.65	14.26
81 Manufacturers of electrical industrial equipment	13.61	17.58	13.17	16.39	22.16	16.63
82 Other electrical products manufacturers	17.22	15.86	11.65	23.89	22.08	14.87
83 Cement and lime products manufacturers	5.17	4.30	0.73	6.23	5.81	0.52
84 Concrete and gypsum products manufacturers	15.57	6.46	3.64	30.33	10.69	5.95
85 Clay, stone, and refractory products manufacturers	12.50	10.88	9.91	19.28	16.60	15.28
86 Glass and glass products manufacturers	13.57	11.56	12.44	17.26	14.58	15.33
87 Other nonmetal mineral products industries	12.05	11.81	10.26	20.33	20.73	17.71
88 Petroleum and coal products industries	6.25	7.70	7.90	27.61	48.37	44.41
89 Explosives and ammunition manufacturers	8.69	9.21	8.37	10.00	11.71	8.56
90 Manufacturers of mixed fertilizers	0.66	0.73	0.45	- 7.95	- 7.79	-27.23
91 Manufacturers of plastic resins	5.68	4.93	6.01	7.30	6.15	6.01
92 Manufacturers of pharmaceuticals and medicines	12.64	11.80	8.00	19.64	22.04	12.82
93 Paints and varnishes manufacturers	16.49	16.43	13.53	29.73	33.97	25.27
94 Manufacturers of soap and cleaning compounds	15.43	15.28	12.52	33.05	34.96	22.59
95 Manufacturers of toilet preparations	21.04	19.51	16.99	40.77	40.13	31.12
96 Industrial and other chemical industries	7.06	6.69	6.74	8.49	8.91	6.66
97 Miscellaneous manufacturing industries	12.72	11.17	10.76	17.24	15.27	14.50

1 Includes all goods-producing industries as in Dominion Bureau of Statistics, *The Input-Output Structure of the Canadian Economy, 1961*, vol. 1, Cat. No. 15-501 (Ottawa: Queen's Printer, August 1969), Table IOIC-L, p. 182. Rates of protection for tobacco and alcoholic beverages have been excluded, however, since recorded import duties on commodities produced by these industries include excise taxes; measures of protection based on such data are much exaggerated.

SOURCE Bruce W. Wilkinson and Ken Norrie, *Effective Protection and the Return to Capital*, Economic Council of Canada (forthcoming).

B

**RANKING OF CANADIAN
PRIMARY AND MANUFACTURING INDUSTRIES
BY RATE OF PROTECTION
AND FACTOR CONTENT**

Table B-1

Ranking of Canadian Primary and Manufacturing Industries, by Rate of Protection and Factor Content¹

	Tariff rates, 1970		Factor content ²			
			Resource intensity		Labour intensity	
	Nominal	effective	Total	Nonrenewable	Total	University
Primary						
1 Agriculture	75	77	2	44	3	88
2 Forestry	91	86	1	66	49	85
3 Fishing, hunting, trapping	83	92	5	56	2	90
4 Iron mines	89	90	3	1	88	32
5 Base metal mines	90	84	9	6	89	80
6 Uranium mines	93	88	10	7	92	91
7 Other metal mines	92	87	6	3	13 ³	11 ³
8 Coal mines	88	81	11	8	26 ³	92
9 Petroleum, gas, and services incidental to mining	86	80	7	4	93	20
10 Asbestos mines	85	85	8	5	87	70
11 Other nonmetal mines	82	82	4	2	81	86
Manufacturing						
12 Slaughtering and meat processors	68	62	14	57	10	79
13 Poultry processors	34	3	15	61	6	82
14 Dairy factories	20	1	16	51	9	84
15 Process cheese manufacturers	51	56	30	74	45	25
16 Fish products industry	53	21	19	59	1	78
17 Fruit and vegetable canners and preservers	27	26	28	49	23	41
18 Feed mills	61	36	20	52	15	67
19 Flour mills	79	89	13	54	8	65
20 Breakfast cereal manufacturers	19	13	32	72	42	30
21 Biscuit manufacturers	65	72	37	78	25	71
22 Bakeries	49	53	34	68	16	58
23 Confectionery manufacturers	38	43	47	86	32	54
24 Sugar refineries	36	10	46	90	90	93
25 Vegetable oil mills	76	29	12	48	7	81
26 Miscellaneous food industries	64	61	31	71	61	45
27 Soft drink manufacturers	72	79	88	83	57	60
28 Distilleries						
29 Breweries and wineries						
30 Leaf tobacco processing						
31 Tobacco products manufacturers						
32 Rubber footwear manufacturers	6	19	85	80	12	26
33 Tire and tube manufacturers	15	50	86	62	85	73
34 Other rubber industries	32	63	82	58	72	28
35 Leather tanneries	58	30	25	53	14	43
36 Shoe factories	3	4	58	84	4	49
37 Glove and luggage manufacturers	9	12	61	69	5	34
38 Cotton yarn and cloth mills	13	16	93	91	53	89
39 Wool yarn and cloth mills	10	18	56	75	19	53
40 Synthetic textile mills	7	11	80	67	69	33
41 Carpet, mat, and rug industry	1	5	83	70	47	57

(cont'd.)

