PART II

CANADIAN OPPORTUNITIES IN AN OPEN WORLD

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Introduction

The global environment presents an enormous challenge to Canada today, and that challenge will increase over the next two decades. In political terms, it is one of managing international interdependence and of building new relationships that will accommodate the growing importance that nations have for one another. In legal terms, it is one of adjusting existing structures to new realities. In economic terms, it is one of accommodating and mastering new technologies and of adjusting to a more competitive world economy than has ever been known before. In sum, the challenge is one of change, adaptation and adjustment. It constitutes one of the most difficult problems faced by modern nations and their governments.

The challenges of the global environment bear on all countries, and Canada is not alone in facing them. Nor are the problems more severe for Canada than for other countries. Today many nations are going through an exercise of soul-searching to determine how modern global relationships will affect their futures. The task involves examining the nature of the global challenge and then exploring how particular national institutions and processes can respond to that challenge. This undertaking is first of all a task of analysis, one that takes account of the historical development of a nation and its people, and of the unique institutions and processes that it has established to govern itself. Secondly, it is a task of decision and action, one that adjusts national practices to the realities of the global environment.

Any analysis of Canada and the global environment must take account of the themes of the Canadian historical experience. These themes distinguish our experience from that of other nations. They appear in the history of our country from its earliest beginning, and they must be addressed in any program for future change. One such theme is that Canada's domestic economy is largely defined by its relation to the global economic system. Most

Canadians or their ancestors are or were immigrants from Europe, and they brought with them customs and culture from the "old" countries. Once in North America, Canada's immigrants found their culture profoundly affected by the economic geography of their new land. Trade with their mother countries and with industrial centres in Europe and the United States sustained economic activity in Canada and, in turn, shaped the institutions of the new country. As Canada's eminent political economist Harold Innis has observed, Canada emerged as a political entity with boundaries largely determined by the fur trade. In his words: "The lords of the lakes and forest – the beaver – have passed away, but their work will endure in the boundaries of the Dominion of Canada and in Canadian institutional life." Today the image of Canada is less romantic, but our nation's economy is still deeply influenced by external economic relations, as reflected in the fact that foreign trade accounts for over 30 per cent of Canada's gross national product. In this dimension, Canada ranks among the most trade dependent of the nations belonging to the Organisation for Economic Co-operation and Development (OECD).

A second theme is that of Canada as a hinterland and resource-producing economy. In the colonial period, Canada was situated on the margin of European civilization, and its economic relations with the centre were driven by its exports of staples: fish, fur and, later, timber and wheat. As the nation grew, and as a changing technology came to demand increased use of metals, Canada's vast riches of minerals and ores were developed for export to more highly industrialized nations. Today Canada is a fully-industrialized nation producing a wide range of manufactured goods. While resources continue to be an important building block in the Canadian economy, their relative function will not be as great in the future as it has been in the past. In pursuing resource-development opportunities, Canada will continue its long-standing policy of seeking to extend the further processing of resource products beyond the primary stage.

A third theme is that of industrial development. Since Canada's beginning as a nation, our governments have sought to promote the growth of a manufacturing industry so that Canadians would have opportunities to earn their living in ways other than as "hewers of wood and drawers of water". The cornerstone of these efforts was the National Policy announced by Sir John A. Macdonald in 1878 and implemented by his government in 1879. This policy instituted a protective tariff for Canadian manufacturers and provided east-west transportation links meant to build a strong national economy. The goals, and to some extent the means, of the National Policy have been maintained to the present day; they are reflected in the fact that Canada's tariffs are some of the highest among those applied by the OECD nations. At a time when nations have been debating the appropriate form of industrial policy with which to face the problems of the 1980s and the years beyond, it is useful to recall that Canada's industrial policy has undergone major changes since the National Policy was introduced in 1879. It is also important to remember that the cornerstone of Canada's industrial policy has been its trade policy.

A fourth theme is that of the role of the state in the economy. Because Canada historically exported raw materials, the Canadian government became closely involved in economic activity through providing transportation, finance and other support services. It spent heavily on railroads and canals, and provided large grants and subsidies to support other infrastructural development. Government involvement in the economy began in earliest colonial times with the trade in fur and fish, and the pattern reinforced itself with each new staple commodity Canadians produced. In our own day, governments, both federal and provincial, are major players in our national economy, and any attempt to analyse and make recommendations to improve Canada's economic performance must necessarily take account of this fact.

A fifth theme concerns Canada's relations with the United States. In historical terms, the United States constitutes a central problem for Canada because it provides such a strong engine of growth for our exports, and yet, on account of its strength, may pose a threat to our Canadian identity.[1] Much of Canadian domestic and foreign policy has been heavily influenced by the Canada-U.S. relationship. For example, the National Policy was both a domestic policy of economic development and also a foreign policy designed to stem the southward flow of emigrants from Canada to the United States. Moreover, it was promoted, in part, on its appeal to anti-Americanism. In modern times, economic events have deepened Canada's economic relations with the United States, and this development, in turn, has magnified Canadian concern with the problem of renewing and strengthening our national identity. Today Canada-U.S. relations are an unavoidable issue on our nation's economic-policy agenda, and it is certain that their handling will be as deeply politicized in the future as it has been in the past.

These, then, are five themes that have influenced Canada's economic development. In the 1980s and beyond, Canada will face new problems, but its response will blend old institutions and procedures with adjustment to new realities. These themes will help to define the new problems Canada faces, and they will set the parameters within which our nation will take future action. The task for Canada is to retain its character and identity while meeting the challenges that a changing economic environment will place before it.

Note

1. See J.L. Granatstein, "The Issue That Will Not Go Away: Free Trade Between Canada and the United States", in *The Politics of Canada's Economic Relationship with the United States*, vol. 29, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).

The Formative Years: From Colonial Times to 1945

From the earliest stages of European settlement, economic activity in Canada has been based substantially on trade. As, first, France and, subsequently, England founded settlements in the northern half of North America, the economies of the various political units established there followed widely-recognized patterns of colonial development. The colonies supplied the mother country with their most valuable and readily accessible raw materials and were, in turn, supplied with manufactures. This interchange, which some Canadians have come to view as an exploitive connection, was originally a relationship of convenience and even of necessity. The investors who sponsored settlement of the colonies relied on returns from natural resources to make their enterprise profitable. The European settlers relied on manufactured goods from "home" to make their life in the new world tolerable.

Canada's early development, like that of other colonies, was based on the export of a small number of staple goods: first, furs and fish, and subsequently, timber and wheat. Later, Canada's international economic relations reflected both continued reliance on extensive trade in staple products and the desire to develop a manufacturing sector; manufacturing was seen as necessary to ensure long-term national stability and prosperity. Historically, the first of these two thrusts has been the major force behind Canada's policy of liberalizing trade. The second has provided our motive for adopting protective trade measures.

In the late 1840s, Canada's economy began its evolution from the old colonial system to a regime in which trade with the United States has become increasingly important. The repeal of the Corn Laws in Great Britain, in 1846, sparked some Canadian interest in trade reciprocity. The shift in British policy from mercantilism to free trade confronted Britain's colonies with the necessity for changing their own trade policies. Coupled with this pressure was the economic damage that the world depression of the early 1850s inflicted on British North America: businesses went bankrupt, public debt increased, and unemployment grew. It was under these circumstances that the British North American colonies, in pursuit of renewed economic prosperity, turned to trade with the United States.

Although the Americans had rejected the British North American Colonies' earlier offers of reciprocal free trade, the United States signed a Reciprocity Treaty with these five colonies in 1854. By the terms of this treaty, all signatories gained rights of reciprocal free trade in natural products, free navigation of the St. Lawrence and Great Lakes water systems, and fishing rights off the Atlantic coasts. Predictably, the Reciprocity Treaty increased trade between the colonies and the United States. From 1854 to 1855, the volume of trade between the United States and the British North American Provinces more than doubled.

By 1866, however, the U.S. Administration realized that imports from the BNA colonies were beginning to outweigh corresponding American exports, thus creating an unfavourable bilateral trade balance for the United States. In addition, bitterness developed south of the border about certain tariff increases on goods manufactured in the colonies, which were not covered by the Reciprocity Treaty. Finally, and perhaps most important, ill feeling was generated against the colonies during the U.S. Civil War, partly because of Britain's apparent support of the South against the Union, as evidenced, for example, by the seeming British and Canadian laxity in controlling Southern representatives in Canada during the war and by incidents like the St. Albans raid. For these and other reasons, on March 17, 1866, the United States exercised its right under the Treaty to terminate its agreement.

In that same year, Sir Alexander Galt, the then Minister of Finance, introduced the Tariff of 1866, which represented a direct reversal of the high-tariff policy that he had proposed in 1858. The Act of 1858 had, for the first time, advocated protectionist principles in Canada; the Tariff of 1866 reduced the average duty on imported goods. These reductions were intended to help secure the union of the British North American Provinces in Confederation. Few British North Americans, however, supported the idea of uniting the economy of the proposed Confederation with a common tariff. In the Maritime colonies, which traditionally had favoured free trade, one of the strongest arguments put forward against entering Confederation was the high level of duties imposed by the Province of Upper Canada. Many Maritimers feared that their prosperity would be seriously undermined if their trade were to be effectively restricted to the "two or three millions of people who live in the rear".[1] Furthermore, they believed that rapid expansion into the West, which the proponents of Confederation living in the Canadas hoped to achieve, would impose additional and onerous financial burdens.

For the Fathers of Confederation, the creation of a viable and integrated national economy was a prime goal. Representatives of Canada at the pre-Confederation meetings, especially John A. Macdonald and George Brown, gave this aim an especially high priority. They believed that their objective of an effective economic union could be achieved only through the integration of the diverse resources and industries of the various provinces. The colonies could no longer rely on a single resource or industry: if the Maritime fisheries encountered difficulties, for example, agriculture in Upper Canada would be a dependable resource to help restore the economic balance.

Inherent in this objective was the goal of increased trade both inside and outside the proposed union. There was hope that the removal of tariffs among the provinces-to-be and the improvement in their communication would eventually result in increased trade when the provinces entered Confederation. It was expected, too, that union would result in increased international export trade, and that the new nation of Canada would achieve a prominent place in international markets. Although manufacturers and politicians expected Confederation to stimulate growth in trade and economic development, it was apparent that:

> *There was no general demand that Confederation should be strengthened by a national policy of protection ... It was not upon protection, but upon geographical position, natural resources and widened markets that the manufacturing interests of the different provinces based their hopes.*[2]

Shortly after Confederation, in the early 1870s, Canada tried to negotiate a new Reciprocity Treaty with the United States; the attempt failed. In 1878, Sir John A. Macdonald, with the same objectives in view that he had held earlier, decided to adopt a policy of protectionism. On March 7, 1878, Macdonald made his intentions known in the House of Commons. He moved that:

> *... the welfare of Canada requires the adoption of a National Policy, which, by a judicious readjustment of the Tariff, will benefit and foster the agricultural, the mining, the manufacturing and other interests of the Dominion; that such a policy ... will prevent Canada from being made a sacrifice market, ... and moving (as it ought to do) in the direction of a reciprocity of tariffs with our neighbours, so far as the varied interests of Canada may demand, will greatly tend to procure for this country, eventually, a reciprocity of trade.*[3]

Canada's continuing desire for reciprocity was, then, a major force behind Macdonald's proposal. At the time, Macdonald believed that the low tariff Canada had imposed was benefiting the United States to the detriment of Canadian economic interests, especially in manufacturing. He argued that since Canadian markets were already open to the Americans, there was no incentive for the United States to negotiate a new Reciprocity Treaty. "It is only by closing our doors" he claimed, "and by cutting them out of our markets, that they will open theirs to us."[4] Macdonald's policy was, in many ways, a second attempt to achieve the economic goals which the Fathers of Confederation had hoped to attain through Union, but which so far had not been reached.

Macdonald had other reasons, directed to the same end, for the introduction of a protectionist tariff. First of all, he considered the tariff a means of controlling emigration, believing that it would retard the outflow of Canadians to the United States. Under the new tariff, he was sure, Canada's industries would flourish, and employment would increase; thus Canadians would no longer have to move south of the border in search of jobs. Secondly, he saw the introduction of high tariffs as a means of fostering industrial development in Canada. If manufacturers enjoyed reasonable protection, they, like their American counterparts, could develop their own resources and gain control over a number of key industries within their particular sectors. This development would stimulate investment which, in turn, would provide revenues to finance new transportation facilities and generally expand the Canadian economy.

Macdonald and others saw protection, too, as representing a policy of "nation building" through import substitution. Tariff adjustment, they contended, would increase trade among the provinces and send products to eastern and western areas of Canada, instead of to the United States or to England. It would also encourage manufacturers and consumers to buy from Canadian suppliers. The increased duty on certain articles would be especially significant for goods that Canadians could produce and manufacture themselves. The device worked: the new tariffs fostered and encouraged interprovincial trade. The result was much to be desired, for even after

Confederation, the provinces had had little connection with one another, except for a common allegiance to Great Britain.

The tariff was put to its first popular test in the election of 1891. Export trade had been traditionally important to Canada, and it had always proved difficult to maintain a balance between measures which expanded trade and those which protected domestic industries. Moreover, the 1880s had been difficult years for our country. As a result, many Canadians had begun to question the protectionist approach and, indeed, to look again at Canada-U.S. reciprocity as a likely source of renewed economic prosperity.

The Liberal party, now under the leadership of Wilfred Laurier, adopted as an election platform "unrestricted reciprocity", a Canada-U.S./free-trade arrangement which allowed both countries to set their own tariffs. Sir John A.'s Conservatives had, indeed, briefly explored the possibility of reciprocity with the United States, but when their overture was rebuffed, they quickly labelled the Liberal position "virtual treason". In the opening speech of the 1891 election campaign, Macdonald made his now-famous statement: "A British subject I was born, a British subject I will die." His purpose was to evoke patriotism to Queen and Empire in order to defeat the French, Roman Catholic-led Liberals. The Liberals dropped the issue of reciprocity, at least publicly, and subsequently won the election of 1896.

In 1904, the then Minister of Finance W.S. Fielding, in defending Canada's tariff levels, clarified the industrial development goals of the tariff:

> *I think, Sir, as to whether or not it is adequate protection we have some evidence of a gratifying character that the tariff, without being excessive is high enough to bring some American industries across the line and a tariff which is able to bring these industries into Canada looks very much like a tariff which affords adequate protection. If my honourable friends opposite wish to see some of the good results of the tariff let them go up to the city of Hamilton and look at the vast industries which have been established there by American capitalists who have come across the line under the operation of this tariff, and who are now engaged in carrying on very large businesses. Let them go to the city of Toronto and they will find similar organizations of American capital starting in the manufacturing business. So, we are able to say that not only has the tariff been a great revenue tariff, but one which has afforded a reasonable degree of incidental protection and one which has brought about, as far as these industries are concerned, very gratifying results.*[5]

Between 1900 and 1910, Canada's average annual manufacturing-growth rate was 5 per cent. Growth at this pace had been unprecedented in British North America. Although the tariff had achieved some apparent success in promoting Canadian manufacturing and interprovincial trade, the issue of Canada-U.S. reciprocity was still in the air. The Liberal government continued to put out feelers in Washington. It was encouraged in this undertaking by the pro-free-trade sentiments of Western farmers, who resented paying artifically high prices for farm implements and manufactures produced in central Canada.

In December 1910, farmers besieged the Parliament buildings in Ottawa to press their case. The government was impressed by these demonstrations, not only because of their vehemence, but because of the continuing importance of staple products and their producers to the Canadian economy. As vital as the manufacturing sector was becoming, staples – wheat, fish, timber and minerals – continued to be the backbone of the economy, especially in western and eastern provinces. Thus the growth of manufacturing in central Canada, combined with the continued prominence of staples production in the Atlantic and western provinces, made the reciprocity debate a regional conflict. This geographic dimension of the free-trade issue has subsequently contributed to the growth of regional conflict in Canada, as well as to the sense of alienation in the less populous Western and Maritime regions.

In January of 1911, an election year, Finance Minister Fielding announced to Parliament that a reciprocity agreement had been concluded with the United States. That agreement provided for free trade in a wide variety of primary products and for tariff reductions on many other goods, notably farm machinery and implements. It was clearly aimed at supporting the agricultural community, but it also retained considerable protection for manufactured goods. Nonetheless, as Conservative leader Robert Borden considered how to oppose the agreement, he found willing and active support in the central-Canadian business and financial community. Business people, including many disaffected Liberals, feared that free trade in primary products was just the beginning of a process that would soon engulf their firms and remove the protection they had enjoyed. They resolved to support the Conservatives in their fight against the Liberals on reciprocity and in the election. Their support, however, was conditional: Borden secretly agreed that if he were elected, he would bring in ministers from outside Parliament and consult a group of prominent, formerly Liberal, business leaders on the composition of his Cabinet. These conditions met, the business community put its substantial resources into the fight against reciprocity, through the Canadian National Association and the Canadian Home Market Association, which was sponsored by the Canadian Manufacturers' Association.

The resounding defeat of Laurier's Liberals in 1911 came about, in part, because of the strength of Henri Bourassa's *Nationalistes* in Quebec, but to an even greater extent, because of the reciprocity issue. The latter reason made that defeat significant on two counts. First, the Liberal loss demonstrated the power and resolve of central Canada's manufacturing interests, which had grown and thrived behind the protective wall of the National Policy. Secondly, the Conservatives won the election because of the popular appeal of the anti-reciprocity argument, based on a carefully orchestrated campaign of anti-Americanism and, implicitly, of British and Canadian nationalism. The election campaign of 1911 demonstrated the strength of Canada's new nationalism, particularly in the context of the presumed threat to Canadian sovereignty, posed by the possibility of free trade with the United States. This perception of looming American economic domination has since promoted an appeal to Canadian nationalism whenever the issue of Canada-U.S. trade has surfaced in debates on these matters.

In spite of Canada's rejection of reciprocity in 1911, its trade with the United States continued to grow. The growth was hastened by the First World War, which generated increased economic integration and co-operation between the two North American Allies. The United States emerged from the War with the world's strongest economy, but Britain had declined in economic strength. For Canada, this development resulted in an inevitable change in foreign-investment patterns. Capital investment from the United States rapidly equalled and soon surpassed the traditionally dominant investment from British sources. In a country which has always relied heavily on foreign capital to finance its economic development, this change was of profound economic and political importance.

In 1921, the trend towards Canada-U.S. economic integration was temporarily halted by the passage, in the United States, of the Emergency Tariff Act. This Act initiated a decade of steadily increasing American tariffs, matched turn for turn by Canada, and culminating in the Smoot-Hawley Tariff of 1930, which set the record of American trade protection. Combined with the market crash of the Great Depression, this escalating protection crippled Canada-U.S. trade. Prime Minister Bennett retaliated against the Smoot-Hawley Tariff by trying to extend British Imperial preferences to compensate for lost U.S. trade. Such measures, however, were plainly inadequate, and the unprecedented protection imposed by the United States was clearly harmful. In 1933, Franklin D. Roosevelt became president. With his predisposition to lower tariffs, he and Bennett soon agreed, under the U.S. Reciprocal Trade Agreements Act of 1934, to begin a search for means to increase the exchange of commodities between their two countries.

By the early 1930s, Canada, for the first time, had a small team of trade experts in the civil service. Nevertheless, progress towards trade liberalization was slow, and talks with the United States stalled in August 1935. They were enthusiastically resumed, however, after MacKenzie King defeated R.B. Bennett in the federal election of the same year, and on November 15, 1935, the first Canada-U.S. trade pact since the Reciprocity Treaty of 1854 was signed. By the terms of the new treaty, each nation extended most-favoured-nation (MFN) status to the other and agreed to a few more specific provisions. The result was to roll the tariff back almost to its 1920 level.

Both Canada and the United States, however, regarded this agreement as only a first step, especially in view of their bitter experiences during the Great Depression. "Our stake in world trade," wrote External Affairs counsellor Norman Robertson, in 1937, "and the peculiar degree of dependence of our industries on export markets have identified Canada's real national interest with the revival and liberation of international trade."[6] It was not possible at the time, however, for the Americans to make further tariff cuts, since political constraints and the U.S. Reciprocal Trade Agreements Act prevented them from cutting their tariffs by more than 50 per cent. Nor could we Canadians cut our tariffs unilaterally because we were committed to maintain a margin of trade preference with other British Empire countries. The system of Imperial preferences meant that further Canada-U.S. trade negotiations would, of necessity, have to involve trade negotiations with

Britain and other Dominions. It was, in fact, in the course of British-American trade talks, in 1937, that the next round of Canada-U.S. talks was initiated. These talks were held in response to British requests that Canada abandon certain preferences in order to facilitate British-American tariff cuts.

The talks that followed were important. Like the first multilateral trade negotiations, they set the pattern for the international conduct of trade policy during the post-Second World War era. For each commodity under consideration, Canada had to hold separate discussions with the United States and Britain and, frequently, with Australia, New Zealand and South Africa, as well. Although the discussions were frustratingly slow, they yielded an agreement, signed on November 17, 1938, whereby Canada gained easier access to the United States for 129 of its commodities, and the United States removed or reduced most of its remaining import quotas. The United States, for its part, gained improved access to Canada for a variety of its manufactured goods. By way of further concession, Canada was forced to relinquish British preferences on a number of its primary products.

These negotiations set the precedent for the multilateral trade-liberalization discussions that have dominated the post-war trading system. Predictably, the lowering of Canadian tariffs on U.S.-manufactured goods raised opposition from the Canadian Manufacturers' Association. The talks, however, resulted only in tariff reductions: free trade was not extended to any new items. The avoidance of free-trade terminology may well have been an important feature in preventing any widespread, emotionally based, nationalistic opposition to the agreements. Presented as a simple attempt to get trade moving again and to create jobs, the agreements disarmed the critics; any complaints sounded like special pleading.

Notes

1. Cited in D.G. Creighton, "British North America at Confederation", study prepared for the Royal Commission on Dominion-Provincial Relations, Appendix 2 (Ottawa: J.O. Patenaude, 1939), p. 41.
2. *Ibid.*, p. 47.
3. Canada, House of Commons *Debates*, vol. 1, 1878, p. 854.
4. *Ibid.*, p. 862.
5. Canada, House of Commons *Debates*, vol. 3, 1904, p. 4351.
6. Cited in J.L. Granatstein, *A Man of Influence: Norman A. Robertson and Canadian Statecraft, 1929–68* (Ottawa: Deneau, 1981), p. 66.

The post-War Years: Predominance of the International System

The Second World War marked Canada's coming of age as a sovereign nation. Canada contributed significantly to the war effort, built up its manufacturing sector to produce war materiel, and established lasting relationships with a growing range of countries. By the end of the war, it was ready to assume an important and influential role in world affairs, particularly in the areas of trade and finance. Despite these ambitions, the period immediately after the war was one of stagnation for Canadian external trade as our overseas customers struggled to recover from years of destruction and subsequent balance-of-payments difficulties. These problems were particularly serious for the United Kingdom, and they caused further deterioration in the relative position of the United Kingdom among Canada's trading partners.

The economic effects of the war did not last long, however, and by 1950, production and trade had revived in the North Atlantic area. World trade grew steadily after 1950, averaging about 6 per cent per year and outpacing world growth in production. The proportion of world output of goods and services that crossed national boundaries almost doubled over this period, rising from 11 per cent in 1950 to 21 per cent in 1980. The change in composition of trade has been as significant as its absolute growth. Trade in industrial products and services has grown steadily, compared to trade in agricultural products and raw materials. Manufactured goods now account for a much larger share of trade than they did in the immediate post-war period.

Between 1950 and 1970, trade grew most rapidly among the Western industrialized countries and with Japan. Post-war reconstruction and the formation of the European Community (EC) were among the processes that contributed to this development. While relative shares of total trade changed, all Canada's chief trading partners experienced substantial growth in the volume of their foreign trade, relative to domestic production. Among them, Germany, Japan and some other nations made spectacular gains; still others, such as the United States and the United Kingdom, were faced with substantial declines in their shares of world trade. The U.S. share of world exports, for example, dropped from 22 per cent in 1950 to 10 per cent in 1980, while its exports as a proportion of U.S. gross national product (GNP) rose from about 5 per cent to 10 per cent over the same period.

During these years, the European Community emerged as the world's largest trading bloc; its external trade now equals the combined shares of the United States and Japan. The developing world also made gains: by 1983, the developing countries' share of world trade had reached almost 30 per cent. As for Canada, between 1951 and 1960, its exports grew, in real terms, at an average annual rate of about 4 per cent for the decade after 1951. This rate is low compared to that of the 1960s, when Canada's exports attained an annual average growth rate of over 9 per cent.

During the 1950s, Canada's economic infrastructure also developed extensively: the building of pipelines, the construction of the St. Lawrence

Seaway, and a major expansion in oil, metals and minerals paved the way for the increase of exports in the 1960s. Much of this development was secured through foreign investment.

Rising exports of finished manufactured goods accounted for the expansion of Canadian trade that took place in the 1970s. Canadian exports of this type of goods nearly doubled in volume between 1971 and 1981. Primary manufactured goods, generally consisting of fabricated materials, were sold to foreign markets in quantities slightly more than 40 per cent above the total of 1971 shipments. In addition, Canada exported almost 40 per cent more foodstuffs. Between the early and late 1960s, Canadian exports of fabricated materials and finished manufactured goods rose from about 60 per cent to nearly 70 per cent of our total export trade, and they have remained at this level. The relative increase has been greatest for our exports of fully-finished manufactured products and especially, under the Auto Pact, for our foreign sales of autos and parts.

Development of International Institutions

A significant feature of the period from 1945 to 1980 has been the development of international institutions that influence the global trade environment. The disruption of the world financial and trade systems that occurred in the 1930s and 1940s, first through depression and then through war, had made confirmed multilateralists of Canada's post-war political leaders. They believed that strong multilateral institutions would reduce the risks of world protectionism and isolationism; that they would encourage the evolution of an open-world/trade and /payments system within which the Canadian economy would prosper; and that they would provide an opportunity for Canada to influence directly the policies of the major powers in ways favourable to our further development as a nation. The multilateral systems that were created, and their institutions, rules and procedures were also expected to affect profoundly the relationships Canada would forge with a growing number of bilateral trading partners.[1]

The world trade and economic institutions founded in the 1940s, largely within the broad framework of the United Nations, were dedicated to the establishment of a liberal multilateral order based on the free flow of goods and services, and on convertible currencies that would permit multilateral settlement of national accounts. Central to the system were the twin pillars of the General Agreement on Tariffs and Trade (GATT) and the International Monetary Fund (IMF). These two institutions were founded on the proposition that a liberal trade system based on agreed rules would lead to prosperity and growth for its members and thus contribute to global peace and stability. They were based on the economic theory of comparative advantage, and on the premise that the competitive forces at work in international trade and the effective operation of the price system would benefit the world economy and the economies of individual countries. The post-war planners realized that to create a world of strong multilateral institutions would entail some sacrifice of national sovereignty, but they considered this disadvantage a small price to pay for a system that could help to prevent a recurrence of the chaos and disorder of the previous 20 years. Generally speaking, the system they planned has worked well and has contributed to the increasing international division of labour, to a rapid growth of world production and international trade, and to extensive interdependence among nations.

In the post-war period, then, Canada has expended a great deal of effort in defining, refining and pursuing its interests through these multilateral institutions. This activity reflects many factors, but above all, it demonstrates Canada's interest in, and commitment to, developing a sound international framework for its international trade and payments. Canada has used its involvement in the building of multilateral institutions as one way to avoid becoming overly dependent on exclusive two-way relationships with more powerful nations. Moreover, it has maintained a strongly multilateral policy in the post-war decades, in the hope of encouraging the United States to increase its commitment to multilateral frameworks and, subsequently, to join other nations in an attempt to establish counterweights to American power. This multilateral approach seemed, in the past, to offer the best means of protecting and advancing Canada's international interests.

Bilateral Relations

For a period of almost forty years, Canada and its major trading partners have generally pursued their international economic relations multilaterally. The nature of international transactions, requires, nonetheless, that Canada use bilateral, as well as multilateral, instruments to pursue its trade interests. The prevalence of bilateral arrangements based on mutual economic interests and political ties shows that a growing number of nations insist on dealing with one another within a bilateral, government-to-government framework. This framework appeals, in particular, to the newly industrialized countries (NICs), which are becoming ever more important to Canada.

Canada's best-known bilateral agreement is the Canada-U.S. Automotive Products Trade Agreement (Auto Pact). This agreement, signed in 1965, has had the effect of integrating North American auto sales and production into a single market. Through a series of safeguards and incentives, it ensures that the value of production in Canada is guaranteed as a proportion of auto sales in the Canadian market. Indeed, the Auto Pact has substantially increased Canada's automotive exports. The recent increase in our exports of fully finished goods has stemmed, in large part, from the rationalization of the Canadian and American auto industries under the Pact. In 1984, for example, the auto industry accounted for exports worth almost $30 billion, or nearly 27 per cent of our total foreign sales of goods; this compares to a share of only 2.3 per cent in 1964. Rationalization has also produced increases in Canadian imports of automotive products, which reached a value of nearly $26 billion in 1984.

In addition to the Auto Pact, Canada has negotiated, from time to time, a wide range of other bilateral economic agreements. It has struck bilateral agreements relating to taxes, air travel, general economic co-operation, science and technology exchange, export credit and insurance arrangements, anti-trust measures, trade restraint (particularly in the textile and clothing sectors), international aid (establishing levels and types of assistance, and linking aid to the purchase of Canadian goods), nuclear energy (including the provision of nuclear fuel and technology, the sale of a CANDU reactor, and commitments to safeguards), and any other matters which a particular bilateral relationship may involve. The bilateral rights and obligations represented in these agreements forge additional links between Canada and its various trading partners and define more closely the constraints and opportunities Canada faces in the global environment. They also provide an additional framework, beyond those provided by multilateral institutions, for the resolution of disputes.

Canada's Trade Policies, 1945–1980

In the post-Second World War period, Canada has participated actively in the multilateral trade negotiations conducted under the GATT. Most early GATT negotiations were relatively limited in scope. Substantial progress toward tariff liberalization in multilateral trade was first achieved in the Kennedy Round negotiations (the sixth in the series), which came to an end in 1967. Canada's participation in that round presented our government with a clear choice: Was Canada to maintain its traditional use of protective tariffs under the National Policy, or should it co-operate in a multilateral attempt to liberalize trade, especially trade in manufactures? We resolved this dilemma by adopting a middle course designed to support the liberal international aims of the round and still retain some protection that our growing industries required. Other participants in the round introduced a formula or "across-the-board" approach to tariff reductions, in an effort to maximize achievements in this area. Canada, Australia and New Zealand rejected this approach. Canada maintained that most of its exports were primary products on which tariffs were low, while its imports consisted of industrial products on which tariffs were much higher. Hence, if our government accepted a formula reduction of tariffs, it would extend more benefits than it received. Instead, it negotiated tariff reductions with its major trading partners on an item-by-item basis, in order to achieve an exchange of concessions.

The Kennedy Round left Canada with a higher average level of tariffs than the United States or the European Community. Naturally, this led our major trading partner to make representations to our delegates in the next GATT negotiations, the Tokyo Round of 1973–79. Participants in that round again adopted a formula approach to tariff cutting, and they strongly urged Canada to do the same. After extensive internal discussions, the Canadian government tabled offers consistent with a formula approach. In the end, Canada made a generous offer which will leave our average weighted tariff on dutiable imports at about 9 to 10 per cent in 1987, when all Tokyo Round cuts are phased in. Taking into account duty-free imports, the overall incidence of the tariff should be about 4 per cent, a level of tariff protection similar to that maintained by the United States, the European Community and Japan. Thus Canada's actions during the Tokyo Round, which were prompted by a desire to proceed towards an open and liberal world economic environment, moved our country a further step away from the protectionism of the National Policy. Trade negotiation, however, is a matter of give and take, and the Tokyo Round produced benefits for Canada that were decidedly in our national interest. For one thing, we received an attractive tariff offer from the United States, especially on our exports of semi-processed goods. Most of the Tokyo Round agenda concerned non-tariff barriers (NTBs), and in this area, too, Canada was a net beneficiary. A GATT code was written on government procurement that will increase the capacity of Canadian firms to supply products to foreign governments. Technical problems relating, for example, to product standards and import-licensing arrangements were reduced. Our most important objective, to encourage the United States to adopt a realistic injury test before levying countervailing duties, was achieved as part of negotiations on a multilateral code governing subsidies and countervailing duties. Already this injury test has been important for Canada in the matter of litigated trade disputes in the United States. It has helped us to reduce the harmful effects of one form of U.S. "contingent protection", which has been described by Canadian trade negotiator Rodney Grey as "legal protection when and where you need it". This intermittent protection has been, and continues to be, one of Canada's main concerns in trade relations with the United States.

Looking at the Past and Looking to the Future

Over the past 120 years, then, Canada has matured as a nation and as an economic entity. The process has been most rapid during the last 40 years. A recurrent theme throughout our history has been the important influence exercised by external forces. It could be suggested, indeed, with only slight exaggeration, that Canada was formed in reaction to mid-nineteenth century British and U.S. trade policies, and that the gradual development of our nation was shaped, to a great extent, by external influences. Our foreign economic policy has been based, in large part, on a desire to channel these forces in directions beneficial to natural growth. Since Confederation, Canada has adopted a pragmatic policy stance, born out of recognition that our country was neither strong enough nor large enough to chart a wholly independent course.

Since the mid-1940s, multilateral institutions have provided the principal means of imparting stability and predictability to Canada's external relations and the outside influences that affect them. By participating in these global institutions, Canada has become an influential partner in their management and a nation well integrated into world economic systems. The multilateralism practised over the past 40 years has served our country well: it has nurtured a trading nation with a much stronger industrial base, more capable of confronting the pressures emanating from the international economic environment. Even in this post-war era of multilateralism, however, Canada has experimented effectively with bilateral negotiations aimed at achieving specific objectives compatible with broader international concerns.

Note

1. The development of multilateral institutions and their influence on Canadian economic development are discussed in M.M. Hart, *Canadian Economic Development and the International Trading System*, vol. 53, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).

CHAPTER 4

Canada in the Global Economy: *The Present Situation*

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Introduction

Canada entered the world of the 1980s as a developed industrial state which has derived benefits from post-war liberalization of international economic relations. Canadian trade has faced decreasing duties abroad while managing to develop, with the help of foreign capital, a strong industrial base further consolidated by the gradual removal of tariffs and by the gradual exposure to international market forces. In recent years, Canada has carefully charted a middle course between the familiar shore of its long-standing protectionist policy and the far harbour of a more open, liberal and international, economic environment.

In the decades to come, however, Canadians should not assume that the policies of the past will ensure our nation's adaptation to the new pressures deriving from the global environment and, especially, from our country's close relationship with the United States. Indeed, this Commission believes that Canada stands at a turning point in its economic history, and that a new era demanding innovative foreign and domestic economic policies is about to dawn for Canadians. This new era will require our governments to develop and implement policies which will facilitate adjustment in the Canadian economy to a rapidly changing and increasingly interdependent world. Canada needs policies which will provide the flexibility to adapt rapidly to changing external influences. Without such policies, Canadians will not achieve the sustained growth necessary to maintain our present standard of living. This challenge confronts us across the broad spectrum of foreign economic policy, which must take account of trade, foreign investment, aid, immigration, and other areas of responsibility. In all these fields of global economic activity, we Canadians will need to define our place, exert our influence, and pursue responsive domestic policies. Of greatest moment, however, will be our future trade policies.

Trade has always been of prime importance to Canada's economic development; it is the vital link between the Canadian economy and the international competitive environment. Successive governments have emphasized the function of trade in strengthening our Canadian economy, in promoting the continued development and expansion of our resource-based industries, and in building our industrial capacity to achieve a competitive position in specialized international markets. It is through the gradually increasing exposure of Canadian producers to competitive world-market forces that the Canadian economy, as a whole, has become more productive. Trade and trade policy have also helped to improve Canadians' standard of living by expanding the markets for Canadian producers and hence the economic scale of their operations, by providing us with imported goods that would be more expensive to produce domestically, and by improving the quality of employment.

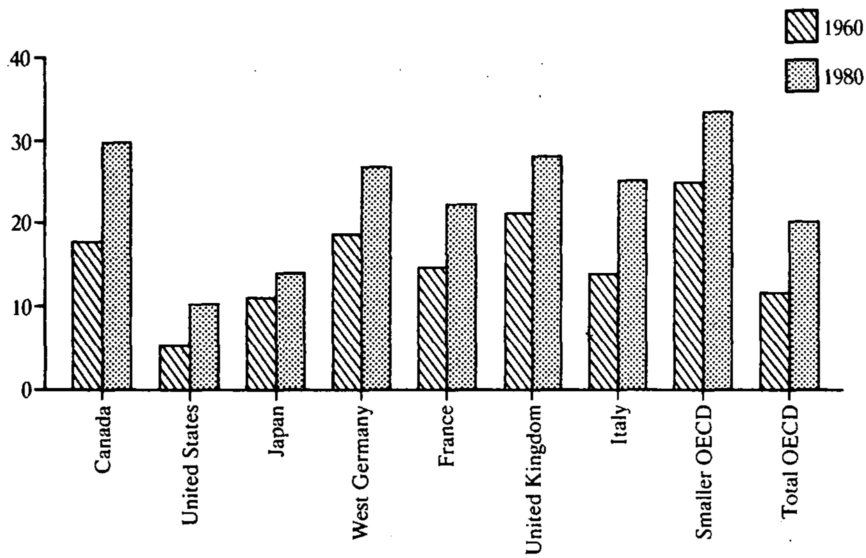
In a technical sense, trade policy is the collection of laws, regulations and government decisions which affect the export and import of goods and services. These individual policy documents have been conditioned and, to a large extent, determined by our perception of the sort of trade environment that would best suit Canada's economic interests. In broad terms, Canadian trade policy has been the art of the possible. Throughout our history, the Canadian economy has depended heavily on world markets. As a basic proposition, successive Canadian governments have tried, through trade negotiations, to obtain the most favourable terms of access to foreign markets, while maintaining some measure of protection for Canadian production. Canadian trade policy has thus been developed as a compromise between the objective of improved access to foreign markets and the desire to provide protection for important Canadian industries. Our trading partners must also consider a similar set of factors in determining how they will negotiate with us and with others.

