Policy Analysis

# Cato Institute Policy Analysis No. 88: Stumbling Toward a U.S.-Canada Free Trade Agreement

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**Executive Summary**

Officials of the U.S. and Canadian federal governments are now negotiating a free trade agreement between our two countries. A proposed agreement is expected to be submitted for approval by Congress in October 1987. Although a free trade agreement would yield significant benefits for the United States and substantial benefits for Canada, approval of the proposed agreement by both governments is not assured. The primary barriers are the United States' record of indifference to Canadian concerns and Canada's record of extraordinary sensitivity about its independence from the United States. Significant concessions by each government will be needed to ensure approval of the proposed agreement by the other government. Failure to attain mutual approval is likely to lead to a deterioration of the trade relations between the United States and Canada and jeopardize the prospect of success in the round of multilateral trade negotiations that was initiated in Uruguay in September 1986.

## The Current Status of U.S.-Canada Trade

The United States and Canada are the world's largest trading partners. U.S. merchandise exports to Canada in 1985 were $53.9 billion--25 percent of total U.S. exports and 81 percent of total Canadian imports. Canadian merchandise exports to the United States in 1985 were $69.6 billion--78 percent of total Canadian exports and 19 percent of total U.S. imports.[1] U.S.- Canada merchandise trade has increased rapidly, particularly since the implementation of a bilateral auto pact in 1965. (See Table 1.) A substantial U.S. surplus in services trade with Canada offsets much of the U.S. deficit in merchandise trade. The largest U.S. merchandise exports to Canada are motor vehicles and parts, electronic equipment, coal, and chemicals. The largest Canadian merchandise exports to the United States are motor vehicles and parts, petroleum and natural gas, and wood products.

**Table 1**
**U.S.-Canada Merchandise Trade, 1965-85 (U.S. $ Billions)**

| | U.S. Exports to Canada | | Canadian Exports to the U.S. | |
|---|---|---|---|---|
| Year | Total | Auto | Total | Auto |
| 1965 | 5.6 | 0.8 | 4.8 | 0.2 |
| 1970 | 9.1 | 2.5 | 10.6 | 3.6 |
| 1975 | 22.8 | 6.5 | 21.4 | 6.4 |
| 1980 | 40.7 | 8.9 | 42.0 | 8.7 |

| | | | | |
|---|---|---|---|---|
| 1985 | 53.9 | 17.5 | 69.6 | 24.7 |

Source: U.S. Department of Commerce.

Moreover, most U.S.-Canada trade is already duty-free- -70 percent of the U.S. merchandise exports to Canada and 85 percent of the Canadian merchandise exports to the United States. As of 1988, when the Tokyo Round tariff reductions are complete, the average Canadian tariff on U.S. exports will be 3.8 percent and the average U.S. tariff on Canadian exports will be 0.7 percent, according to estimates weighted by the current volume of bilateral trade by product. Each country's average tariff on trade with its neighbor is already substantially lower than its average tariffs on trade with other countries. Both Canadian and U.S. tariffs on several groups of products, however, will still be quite high, and the tariffs in Canada will be substantially higher than the tariffs in the United States. (See Table 2.)

The primary effect of the tariffs that remain after the Tokyo Round reductions will be to restrict the extent of specialization in both U.S. and Canadian industries, generally within the same product groups. Some important bilateral trade issues, moreover, involve products and services for which the current volume of trade is larger and that are not subject to duties.

**Table 2**
**Selected Post-Tokyo Round Tariffs on U.S.-Canada Trade (%)**

| Product Group | Canada | U.S. |
|---|---|---|
| Clothing | 23.7 | 18.4 |
| Footwear | 21.5 | 9.0 |
| Textiles | 16.9 | 7.2 |
| Furniture | 14.3 | 4.6 |
| Metal products | 8.6 | 4.0 |
| Chemicals | 7.9 | 0.6 |
| Electrical machinery | 7.5 | 4.5 |
| Rubber products | 7.3 | 3.2 |

Source: Drusilla Brown, professor of economics, Tufts University, in testimony before the House Subcommittee on Economic Stabilization, based on data from the Office of the U.S. Trade Representative, August 5, 1986.