Table B-1 (cont'd.)

	Factor content ²					
	Tariff rates, 1970		Resource intensity		Labour intensity	
	Nominal	effective	Total	Nonrenewable	Total	University
Manufacturing (cont'd.)						
42 Linoleum and coated fabrics industry	8	28	55	46	41	14
43 Textile bags and canvas products industry	16	34	90	88	18	51
44 Other textile industries	29	55	84	77	27	31
45 Hosiery mills	4	8	91	89	17	48
46 Other knitting mills	2	6	89	87	22	56
47 Clothing industries	5	14	76	93	11	68
48 Sawmills	87	76	21	79	28	87
49 Veneer and plywood mills	35	22	23	82	30	77
50 Sash and door, and planing mills	40	35	35	85	20	75
51 Other wood industries	44	33	33	60	24	50
52 Household furniture industry	12	25	65	73	21	59
53 Other furniture industries	18	31	70	64	31	52
54 Pulp and paper mills	71	70	26	47	75	66
55 Asphalt roofing manufacturers	41	51	43	25	80	44
56 Paper box and bag manufacturers	21	24	40	63	51	46
57 Other paper convertors	28	27	44	45	46	38
58 Printing, publishing, and engraving	57	65	71	92	39	22
59 Iron and steel mills	73	71	29	14	77	63
60 Steel pipe and tube mills	47	41	38	16	78	72
61 Iron foundries	56	59	50	21	38	62
62 Smelting and refining	80	74	17	9	84	40
63 Aluminum rolling, casting, and extruding	69	42	24	12	74	19
64 Copper and alloy rolling, casting, and extruding	60	7	22	11	76	36
65 Metal rolling, casting, and extruding, n.e.s.	67	46	27	13	64	37
66 Boiler and plate works	46	58	63	30	36	16
67 Fabricated structural metal industry	24	39	53	24	58	21
68 Ornamental and architectural metal industry	17	20	54	26	43	42
69 Metal stamping, pressing, and coating industry	31	37	51	22	70	69
70 Wire and wire products manufacturers	48	57	49	20	68	61
71 Hardware, tool, and cutlery manufacturers	30	40	78	42	33	17
72 Other metal fabricating industries	45	52	57	27	40	35
73 Machinery and equipment manufacturers	66	73	69	33	52	18
74 Refrigerator, office, and store machinery manufacturers	63	69	92	76	79	29
75 Aircraft and parts manufacturers	78	83	87	55	29	3
76 Motor vehicles and trailer manufacturers	74	75	79	43	73	55
77 Motor vehicle parts manufacturers	77	91	64	31	63	76
78 Other transportation equipment industries	50	60	72	36	65	83
79 Manufacturers of electrical appliances	14	15	68	32	48	12
80 Manufacturers of communications equipment, including wire	37	49	62	29	56	8
81 Manufacturers of electrical industrial equipment	23	38	77	40	54	2
82 Other electrical products manufacturers	33	47	73	39	50	10
83 Cement and lime products manufacturers	81	78	60	28	82	74
84 Concrete and gypsum products manufacturers	70	68	42	18	60	47

(cont'd.)

Table B-1 (concl'd.)

	Factor content ²					
	Tariff rates, 1970		Resource intensity		Labour intensity	
	Nominal	effective	Total	Nonrenewable	Total	University
Manufacturing (concl'd.)						
85 Clay, stone, and refractory products manufacturers	43	45	45	17	44	39
86 Glass and glass products manufacturers	26	44	74	41	35	64
87 Other nonmetal mineral products industries	42	32	36	15	71	23
88 Petroleum and coal products industries	55	2	18	10	91	27
89 Explosives and ammunition manufacturers	52	64	67	35	66	5
90 Manufacturers of mixed fertilizers	84	93	41	19	67	9
91 Manufacturers of plastic resins	62	67	59	38	83	7
92 Manufacturers of pharmaceuticals and medicines	54	54	81	81	59	1
93 Paints and varnishes manufacturers	22	17	52	34	62	4
94 Manufacturers of soap and cleaning compounds	25	23	39	50	55	6
95 Manufacturers of toilet preparations	11	9	75	65	34	13
96 Industrial and other chemical industries	59	66	48	23	86	15
97 Miscellaneous manufacturing industries	39	48	66	37	37	24

1 Includes all goods-producing industries as in Dominion Bureau of Statistics, *The Input-Output Structure of the Canadian Economy, 1961*, vol. 1, Cat. No. 15-501 (Ottawa: Queen's Printer, August 1969), Table IOIC-L, p. 182. The tobacco and alcoholic beverage industries have not been ranked, however, because their calculated rates of protection would be greatly exaggerated (see Appendix A).