Even a brief consideration of the range of our international responsibilities and opportunities makes it plain that we must increasingly recognize that Canada's trade performance is affected by the whole range of our domestic economic policies. Foreign policy, export-trade policy and marketing issues all influence Canada's trade performance, but they need to be related to our government's industrial and economic development strategies. We must take into account that domestic and international issues affect one another, and that government-policy considerations affecting these issues should not be viewed in isolation, but rather should be so constructed as to reinforce one another. A strong domestic foundation is vital to Canada's future trade and economic performance. To achieve more efficient and internationally competitive Canadian resource, manufacturing and service industries will require close co-ordination and coherence between trade policy and domestic framework policies. Taking account, then, of the full range of our domestic policies, Canada's private sector must seek out and develop markets at home and abroad. Canadians will thus need to reach strong national consensus about the kinds of framework and support policies needed so that individuals can confidently plan and pursue their interests. Commissioners consider these policies in Part V of our Report.

Canadian Trade in the 1980s

Between 1950 and 1980, world trade grew at about 6 per cent per year, outpacing the growth of world production as national economies became more open and thus more integrated. Figure 4-1 documents this greater trade exposure of the industrialized economies and shows that Canada is among the most open of the large economies of the Organisation for Economic Co-operation and Development (OECD).

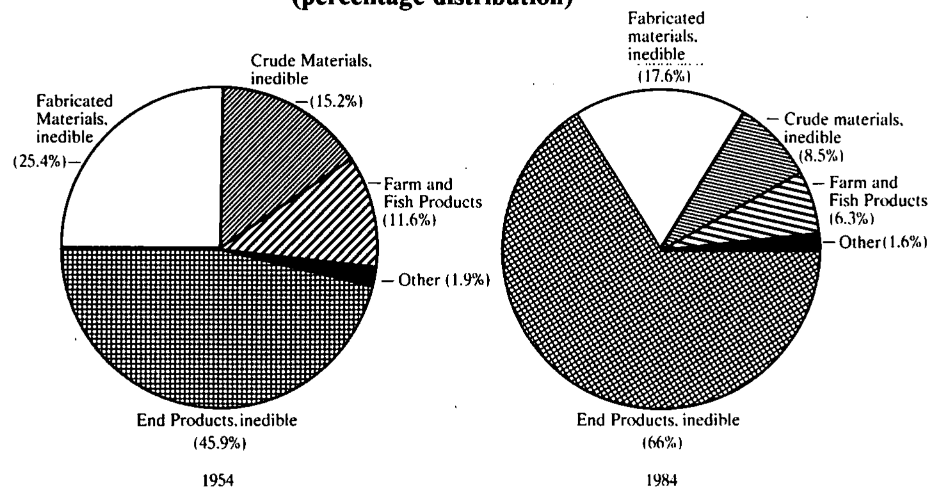
FIGURE 4-1 Exports of Goods and Services by Country, as Percentage of Gross Domestic Product, 1960 and 1980



Source: Organisation for Economic Co-operation and Development, *Historical Statistics 1960-1981* (Paris: OECD, 1983), Table 6.12, page 67.

The nature of the commodities that Canada imports and exports has undergone significant change since the end of the Second World War. As Figures 4-2 and 4-3 demonstrate, trade in end products has become more important while, relatively speaking, that in raw materials and farm and fish products has shrunk. As a result of the 1965 Automotive Products Trade Agreement (the Auto Pact) with the United States, the import and export of motor vehicles and parts has expanded greatly, accounting for much of the growth in end-products trade. In 1954, these products accounted for only 7.6 per cent of Canadian imports, but they represented 27.3 per cent of that total in 1984. Similarly, automobiles and parts comprised a mere 1 per cent of Canadian exports in 1954, but amounted to 26.4 per cent in 1984. Over the same period, there has been a decline in the relative importance of Canadian exports of metals and minerals, but significant growth in our exports of

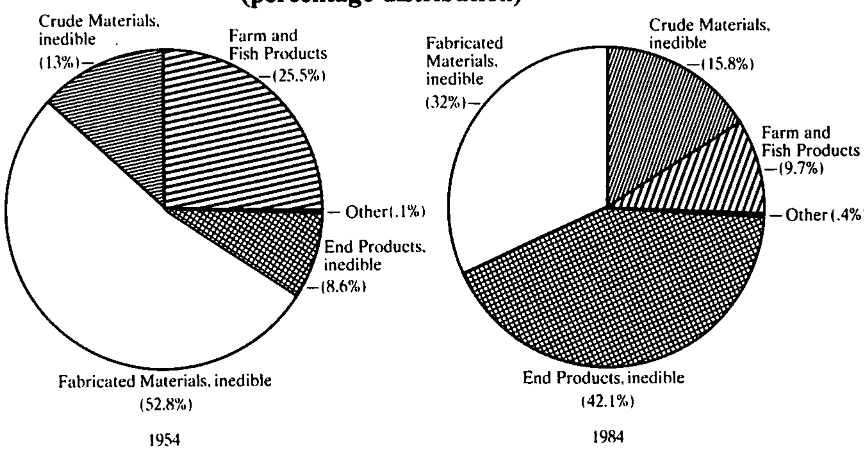
FIGURE 4-2 Canadian Merchandise Imports by Commodity, 1954 and 1984 (percentage distribution)



Source: Statistics Canada, *Historical Statistics of Canada,* 2d ed. (Ottawa: Statistics Canada, 1983), Series G429, G431, G433, G435, G437, G439, G441.
Statistics Canada, *Summary of External Trade, December 1984,* Cat. No. 65-001 (Ottawa: Minister of Supply and Services Canada, 1985), Table 3.

Note: Unallocated balance-of-payments adjustments were added to total imports in the calculation for 1984.

FIGURE 4-3 Canadian Merchandise Exports by Commodity, 1954 and 1984 (percentage distribution)



Source: Statistics Canada, *Historical Statistics of Canada,* 2d ed. (Ottawa: Statistics Canada, 1983), Series G415, G417, G419, G421, G423, G425, G427.
Statistics Canada, *Summary of External Trade, December 1984,* Cat. No. 65-001 (Ottawa: Minister of Supply and Services Canada, 1985), Table 6.

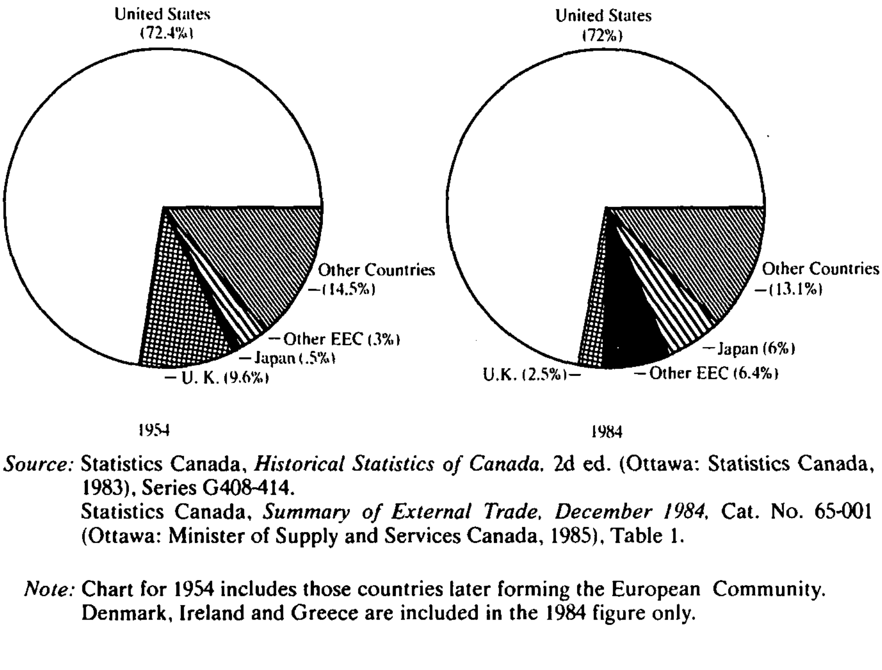
Note: Unallocated balance-of-payments adjustments were added to total imports in the calculation for 1984.

energy materials. The relative decline of exports of fabricated materials reflects, in part, the shrinking importance of forest products. These accounted for 34.8 per cent of Canadian exports in 1954, but only 12.5 per cent in 1984.

While the product composition of Canadian trade has been changing, so, too, has the identity of our chief trading partners. Figures 4-4 and 4-5 illustrate this change. The increasingly predominant position of the United States as Canada's principal trading partner is evident, as is the growing importance of our trade with Japan. The importance of our trade with the United Kingdom has continued its long decline from the days when it was Canada's largest export market.

FIGURE 4-4 Canadian Merchandise Imports by Countries and Trading Areas, 1954 and 1984

(percentage distribution)

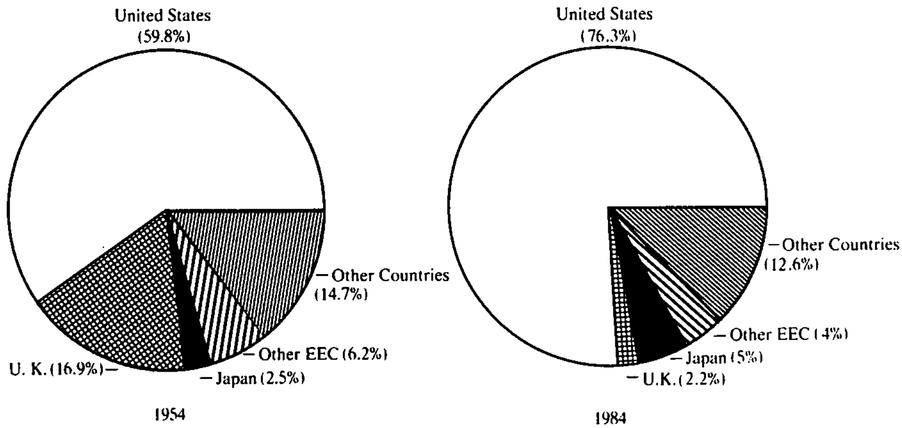


Source: Statistics Canada, *Historical Statistics of Canada*, 2d ed. (Ottawa: Statistics Canada, 1983), Series G408-414.
Statistics Canada, *Summary of External Trade, December 1984*, Cat. No. 65-001 (Ottawa: Minister of Supply and Services Canada, 1985), Table 1.

Note: Chart for 1954 includes those countries later forming the European Community. Denmark, Ireland and Greece are included in the 1984 figure only.

If exports and imports of both goods and services (including transfers) are considered, the relative importance of the United States and Japan decreases slightly. In 1984, for example, merchandise and non-merchandise receipts from the United States amounted to 71.4 per cent of total receipts. This figure compares with a U.S. share of Canadian merchandise exports of 76.3 per cent. On the import side the United States accounted for 67.9 per cent of payments abroad, compared with their 72.4 per cent share of Canadian merchandise imports.

FIGURE 4-5 Canadian Merchandise Exports by Countries and Trading Areas, 1954 and 1984 (percentage distribution)



Source: Statistics Canada, *Historical Statistics of Canada*, 2d ed. (Ottawa: Statistics Canada, 1983), Series G401-407.
Statistics Canada, *Summary of External Trade, December 1984*, Cat. No. 65-001 (Ottawa: Minister of Supply and Services Canada, 1985), Table 2.

Note: Chart for 1954 includes those countries later forming the European Community. Denmark, Ireland and Greece are included in the 1984 figure only.
Figures on 1984 Chart do not sum to 100 because of rounding.

Challenges from the Global Environment

A major problem for most nations today is to find a means of reinvigorating economic growth that will help them reach the high-growth levels that were the norm through most of the post-war period. Nor is slow recovery from the severe recession of the early 1980s the only problem facing the world economy. Substantial change, especially industrial change, is occurring, and it reduces stability and predictability for governments and their constituents. High interest rates in one nation affect interest rates and exchange values in another country; high exchange values create pressures on trade balances; and falling trade balances can expand problems of international debt. This interplay of forces, creating a sense of greater risk and uncertainty makes national governments less secure in the control of their economies than they were in the 1950s and 1960s.

Canada, of course, shares this world-wide problem, the general sense of uncertainty and loss of control. Moreover, it faces specific challenges arising from the international environment that bear particularly on our future aspirations and opportunities. As we have seen in Chapter 2, these challenges emerge from growing international competition; the need to adjust to the new competition; the changing nature of international capital flows; intensified regionalism; and more discriminatory trading arrangements.[1]

International Competition

International specialization based on comparative advantage, which eased the way for trade liberalization in the early post-war years, has changed over the past two decades. In the earlier period, trade liberalization was made easier by the fact that only the Western industrialized countries were seriously involved in the process. The developing countries, often still in colonial status, provided raw materials and only rarely competed with the industrialized countries in exporting manufactured goods; the East European countries were generally excluded from the trading system by the Cold War. It was plain that comparative advantages among the industrialized countries depended on differences in their supplies of capital, labour and natural resources, as well as in their technology. While it was expected that comparative advantage would vary, it was assumed that changes would be evolutionary and predictable, and that their pace would allow time for countries to make adjustments.

Current rapid changes in trade patterns tend to impose much greater burdens on mature industrialized countries and therefore to cause much more serious domestic political opposition to imports than occurred in an earlier period. Japan, for example, has caught up with or surpassed the United States as the international leader in industrial technology in many sectors. Its competitive drive has been so strong that North American producers have found it extremely difficult to adjust rapidly enough: the domestic markets of some have withered, and they have been unable to secure export opportunities which would offset this erosion. Canadian manufacturing industries have faced strong competition from Japan in a variety of advanced manufacturing sectors, such as those producing cars and electronic equipment. Some of our exporters have lost foreign markets to the Japanese, although their loss has been limited by the fact that Canada has never had a significant export presence in many of the sectors in which the Japanese have been strong. The most severe direct loss of Canadian export markets occurred in the late 1970s, as a result of Japanese auto exports to the United States.

There is a tendency to assume that the imbalance of Canadian-Japanese trade in manufactures originates solely in Japanese protectionism. Certainly, Japan did impose overt protection in the first two decades after the Second World War. Today, however, Japanese protection does not *appear* to be appreciably greater than that of other industrialized countries, at least as assessed under the rules of the General Agreement on Tariffs and Trade (GATT). Nevertheless, for many products it continues to be very difficult to penetrate the Japanese market. The challenge posed by Japan today stems both from its trade policy and from the competitive economic performance of its whole society. Government policy plays a part in promoting this performance, but it is unrealistic for Japan's trading partners to attribute Japanese success wholly to government intervention and protection. At the same time, Japan is under growing pressure to open up its own economy or to face stronger retaliation against its exports in the European Community (EC) and the United States.

The emergence of the newly industrialized countries (NICs) made another post-1960s change in the international structure of comparative advantage. This change will be profoundly important for Canada in the future. The NICs are highly competitive producers and exporters of certain high-volume, standard-technology, manufactured goods, the production of which requires relatively large numbers of low-skilled workers, but comparatively little capital and raw material. Textile, clothing and footwear sectors were among the first affected by competition from these new producers, but the NICs have since become competitive in steel, ships, automobile parts and household electronics. Meanwhile, other developing countries have become exporters of resource-based products in increasingly serious competition with Canada.

Canadians should be careful not to exaggerate the past effect of competition from NICs. So far, trade with those countries has probably had little, if any, net effect on rates of employment in the Western industrialized countries, since growing exports to them have compensated for employment losses in certain sectors that compete with NIC imports. The real test, however, is yet to come. In 1977, NICs accounted for only 8.1 per cent of all manufactured goods imported by members of the Organisation for Economic Co-operation and Development (OECD) and for just over 1 per cent of total OECD consumption of manufactures. These shares have increased somewhat since 1977, but the effect of NIC competition on overall manufacturing production and employment in the industrialized countries, while still relatively small, was perceived to enlarge as a result of the 1981-82 recession.

Although the absolute trade volumes and overall effects of the NICs have been small, the unemployment problem associated with competition from NIC exports has been concentrated in certain sectors, such as textiles and clothing. The low-skill level of the displaced workers, their age and other characteristics make it difficult for them to find other employment. The concentration of the threatened industries in specific regions of our country has heightened the political sensitivity of the problem.

The Challenge to Adjust

An open-trade stance relative to both imports and exports may impose substantial transitional costs on both capital and labour in sectors affected by externally initiated changes. If Canada further relaxes import restrictions, jobs are likely to be lost in sectors under import pressure. Moreover, where that pressure stems from lower-wage newly industrializing countries or less-developed countries (LDCs), a disproportionate share of the burden of domestic adjustment is likely to fall on lower-income, lower-skilled workers. This effect will rightly strike many Canadians as unfair and unacceptable.

Some industries, of course, will have to face structural adjustments in order to exploit fully the new opportunities occurring in export markets. These changes, in turn, will require even more extensive inter-sectoral adjustments within the labour force if firms are to benefit from the economies of scale and the specialization needed to make Canada effectively competitive in either a North American or a world market. Conversely, freer trade will increase Canada's output and, probably, its manufacturing-employment levels, as well. The challenge, therefore, will be to facilitate, rather than to frustrate, adjustment.

In the past, Canadian policy towards sectors threatened by imports has been designed, in large measure, to postpone, rather than to facilitate, adjustment.[2] For some industries, such as textile, clothing, and footwear manufacturing, this policy has meant high-tariff and quota protection supplemented by subsidies to enable firms to modernize. Much more modest subsidies have been paid to displaced labour. These policies have retarded Canada's process of adjustment, even in buoyant economic times, when alternative economic opportunities for displaced labour and capital were more abundant than they have been in recent years.

Dynamic growth strategies are born of dynamic adjustment strategies. The success of Canada's adjustment strategies must be measured according to the speed with which they enable our industries to adapt to changing economic opportunities, and not according to their capacity to postpone adjustment. This contention was supported in a number of briefs submitted to this Commission. For instance:

> *Protectionism is not a valid answer to the fundamental changes occurring in international trade. Conserving outdated production, protecting against the less expensive goods of the NICs, subsidising high energy consumption production and production methods, only delay the essential changes.*
>
> *The principle must be that any help to industries or sectors hit by sudden and heavy structural changes is transparent and given on a reducing basis* with a clear and final time limit. *There must be consensus on this point. An open economy like Canada's must embrace flexibility.*
>
> (International Business Council of Canada, Brief, November 28, 1984, pp. 2–3.)

The key is to facilitate rather than to resist change, to widen access to large export markets and to avoid an excessive preoccupation with defending smaller domestic markets against imports.

The importance of successfully meeting the adjustment challenge is also expressed in the following observations in one of this Commission's research studies:

> *It may be tempting to delay adjustment, and indeed, such measures as quotas or subsidies bring immediate relief and political benefits – but they entrench the problem. A non-competitive activity in an open economy needs an ever-increasing battery of aid, as has been amply demonstrated in the case of textiles and clothing. Labour, management, machinery and materials all become locked into a marginal activity, perversely drawing resources from more efficient activities to pay for maintaining a non-competitive sector. Short-term help to ease adjustment may be readily defensible, but too often it rapidly evolves into long-term help to avoid adjustment. Policies must thus be carefully designed and implemented to avoid crossing the line from one to the other.*[3]

In the years ahead, an integral and key part of Canada's trade policies must be a set of adjustment measures which compensate Canadians disadvantaged by trade-related developments, but which also facilitate, rather than resist, change. A flexible, adaptable, economic structure is essential if we are to make full use of the opportunities available to us through interactions with our global environment.

International Investment

Increasingly, international trade occurs between related parties, especially international firms and their affiliates; this fact, in itself, raises questions about the consequences of non-arm's-length international transactions. Furthermore, the location of affiliates has an important bearing on trade flows. The location of major foreign investments is more and more often negotiated between governments and international firms, and motivations on both sides are often political. To attract foreign investment, most governments regularly provide investment incentives, such as direct subsidies, or "tax holidays" (that is, exemption from corporate taxes for either a specified or an indefinite period). In addition, they often impose performance requirements to influence the economic behaviour of firms that establish themselves within their jurisdiction. These practices open the door to considerable competition among governments for attracting foreign investment.

For their part, international firms have shown a capacity to adapt their investment decisions to the practices of host governments, and they have varied their investment patterns in ways that could produce trade flows different from those based solely on factor costs or market opportunities. The principle of comparative advantage has thus been subject to reinterpretation in light of modern investment practices. Comparative advantage has traditionally depended on resource endowments or on slowly accumulating capital stocks; today, however, it depends increasingly on major investment decisions, on research and on the development of human capital through training. It is now easier to acquire a comparative advantage in a particular sector through manipulation, and this development offers countries a greater opportunity to influence their own trade patterns. As a result, the composition of trade flows is becoming more subject to the actions of governments. Members of the General Agreement on Tariffs and Trade (GATT) assume that governments generally act by imposing restrictions, and GATT rules attempt to regulate the manner in which governments may apply those restrictions. Modern foreign-investment policies give governments greater scope to create trade, and except in the matter of subsidies, GATT rules generally do not regulate this aspect of international activity.

The high degree of foreign ownership within the Canadian economy has strong influences, both negative and positive, on Canada's export patterns and prospects. Combined with the trend toward the "internationalization" of business, extensive foreign ownership now accounts for the high proportion of Canadian trade that consists in intra-corporate transfers: that is, transfers of goods and services among branches of a single transnational corporation. A survey covering about half the sales of foreign-owned firms in Canada showed that by the late 1970s, about 80 per cent of their exports to and imports from the United States were intra-firm transactions.[4] Much of this was in the form of petroleum exports or trade under the Auto Pact. While comparably precise figures for Canada's trade with other regions are not available, indications are that intra-corporate transfers account for a smaller, but still significant, part of our overseas trade. Conversely, producers may be prohibited from exporting – or restricted in the markets to which they can export – by administrative arrangements with the parent corporation, arising out of the latter's strategy for supplying various world markets. Even Canadian-owned firms, if they are licensed to make use of foreign technology, may similarly be restricted to our domestic market.

World product mandates may provide one possible solution to the problem of externally-imposed export limitations on foreign-owned manufacturing subsidiaries in Canada. Federal and Ontario government policies encourage such subsidiaries to specialize in a small number of product lines and to export a portion of their output to all of the parent company's markets. This procedure is intended to replace some companies' current practice of reproducing all of the parent company's product lines on a small inefficient scale and restricting sale of their products to our protected domestic market. In return for rationalizing production and increasing exports, the federal government offers duty-remission schemes, whereby the subsidiary with a world product mandate is permitted to import, at reduced rates of duty, required goods needed to enlarge its product line. Such schemes, while not yet widely applied, are proving attractive to a growing number of companies seeking to make better use of their Canadian investment. The technique may well prove of great value as part of a more general trend towards rationalizing productive facilities along North American lines. However, Canadian subsidiaries seeking a world product mandate must still demonstrate that they are competitive. In today's open market, no company can afford to carry a non-competitive branch or affiliate.

While the high degree of foreign – especially U.S. – ownership of industry in Canada may have contributed to the lack of diversification in our export trade, it would be a mistake to view foreign ownership as a negative factor. The use of a foreign parent's technology, brand name and marketing organization can enhance a subsidiary's opportunities to make foreign sales, and sales orders generated by the parent may be filled, in whole or in part, by the subsidiary. Those enterprises may provide better markets for exports from the Canadian subsidiary, and these may be less risky than those acquired through arm's-length dealings. Rationalization and specialization thus lead to greater trade flows, albeit within a corporation. This type of trade, however, is equally sensitive to secure access.

Canada, like other countries, is trying to develop productive high-technology industries. The global nature of technology in these industries often means that if Canada is to participate, it will have to do so in partnership with foreign firms. Furthermore, if Canada is to attract investment, it will have to compete with other countries. Such competition, however, enables foreign companies to play off one government's offers against another's. In the late 1970s, for example, the major North American automobile manufacturers successfully played off the various provincial and state governments against one another as these authorities provided investment incentives for new plants, the locations of which might already have been decided. Obviously, the cost to governments of subsidizing foreign investment can quickly accumulate, yet there is considerable evidence that incentives are not the determining factor. Nevertheless, the perception of Canada held by potential foreign investors *is* an important factor in our nation's ability to attract future investment.

Growth of Regionalism

The multilateral trade and payments system is founded on the principle of non-discrimination. In practice, this principle requires that GATT-member nations apply the same regulations and restrictions on trade to all their trading partners. The principle of non-discrimination, which is the foundation on which any multilateral trading system must be based, has been deeply threatened by the establishment of preference areas or regional trading blocs. These blocs have become more important since the 1950s, despite the commitment of all GATT members to accord non-discriminatory treatment to their trading partners. By far the most important is that formed by the European Community (EC) and its many associates. This bloc now includes a number of Mediterranean countries, as well as developing countries in Africa, the Caribbean and the Pacific. The countries of the European Free Trade Association (EFTA) are linked to the European Community by industrial free-trade agreements. Roughly one-fifth of total world trade now takes place within the huge, EC-centered, preferential trading system. Other notable preferential trading systems include the Association of South-East Asian Nations (ASEAN), the Caribbean Common Market (CARICOM), and the Generalized System of Preferences, which most Western industrialized countries apply on a non-reciprocal basis to imports from developing countries. These systems are all discriminatory, through tariffs and non-tariff barriers, in favour of trade among their members. Although this discrimination virtually always departs from the spirit of the GATT, it has been legitimized, in most instances, either by waivers from GATT obligations or by application of Article XXIV of the General Agreement.

The trend towards regionalism in the world trading system holds considerable dangers for our nation. Because Canada is not a member of any preferential trading bloc, it is one of the few major industrial countries lacking free access to a market of over 100 million people. The relatively small size of our domestic market puts us at a competitive disadvantage with the EC countries, the United States and Japan, since all those nations have sufficiently large domestic markets to provide a strong base for developing competitive exports.

The European Community's discrimination against non-associated suppliers has directly affected Canadian exports to Europe. Resource exports have suffered most severely, since Canada has never developed a strong export trade with Europe in manufactures. Wheat offers a notable example: the EC's Common Agricultural Policy (CAP) has severely reduced Canadian access to what were once large markets in Britain and certain continental European countries. Newsprint exports have also been threatened by the preferential trade agreements negotiated between the EFTA countries and the Community. In addition, some Canadians have expressed concern that tariff and non-tariff/barrier preferences granted to developing countries associated with the EC could cut into our exports of minerals and processed mineral products. To date, however, there is no evidence that this has happened, since few of the developing countries associated with the EC produce significant quantities of the minerals Canada exports to the Community.

Another negative consequence for Canada of the trend to regionalism is the growing tendency for issues of world trade policy to be settled in trilateral negotiations involving the United States, Japan, and the European Community. When these giants reach a settlement, Canada may be given limited opportunity to voice its concerns on the issue in question. Furthermore, even when Canada is fully involved in negotiations, the development of units of the EC and, to a lesser extent, the EFTA reduces our opportunities to influence the outcome by allying ourselves with other medium-sized countries. Among smaller industrialized countries, only Canada, Australia and New Zealand stand alone. There is a tendency, too, in such tripartite negotiations, to throw Canada arbitrarily into the U.S. orbit, and the decision to do so involves assumptions that impede Canadian efforts to establish a distinct voice in international economic relations.

Alarming as this situation may be, Canada, in the last analysis, can do little to reverse the trend towards regionalism in the world political economy because the process essentially involves relationships among third parties. However, this trend does increase the urgency for Canada to define its role in the international trading system of the future.

Notes

1. These themes are discussed in more detail in Michael C. Webb and Mark W. Zacher, "Canadian Export Trade in a Changing International Environment", in *Canada and the International Political/Economic Environment*, vol. 28, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
2. See Department of Regional Industrial Expansion, "Experience in Canada with Adjustment Policies", and Matthew Robertson and Alexander Grey, "Trade-related Worker Adjustment Policies: The Canadian Experience", in *Domestic Policies and the International Economic Environment*, vol. 12, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
3. M.M. Hart, *Canadian Economic Development and the International Trading System: Constraints and Opportunities*, vol. 53, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
4. Reported in Economic Council of Canada, *On the Mend*, Twentieth Annual Review (Ottawa: Minister of Supply and Services Canada, 1983), p. 22.

Trade with Our Principal Partners

Over the years, Canada has developed mutually beneficial trade and investment links with a range of trading partners. In order fully to assess the choices before us, we need to ask and answer a number of questions: What is the nature of our ties with our major trading partners? How are our relations likely to evolve over the next few decades? Is the multilateral trading system still the best means to manage relations with such a diverse group of countries? Will future multilateral negotiations result in better and more secure access to these markets?

Trade with the United States

The United States and Canada are each other's principal trading partners. Three-quarters of Canadian trade is now directed to the United States, representing a total of $156 billion-worth of exports and imports in 1984. Recent global economic developments – the challenges of freer trade, the pace of technological change, the restructuring of Western economies, the emergence of the new Japan – point to a future in which the importance to Canada of our U.S. relationship may well increase further, not decline. We Canadians are being driven still closer to our neighbour by factors which we have difficulty controlling. No matter which way we direct our future policies, our relations with the United States will continue to constitute a primary, even a predominant, factor in the determination of our foreign, defence and economic policies. The success of the goal of economic renewal in Canada will thus depend, in no small way, on the nature of Canada's ties with the United States.

This Commission has been impressed by the view of many Canadians that the time may now be ripe for a new approach to Canadian trade relations with the United States. These men and women believe that Canada can no longer rely on the policies and practices of the past; that the intimate and extensive links between the two countries, as much as the state of our economy and of the international trading system, no longer allow Canadians room to manœuvre; rather, they make us more vulnerable.

One of the factors which brings home the degree of our vulnerability is the protectionist legislation poised for passage in Congress. This legislation is being driven by concern about the size of the U.S. merchandise-trade deficit and the strength of the U.S. dollar, as well as by a perception that only the United States plays by the international rules and has become a victim of its past generosity. The threat of protection imposed by the U.S. Congress is of particular concern to Canada. Any increase in protectionist legislation could hold serious implications for job-creating investment. Even where we are not the principal target, we risk being the major victim of a spate of protectionist legislation before Congress. No realistic amount of diversification can offset the degree of Canada's vulnerability to unilateral action by the United States.

The issue is more than a potential threat. Existing U.S. trade legislation already allows American companies constantly to harass their foreign competitors. These laws include provisions for imposing countervailing duties against subsidized imports, anti-dumping duties, emergency relief from seriously injurious imports, retaliation against "unfair" trade practices, and relief from imports deemed prejudicial to U.S. national security. Rules formulated in the General Agreement on Tariffs and Trade (GATT) may prevent the final imposition of duties or quotas unless the case is strong and proper procedures are followed, but they do not prevent frivolous complaints and strong Congressional pressure on the Administration to agree with the complainant. The American penchant for litigation guarantees that at any one time, Canadian governments and exporters are fully engaged in preventing the imposition of a special duty or quota of one kind or another. Some Canadian industries are wondering whether they can afford many more victories. Others have not been so lucky.

Canadian well-being thus depends substantially on our relations with the United States. There is significant scope for the reduction or removal of barriers to cross-border trade in goods and services, and for improving the management of bilateral issues in a variety of areas. Discord in Canada-U.S. relations can place significant constraint on Canadian policy making; mutual commitment to common goals can open substantial opportunities.

Our past policies have indicated our general tendency to resist the forces driving us closer to the United States. One of the reasons for this resistance has been the belief that Canadian policy decisions should be made as though we could and should counter the American presence. This stance has abetted only to a limited extent our efforts to hold back the forces driving us to a closer economic relationship with the United States. What is more important, it has frustrated efforts to seize opportunities arising from our close ties.

This Commission's public consultations highlighted a perception shared by the Canadian business community that:

> *When you are protected at home, something happens to your costs, something happens to the structures that automatically means you are not going to be competitive on a world scale . . . If Canadian industry can be competitive with U.S. industry, you could almost feel quite comfortable about multilateralizing the result.*
>
> (Howard Hart, Transcript, Montreal, May 31, 1984 [vol. 2] p. 338.)

Furthermore, though the degree is hard to measure, it seems that policies designed to resist the attraction of the United States may have left Canada less open to consideration of trade-offs and potential new areas of co-operation from which both Canada and the United States might have benefited.

Commissioners see a clear need to take a new direction. We Canadians now have a stronger sense of confidence in our own institutions and in our ability to safeguard discernible differences between the two countries than they may have had in years past. We are ready for and are expecting such a change.

Trade with Western Europe

The European Community (EC)[1] is the world's largest trading body and a key player in both international trade relations and in the GATT system. It has participated actively in past GATT negotiations which have resulted in a considerable lowering of its external barriers to trade, particularly in industrial goods. To a large extent, however, the EC is preoccupied with its own internal problems. These problems are partly the result of its enlargement to include other European countries than those which formed the original Community, and partly a consequence of its management of the relations with its key trading partners in Europe and the Mediterranean area. The EC is less enthusiastic than it once was about any new efforts to strengthen multilateral discipline, although it is playing its part in efforts to formulate an agenda for future trade negotiations.

Writing almost thirty years ago, on the eve of the formation of the European Economic Community, the last Royal Commission on Canada's Economic Prospects noted:

> *If it were to be successful in creating a common market in Western Europe, efficiency would be improved, output increased, and the ability of the whole area to trade with the rest of the world, including North America, raised to a higher plane. On the other hand, if the project were to be only partially successful, it might prove to be only another engine for discriminating against dollar imports.*[2]

Experience shows that both observations have turned out to be true. European economic integration contributed in no small measure to growth and prosperity in Western Europe. Greater prosperity contributed to making Europe an attractive export market. European discrimination, however, has frustrated Canadian traders seeking to penetrate that market. Europe's share of Canada's exports has steadily declined since 1965, as the U.S. share steadily rose.

Dana Wilgress, one of the principal architects of Canada's post- Second World War trade policy, observed some twenty years ago that the advantages for Canada of European integration would be long-term and intangible, while the disadvantages would be immediate. He went on to say:

> *All that can be said with safety at the present time is that the long-term advantages appear likely to compensate for the short-term disadvantages—although if the United Kingdom becomes a Member of the Community, the long-term advantages will have to be very great to compensate Canada for the loss of the preferential position now enjoyed in the U.K. market.*[3]

Entry of the United Kingdom in 1971 had the effect Wilgress feared. By 1984, the U.K. market took up only 2.2 per cent of Canada's exports, compared to 41 per cent in 1938, 27 per cent in 1947, and 18 per cent in 1955. European integration accelerated a trend already apparent in the 1950s. The Community as a whole—indeed Europe as a whole—does not provide the market for Canada that the United Kingdom represented only a generation ago.

Our federal government sought to reverse this trend a decade ago by establishing a "contractual link" with the Community. A considerable amount of political will and negotiating effort was expended and eventually culminated, in 1976, in a Framework Agreement providing for consultations, industrial co-operation, technology exchanges and other techniques to foster stronger economic ties. The Agreement is supplemented by a number of consultative mechanisms with individual member states, including France and the United Kingdom. These and the Framework Agreement, however, have produced little direct effect. They have not opened Community markets; they have not given Canada a privileged position; and they have never caught the imagination of the private sector. They have proved, indeed, to be largely a vehicle for bureaucratic contacts and consultations. The realities of distance, lack of intra- and inter-corporate links, and the continuing high levels of trade barriers which protect European processing and manufacturing industries all reduce the likelihood of a major expansion in trade. A realistic assessment of the relationship, ten years after the signing of the Framework Agreement, suggests that Canada's economic opportunities in Europe are limited.

Nevertheless, the Community is still Canada's second-largest trading partner, accounting for 7.8 per cent of our trade in 1984. As with the corresponding Canada-U.S. relationship, Canada depends more heavily on its trade with the EC than does the Community on its trade with Canada. There would appear to be significant areas in which economic co-operation and trade between Canada and the EC could be further developed. In a number of these areas, however, it will be necessary for Canada to negotiate further adjustment in the Community's import system before the benefits of such co-operation can be fully realized. This is particularly true for trade in fisheries' products, further-processed resource products, and sophisticated end products, such as telecommunications equipment. European agricultural policies remain of considerable concern to Canadian agricultural producers. These policies, which involve the Community's use of large export subsidies, both inhibit our prospects for agricultural sales in Europe and endanger our position in third-party markets.

In their trade and economic policies, the non-EC countries in Western Europe tend, as does the Community, to be preoccupied with the issues centered on European integration. The members of the European Free Trade Association (EFTA), are now firmly linked to the Community through industrial free-trade agreements. Spain and Portugal will enter the EC in January 1986, and Turkey has an association agreement. These preferential arrangements have reduced Canada's access to these markets. Trade with these countries is largely similar in composition to that with the Community: Canada exports resource-based products and imports specialty-manufactured and agricultural products. The volume of goods exchanged is modest. Canadian access to these markets is governed by the GATT, and the General Agreement provides the contractual basis for the conduct of relations. For Europe, however, GATT has been reduced to a secondary status. That area's most important trade agreements are now those which provide for preferential relations between the various European trading partners.

Trade with the Asia-Pacific Region

In recent years, Canadians have variously perceived the Asia-Pacific rim as a boundless frontier of economic opportunity, as a threat to the well-being of many of our domestic industries and communities, or as marginal to many of our mainstream economic concerns. It has proved difficult to describe our economic relations with Asia-Pacific without either exaggerating or discounting the region's importance, or without establishing a myopic focus on either import competition or export opportunities.

Canadians' apparent inability to get a clear perspective on Asia-Pacific is primarily a result of the newness and uncertainty which many Canadians associate with this relationship. We lack a balanced and mature appreciation of our economic links with the Asia-Pacific countries. Much more readily, if not instinctively, we accept the benefits and the costs of economic interdependence with our traditional trading partners; we comprehend the dimensions and probable future scope of these relationships much more easily.

The Asia-Pacific region is now the most dynamic in the world economy. As Table 4-1 indicates, Asia-Pacific is by no means a homogeneous entity, yet the developed and developing countries of the region have been commonly distinguished by rapid economic and trade growth. Together they have forced a considerable shift in the focus of international economic activity from the Atlantic to the Pacific, and their economic ascendancy may result in the next century becoming the "century of the Pacific".