**The Benefits of a Free Trade Agreement**

Given the large volume of tariff-free trade, the low level of the average tariffs, and the generally uncontentious trade relations between the United States and Canada, why have both governments made a commitment to a free trade agreement? The most direct answer is that removing the remaining tariffs would generate significant benefits for the United States and substantial benefits for Canada. A more complete answer is that there are significant nontariff barriers to trade in both products and services. The most important answer is that the two nations' generally harmonious trade relations are probably not sustainable without a new agreement. Congressional pressure has forced the Reagan administration to implement U.S. trade laws more aggressively, at considerable current and prospective costs to Canada. Similarly, Canada's measures to induce foreign investment in its auto industry threaten to undermine the bilateral auto pact that is the basis for most of the current tariff-free trade, and the Canadian government is vulnerable to a resurgence of economic nationalism that would worsen the two nations' trade relations.

Several studies of the net benefits of a U.S.-Canada free trade agreement, most of which were conducted by Canadian economists, report estimates derived from complex models of the U.S. and Canadian economies. Although such estimates are based on some assumptions that are not testable, they indicate the general magnitude of the benefits of a free trade agreement.

The primary difference in the studies involves their assumptions about the potential economies of scale. A study by

Bob Hamilton and John Whalley of the University of Western Ontario probably provides the best estimates that are based on the assumption of constant returns to scale in both countries.[2] The study also assumes that because the U.S. market is so much larger, U.S. prices are fairly independent of the level of trade with Canada. If that is the case, the burden of both U.S. and Canadian tariffs is borne primarily by Canada, and the tariffs are therefore responsible for raising the prices charged to Canadian consumers and reducing the prices charged by Canadian exporters. Hamilton and Whalley estimate that under 1977 conditions, a free trade agreement would increase U.S. real GNP by about 0.03 percent and would increase Canadian real GNP by about 0.7 percent. Although those poten-tial net benefits are not large, the benefits to individual producers would be more substantial.

A considerable body of evidence, however, indicates that many Canadian manufacturers operate at a level lower than the most efficient scale of production. An innovative model of the Canadian economy that incorporates potential economies of scale has been developed by David Cox of the University of Western Ontario and Richard Harris of Queen's University.[3] Using that model yields the conclusions that bilateral free trade would increase the specialization of the Canadian economy, substantially increase the total level of trade, and, under 1976 conditions, increase the real GNP of Canada by 6.5 percent. For several reasons, the most important of which is the reduction in both countries' tariffs during the Tokyo Round, Harris currently estimates that a free trade agreement would result in about one-half of that increase in GNP.[4] The Cox and Harris model also indicates that bilateral free trade would lead to a substantial reallocation of labor within and among Canadian industries but only a little reallocation among regions. A similar model, unfortunately, has not been developed for the U.S. economy. Some American firms would experience economies of scale if they increased their sales to the Canadian market, but, given the large size of the U.S. market, the total benefit to the United States from that source would likely be small.

For the following reasons, however, the benefits that both countries derived from a free trade agreement would likely be greater and more numerous than the Canadian models suggest:[5]

-- The models do not reflect the variance of tariff rates within broad product groups. Since the misallocative costs of a tariff are a function of the square of the tariff rate, using a less aggregative model would yield somewhat higher estimates of the benefits of eliminating tariffs.

-- The models do not reflect many of the nontariff barriers to free trade that exist in both countries. A reduction of such barriers would be especially beneficial to the United States.

-- The models do not reflect the effect of an increase in real GNP, especially in Canada, on the volume of trade.

-- The models do not reflect the benefits of an increase in both U.S. and Canadian firms' competitiveness in other markets.

-- The models do not reflect benefits resulting from a reduction in some of both countries' subsidies and regulations, which a free trade agreement would probably require.

-- A U.S.-Canada free trade agreement would provide valuable experience and a blueprint for the more difficult and important negotiations in the new multilateral trade round. At the insistence of the United States, the talks in the ongoing multilateral round will address trade issues affecting agriculture, services, and investment as well as the proliferation of nontariff barriers. The United States and Canada have a common language, a shared political heritage and legal system, similar economies, a large volume of trade, and generally good trade relations. If we cannot resolve the remaining bilateral trade issues to our mutual benefit, the prospect of success in the multilateral round will be dim.

-- Most important, the status quo is not an option. In the absence of a bilateral agreement, trade issues involving automobiles, agriculture, lumber, and several types of services are likely to fester. That would lead to a worsening of U.S.- Canada trade relations, at a cost to both countries.

Although those additional benefits of a free trade agreement have not been quantified, the available evidence was sufficient to convince both governments that such an agreement would yield significant net benefits.