2 The factor content columns rank each industry by its total direct and indirect use of natural resources and total direct and indirect use of labour. Thus forestry, for example, ranks very low as far as protection is concerned, very high for use of natural resources, and low for use of university-trained labour. Factor content ranking is mainly on the basis of the 1961 input-output table.

3 These rankings may be distorted because of the effects of subsidies.

SOURCE Bruce W. Wilkinson and Ken Norrie, *Effective Protection and the Return to Capital*, Economic Council of Canada (forthcoming); and Harry H. Postner, assisted by Don Gilfix, *The Factor Content of Canadian International Trade: An Input-Output Analysis*, Economic Council of Canada (forthcoming).

C

THE FACTOR CONTENT OF
CANADIAN TRADE

A study prepared for the Council examines the content of Canadian trade in terms of the factors used in the production of our exports and import-competing goods:¹ labour, classified by formal educational level (elementary, high school, and university); physical capital, in terms of both structure and machinery; and natural resource products, divided into renewable and nonrenewable categories.

Table C-1 examines the relative importance of these factors in Canada's total trade and in bilateral trade with each of our major partners. The table shows how much of each factor is required to produce a typical million dollars' worth of Canadian exports and of imports, if the latter had been produced in Canada. For example, it took 107.9 man-years of labour to produce a typical million-dollar bundle of Canadian exports to the world as a whole, while 110.3 man-years of labour would have been required to produce in Canada the commodities included in a typical million-dollar bundle of imports. Therefore, on balance, each million dollars' worth of exports and imports involved an import of 2.4 man-years of labour. Dividing this figure by the total quantity of the factor supplied for the year to the Canadian economy, we obtain the relative factor content per million dollars of Canadian merchandise trade (Table C-1).² Multiplying this figure by the total value of exports or imports provides the relative factor content of total Canadian merchandise trade (Table 2-8).³

Table C-1 shows that our imports tend to be more labour-intensive than our exports. On the other hand, our exports tend to be more intensive in fixed capital and natural resources than our imports. The picture that emerges then, is clear: Canada's international trade amounts, in large part, to a net exchange of natural resources and the services of capital for the services of labour.

There are similarities among the various bilateral trade flows. In all cases, a similar increase in exports to, and imports from, each of our major trading partners would generate an increased demand for Canadian natural resources and capital. But there are also important differences. Such a balanced increase in our trade with the United States, for example, would lead to a decrease in the demand for all kinds of labour in Canada, especially high school-educated labour. The displacement of university-trained labour would be relatively slight. By contrast, an increase in our trade with the United Kingdom, the EEC (six), Japan, and EFTA would, largely because of the importance of agricultural exports

1 Harry H. Postner, assisted by Don Gilfix, *The Factor Content of Canadian International Trade: An Input-Output Analysis*, Economic Council of Canada (forthcoming).

2 Since the net factor content of a million dollars' worth of trade is very small in relation to the total supply of that factor to the Canadian economy, all of the figures in the relative factor content columns of Table C-1 have been raised by a factor of 10^6 for ease of presentation.

3 In practice, where trade is not balanced, the lesser of exports or imports has been used as a proxy for total trade.

to these areas, result in an increased demand for labour with elementary education – but only at the cost of significant decreases in the employment of high school- and university-educated labour.