TABLE 4-1 Economic Indicators of Asia Pacific Countries

	Population (in millions) mid-1982	GNP per Capita U.S. $ 1982	GNP per Capita Annual Growth 1970–82	Merchandise Trade Average Annual Growth	
				Exports 1970–82	Imports 1970–82
Japan	118.4	10 080	6.1	8.5	3.5
China	1 008.2	310	5.0	—	—
Hong Kong	5.2	5 340	7.0	9.4	11.9
South Korea	39.3	1 910	6.6	20.2	9.8
Indonesia	152.6	580	4.2	4.4	12.3
Thailand	48.5	790	4.5	9.1	4.3
Malaysia	14.5	1 860	4.3	3.8	7.3
Philippines	50.7	820	2.8	7.9	2.1
Singapore	2.5	5 910	7.4	—	—
(Canada)	24.6	11 320	3.1	4.0	4.3
(United States)	231.5	13 160	2.2	5.6	3.8

Source: *World Development Report 1984* (New York: Oxford University Press for The World Bank, 1984), pp. 218–21, 234–35.

For Western Canada, of course, and particularly, for British Columbia and a small number of major firms throughout Canada, the Pacific has long loomed large in economic terms. British Columbia exports more goods across the Pacific than to the United States. Many Canadians, however, have only recently come to appreciate the economic might and potential of the Asia-Pacific countries. These countries have also become the main source of troublesome import competition and the special targets of most of Canada's recent protectionist measures.

The countries of the Asia-Pacific region differ widely in terms of their size, resource base, level of development, and political, cultural and linguistic characteristics. In economic terms, they can be divided into four groups: the resource-poor, advanced industrial state of Japan; the resource-rich, vast but underdeveloped, continental economy of China; the resource-poor, rapidly and newly industrializing countries (NICs) of South Korea, Taiwan, Hong Kong and Singapore; and the more richly endowed, "near-NICs" of Southeast Asia: Indonesia, Thailand, Malaysia and the Philippines.

Important differences, as well as some similarities, exist within these groups; the city states and *entrepôt* centres of Hong Kong and Singapore, for example, differ from the somewhat larger and more diverse economies of South Korea and Taiwan. Despite these distinctions, the four can be grouped together, not just because of their geographical proximity, but by virtue of their rapid economic growth during the 1970s and 1980s. The Asia-Pacific countries, with the exception of China, also have in common a high dependence on trade and market-oriented economies. In recent years, economic growth in the Asia-Pacific developing countries has greatly outpaced that in Canada and the United States – and in the developed world generally – and Japan's economy similarly outperforms its industrial-country peers.

At present, Canada's economic relations with the Asia-Pacific rim can be characterized in the following ways:

- The Asia-Pacific countries are Canada's fastest growing trading partners and have recently replaced Western European countries as our most important non-U.S. trade region. There has not been any radical shift, however, in overall Canadian trading patterns and our Pacific trade, while buoyant, has not been booming.
- In aggregate, the traditional dichotomy in our trade relations with the Asia-Pacific – primary commodity exports derived, for the most part, from Western Canadian provinces and end-product imports which compete with central Canadian manufacturing industries – remains relatively unchanged.
- Canadian investment in the Asia-Pacific is dominated by the activities of a few major Canadian corporations and is underdeveloped relative to Canada's current trade profile in the region. Asia-Pacific investment in Canada is at an embryonic stage.
- Canadian financial institutions have extensive links in the Asia-Pacific region and represent a necessary bridge for Canadian exports.
- Canada's aid relations are significant to only a few Asia-Pacific developing countries, and even there, are of less economic importance – and probably even of less political consequence – than our trade relations.

Canadians are probably most familiar with Japan's rapid economic transformation. They have watched as Japan's export basket ceased to be filled predominately with light manufactures, as in the 1950s and 1960s, came to include more capital-intensive industrial products such as automobiles, steel and ships in the 1970s, and has been stocked with more knowledge-intensive products in the late 1970s and 1980s. By North-American and European standards, economic restructuring in Japan has been swift while the use of forward-looking industrial plans and the function of government-business co-operation have been unique. The imperatives of managing a resource-poor country and reducing its inherent vulnerabilities have driven this rapid and ongoing economic transformation. They also underlie the growing vertical integration and internationalization of the Japanese economy typified by increasing overseas investments in resource supplies and product markets. However, Japan's import profile has remained relatively unchanged and continues to be dominated by fuels and other mineral and agricultural commodities.

Canadians have been frustrated by their lack of success in penetrating the Japanese market with more sophisticated products. In spite of major efforts on the Canadian side and assurances from the Japanese government that it also is committed to economic and industrial co-operation with Canada, concrete results have been few. Examples of frustrated efforts by Canadian exporters in the face of Japanese restrictions of one kind or another are many. Nevertheless, some hopeful signs are appearing that Canadian business interests may achieve progress in gaining access to the Japanese market for certain sophisticated products, including telecommunications.

Dealing successfully with Japan is more than a GATT problem. Of equal importance is the impact of Japanese trade and industrial policies and practices on other countries, particularly the United States. U.S. concerns are not dissimilar to those of Canada, but U.S. leverage, both in economic and political terms, is considerably greater than Canada's. Japan has become aware of foreign frustration with its import regime and foreign dissatisfaction with the lack of penetration of their manufactured and processed goods into its market. A number of recent decisions by its government show that this concern is being translated into concrete action. A number of packages of specific unilateral trade concessions have been put forward in response to foreign pressure largely imposed by the United States and the European Community, and these concessions have been of limited benefit to Canada. The possibility that Japan might accommodate U.S. interests in ways that could be discriminatory and detrimental to Canadian trade is therefore of special concern to Canada.

While Japan is generally committed to the multilateral system, it tailors its export and import practices to the needs of the moment and often prefers bilateral accommodation to pursuit of its rights under GATT. It has never, for example, sought compensation for safeguard actions by its trading partners which largely affected its interests, nor has it resorted to the GATT dispute-settlement procedures to solve its bilateral trade problems. Nonetheless, it has frequently been the object of GATT complaints, resort to conciliation, and safeguard actions.

The Japanese share the general perception that it is important to maintain and strengthen the multilateral trading system. Their approach, however, is more directly based on their own bilateral trade problems with the United States and the European Community. At times these problems have translated into a heightened determination to develop a positive and forward-looking multilateral trade agenda which will divert attention from specific bilateral irritants. The Japanese did not formulate any particular suggestions during the preparations for the Kennedy and Tokyo Rounds and frequently develop their ideas on the basis of suggestions from the United States, the Community, and Canada. Japan can usually be expected to be co-operative in addressing a wide variety of topics and to delay reaching any definite decisions until the views of most other major participants have become clear. It has therefore been somewhat surprising, but encouraging, that the Japanese have been more active lately in initiating multilateral discussion.

Canada's trade relations with the Asia-Pacific are still dominated by our two-way trade with Japan: commodity based exports, on the one hand, and increasingly sophisticated manufactured imports, on the other. However, without exaggerating their absolute importance in terms of size, our most dynamic two-way Pacific trade is with the fast-growing NICs, and to a somewhat lesser extent, ASEAN. These countries tend to import a more diversified mix of goods from a wider cross-section of the Canadian economy than does Japan. At the same time, however, the Asia-Pacific developing countries are also beginning to export more capital and skill-intensive products, widening their range of import competition in the Canadian market.

There are a number of reasons to believe that Canada's economic relations with the Asia-Pacific rim will continue to strengthen and diversify in the decades ahead. The single most important of these reasons is the relatively high growth rates projected for the region and, particularly, for the "newly" and "nearly" industrializing economies of East and Southeast Asia. The growth in output and trade of these countries is likely to continue to outpace significantly that of Canada's traditional trading partners, the United States and Western Europe. The dynamism of the Asia-Pacific countries will result both in new export opportunities for Canadian industries and in intensified import competition across a wider spectrum of industries. It is less certain, however, whether Canada's business interests will be able to expand beyond their present areas of market penetration in the Asia-Pacific, and how readily they will adjust to new import pressure at home. It *is* certain, however, that competition will continue to be very stiff. Canada is a relative late-comer to Asia-Pacific trade, and most other industrial countries are also looking to this dynamic region for opportunities to increase exports and expand employment. Not only must we Canadians become more familiar with the region and with Asian ways of doing business, but we must also commit ourselves to developing, over time, a solid business relationship: familiarity and trustworthiness are important elements of business relations in Asia.

As part of its "Third Option" of diversification adopted early in the 1970s, the federal government sought to develop government-to-government arrangements which would enhance the opportunities available to Canadian business. With the exception of China and Taiwan, all the countries in the region are members of GATT, and the General Agreement provides the contractual basis for our trade relations with these countries. In addition to GATT, however, Canada has entered into a Framework Agreement with Japan and a number of industrial co-operation agreements with smaller countries. Canada has a bilateral trade agreement with China, but does not recognize Taiwan. The thrust of all these agreements is to facilitate government-to-government contact which, in turn, provides an umbrella for private sector co-operation.

In the longer term, Canada should be prepared to devote greater effort bilaterally to enhance our trade relationship with Japan. Although this Commission has not accepted the proposal[4] for a bilateral free-trade agreement with Japan, made by a noted Canadian economist, Robert Mundell, Commissioners have been sufficiently intrigued with the notion and sufficiently concerned with the issue to ask our researchers for advice. It may be that over time, Canada and Japan could develop a stronger formal or contractual relationship bilaterally, regionally or within the context of multilateral negotiations. The key is to recognize the importance of the relationship and to give it the priority it deserves.[5]

In policy terms, therefore, there will be ongoing need for co-ordination and co-operation between Canada's government and the private sector in developing a greater awareness of business opportunities in the Asia-Pacific region. Business-government relations are usually quite close in this part of the world, and national governments are often heavily involved in major business projects. Increasingly, too, some of the Asia-Pacific countries, such as Indonesia and Malaysia, in an attempt to manage balance-of-payments problems, are attaching growing importance to bilateral trade balances and to counter-trade agreements. Given the nature of its political and economic system, China, too, is prone to monitor closely bilateral trade accounts, and counter-trade fits well with its institutional exigencies. Nevertheless, while there is an important role for the Canadian government to play in providing information, facilitating contacts, "catalysing" export contracts, and raising Canada's profile in the region, the role of government must be kept in perspective: it is ultimately up to the private sector to make itself competitive and to take advantage of these new market opportunities.

Canada's policy of domestic protectionism will be of growing importance to our future relations with Asia-Pacific, particularly in relation to the region's developing countries. Canada is not, of course, the only developed country that has imposed special trade restrictions on key manufactured exports from Asia-Pacific countries, nor is it necessarily the most restrictive. Neither, however, has Canada the market power of some of the other industrialized countries. For this reason, we could stand to lose more than others if the developing countries should choose, in the future, to take issue with developed-country protectionism. Canada has already had one sobering experience of this sort when, in 1984, Indonesia resisted Canadian efforts to curtail certain of its clothing exports and threatened to scuttle some major Canadian export contracts involving substantial Canadian commodity and capital goods exports.

It takes experiences such as this to establish the important relationship between import and export policies. Unfortunately, this link is forged too infrequently, and the connection is hampered by the bureaucratic separation, within government, of much import- and export-policy making. Canada sometimes treats "trade policy" as a synonym for "export policy", and our governments, when they come to make decisions, often take inadequate account of the wider economic and trade implications of import-policy moves. This lack of appreciation of the two-way nature of trade is most evident in our dealings with our new, developing-country, trade partners. In the future, these partners can be expected to offer more forceful resistance to our protectionist actions, particularly those which discriminate against them in areas such as textiles and clothing.

Trade with Other Developing Countries

In the years since the Second World War, Canada has played a special role in global affairs through its interaction with the developing world. As a middle-level power with no territorial or military ambitions, Canada has been accepted by developing countries as genuinely interested in helping the development process in less-developed countries (LDCs), even though our policy actions on trade and aid issues have not always matched this image. Some Canadians, for instance, are concerned about LDC demands for selective treatment in their favour in some of our key export markets, where their products provide the competition. Nevertheless, the generally favourable view of Canada, held in the developing world, reflects our belief in the use of quiet, but active, diplomacy, along with a willingness to discuss and help with the problems of the developing world. This approach to world problems has been reflected, in recent years, in Canada's active participation in the ongoing debate on North-South issues.

Canada has a much more precise interest in the developing world than can be reflected in general humanitarian considerations. We have, for instance, interests in particular issues that are similar to those of the developing countries. These interests include trade in resources, price stability for primary products, and transfer of technology. Moreover, Canada shares the interests of all smaller, trade-dependent countries in the healthy functioning of the international trade and payments system. Most important of all, the developing countries are our future and, to some extent, existing trade partners. The potentially vast markets of the less-developed countries, while still relatively untapped by Canadian exporters, are becoming increasingly important. Thus, while our present relationship with the developing world may still be dominated by humanitarian considerations, the foundations are now being laid for a mutually beneficial commercial relationship in the future.[6]

Compared with that of other members of the Organisation for Economic Co-operation and Development (OECD), Canada's share of trade with developing countries is relatively small, in proportion to our total international trade. In 1983, for example, 7.5 per cent of our imports and 7.1 per cent of our exports were with non-oil/exporting developing countries, while 28.9 per cent of U.S. imports and 29.4 per cent of U.S. exports were with these countries. Our relatively smaller share of trade with developing countries may be partially explained by the fact that as a major exporter of resources and agricultural products, Canada tends to compete with developing countries in third-party markets. While this competition may somewhat constrain our opportunities to export to developing countries, it also gives us some community of interest in certain aspects of trade policies.

Canadian trade with developing countries is concentrated in the Asia-Pacific and Latin American regions. Our imports from Latin America consist largely of fuels and primary products, while those from East and South Asia are mostly manufactured products. Conversely, Canadian exports to Latin America consist largely of manufactured products, but fuels and primary products are somewhat more important in our exports to East Asia.

Although the total amount of Canadian exports to the developing nations is relatively low, those nations represent a fast-growing export market. The high-growth countries of the developing world, especially the Pacific Rim countries, offer considerable export potential. In the years ahead, these countries will provide growing markets for our services in such areas as high-technology industries, aircraft production and engineering management. Other developing countries are likely to provide a market for Canadian expertise in engineering consulting, the construction of nuclear and hydro facilities, and communication and transportation infrastructure. Experience in extracting and processing resources will enable Canadian firms to help the developing nations to undertake these activities. Canada is also in a position to provide educational services to these countries.

Canada retains the same sort of economic protection against the developing countries as do the other members of the OECD. In the mid-1970s, non-fuel imports to Canada from developing countries faced a weighted-average tariff of 11.4 per cent, as against only 6.7 per cent for imports from other developed countries. For manufactured imports, the average Canadian tariff faced by developing countries was over twice as high as that encountered by developed countries: 15.5 per cent for the LDCs as against 7.2 per cent for the others. Tariff reductions negotiated in the Tokyo Round again treated "sensitive" Canadian industries with special care, and this caution further accentuated the existing bias favouring protection for unskilled-labour/intensive products.

Canada has implemented preferences in favour of developing countries through the Generalized System of Preferences (GSP), introduced in the early 1970s within the United Nations Conference on Trade and Development (UNCTAD). Under this program, the developed countries are allowed to grant special tariff preferences on products from developing countries, without receiving reciprocal concessions from the latter. Canada implements the GSP under the Canadian General Preferential Tariff (GPT). In practice, this concession is of limited importance, as most textiles, footwear and some electronics products are ineligible. Imports under the GPT amount to only about 4 per cent of all Canadian imports from developing countries and 0.2 per cent of total Canadian imports.

Non-tariff barriers (NTBs) against developing countries became increasingly important in the 1960s and 1970s as Canada, along with other developed countries, adopted policies to slow and control penetration of its domestic market by imports of textiles, clothing and footwear from these countries. Prominent among these global undertakings is the GATT Multi-fibre Agreement, the origins of which go back more than twenty years. While Canada is certainly not alone in pursuing these policies, neither has it been a leader in the effort to develop an alternative to increasing protection of this type. The trade restrictions imposed on these items were intended as temporary measures to allow the industries producing them to adjust to new competitive conditions. Unfortunately, this method of achieving adjustment has been ineffective, as restrictive policies have remained in place and have taken on a degree of permanence. These measures are costly to Canadian consumers and to those developing countries attempting to expand their export-oriented manufacturing activities.[7] Many developing countries are already struggling under other heavy debt burdens. While developed countries have a considerable stake in maintaining conditions under which LDCs can service their debts, discriminatory protectionist measures often act against these interests. They are also inconsistent with the desire of Canadians to help the development process of the LDCs. One Canadian company told Commissioners:

> *International aid to the Third World should be directed toward increasing their ability to stand on their own, with Canada providing a market opportunity for resulting products, as they, in turn, provide a market opportunity for Canadian products.* (George Weston Limited, Brief, September 18, 1984, p. 2.)

Quebec and Southern Ontario would probably be the regions most seriously affected by more liberal Canadian trade policies towards the developing world. Our governments should, of course, provide effective adjustment assistance for retraining and relocating workers affected by a removal of protective trade measures. In the past, adjustment assistance has been given to firms to enable them to modernize and thus retain workers in their previous jobs. An adjustment-assistance program which facilitates, rather than prevents, relocation of workers may ultimately prove to be the key for improving our trade policies towards the developing world.

Canadian Aid Performance

Foreign aid, or "official development assistance", has long been considered an important means by which Canadian government policies affect the developing countries. Despite the importance of aid as a policy tool, it is scarcely the only link between developed and developing countries. Such interactions are dominated by commercial relationships. The value of trade flows, together with commercial capital flows, dwarfs the importance of foreign aid in all but exceptional developing countries. "Official transfers" to non-oil developing countries totalled only $11.7 billion in "special drawing rights" (SDRs) in 1982, while their total exports of goods and services amounted to nearly $400 billion SDRs as Table 4-2 shows. Similarly, Canada's trade flows with developing countries are much larger than our aid flows.

TABLE 4-2 Major Elements in the Aggregate Balance of Payments of the Non-Oil Developing Countries, 1982

	(billions of SDRs)	
Current Account		
Merchandise exports	295.7	
Other goods and services exports	103.7	
Subtotal		399.4
Merchandise imports	– 340.0	
Other goods and services imports	– 154.6	
Subtotal		494.6
Capital Account		
Private transfers	21.4	
Official transfers	11.7	
Direct investment	10.7	
Portfolio investment	5.3	
Other long-term capital inflow	35.6	

Source: International Monetary Fund, *IMF Survey 13* (January 9, 1984), p. 13.

In 1980, the federal government announced its intention of raising the annual amount of Canada's foreign aid to 0.5 per cent of gross national product (GNP) by 1985 and to make its "best efforts" to achieve an aid/GNP ratio of 0.7 per cent by 1990. The present government has announced that aid will be 0.6 per cent of GNP by 1990, and that the 0.7 per cent target will not be met until 1995. In the past, such longer-term targets have not always been taken seriously enough. The 1984 federal budget, for example, announced our government's intention to use up to one-half of the increase in future aid allocations to stimulate Canadian exports to developing countries. The question raised by this plan is how much aid will actually reach the developing countries. Norway, the Netherlands and Sweden have all stated their intention of keeping their aid flows at 1 per cent of their GNP. Since these countries have already achieved this level of aid performance, the credibility of their promises is greater than ours in the developing world.

In 1975, the Government of Canada pledged to "untie" its bilateral development loans to the extent of permitting developing countries to compete with Canadian companies for contracts let by the Canadian International Development Agency (CIDA). It has not yet taken this step. A recent study of Canadian aid to Bangladesh concluded that "tying" regulations constitute an important operational constraint on the activities of CIDA in that country.[8]

These regulations inhibit activities in the rural and social sectors, which have ostensibly been made priority areas for Canadian assistance. Because untied resources have been reserved for aid to rural activities, projects in other sectors have frequently suffered most from the effects of tying. In a study of Senegal, for instance, the effectiveness of CIDA projects was evaluated as significantly reduced by the intrusion of Canadian commercial and other interests into the consideration of their choice and design.[9]

The degree of public support for effective international aid programs is also a major element in determining national aid performance. One measure of this support is the extent of voluntary private giving to developing countries. The share of GNP voluntarily directed to overseas aid has fallen in Canada over the past decade, as it has both in the United States and in the OECD as a whole. Conversely, a striking feature of the data on official aid performance is that generous governmental aid is reflected in private aid performance. The strong aid performance of the Dutch, Swedish and Norwegian governments seems to reflect a more positive perception of developing countries among their citizens than is discernible in North America. This situation implies that a prerequisite to improved foreign aid performance in Canada may be increased public awareness of the need for aid. This imperative was brought home to Commissioners by the Canadian Association for the Club of Rome:

> *Canadian policy belongs in a global context—a context that recognizes a changing world and its impact on Canadian policy and potential . . . An integral part of establishing the future in an international context is greater emphasis on Canada's role and responsibility in using its talents and wealth to help bring about a reduction in hunger and poverty in the Third World . . . The Federal government and private organizations in Canada have made some significant contributions to international development and to the creation of a stronger, more stable economic and social order, but the country as a whole lacks the political base to establish a high priority for the kind of co-operation that would give substance to the policies of industrial nations towards the Third World. A clear commitment to this objective will not come easily or quickly, or without strong government and institutional leadership to develop a broad political base.* (Canadian Association for the Club of Rome, Brief, July 18, 1984, p. 6.)

Trade with Other Regions

Canada has traditional trading links with Australia and New Zealand. While trade relations are largely governed by GATT, for both countries there remain vestiges of the bilateral preferential arrangements first negotiated at the 1932 Ottawa Conference. The agreement with New Zealand has recently been renegotiated with a view to modernizing these preferences to bring them into line with present-day trading patterns. Similar discussions have been held with Australia. Although the remaining preferences affecting both countries are small, they remain important to individual companies in Canada and provide them with a slight competitive edge over their American and European competitors.

Australia and New Zealand have negotiated a free-trade arrangement, and its provisions are currently being put into effect. This will have some effect on the remaining preferences Canada enjoys. At the same time, if Canada and the United States should seek to forge closer economic ties, Australia and New Zealand can be expected to view these with some understanding.

Trade relations with state-trading countries will continue to make a contribution to the well-being of individual producers and regions, especially for fully manufactured products. The volume of trade is unlikely to grow significantly, but the opportunities for expansion of exports of particular product lines is significant. For the state-trading economies, exploitation of opportunities through counter-trade may prove more rewarding than traditional trade flows, requiring a more than usual element of government participation. The Soviet Union has long been a major importer of Canadian grains, and together with other Eastern European countries, might become a market for Canadian manufactured goods. Though opportunities are conditioned by East-West political realities and financial constraints, there remains adequate scope to develop broad, stable and sophisticated trading ties with the centrally planned economies.

Although a number of state-trading countries are members of GATT, their participation is anomalous. GATT assumes that trade is largely the product of private transactions which may be influenced by government policies and practices. It seeks to limit the scope for government interference in private transactions. Foreign trade is a monopoly of the state in state-trading countries and thus is conducted on a wholly different basis. The participation of these countries in GATT has little effect on their trade policies. In most instances, access results only from direct government-to-government negotiations. Bilateralism, rather than multilateralism, continues to be the main focus for trade relations with these countries.

Notes

1. The European Community or Common Market consisted in 1984 of Ireland, the United Kingdom, France, Italy, Greece, the Federal Republic of Germany, Denmark, the Netherlands, Belgium and Luxembourg. The Community was established as a result of the integration in 1965 of the separate but related communities established earlier: the European Coal and Steel Community (ECSC) was formed in 1952, the European Economic Community (EED) was established by the 1957 Treaty of Rome, and the European Atomic Energy Community (EURATOM) was established in the same year. The European Free Trade Association, consisting of Sweden, Norway, Finland, Austria, is linked to the EC by means of industrial free-trade agreements. Turkey and the Mahgreb countries are linked by association agreements, and are considered by some to be a sort of membership-in-waiting. Portugal and Spain will be joining the European Community on January 1, 1986. The former European colonies in Africa, the Caribbean and the Pacific are linked by means of the aid and trade Lomé Convention. Various institutions link the constituent elements, including the Commission, the Council of Ministers, the European Parliament and the European Court. Of these, the Commission is the most important for Canada as it is the Community's executive body, responsible for foreign commercial policy. It is supported by an army of bureaucrats in Brussels.

2. Canada, Royal Commission on Canada's Economic Prospects, *Final Report* (Ottawa: Queen's Printer, 1957), p. 72.

3. L.D. Wilgress, *The Impact of European Integration on Canada* (Montreal: Private Planning Association of Canada, 1962), p. 25.

4. Robert A. Mundell, Transcript, Toronto, December 8, 1983 [vol. 64], pp. 13342–53.

5. R.J. Wonnacott, "Notes from an Address on the Proposal for a Canada-Japan Free Trade Area", in *Canada and the Multilateral Trading System*, vol. 10, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).

6. The themes in this section are examined in more detail in G.K. Helleiner, "Underutilized Potential: Canada's Economic Relations with Developing Countries", and Margaret Biggs, "The Developing Countries in the International Trading System", in *Canada and the Multilateral Trading System*, vol. 10, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).

7. For a detailed analysis of Canada's textile-import policies, see M.M. Hart, *Canadian Development and the International Trading System: Constraints and Opportunities*, vol. 53, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).

8. Roger Ehrhardt, *Canadian Development Assistance to Bangladesh: An Independent Study* (Ottawa: North-South Institute, 1983).

9. Réal Lavergne, *Canadian Development Assistance to Senegal* (Ottawa: North-South Institute, 1985, forthcoming).

The Choices Before Us

The recession of the early 1980s and its aftermath deepened Canada's reliance on the United States at the expense of our trade relationships elsewhere. Current trade figures indicate that this trend will continue. In 1984, trade with the United States accounted for 76.6 per cent of Canadian exports and 72.8 per cent of imports. The positive side of this relationship is that the United States is a quality customer, and takes far higher percentages of Canada's fabricated and manufactured end products than do our other trade partners. Moreover, the United States is a good source of quality imports. The negative side of this relationship, however, is that the natural flow of Canadian manufactured exports has made Canada much more dependent on the American market-place and, more important, on the trade policies of the U.S. government, which ultimately controls access to that market-place.

A trade concentration – particularly an export concentration – can be a concern for a nation just as it can for a single firm. There is security in a wide diversity of customers. Conversely, the greater the amount of trade with any one partner, the greater the need for a certain and secure relationship with that partner. Our relationship with the United States, however, is neither certain nor secure, for while trade statistics demonstrate the importance of the United States to Canada's economy, Canada is relatively much less important to the United States. Our country is the largest of America's trading partners, accounting for 19.3 per cent of U.S. trade in 1983, but it is not perceived to be as important to the United States, in terms of international political economy, as the European Community (EC) or Japan. The real concern is that Canada might be disproportionately affected by a given American multilateral trade policy. That policy could have some effect on all the United States' trading partners, but it would have a far greater effect on Canada because of our concentration on U.S. trade.

Given that Canada has a close, even a trade-dependent, relationship with the United States, we would do well to ensure that our trade policy nurtures industries which can compete in the U.S. market, and which have access unimpeded by U.S. protection. Canada, as the smaller power, still suffers from a lack of competitiveness perpetuated by protectionism. A long-standing Canadian economic goal has been to increase the fabricated and end-product/manufacturing component in Canadian exports, but our nation is unlikely to achieve this aim while pursuing a policy of protecting secondary manufacturing. Paradoxically, strong industries result from open markets rather than protected ones because they grow stronger by responding to foreign competitive pressures.

Trade protection in Canada, as in any nation, is implemented, essentially, by two means: tariffs and non-tariff barriers (NTBs). On tariffs, the position between Canada and its major trading partners is unbalanced: by 1987, U.S. average tariffs on dutiable imports will be about 4 to 5 per cent (though on imports from Canada, it will average about 1 per cent, because of the Auto Pact and the high level of duty-free resource imports), while Japanese and EC average tariffs will be in the 5 to 7 per cent range; Canadian average tariffs on dutiable imports will stand at 9 to 10 per cent. Obscured by such averages is the fact that tariffs are much higher on some items. Average tariffs are calculated on a "trade-weighted" basis. This means that they are heavily influenced by the volume of trade in each component, and these volumes are likely to be higher for low-tariff items. For this reason, too, we tend to underestimate the significant effect of tariffs on trade. Still, it is probable that tariff protection affects the Canadian economy more substantially than it does the U.S., Japanese and EC economies, not only because of average levels of duties, but also because of the nature of the protection. One reason is that some Canadian tariffs, particularly those on machinery products, are applied only if similar goods are made in Canada. This practice can create considerable uncertainty for Canadian importers of, say, American products, and it serves to extend tariff protection automatically for newly-developed products whether that protection is needed or not. In other words, this important manufacturing sector might be presumed to need protection that it could well do without.

The tariff schedule, too, demonstrates the presumption that Canadian enterprises need protection. It is inherently difficult to compare different nations' tariff schedules, but one way to approximate a comparison is to examine "basket-category" rates of duty. Tariff schedules are historical documents designed to serve for a long time, and as they have gradually developed they have come to include "basket", or otherwise unspecified, categories that were intended to include and protect products not yet developed or classified. Basket rates thus provide a basic level of protection, which may be adjusted upward or downward when a specific product is classified.

A sample of Canadian and U.S. basket rates is provided in Table 4-3. This table demonstrates that the Canadian rates are consistently and, for some products, substantially higher than U.S. rates. Similar examples could be found for EC and Japanese tariffs. The higher Canadian basket rates are a legacy of the National Policy, and they demonstrate the assumption that Canadian manufacturing needs protection provided by Canadian trade policy. Today, however, in a much more developed industrial economy, such tariff protection only serves to insulate Canadian industries from the world marketplace, even when they do not need it in order to compete. Such tariffs penalize Canadian industrial users and consumers by allowing Canadian producers to keep their prices as high as the tariff will allow. In some sectors, foreign buyers of Canadian products pay less than domestic buyers. Protection, especially in such instances, is no longer warranted. It would be in Canada's interest to reduce such tariffs, particularly on manufactures, in any way it can.

Again, as with tariff protection, Canada's use of non-tariff barriers does not balance that of its trading partners. The United States, the European Community, Japan and Canada all make use of NTBs, but the first three countries make more prominent use of these devices than does Canada. The United States, for example, frequently resorts to countervailing and anti-dumping duties, administrative regulations, and preferential government

TABLE 4-3 **A Comparison of Canadian and U.S. Basket-Category Mean Tariff Rates, 1983–1987**

Product	Canadian Tariff Line Item	Canadian Tariff (%)		U.S. Tariff (%)		Comparable U.S. Tariff Line Item (TSUS)[a]
		1983	1987	1983	1987	
Manufacturers of wood, n.o.p.[b]	50600-1 MFN[c] line 46	12.1	9.2	6.6	5.1	207.00
Manufacturers of iron or steel, n.o.p.	44603-1 MFN line 29	13.9	10.2	7.6	5.7	657.25
Manufacturers of aluminum, n.o.p.	35400-1 MFN line 29	13.9	10.2	7.6	5.7	657.40
Paper and paperboards of all kinds, n.o.p.	19700-1 MFN line 46	12.1	9.2	6.9	5.3	256.90[d]
Manufacturers of glass, n.o.p.	32615-1 MFN line 29	13.9	10.2	9.6	6.6	548.05
Articles of materials of plastines,[e] n.o.p.	93907-1 MFN line 230	15.5	13.5	6.9	5.3	774.55
Machinery, n.o.p.	42700-1 MFN line 46	12.1	9.2	4.4	3.7	678.50

Source: Canada, Revenue Canada, Customs and Excise, *Customs Tariff* (Ottawa: The Department, Directives Management Division, 1984); *The International Customs Journal: United States of America* 21 (April 1983) and *Annex* (January 1984).

a. TSUS = Tariff Schedules of the United States.
b. N.o.p. = not otherwise provided for.
c. MFN = most-favoured nation.
d. In addition to paper and paperboard, the U.S. category includes articles made of pulp and papier-mâché.
e. Plastines are plastic end-products.

procurement, such as "Buy America" requirements. Such American NTBs affect Canada and, particularly, investment in Canada more seriously than our NTBs affect our major trading partners.

There are two prominent examples of the effect of American NTB practices on Canada. The first concerns countervailing duties. It occurs when the United States reserves the right to apply special import duties to foreign products that might have benefited from a subsidy supplied by a foreign government. This practice is intended as a legitimate counter-measure against unfair trade, but the practice itself is open to abuse, particularly when it permits U.S. firms to harass foreign competitors with threats of countervail lawsuits. The Canadian lumber industry recently faced a countervail suit, and while Canada won the case, the proceedings entailed a long and expensive legal battle for the Canadian industry; the industry now faces a renewed threat of Congressional action to limit access to the U.S. market for Canadian lumber. The Canadian fishing industry may be facing a similar experience, for a late-1984 report of the U.S. International Trade Commission claimed that Canada had provided subsidies to producers, particularly in the Maritime Provinces. The result of this practice is that, rightly or wrongly, Canadian exporters of goods to the United States can be subjected to, or threatened by, costly legal proceedings that are beyond their control to avoid. The effect is to make business, either Canadian or foreign, think twice about investing in Canada, particularly if the investment will result in products largely exported to the United States. Of course, such exports would be necessary to the efficient operation of any large-scale modern plant located in Canada.

Government procurement provides a second example of American NTB practices disadvantageous to Canada. The United States has a general Buy America Act, and Buy America provisions are part of various pieces of U.S. legislation that regulate procurement by either federal or state governments. These provisions have borne particularly heavily on Canada's internationally competitive mass-transit industry; indeed, to sell their products in the United States, firms like Bombardier have been required to set up plants in that country. This necessity reduces the level of investment in Canada that could be made by a Canadian industry which is truly "world class", and with this loss of investment is coupled a loss of high-quality jobs as well.

The United States is certainly not the only nation to impose foreign NTBs that frustrate Canadian exporters. Indeed, Canadian producers are most familiar with the threats inherent in U.S. practices, based on the importance of the U.S. market to their continued good health. Non-tariff barriers to other markets have been successful enough to make such markets less significant for more fully manufactured products, despite reductions in tariff barriers. Such NTBs as import quotas, subsidies, and variable import levies permeate trade in agricultural and fishery products, and act as effective shields to the EC and Japanese markets for such products. The Community continues to insist on cumbersome standards procedures and arcane procurement practices. Japan specializes in invisible barriers, difficult to document and impossible to circumvent, and effective in frustrating Canadian exporters of manufactured and agricultural products. Even with competitive products to sell, access to off-shore foreign markets is by no means assured.

Thus, from a brief examination of tariffs and NTBs, it seems plain that Canada is a two-time loser from trade protection. We suffer reduced domestic competitiveness of manufactures, of which one cause is our own tariff protection. As compared to countries with large internal markets, we suffer, too, from an uncertain investment climate and from the loss of job-creating investment. Both these disadvantages are made worse by the function of foreign NTBs.

Canada's manufacturing performance is a further cause of concern. Our country's traditional trade portfolio consisted of export surpluses in agriculture, crude materials and fabricated (that is, semi-processed) goods. Canada, however, runs a substantial deficit on fully-manufactured end products. It had such a strong surplus of raw materials and semi-processed goods, however, that our government was able to conduct an expensive policy of import substitution under the protection of the National Policy. Today, this arrangement is more difficult to justify. The real growth in international trade has been in manufactured goods: as the Economic Council of Canada has noted, "the commerce in food and raw materials among market economies today is approximately 2.5 times as great, in real terms, as it was two decades ago whereas the corresponding figure in respect of manufactured goods is about 5 times [as great]."[1] Over this period Canada, too, has increased substantially its exports of fabricated and end products, and while we still have a large deficit on manufactured end products, at least that deficit is a much smaller proportion of Canada's total trade in those products than it was in 1960.[2] Since world trade over the next decade is not expected to favour primary products, it is clear that Canada will have to increase its capacity to export manufactured products if we are to remain competitive in international trade. It is a truism that nations export in order to import the goods they want. If we fail to expand our manufactured exports over the next decade, we shall suffer a reduced capacity to import and, with that reduction, a corresponding drop in our standard of living. Britain's poor economic performance shows that the stakes are high in this matter, for with its slow productivity growth and its erosion of international competitiveness over the past 30 years, its standard of living, also, has declined: its place was one of the highest in Europe in the mid-1950s, only to become, in the mid-1980s, one of the lowest for the member countries of the European Community.

Thus, to an important extent, Canada's future trade performance will depend on our country's manufacturing performance. To achieve an improved manufacturing performance will not, however, be easy. There are major changes occurring world wide in the manufacturing sector that increase the competition for all countries. There has been a growth in world industrial capacity, producing a trend which will continue in future years as developing countries expand their manufacturing capabilities. In some areas, modern technology has brought rapid change to individual product lines that tends to shorten product-life cycles. Part of this development takes the form of process technology, such as the development of robotics, and part brings about changes in products themselves. All this puts a premium on innovation, on the capacity to increase output rapidly, and on the ability to capture market share. Finally, improvements in international transportation mean that domestic markets can more and more be serviced from abroad. The result is that firms in Canada and elsewhere must compete more effectively or else retreat before international competition. Modern developments have given firms the capacity and incentive to obtain access to foreign markets, and they have also removed some of the natural protection, such as transportation difficulties, that previously served to insulate economies. Again, the message is that there is less and less place to hide, and that Canadian well-being depends ultimately on the future competitiveness of the Canadian economy. The Economic Council of Canada has claimed that much of Canada's future competitiveness may be determined by the trade policy our country chooses to pursue in the next decade:

> *The long-term rate of growth of the Canadian economy is largely determined by improvement in its competitive productivity. Current projections suggest that such improvement will be significantly less during the 1980s than in the late 1960s and early 1970s ... one cannot discount the fact that competitive rigidities and protectionist sentiment and practices have been increasing in the economy in recent years, holding back productivity improvement.*[3]

Policy Choices

One important choice Canadians must face will be whether to pursue our nation's foreign economic goals bilaterally or multilaterally. In coming to our decision, we should do well to remember that these choices need not be exclusive. If we make wise decisions, our choices will be complementary, and one will reinforce another. Our strong preference for multilateralism, which has characterized our policies over the past 40 years, was partly a reaction to the particularism and bilateralism of the 1920s and 1930s. Some of these forces are still present, discernible, for example, in our attempts to find bilateral solutions for difficult import problems through orderly marketing arrangements and voluntary export restraints. However, Canada also makes use of positive bilateral policies and instruments, such as those which resolve issues unique to a particular relationship, or those which open markets between two countries when other nations are not prepared to take that step. Indeed, well-chosen bilateral instruments may serve as catalysts that will strengthen multilateral institutions.