**The Asymmetric Perceptions of U.S.-Canada Free Trade**

The political route to a free trade agreement, however, will be rocky. A major barrier to the approval of the proposed agreement, as mentioned above, is the difference in the perceptions of bilateral trade issues in the two countries.

The United States, with rare exceptions, takes Canada for granted--a consequence of a long history of generally good relations. Many Americans perceive Canada as a friendly country of Mounties and forests somewhere north of Minneapolis. In a New Republic contest for the most boring headlines of the year, the first prize was awarded for a New York Times head-line, "Worthwhile Canadian Initiative." The U.S. press rarely reports on the negotiations for the proposed free trade agree-ment and its prospective effects. Although President Reagan's 1987 State of the Union Message mentioned his commitment "to complete an historic free trade arrangement between the world's two largest trading partners--Canada and the U.S.," such an agreement is not a major element of his program. Peter Murphy, the chief U.S. negotiator, is an able middle-level trade offi-cial supported by only a small staff and a few interagency committees. Few U.S. organizations and politicians have taken a strong position either for or against the proposed agreement. Negotiating a free trade agreement with Canada is clearly not a major priority in the United States.

The contrast with Canadians' perceptions is dramatic. For many years trade with the United States has been a central issue in Canadian politics. Prime Minister Brian Mulroney has made the proposed agreement the lead element of his economic program, and its failure to win approval could bring down his government. Simon Reisman, the chief Canadian negotiator, is a Liberal former senior minister supported by a large independent staff. The negotiations for and the prospective effects of the proposed agreement are regularly front-page news in the Canadian press. Many Canadian organizations and politicians have already expressed strong support for or criticism of the agreement. The outcome, whether it is approval of the agree-ment or a rejection by either government, will have a fundamen-tal effect on Canada's economy and politics for many years.

However, the two governments have been afflicted by some similar problems. The Reagan administration has been severely weakened by the Democratic victory in the 1986 congressional elections and by the continuing Iranamok saga. The large U.S. trade deficit has increased congressional pressure for protectionist measures and reduced the prospect for U.S. approval of the proposed agreement with Canada. The Mulroney government has been severely weakened by personnel scandals and by the perception that it is ineffective. Its critics continue to cite Canada's total trade deficit in manufactures, which is proportionately as large as that of the United States.

**Prior Trade Negotiations and Agreements**

A survey of prior U.S.-Canada trade negotiations and agreements provides insights into the problems and perceptions that will affect the outcome of the current negotiations.[6] The first such trade agreement was a consequence of Britain's repeal of the Corn Laws in 1846, which had the effect of eliminating the substantial advantage of Canadian exports in the British market. The Canadian colonies responded by increasing the duties on British goods and reducing the duties on U.S. goods in 1847, thus reorienting Canadian trade from Britain to the United States. The Canadian colonies also initiated negotiations for free trade with the United States--at the time, much of the business community favored political union as well-- but in 1851 the first round of negotiations failed because of U.S. indifference. A second round of negotiations led to the approval in 1854 of the Reciprocity Treaty, which provided for free trade in natural products and a few manufac-tures plus U.S. fishing rights off Canada's east coast.

The relations between the two countries deteriorated during the Civil War (a side effect of U.S. resentment of British support for the Confederacy), and the United States abrogated the Reciprocity Treaty in 1866. In response, the colonies formed the Canadian Confederation in 1867 and began to sort out their own commercial policies. The new Canadian government initiated negotiations for a new reciprocity treaty in 1874, but the U.S. Senate did not approve the proposed treaty. After that series of rebuffs from the United States, Canada once again turned inward. A Conservative victory in 1878 led to Prime Minister John MacDonald's "National Policy" of high tariffs, which were intended both to protect Canada's emerging manufacturing industries and to serve as a bargaining chip in negotiations for access to the U.S. market.

Those developments set the pattern of U.S.-Canada trade relations for nearly a century. Canada initiated new nego-tiations for a bilateral agreement in 1891 and expressed further interest during the late 1890s, but its overtures were again rejected by the United States. Canada had proposed a free trade agreement (with independent external tariffs), but the United States preferred a customs union (with common external tariffs). In 1911 a Liberal government negotiated a reciprocity treaty providing for free trade in natural products and reduced tariffs on manufactures, and the treaty was approved by Congress. The new Speaker of the House, however, elicited Canadians' sensitivity about their country's indepen-dence from the United States by suggesting that the agreement would probably lead to political union. Canadian industrialists provided the campaign slogan, "No Truck nor Trade with the Yankees," that helped the Conservative opposition defeat the Liberal government and the proposed reciprocity treaty in the 1911 election.