Table C-1

Factor Content of a Balanced Increase in Canada's Bilateral Merchandise Trade of One Million Dollars, 1967

(All value items are in constant 1961 prices)

	World			U.S.			U.K.		
	Exports	Imports	Relative factor content	Exports	Imports	Relative factor content	Exports	Imports	Relative factor content
	X	M	$(X-M)/F$	X	M	$(X-M)/F$	X	M	$(X-M)/F$
Total labour employed (man-years)	107.9	110.3	-0.5	98.3	112.5	-2.7	118.3	112.5	1.1
Elementary	47.7	42.1	2.9	39.8	42.7	-1.5	58.2	41.3	8.7
High school	51.9	59.2	-2.6	50.2	60.7	-3.8	52.1	61.5	-3.4
University	8.3	9.1	-1.7	8.4	9.1	-1.5	8.0	9.7	-3.6
Total gross fixed capital (thousands of dollars)	3,107	2,530	5.4	2,996	2,431	5.2	3,309	2,327	9.1
Gross structures	1,615	1,313	5.1	1,596	1,205	6.5	1,659	1,131	8.8
Gross machinery	1,492	1,217	5.8	1,400	1,226	3.6	1,650	1,196	9.5
Renewable natural resources (thousands of dollars)	212	81	26.8	125	85	8.2	308	43	54.2
Nonrenewable natural resources	267	169	30.0	256	135	37.1	335	98	72.6
Total trade (millions of dollars)	9,349	10,945		6,021	7,886		985	706	

(cont'd.)

Table C-1 (concl'd)

	EEC			Japan			EFTA		
	Exports	Imports	Relative factor content	Exports	Imports	Relative factor content	Exports	Imports	Relative factor content
	X	M	$(X-M)/F$	X	M	$(X-M)/F$	X	M	$(X-M)/F$
Total labour employed (man-years)	123.5	112.8	2.1	124.4	120.7	0.7	109.6	115.0	-1.0
Elementary	62.1	42.4	10.2	64.9	48.4	8.5	51.8	44.9	3.6
High school	53.5	61.0	-2.7	52.1	63.0	-3.9	49.7	60.5	-3.9
University	7.9	9.4	-3.2	7.4	9.3	-4.0	8.1	9.6	-3.2
Total gross fixed capital (thousands of dollars)	3,434	2,413	9.5	3,375	2,365	9.4	3,020	2,443	5.4
Gross structures	1,710	1,158	9.2	1,714	1,091	10.4	1,518	1,172	5.8
Gross machinery	1,724	1,256	9.8	1,661	1,274	8.1	1,502	1,271	4.8
Renewable natural resources (thousands of dollars)	390	61	67.3	438	52	78.9	196	90	21.5
Nonrenewable natural resources	339	89	76.6	395	78	97.2	433	124	94.7
Total trade (millions of dollars)	554	664		457	333		140	245	

NOTE Each figure in the $(X-M)/F$ columns has been raised by the power 10^6 .

SOURCE Harry H. Postner, assisted by Don Gilfix, *The Factor Content of Canadian International Trade: An Input-Output Analysis*, Economic Council of Canada (forthcoming).

D

**PROJECT STAFF, CONSULTANTS, AND
AUTHORS OF BACKGROUND STUDIES**

Project Staff

Director: Dr. P. M. Cornell

Mr. G. Audet	Mr. R. A. Matthews
Mr. J. P. Campbell	Dr. H. H. Postner
Mr. R. Dauphin	Ms. J-A. Raynes
Mr. J. R. Downs	Mr. D. Wakid
Mr. D. L. Emerson	Mr. C. Wenaas
Mr. D. Gilfix	
Ms. E. Gruszecka-Grant	Ms. Noreen Halpin
Mr. N. Mathieu	Ms. Wendy Dunlop

Consultants and Authors of Background Studies

Professor A. Breton, University of Toronto
Professor G. Curzon, University of Geneva
Professor H. E. English, Carleton University
Professor W. D. Gainer, University of Alberta
Professor K. A. J. Hay, Carleton University
Professor J. Henry, University of Ottawa
Professor B. H. Higgins, University of Ottawa
Professor John Letiche, University of California, Berkeley
Professor P. V. Lyon, Carleton University
Professor J. R. Melvin, University of Western Ontario
Professor K. Norrie, University of Alberta
Professor H. M. Pinchin, Colgate University
Professor T. L. Powrie, University of Alberta
Professor G. L. Reuber, University of Western Ontario
Professor J. J. Richter, University of Alberta
Professor K. Valaskakis, Université de Montréal
Professor D. A. Wilton, Queen's University
Professor B. W. Wilkinson, University of Alberta
Professor R. J. Wonnacott, University of Western Ontario

HF/1766/.L66/1975 of Canada
Economic Council of Canada A New
Looking outward : a For Canada
new trade strategy daol
c.1 tor mai

Date Due

~~APR 16 1978~~

~~APR 26 1977~~

~~APR 27 1978~~

~~JUN 20 1979~~

~~JUL 25 1979~~

~~DEC 5 1979~~

~~JAN 11 1980~~

~~JUN 16 1980~~

FEB 09 1984
JUN 25 1985

JUL 9 1985

JUL 29 1985

AUG 23 1985