Over the past 50 years, Canada has forged beneficial relationships with many trading partners on a one-to-one basis. These relationships are controlled by both multilateral and bilateral agreements so that governments, when addressing issues of mutual interest, can resort to either bilateral or multilateral commitments, or to both. Pressures on the present global institutions strongly suggest that in future, governments may rely more and more on bilateral commitments. The importance to Canada of pursuing some of our interests bilaterally, though within the framework of rules provided by the multilateral system, became a recurrent theme both in the public hearings and in the research program of this Commission. One researcher, for example, claimed that the evolving international trade environment might well make multilateralism a less effective approach to trade policy in the future than it has been in the past. In particular, a policy of multilateralism might fail to provide Canada with efficient means to build up its domestic economy and to deal effectively with growing U.S. economic nationalism and protectionism. The risk created by this potential weakness in multilateral institutions is all the more serious because, of all the changes occurring in the world economy, those relating to the increasingly defensive U.S. economic stance are probably the most critical from Canada's point of view.[4] In pursuing its economic interests over the next 20 years, Canada will do well to be sensitive to this aspect of the global environment.

As a result of our hearings across the country and our study of the numerous briefs presented to us, we Commissioners believe that there is broad consensus in Canada about the objectives of Canadian trade policy as described in the federal government's 1983 trade-policy paper.[5] We were told again and again that our government should use the instruments available to it to stimulate a stronger, more efficient, productive, competitive and growing economy, and promote a more stable and open international trading environment. We heard, too, that Canadian producers need better, more stable and more secure access to a large market. Many consider that the Canadian market is too small to achieve the economies of scale that would stimulate greater productivity and efficiency.

Canadians argue about the best way to achieve these objectives. Essentially, the arguments revolve around two sets of issues: How best are we to use trade policy instruments to achieve a stronger, more competitive economy? How best are we to promote better and more secure access to foreign markets? The two issues, of course, are not unrelated. In an era when market access is largely the product of negotiations between governments, a country must pay for improved access to foreign markets by opening up its own market, whether it pursues negotiations multilaterally or bilaterally. In Canada, as elsewhere, this fact is not always well appreciated. Even so, there are other reasons for extending or reducing protection. As we noted above, Canada's economy is open and trade-dependent, and our industrial policy has been dominated by trade policy.

Economists have long argued the advantages of free trade for small economies that have little influence over their terms of trade in world markets. A country gains by exporting those commodities which it can produce relatively cheaply as compared with the rest of the world. It should, therefore, specialize in producing those goods and use the proceeds of their sale in world markets to finance its imports. In short, comparative, rather than absolute, advantage should determine the direction of trade policy. Over the years, however, many Canadians have acquired a strong aversion to developing an economy in which we are largely producers of primary resource products, even though we have traditionally seen our comparative advantage as lying in our resource industries. As a result, much of our policy making has been devoted to strengthening and establishing an industrial base in Canada.

It is now more than ever important for Canadians to recognize the virtues of allowing greater play to free-market forces in determining the direction of our economic development. In the opinion of one informed observer:

> *It is high time as Canadians that we started to concentrate on those things we can do best, those things where we have a natural advantage, either because of our geography or our resources, and stopped trying to push water uphill all the time at great cost . . . not only [to] the taxpayers but to our standard of living. We have done too much of this . . . and we would be much better off [to] pursue goals that become natural because of our geography and our location in the world.*
>
> (Senator Van Roggen, Transcript, Vancouver, September 7, 1983 [vol. 2], pp. 337–38.)

Only by moving in this direction will Canada achieve full benefit from its trade. Canadians must resist pressures to introduce more protection into our economy; we must, instead, slowly reduce and eventually remove our protective trade barriers as we proceed by way of bilateral and multilateral negotiations with our trade partners.

This Commission heard, however, from Canadians who advocated a course of increasing protection and encouragement for the development of secondary manufacturing through import substitution. Such an approach would use protectionist measures such as production quotas, content requirements and high tariffs as a defensive strategy to counteract the effect both of high foreign investment in Canada and protectionism in foreign markets.

In a brief to this Commission, Professor Abraham Rotstein, a leading proponent of such a defensive strategy, called for a halt to further movement toward freer trade and argued for a much greater emphasis on a more active industrial policy as a first priority.[6] The first building block of such a strategy, in his view, would be import substitution. Commissioners address the issue of industrial policy in another part of this Report. Nevertheless, without anticipating too much at this point, we wish to state that we do not recommend the type of massive intervention proposed in this alternative approach, although we do believe that it is important to co-ordinate industrial policies very closely with trade policy.

A policy of import substitution would be a reaffirmation of the techniques of the National Policy. Like that policy, it would create some industrial growth, largely by encouraging foreign companies to set up branch plants in Canada in order to avoid Canadian trade barriers. Such plants would likely be designed to serve only our small Canadian market, and as a result, they would be inefficient by world standards. This does not constitute the best strategy for attracting foreign investment to Canada. If Canada is to have foreign investment, it should be investment that has located here because of the productive opportunities available in our country, and not because of need to circumvent artificial trade barriers.

Part of the defensive strategy is to emphasize building greater strength within Canada before opening the doors further to import competition or seeking broader access abroad. There is a certain appeal to ensuring one is fit to meet the competition before entering the ring. Nevertheless, this form of preparation suffers from several drawbacks. Without foreign competition, there is no particular incentive to force new internal competitiveness. Adjustment is therefore delayed or, often, fails to take place at all. Moreover, it is not clear how countries would choose particular areas of their economies for scaling up to world standards. Another difficulty, posed by purely domestic rationalization, is that there are costs both of up-scaling and of down-scaling sectors. Where sectors are being down-scaled by whatever process (not usually spelled out) there is less chance for workers to gain alternative employment because this process does not take advantage of the benefits of broader foreign access. Sectors that are up-scaling to take advantage of a larger world market are doing so on the premise that the government will eventually negotiate freer trade. Can Canadians really expect business and labour to operate effectively under these incentives?

Commissioners think not. The benefits of domestic rationalization are far greater where they are combined with international rationalization through trade negotiations.

A policy of import substitution would cause still other problems. It is inconsistent with the trend toward freer multilateral trade that industrial nations have pursued in the General Agreement on Tariffs and Trade (GATT) for the past 40 years. Canada has traditionally viewed the development of strong multilateral institutions like the GATT to be in our interest, and consequently we have been a strong proponent of GATT efforts to liberalize trade. Import substitution would represent a sharp break with our strong support of GATT and GATT's liberalizing influence in international trade. Moreover, a policy of import substitution carried out by an already-industrialized nation like our own would surely invite retaliation and thus lead to reduced and less-secure access to foreign markets, for other nations would view the industries and jobs that Canada created through import substitution as effectively stolen from our trading partners. We depend on international trade, and we benefit enormously from our exchanges with other countries. A Canadian policy of import substitution would therefore be threatening to the multilateral trading system and inconsistent with our long-term needs and interests.

This Commission, then, rejects unequivocally a general policy of aggressive import substitution. We believe that Canada should seek, and would benefit from, more liberal trading conditions, both at home and abroad. In Commissioners' opinion, the question is not, "Should we Canadians open up our own market?" Rather, it is, "How, at what pace, and in return for what access to foreign markets are we to offer readier access to our own?" Such an approach is also consonant with the desire of many Canadians who see the need for a more stable and more open international trading environment. We heard many interesting and innovative suggestions about what could be done, but for ease of analysis and presentation we shall reduce them to three major approaches.

Canada might:

- Maintain its present policy. It might keep to the level and type of protection currently in place, but make selective efforts both to improve access abroad and to protect Canadian industry on a limited case-by-case basis.
- Participate actively in a new round of multilateral trade negotiations under the auspices of the GATT, in order to improve and secure our access to foreign markets, to open up our own market, and to strengthen the legal framework for international trade
- In addition to taking the initiative for the elimination of trade barriers at the multilateral level, open negotiations with the Government of the United States to reach an agreement on a substantial reduction of barriers, tariff and non-tariff, between Canada and the United States.

Commissioners recognize, of course, that the day-to-day choices which governments face cannot be parcelled so conveniently into three packages, for no situation is ever that neat, nor is there any reason why pursuit of one approach should exclude an element of another. Nevertheless, we believe that the distinctions among these three approaches are clear enough that we can delineate the advantages and disadvantages they would represent for Canada, both in the near future and for the rest of this century.

The first approach, then, would be to maintain a *status quo* policy. It would be politically attractive because it would not require innovative action, but it is problematic because it might leave Canada caught for too long in awkward transition between two incompatible trade strategies: the historic developmental and protectionist approach of the National Policy as opposed to the more modern, multilateral, liberalizing policy of the GATT. The problem is that this transition has now reached the stage where Canadian manufacturers are without sufficient protection to insulate them effectively from foreign competition or without sufficient access to foreign markets. To maintain this policy stance would be likely to deny Canada the future economic benefits of a more productive export sector. If Canada maintains its present policy, it risks facing a stagnating economy in the future. We could, of course, gradually reduce our current level of protection through continuing participation in future multilateral trade negotiations, but unless we aggressively pursue trade liberalization, the reduction might proceed at a pace too slow to effect the kinds of changes Canada must make to remain competitive.

It is difficult to hold onto the *status quo*: either a nation faces and overcomes new challenges, or it declines. Similarly, a *status quo* trade policy would be difficult to conduct. Protectionist demands would be hard to resist, and there are, indeed, signs that resistance may already have weakened. In June 1984, the Government of Canada passed the Special Import Measures Act, which included legislation on countervailing duties, emergency safeguard measures and other NTBs. The thrust of this legislation is to make contingency protection easier to impose in Canada. For example, injury criteria have been relaxed to make it easier for courts to find against foreign producers on the grounds of injurious imports. In addition, the range of adverse effects that could trigger countervailing and anti-dumping duties has been broadened to benefit import-competing domestic producers. Other changes have given our government more flexibility to manage trade, and this development will probably make Canada less accessible to foreign imports. The Act is an example of the kind of incremental drift toward increased protectionism in the name of "fair" trade that becomes possible in the absence of a clear policy commitment to broader trade liberalization.

Finally, as we have noted, trade policy and industrial policy are inextricably linked. Those who favour more open approaches to trade policy usually advocate a more market-minded, but supportive, industrial policy. Those who wish to place less reliance on economic forces usually advocate more government intervention in industrial policy. Commissioners believe that a *status quo* trade policy might lead very quickly, over the next few years, to calls for a planned economy. This degree of intervention, however, is inconsistent with the view of industrial policy that we have taken elsewhere in this Report. We argue that a highly interventionist industrial policy should be considered only if the world becomes a much darker place than we expect it to be in the future. Otherwise, an industrial policy emphasizing efficiency and excellence is most likely to contribute to Canada's overall goals. In general, therefore, although maintenance of the *status quo* has its attractions, it does not promise enough benefit to overcome its disadvantages.

Maintenance of the *status quo* may also prove an insufficient means of gaining for Canadian producers better and more secure access to foreign markets, especially the U.S. market. Since 1947, Canada has generally pursued multilateral trade negotiations to gain access to foreign markets. We have pursued this course because it has proved to be the most effective way to improve and secure access for our products and to instil order, stability and predictability into our trade relationships. Active participation in the multilateral system has allowed Canadians to benefit from a more efficient allocation of our nation's resources on a world-wide basis.

A second approach for Canada would be to embark on a deliberate and aggressive policy of trade liberalization in order to make our manufacturing sector more competitive and to broaden our access to foreign markets. The historic protection provided by the National Policy has left Canada with an industrial manufacturing base much of which is designed to service the small Canadian domestic market. More and more, this manufacturing base suffers from a scale of production that is too small to be competitive by world standards. The most severe problems of Canadian industry are lack of product specialization and short production runs. Other problems include the lack of product innovation, which is especially related to the branch-plant characteristics of our economy. These difficulties of Canadian production are not new: indeed, they have been referred to repeatedly in government reports and academic studies of our economy.

There is urgent need for Canada's economy to expand economies of scale and to realize greater productivity. Multilateral trade negotiations provide one way to accomplish this end. Freer trade would create a desirable restructuring and rationalization of Canadian industry as a result of increased competition from abroad. By becoming more competitive and gaining better access to world markets, Canadian manufacturers would become better able to survive in a more competitive, global trading environment. Ultimately, it is only by creating a more competitive domestic economy that Canada will be able to create the new jobs needed to reduce unemployment.

The power of freer trade has been amply demonstrated by historical examples, including many offered in our own country. Britain's repeal of the Corn Laws in 1846 ushered in the period of its greatest economic growth. The disastrous depression of the 1930s was deepened and lengthened by protectionism. The rapid economic growth of Western industrialized countries that began in the mid-1950s and ended in the 1970s was partly a product of the liberalizing influence of GATT negotiations. Although Commissioners do not wish to overemphasize the connection, we do note that the decline in economic growth that began in 1973 has coincided with the adoption of more protectionist policies and a reduction of GATT influence. Both the 1930s and the 1970s have demonstrated the "bankruptcy" of protectionist policies. In Canada, our strongest and most progressive industrial sectors are those most fully integrated into world markets: that is, those which operate under low levels of protection at home and face low barriers to export markets.

Multilateral negotiations, however, have become highly complicated and long-drawn-out affairs. Attempts are currently under way to explore whether a basis can be found for another round of GATT negotiations. A new round would focus on elaborating world trade law and reducing barriers to world trade. These developments would be in Canada's interest, but the results of a future GATT negotiation are *not* just around the corner. Initiating a new round is a complicated process, yet it would centre largely on the interests of three or four major players: the United States, the European Community (EC), the less-developed countries as a group, and Japan. Canada is an important player in the system, but our country does not set the agenda or determine the outcome. There is as yet no consensus on any issue. When negotiations are joined, they will last a long time, and they will not necessarily provide solutions for specific Canadian concerns, particularly as these relate to trade with our most important trading partner.

Exclusive concentration on multilateralism may not be able to provide Canada with better and more secure access to our most important market. The growth of our exports to the United States has been the product of proximity, close inter- and intra-corporate ties, and the relative openness of that market compared to that of our other major trading partners: the European Community and Japan. The very accessiblity of the U.S. market compared to that of the others means that the United States is unlikely to extend its multilateral policies much further unless it is satisfied that the Community and Japan are likely to reciprocate. While there are benefits to negotiating access to the U.S. market in concert with these two partners, there is also the disadvantage of being held hostage to EC and Japanese willingness to open their markets to U.S. exports.

A third approach option would be to try to reap the advantages of the multilateral approach and, at the same time, pursue complementary Canada-U.S. bilateral free trade. This would be a bold move and would elicit strong controversy. Even though there now appears to be substantial public support for freer trade with the United States, it would not be easy for Canada to negotiate an acceptable agreement. In Commissioners' view, the second and third approaches deserve to be weighed very carefully. Our own analysis follows in the next two chapters.

Notes

1. Economic Council of Canada, *On the Mend*, Twentieth Annual Review (Ottawa: Minister of Supply and Services Canada, 1983), pp. 19–20.
2. Economic Council of Canada, *The Bottom Line: Technology, Trade, and Economic Growth* (Ottawa: Minister of Supply and Services Canada, 1983), p. 99.
3. Economic Council, *On the Mend*, p. 95.
4. See John M. Curtis, "Which Way? Canadian Trade Policy in a Changing World Economy", in *Canada and the Multilateral Trading System*, vol. 10, prepared for

the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).

5. Canada, External Affairs Canada, *Canadian Trade Policy for the 1980s: A Discussion Paper* (Ottawa: Minister of Supply and Services Canada, 1983).

6. See Canadian Institute for Economic Policy, Brief, February 1984. This brief was later published. See Abraham Rotstein, *Rebuilding from Within: Remedies for Canada's Ailing Economy* (Ottawa: Canadian Institute for Economic Policy, 1984).

CHAPTER 5

Canada and the General Agreement on Tariffs and Trade

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Introduction

Commissioners strongly believe that a more liberal trading environment will expose Canadian producers to the beneficial effects of more world competition and will provide the framework within which our country will be able to improve its access to foreign markets. At the same time, we Canadians must also look to securing the access we currently enjoy, with the intent of removing as much uncertainty as possible from Canadian firms seeking world markets in order to develop their business. In this more liberal and secure trade environment, our exporters will be able to use improved access to exploit fully the opportunities available to Canada in the global economy.

Since 1947, the means Canada has used most frequently to improve and secure access to foreign markets and gradually to liberalize access to our own market have been multilateral negotiations under the General Agreement on Tariffs and Trade (GATT). Many Canadians are convinced that the GATT has served us well by offering wider access to export markets abroad and by providing for discipline in world trade, thus guaranteeing some security of access to international markets. GATT has also provided a basis for an orderly liberalization of our own market, thus ensuring our development into a more competitive economy. Among those who appeared before this Commission, the Canadian Chamber of Commerce made this point succinctly:

> *Because of its high level of dependence on trade and the relatively limited size of the domestic market, Canada, more than virtually any other industrial nation, is critically reliant on a liberal and open international trade environment. It is in Canada's interest that multilateral institutions such as GATT are maintained and strengthened.* (Canadian Chamber of Commerce, Brief, October 3, 1983, p. 19.)

In evaluating the trade-policy options available to Canadians in the years ahead, it is necessary to assess both the benefits we have already derived from participation in the GATT and our future prospects. How much broader access to world markets can we obtain through GATT measures? At what pace and with what degree of security?

The GATT's Achievements

The GATT inherited a legacy of high and often discriminatory tariffs reinforced by a tangle of non-tariff barriers (NTBs) that also were frequently applied on a discriminatory basis. Retaliation and counter-retaliation were the normal means of attempting to settle disputes. Seven GATT negotiating rounds have taken place since the General Agreement was signed in 1947. Canada has fully participated in these rounds. In the second to fifth rounds, the actual reductions achieved in trade barriers were relatively modest. The Kennedy and Tokyo Rounds, however, achieved significant cuts. Today, the industrial tariffs of the developed market economies are probably lower than at any time since the late 1870s and substantially lower than during the 1930s. (For example, the U.S. average tariff during the 1930s stood at 50 per cent, whereas after the Tokyo Round cuts are fully implemented, the average tariff on industrial products will be 5 per cent.) In addition, virtually all of these industrial and fish tariffs and many agricultural tariffs are "bound". They can only be increased if they are renegotiated on the basis of paying compensation or accepting retaliation. The cumulative effect of the GATT rounds has been significant, especially in establishing the habit of multilateral negotiation and practices, and in generating the momentum for further trade liberalization at each stage.

The GATT has also made progress in the removal of non-tariff barriers or, where removal is not appropriate, in bringing NTBs under better international discipline and reducing the scope for their misuse. In the early 1960s, European countries, Japan, and other nations removed thousands of quantitative restrictions. This landmark achievement resulted in the substantial liberalization of trade. The Tokyo Round agreements relating to valuation, dumping, technical barriers, government procurement, subsidies and countervailing measures, and import licensing marked a long step toward reducing the risk that such measures might be misused to restrict trade. As time passes and observers gain perspective, the agreements on technical barriers and government procurement, which, for the first time, bring these types of barriers under the GATT, probably will be seen to have made important contributions to the liberalization of trade. Trade in industrial products, most fish products, and some agricultural products has become less constrained by non-tariff barriers than at any time since before the Great Depression. Equally important, the GATT has begun the process of establishing the rule of law in the conduct of international trade relations. The system for adjudicating disputes neutralizes disparities in power between the parties in disagreement and usually results in prompt and fair settlements.

The developed market economies now offer freer access, overall, for products exported by other developed market economies than they have offered at any time since the early 1900s. Moreover, a much smaller risk exists that such access will be reduced or cancelled out by raising tariffs or imposing other barriers to trade. Since the GATT was established, the value of world trade has increased more than six times. During most of this time, most of the developed market countries, including Canada, experienced a faster rate of export growth than did their national economies. The liberalization of trade under the GATT was the necessary basis of the expansion of world trade and the growth of the industrial economies.

It is essential that Canada have stable access to foreign markets, especially the markets of the United States, the European Community (EC) and Japan, as well as opportunities to negotiate improved access to foreign markets on reasonable terms. Such access is best incorporated in a contractual framework that seeks to neutralize disparities in power. Measured by these basic interests, the performance of the GATT to date has been without historical precedent and generally satisfactory, not in any absolute sense of perfection, but in comparison with that of earlier periods. Without GATT, it is unlikely that Canadian exports would have grown at a faster pace than the national economy during the post-war years.

Difficulties Facing GATT

While there can be no question that the GATT has been instrumental in reducing trade barriers and has thus facilitated the growth in post-Second World War trade, it is now at a difficult stage in its evolution. Over time, its membership has expanded, and negotiations have become more difficult to conduct. The GATT is no longer – and appropriately so – the cosy club of 23 countries which negotiated the original General Agreement in 1947. Indeed, negotiating simultaneously with 100 or more countries is quite a different matter from negotiating with the original members, and the "lowest common denominator" seems, at times, to determine the outcome of GATT proceedings. More trade is now managed through voluntary export restraints, orderly marketing agreements have increased in number, and resort to quotas has grown more frequent. Issues of concern both to Canada and to our main trading partners have not, on occasion, been fully pursued because of our collective inability to convince all parties to the negotiations of the worth of alternative proposals.

The issue now facing Canadians is to decide how much further benefit, in the form of improved and assured access to world markets, the GATT process can offer us. Canada, like other nations, has long recognized the need to facilitate progressive movement to a more liberal trading environment. Now, however, proposals for trade liberalization are countered by demands for new restrictions on imports and for the protection of existing industries, in order to preserve employment. An international economic system based on specialization and the free flow of goods and services imposes restrictions on each country's right to pursue its own particular goals and policies. As Canadians enter the latter years of the current century, we must consider seriously whether the multilateral approach to the liberalization of trade offers broad enough prospects for our economy.

It cannot be assumed blithely at this stage that the rule of law, such as it is, and the political will underlying it will continue to be a feature of world trade and the global economic order. Many governments are intervening to a greater extent in their domestic economies; they are formulating all kinds of "strategies" for industrial and agricultural development, which, in many instances, amount simply to elaborate assistance programs that need to be defended by the imposition of controls on competitive imports. As a result, some governments, especially those of the larger countries, now tend to regard the international economic and trade rules as extensions, in essence, of particular domestic policies: regulations to be observed only when they accommodate those policies and to be changed or evaded when they do not.

The general principles enshrined in the General Agreement itself were originally intended to provide a framework for the conduct of trade relations, for periodic negotiations to reduce trade barriers, and for the introduction of a liberalizing bias into members' trade policies. Over the years, the desire to impose discipline and thus maintain the integrity of tariff reductions has been one of the influences which has gradually changed the character of the GATT. This change became especially obvious during the Tokyo Round, when members made a concerted effort to translate general principles into detailed rules and procedures. Unfortunately, it has had perverse and unintended side effects. Rather than continuing to push for the elimination of trade barriers, GATT now sanctions certain barriers as long as these are imposed in a particular manner and follow specific procedures. This development has encouraged certain member states which had not used certain types of trade barriers to arm themselves with the full panoply of GATT rights in order to defend themselves against other members. Canada has been no exception. Until 1977, Canada lacked complete procedures for imposing countervailing duties. We now have a fully developed system wholly consistent with our GATT rights, but not necessarily in our best interests. Thus, through its members' efforts to impose discipline, GATT negotiations have directly stimulated the introduction of new trade barriers in countries which previously had seen no need for them.

In general terms, the GATT has made significant progress in reducing tariff barriers. Those that remain are often the most difficult to negotiate, especially on a multilateral basis. The present problem areas of trade policy now have less to do with tariffs and more with non-tariff barriers (NTBs). These latter forms of protection are extremely difficult to identify and monitor, since they are often inseparable from a nation's domestic policies. The provisions of the General Agreement relating to NTBs deal only with broad principles and not with detailed rules. The Tokyo Round marked the first comprehensive attempt to bring such measures within a framework of rules, but the process is far from complete, and not all the applicable codes are fully satisfactory.

Closely related to the problems of NTBs are difficulties pertaining to dispute-settlement procedures in the GATT. Member countries are committed to consult bilaterally in the event of a dispute; if bilateral consultations prove unsuccessful, the parties may request a panel review. This procedure worked reasonably well as long as there was broad agreement on the value of a liberal trading environment, but of late, a number of problems have arisen. These include the absence of effective monitoring, compliance and enforcement methods; increased use of protective measures not covered by GATT rules; and non-adherence by contracting parties to GATT-panel recommendations. These problems all relate to the widening divergence of views among participants on the nature and purpose of the GATT. Since the Kennedy Round, there has been an increasing tendency for countries to settle trade-policy disputes bilaterally, outside the GATT. The trend to resort to non-GATT agreements and the consequent erosion of the GATT principle of non-discrimination has made Canadians more concerned about guarantees of continued access to world markets.

An important characteristic of the GATT system has been the desire to maintain an overall balance of advantage for all participants through application of the principle of reciprocity. If any member should consider that its interests have been adversely affected, GATT dispute-settlement procedures allow it to pursue a new balance, either on a one-to-one basis or through collective action. The GATT is thus a dynamic political institution operating within a framework of rules, none of which are absolute, and many of which are obscure and subject to diverse interpretations. Its dynamism, however, favours the more powerful members which can afford to take action that may adversely affect a smaller country, secure in the knowledge that retaliation is unlikely. If a measure is challenged, it remains in effect until the dispute-settlement mechanism runs its course. If the challenge is upheld, a recalcitrant major power can make minor adjustments and force renewed resort to dispute settlement. Conversely, great powers can readily retaliate against any trade-policy measure that is not in its interest and force a smaller power to resort again to dispute-settlement procedures.

Canada's experiences with the European Community in the matter of gaining access to the EC market for Canadian high-quality beef, lead and zinc, and newsprint have all demonstrated the truth of this perception. The newsprint case was especially educational. Following negotiations with the Scandinavian countries, the Community considered that it would be to its advantage to reduce a duty-free quota, bound to Canada, for newsprint. Canada repeatedly challenged the EC and was vindicated by a GATT panel; in the end, however, for the sake of our relations with the Community, our government, in order to resolve the issue, felt constrained to accept a lower quota than we had paid for in previous multilateral negotiations. The Community obviously considered its commitments to a free-trade agreement with the Scandinavian countries and its desire to limit the access it granted for newsprint of more importance than its relations with Canada or its obligations under GATT.

A third general problem concerns the integration of the less-developed countries (LDCs) into the full GATT system. These nations lack the capacity to influence or alter negotiations effectively in their favour. Bargaining power in GATT relates to market power. LDCs have neither had sufficient market power, nor displayed a desire, to open up their own markets and thus deploy what limited bargaining power they do possess. Their perception of the post-war trade-and-payments system is radically different from that of the developed countries, and thus their approach to negotiations is different. The future strength of the multilateral trade system, however, requires the full support and participation of all its members; without that support, its members will become obsessed with the problems of one group to the detriment of others.

The GATT does not exist independent of the will of its members, nor is it capable of arriving at decisions with which its members cannot live. It is not a judicial system, nor is it a law-enforcement body. Rather, it represents the collective will of its member states. It represents the cumulative result of many major and minor negotiations relating both to general rules and to specific trade concessions. If its discipline has eroded, the reason is that its participants have not seen fit to accept greater discipline.

The GATT system today encompasses much more than the 38 articles of the General Agreement. To these must be added:

- Detailed tariff schedules amended by seven rounds of general negotiations and many "out-of-season" individual negotiations
- The Protocols of Accession and Association which spell out precise terms and conditions applied by members at variance with the General Agreement
- The ancillary codes and agreements negotiated during the Kennedy and Tokyo Rounds, to which not all GATT members are party
- Almost forty years of experience, understandings, interpretations, panel findings, working party reports, and agreements contained in the 31 volumes (as of 1985) of *Basic Instruments and Selected Documents*
- The Multi-fibre Agreement, an organized derogation from the discipline of Article XIX, which permits its 52 participants to apply discriminatory quotas to trade in textiles and clothing
- Various other derogations and waivers, particularly those under Article XXIV, which provide for discriminatory free-trade areas, common markets and customs unions.

In short, over the years, the GATT has evolved into a highly complicated system marked by various levels of commitment and participation. It is far from representing a clear-cut code of international rules applied by all its members on a non-discriminatory basis.

The attitudes of various GATT-member governments to the purposes that the GATT system serves have devolved over the years to the point where there is no longer ready consensus about what future actions should or should not be taken through GATT. It is particularly important that we Canadians understand the attitudes toward GATT of the United States, the European Community, Japan and the LDCs as a group.

The United States has long enjoyed its role as the principal force behind the GATT. It sees this institution as the best way to manage its numerous and varied trade relations. As sponsor of many of the issues currently dominating the international trade-policy agenda, it is strongly committed to a revitalization of the GATT through a new multilateral trade negotiation. But whereas in years past, U.S. participation in GATT was as much inspired by political and strategic considerations as by trade and economic factors, the latter are now much more important. The United States sees itself as the victim of its past generosity. It views its market as more open than any of those of its trading partners, its economy as more vibrant, and its currency as stronger; it also sees its trade deficit as unacceptably large. It therefore looks forward to a future GATT round, not only in terms of reforming that institution, but also in terms of righting the imbalances that have evolved within it. The United States no longer considers that there is any strategic advantage in "going first". It is not prepared to open its market further until it is clear that other markets will be significantly more open, and that greater discipline will be imposed on unfair trade practices. An indication of the American attitude is that while the United States is pushing for an early start to negotiations, it is not seeking a tariff-cutting authority, as it did in earlier negotiations.

U.S. participation in GATT, while generally forward-looking and biased towards trade liberalization, has not always been benign. The United States has sometimes used GATT to give international legitimacy to its particular trade policies. Considering its dominance, it has generally done so successfully, whether these policies were in every member's interest or not. It was the U.S. request for a waiver from its GATT obligations in relation to agricultural import restrictions which formed the origin of GATT's inability to exercise more discipline over trade in agricultural products. It was U.S. sponsorship of the Multi-fibre Agreement which gave rise to the past 25 years of organized protectionism in trade in textiles and clothing. And it was U.S. preoccupation with rules and procedures which introduced what some observers now see as GATT's greatest danger: the complete legitimization of systems of contingency protection.

Since GATT's inception, its members have sought to instil stability, predictability and transparency into international trade relations by negotiating general rules applicable to all member states. Business confidence and investment require such order and stability in an interdependent world. Systems of contingency protection, however, have exactly the opposite effect. These systems involve elaborate rules and procedures relating both to injurious, dumped and subsidized imports and to seriously injurious (that is, politically intolerable) imports; they also allow governments to impose quotas, surcharges or penalties on such imports. These systems have now replaced tariffs in industrialized countries as the principal tool of economic protection. They allow imports to enter until such time as affected domestic producers can convince government that they should be curtailed. Nowhere is such a system more complete than in the Unites States. U.S. trade law, which is generally consistent with U.S. obligations to GATT because the United States has been the principal sponsor of the rules, gives American business interests broad scope to harass their foreign competitors and thus deter investment. The U.S. call for more rules and discipline in international trade relations, therefore, holds an ominous message for other countries.

Since its inception, the European Community has been driven by a perception of the world trading system which is fundamentally at odds with that of the United States. Its priorities are based on the development of a preference system around the European heartland that discriminates against its main competitors, the United States and Japan. Most of its trade is now governed by the terms of the Treaty of Rome and related agreements, and not by the GATT. The GATT system serves mainly to manage EC-trade relations with the United States, Japan and Canada, and these, while not unimportant, provide a decreasing proportion of EC trade. The strengthening of the multilateral system is thus of decidedly secondary interest to the Community. The EC does not perceive many of the issues on the U.S.-sponsored/trade-policy agenda as critical to its advantage; indeed, it sees some of them as a positive threat. Thus it is playing a delicate game of welcoming proposals for negotiations, but frustrating efforts to put them into operation or to define an agenda.

There are sharp differences between the EC and the American perceptions of the role of the state in the economy, and these are clearly apparent in their differing approaches to future trade negotiations. The European Community perceives the U.S. desire to revitalize the GATT and to strengthen international discipline as a threat to many of its internal policies. The United States sees a need to develop rules which will penalize governments for intervening in its economy in order to meet particular social and political goals. An issue that symbolizes this difference is the EC Common Agricultural Policy (CAP). Under the CAP, prices for farm produce are set by the state on a basis essentially unrelated to costs. As a result, even the least efficient farmer in the Community can be confident of making a comfortable living. The integrity of these prices is maintained by a system of variable levies and import quotas meant to keep more competitive foreign produce out of the EC market. Almost all producers are, in effect, subsidized and produce huge surpluses which can only be disposed of by dumping them on international markets at distress prices. To the European Community, the CAP is an expensive, but necessary, policy to bind the Community together, assure it virtual self-sufficiency in agriculture, and maintain small farmers' income at a level similar to that of urban industrial workers. Community policies, in place without interruption for some twenty years, have closed the EC market to more competitive foreign produce and have made it an unfair competitor in third markets. To the United States, the CAP is proof positive of the bankruptcy caused by too much state intervention. Such differences are not readily reconciled in multilateral negotiations, especially when they are replicated across other sectors.

The European Community is ambivalent, too, about the efficacy of the rule of law in international trade relations. It views strengthening of the rule of law and dispute-settlement mechanisms as a threat to its ability to reach bilateral and sectoral deals with those most affected by particular practices. While the United States may have invented the discrimination inherent in the rules governing international trade in textiles and clothing, the Community has perfected it and periodically tightens those rules' restrictive and discriminatory effect. It finds third-party arbitration, as called for under GATT rules, an intrusion into its own already-complicated decision-making process. It does not welcome such intrusions and generally ignores unwelcome conclusions.

Japan participates actively in the GATT and, together with the United States, is calling for a new round of trade negotiations. Nevertheless, it does not fully adhere to GATT principles, either in its export policy, where it is prepared to accommodate its trading partners in ways inconsistent with the

General Agreement, or in its import policy, where myriad subtle rules and practices seriously frustrate the more forthright Western business approach. Japan shares the perception that it is important to maintain and strengthen the integrity of the multilateral trading system, though its motives may be more closely related to a desire to divert attention from specific bilateral trade irritants than to a desire to impose greater general discipline. Although Japan can be counted on to participate fully in GATT activities, it is unlikely to provide leadership. In the long run, better access to the Japanese market is less likely to be achieved through GATT than through bilateral negotiations, particularly those patterned on the negotiations of the United States.

Less-developed countries which participate in GATT are not subject to the same discipline and obligations as industrialized countries. Over the years, GATT members have systematically waived obligations or introduced special measures that differentiate in their favour. Nevertheless, the LDCs see the multilateral trade-and-payments system as a means of establishing new dependencies through economic exploitation. They view the failure in negotiating multilateral safeguards and the perpetuation of the discriminatory provisions of the Arrangement regarding International Trade in Textiles (Multi-fibre Agreement) as evidence of the GATT's lack of response to their aspirations. They believe that the GATT needs a fundamental restructuring to the point where it requires its members to discriminate positively in their favour until such time as their economic development approaches that of the countries that make up the Organisation for Economic Co-operation and Development (OECD). Understandably, their view of the GATT is not widely shared by developed countries:

> *It is difficult to argue that developing countries, having almost unlimited rights to protect themselves against imports, could somehow be harmed by other countries keeping themselves open to trade. Even legitimate criticisms about the levels of protection established by many countries on developing country exports such as textiles and clothing are not altogether valid. Notwithstanding the protection, actual levels of market penetration of these products are substantial in many industrialized countries, although they would certainly be higher without the high level of protection these sectors enjoy. The GATT system is not a system which exploits developing countries; rather, it provides developing countries with some assurance of relatively open markets, particularly in comparison to the markets of the centrally planned countries, or to the markets of the developing countries themselves. For these reasons, it is unlikely that fundamental changes in the international trading system will be made in response to LDC demands. Any changes will be in response to more broadly based needs.*[1]

Despite these seemingly incompatible attitudes on the part of the major participants, the GATT remains a remarkably successful instrument and a symbol of multilateral co-operation. The challenge in future negotiations will be to retain that record and even improve on it. This will be a very difficult challenge to meet and will take substantial amounts of political determination, time and compromise.

The current situation, therefore, should not be overdramatized. The international trading system, though weakened, has not collapsed. While the GATT rules and norms of behaviour have been avoided or disregarded in a number of areas, they continue to govern much of the world's trade, and they remain the standard against which trade actions are measured. Overall, it appears that no country, large or small, is prepared to countenance the collapse of the existing international systems for economic co-operation for fear of the consequences. Many proposals have been made for reforming and re-energizing the international trading system. These range from the suggestion that a new GATT round be initiated later in this decade, to the statement that the GATT should, instead, pursue trade liberalization and the extension of the rules governing international trade through one or several approaches, including bilateral, regional or functional arrangements.

The GATT was the product of the uneasy compromise between the perfectionists and the protectionists. U.S. ratification of the Havana Charter foundered on the dissatisfaction both of those who wanted the International Trade Organization (ITO) to be a perfect embodiment of the economic principles of free trade and of those who believed that any international rules would prevent the United States from protecting its market from unwanted foreign competition. Although the GATT emerged as the interim compromise, the tension between perfectionists and protectionists has animated its existence ever since. That tension will be a major force in future negotiations.

Note

1. M.M. Hart, *Canadian Economic Development and the International Trading System*, vol. 53, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).

The Prospect for Future Negotiations

Multilateralism has formed the basis of Canadian trade policy since the Second World War. Overall, Canada has adhered to multilateral principles, while accepting the need for complementary bilateral initiatives in areas where it has relatively more strength and hence occupies a better bargaining position. This tendency has rested primarily on the belief that all countries – especially a relatively small economic power – can make greater gains in this kind of forum than in any other. It has been argued that the multilateral approach to trade policy results in a situation where the Canadian interest is likely to be consonant, on any given trade issue, with that of one or other of the major economic powers.

The evolution of international rules in economic areas, to the extent that this development will continue over the next decade or so, will have important implications for domestic economic and foreign trade legislation in the countries concerned. As an outcome of the Tokyo Round, for example, significant changes were made in Canadian and U.S. trade legislation. Cynics may argue that the international rules are written by the larger countries simply to accommodate their own laws and policies. Although this argument is valid to some extent, it is not entirely so. If the international rules are to have any authority, they must necessarily win agreement through a process of negotiation in which the interests of a significant group of countries are also accommodated, and they must also be interpreted and observed in ways which, over a period of time, will command the respect of the system's members. That they have eroded over the past few years does not mean that the whole system must be discredited.

Prospects for a new GATT round in the late 1980s are still uncertain, but the United States and Japan are pursuing the initiative, and Canada is giving its strong support. The European Community appears to remain largely unenthusiastic. Nevertheless, the probability of a new round now appears to be good, although neither the scope nor the timing is easy to predict.