The United States and Canada entered confidential negotiations for a comprehensive free trade agreement in 1947. After a year they produced a draft agreement that provided for the immediate elimination of all tariffs, the gradual elimination of most quotas, and the adoption of a procedure for joint consultation. Liberal prime minister Mackenzie King, writing in his diary, reflected that the prospective effects of the agreement were "so far-reaching for good on one hand, but possible disaster if project were defeated that I find it necessary to reflect a good deal before attempting final decision."[7] In the end King's caution prevailed over his vision, and the treaty died.

Current U.S.-Canada trade relations are governed primarily by the General Agreement on Tariffs and Trade (GATT) and several bilateral sectoral agreements. Duty-free trade in farm machinery was approved in 1944. The Defense Production Sharing Agreement of 1958 provided for cooperation in weapons development and manufacture. The most important sectoral agreement is the auto pact--the Automotive Products Trade Agreement of 1965-- which was precipitated by pressure on the U.S. government from American parts manufacturers. They had charged, with considerable merit, that a new Canadian policy of reducing the duty payments on imported auto parts by an amount equal to the increase in automotive exports from Canada was in effect an export subsidy. Accordingly, they had called for the United States to impose a countervailing duty on automotive imports from Canada.

In order to avoid a confrontation on the issue, the two governments, after hurried negotiations, approved an agreement that provided for duty-free trade on all new automobiles and all original-equipment parts except tires. The other provisions of the agreement, however, were asymmetric. In order to qualify for duty-free trade, manufacturers had to maintain the preagreement ratio of Canadian production to Canadian sales as well as the preagreement level of Canadian value-added on their Canadian production. In separate agreements, to which the U.S. government was not a party, the manufacturers made commitments to increase their Canadian value-added by at least 60 percent of the increase in their Canadian sales. Although the auto pact was rigged in favor of Canadian production and has been the subject of periodic controversy in the United States, it has worked quite well. Trade in automotive vehicles and parts has grown rapidly and now constitutes about one-third of the merchandise trade between the two countries.

**The Background of the Current Negotiations**

The current negotiations for a more comprehensive free trade agreement came in the wake of a string of policy failures by Canada and opening moves by the United States. During the late 1950s Progressive Conservative prime minister John Diefenbaker attempted to shift up to 15 percent of Canada's trade from the United States to Britain. During the 1970s Liberal prime minister Pierre Trudeau attempted to shift Canadian trade from the United States to countries in Europe and elsewhere. Both of those efforts proved to be failures. The U.S. share of Canadian trade increased substantially during the interim, in part because of the auto pact, and the European share declined substantially.

The first of a series of U.S. efforts came in 1979, as a result of initiatives by leaders of both major parties. In the Trade Agreements Act of 1979, Congress requested a study of "the desirability of entering into trade agreements with countries in the northern portion of the western hemisphere to promote . . . the mutual expansion of market opportunities." In the same year Republican presidential candidate Ronald Reagan proposed a North American Accord. A 1981 report to Congress by the U.S. trade representative concluded that the United States should pursue separate trade discussions with Canada and Mexico rather than regional discussions. During Reagan's first term, U.S. Trade Representative William Brock aggressively promoted several bilateral free trade agreements, in part to pressure reluctant European governments to initiate a new round of multilateral trade talks. A free trade agreement between the United States and Israel was completed and approved in 1985. A similar agreement with the ASEAN countries was considered, but it was deferred when Reagan's planned visit to southern Asia was canceled following the murder of Benigno Aquino in the Philippines. U.S. officials recognized, however, that given the Canadians' sensitivity, a formal invitation to discuss a U.S.-Canada free trade agreement would have to originate in Canada.

The prospects for negotiating a more comprehensive U.S.- Canada free trade agreement, however, did not at first seem encouraging. In 1983 the Trudeau government proposed negotiations for additional bilateral sectoral agreements; although the two governments agreed to discuss trade in four sectors, the proposed negotiations were not implemented because the United States preferred a broader agreement. During his campaign for leadership of the Progressive Conservative party, Mulroney stated, "Free trade affects Canadian sovereignty and we will have none of it, not during the leadership campaign or at any other time." There was no mention of a free trade agreement during Canada's general election campaign in 1984.