The impetus behind widening international consensus in favour of new negotiations is to be found in:

- A desire to curtail protectionist pressures that are seriously threatening multilateral trade co-operation
- The resurgence of the view that GATT members either move towards further liberalization or regress to the beggar-your-neighbour policies of the 1930s
- A desire to strengthen existing international rules which constrain government fiscal practices and thus reduce budgetary deficits now frustrating growth and adjustment
- A desire to improve and to clarify existing rules to make the trading environment more predictable
- A desire to broaden the scope for international trade co-operation to cover more areas not now subject to international disciplines including, for example, trade in services

- A desire to look for a more closely co-ordinated framework that effectively takes into account the linkages between trade policy, industrial policy and international financial relations
- A desire to bring the developing countries more effectively into the multilateral framework on the basis of some reciprocity of benefit. There is growing awareness that the real solution to developing-country indebtedness lies in improved trade flows between developed and developing countries, arising from better access to developed markets.

Important as these general desires may be, real impetus is more likely to result from events in the United States, as it did for the Tokyo Round. The United States has long been, and will continue to be, the world's most attractive single market. In retrospect, the United States' devaluation of its dollar and its introduction of an import surcharge in August 1971 were crucial to launching the Tokyo Round. The present U.S. budget deficit, strong dollar, and trade and current-account deficits could precipitate another 1971-type crisis. The number of protectionist bills being readied for consideration in Congress is similarly ominous. Despite its differences with the United States, the European Community may find such threats easier to contain within the context of a general trade negotiation. The Japanese have already reached this conclusion. Experience during the Tokyo Round demonstrated that U.S. Congressional protectionism is more easily managed and held off in such a setting. The Administration shares this perception and will use it as an effective tool to advance U.S. interests.

While the impetus for a new round of multilateral trade negotiations may be fear of developments in the United States, a successful negotiation will require that participants spell out their objectives, that these objectives be reasonably compatible or susceptible to compromise, and that the major players display sufficient flexibility and political will to drive the negotiations to a successful conclusion. For its part, Canada, as one of the more important players, will have to advance its interests, pursue its objectives, and make its contribution. Broadly stated, Canada's objectives would include:

- A more ordered world trading environment, promoted by the introduction of sufficient stability, predictability and transparency in international trade relations to inspire business confidence and thus lead to job-creating investment
- More secure access to its major markets, particularly the U.S. market
- Improved opportunity for the further processing of our natural resources before export, by reducing barriers to manufactured goods
- Improved access and trading conditions for agricultural and fishery products
- An improved framework of rules that will encourage orderly adjustment in the Canadian economy.

Our trading partners share some of these objectives; there is, however, little consensus on the means of achieving them.

A new round would establish much of the international trade-policy agenda for the remainder of this century. The overall agenda would probably cover negotiations in a number of areas, including the following.

Safeguards. Participants will examine new constraints on the use of emergency measures of protection against injurious imports of particular products – the "escape-clause" provisions – covering matters such as the action on steel and lumber threatened by the United States, Canadian action on footwear, and negotiated export restraints on motor vehicles. This general issue has been subject to discussion and negotiation for more than ten years, and no resolution is in sight. The contention has come to symbolize the erosion of GATT discipline, especially for LDCs. Progress on this issue will be very difficult, but failure to make progress will further discredit the GATT system. Canada has long expressed strong support for discipline in this area.

Agriculture. Negotiations will be designed to liberalize trade in agricultural products, to limit or eliminate the use of subsidies, and to limit the trade-distorting effects of domestic support measures. Of particular concern is the problem of competitive export subsidies used to dispose of surpluses generated behind high levels of protection. Negotiations would largely revolve around U.S.-led efforts, strongly supported by Canada and Australia, to reduce the distorting effects of certain types of domestic policies. Again, progress is likely to be difficult.

Developing Countries. Members will examine the scope for liberalizing trade for the benefit of developing countries in terms of their economic development requirements, while at the same time securing increased obligations from the newly industrialized countries that continue to maintain high levels of protection. This is another very difficult issue which will require a high level of political will and U.S. leadership, and a willingness on the part of LDCs to differentiate among themselves and thus allow the more advanced among them to assume more obligations.

Government procurement. Negotiations have already commenced regarding the broadening of the existing GATT Agreement on Government Procurement. This undertaking introduces the concept of national treatment to, and non-discrimination among, parties to the Agreement in the matter of purchases by governments. Work will continue, but it is unlikely to be completed in isolation from broader multilateral negotiations which will offer the scope for the trade-offs required to strike a comprehensive deal. Negotiations, however, will not be truly multilateral in that most LDCs do not participate in the Agreement and have shown little inclination to join.

Trade in services. International rules might be developed respecting trade in those services that lend themselves to the negotiation of a general framework of rules. So far, only the United States is convinced of the need to negotiate rules; other members are prepared to examine the issues involved. "Services" in this context applies to a whole range of economic activities, including insurance, consulting, banking, accounting, advertising, transportation, communications, art, design, education, legal and health services. For a number of these activities there already exist various bilateral and multilateral agreements, such as the many bilateral air agreements and the framework of the International Civil Air Organization; for others, there are virtually no international rules. In some areas, there are many impediments to international commerce; in others, none. Many of the issues relating to trade in services are closely associated with rules about investment, such as the right of establishment. Whether such diverse economic activities are susceptible to general rules is an open question. Whether such general rules are desirable is a question at the heart of the debate.[1]

Textiles and clothing. This issue is of key interest to developing countries in view of the scheduled expiration of the GATT Multi-fibre Agreement (MFA) in July 1986. Many LDCs see U.S. and EC commitment to phasing out the MFA over the rest of the decade as a pre-condition for agreement to broader multilateral negotiations, a view these two members find hard to accept. The issue is closely related to safeguards negotiations and, together with these, symbolizes for LDCs their view that the GATT is an instrument which the more powerful countries use to legitimize their economic exploitation of the weak.

Tariffs. Members might negotiate further reductions in tariffs which continue to have important effects on trade in certain markets, such as Australia and Japan, in certain products, such as petrochemicals. At least in its early stages, a new round is likely to concentrate on harmonizing tariff structures and levels rather than on tariff cutting. Only if much progress is made on other issues is the U.S. Administration likely to seek a tariff-cutting authority from Congress.

Non-tariff measures. This is a very broad category of issues and is likely to be the main focus of the agenda. The issues involved will need to be more clearly defined before participants are likely to commit themselves to negotiations.

Resource industries. Participants might examine the possibility of further liberalizing trade in a broad range of unprocessed, semi- and fully-processed, and related machinery products of interest to primary-resource industries such as agriculture, forestry, the fishery and non-ferrous metals and minerals. This is one of Canada's chief negotiating objectives, but it is not widely shared.

Strengthening the multilateral system. An examination might be made of the scope for strengthening the institutional framework for trade co-operation (that is, the GATT processes and procedures including those related to dispute settlement) and for closer co-ordination of international trade and financial institutions. This issue touches on many others and could be identified as the theme underlying the whole of the negotiation.

The list of issues to be addressed in future negotiations is long and comprehensive, and many of the issues are extremely difficult. For none is there yet sufficient consensus to be able to indicate the likely outcome. Even though there appears to be growing political will to begin serious preparations for commencing formal negotiations, the lack of agreement on most topics suggests that the preparatory process will be prolonged. For example, LDCs are insisting that industrialized countries provide verifiable evidence that they are prepared to begin dismantling their protectionist textile- and clothing-import regimes, and this requirement may prove a stumbling block for a number of years. The reservations of the European Community about the perceived attack on its agricultural policies will make it a reluctant participant. LDC concerns about the American call for discipline in trade in services, which they consider to be aimed largely at them, will not readily be overcome.

Even when such reservations have been removed, it will not be easy for participants to reach agreement. As we noted earlier, to reach consensus among 100-odd participants is extremely difficult, especially when the dominant players are sharply divided. The European Community sees little need to strengthen the multilateral system or to reach agreement on many of the issues on the agenda. The United States may consider dismantling its textile- and clothing-import regime too high a price to pay if results in other areas do not achieve its objectives. The more advanced developing countries may find partial progress on safeguards and textile and clothing issues insufficient incentive to persuade them to accept more discipline on trade in services, particularly since they find the United Nations Conference on Trade and Development (UNCTAD) a more suitable forum than the GATT for discussing such trade.

Despite all these difficulties, progress will eventually be made, since no country is prepared to see the system collapse, and lack of progress would eventually lead to its demise. Compromises, therefore, will be made and partial solutions accepted. This stage, however, may not be reached for another decade. Each successive GATT round has taken longer to prepare and to conclude than the previous round as the numbers of issues and participants have proliferated. The Tokyo Round took five years to prepare and six years to conclude. Indeed, there are some observers who see the next round as the final one, in the sense that it will usher in a period of continuous negotiation. The number of issues is now so large and the items for negotiation are so varied that it will scarcely be possible to wrap them all into a final package which can bring negotiations to a conclusion.

For Canada, such a state of affairs has serious implications. Canada is more dependent on the international trade system than are most other GATT members and thus relies more on progress in negotiations than do most other major players. Canada, however, as already mentioned, lacks unimpeded access to a large market. What access we have is the product of, and guaranteed by, GATT negotiations. Prolonged negotiations with an uncertain outcome thus do not meet the first and most important of Canada's objectives: a more ordered world trading environment capable of stimulating job-creating investment.

Finally, if multilateral negotiations were to proceed with more dispatch than appears to be likely, and if they were to achieve more than Commissioners anticipate, would such an outcome address Canada's most important trade policy challenge: better and more secure access for three-quarters of our exports? In other words, would even the most optimistic outlook for future multilateral trade negotiations be sufficient to meet our objectives for our most important market? Commissioners think not. Take, for example, government procurement: U.S. "Buy America" provisions are a major obstacle for a number of Canadian industries, including urban transport, steel, and telecommunications equipment. The GATT Government Procurement Agreement, negotiated during the Tokyo Round and now in process of expansion in its coverage, opens up a U.S. procurement market estimated to be worth about $25 billion. This represents less than 5 per cent of the total U.S. federal and state procurement market. Current GATT negotiations may increase this proportion to 10 per cent or even 15 per cent. Canadian industry, however, would benefit greatly from application of the principle of national treatment, that is, full participation in the U.S. market equivalent to the access enjoyed by U.S. suppliers. Many business enterprises would be prepared, on this basis, to share the total Canadian market of some $50 billion. The entrepreneurs have done their sums. Even 5 per cent of the U.S. market is worth more than 50 per cent of our market. It is an objective well worth pursuing.

Similarly, during the Tokyo Round, Canada's petrochemical industry showed itself prepared to share the Canadian market in return for better access to the U.S. market. Canada pursued this objective, but it foundered on the objections of the U.S. industry to sharing that market with their EC and Japanese counterparts. Similar disappointments are likely to occur during the next multilateral negotiations. There are, as we have stated, benefits to negotiating in concert with others. The price paid, however, is that progress is sometimes held hostage to the offer of the least liberal of the major participants. Thus a country prepared to proceed further towards liberalization must scale down its sights to that of its multilateral partners.

Canada cannot, however, afford to forgo active participation in forthcoming multilateral negotiations. Rather, we must approach such negotiations realistically. Multilateral negotiations have proved of immense value in the past. They are likely to be of significant value in the future. The GATT will remain the major forum for trade liberalization and for the gradual consolidation of a rule-oriented system for conducting trade relations, but it should no longer be seen as an exclusive and sufficient forum.

Note

1. See Rodney de C. Grey, "The Service Industries: A Note of Caution About the Proposal to Negotiate Rules About Traded Services", in *Canada and the Multilateral Trading System*, vol. 10, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).

Conclusions

Commissioners believe that multilateral trade negotiations under the GATT should remain a central theme of Canadian trade policy. As noted in the federal government's 1983 discussion paper, *Canadian Trade Policy for the 1980s*, "given Canada's large stake in trade, Canada must in the first place seek to preserve and enhance the multilateral trading system, in fair weather or in foul. This is not a matter of choice, but one of practical necessity . . ."[1] We are unconvinced, however, that Canada should continue to pursue the multilateral route to trade expansion to the exclusion of opportunities which can best be realized bilaterally. Indeed, we believe, given the state of international consensus on reform of the multilateral system, that it would be naïve for Canada to put all its eggs in the multilateral basket. A major reform of the trading system, important as it is, does not devolve on Canada. We can play our part, but we cannot lead. Fresh opportunities await Canadians if we are willing to explore pragmatically all possible avenues to better and more secure market access, and if we view the pursuit of both the bilateral and the multilateral routes to trade liberalization as desirable, joint and complementary means to the same end. Indeed, we are of the view that multilateral trade negotiations should be seen as representing long-term possibilities largely related to a broad framework of concerns, while bilateral opportunities may be seized in the nearer future and might lead to direct benefits. This is a position shared by many intervenors who appeared before Commissioners, or who provided us with briefs. For example:

> *While continuing to give the fullest support to the maintenance and improvement of the multilateral trading system, Canada should look carefully at the means by which bilateral arrangements could be put in place to supplement our multilateral rights and obligations, and to serve as a substitute should the international support for the multilateral system begin seriously to be eroded.*
>
> (Canadian Export Association, Brief, October 23, 1983, p. 2.)

Note

1. Canada, External Affairs Canada, *Canadian Trade Policy for the 1980s: A Discussion Paper* (Ottawa: Minister of Supply and Services Canada, 1983), p. 37.

CHAPTER 6

Freer Trade with the United States

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Introduction

In a seminal article published late in 1984, Canadian journalist Anthony Westell examined what had gone wrong with the "Third Option". This was the trade policy by which the federal government sought to strengthen the domestic foundations of the Canadian economy, diversify trade relations, and reduce Canada's vulnerability to the United States. After reviewing the problems of the "Third Option", Westell suggests that over the years, our government had, in fact, drifted gradually into the "first option": a fairly steady maintenance of the *status quo* in our relationship with the United States. What our government should have done and can still do, he argues, is to pursue the "second option": to move deliberately toward closer integration with the United States. He concludes his examination:

> *The basic argument being made here is that Canadians, both as individuals and as a political nation, are more likely to prosper and fulfill themselves in free association with Americans than they are by seeking to protect themselves from US competition and influence. The desire to escape from US influence, the desire to put distance between Canada and the United States, arises in large measure from fear of absorption by the US and from jealousy of US wealth, power and vitality. But fear and jealousy are corrosive in national as in personal life; they feed the Canadian sense of inferiority, encourage parochial attitudes, and give rise in politics to nationalist policies that are bound to fail because they are against the tide of events and against the private aspirations of most Canadians who wish to enjoy the maximum freedom to trade, invest, travel and exchange ideas.*[1]

Relations with the United States have consumed Canadian energies from our country's very beginning. Most Americans live their whole lives only dimly aware of Canada and its people, but Canadians in all provinces have always fretted about our neighbour to the south. It is not easy to live next door to the most powerful, energetic and wealthy nation in the world. One reason why Americans are wealthier than we are is that they comprise an economic union of 240 million people, while our economic union is made up of only 25 million people. In an age of specialization, a difference of such scale matters a great deal.

Whether our association with our neighbour is easy or not, we "need" the United States. It buys about a fifth of what we produce, and it sells us many of the products which make our own lives rich and varied. We watch American television, drive American cars, eat American vegetables, drink American orange juice, and wear American clothes. The United States, however, also needs us. It needs our iron ore to make cars, our paper to print newspapers, our subway cars to travel to work, and our lumber to build homes. We are not only their best customer, but also their principal supplier.[2]

The extent of our links is demonstrated by the fact that every day of the year, thousands of cars, planes, trains, trucks, people and ideas flow back and forth across the Canada-U.S. border: more traffic than between any other two nations on earth. The closeness of this relationship offers both tremendous benefit and risk of harm. We Canadians are wealthier because of the Americans, but we are also vulnerable to changes in their fortunes. In 1972, this vulnerability caused our federal government to find deliberate ways to differentiate ourselves and to strengthen our links with other trading partners. Our vulnerability, however, can also be reduced by strengthening the links we have with the United States. Canadian business has reached a stage where our domestic market can no longer assure our continued growth, and where our access to foreign markets is no longer perceived to be secure enough to stimulate long-term, job-creating investment. One senior corporate executive has pointed out:

> *We, manufacturers, are caught in a catch 22 situation. On one hand, the tariffs in Canada are no longer high enough to offset the higher costs of producing solely for the Canadian market. On the other hand, even modest tariffs into the U.S. can make it difficult, if not impossible, to set up production in Canada to export into that market. When dealing on the location of a new production facility, why locate it on the small market side of the border especially when it's dependent on exports and faces the problems of the Non-Tariff Barriers. We need to be inside those safeguards.*
>
> *Unless we can negotiate increased and assured access to the U.S. market, Canadian industry will be unable to take the risks involved in making the substantial investments required to operate on a North American basis. Whether the strategy chosen to take advantage of the U.S. potential is specialization, rationalization, or whatever, secure access to the American market is mandatory.*[3]

In Chapter 5, Commissioners examined the prospects for gaining more secure and better access to foreign markets through multilateral trade negotiations. While we are convinced that such negotiations are important to Canada's future well-being, we are not persuaded that they will address our immediate problems quickly and thoroughly enough. Nor do we believe that they are likely, in this century, to provide the best foundation for our relationship with our principal trading partner.

We turn, in this chapter, to an examination of the advantages and disadvantages of forging closer economic links with the United States. While such a relationship has often been described as one of free trade, it is both much more and much less. The economic concept of free trade (that is, trade which is unfettered by government-imposed trade restrictions), is unlikely ever to be achieved between two sovereign countries. Indeed, after 120 years of internal economic union, it does not now exist among Canada's ten provinces. Thus, trade between Canada and the United States will always be subject to more restrictions than the economists envisage. At the present time, however, and in present circumstances, it should represent more than the historic concept of free trade (that is, the removal of all tariff barriers), for even if all tariffs were to be removed, trade would still be restricted by the many other types of barriers governments have devised. What kinds of barriers, then, can be brought down bilaterally? If these barriers were removed, what would be the political and economic consequences of such a development? And what effects might that development have on Canadian industry? An examination of these issues should clarify what may be available to Canadians down the bilateral route. To avoid what Commissioners believe is a sterile debate, we shall use the terms "free trade" and "freer trade" interchangeably.

Notes

1. Anthony Westell, "Economic Integration with the USA", *International Perspectives* (November/December 1984), p. 22. For a discussion of the "Third Option", see Mitchell Sharp, "Canada-U.S. Relations: Options for the Future", *International Perspectives* (Special Issue, Autumn 1972).
2. A general review of Canada-U.S. relations can be found in Frank Stone and Carol Osmond, "Institutional Arrangements for Managing Canada-U.S. Bilateral Economic and Trade Relations", in *The International Legal Environment*, vol. 52, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
3. J.E. Newall, Chairman, Du Pont Canada Inc., "Canadian Trade Challenges", an address to the Conference Board of Canada International Conference, Toronto, February 6, 1985, pp. 10–11.

A New Canada-U.S. Framework for Trade

A satisfactory analysis of the economic and political consequences of Canada-U.S. free trade should be based on some concrete notions of what a free-trade arrangement might involve, and how it would work in practice. Commissioners' purpose in this section is to analyse Canada's major options for the conduct of bilateral trade relations over the next 25 years. We are not attempting to offer advice on the most appropriate short-term negotiating agenda. Rather, our purpose is to formulate broad negotiating objectives and procedural frameworks to give direction and focus to future bilateral efforts towards freer trade.

Three basic components of a possible free-trade agreement deserve careful consideration. The first of these components is the format, or procedural framework, for conducting bilateral negotiations. Should talks, for example, focus on particular industrial sectors? Alternatively, should they aim at across-the-board liberalization? Again, should certain industries or sectors be exempt from consideration in any negotiations? The second component consists of those substantive provisions of a treaty that govern the elimination or limitation of trade barriers. Should a free-trade arrangement cover all non-tariff barriers (NTBs), including instruments of contingent protection? Should it include production or employment safeguards? The third, and perhaps most important, basic component comprises the procedures and legal mechanisms for implementing and enforcing a free-trade agreement. Should such an agreement be implemented as a formal treaty under U.S. law, a move which would require Senate ratification? Should Canada and the United States adopt a dispute-settlement procedure that incorporates the possibility of binding arbitration, a feature not fully developed in the existing enforcement system of the General Agreement on Tariffs and Trade (GATT)?[1] Another prime issue impinging on the legal organization of Canada-U.S. economic relations is the choice of a process for managing federal-provincial conflicts arising from trade-policy issues. The successful outcome of any negotiations will depend on the design of a structure to promote federal-provincial consensus and co-ordination.

These three general features of a free-trade agreement must be analysed in the context of certain broad policy objectives and constraints for North American trade liberalization. The first, and most important, concern is for Canadian producers to obtain barrier-free market access under a negotiated arrangement which ensures that access is dependable and secure from future political and legal challenges. Only if entrepreneurs and investors are confident of the arrangement's permanence and effectiveness will Canadian industry be likely to make the necessary adjustments and long-term commitments required to maximize the economic benefits of freer trade.

U.S. trade policy is created and applied through political and legal processes which decentralize decision-making power and enhance the political influence of relatively small and narrowly based interest groups such as unions and trade associations. The most notable examples of this fragmentation of power within the U.S. system are the legal mechanisms that afford producers contingent protection from import competition. These mechanisms usually involve countervailing duties, anti-dumping duties and emergency protection for U.S. producers suffering serious competitive injury from imports. U.S. legislation gives domestic producers the right to launch costly lawsuits against foreign rivals, with little risk of loss if the claims of unfair and injurious import competition are proved groundless. Since these U.S. lawsuits are initiated by private firms, it is seldom possible to predict when they will be launched. Thus the threat of harassment they pose deters Canadian investment in new plants and equipment when the future profitability of such facilities depends on uninterrupted access to the North American market. Since free trade would be of primary importance to Canadian industrial development, the federal government would need to anticipate potential problems and to spell out, as fully and precisely as possible, the rules and procedures governing any bilateral arrangement.

A second broad concern in this same area of negotiation must be the maintenance and strengthening of the GATT, the International Monetary Fund (IMF) and other multilateral economic institutions. Commissioners recognize the substantial benefits that have accrued to Canada from the GATT multilateral system. We perceive that this system will continue to serve Canada well, in part by managing Canadian relations with our most important trading partner. If North American free trade were to jeopardize or undermine the stability of the GATT system, it would be a steep price for Canadians to pay in order to secure improved access to the U.S. market. There is no inconsistency in principle, however, between continued support for the GATT and a Canada-U.S./free-trade arrangement. GATT law authorizes the creation of free-trade areas under certain conditions, and it is particularly important that any Canada-U.S. agreement be designed to comply with that treaty's legal requirements. Basically, Article XXIV of the General Agreement states that in order to qualify as legally valid, a free-trade agreement must require the elimination of all barriers or restrictions on "substantially all trade" among the signatories. A review of cases involving the application of Article XXIV indicates that if parties to an arrangement free 80 per cent, by value, of the commodities they trade, they will be deemed to have satisfied the GATT's "substantially all trade" standard. While it seems probable that Canada and the United States could negotiate a mutually acceptable agreement that satisfied this test, Article XXIV imposes somewhat flexible constraints on the terms of any treaty used to create bilateral free trade.

Finally, it is important that any formal arrangement be designed to mitigate the inevitable tensions that it would create for Canadians. On the one hand, we have a natural desire for closer trade relations with the United States; on the other hand, we are determined to preserve our national autonomy in social, economic and defence policies even when this choice requires that we chart a policy course different from that adopted by our closest partner and ally. Free trade will intensify competition for many Canadians, whether they work in export-oriented businesses or in firms concentrating on our domestic market. Stronger competitive pressures, in turn, will further political initiatives aimed at modifying such federal and provincial policies that put U.S. firms at a disadvantage in relation to our tax and regulatory measures. Moreover, closer trade relations will increase the force of U.S. political influence at both levels of Canadian government. In future bilateral disputes unrelated to trade in goods and services as GATT would traditionally define it, the American government might be tempted to threaten the suspension or unilateral alteration of any existing free-trade agreement, in order to persuade Canada to accept a compromise that was relatively more favourable to U.S. interests. Canada would hold larger economic stakes in preserving an effective bilateral free-trade agreement than would the United States, and it is therefore important to negotiate a legal arrangement which incorporates strong safeguards. These limitations must constrain the power of either nation to use the trade relation to influence other public policies that are functionally unrelated to trade in goods and services.

The Negotiating Format

Canadian Trade Policy for the 1980s[2] indicated that the Canadian government would study options for achieving freer trade with the United States. One plausible strategy it suggested was to negotiate bilateral free-trade agreements that are limited to a number of specific industries. In early 1984, Canada's International Trade Minister Regan and U.S. Trade Representative Brock announced a joint national study of the prospects for liberalizing trade in four product areas: steel, farm machinery, urban transit equipment, and computer services. These recent expressions of interest in a sectoral negotiation might well be attributed to several advantages of an industry-by-industry approach to freer trade. To negotiate on a sectoral basis limits the scope of potential problems of economic adjustment which might, in some circumstances, entail higher public expenditures. Moreover, a piecemeal or incremental approach focuses the issues in ways that encourage both bilateral negotiations and public debate: that is to say, it gives the free-trade initiative a concrete set of objectives that can be analysed and discussed quite readily.

A sectoral negotiating approach, however, is open to several serious objections. An agreement to remove tariff and non-tariff barriers in only a few industries or sectors might violate GATT Article XXIV, which requires that a free-trade agreement remove barriers to "substantially all" the trade between the signatories in order to qualify as a valid preferential arrangement. Canada and the United States could answer a legal challenge under this regulation by maintaining that bilateral trade has already been freed enough to justify future step-by-step reductions. This defence against a charge of using bilateral trade restrictions would be a strong one if only tariff barriers were considered, but if NTBs were also taken into account, the factual support for this defence would be weaker. The U.S. Administration sought and obtained an explicit waiver of compliance with the provisions of Article XXIV when the Auto Pact was negotiated in the mid-1960s. Such a waiver requires the consent of two-thirds of the GATT contracting parties, and Commissioners believe that it would be politically difficult to employ this procedure to validate a series of sectoral agreements in the mid-1980s.

A second disadvantage of sectoral bargaining is that it offers an unwieldy format for dealing with the critical issue of contingent protection. Sectoral bargaining would make it necessary, for example, to negotiate industry-specific exemptions from U.S. and Canadian laws regulating unfair trade practices, and industries that are not accorded exempt status might perceive such exemptions as unjust.

A third objection applies to the practical politics of the sectoral approach to free trade. An industry-by-industry approach limits inter-sectoral trade-offs during free-trade negotiations and makes it more difficult to organize effective political coalitions in support of trade liberalization. Canadian and U.S. firms operating in sectors targeted for negotiation are likely to support or oppose freer trade according to their assessment of prospects for their particular industry or firm. The problem is that investors and employees in industries unaffected by the bargaining are unlikely to provide much support for freer trade in other sectors. Moreover, if negotiations are limited to only a few sectors, there is unlikely to be sufficient public support to overcome the inevitable resistance to the withdrawal of protectionist measures. A further disadvantage would be the possibility of more severe trade distortions in sectors such as textiles, where producers might lobby for imposing more restrictive import quotas on third countries if imports from the preferred trading partner increase. Distortions could also arise if end products are traded free of barriers, while trade in primary products or intermediate goods remains subject to restrictions. For example, free trade in wine might not be sustainable without free trade in grapes if U.S. growers enjoyed substantial cost advantages over their Canadian rivals.

In contrast to a sectoral approach, negotiations aimed at securing a broader, more general, free-trade area would be consistent with GATT principles; they would also avoid many of the political and economic disadvantages of a piecemeal strategy for trade liberalization. Again, a general or "across-the-board" approach would be more likely to promote productive bargaining on the critical issue of contingent protection and on the elimination of other non-tariff barriers which affect many sectors. This Commission is firmly of the opinion, therefore, that a limited sectoral/free-trade arrangement with the United States would go only a short way towards meeting Canada's negotiating objectives. The need is for a broader or comprehensive free-trade arrangement.[3]

Three basic types of across-the-board arrangements have been discussed as feasible options for North American economic integration: a common market, a customs union, and a free-trade area. It is important to distinguish among these three possibilities because much of the public debate on the general issue of "free trade with the United States" has been confused by a failure to do so.

A common market calls for:

- Free movement of goods and services among member countries
- Common tariffs and harmonization of protected-trade policies applied to the outside world (that is, to non-members)
- Free movement of labour and capital among member countries.

This arrangement is the most complete form of economic integration in current use that maintains the political sovereignty and formal independence of member countries. It is not, however, the most complete form of integration *per se*. A common market need not, for example, form a monetary union where the member countries share a single currency that is subject to a single central bank's monetary policy. To form a common market is the primary objective of the European Community (EC), and its member countries have made great strides in harmonizing their economic policies, even though much remains to be done.

For two major reasons this Commission rejects the common-market form of free trade as inappropriate in the North American context. A common market requires that a uniform set of trade and allied commercial policies be applied to all non-member countries. In the past, Canada has not always wished to follow U.S. initiatives on trade with the outside world: for instance, Canada maintained trade relations with China and Cuba after the United States ceased to do so. If we Canadians are to preserve our autonomy in foreign political and economic policies, our government cannot accept a common market's legal restrictions on its capacity for independent action. Again, a common market would require the co-ordination of other policies besides those concerned with foreign trade, since it involves the "free movement" of both labour and capital among member states. Control over foreign immigration is a basic and very important national policy, and the obvious need for Canada to maintain control in this field is sufficient reason to rule out a common market. Moreoever, in Commissioners' view, it will be desirable for Canada to reserve the right to exercise some controls over the movement of U.S. capital into this country. Such reservations to enable Canada to deal with specific problems arising from the operation of U.S.-controlled firms in our country would be impermissible under a common market.

In a customs union, Canada and the United States would have to agree to remove all barriers to their trade in goods and services, and to impose a single set of commercial policies on imports from third countries. Since Commissioners have already argued that a common external trade policy would be unacceptable to Canada, we must also reject the option of a customs union with the United States. Because of the relative size of the two countries, Canada could not hope to exercise equal influence in establishing a common set of tariff and tariff-related policies; thus the commercial policy of both nations would be made, by and large, in Washington. For example, a customs union would not allow Canada to reduce protection against third countries unless it could persuade the United States to take the same action. Given the possibilities for conflict that inevitably lie in such a high degree of policy co-ordination between two countries, a less ambitious form of association is desirable. Any such tight co-ordination is likely to be politically unacceptable to both nations, nor would it be required to achieve most or all of the economic benefits of Canada-U.S. free trade.

A free-trade area is the form of across-the-board arrangement most often suggested for Canada and the United States. In such an area, each country may impose its own restrictions on movements of capital and labour between partner countries. Each nation has the right, also, to levy its own taxes and to stipulate its own regulations for goods entering from third countries. All that the free-trade agreement guarantees is that for the most part, goods and services originating in a member country may enter other member countries free of tariff and non-tariff restrictions. A process of elimination leads Commissioners to regard this form of arrangement as more advantageous than either a common market or a customs union. Any less broadly encompassing form of agreement threatens to leave Canadian investors and employees handicapped by the constraints of a relatively limited domestic market. Any more comprehensive arrangement is unacceptable because of the constraints it would place on Canada's ability to pursue its own social and economic policies.

Several additional considerations suggest the choice of a bilateral free-trade agreement. Since each member would be free to reduce its tariffs against third countries, a free-trade arrangement might lead to fewer global trade restrictions than would a common market or a customs union. On the other hand, each member could pursue import-substitution policies sanctioned by the GATT against products from non-member countries, without the need for practising complete consistency with its partner's policies. Moreover, it is relatively easy to bring new nations into a free-trade area because its expansion avoids the costly and time-consuming process of policy harmonization that must accompany the two more comprehensive forms of free-trade arrangement.

What, then, would be the nature of a Canada-U.S., bilateral, free-trade agreement? And how would it work? The answer to the first question need not be speculative, for there are international models of free-trade agreements that could guide any Canada-U.S. action. One example appears in the 1983 Trade Agreement between New Zealand and Australia, which is designed to eliminate mutual trade restrictions and to create a free-trade area. This agreement provides that for most products, New Zealand and Australian tariffs on each other's exports will fall to nil by the mid-1990s. Some products are excepted, of course, to take account of special circumstances. On the non-tariff side, there is a series of Articles that curtail the right of each country to apply non-tariff barriers, such as countervailing duties or safeguard measures, against the other country's exports. To administer the accord, the Trade Agreement provides that the ministers concerned meet annually to review the arrangement, and, further, that if difficulties arise, consultations be undertaken promptly, at the written request of either partner. If such a consultative mechanism were used in North America, it would be wholly consistent with the ordinary flow of government business between Canada and the United States.

Canadian public opinion has occasionally seen the operation of a Canada-U.S./free-trade agreement as enormously significant. To assess how a free-trade agreement might actually work, however, let us consider the Canadian manufacture of ordinary lead pencils and crayons, which, in 1984, carried a Canadian tariff of 14.6 per cent of their value. Under the Tokyo Round concessions already accepted, that tariff is designed to fall to 11.3 per cent by 1987, and this projected move will promote adjustment to world-wide competition in this Canadian industry. Under a Canada-U.S./free-trade agreement, the tariff on these products might be further reduced to nil; the reductions might be phased in, for example, between 1987 and 1997. This arrangement would mean that during the ten-year adjustment period, Canadian producers of pencils and crayons would see the products of their American competitors becoming cheaper at the rate of approximately 1.1 per cent per year. The falling Canadian tariff would lower consumer prices in Canada and stimulate competitiveness and productivity as well, but its effects would hardly be sudden, nor would they be devastating to the Canadian economy. Moreover, any negative effects on Canadian business that did result would have to be balanced against the compensating benefits in other areas, where Canada would gain from falling U.S. tariffs. What both sides in such a debate need, above all, is a sense of proportion: bilateral free trade would be neither a panacea for Canada nor a disaster. On balance, however, it would help our country.

Within the framework of a general free-trade agreement, it would still be possible to exclude certain sectors or industries from the scope of bilateral negotiations. Article XXIV of the GATT has been interpreted to authorize the exclusion of up to 20 per cent of the total trade in goods among the members of a legitimate free-trade area. Moreover, since trade in services lies outside the jurisdiction of the GATT, Canada and the United States are not legally constrained to remove all barriers affecting it. There is, therefore, no legal impediment to the negotiation of a limited number of exclusions on a case-by-case basis. Several Canadian industries might, in fact, have special needs or problems that would justify their total or partial exclusion from a general free-trade regime. While Commissioners do not believe that any industry should automatically be excluded from consideration, nevertheless, we recognize that as negotiations proceed, it may prove necessary to make exceptions. Such a development would be entirely consistent with our understanding of a free-trade agreement.

Both Canada and the United States use import quotas to restrict trade in some agricultural products.[4] Both nations impose quotas on poultry, dairy and some meat products, in support of their domestic supply-management programs. Canada also imposes seasonal tariffs on fresh produce in order to support farm incomes. The removal of these quotas and tariffs would necessitate a co-ordinated approach to the supply-management and other agricultural support policies currently maintained by both countries. The task of harmonizing these policies through extensive negotiations with the United States is likely to be technically complex and politically difficult. These potential problems may justify deferring free trade for agricultural products to which import quotas currently apply, at least until detailed agreements can be worked out concerning supply-management and other subsidy policies.

The U.S. Administration has recently stressed the need for liberalizing trade in services, principally transportation, communications, banking, insurance, engineering and construction, and business consulting. It has indicated that the reduction of barriers to trade in services will be one of its top-priority negotiating objectives in any future GATT round. Trade in service industries will probably figure prominently in any Canada-U.S. trade talks.

Several of Canada's service industries, such as banking, insurance and allied financial activities, would appear to be capable of substantial export successes in the U.S. market. The removal of existing Canadian restrictions on the entry of U.S. firms in some fields could result in significant penetration of Canadian markets by U.S.-based competitors without conferring comparable benefits in the other direction. Overall, it is likely that the United States has more to gain from the reciprocal reduction of barriers to trade in services than has Canada. For this reason, perhaps, Canada might reasonably expect that in return for its willingness to provide more open access to its services market, the United States might offer guarantees of improved access for goods exported from Canada.

Despite U.S. enthusiasm for rapid progress in trade in services, several difficulties might lie in the way of a broad across-the-board approach to liberalizing bilateral trade in many types of services. Although both governments have recently undertaken exploratory research, there is still insufficient objective information on the economic consequences of existing national regulatory barriers to trade in services. Both Canada and the United States maintain entry controls and similar regulations which exclude foreign-controlled enterprises or limit their allowed share of the domestic market in many service sectors such as banking, transportation and communications; other barriers, too, operate in particular sectors. Any useful analysis of service-trade issues must focus, therefore, on the national regulatory arrangements specific to each particular type of service. For example, government-procurement preferences for local suppliers are a major impediment to trade in engineering and construction services, while restrictions and cost-increasing regulations on the trans-border transmission of business data are a major irritant to those who trade in financial and business-consulting services. The negotiations on this diverse set of problems will be further complicated by considerable differences in the national regulatory policies that currently apply in many service sectors. Free trade in transportation or in financial services, for instance, will require the harmonization of diverse national rules governing price competition, service quality, consumer protection and other equally contentious matters. The fact that each particular service industry is affected by regulations that are virtually unique suggests that future negotiations on services should be conducted on a sectoral basis. While it may be desirable to establish some general rules applicable to all service sectors, such as a code for government procurement, it seems clear that more detailed standards and the settlement of future disputes will have to be handled by specialized bilateral bodies responsible for particular service industries.

Cultural activities may also require special treatment under a general free-trade agreement. Canada provides both import protection and subsidies for cultural activities, because of the widely held view that our domestic market is not large enough to support these activities. Current policies aimed at creating and disseminating more Canadian cultural products, such as the so-called "Canadian content" rules imposed by the Canadian Radio-television and Telecommunications Commission (CRTC), discriminate against U.S. firms in the cultural industries and might therefore be inconsistent with a general free-trade scheme. Talks with the United States might show that many existing policies would be compatible with the maintenance of an acceptable free-trade regime; those that did cause substantial competitive distortions could be replaced by more-or-less equally effective substitute measures. In any event, Canada could insist on explicit treaty provisions that would authorize public funding of its cultural activities and permit affirmative discrimination for Canadian producers, in order to compensate for the handicap of our small domestic market. The examples of the European Free Trade Association (EFTA) and the European Community demonstrate that substantial subsidization of cultural activities is possible within an effective free-trade framework.

Finally, there may be a need for special rules to govern bilateral trade in energy and other natural resources. Canadians' principal concern regarding natural resources is whether a free-trade arrangement would constrain our ability to impose production quotas, taxes and export controls, to further national security and industrial policy objectives. The GATT specifically provides for such controls, unless they are discriminatory or act as disguised restrictions on international trade. National tax and subsidy policies governing petroleum products will need to be harmonized to some extent. The most difficult negotiating problems are likely to centre on the potential use of export controls covering non-renewable commodities such as oil and perhaps, in the future, water. It is possible, for instance, that the United States may seek to negotiate some legal assurance of access to future Canadian resource supplies. Any guarantee to U.S. resource consumers must, however, preserve Canada's authority to limit exports in order to meet anticipated domestic requirements for such resources. Article XX(g) of the GATT permits signatories to maintain non-discriminatory measures "relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption." A similar provision could be included in any general agreement covering trade in non-renewable resources.

Commissioners have described these areas of economic activity, not because we doubt there is substantial scope for removing obstacles to trade in these sectors, but because we recognize that these are among the most difficult areas in which to achieve full free trade. The United States undoubtedly has similar concerns. Our view, however, is that such obstacles should not stand in the way of agreement. While we believe a sectoral approach to be unwise, the temporary or even permanent exemption of certain sectors might be a prudent or even a necessary means to reach agreement.

Substantive Provisions

As we have noted, Article XXIV of the GATT directs that the parties to a general agreement eliminate all barriers to substantially all their trade in goods as a prerequisite to the creation of a valid free-trade area. A Canada-U.S./free-trade agreement should regulate the three general types of barriers that currently restrict trade between the two nations: tariffs, contingent-protection measures, and other non-tariff barriers (NTBs). Canada must certainly negotiate for effective restraints on American contingent-protection measures and other NTBs; an agreement aimed only at phasing out tariffs would not provide the security of access required by Canadian producers. Since both national legal systems sharply differentiate the legal instruments and procedures used to implement these three types of trade barriers, it will be necessary to draft specific treaty rules applicable to each one.

When the Tokyo Round tariff cuts are fully implemented in 1987, it has been estimated that some 80 per cent of Canada's exports to the United States will enter that country duty free; a further 15 per cent will enter at duties of 5 per cent or less, and only 5 per cent will enter at higher duties. These figures are somewhat misleading, however, as they mask the fact that certain commodities are not traded because of U.S. tariffs that effectively neutralize the comparative advantage of Canadian producers. In other words, an exclusive focus on our current sales to the United States obscures the fact that our exports tend to flow through duty-free holes in the U.S. tariff wall that are open to such Canadian exports as resources and autos. In 1987, a significant number of manufacturing firms in Canada will still be deterred from exporting goods by remaining U.S. tariffs. In certain resource sectors, U.S. tariffs set at 2 or 3 per cent are still high enough to discourage new investment in Canadian mines and plants. From the U.S. standpoint, the removal of Canadian tariffs is likely to confer substantial benefits on many manufacturing industries. Nevertheless, while the overall incidence of the Canadian tariff is likely to be lower than 5 per cent by 1987, the average tariff on dutiable goods will stand at 9 to 10 per cent, and some tariffs will remain as high as 25 per cent. An appropriate procedure for cutting both nations' tariffs to zero will need to be spelled out clearly in any free-trade agreement. GATT Article XXIV permits a "reasonable" amount of time for gradual implementation of free-trade arrangements. There are a number of options available for tariff elimination which are worthy of careful consideration.

One possibility is to eliminate tariffs completely on a particular date, which might be announced two or three years in advance. This would give firms a deadline around which to plan the rationalization of their operations in order both to meet new competition and to enter the U.S. market. This adjustment could well require considerable new investment in capital equipment and in the training of workers in new skills.

Another possibility would be to agree to phase in the tariff cuts over a number of years. The rate at which Canadian and U.S. tariffs were cut could differ. As it is widely acknowledged that greater industrial adjustments will be required in Canada, a case might be made for a slower phase-out of Canadian tariffs to ease the adjustment process, say over a period of ten years, while the United States would eliminate tariffs in five years. This arrangement would provide Canadian producers with better access to the U.S. market while they still retained some temporary protection in the Canadian market.

The choice of a method of tariff removal will hinge on an evaluation of the ensuing adjustment process. Whatever method is chosen, Commissioners expect that an extensive program of adjustment assistance will be desirable to achieve the benefits of freer trade with the least cost. We shall review this question in Parts III and V of this Report.

In contrast to a customs union and a common market, which impose common external tariffs, a free-trade area retains differences in national tariff levels and tariff policies where these measures affect third parties. Since each member of a free-trade area sets its own external tariff, third countries have an incentive to get their exports into the free-trade area by first shipping them into the member country with the lower external tariff and then sending them into the other member's market duty free. To prevent such "deflections of trade", Canada and the United States would have to establish "rules of origin", stipulating that imports from a third country must satisfy national-content requirements in order to qualify for free entry. A rules-of-origin system may be liberal or strict. A liberal system allows a substantial proportion of the value of "free-trade/area products" to originate in non-member countries. The European Free Trade Association, for example, has adopted a liberal set of rules of origin which generally provide that a product qualifies for duty-free treatment if at least 50 per cent of its export price originated in activities conducted within the free-trade area. EFTA countries initially feared that sizeable deflections of trade to lower-tariff members of the free-trade area would occur unless relatively strict rules of origin were adopted; these suggested rules required that 70 per cent of a product's export price originate in the free area. The disadvantage of a strict regime is that if other free-trade/area members are not the least-cost suppliers for semi-processed and raw-material inputs, export-oriented industries may find themselves priced out of third-country markets because of their input-cost disadvantage. The EFTA's liberal rules of origin have, however, worked reasonably smoothly, and there has been relatively little of the trade diversion that was anticipated. One factor considered important to this successful result was that in EFTA countries, tariff levels on raw materials and semi-processed goods were low or non-existent. Since the same general situation prevails for Canadian and U.S. customs duties, it is likely that a liberal origin system would provide adequate protection from harmful trade deflection.

In addition to a phased withdrawal of tariffs and effective rules of origin, the Canada-U.S./free-trade agreement would also have to deal with a range of NTBs that have substantially impeded trade between the two countries. As events of recent years have demonstrated, Canada's exports of goods to the U.S. market are vulnerable to several different types of barriers. The policy rationales and procedures governing these NTBs must be taken into account in designing a free-trade arrangement. U.S. non-tariff barriers affecting Canadian exports can be separated into two basic categories:

- Measures of contingent protection, principally anti-dumping duties, countervailing duties and safeguard or "escape-clause" actions
- Laws or regulations which, either explicitly or through administrative practice, impose discriminatory burdens on goods of foreign origin through

government-procurement practices, product-quality and safety standards, quantitative restrictions on agricultural products, and similar measures.

Measures of contingent protection can be further subdivided into those governing "fair" trade (such as safeguard actions), and those regulating certain "unfair" trading practices (such as anti-dumping and countervailing duty proceedings). This "fair/unfair" distinction arises from the GATT rules which authorize nations to retaliate with compensatory duties on imports benefiting from foreign subsidies and on imports that are "dumped", that is, sold for export at prices lower than those prevailing in the exporter's home market. U.S. firms that can prove material or non-negligible commercial injury by way of lost sales or declining profits caused by subsidized or dumped imports are legally entitled to demand the imposition of retaliatory customs duties calculated to offset the unfair competitive advantage favouring the imported products. Of course, the main problem with these contingent measures aimed at unfair practices is that they may be employed by U.S. competitors to harass Canadian exporters for technical or extremely minor infractions of the rules or even for perceived infractions resulting from different laws or practices.

Safeguard or escape-clause action differs in several important respects from these defensive unfair-trade measures. The GATT provides that temporary protection against imports which cause "serious injury" to the sales or profit levels of domestic producers is legitimate, provided that the retaliatory duties or quotas are imposed on a most-favoured-nation (MFN) basis, and that agreement is reached with exporting nations which are adversely affected by the safeguard action. (Agreement usually involves compensation or guarantees concerning the duration of, or other limitations on, the protective measures imposed.) Proceedings for safeguard protection can be initiated by private individuals or groups, but the final arbiter in the United States is the President, who is given broad legal discretion to grant or deny safeguard relief. In Canada, Cabinet is the final arbiter in this matter. In the past decade, American Presidents have adopted the practice of providing safeguard protection by negotiating "voluntary export restraints" or "orderly marketing arrangements" with the exporting countries whose firms were principally responsible for the injurious imports. While this U.S. Administrative practice probably violates the GATT requirements for valid safeguard action, it is highly beneficial to Canada, whose exporters have rarely been the principal sources of commercial injury to their U.S. competitors. Given the existing structure of U.S. foreign-trade regulations, how should a Canada-U.S. agreement deal with these existing and contingent impediments to North American free trade?

Anti-Dumping and Countervailing Duties

It is improbable that any U.S. Administration would agree simply to exempt Canadian goods from the possible application of anti-dumping or countervailing duties. Such an agreement would seem possible only if Canada were prepared to accept stringent obligations to prevent subsidies or dumping which resulted in serious disruption of U.S. markets. It would not be necessary for Canada to promise that its governments would never provide subsidies, or that its exporters would never dump, but rather to agree that both parties should accept a binding obligation to ensure that neither subsidies nor dumping caused an unreasonable degree of disruption in their respective markets. Under such a broad legal principle, questions of interpretation and enforcement would determine the efficacy of the agreement.

Another option would be to alter U.S. federal law to provide that Canadian goods would not be included with the products of other countries for the purpose of determining whether a U.S. industry had suffered "material injury", a prerequisite for the imposition of both anti-dumping and countervailing duties. In other words, dumped or subsidized imports from Canada could only be restrained if it were established that they were exclusively responsible for creating a material level of injury to U.S. competitors. Canada has won most significant countervailing duty cases in which Canadian goods were the alleged principal source of injury because U.S. producers have been unable to prove the existence of a *material* level of lost sales or reduced profits caused by Canadian imports, such as softwood lumber and urban transport equipment. The six cases where countervailing duties were imposed by the United States, between 1975 and 1979, on Canadian exports were all terminated in 1980, when the American government introduced the injury test, and American producers were unable to prove material injury.

A third option for limiting the impact of U.S. unfair trade-practice regulations is to shift their enforcement from a national administrative tribunal (that is, the United States International Trade Commission) to some new intergovernmental body established under the free-trade arrangement. On this basis, the agreement could contain provisions establishing a standing tribunal to adjudicate on anti-dumping and countervailing duty complaints originating from private industry or labour groups in either country. The tribunal would, in effect, assume the administrative and executive decision-making functions that are currently performed in Ottawa and Washington. This strategy for improving security of access would place principal reliance on the neutrality of an essentially judicial panel composed of appointees from both nations and a neutral chairperson possibly selected from third countries or chosen by agreement of the national appointees. An effective panel system would probably also require the creation of an administrative support staff possessing commercial, economic and legal expertise. The staff might be assembled from government officials seconded from departments with responsibility for trade, economic development and external affairs. A panel and staff composed in this way should ensure the even-handed application of existing national rules on dumping and subsidized imports.

Safeguard Action

A modest Canada-U.S. agreement was signed in February 1984, to provide for advance notification of safeguard proceedings initiated in either country.

The agreement provides for at least 30 days' notice before restrictions are imposed; consultations on measures to minimize any adverse effects; and a declaration that short-term tariff relief is preferable to quantitative restraints as the instrument for providing safeguard protection. It is clear that any agreement which would provide more secure market access for Canadian and U.S. exporters would have to impose more substantial constraints on the use of U.S. and Canadian safeguard action. The rules discussed here governing safeguards against fairly traded, but politically intolerable, imports should be distinguished from the adjustment or transitional measures that may be used to implement a free-trade agreement. The parties to such an arrangement might agree to permit safeguard protection in specified circumstances during, for example, a ten-year period following the signing of the pact. The problem raised here is whether safeguard action should ever be available to the parties after the adjustment or transition period expires.

One can argue that the preferred solution would be the complete dismantling of safeguard protection applicable to goods originating in either country. The main purpose of a free-trade arrangement's guarantee of market access may well be to create positive incentives for the parties to undertake industrial restructuring. In this instance, the continued availability of safeguard protection to firms injured by imports would substantially undermine the economic goal of the signatories. On the other hand, a free-trade agreement which offered no prospect of escape for injured domestic industries would probably attract substantial political opposition in both nations. An alternative to a complete dismantling of protection is to draft a rule providing that only if Canadian exports were found to be the primary cause of serious injury to U.S. competitors would the safeguard action apply to Canadian producers. Another possibility would be to retain safeguard measures, but to transfer the responsibility for their enforcement (that is, for determining whether a domestic industry had, in fact, suffered serious injury) to a transnational panel or tribunal created by the free-trade agreement. Therefore, as with anti-dumping and countervailing duties, the choice of a negotiating strategy on safeguards depends, in part, on designing appropriate institutions for implementing the free-trade arrangement.

Other Non-Tariff Measures

The remaining major non-tariff measures which now limit Canadian exports to the United States are:

- Discriminatory federal- and state-government/procurement practices
- Federal and state product standards that conflict with prevailing Canadian standards
- Federal customs-classification rules and administrative procedures that impose unreasonable cost burdens on exports from Canada.

It is essential that any proposed free-trade agreement provide some effective mechanism for removing or limiting the protectionist effects of these U.S. laws and policies. The major drafting problem relating to these NTBs derives from their resistance to control through the enforcement of detailed rules. A prime example of this difficulty appears in government-procurement practices. North American governments employ dozens of strategies for discriminating in favour of domestic suppliers in the tendering processes. While explicit statutory discrimination, such as the federal and state "Buy America" laws, would be repealed under a free-trade agreement, the attempt to write specific rules to eliminate discrimination in government contracting would create strong incentives to invent new ways to circumvent that agreement. This problem of detailed rules is related to a second impediment to the predictable regulation of these NTBs. Some non-tariff measures may be justifiable on national policy grounds, in spite of their trade-limiting effects. Consumer-product/safety standards covering lawnmowers, for example, may specify the installation of certain protective devices when these items are offered for sale in the U.S. market. If Canada did not require the use of similar devices, would Canadian manufacturers be justified in arguing that the U.S. safety standard imposed an unreasonable burden on imports from Canada? This may seem an isolated example, but there have been many instances in which it has been difficult to determine whether divergent national product standards were motivated by legitimate differences in safety or consumer-protection policies, or by a desire to discriminate against foreign goods. (One instance of the latter motive appeared in the Canada-U.S. metal can-grading dispute.) In short, reasonable people will frequently have differences of opinion concerning acceptable justifications for limiting or restricting trade among nations.

A Canada-U.S./free-trade agreement should, then, contain detailed codes of national conduct controlling government procurement, product standards and customs procedures. Yet the experience with similar codes of conduct under the GATT indicates that highly detailed rules are relatively easy to circumvent, and that effective implementation of such an agreement requires the application, on a case-by-case basis, of general standards prohibiting unnecessary or unjustified protection against imports. Thus problems exist both in finding means to prevent evasion of the proposed agreement and in managing what are likely to be difficult questions of legal and political judgement in interpreting the agreement's provisions. These problems suggest that the design of an effective institution for implementing the agreement would be the primary determinant of the treaty's future success in regulating non-tariff measures.

Adjustment Assistance and Transitional Measures

Commissioners' assessment of the economic costs of free trade indicates that Canadian investors and employees are likely to bear relatively larger adjustment burdens than their U.S. counterparts. A free-trade agreement should therefore incorporate explicit provisions that reflect the proportionately greater costs of adjustment that Canadians will face. It should provide for transitional safeguards which permit temporary limits on the speed of adjustment, and it should operate to smooth out the dislocation and re-employment of workers and physical capital. One legal mechanism that can be employed to provide temporary relief from import competition is the system of "trigger points" used in the Sweden-EC/free-trade agreement. Basically, this mechanism establishes a temporary safeguard scheme that is triggered if imports flood in at higher-than-anticipated rates after the free-trade agreement is put into effect. This scheme would allow more-severely affected industries to delay meeting the general tariff-cutting schedule established by the treaty. The agreement should clearly establish, however, that these authorized delays in the removal of protective measures are nothing more than short-term transitional safeguards. The history of these provisions, as they relate to permanent employment or value-added guarantees, suggests that the more specific the attempt to protect existing Canadian employment patterns, the greater will be the administrative and political difficulties of enforcing the agreement. Many of the problems encountered with the Auto Pact guarantees, for example, including the long-standing dispute concerning their intended duration, are inherent in this form of contractual undertaking. Similar problems are likely to surface if such provisions are included in the free-trade agreement.

Other trade-liberalization experiences, such as the formation of the European Community and EFTA, and the initiation of the Kennedy Round, suggest that adjustment costs resulting from the removal of trade barriers have turned out to be smaller than expected. Moreover, two institutions already exist that should help to reduce the costs of short-term adjustment. The flexible Canadian exchange rate should provide some braking mechanism against a rapid influx of imports and a loss of employment in Canada. Moreover, the presence of U.S. multi-nationals in Canada may also make our adjustment easier, since they already have facilities for distributing throughout the United States any newly specialized output of their Canadian plants. Despite the aid of these natural balancing forces, there is widespread anxiety about the severity of adjustment burdens which particularly import-sensitive industries might have to bear as a result of Canada-U.S. free trade. Commissioners are certain that an extensive adjustment-assistance program will be needed as an integral part of any free-trade arrangement, both to assist factors of production leaving declining industries and to promote their rapid absorption into expanding sectors. Since investors, workers and managers will begin to plan their strategies for adjustment even before a final agreement is reached, it is essential that both nations accept an overall adjustment-assistance framework well in advance of concluding a formal treaty.

Transitional assistance could take many forms: government-backed loans, special research and development (R&D) grants, or accelerated depreciation for Canadian firms which are rationalizing in order to expand into the U.S. market.[5] Commissioners' preference, however, is for programs designed to support displaced workers and to speed up their retraining or re-employment. Much of what Commissioners will have to say in Parts III and V about the design of effective and equitable adjustment programs (including the proposed Transitional Adjustment Assistance Program) is directly applicable to managing the process of industrial change that will result from free trade. Any adjustment subsidies would have to be authorized explicitly by the agreement and would therefore be exempt from U.S. countervailing duties.

Finally, Commissioners have been intrigued by the suggestion, made in 1984 by an "old hand" experienced in negotiating trade agreements with the United States. Speaking to a conference on U.S.-Canadian economic relations sponsored by the Brookings Institution, Simon Reisman suggested that one way to ensure stability in a free-trade arrangement would be to establish a Canada-U.S. Trade Disruption Insurance Program (TDIP). Under such a scheme the two governments would establish and, initially, support a fund in proportion to the exports of each to the other; later the fund would be maintained by a small premium on exports. It would insure exporters against damages resulting from trade-disrupting measures adopted by either government. A board of directors would consider claims and assess either government for damages. Mr. Reisman went on to say:

> *A program of this kind would go a long way toward removing fears about commercial policy instability that inhibit investment and trade. It is put forward on the assumption that actual restrictive measures would be infrequent, an assumption not inconsistent with recent experience. Because a trade restriction would be costly, the obligation to replenish the fund would itself serve as a deterrent to its use.*[6]

While Commissioners see no need to develop such a scheme in detail in these pages, we are confident that measures such as this can and should be developed to add to the integrity of any Canada-U.S./free-trade agreement.

Implementation

In order to be legally and politically effective, any free-trade agreement requires independent governing institutions and implementation procedures. These arrangements are needed to ensure that the legislation and regulations of both member nations be brought into full compliance with the treaty's provisions. Canada's need for dependable market access suggests that an effective intergovernmental body should be established to administer the agreement, and that a legally binding process should be designed for resolving disputes over the proper interpretation of its obligations. Because there would likely be opposition from those groups of investors and workers who would bear the costs of adjusting to freer trade, it is equally important that a Canada-U.S./free-trade arrangement should be implemented through legal processes which would ensure its political durability and provide safeguards against subsequent national laws or regulations that would detract from its essentials.

To implement the free-trade arrangement under U.S. domestic law, the agreement could be structured as a formal treaty, or it could be put into effect through conforming federal and state legislation. The primary advantage of a treaty is that its provisions would clearly take precedence over any state statute which legislated trade barriers; its existence would also impose procedural constraints on subsequent federal legislation. Thus, implementation through a formal treaty would provide Canadian exporters with a strong legal guarantee of future market access. The disadvantage of this strategy is that under U.S. constitutional law, a treaty must be ratified by a two-thirds majority of the Senate. Past experience with this ratification procedure indicates that it would be difficult to secure the required margin of Senate approval for the kind of comprehensive and detailed free-trade agreement that would best serve Canadian interests. The major risk in attempting to obtain Senate ratification at this time of highly protectionist sentiments in Congress is that the process might generate a series of amendments designed to weaken the treaty to the detriment of Canadian producers.

The second option is to implement the free-trade agreement by obtaining the enactment of U.S. federal and, if necessary, state legislation that conforms to its major obligations. Although it would be useful to have conforming state legislation in all instances, the practicality of this solution is less certain, and it is not entirely clear from a constitutional point of view. This option entails a less secure form of legal arrangement, since the implementing statutes could be amended by subsequent legislation. The main advantage of the statutory approach is that it would allow implementation through simple-majority voting procedures, both in the Congress and, if necessary, in State legislatures. Moreover, the risk of the agreement being watered down or otherwise renegotiated at the legislative-approval stage could be reduced if the President were to seek advance negotiating authority from Congress, spelling out in detail the content of a free-trade arrangement acceptable to the United States. The U.S. Congress implemented the recent Tokyo Round agreements through the enactment of conforming legislation under a so-called "fast track" procedure. This process requires that Congress pass implementing legislation within 90 days of the President's formal declaration that he intends to sign an international agreement binding the United States; it also limits the introduction of amendments to the implementing legislation during the latter's passage through Congress. Commissioners believe that it would be desirable to encourage the U.S. government to employ the fast-track process when seeking approval of any Canada-U.S./free-trade agreement.

Canada's parliamentary form of democracy virtually guarantees that a majority government will succeed in securing legislative implementation of any international agreements it signs. Canada, however, shares with the United States a federal constitutional structure, and both nations have the same basic problem of accommodating local and regional interests in the conduct of foreign economic relations. Since Canadian provinces possess more extensive constitutional authority to tax, subsidize and regulate economic activities than do the American States, the problem of securing consensus between the two levels of government would be relatively more difficult to manage in Canada than in the United States. It is clear that if the provinces and States are to be bound by the rules of the proposed federal free-trade agreement, concerning such matters as government procurement and industrial subsidies, then their governments should be consulted in advance of, and during, the bilateral negotiating process.

Institutional Arrangements and Dispute Settlement

The question of appropriate institutional arrangements for a Canada-U.S./free-trade agreement is, to a large extent, predetermined by choices made on other important issues, such as the scope of the barriers and commodities to be covered and the desired generality of the legal standards in the treaty. Moreover, virtually any form of free-trade framework would require some minimal arrangements to support a number of essential functions: making basic executive and administrative decisions; providing technical-staff services; and adjudicating on complaints and appeals made under the agreement. The scope for choice in the design of an effective institutional structure is, therefore, limited by other decisions and by the need to satisfy basic functional requirements. The questions that would remain involve two basic design choices: Will the key decisions taken under the proposed free-trade agreement be made by the two national executives? Or will they be made by a standing body comprised of appointed representatives, with long fixed terms and formal legal independence from their home governments? Will a governing institution, regardless of its form, have the authority to issue legally binding directives to the national, state and provincial governments? These questions are interrelated, since choices about the structure and composition of a decision-making body are likely to be influenced strongly by the legal consequences of its official actions.

An intergovernmental arrangement to carry out administrative functions, provide technical advice, conduct economic research, and assist in the conciliation of disputes arising under a free-trade agreement would be essential, but there is no convincing argument for creating an elaborate supranational structure independent of national, state and provincial government departments. It will, however, be essential to involve executive officials at the highest level of government in the implementation of a free-trade arrangement. All major decisions concerning the interpretation and implementation of the agreement should be made by a committee of national officials at the ministerial level. For example, this committee could consist of the Ministers of External Affairs, Finance, International Trade and Regional and Industrial Expansion. On the U.S. side, it could include the Trade Representative and the Secretaries of Commerce, State and Treasury. Since each nation would have equal voting representation in the "Committee of Ministers", each would retain a *de facto* veto power over all aspects of the agreement's implementation. Most modern free-trade arrangements employ intergovernmental bodies consisting of ministerial-level officials from each member government. Decisions are taken on virtually all important issues only on a unanimous vote of national ministers. Because Commissioners believe that the effective implementation of a free-trade agreement will involve difficult questions of political, as well as legal, judgement, it is essential that politically accountable officials of both nations accept responsibility for the enforcement of any agreement's obligations.

The size and composition of the administrative staff required to support a ministerial committee structure would depend on the choices made concerning several important options discussed earlier. If, for example, the enforcement of anti-dumping and countervailing duties, and safeguard measures is to become a responsibility of the Committee of Ministers, it will be necessary to create a panel with appropriate staff support to adjudicate on private complaints. Under this option the Ministerial Committee could exercise appellate review over specific decisions of the panel.

Since any workable agreement is likely to contain rules and standards framed in broad and indefinite terms, conflicts would probably arise over the appropriate interpretation of the treaty's provisions. While this Commission believes that the Committee of Ministers should take final responsibility for resolving disputes arising under the treaty, (subject to the arbitral procedure proposed below), it might be expedient for the Committee to appoint a consultative council whose members could engage in fact-finding and conciliation to further dispute resolution. A council might be composed of private experts such as retired public servants, business executives, union leaders, professionals, and academics; the members would be assigned to panels created to rule on specific complaints. Panels of council members would investigate complaints of non-compliance, originating from either government, and try to facilitate negotiated settlements at the departmental level. If negotiations resulted in a stalemate, the panel would be required to make recommendations to the Committee of Ministers concerning the appropriate resolution of the dispute. A consultative council could also assist the ministers and their departments with formulating and bargaining on amendments to the free-trade agreement, either extending its coverage or changing its major rules.

While there is no compelling need for a permanent executive body independent of the two national governments, the creation of a standing arbitral tribunal to resolve disputes concerning the proper interpretation of the proposed free-trade agreement would be desirable. The option of binding arbitration as a last-resort solution, in cases where the standard fact-finding and conciliation processes failed to resolve a serious dispute, would strengthen the stability and predictability of North American free trade. In future disputes over the meaning of the treaty's provisions, Canadian interests might be better served if the conflict were resolved through binding arbitration by a tribunal with strong bi-national representation. Such an arrangement might be preferable to a bargaining process involving a strong adversary with comparatively less to lose from the weakening or abrogation of the agreement. An accord to submit future disputes to binding arbitration at the instance of either nation would send a strong message to private investors concerning the durability of Canada's guarantee of access. An effective court or tribunal would, of course, require neutral members in order to ensure that a body comprised of equal numbers of national representatives would not be paralysed by deadlocks. Moreover, an arbitral panel would safeguard Canadian political autonomy by operating as a check on unfair or insensitive demands backed by threats of non-compliance with the agreement. A five-member standing body consisting of two Canadians, two Americans and one neutral member would appear to Commissioners to form a satisfactory arbitral panel. Decisions could be taken on the basis of simple-majority voting, and members could serve for five-year renewable terms. The selection of the neutral voting member would be a matter of great importance: it would be essential that the person chosen possess the skills and diplomatic experience required to perform capably this sensitive function. The panel's jurisdiction could be limited to the resolution of disputes arising from conflicting interpretations of the agreement. It is probable that serious disputes of this type would arise rather infrequently. In fact, we anticipate that most disputes would be resolved through bargaining at the administrative and ministerial levels of the organization proposed in this Report, if only to avoid resort to binding arbitration.

Notes

1. See John J. Quinn, "The International Legal Environment: An Overview", in *The International Legal Environment*, vol. 52, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
2. Canada, External Affairs Canada, *Canadian Trade Policy for the 1980s: A Discussion Paper* (Ottawa: Minister of Supply and Services Canada, 1983).
3. For a more detailed discussion of the sectoral approach, see Michael Hart, *Some Thoughts on Canada-United States Sectoral Free Trade* (Montreal: Institute for Research on Public Policy, 1985). For an assessment of U.S. attitudes, see Gary C. Hufbauer and Andrew J. Samet, "U.S. Response to Canadian Initiatives for Sectoral Trade Liberalization, 1983 to 1984", in *The Politics of Canada's Economic Relationship with the United States*, vol. 29, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
4. See Thorald K. Warley, "Issues in Canadian Agricultural Trade Policy", in *Canada-United States Free Trade*, vol. 11, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
5. Ronald J. Wonnacott, "Potential Economic Effects of a Canada-U.S. Free Trade Agreement", in *Canada-United States Free Trade*, vol. 11, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985). This subject has also been discussed in a paper published by the Ontario Economic Council: *Canada/United States Free Trade: Problems and Opportunities* (1985).
6. Simon S. Reisman, "The Issue of Free Trade", in *U.S.-Canadian Economic Relations: Next Steps?*, edited by Edward R. Fried and Philip H. Trezise (Washington, D.C.: Brookings Institution, 1984), p. 50.

Costs and Benefits of Freer Trade with the United States

We Commissioners based our decision to consider bilateral free-trade negotiations with the United States on our assessment of Canada's current economic position, the global environment, and the advantages which would accrue over time from such a step. The key to our thinking was the extent of Canada's trade with the United States, compared to that with other countries. Canada's trade with the United States has continued to grow, even during the last few years. This concentration of trade, particularly in Canadian exports, clearly reflects the benefits Canada receives from trading with the United States. Obviously, the more extensive the trade, the greater the need for a certain and secure relationship between the traders.

Trade makes the United States important to Canada's economy, but Canada is perceived to be less important to the United States. Our nation is the United States' largest trade partner, yet we accounted for less than 20 per cent of U.S. trade between 1980 and 1983. U.S. observers often perceive our country incorrectly, as less important to the United States than is the European Community (EC) or Japan. Indeed, many Canadians are deeply concerned that because trade with Canada is quantitatively less important to Americans than is their trade with us, the United States might implement protective trade measures harmful to Canadians and be relatively unaware of, or unconcerned by, the consequences. Although the U.S. Administration might believe that these measures would apply equally to all U.S. trade partners, the protection might, in fact, have much the greater effect on our country because of our high degree of concentration on U.S. trade. Since the United States is by far our most important trading partner, managing our U.S. trade, whether through bilateral or through multilateral arrangements, is central to our foreign economic policy. Furthermore, because our trade has involved us so thoroughly in the U.S. economy, loss of access to U.S. markets constitutes a danger for Canada against which we Canadians must guard.

It is imperative that Canada reduce both the uncertainty of our access to U.S. markets and the adverse effects that might result from any trade-restrictive measures.

> *We must face the world as we find it. Canada should act with all possible speed to establish firm and secure access to at least one world-scale market since Canada can only achieve its objective of [attaining] economic efficiency if producers are able to utilize all available economies of scale. Given Canada's geographical proximity to and historical linkages with the United States, [these intervenors] recommend that Canada should regard better access to that market through free-trade arrangements as its primary trade objective.*
>
> (Royal Bank of Canada, Brief, August 1, 1984, p. 55.)

Access to Markets and Canadian Competitiveness

Canada would gain several advantages by negotiating a free-trade agreement with the United States. In the first place, freer trade would reduce the exposure of Canadian exporters to American non-tariff barriers (NTBs) such as countervailing duties and, hence, increase our *security* of access to the U.S. market. Of all the major economies in the developed world, Canada is unique in its lack of a large internal market like that of the United States or Japan and of access to a market of over 100 million people through a bilateral or other free-trade arrangement. Many years ago, the major European countries negotiated such an arrangement and formed the European Community (EC). The smaller European countries, in turn, negotiated similar arrangements among themselves to set up the European Free Trade Area (EFTA), and they have subsequently negotiated further access to the European Community. By contrast, Canada's access to foreign markets depends largely on the outcome of multilateral trade negotiations in the General Agreement on Tariffs and Trade (GATT). The multilateral trading system has its advantages, and our continuing involvement in those negotiations would offer Canada potential gains. Nevertheless, the benefits of access to our largest market, the United States, are critically dependent on our maintaining secure access.

Even if access is not actually withdrawn, insecurity of access imposes costs. The chance that access might be withdrawn as a result of the application of safeguard measures or countervailing duties imposed by the United States substantially restricts the ability of Canadian firms to take advantage of increased trading opportunities. Only if our access is secure, will firms be willing to make the necessary long-term investments in plant, technology and human resources that are needed to secure fully those gains which accompany access to a larger market. Improved security of access and improvements in the terms of access themselves would therefore be equally important to Canada as part of a free-trade arrangement with the United States.

The global environment within which Canada operates is becoming increasingly insecure. Over the last two years, there has been discussion in the United States of the possible aggressive use of reciprocal trade measures as a means of forcing major American trading partners to open their markets to U.S. suppliers. According to the extreme form of such proposals, the U.S. Administration would impose trade barriers against other countries at levels equal to the trade barriers which the U.S. faces on a market-by-market and product-by-product basis.[1] Although, at the present time, such U.S. legislation still seems a remote possibility, there is no doubt that widespread change in opinion on trade policy is currently developing in the United States. American thinking now accepts the aggressive use of trade-policy instruments to gain increased access to foreign markets in U.S.-supplier countries. The dangers posed to Canada by the use of these instruments and our difficult experience, in recent years, in the steel, lumber and copper industries strongly suggest the benefits of improving our security of access to U.S. markets. A free-trade arrangement would reduce the hazard that Canada, as an innocent party in a wider trade conflict, could lose part of its access to its largest market.

Another advantage of Canada-U.S. free trade is that it would *improve* our access to the U.S. market in areas where that country now employs tariff and non-tariff-barrier (NTB) protection. While the U.S. economy has less tariff protection than Canada, there are important areas where American tariffs restrict the potential for increased Canadian exports. Certain steel products would fall into this category, as well as the petrochemical sector. This sector is especially important to producers in western Canada, but Canada's capacity to achieve improved access for petrochemicals in the multilateral Tokyo Round was circumscribed by the implications of this deal for U.S. trade with the European Community. In a bilateral agreement, Canada could negotiate for improved access to the U.S. market, in sectors like petrochemicals, without being constrained by the relations between the United States and its other trading partners. Although Commissioners believe that improved access is important for the export of certain commodities and services, Canada's goals should not be interpreted as a desire to become even more dependent on trade with the United States. Paradoxically, we believe that improved and secure access to that market will, in the long run, be the best means to achieve greater diversity of our economic and trade relations. To clarify this contention, we turn to the third advantage.

The most important advantage to Canadians of a free-trade agreement with the United States would be its effect on productivity and thus, in particular, on the competitiveness of our manufacturing sector. Improved and more stable access would create opportunities for Canadian business and increase the tendency toward specialization and rationalization of Canadian production.

As we noted above, the historic protection provided by the National Policy has left Canada with an industrial manufacturing base too small to be competitive by world standards. Government reports and academic studies of the Canadian economy have referred repeatedly to these difficulties. In 1961, for example, the Royal Commission on the Automotive Industry (the Bladen Commission) reported its extensive examination of the Canadian auto industry.[2] That industry was then suffering from chronic underproductivity, and the Bladen *Report* identified low-volume production as the main cause of that condition. The *Report* provided the theoretical analysis that eventually led to the Canada-U.S. Auto Pact and to the rationalization of the Canadian automobile industry in the larger North American market. That rationalization promoted longer production runs and a greater degree of product specialization in the Canadian sector of the industry, and these factors, along with sharply increased investment in Canada by U.S. multi-nationals, produced a more than twelve-fold increase in Canadian auto exports between 1965 and 1981.

The concerns addressed in the Bladen *Report* in 1961 are now relevant to much of Canada's manufacturing industry. Our industry urgently needs to increase economies of scale in order to realize greater productivity. Establishing freer trade with the United States is one important way to accomplish this end. Freer trade would create desirable restructuring and rationalization in Canadian industry that would evolve from increased competition with U.S. industry. By becoming more competitive with American firms, Canadian manufacturers would also increase their ability to survive in a more competitive, global trade environment. Ultimately, it is only by creating a more competitive domestic economy that Canada will be able to produce the additional jobs needed to reduce unemployment.

As the Economic Council of Canada stated in its first submission to this Commission:

Many appear to believe that freer trade and expanded trade with the United States precludes expanded trade with other countries. There is no logical basis for this view; in fact, expansion of our export sector to serve U.S. customers could well facilitate the economies of scale needed to reach more distant markets. (Economic Council of Canada, Brief, November 28, 1983, p. 28.)

As a result, then, of a Canada-U.S. free-trade agreement, we could lower unit costs of production, at home and abroad. This advance would enable Canadian firms to concentrate on their most efficient product lines, thus lengthening production runs and further lowering costs. The resulting expansion of trade would increase the variety of products available to Canadian consumers, for even though our own economy might produce fewer types of each product, more types overall would be available to consumers because of increased trade.

As an example of the kind of restructuring that freer trade would promote in Canadian industry, consider the Strategic Plan developed by Canadian General Electric (CGE) in 1978.[3] For most of its existence, CGE was, in effect, a mini-General Electric operating in Canada and producing, behind high tariff walls, a wide range of products, essentially for the Canadian market. In the late 1970s, however, in response to the challenge of Tokyo Round tariff cuts, CGE assessed its capacity to restructure through the specialization, rationalization and internationalization of its operations. The company's objective was to turn out products that could be manufactured in sufficient volume to compete against imports on the Canadian market. To this end, CGE meant to seek niches in international markets that would enable it to produce the volume of goods needed to reduce its manufacturing costs. The company invested in world-class, high-technology products (such as pulp and paper machinery) in which it had a competitive advantage, and it sought "world product mandates" from its parent firm in order to market its products internationally. At last count, CGE listed 22 product mandates earned, which accounted for 31 per cent of its manufactured-product sales. The type of restructuring represented in the CGE Strategic Plan benefited the company and helped, as well, to make our national economy more resilient. Freer trade would serve to stimulate a similar restructuring in other Canadian industries. Moreover, as CGE itself noted, the current low value of the Canadian dollar against the U.S. dollar will give Canadian business a five- to ten-year "window of opportunity", and its duration will afford time for firms to restructure to meet international competition. That this window of opportunity exists now makes the present time all the more advantageous for establishing freer trade while Canadian business has the breathing room to adjust and restructure.