The subsequent change in Canada's position may have been brought about by Canadian firms' recognition of the importance of having assured duty-free access to a large market. Their concern was magnified by increasing protectionist pressures in the United States. For whatever reason, Mulroney changed his mind. As prime minister of the new Progressive Conservative government, he met with President Reagan at the Shamrock Summit in Quebec City in March 1985 and agreed "to give the highest priority to finding mutually acceptable means to reduce and eliminate existing barriers to trade in order to secure and facilitate trade and investment flow." The trade representatives of the two governments were instructed to develop an agenda for negotiations within six months.

The next important development was the endorsement of bilateral free trade negotiations by the Royal Commission on the Economic Union and Development Prospects for Canada in August 1985. Donald MacDonald, the chairman of the commission, had been a senior economic minister in Trudeau's Liberal government, and the commission's endorsement reduced the danger that the negotiations would become a partisan issue. On September 26, 1985, Mulroney formally requested negotiations and pledged that Canada would "seek to negotiate the broadest possible package of mutually beneficial reductions in tariffs and nontariff barriers between our two countries."

The next obstacle to the negotiations almost proved to be terminal. Under U.S. trade law, the Reagan administration could initiate trade negotiations through the "fast track" procedure only if the House Ways and Means Committee and the Senate Finance Committee did not disapprove such negotiations within 60 days after being notified of a request for them. The Senate Finance Committee, however, failed to disapprove the negotiations by only a 10-10 vote--a vote that reflected congressional indifference and inadequate consultation by the administration more than strong opposition to the negotiations. Following that equivocal expression of support by Congress, negotiations finally began in May 1986.

**Related Trade Measures**

Both governments have taken trade measures that threatened to undermine the negotiations. On the day the first round of negotiations was completed, the United States imposed a large tariff on imports of cedar shakes and shingles, primarily from Canada, under an "escape clause" provision of U.S. trade law that exempts the government from providing proof of unfair trading practices. The timing of the cedar tariff decision, however, reflected the usual ineptness of the Reagan White House during the period rather than a calculated attempt to disrupt the negotiations.

To maintain the momentum for the negotiations, both President Reagan and Vice President Bush called Mulroney to apologize for what seemed like a rebuff. Canada responded to the cedar tariff decision by imposing increased tariffs on books, computer parts, and a variety of other manufactures. In October 1986 the Commerce Department announced a preliminary finding that the low stumpage fee charged to Canadian mills of softwood lumber constituted an export subsidy and should be subject to a countervailing duty of 15 percent. Because a petition based on almost the same information had been rejected in 1983, there was strong reason to believe that the primary purpose of the 1986 finding was to protect several Republican Senate seats in the November elections. The issue was resolved in December 1986, only when Canada agreed to impose a comparable export tax in order to avoid the imposition of a countervailing duty by the United States. Those two actions strongly reinforced the Canadians' concern about the security of their access to the U.S. market in the face of sectoral and regional political pressures in the United States.

Canada too is not without blame for taking measures that threatened to undermine the negotiations. In March 1985, a few days before the Shamrock Summit, Canada reinstated a provision of a program that permitted foreign manufacturers there to have their exports to the United States used as a basis for remissions of Canadian duties on imports from their home countries. The United States had objected strongly to a similar measure in 1978, claiming that such a duty remission program constituted an export subsidy. As a result, Canada had stopped basing the duty remissions on exports to the United States. In response to complaints from Michigan politicians, the United States strongly objected to the new duty remission program in 1986. Failure to resolve that issue, on which the U.S. position is clearly correct, would probably doom a bilateral free trade agreement and could lead to a U.S. abrogation of the auto pact.

In March 1987 Canada proposed to bar foreign firms from distributing movies there that they did not produce and for which they held the U.S. distribution rights but not the worldwide rights. The proposed measure would reduce U.S. movie sales in Canada by about 20 percent. Although President Reagan objected to the proposal during his April visit with Prime Minister Mulroney, it is expected to be reintroduced this summer. In March 1987 Canada imposed a large tariff on imports of U.S. corn, even though the volume of such imports had declined sharply and is now very small, to counter a U.S. subsidy.

All of those trade measures seem like a strange way of supporting the negotiation of a free trade agreement between friends, and they may yet reduce the prospects for approval of the proposed agreement by both governments.