Improved and more secure access to a larger market would further promote Canada's relative advantage over third countries, both in the U.S. market and in head-to-head competition in those third countries' markets. Numerous briefs submitted to this Commission have stressed the importance to Canada of establishing trading preferences in the U.S. market. A general bilateral free-trade agreement could establish such preferences across the board; this action would produce a substantial increase in the opportunities that Canadian business would enjoy in export sales.

A free-trade agreement with the United States must not be allowed, however, to harm Canada's trade with other countries to any significant degree. When countries reduce trade restrictions on a bilateral basis, the effects are usually twofold: new trade is created, but trade is also diverted from third countries. Under a Canada-U.S. agreement, significant diversions on the Canadian side are unlikely because a large portion of our trade already takes place with the United States. The chief effect of such an agreement, in Commissioners' view, would be that Canada's North American trade would take place on terms more beneficial to Canadians. The arrangement would, in fact, create trade, rather than substantially divert it from Canada's non-U.S. suppliers.

Benefits to Incomes and Output

If the success of arguments in favour of free trade with the United States hinges on the benefits to be obtained from increased and more secure access to American markets, it becomes highly important to assess the potential net benefits to Canadians, in terms of lower costs, higher wages and incomes, and increased output of the economy in general.

The conclusion reached on the basis of this assessment should strongly influence the Canadian decision on whether or not to proceed to negotiations. Commissioners have carefully considered studies of this issue, along with reports by our research staff.[4] Our conclusion has been that in the long run, Canada would benefit substantially from bilateral free trade with the United States, particularly from access to the expanded unrestricted market and from economies of scale. Many studies have confirmed this view, and among Canadian economists it now seems a mainstream opinion. The consistency expressed in this area of intellectual debate over the last 30 years has impressed us in our deliberations, and we therefore base our case, in part, on these studies. We would also emphasize, however, that the studies concentrate on only one component of the potential gains, that of reduced trade barriers in both Canada and the United States. They do not address the additional arguments of improved security of access and of the potential enhancement of Canada's multilateral negotiating abilities. Hence, while we accept these studies' general consensus on potential benefits from reduced barriers, we also argue that other benefits, too, must be weighed into an evaluation of free trade. These further strengthen the case.

As early as 1957, economist John Young sought to quantify the effect of a move by Canada towards freer trade through the complete elimination of the Canadian tariff. In his study for the Royal Commission on Canada's Economic Prospects,[5] he estimated the cost to Canadians of our tariffs. Using 1954 data covering 13 categories of goods, Young compared Canadian prices with the prices of foreign (generally U.S.) goods. On this basis, he estimated the cost of the tariff at between $0.6 and $0.75 billion: the equivalent of 3.5 to 4.5 per cent of gross private expenditure net of indirect taxes (such as excise and sales taxes). He considered that the inclusion of other factors, such as the higher costs of goods purchased by governments as a result of the tariff, would have increased the cost to about $1 billion. Young concluded:

The principal result of this analysis can be summarized in a sentence. In general and over the long run, increases in protection can be expected to lead to economic losses and decreases in protection to economic gains for the country as a whole. This follows not only from the direct effect the Canadian tariff has on the Canadian economy, but also from the effect Canadian commercial policy has on the treatment accorded this country's exports.[6]

In 1967, Ronald and Paul Wonnacott produced the first major study of the possible effects of Canada-U.S. free trade.[7] Using 1958 data, the authors found that the total cost to us of Canadian and U.S. trade barriers represented a little more than 10 per cent of Canadian gross national product (GNP); 4 per cent of this amount the authors attributed to Canadian trade barriers, and 6 per cent to U.S. barriers. They have since periodically reviewed and updated their study, refining their findings in the light of changing circumstances. Writing in 1982, they noted:

Essentially, the case for free trade has remained the same over the past decade or two, although the gains we measured would be somewhat reduced because of the trade liberalization that has already occurred. These gains would come from increased productivity in manufacturing . . .[8]

In 1971, Ronald Shearer, John Young and Gordon Munro produced one of a number of studies on the estimated results of free trade on one or more regions of Canada. They considered the effects on British Columbia of the removal of tariffs among the North Atlantic countries. Using a method similar to the concept in Young's 1957 study, the authors suggested that British Columbians might stand to gain an amount ranging between 4 and 7 per cent of their incomes from free trade. They concluded further:

Western Canada – and specifically British Columbia – suffers from being in a customs union with the rest of the country; the central provinces suffer from not being in a customs union with the rest of the world . . .

North Atlantic free trade would raise incomes in the industrialized regions of Canada relative to incomes in areas like British Columbia, although incomes would rise absolutely in both places. Free trade would be less of a stimulus to economic expansion in British Columbia than in the industrialized central part of the country.[9]

A later work published by James Williams in 1978 concentrated specifically on Canada-U.S. free trade.[10] Williams approached the problem of calculating the cost of Canadian and U.S. tariffs by estimating the maximum value of consumption that could be generated by the Canadian economy under both bilateral free trade and a situation of unchanged trade policies. The difference between these two values, that is, the amount of additional consumption possible under bilateral free trade, comprised the estimated gains to Canada from such an arrangement. By Williams' reckoning, the elimination of Canadian tariffs would produce a 1.36 per cent increase in consumption; elimination of U.S. tariffs would provide a 2.03 per cent increase; and elimination of both tariffs would give a 3.97 per cent increase.

Roma Dauphin's study,[11] also published in 1978, used Williams' results to estimate the effect of unilateral free trade (that is, the elimination of Canadian tariff and some non-tariff barriers) on the regional distribution of income in Canada. On the basis of 1971 Canadian data, Dauphin calculated that real incomes would increase in the Atlantic region, the Prairies and British Columbia; little change would occur in Ontario and Quebec, although a larger increase in real wages would occur there. All regions would therefore gain from free trade.

In the most recent work in this tradition, Richard Harris and David Cox have developed a micro-economic simulation model of the Canadian economy, which they have used to analyse Canada's trade policies. In work published in 1983, and in subsequent work summarized in this Commission's research publications, Harris and Cox have used their model to estimate the effects of unilateral free trade, full multilateral free trade, bilateral free trade with the United States, and sectoral Canada-U.S. free trade.[12] The authors divide the Canadian economy into 29 industries, 20 of them in the manufacturing sector. In their model, the removal of Canadian tariffs increases domestic competitive forces, and compels rationalization of our domestic industry. The removal of foreign-trade barriers facilitates Canadian penetration of foreign markets, permitting economies of scale to be more fully exploited. In their 1983 study, they reported results for the effects of unilateral and multilateral free trade on the Canadian economy. Under unilateral free trade, they estimate that Canada's GNP will rise by about 3.5 per cent. Multilateral free trade would raise GNP by about 7 per cent.

In his summary article for this Commission, Harris[13] reports results for bilateral and sectoral Canada-U.S. free trade. His analysis of sectoral free trade takes account of the effect of the bilateral elimination of trade barriers in textiles, steel, chemicals, urban transportation equipment, and agricultural machinery. He examines this hypothetical situation both with and without export subsidies, most of them provided by the U.S. government. Where sectoral free trade continues to be supported by export subsidies after a bilateral agreement is struck, an aggregate welfare gain occurs, amounting to a 1.9 per cent increase in base Gross National Expenditure (GNE).

The corresponding analysis, presented in the same paper, of full bilateral free trade involves the elimination by both partners of tariffs and non-tariff barriers (NTBs), including export subsidies, in all industries studied. The author estimates gains significantly larger than those under sectoral free trade. These amount to 9 per cent of national income, a higher figure than that achieved under multilateral free trade. Even though the gains from bilateral free trade depend on the joint removal of trade restrictions on only about 70 per cent of Canada's trade (as compared with 100 per cent in the multilateral case), preferential access to U.S. markets more than compensates Canadians for the difference. As a number of analysts, including the authors themselves, have warned, the results of this analysis must be accepted cautiously. Nevertheless, the broad thrust of its conclusions supports those of earlier studies. Gains to Canada from Canada-U.S. free trade would be significant and widespread. As a nation, we stand to benefit a good deal from such an arrangement.

All economic analyses of possible effects of changes in Canada's trade policies examine unobservable situations; inevitably, therefore, their results are uncertain. Analysts must make a range of simplifying assumptions, and supportive data are frequently unavailable. In evaluating these studies and working their results into our deliberations, Commissioners have noted the differences among researchers' estimates of the gains to be made from free trade. In many instances, these differences are the result of the different methods and data employed by the researchers, and this variety makes it impossible to predict with absolute precision the effects of free trade. Nevertheless, the results of the analyses have convinced us that such disagreements as exist are quantitative and not qualitative. The debate concerns the *size* of long-term gains that free trade has to offer Canada, not whether such gains will occur.

We Commissioners do not see our role as one of arbitrating differences of opinion among individual researchers, but of using our analyses to help Canadians reach the best judgement about the appropriate course for Canada to follow. These studies have helped to convince us that there is a high probability that Canada would experience significant gains from free trade with the United States. The long-term gains suggested by these studies lie in the range of 4 to 10 per cent of Canadian GNP. Considering that tariffs will be lower by the end of the Tokyo Round tariff cuts than the levels used in these studies, this range might perhaps be lowered to 3 to 8 per cent of GNP. These are still substantial gains, and they exclude other factors such as the contingent protectionism and other non-tariff barriers which create uncertainty for Canadian producers. They therefore provide strong support for our proposal of freer trade with the United States.

Regional Considerations

Since Confederation, trade policy and regional interests have been closely linked. Both our eastern and western provinces have long considered that central Canada has used the tariff to its own advantage by forcing itself on them as a trading partner, rather than leaving them the option to trade with more competitive foreign suppliers. They see the tariff largely as an instrument for protecting manufactured products, which are produced in central Canada. The tariff supposedly forces hinterland regions to pay higher prices for manufactured imports, produces large volumes of interprovincial trade and smaller volumes of international trade, and transfers income to central Canadian manufacturing industries from hinterland consuming regions.

Irrespective of whether or not this perception is true, it has proved over the years to exercise subtle influence over the conduct and formation of our trade policies. It has generally been assumed that western and eastern provinces would welcome any move towards freer trade, whether this be unilateral, through a negotiated arrangement with the Americans, or multilateral, through GATT negotiations. Equally, it has been assumed that both Ontario and Quebec would oppose any such moves.

During the course of this Commission's hearings, however, we have been impressed by the degree to which this traditional heartland-hinterland view of Canadian trade policy is now being challenged from several quarters. Both the very concept of a region and the notion of how regions are affected by changes in trade policies are central to any discussion of interregional effects of those policies. If factors of production are mobile between regions, however, as they now appear to be, how can it be determined whether a given region gains or loses from a change in trade policies? Some of the residents will be affected, but if workers move in and out of regions in response to changes in trade policy, the size of a region is not fixed, and interregional effects of trade policies become hard to "nail down".

Again, who owns interregional assets? And how does their ownership affect analysis of interregional effects of trade policies? Through pension funds, stock ownership, and other forms of financial intermediation, for instance, residents (say, of Ontario) will own assets that are located in other provinces (say, Alberta). Interregional effects of trade policies, measured in terms of the impacts on factors of production located in particular regions, will be different from the results for residents of a region. Thus the interregional effects of our tariffs or other trade-policy measures may have quite different results from what is often supposed when they percolate through to the ultimate recipients of the returns to factors used in particular regions.

Observers often fail to appreciate that our own trade barriers and those we face abroad typically affect Canada's regions in opposite ways. To the degree that the traditional view of interregional effects of Canadian protection is correct, the interregional effects of trade barriers abroad, especially when they are higher for manufacturing than for non-manufacturing products, operate in the opposite direction. Moreover, the threat from contingent protection in the United States applies to industries in all regions, and the estimates of benefits from bilateral free trade with the Americans seem to suggest that the advantages will be spread broadly throughout our economy.

Commissioners therefore believe that the regional divisions on the free-trade issue that have been prominent in the past should not occur in the same way today. While some regions may anticipate adverse effects from free trade, we believe that the likelihood is that all regions will benefit, and that Canadians everywhere will be able to enjoy a higher standard of living. To put an even finer point on this conviction, we believe that freer trade with the United States would make a major contribution to Canada's regional development and to national competitiveness and overall confidence.

Problem Areas

While the economic benefits of Canada-U.S. free trade hinge largely on the gains Canadians would enjoy from increased and more secure access to a larger market, Commissioners recognize that there are also potential economic costs. One argument commonly raised against free trade is that it might induce significant amounts of investment to leave Canada. Protection has encouraged foreign firms to invest here: once tariffs are in place, these firms benefit from producing in Canada, rather than servicing our market from abroad. What, then, would happen to the level of investment in Canada under free trade?

If Canada were to remove its protection unilaterally, investors entirely dependent on the Canadian market might well withdraw. The net effect on investors of bilateral free trade is less clear. It is true that investors attracted to Canada by our protection would have less incentive to remain, but firms previously discouraged from investing here by the presence of U.S. trade barriers could enter Canada and produce for both a foreign (U.S.) and a domestic market. The possibility of penetrating the U.S. market from a secure Canadian base, unimpeded by U.S. trade barriers that inhibit competition from Canada, could well encourage investment and job creation here to a much greater extent than elimination of protection would discourage them.

Commissioners are strongly of the opinion that attempts either to stimulate or to restrict foreign investment in Canada by using domestic trade barriers as levers are inappropriate. Whatever the desired level of foreign investment in Canada, it is more fitting to achieve it through tax and subsidy policies toward domestic and foreign firms and the regulatory stance of Investment Canada. Trade barriers are unsuitable instruments with which to control foreign investment. It strikes us as ill conceived to refrain from negotiating free trade with the United States because of Canadian concern that unprotected trade between the two countries could discourage investment here. Canada should meet these concerns and achieve its objectives by using instruments other than protective barriers.

Some Canadians see protection as a stimulus to our manufacturing industries, and are concerned that without protection, disruptive adjustments would be required. It is true that a unilateral move towards free trade, involving the elimination of Canadian trade barriers only, could well reduce the size of our manufacturing industries. Rodrigue Tremblay, an economist at the Université de Montréal and a former Quebec Cabinet Minister, told Commissioners:

> *Unilateral disarmament [of trade barriers] is of less interest [because it] would create major problems of industrial reorganization, since certain industries would completely disappear from Canada [and this would have] serious regional consequences. This does not hold when one speaks of a reorganization that applies [only] to North America because, in the latter case particularly, the reorganizaton occurs on an industry-by-industry basis.*
>
> (Rodrigue Tremblay, Transcript, Montreal, May 31, 1984 [vol. 2], p. 361.)

Bilateral free trade would probably produce a different situation. Elimination of foreign-trade barriers would stimulate manufacturing industries, including those likely to be diminished by the disappearance of Canadian protection. Studies on this matter suggest the likelihood of a net increase in our manufacturing production: the stimulative effect of increased penetration of markets abroad would more than offset the reduction caused by removal of our own protection.[14] Adjustment may therefore be less difficult under bilateral free trade, especially if it tends to take the form of reallocation among firms within industries, rather than simple changes across industries, as Canadian production becomes rationalized.

However, in evaluating short-term adjustment costs under any Canada-U.S./free-trade arrangement, Canadians must consider many elements. We must identify the industries which would expand and those which would contract, and the extent of the changes for each. We must assess disruptions in the markets for labour and other factors of production, calculate the length of unemployment periods for workers affected, and evaluate the costs of forgone opportunities in terms of lost production. We must determine the length of adjustment periods and separate the factors listed from all the others taking place at the same time in our economy. Because there are so many factors involved and the data are so limited, it is difficult to assess the possible adjustment costs of a Canada-U.S./free-trade agreement.

Studies made in other countries where data are more plentiful have compared the relative size of the long-term gains from expected higher real incomes with the shorter-term costs of adjusting to the new situation. These adjustment costs consist of temporarily higher unemployment and forgone production as productive resources move from one firm to another or from one industry to another. The ratio of the long-term gains to the short-term costs of trade liberalization range between 25:1 and 80:1. An American study in 1978 estimated the effects on a number of countries, including Canada, of a 60 per cent multilateral tariff cut from pre-Tokyo Round levels.[15] If the tariff cut excluded textiles, but eliminated all tariffs of less than 5 per cent, the adjustment costs to Canada were estimated at $286.8 million (in 1974 U.S. $). The present value of the long-term gains was estimated at $17.8 billion (1974 U.S. $). Thus the ratio of the adjustment costs of the estimated long-run benefits to Canada was 62:1. This figure falls within the same range as those offered in other studies.

Commissioners recognize that adjustment difficulties in Canada could well be somewhat more costly than those assessed elsewhere. Our economy is spatially more diverse than that of most other developed economies, and Canadians would be entering a free-trade agreement with a country much larger than our own. Nevertheless, even if we multiplied the estimated short-term adjustment costs by factors of, say, five or even ten, the net balance in favour of free trade would still be great and unmistakable.

This Commission's view is that on balance, long-term gains from bilateral free trade would almost certainly heavily outweigh short-term adjustment costs. Some Canadians will say that a policy judgement such as this should be based on total certainty. Commissioners believe, however, that uncertainties about effects will always remain the very nature of debate about policy, even after decisions have been made; nor is there any need to presume that maintenance of the *status quo* is always the appropriate operating principle. We are convinced that on this important issue, the weight of evidence lies in the direction we have stated. Consequently, the importance of improving and securing Canadian access to export markets has convinced us that change is the better choice, but we look forward to further discussion of these matters in the debate which will undoubtedly follow. We fully acknowledge that that debate would clearly be advanced by the availability of more precise data on this issue.

A third argument sometimes raised against free trade is the risk that it could reduce Canada's ability to negotiate multilaterally for access to export markets. It would be ideal if Canada could expand and secure its access to export markets in the United States through multilateral, rather than bilateral, negotiations. A multilateral trading system based on clear rules and transparent trade barriers now has a proved track record of almost forty years. Indeed, the advantage of multilateralism has been one of the major themes in Canadian trade policy since the Second World War.

Free trade with the United States would not pose major legal problems under the General Agreement on Tariffs and Trade (GATT) if its Article XXIV were respected. Legal aspects, however, may be less important than other factors. Some Canadians who oppose free trade argue that while Canada is not a dominant force in multilateral negotiations, our presence there is important. They believe that major bilateral negotiations between Canada and the United States could further fracture the multilateral system which has served us well. Commissioners believe, however, that the converse is more likely. The formation of the European Economic Community in 1958, for instance, helped to accelerate multilateral negotiations under the GATT's Dillon Round, in 1960–61, as the larger powers sought to deal with the new trade group. The entry of the United Kingdom into the Community in 1971 helped to launch the Tokyo Round. A similar situation could well evolve over the next few years if Canada were to negotiate a bilateral trade arrangement with the United States.

Commissioners do not deny that Canadians must make a delicate judgement on this issue. Canada is a relatively small country, and any bilateral arrangement we made with the United States might serve to accelerate multilateral negotiations. Alternatively, it could harm the multilateral trading system. While this Commission believes that the former outcome is the more likely to occur, unequivocal evidence of one view or the other is hard to find. Commissioners repeat that multilateral and bilateral negotiations are not mutually exclusive: they can be engaged in jointly, and they can be mutually reinforcing. Canadians clearly stand to benefit from increased access to foreign markets and increased security of that access. The method is less important than achievement of the objective. We think both routes worth exploring, and bilateral negotiations especially so.

Notes

1. For a full explication of this proposal, see R.J. Wonnacott, *Aggressive U.S. Reciprocity Evaluated with a New Analytical Approach to Trade Conflicts* (Montreal: Institute for Research on Public Policy, 1984).
2. Canada, Royal Commission on the Automotive Industry, *Report* (Ottawa: Queen's Printer, 1961).
3. See Canadian General Electric Company Limited, Brief, November 21, 1983, pp. 10–11.

4. See, for example, the research papers in *Canada-United States Free Trade*, vol. 11 (co-ordinated by John Whalley), prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
5. John H. Young, *Canadian Commercial Policy* (Ottawa: Queen's Printer, 1957).
6. *Ibid.*, p. 160.
7. Ronald Wonnacott and Paul Wonnacott, *Free Trade Between the United States and Canada: The Potential Economic Effects* (Cambridge, Mass.: Harvard University Press, 1967).
8. Paul Wonnacott and Ronald J. Wonnacott, "Free Trade Between the US and Canada", *Canadian Public Policy* 8 (Supplement, 1982): 412–27. See also Ronald J. Wonnacott, "Potential Economic Effects of a Canada-U.S. Free Trade Agreement", in *Canada-United States Free Trade*, vol. 11, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985). This subject has also been discussed in a paper published by the Ontario Economic Council: *Canada/United States Free Trade: Problems and Opportunities* (1985).
9. 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* (Toronto: University of Toronto Press for the Private Planning Association of Canada, 1971), p. 203.
10. James R. Williams, *The Canadian-United States Tariff and Canadian Industry: A Multisectoral Analysis* (Toronto: University of Toronto Press, 1978).
11. Roma Dauphin, *The Impact of Free Trade in Canada*, study prepared for the Economic Council of Canada (Ottawa: Minister of Supply and Services Canada, 1978).
12. Richard G. Harris with David Cox, *Trade, Industrial Policy, and Canadian Manufacturing* (Toronto: Ontario Economic Council, 1983); and see also the research papers in *Canada-United States Free Trade*, vol. 11, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
13. Richard G. Harris, "Summary of a Project on the General Equilibrium Evaluation of Canadian Trade Policy", in *Canada-United States Free Trade*, vol. 11, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
14. See Harris, *Trade, Industrial Policy, and Canadian Manufacturing*, p. 115; and Williams, *The Canadian-United States Tariff and Canadian Industry*, p. 34.
15. See William R. Cline, Noboru Kawanabe, T.O.M. Kronsjö, and Thomas Williams, *Trade Negotiations in the Tokyo Round: A Quantitative Assessment* (Washington: D.C.: Brookings Institution, 1978).

The Effect of Freer Trade on Canadian Industry

Canada's business and labour communities remain uncertain about freer trade, as is natural about any major initiative of government. Governments cannot foretell precisely the effects of a new policy. They can act, however, on the basis of available facts and good judgement. To determine the facts and reduce uncertainty, this Commission undertook sectoral studies of the probable effect of freer Canada-U.S. trade on Canadian industry.[1] Commissioners emphasize that these studies represent a preliminary analysis, and that the Canadian government stands in need of more detailed information before it negotiates freer trade with the U.S. Administration or any other government.

Some critics have charged that the costs of freer trade would be excessive, and they have raised the spectre of large-scale transfers of labour among sectors of our Canadian economy, with consequent high increases in unemployment. Such events are unlikely. Freer trade would chiefly affect our manufacturing sector, and this sector now accounts for less than 20 per cent of Canadian employment. Thus, at most, freer trade would directly affect only one-fifth of our country's labour force. It is important to maintain a balanced perspective when analysing Canada's trade and not to overstate either the costs of freer trade or its benefits.

In hearings held in 1980, before the Standing Senate Committee on Foreign Affairs, the Canadian Manufacturers' Association (CMA) stated that a survey of 1031 Canadian firms indicated that only about one-third anticipated contraction as a result of Canada-U.S. free trade. About half the remaining companies expected expansion, and half foresaw no change. Recent informal soundings indicate that as few as 20 per cent of CMA members anticipate contraction from bilateral free trade. The growth anticipated by other members would offset this contraction. Overall, Canadian business seems to judge that freer trade would be in its best interests.

Sector Analysis

To analyse the probable effect of freer trade on Canadian industry, this Commission separated Canada-U.S. trade into workable subdivisions or sectors. These sectors appear in Table 6-1, together with figures recording Canada's trade with the United States and other nations for 1978 and 1983. The data suggest Canada's weakness in all manufacturing sectors except automotive products. In general, our trade balances in manufacturing are negative: in 1983, Canada had a negative trade balance of over $1 billion in each of a group of sectors: textiles, machinery, electronics, electrical machinery, scientific equipment and consumer products. As partial compensation, however, there were strong export increases in such sectors as machinery and equipment. Between 1978 and 1983, our trade balances improved in most manufacturing sectors. This is particularly true for trade with the United States, which showed improvement in all manufacturing sectors except electronics and scientific and medical equipment. In 1983, Canada had an unusually high export surplus, over the United States, of more than $4 billion-worth of automotive products. This surplus accrued largely because of the resurgence of U.S. sales of medium-sized to large autos, a Canadian specialty.

Table 6-1 also confirms that most of Canada's exports are resource based. We continue to have large export surpluses in sectors such as agriculture and food processing, forestry products, metals and minerals, and energy. The most dramatic change occurred in the energy sector, with increased sales of electricity, natural gas and petroleum derivatives to the United States, and increased coal exports to other countries. We achieved a net increase in these exports of over $5 billion (in 1983 $) between 1978 and 1983. During these same years, agricultural exports showed strong growth; wheat sales outside North America represented the largest proportion. Exports of forestry products and metals and minerals, declined, however, between 1978 and 1983; while these sectors remain important to Canadian trade, they may not grow much in future.

The study next examined the sectors themselves. Table 6-1 generally confirms the traditional picture of Canada as an exporter of resource-based products and an importer of manufactured goods. Consequently, the sector studies might well have reflected consistent underlying strength in resource sectors, and consistent weakness in manufacturing industries operating behind uniformly high tariff walls. Reality proved to be quite different. Instead of weakness, we found substantial areas of great strength in Canadian manufacturing. Instead of sameness, we found great diversity in industrial performance, patterns of protection, and patterns of adaptation to the prospect of freer trade with the United States.

Diversity of Industrial Performance

There is substantial import-export Canada-U.S. trade in all manufacturing sectors; in most of these, Canadian exports have grown faster than have imports. No manufacturing sector is unequivocally weak. For instance, Canada's imports of electrical machinery from the United States are over four times greater than our corresponding exports to that country, but even that sector has areas of substantial export strength. In textiles, clothing and footwear, Canada has a large overall deficit in U.S. trade, but we ran surpluses in 1983 in clothing and footwear.[2] Canadian quotas on imports helped to produce the surplus in footwear. Although we ran a sharp deficit in the processing of fruits and vegetables, we had a large surplus in the processing of meat and poultry; surpluses in alcoholic beverages tended to offset deficits for fresh fruits and vegetables. Our furniture sector has been historically weak; in 1978, it ran a deficit with the United States of nearly $109 million (in 1983 dollars); however, it posted a surplus of $185 million in 1983. Most of this growth occurred in office furniture, yet household furniture, despite a continuing deficit, recorded a four-fold export increase.

The earliest and most striking evidence of the diversity of Canada's trade performance was the difference apparent from firm to firm. The most important variable in industrial performance is quality of management, which occurs at the level of the firm, and not of the sector. Thus, in the generally weak electronics sector, the Canadian multi-national Northern Telecom is a world leader in telecommunications technology. Our imports in hand tools and farm equipment are seven times greater than our exports, but the efficient Canadian branch of Black and Decker has acquired, through world product mandates, a flourishing U.S-export trade. Finally, in scientific and medical products, where Canada ran a $1 billion deficit in 1983, the Canadian firm of Madson Electronics delivers only 8 per cent of its sales in this country and could not survive without the American market.

The list could be expanded almost indefinitely, but the point is clear: Canada has proved its industrial capacity at the level of the individual firm and sub-sector, even in sectors that normally run a deficit in U.S-trade. If these firms or industries can successfully meet direct U.S. competition, others can do so, as well. Thus Canada would be likely to achieve substantial benefits from more open trade even in our weakest manufacturing sectors.

Diversity of Protection

Again, this Commission's sector studies show diversity in Canada's pattern of economic protection. As Commissioners noted earlier, most Canadian tariffs are higher than corresponding U.S. tariffs, but the United States makes more extensive use of non-tariff barriers (NTBs) than does Canada. Yet certain exceptions to this generalization have an important bearing on the process of adjustment to freer trade. Some Canadian sectors, for example, are already operating effectively without tariff protection. These include automobiles, where trade is governed by a bilateral agreement; fish products, where Canada has an unquestioned comparative export advantage; and aircraft, where trade is governed largely by a multilateral sectoral-free/trade agreement. In these sectors, freer trade with the United States would make little difference to Canada. Even in fishery products, where the United States maintains some protective measures, availability and quality of the resource influence trade flows to a greater degree than does the level of trade barriers. Nevertheless, a high tariff protects some Canadian sectors: for example, furniture enjoys tariff protection of about 15.5 per cent of value, and textiles and clothing are protected at rates that average about 20 per cent. While freer trade might entail higher adjustment costs in these sectors, in certain others, such as furniture, the current strong position of exports suggests that parts of the sector could bear the adjustment costs.

Canadians make few complaints about generally lower U.S. tariffs, but the few sharp exceptions to this general observation tend to confirm Commissioners' views that Canada would gain if access to the U.S. market were improved by means of bilateral tariff reductions. Canada could gain, for example, from reduced U.S. tariffs on agriculture and food processing and on textiles, clothing and footwear. Furthermore, Canada applies tariffs selectively on strategic goods, a practice that can greatly increase the effect of a tariff on foreign producers. Thus, in 1983, methanol, a primary petrochemical, had a U.S. tariff of 18.0 per cent and a Canadian tariff of 10.0 per cent; plywood, an important intermediate product in domestic construction, carried a U.S. tariff of 20 per cent and a Canadian tariff of 15 per cent.

TABLE 6-1 **Canadian Trade Balances by Sector, 1978 and 1983**[a]

	(Canadian millions $; 1983 dollars)[b]													
	Exports				**Imports**				**Balance of Trade**					
	1978		**1983**		**1978**		**1983**		**1978**		**1983**		**Change from 1978-83**	
	U.S. 1	**R.O.W.[c] 2**	**U.S. 3**	**R.O.W. 4**	**U.S. 5**	**R.O.W. 6**	**U.S. 7**	**R.O.W. 8**	**U.S. 9[d]**	**R.O.W. 10[e]**	**U.S. 11[f]**	**R.O.W. 12[g]**	**U.S. 13[h]**	**R.O.W. 14[i]**
Agriculture and Food Processing	1 536	5 135	1 980	6 907	2 802	2 742	2 493	2 062	(1 266)	2 391	(514)	4 845	752	2 454
Fish and Fish Products	866	670	960	612	221	171	237	182	645	449	724	429	79	(20)
Sundry Crude & Fabricated Materials, n.e.s.	373	1 355	465	1 031	1 242	477	1 026	372	(871)	876	(560)	659	311	(217)
Forestry Products	11 132	3 999	9 466	3 729	1 258	213	1 204	198	9 874	3 785	8 263	3 531	(1 611)	(254)
Metals & Minerals	8 378	5 421	7 465	4 834	4 247	2 385	4 790	2 056	4 132	3 099	2 674	2 778	(1 458)	(321)
Energy	8 110	1 427	11 400	1 373	2 200	4 816	1 932	3 232	5 908	(3 389)	9 468	(1 860)	3 560	1 529
Textiles, Clothing and Footwear	343	398	408	306	1 437	2 383	1 200	2 482	(1 092)	(1 985)	(792)	(2 176)	300	(191)
Chemicals & Petrochemicals	2 508	929	2 908	1 663	3 261	1 064	3 587	1 120	(785)	288	(679)	544	106	256

TABLE 6-1 (con'd.)

(Canadian millions $; 1983 dollars)[b]

	Exports				Imports				Balance of Trade					
	1978		1983		1978		1983		1978		1983		Change from 1978-83	
	U.S. 1	R.O.W.[c] 2	U.S. 3	R.O.W. 4	U.S. 5	R.O.W. 6	U.S. 7	R.O.W. 8	U.S. 9[d]	R.O.W. 10[e]	U.S. 11[f]	R.O.W. 12[g]	U.S. 13[h]	R.O.W. 14[i]
Machinery and Equipment	2 726	934	2 471	960	7 206	1 691	5 291	1 355	(4 478)	(757)	(2 820)	(395)	1 658	362
Automotive Products	18 268	1 614	20 986	733	19 110	1 927	16 916	2 334	(842)	(311)	4 070	(1 600)	4 912	(1 289)
Urban Transportation	36	8	125	0.9	41	3	66	0.2	(5)	5	59	0.7	64	(4.3)
Ocean and Marine Industries	190	213	152	183	242	144	184	602	(52)	70	(32)	(419)	20	(489)
Aircraft	853	417	1 390	427	1 231	96	1 727	87	(376)	321	(337)	339	39	18
Electronics	1 419	605	2 461	1 018	3 256	1 296	5 130	1 857	(1 838)	(691)	(2 668)	(839)	(830)	(148)
Electrical Machinery and Equipment	375	270	512	192	2 377	627	2 127	688	(2 001)	(357)	(1 614)	(495)	387	(138)
Furniture	180	33	373	34	288	134	188	146	(109)	(101)	185	(112)	294	(11)
Scientific and Medical Equipment Products	196	130	294	140	1 084	275	1 346	318	(888)	(145)	(1 052)	(179)	(164)	(34)

Miscellaneous Consumer Products	368	187	582	135	1 672	1 340	1 680	1 237	(1 304)	(1 154)	(1 098)	(1 102)	206	52
Other End Products and Special Transactions	1 110	515	1 913	501	2 760	1 364	2 936	1 148	(1 649)	(849)	(1 024)	(647)	625	202
Total[j] — All Sectors	59 067	24 990	66 333	24 631	56 003	23 194	54 103	21 483	3 065	1 796	12 229	3 148	9 164	1 352

Source: Gilbert R. Winham, "Canada-U.S. Sectoral Trade Study", working paper prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Ottawa, 1985).

a. Data supplied by Statistics Canada, External Trade Division. For additional information, including further breakdown within sectors, see Canada-U.S. Sectoral Trade Study, Royal Commission on the Economy, April 1985.

b. GNE Deflator: 1971 = 100; 1978 = 193.8; 1983 = 290.5. Reference: Statistics Canada Catalogue #13-001, Table 21.

c. Rest of World.

d. Column 9 equals Column 1 minus Column 5.

e. Column 10 equals Column 2 minus Column 6.

f. Column 11 equals Column 3 minus Column 7.

g. Column 12 equals Column 4 minus Column 8.

h. Column 13 equals Column 11 minus Column 9.

i. Column 14 equals Column 12 minus Column 10.

j. Total includes small residuals for each trade category.

Another example of tariff disparity comes from the area of clothing. Canada has a competitive edge over the United States in the manufacture of high-fashion garments. The United States, however, maintains tariffs on "ornamented" clothing that average about 10 per cent higher than duties on non-ornamented clothing, which stand at about 35 per cent. This distinction effectively reduces the U.S. market for Canada's exports. Our exports would have a new "window of opportunity" if these strategic tariffs were removed.

Four types of U.S. non-tariff barriers particularly affect Canadian exports, though some products, such as furniture, hardware and hand tools, face none. One commonly applied NTB is the safeguard provision (an "Article 201 action") established under the U.S. Trade Act of 1974. It authorizes the U.S. Administration to impose quotas or additional duties on foreign imports deemed to be causing injury to competing U.S. producers. The American government recently attempted such an action against Canadian copper exports, but pressure from domestic users of imported copper persuaded it to desist.

Customs-classification procedures cause a particular problem in textiles, clothing and footwear. There are many U.S. tariff items in this sector and officials have considerable leeway in choosing among these items in applying duties. The choice factor itself creates uncertainty for Canadians.[3] Again, U.S. legislation pertaining to countervailing duties particularly affects Canadian resource-based sectors that might have been subsidized. Perhaps the most troublesome forms of NTBs, however, are the U.S. Administration's preferential procurement practices. These are especially disadvantageous for sectors exporting large capital goods such as electrical machinery, electronic equipment and non-electric machinery. They also touch more consumer-oriented sectors: the Berry Amendment covers the purchase of textiles by the U.S. Department of Defence, and extensive state and local legislation sets domestic preferences for purchases of clothing and footwear.[4]

Canada, too, makes use of non-tariff barriers, although some of these actually harm our own interests. Most provinces showed preferences for local or Canadian production in their government purchases. Quebec, for example, in many instances allows only Quebec firms to bid for contracts, and may favour those tenders offering higher Quebec content. Ontario gives a 10 per cent preference to its own companies. Provincial governments often buy from "domestic" producers on a non-competitive basis, shunning lower bids from outsiders. These policies have fragmented the Canadian market and reduced the ability of Canadian companies to collaborate in bidding on large foreign projects. They have also led, in some instances, to undue competition among Canadian companies operating in foreign markets. Obviously, Canada would benefit from removal of this sort of protection under a wider Canada-U.S./free-trade arrangement.

Diversity of Adaptation to Freer Trade

There is no single common denominator which reflects the way that different sectors, or even different firms, might respond to the stimulus of freer trade. To simplify our sectoral analysis, however, Commissioners chose to consider the likely response in three different categories: strong exporting sectors, resource-based sectors, and weaker exporting sectors.

Strong sectors. Urban transit constitutes a strong sector. It covers a diverse range of products, from complete vehicles and vehicle-control and -communication systems, through fare-control, traction-power and track systems, to passenger-distribution and maintenance systems. The sector includes five major transit-vehicle producers, 25 significant manufacturers of components and materials, a number of consulting and engineering firms, and about 200 firms peripherally involved in urban transit. Though rapidly growing in Canada, it is not so strong in the United States.

Despite the weakness of the U.S. urban-transit sector, the Canadian industry faces stiff NTB protection in the U.S. The major NTB consists of the "Buy America" provisions of the Surface Transportation Assistance Act (STAA), which provides the major source of funding for new U.S. urban-transit projects. The Buy America provisions have forced Canadian firms seeking U.S. contracts to establish plants in the United States. For example, both Bombardier and Ontario Bus Industries have established permanent U.S. production facilities, while other Canadian firms are prepared to sub-contract final assembly work to American companies. It has been noted in our sector study that, "a major reason for negotiating freer trade would be to prevent the outflow of capital investment which the Buy America provisions have encouraged."[5]

Freer trade would strongly promote the interests of Canada's urban-transit sector, but not without cost. Removal of Canadian barriers would expose our producers to domestic competition from the more efficient European and Japanese subsidiaries which have located in the United States as a result of Buy America regulations. However, free trade would reduce the incentive for Canadian industry to locate in the United States, to the benefit of our own economy and labour market. Thirty years ago, an influential article[6] on Canadian trade policy noted the capacity of U.S. tariff protection to discourage domestic manufacturing in Canada, to the detriment of Canadian labour and Canadian developmental aspirations. Today U.S. tariff protection is much weaker and no longer has this effect, but the argument is still valid for U.S. NTBs. Thus freer trade and reduction of these less visible American barriers would facilitate the future growth and security of the stronger areas of our Canadian economy.