**Major Issues in the Current Negotiations**

The United States and Canada entered the current free trade negotiations in substantial accord on many issues. Most important, they appear to have agreed that all tariffs on bilateral trade should gradually be eliminated. That might best be achieved by reducing the tariffs by one-tenth of the tariff rate per year or by one percentage point per year, whichever amount is larger. Doing so would reduce U.S. tariffs somewhat more rapidly than Canadian tariffs, eliminate small tariffs earlier, and eliminate all tariffs on bilateral trade by the end of 10 years. Among the other trade-related objectives on which the two countries appear to be in substantial agreement are the following:[8]

-- national treatment of government purchases,

-- reduction of regulations that impede trade,

-- improvement of the Air Transport Agreement,

-- facilitation of travel for business purposes, and

-- protection of intellectual property rights.[9]

Although the United States' position has been that all trade- related issues are on the table, the two countries have also agreed that the current trade negotiations will not consider a customs union (with common external tariffs) or exchange rate issues. Statements of the above objectives will form the core of the proposed free trade agreement; the rest of the agreement will involve issues in which U.S. and Canadian objectives differ.

**U.S. Objectives**

The U.S. objectives that are the most contentious in Canada include the following:

-- removal of nontariff barriers to trade, particularly in agriculture and services,

-- removal of restrictions on U.S. investment in Canada,

-- reduction of federal and provincial regional development subsidies, and

-- rescindment of the duty remission program designed to promote foreign (non-U.S.) investment in the Canadian auto industry. **Each of those issues deserves elaboration.**

Canadian agriculture, like American agriculture, is plagued by subsidies, tariffs, quotas, and marketing orders that limit competition both within the domestic market and from foreign producers. The production of fruits, vegetables, and tobacco, which constitute about 15 percent of Canada's agricul-tural output, is partially protected; the production of dairy products, poultry, and eggs, which constitute about 21 percent, is wholly protected.[10] Many of the regulations on agricultural products were imposed by the provincial governments, whose interests are not directly represented on the Canadian negotiating team. The Canadian Federation of Agriculture has opposed addressing agricultural issues during the free trade negotiations, and such issues may prove to be too complex to be resolved through a first-round agreement. Their resolution is probably not necessary for congressional approval of the proposed free trade agreement, but certain concessions by each country would benefit both countries. Opening the Canadian market to U.S. dairy and poultry products, for example, would increase congressional support for the agreement. In exchange, the United States might be willing to increase its quotas on imports of Canadian sugar and red meat. A major benefit would be the reduction of both countries' domestic subsidies and regulations, which would be necessary to permit more bilateral trade in agricultural products.

The negotiators are likely to have little trouble agreeing on the principles that should govern bilateral trade in the various financial, professional, and travel services. In fact, substantial progress has already been made. The most important principle is that a firm from one country operating in the other should be given national (or provincial) treatment. In other words, a U.S. firm operating in Canada should be subject to the same taxes, regulations, and other conditions as a Canadian firm, and a Canadian firm operating in the United States should be subject to the same conditions as a U.S. firm. The adoption of that standard would eliminate discrimination within each market but would not require a convergence of the two countries' tax codes or regulations. The U.S. negotiators should continue to resist pressure from Congress for a recipro-cal treatment standard, under which a U.S. firm operating in Canada would be subject to the same conditions as a Canadian firm operating in the United States; such treatment is not truly reciprocal in the absence of a common tax code and regu-lations.

One of the most contentious issues in Canada is the protection of its cultural industries. Canadian firms are not allowed to take tax deductions for advertising in American magazines or on American television programs, for example, and, as mentioned above, a proposed measure would restrict the distribution of American movies in Canada. Although the issue is not important in the United States, the Canadian position on it is simply unreasonable. The United States has not objected to the Canadians' subsidies of their cultural industries; indeed, many Americans benefit from those subsidies. Rather, it has objected to the clearly discriminatory allocation of access, the benefits of which accrue primarily to Canadian distributors, not directly to the producers of Canadian culture. American television stations have also voiced a legitimate grievance: that their signals are rebroadcast in remote areas without their approval and without their being compensated.

The Mulroney government has substantially reduced the United States' concerns about restrictions on U.S. investment in Canada, by easing the discriminatory provisions of the Foreign Investment Review Act and the National Energy Program. The primary investment-related objective of the free trade negotiations should be to assure both Americans and Canadians that their investments will not be subject to the retroactive application of any future regulations that discriminate among investors by national origin. A law that restricts foreign ownership of Canadian financial institutions to 25 percent of the outstanding shares protects those institutions from takeovers by foreign firms but not competition from them; it is not a significant barrier to foreign investment.

Federal and provincial regional development subsidies are a contentious issue in the United States as well as in Canada and have been the grounds for countervailing duties. The U.S. position on such subsidies is unreasonable; as a rule, they change the regional distribution of production but not the total level of production and therefore should not be considered export subsidies. U.S.-based firms, of course, have no cause of action against subsidies of their competitors in other states. The best approach would be to extend the same standard to Canada, but Congress has made it clear that it is not willing to exempt Canada from any of our trade remedies. The second-best approach would be to increase the minimum standard for a subsidy that warrants a countervailing duty from 2.5 percent of cost to 5 percent or 10 percent.

A provision to change a Canadian program so that exports to the United States are no longer part of the basis for the remission of duties on imported auto parts is a necessary condition for congressional approval of the proposed free trade agreement. Moreover, unless the program is changed, the United States is likely to abrogate the auto pact, which would substantially reduce the volume of bilateral trade. The periodic extension of the duty remission program in its present form suggests that the Canadians do not realize the seriousness of the issue.

## Canadian Objectives

The Canadians' dominant objective in the free trade negotiations is to avoid what they describe as "contingent protection" by the United States. They perceive correctly that the growing protectionist sentiment in the United States has led its government to implement legal trade remedies more aggressively and to put extralegal pressure on other governments to impose "voluntary" export restraints. In some cases, such as the cedar and softwood lumber decisions, Canada has been directly affected. In other cases, such as the steel agreements, Canada has been indirectly affected by measures aimed at other countries. The Canadians are more concerned about the variability, unpredictability, and apparent arbitrariness of the implementation of U.S. trade laws than about the current level of U.S. tariffs and other trade restraints. Canada would prefer to be exempt from U.S. trade remedies, but Congress is most unlikely to grant that exemption. Although the Canadians are extremely sensitive about their independence, in effect they want U.S. trade laws to treat them as Americans. That will surely prove to be one of the most difficult issues for the U.S. negotiators to resolve.

An ideal agreement would indeed exempt Canada from U.S. trade remedies--in other words, treat trade with Canada the same as trade with California--but a viable alternative is to resolve the issue on a piecemeal basis. The easiest problem to eliminate is dumping below the domestic price; a simple agreement to permit reexport of any good would be sufficient to prevent it. An agreement to gradually reduce subsidies and gradually increase the minimum standard that triggers counter-vailing duties would eventually lead to the elimination of those duties. The most difficult problem to eliminate is the "escape clause," or "safeguard," basis for trade restraints. The only solution is for each country to agree to substitute temporary subsidies to industries injured by increased imports from the other country for increases in tariffs or other trade restraints directed specifically at that country. Although the issue is complex, it must be resolved in order to make a free trade agreement worthwhile to Canada.

Another potential roadblock is that the premiers of Ontario and Quebec have made their support for a free trade agreement contingent on the United States' willingness to maintain the auto pact. The concern reflected in that stance appears to be unmerited. U.S. auto firms have made major investments in Canada in order to supply both countries' markets, and labor costs are now substantially lower in Canada than in the United States. Unless labor relations in Canada deteriorate substantially, the provisions of the auto pact that favor Canadian producers are likely to be redundant. The Canadians should not expect to have both certain access to the U.S. market and certain protection of their producers.

The Canadians have also expressed concerns about the Buy America provisions of federal and state legislation and about the inadequacy of the current bilateral dispute settlement procedures, but those issues should be relatively easy to resolve. The United States appears prepared to delete all of its Buy America provisions that affect Canada except the ones based on the most narrow national security grounds. And the proposed free trade agreement, as explained below, will surely establish a joint trade commission to develop recommendations for resolving subsequent trade issues.

## The Framework for a Free Trade Agreement

Article 24 of the General Agreement on Tariffs and Trade provides the basis for a bilateral trade agreement. The article authorizes such an agreement only under the following three conditions: -- that the agreement would eliminate tariffs and non- tariff trade barriers on a substantial proportion of bilateral trade,

-- that the agreement would be implemented within a reasonable period of time, and

-- that the agreement would not lead to an increase in tariffs and nontariff trade barriers on imports from other countries.

Thus, only a broad trade agreement would be authorized by the GATT. Moreover, only a broad trade agreement would be worth- while to both the United States and Canada, given the current large volume of their duty-free trade. A single broad agreement, however, should not be expected to resolve all of the bilateral trade issues. Some of them appear to be too complex or too contentious to be resolved in a few months. An agreement that covered agriculture, changes in the auto pact, and several types of subsidies would be the most desirable, but consideration of those issues can be deferred to subsequent negotiations.

A major political problem in achieving approval of the proposed U.S.-Canada free trade agreement is that each government must offer at least one major concession to make the agreement acceptable to the other government. The U.S. opposition to the agreement is broad but not organized; the general attitude toward trade issues in Congress, however, is more protectionist now than it has been since 1930.

In contrast, the Canadian opposition to the free trade agreement is broad and vocal. Several thousand activists protested against the agreement during the Reagan-Mulroney meeting in Ottawa in early April 1987. According to one account, "this collection included representatives of the peace movement, environmentalists, unionists, members of the 'cultural' industries, spokesmen for the large churches, and nationalists of all stripes."[11] The free trade issue has greatly increased the visibility of Robert White (the leader of the now-independent Canadian Auto Workers), increased the support for the socialist New Democratic party, and divided the Liberals. Mulroney's own political weakness and his government's continuing disputes with the United States over acid rain, defense, and the Northwest Passage increase the importance of a free trade agreement in which the United States is perceived to have made a major concession.

The general problem of maintaining free trade is that the support is diffuse and the opposition is concentrated. The major challenge of each country's negotiators will be to create concentrated support for the agreement in the other country. A broad trade agreement will not be approved without concessions by both governments. For that reason, the agreement must provide for a substantial change in the implementation of U.S. trade remedies that affect Canada. Similarly, Canada's concessions must include changing its duty remission program to exempt exports to the United States. Another Canadian concession that may be required to gain the approval of Congress is a national treatment rule for services, investment, and government procurement. Any negotiating strategy that avoids those issues is bound to fail. The strategy outlined below may also fail, but for the right reasons. If it succeeds, the ben-efits to both countries will be greater and the bilateral agreement will be a suitable model for a multilateral agreement.

Thus, the U.S.-Canada free trade agreement should include the following six provisions:

1. the elimination of all tariffs over a period no longer than 10 years,

2. a relaxation of the trade remedies that specifically govern trade with the other country, combined with a gradual reduction of subsidies on exported products,

3. a change in the Canadian duty remission program for imported auto parts,

4. a national-treatment rule for services, investment, and government procurement,

5. an agreement to undertake negotiations on unresolved trade issues, including agricultural restraints, the auto pact, and various subsidies, and

6. the establishment of a joint trade commission to develop recommendations for resolving any developing trade disputes.

It is disturbing that such an extraordinarily complicated process is needed to permit two firms to trade with each other across a national border. Henry George observed that "the lesson of the protectionists is to do to ourselves in peacetime what an enemy attempts to do to us in wartime." The United States and Canada have a long history of friendly relations; we should approach the negotiations as friends. Only mutual trust can lead to mutual benefits.

**FOOTNOTES**

[1] All monetary data are expressed in U.S. dollars. The reconciled value of U.S. merchandise exports to Canada is $6.6 billion higher than the published U.S. data indicate, largely due to the nonreceipt of records on a variety of agricultural and other merchandise exports.

[2] Bob Hamilton and John Whalley, "Geographically Discriminatory Trade Arrangements," Review of Econoics and Statistics vol. 67, no. 3 (August 1985): pp. 446-55.

[3] David Cox and Richard Harris, "Trade Liberalization and Industrial Organization: Some Estimates for Canada," Journal of Political Economy 93 (February 1985): pp. 115-45.

[4] Richard Harris, "Economic Impact on Canada of Changing Trade Barriers between Canada and the United States," paper presented at a Brookings Institution conference, February 3, 1987.

[5] Most of these points are made in Peter Morici, "An American View of the U.S.-Canada Free Trade Negotiations," paper presented at a Brookings Institution conference, February 3, 1987.

[6] A good summary of the history of U.S.-Canada trade is presented in Paul Wonnacott, "The United States and Canada: The Quest for Free Trade," Institute for International Economics, March 1987.

[7] Ibid.

[8] Ibid.

[9] One property rights issue, however, is still festering. Canada now requires that foreign producers of generic drugs license production to Canadian firms at low royalty rates. Although the Mulroney government promised to change that provision, the issue has not yet been resolved.

[10] T. K. Warley and R. R. Barichello, "Agricultural Issues in a Comprehensive Canada-U.S.A. Trade Agreement: A Canadian Perspective," paper presented at a Brookings Institution conference, February 3, 1987.

[11] Jean-Luc Migue, "Canadian Activists in Solidarity against Trade Bill," Wall Street Journal, April 24, 1987.