Forestry products form another strong sector of Canadian trade. Here adjustment to meet world competition often requires massive capital investments to realize economies of scale. However, uncertainties created by the use or threatened use of NTBs make companies reluctant to commit the necessary assets. Freer trade, particularly in pulp and paper, might make Canadian production more competitive internationally. To establish conditions that encourage investment can thus improve trade. The fact that about half of the paper-making machines in Canada were made before 1950, as compared to about 25 per cent in the United States and 5 per cent in Scandinavia, suggests that there is considerable scope for gains through new investment.

Resource-based sectors. Discussions of freer trade often treat its effect on resource-based sectors as a matter of secondary importance. They assume that manufactured goods are the principal focus of concern in a free-trade arrangement, and that the major costs and benefits will occur in that area. This generalization may be correct, but it obscures some important aspects of the situation. Canada's resource-based trade, to take one instance, involves more fabricated goods than raw materials. In the metals and minerals sector, for example, the proportion of crude-material exports has been dropping over the past 20 years and as compared to fabricated or semi-manufactured products, represented only 18 per cent of Canadian exports to the United States in 1983. Crude materials provided only 1 per cent of total forestry sector exports in the same year.

While tariffs are relatively low on fabricated products as compared to end products, the effect of lower tariffs on resource-based exports should not be dismissed lightly. Low tariffs can affect a nation's profitability of processing, and thus influence investment decisions that determine the location of processing facilities. Moreover, even low tariffs must be administered by customs brokers and customs officials and this necessity represents a cost passed on to the foreign exporter that duty-free treatment does not impose. Thus Canada's resource-based industries could make small but significant gains under freer trade.

The cost factor of foreign trade barriers becomes much more important, however, in the area of NTBs. Canada's resource-based industries have been one of the principal targets of U.S. contingency protection; it follows that an agreement on freer trade could give our industries a stronger guarantee of access to U.S. markets. Recently, Canada has faced countervail action against its west-coast lumber industry, and the U.S. Administration has launched investigations into our hog-slaughtering and fishing industries. Copper imports, including those from Canada, were investigated in 1984, but although they were found to be injurious, the U.S. Administration has not imposed restrictive measures.

These NTBs strike at an area of great strength in Canada-U.S. export trade. They harm, in particular, our non-industrial regions. If these regions are to develop further manufacturing potential, they must increase the fabricated content of resource-based products. Abolition of NTBs directed at these products might well represent the largest benefit such regions would obtain from freer Canada-U.S. trade. The importance of a move in this direction is obvious, for as Canada's non-industrial regions develop economically, they will probably export more fabricated and resource-based products to the United States. As this growth occurs, the risk of future U.S. protection – and of the disadvantages it represents to our resource sector – is likely to grow.

Many Canadians have argued that our historic policy of protection has benefited our industrial heartland, but, by contrast, has forced higher prices on the rest of the country. Protection will probably exacerbate any such problem because it will add to the expenses of resource-producing regions, since resource-based industries are most likely to suffer retaliatory U.S. measures. In Commissioners' view, this possibility constitutes another reason for Canada to negotiate freer trade with the United States.

Weaker sectors. The weaker exporting sectors should be of major concern in any move toward freer trade with the United States. These sectors exist principally in secondary manufacturing: the production of textiles, clothing and footwear; machinery and equipment; electronics; electrical machinery and equipment; furniture; scientific equipment; and consumer products. As we have seen, however, it is difficult to determine the areas of weaker performance in Canada's export trade. Where there has been protection, industries or firms tend to protest if that protection is removed and to predict that the change will produce dire consequences. This reaction can create an impression that a sector is weak overall, though as experience in the furniture sector testifies, such an impression is not always accurate. In assessing the effect of free trade on weaker sectors, we Canadians should not ignore areas of strength even within those sectors. Let us examine, for instance, two of these sectors: furniture and electrical machinery and equipment.

The effect of Canada-U.S. free trade on our furniture sector would be uneven and multi-dimensional, and would impinge in different ways on the household-furniture industry and the office-furniture industry. Free trade would affect productivity, competitiveness, labour-market structure and, to a lesser extent, investment patterns. Overall, producers of household furniture would have to make significant structural adjustments to reap production benefits from freer trade, redirecting their marketing strategies from the smaller, domestic, consumer base to the larger and more competitive North American market. Firms that manufacture office furniture would need to make fewer adjustments: many are already oriented toward the North American market, since the majority are American owned. Increased production, therefore, would represent a less demanding challenge for this sub-sector.

It is difficult to assess the effect of free trade on the furniture industry's ability to meet competition. Asian furniture-producers are already challenging Canada's household-furniture sub-sector, although North Carolina, Virginia and Tennessee still produce much of North America's wooden furniture. Ten large firms operate in those States' furniture sectors, and five of them produce more than the entire Canadian household-furnishing industry. The prospect of lowering tariff barriers to these "giants" intimidates Canadian producers.

Many Canadian household-furniture firms, fragmented and operating in single plants, are in a poor position to diversify, to expand marketing networks, and to finance higher transportation costs. Larger firms would be better able to compete with the United States on a free-trade basis. Bauhaus, of Toronto, for example, has established several plants and exports a substantial portion of its product. Some firms, oriented toward the high-income luxury market, export most of their products. Smaller firms would find a foothold in the market because of the continuing need for regional manufacturing, since most furniture is not easily transported. The quality of Canadian design would appear to be an important factor in determining the ability to compete in the U.S. market. The picture, however, is not entirely rosy. The furniture sector employs some 50 000 employees, half of them in the household sub-sector, and the industry estimates that as many as 10 000 jobs could be lost under free trade as smaller and less efficient firms closed down.

The manufacturers of office furniture could meet American competition without making as many adjustments. Despite tariffs, many firms within this sub-sector are oriented to a continental market. Still, a good number of U.S.-controlled Canadian firms hold significant mandates for research and development (R&D) or for design, and they would appreciate elimination of tariffs which add to their product costs.

The electrical machinery and equipment sector produces equipment that generates and distributes electricity or that uses this form of energy. It covers six major sub-sectors: industrial electrical equipment to generate and transmit electricity; electrical wire and cable; major household appliances, such as stoves and refrigerators; small appliances, such as toasters and tea-kettles; miscellaneous electrical products, including conduits and fittings, lamp bulbs, wiring devices and lighting fixtures; and batteries.

The sector generally consists of mature companies with an output of well-established products, and these circumstances suggest that it should seek and exploit new markets in order to re-establish growth. Although employment has fallen in recent years from a peak of 78 268 in 1981 to 70 862 in 1984 – a marked recovery from the trough of 1983 – it is still one of Canada's largest manufacturing employers and therefore of major economic significance. While the majority of firms in the sector are Canadian-owned, American-owned companies account for most of the industry's shipments, revenue and employment (about 60 per cent in 1975). To underscore this reality, one only need think of such industry giants as Canadian General Electric (CGE) and Westinghouse Canada. Intra-corporate trade is extensive and growing as many larger multi-nationals rework their production strategy to cover the North American continent. CGE is a trend-setter in this endeavour.

If Canada and the United States were to move toward freer trade, large American-owned multi-nationals would benefit. Free trade would promote North American rationalization and hence facilitate greater economies of scale. Foreign firms might obtain access to the larger American market through their Canadian subsidiaries, although those with American operations might close their (probably smaller) Canadian branches unless they could be converted to single-product facilities. The effect of free trade on Canadian-owned firms would vary by sub-sector, but as a rule, firms producing relatively customized products, such as electricity-generating equipment, would benefit from increased market access. Firms producing off-the-shelf items such as distribution transformers for the Canadian market might, on the other hand, face strong competition from American producers.

In general, then, free trade would usher in a period of substantial adjustment for both Canadian and foreign-owned firms. The sector has little growth potential beyond exploitation of new market opportunities. Ultimately, free trade would make it necessary for Canadian firms to "bite the bullet", but with a reasonable expectation of long-term increases in employment and sales.

One issue that arises in assessing the effect of free trade on Canada is whether multi-nationals would continue to use their Canadian facilities and would include Canadian operations in their rationalization plans. The example offered by CGE and evidence from the rationalization strategies of other multi-nationals suggest to Commissioners that these large firms are planning to grant specific product mandates to their Canadian facilities. Such an outcome could yield another important benefit to Canada: increased R&D activity, as multi-nationals move projects related to a given product mandate to the appropriate production facility. At present, branch plants producing full product lines on a small scale for the Canadian market undertake little or no R&D; that aspect of their operation is carried out by the parent firm in the "home" country, with consequent loss to Canada.

Conclusions from Sectoral Analysis

Examination of the furniture and electrical machinery sectors can help focus Canadian concerns about free trade: Would individual firms "go under"? Would whole industries or sectors disappear? Would foreign multi-nationals that have located in Canada and provided productive capacity and jobs return home? Perhaps most important: Would Canadian unemployment increase? These questions relate to economic adjustments. Where such adjustments result from change induced by government policy, they create special responsibilities for government, which must manage the consequences of that change.

The results of this Commission's analysis answer the question: Might free trade eliminate any of Canada's manufacturing sectors? Canada has strength in all sectors of its economy. Indeed, free trade would benefit, and not harm, parts of every sector. Even in weaker industries, there are strong and internationally competitive firms. At the level of the individual firm, however, some companies might not withstand increased competition and would probably go under. For example, Canadian firms in the household appliances sub-sector now receive tariff protection that gives them an approximate 15 per cent cost advantage over their U.S. competitors. Firms unable to forgo that advantage would not fare well against increased foreign competition.

Could management in individual firms, and management and labour working in concert, set levels of productivity consistent with North American standards? A good deal depends on the answer, but empirical studies have already shown that a significant amount of routine adjustment takes place in any dynamic economy.[7] Since the end of the Tokyo Round in 1979, Canadian sectors affected by trade have already made adjustments. The adjustments in weaker sectors more often take the form of declining "birth rates" of firms than of rising "death rates". This reality suggests that the popular image of adjustment through plant closings is inaccurate. Commissioners expect that adjustment to Canada-U.S. free trade would be similar to that following the Tokyo Round. Free trade would stimulate entrepreneurial initiative and boost the birth rate of new businesses in areas where Canada is competitive (such as office furniture), and retard the birth of new businesses in less competitive areas (such as household appliances).

Would multi-nationals leave Canada in reaction to free trade? One argument is that multi-nationals originally located here to circumvent our tariffs and would therefore leave if those tariffs were reduced. Some multi-nationals have already left Canada in reaction to Tokyo Round tariff cuts, but there has been no exodus. For several reasons, such a move would be an unlikely consequence of Canada-U.S. free trade. It is not easy to move capital investment. If there are productive opportunities here, foreign investment will pursue them regardless of trade restrictions. If free trade increased access to the U.S. market and made it more secure, opportunities for productive investment in Canada would increase rather than decrease.

While Canadians need expect no general withdrawal of investment, freer trade would probably increase capital and labour mobility between Canada and the United States. Sectoral analysis indicates that Canada would experience gains and losses in a more fluid situation, but that, in general, we would hold our own. Canadian shipbuilding is competitive with that of the United States, and investment would likely increase that sector. The same forecast applies to pulp and paper. In other areas, such as housewares and sporting goods, the results of freer trade would be mixed. Some net "disinvestment" would probably occur in Canada's tire industry and our medical equipment sub-sector, where foreign firms have established themselves in order to supply a small domestic market. In fact, disinvestment has already occurred among manufacturers of medical equipment – a reminder that the *status quo* does not necessarily offer security for our Canadian economy.

Finally, would freer Canada-U.S. trade affect the level of Canadian employment? Commissioners believe that other forces affecting employment dwarf those that would flow from free trade. Among these is the restructuring of industry which has occurred as Canadian firms attempt to meet increasing world competition. Restructuring could reduce labour in individual firms. For example, the recent restructuring at Canadian General Electric resulted in a drop in employment, and reductions in labour occurred for similar reasons at Westinghouse Canada. Freer trade would increase the trend toward restructuring and a reduction in the number of workers per firm: as noted in an analysis of the chemicals sector, "a restructured sector is likely to be more capital intensive."[8] These employment losses probably could not be avoided; in fact, however, the losses would be greater if firms did not modernize and develop greater efficiency. This reality again emphasizes Canada's need to develop a competitive economy which will stimulate the birth of new businesses. Employment gains are more likely to come from new investment than from protecting existing jobs through trade restrictions. They will also derive from the higher real wages made possible by a more productive economy and, by encouraging Canadians consumers to buy more goods, will create more jobs.

Freer trade may also produce a movement toward larger firms, a trend that could have positive effects for labour as well as business. For example, in the ocean and marine sector, "smaller firms would face the largest adjustment problems."[9] A similar trend might occur in many other sectors, such as electrical machinery, chemicals, scientific and medical equipment, forestry and furniture. Smaller firms, especially those producing a wide range of products mainly for local consumption, generally lack the economies of scale required to compete in a wider North American market.

Commissioners believe that on balance, the decision should be made in favour of wider national benefits as against the costs borne by those in weaker and adversely affected industries. Equally, however, we believe that the Canadian government must help to cover the costs of adjustment within declining sectors and industries, for all Canadians will have either to tolerate the decline of some industries or to accept poorer performance overall from our economy. In recommending freer trade between Canada and the United States, Commissioners also recommend that the Canadian government provide a Transitional Adjustment Assistance Program, directed particularly toward retraining displaced employees. We consider details of such assistance in Part V of this Report.

Notes

1. Gilbert R. Winham, "Canada-U.S. Sectoral Trade Study", working paper prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Ottawa, 1985).
2. Data and tables on sub-sectors (such as footwear) are presented in Winham, "Canada-U.S. Sectoral Trade Study".
3. Canada, Textile and Clothing Board, *Study of the Impact of Potential Free Trade in Textiles and Clothing Between Canada and the United States: Final Report* (Ottawa: The Board, 1984), p. 36.
4. *Ibid.*, p. 35.
5. Winham, "Canada-U.S. Sectoral Trade Study".
6. Clarence L. Barber, "Canadian Tariff Policy", *Canadian Journal of Economics and Political Science* 21 (November 1955): 513–30.
7. Economic Council of Canada, *The Bottom Line: Technology, Trade, and Income Growth* (Ottawa: Minister of Supply and Services Canada, 1983), chapter 9.
8. Winham, "Canada-U.S. Sectoral Trade Study".
9. *Ibid.*

Political Issues

The economic case for freer trade with the United States is strong. It is obvious, of course, that any change of this extent in economic policy is bound to entail a measure of risk, and Commissioners recognize that the consequences of a more open Canada-U.S. trading relationship cannot be predicted in every detail. We are convinced, nonetheless, that the potential economic benefits to Canada of freer trade with the United States far outweigh the costs, and that the principal hazards can be met by instituting appropriate policies of adjustment. Given Canada's increasingly isolated position in the international economy at large, it is difficult, in any case, to conceive of a genuinely effective alternative trade policy.

Nevertheless, we Canadians must also recognize that traditionally, we have been preoccupied as much with the political, cultural and social implications that could result from continental free trade as with its potential effect on our economy. The former concerns are legitimate and important, and obviously, they must be addressed in any serious and responsible evaluation of the bilateral free-trade option. This task, however, is unusually difficult because the issues involved relate to intangibles, and because they raise questions of value. In matters of this kind, unambiguous cause-and-effect relationships are hard to establish and sometimes impossible to verify. Political, cultural and social changes, even when they are profound, often develop only gradually, and at first they may pass unnoticed. They can be as difficult to define as they are awkward to measure. Certainly their scope and character are difficult to guage in advance.

Changes in political, cultural and social behaviour, and in the values that such behaviour reflects, are influenced by a variety of different factors, and not by one factor alone. This reality, of course, further complicates the problem. To identify the particular effect of a single element among many – in this instance, the nature of Canada's trade relationship with the United States – thus presents a challenge capable of defeating even the most sophisticated of modern social scientists' analytical methods. Science can help, but in the end, the answer must come from preference and judgement, subtly combined. Room for disagreement, and hence for public debate, is bound to remain. The question itself, however, is of central importance and warrants a prominent place on the agenda for any discussion of Canada-U.S. trade relations.[1]

Indirect Implications: The Symbolic and the Real

Commissioners are aware that in considering these complicated issues, we are dealing as much with the symbolic as the "real". The problem, of course, concerns the way in which a freer-trading arrangement with the United States would *actually* influence the play of forces affecting Canada's political, social and cultural life. It is just as much concerned, however, with the way that Canadians, Americans and third parties, too, *perceive* the Canada-U.S. relationship. Perceptions are important for two reasons. They can have a potential psychological significance, an effect, for example, on the human sense of "identity" and hence on feelings of psychic well-being. They also affect the individual's own and others' expectations. These expectations, in turn, influence personal conclusions about the nature of reasonable aspirations and the judgements others form about those conclusions and their results. Canadians' goals and capacities are thus determined, not merely by our values and assets, but also by the way in which we perceive ourselves and by the way in which we are perceived by others.

If a bilateral free-trade area were negotiated, would it have a symbolic effect, no matter what its practical economic implications, powerful enough to persuade Canadians that they had finally abandoned (in substance, if not in form) their traditional objective of maintaining a genuinely independent political community culturally and socially different from the United States? It is possible, after all, to argue that this general purpose has underlain the Canadian political experiment throughout its history. Certainly, much of Canadian public policy in such areas as transport and communications, resource and revenue sharing, cultural affairs, broadcasting and constitutional law has been designed, in part, to preserve a separate and distinctive political community, despite the North-South pull of natural market forces. These policy initiatives have exacted an economic and even, perhaps, a political price. Would an announcement that Canada had successfully negotiated a free-trade arrangement with the United States ultimately reduce Canadians' desire to "pay the piper" and hence impel us to move to other forms of integration, as well? Would a formal meshing of the two markets lead to the view that the differences remaining between the two countries are so insignificant, so trivial or so ancillary that they are not worth defending?

Though this concern may be legitimate, few Canadians seem to hold it. Rather, this Commission's public hearings discovered a sense of political confidence which may not have existed just a few years ago. This sense of assurance is evident both in an aura of confidence about the distinctiveness of Canadian political values and in lucid assessments of political reality and of the particular role that Canada might play in international affairs.

Canada's trade, both import and export, is already extremely closely linked to the United States. A free-trade area would help to secure our access to the U.S. market over the longer term and would gradually increase the efficiency of our industrial structure. Presumably, it would also increase the volume of trade between the two countries and ultimately make Canadian products more competitive in markets overseas, besides. Overall, however, there is no reason to assume that the nature of Canada's existing trade dependency on the United States would change significantly. We might conclude, therefore, that a free-trade area would be unlikely to induce psychological or symbolic side-effects that Canadians are not already experiencing.

Nevertheless, it could still be held that this conclusion underestimates the symbolic impact that a formal declaration of Canada-U.S. free trade would have on the Canadian side of the border. To declare a free-trade area after formal intergovernmental negotiations as a concerted act of political will is a procedure very different from the incremental process that has led to the current Canada-U.S. trade relationship. At the very least, a declaration is much more dramatic. In symbolic terms, therefore, its effect might be substantially greater than the resulting change in real economic relations would appear, on the surface, to warrant. Indeed, Commissioners believe that this is part of the reason that the present participants in the free-trade debate are searching for palatable terms to replace "free trade".

To put the issue in perspective, we should, perhaps, consider that much more elaborately integrative economic arrangements have been negotiated elsewhere without causing harmful side-effects. The European Community (EC) is the commonly cited example. The analogy is not entirely persuasive, however, and certainly it will hardly reassure the sceptical. The Community constitutes a multilateral, not a bilateral, arrangement, and the distribution of power among its principal members is far less disparate than that within the Canada-U.S. relationship. In addition, the EC countries differ far more profoundly from one another, in language, in culture and, often, in historical experiences of conflict, than do Canada and the United States.

The concerns of Canadians about the United States are clearly of a different order: they stem, not from preoccupation with the prevention of war and the maintenance of peace, but from a fear of complete assimilation. More persuasive examples are afforded by the free-trade arrangements forged on an individual basis, between the European Community and members of the European Free Trade Association (EFTA): Norway, Sweden, Finland, Portugal, Austria and Switzerland. None of these countries has a population larger than ten million, while the EC population stands at 240 million. Yet no one would suggest that the EFTA members are no longer distinctive, or that they have felt constrained to mirror the Community in their foreign policy or other areas of activity. Certainly there has been no effort to effect political integration. Similarly, the free-trade arrangement between the United Kingdom and Ireland before they both joined the Community did not dispose the Irish to become more like the English; nor have we seen any evidence that New Zealanders are becoming more like Australians as a result of their bilateral free-trade agreement.

Arguments drawn from the experiences of the European Community, EC-EFTA and Australia-New Zealand and reassurances based on the present scope of the Canada-U.S. trade relationship may not be conclusive enough, in themselves, to comfort those concerned that the creation of a formal free-trade area would profoundly weaken that distinctive political will that has inspired Canada's development. Other considerations, however, lead this Commission to conclude that this anxiety can be safely put to rest. The first of these considerations stems from the very disparity of power that is the source of the problem. Traditionally, Canadians have assumed that American influence is so overwhelmingly pervasive that it has left Canada, politically and socially, permanently vulnerable. Some Canadians have even argued that it will be impossible, in the end, to avoid the loss of our distinctive political, social and cultural values. One of the consequences of permanent vulnerability, however, is the tendency to defend oneself by adopting a posture of permanent vigilance. Some scholars have argued quite cogently that in bilateral contexts of this kind, the smaller of the two countries is bound to be especially protective of its distinguishing characteristics. It has often been observed that nothing has made francophone Canadians so determined to preserve the distinctive ingredients of their culture as the fact that they are surrounded by 250 million anglophones. Much the same phenomenon, Commissioners believe, applies to Canada as a whole, in relation to the United States. We do not think, therefore, that a more visible integration of Canadian and American economic markets will lead Canadians to abandon the defence of indigenous political and social norms. Such a development might, in fact, have precisely the reverse effect.

Many of the most distinctive features of Canada's political culture are securely rooted in a historical experience that not only differed from that of the United States, but was, in some respects, deliberately opposed to it. It is a commonplace that Americans established their independence by revolution, whereas Canadians acquired theirs by a succession of relatively peaceful steps. Our evolutionary political development, strengthened by the influence of the United Empire Loyalists, originated in a counter-revolutionary tradition that was deeply embedded in both anglophone and francophone communities. It has produced a markedly different concept of the role of government in society and has profoundly affected the priorities that Canadians attach to various political values. We consider order highly important, for example, to the pursuit of political ends; this is not because we think decorum more attractive than liberty, but because we believe that true liberty, which can be found only in communities where civility is highly valued, cannot be enjoyed without it. Our accommodative approach to the resolution of political conflict, both at home and abroad, reflects a similar conviction. Such attitudes, vital as they are to the survival of the distinctive features of Canadian political life, are deeply ingrained in our society. Certainly it would take more than a change in trade policy to dislodge them.

Commissioners' conviction on this matter is reinforced by our view that in recent years, Canada's linguistic duality has been gaining wider and wider internal recognition and acceptance, and that over time, bilingualism in English and French will become a more prevalent – indeed, a prominent – feature of Canadian life. Canada's accommodation of a large and lively francophone community and culture has always served to distinguish our society from that of the United States, and the need to secure and promote the welfare of our francophone element has led us to adopt policies and conventions that have strengthened our accommodative political culture. The importance of this characteristic as a source of differences between Canadians and Americans is bound to increase as bilingualism becomes more common and is viewed, not as an inconvenience, but as a matter of national pride.

This Commission has been profoundly impressed by the confidence that Canadians have come to show in themselves as individuals and in their country as a political community. The evidence obtained through our public hearings, as well as from personal observation and other sources, has led us to conclude that as a people, we Canadians are no longer victim to that enervating sense of uncertainty that derives from self-perceived "colonial" status, whether that status be formal (as in the days of French sovereignty or of the British Empire) or informal (as some have considered it more recently, in relation to the United States). Our country has matured, and our literature, art, theatre, music, dance and scholarship more and more reflect its vitality. This same spirit can be found, as well, in the imaginative renovation of our cities; in the calibre of our professions; in our adaptations to technological change; in the mix of realism and compassion that is demonstrated in our social policies; in the cosmopolitan flavour of our urban communities; in the determination to protect our natural environment that is central to the Canadian experience; and even in the variety, style and quality of our restaurants and places of popular entertainment. These indicators may be subjective: certainly they must be subjectively read. Yet they all seem to point in the same direction. The day of the apologetic Canadian is gone, and there is no reason to suppose that our present confidence will be undermined by an arrangement designed only to secure a continuing exchange of goods and services with the United States. On the contrary, it seems probable that a free-trade arrangement would actually strengthen our national assurance by providing clear evidence that Canadians can prosper in a highly competitive market, without the aid of artificial protection. From the psychological, as from the economic, point of view, protective barriers may seem, on the surface, to offer a measure of security in a harsh and uncertain environment. We must also recognize them, however, as unmistakable confessions of weakness. Until these barriers are gone, the exhilaration that can come from a true sense of maturity will remain beyond our nation's reach.

Finally, Commissioners are persuaded that we Canadians are perfectly capable of mentally separating our trading activities in the North American market-place from the other aspects of our national way of life. Motives of protection aside, the concerns of Canadians who have traditionally opposed free trade with the United States have been founded on the premise, whether explicit or not, that among the basic determinants of our political, social and cultural habits and values are the prevailing patterns of economic exchange. This proposition should not, of course, be confused with a complex argument sometimes advanced by political theorists. The essential tenet of this contention is that our political beliefs, social norms and cultural practices ultimately reflect the way in which we organize and conduct our system of economic production. How we *produce* our economic goods and services is not ground for argument in the Canada-U.S. free-trade debate. The point at issue is the manner in which those goods and services are *traded*. The assumption underlying the fears of the hesitant observer is that this trade is or, if further expanded, could well become the principal connection through which Canadians will be exposed to, and eventually transformed by, the values and the behaviour of a society both different from and more powerful than our own.

Clearly this is not a proposition that is new to Canadians, nor is it confined to the Canadian context. The free movement of goods and services has often been viewed as an instrument of political, social and cultural change. Its presumed effects have sometimes been regarded as positive (when thought, for example, to be an encouragement to peace) and sometimes as negative (when perceived, for instance, as a vehicle of empire). Whatever its intellectual history, however, free trade constitutes a thesis that cannot lightly be dismissed. At a general psychological level, however, it does not seem to this Commission that the development of such a system would have an automatic "spill-over" effect on the way we Canadians perceive ourselves in political, social or cultural terms. We surely tend to differentiate these other ingredients of our lives from the way in which we market that portion of our gross national product that we export. Digby scallop fishermen are no less Digby scallop fishermen because more of their catch is sold in Boston than in Montreal. If free trade is to reduce our political, social and cultural sovereignty, it must work in ways far more definite and concrete than the psychological.

It is less certain, however, that reactions outside Canada will be as varied, and this is a matter to which Commissioners have given considerable attention. Social scientists often observe that human beings tend to perceive communities other than their own – national communities included – as oversimplified stereotypes. This tendency increases when the observers are at a distance, and when their detailed knowledge of the external group is limited. Distinctions obvious to Canadians may thus be invisible abroad, and accordingly, our participation with the United States in a free-trade area may lead both Americans and nations overseas to assume that Canada and its neighbour are homogeneous, not merely in our marketing arrangements, but in other essential respects, as well. Consequently these external observers may expect that Canadian and American policies and behaviour will be the same, and this disposition may be enhanced by their perception of other similarities between the two societies.

In the United States, persons with a special interest in Canadian affairs would probably make less obvious presumptions of this sort than would the population at large, since the former would be more fully acquainted with the details and complexities of Canadian life. Nevertheless, the preoccupations even of these especially interested sectors are often very narrow. The executives of construction firms along the border may focus with genuine expertise on Canadian cement production, but pay little attention to any other aspect of Canadian life. In fact, ignorance of Canada, even among occupants of important government offices in Washington, understandable though it may be, is nonetheless regarded by knowledgeable observers as a recurring and pervasive problem. Is it possible, then, that the creation of a formal Canada-U.S./free-trade area would lead influential Americans to assume that we Canadians had allied ourselves even more fully than in the past with American objectives and "the American dream"? If so, would these American leaders expect Canadian public policies and pronouncements – especially in foreign affairs – to follow suit? And if they did, would a Canadian government that disagreed with an American position and adopted an independent view risk generating greater resentment in the United States than under present conditions? Further, would that complication, in itself, make Ottawa even more reluctant than it is now to deviate from American preferences?

To some extent these possibilities have already, for some time past, assumed a degree of reality in Canada's foreign-policy environment. The danger, therefore, would be more a result of changes in degree than of changes in kind. Nevertheless, it is certainly possible that after concluding a free-trade agreement, Canada's foreign-policy community would have to deal with expectations of co-operative Canadian behaviour that would be much more deeply rooted in American perceptions than they are now. We should therefore have to make a considerable and continuing effort to prevent policy makers in Washington from assuming that the free-trade arrangement included integration in other policy fields as well. This requirement is part of the ground on which this Commission has based its conclusion, stated in Chapter 2 of this report, that Canada should pursue an actively "internationalist" role in world affairs, giving particular priority, for example, to assisting less-developed countries to resolve their economic problems. Nothing will more quickly dispel the notion that Canadian foreign policy has followed our trade policy than convincingly concrete demonstrations that it has not. To provide this evidence may not prove overly difficult, since Canadians will probably become more aware of our wider foreign-policy capabilities as economic benefits from free-trade with the United States provide us with a new sense of "clout" in the international community. In the words of one study, "a persuasive case can be made that, if a formal bilateral free-trade agreement strengthens the Canadian economy, Canada's ability to pursue an independent foreign policy would be strengthened, not weakened."[2] Thus the cultivation of Washington's respect for Canada's complete sovereignty in the conduct of our external affairs could help to preserve the measure of independence that Canadians have come to expect.

The need for our diplomatic missions overseas to demonstrate this reality, as well as to deploy aggressive public-education strategies would be all the greater because nations elsewhere in the world might be even more prone than Americans to assume that Canada and the United States, once linked under a formal free-trade agreement, would speak and act in unison. This assumption already creates a problem for Canadian diplomats. Foreign-service officers who have worked in Europe, for example, constantly complain that European statespersons and officials fail to distinguish Canada from the United States, in responding to what they take to be a common North American interest. It seems highly probable that this tendency would be increased by the announcement that a Canada-U.S./free-trade area had been established. Even where the tendency to "homogenize" Canada and the United States derived more from tactical calculation than from thoughtless assumption, the very existence of the arrangement would give third-party governments ammunition with which to defend their positions against Canadian complaint. Only with the greatest difficulty, indeed, was Canada able to negotiate a largely innocuous and ultimately ineffective "contractual link" with the European Community. The reluctance of the European governments most concerned, Britain and Denmark prominently among them, would have been even easier to justify if a Canada-U.S./free-trade area had been in place. The problem for Canadian negotiators would have been complicated if the Americans had insisted, as they probably would have done, on "pass-through" safeguards to ensure that they were not deluged with European goods imported by way of Canada. Such circumstances would have provided the Europeans with a ready-made rationale for their resistance, even if their real motive had lain elsewhere.

These situations, real and hypothetical, demonstrate that Canada must make a vigorous and persistent effort to ensure that foreign powers and their interested publics understand the intended limits of any Canada-U.S. agreement. Unfortunately, the very circumstance that would strengthen the necessity for this effort could also make it more difficult to exercise. The free-trade area itself would be visible, lasting and concrete. Equally impressive characteristics would be harder to detect in the exhortations of Canadian diplomats bent on public education abroad or in their sporadic displays of independence of American policies. The challenge to Canada's foreign-policy community would thus be a serious and demanding one, calling for determined and imaginative responses. For internal as well as international purposes, that challenge would have to be met.

Direct Implications: Political Demands and Policy Constraints

It is probable that the most significant and long-term effect of free trade would be the strengthening of national unity and the removal of one of the most persistent and corrosive sources of regional alienation in Canada's political history. The resentment generated by protectionist policies has been especially acute in the West, but it has also been a nagging cause of irritation in Atlantic Canada and in the agricultural communities of Ontario and Quebec. Although, in recent years, multilateral negotiations through the GATT have lowered tariffs a good deal, Canadians elsewhere in the country still believe strongly that the manufacturing and industrial economy of central Canada is being maintained at their expense. To conclude a free-trade agreement with the United States would remove this long-standing cause of dissatisfaction at a single stroke. It is difficult to think of any other act of Canadian public policy that would have so comparably healing an effect. This act could be expected, in time, to contribute enormously to our national sense of Canada as a single community and could regenerate our previous store of general good will. It would correspondingly reduce the level of federal-provincial conflict and increase our capacity to work together for common purposes. Commissioners have concluded that this positive political consequence of a bilateral free-trade agreement represents one of the strongest arguments in its favour. This result would embody long-term advantages for all Canadians as individuals and for the whole of Canada as a political and social community.

It is still possible, of course, that Canada-U.S. free trade would constrain aspects of Canadian public policy in certain specific areas not immediately related to free trade *per se*, but perhaps linked to it indirectly. Though such constraints would count for little, compared to the improvement in national harmony already described, they should nonetheless be taken into account. They could be expected to materialize in one or the other of two general contexts: the first of them a source of pressure from the United States; the second, a source of pressure from Canadians themselves.

The first of these two contexts would derive from fields of activity which, in Canadian eyes, required a measure of state intervention, but where the Americans would regard such intervention as violating the spirit, if not the letter, of the free-trade arrangement. The most obvious sources of this kind of disagreement would be Canadian policies designed to protect or promote indigenous cultural activities, along with measures intended to encourage local, regional or sectoral economic development. As in so many of the situations where difficulty might arise from Canada-U.S./free-trade proposals, these sources of friction would not be entirely new in relations between the two countries. Students of the dispute over transborder broadcasting, for example, will attest to this observation. The problem can result, not merely from initiatives undertaken by the federal authorities in Ottawa, but from those instigated by provincial and municipal governments as well. It has, in fact, appeared not merely in relation to economic strategies at the national level, as with the National Energy Policy, but also in the context of policies of little more than local significance. An example of the latter sort of intervention appears in American reactions to Canadian incentives given to Michelin tire producers or to the builders of fishing boats in Nova Scotia.

While this problem, then, would not be new, it might certainly expand to less tractable dimensions. A free-trade arrangement would heighten free-market expectations in the United States and correspondingly reduce the range of what the Americans would consider appropriate standards of "fair play". It would, in essence, strengthen the conviction of offended American interests that in protesting Canadian governments' intervention in support of our own economy, they were acting from just cause. This conviction would increase American determination to press for changes in Canadian policy and at the same time, make U.S. arguments more difficult for Canadian authorities to resist. In short, if the problem of American influence on our Canadian economy is already serious, the establishment of a bilateral free-trade area could make it more serious still.

Since encouragement to regional economic development is among the most central of the public policy expectations of Canadians, no government properly concerned with the maintenance of national unity and with its own survival in office will be prepared to give up its latitude of decision in this field. Moreover, the case for assisting those engaged in Canadian cultural activities may well be strengthened, rather than weakened, by a bilateral free-trade arrangement, since many Canadians will insist that free trade is "safe" only if other facets of Canadian life are properly protected. It follows that any agreement negotiated with the United States would have to be accompanied by specific exclusions designed to preserve the capacity of Canadian governments at all levels to pursue these important objectives. Undoubtedly, this proviso would increase both the technical and the diplomatic complexity of free-trade negotiations. Certainly it would prolong them, and it could ultimately generate opposing forces in the American Congress. Even after an agreement had been concluded and put into place, it could be expected to lead to recurring disputes over the implementation of the "exclusion" provisions.

There can be no easy solution to this problem, and Canadians should realize from the beginning that coping with it will be part of the price of any Canada-U.S./free-trade agreement. In the past, however, the Canada-U.S. agenda has been crowded with "functional" issues of this kind, and it will continue to be crowded with them in the future. But we cannot avoid these issues simply by perpetuating our current policies. On the contrary, there is good reason to assume that in the absence of an explicit agreement, they will create ever more difficult problems for Canada-U.S. relations. These problems will arise as the Americans become both more aware and more resentful of Canadian policies which, in times of economic hardship, they are bound to perceive as unfair. Therefore, the wisest course for Canada, notwithstanding obstacles along the way, might well be to pursue a free-trade agreement in which exclusions could be clearly defined. It would have the practical effect of removing important Canadian public policy initiatives in the nation-building field from the direct line of American fire.

There is, however, a second context in which a bilateral free-trade agreement might lead to significant change in the configuration of political forces confronting Canadian decision-makers. It would be characterized by constraints emanating, not from the United States, but from within Canada itself. Such constraints, of course, are always present in the political system, but as a specific by-product of free trade, they could be expected to arise primarily in relation to government policies that had the effect of "artificially" increasing the production costs of Canadian enterprises over those of comparable and competing firms in the United States. Cost increases of this kind are sometimes the indirect result of regulatory activity designed to serve other public objectives; for instance, labour codes, safety requirements, environmental regulations and product standards might increase production costs. Increases can also appear more directly as a consequence of any of a number of different forms of taxation. In either situation, the costs are ultimately reflected in product prices, and if those borne by Canadian companies are out of line with those faced by corresponding businesses in the United States, a decline in competitive position can result. The natural disposition of an economic sector which is disadvantaged in this way – and if corporate taxation is a cause, the disadvantage could extend to a very large proportion of the business community – is to protest what it will regard as an unfair handicap and to press for an appropriate relaxation of government requirements.

Again, this is a phenomenon with which governments are already very familiar. Some might argue, therefore, that a bilateral Canada-U.S./trade arrangement would bring very little change in this respect. Nevertheless, political authorities might find such expressions of discontent more persistent and more difficult to resist under a bilateral free-trade regime. The problem might intensify because the new agreement would place businesses in a position to invoke the same standards of "fair play" as Americans are likely to cite in their attacks, for example, on subsidies to support regional economic development. Moreover, Canadian regulations are sometimes more expensive to implement than are American regulations because the former demand a higher standard of performance. To the extent that this difference applies, there could well be a decline in public welfare as previously defined by the internal political process.

Whether such a pattern of policy change would actually develop on a significant scale is hard to predict. Ultimately, the extent of its development would depend on the degree to which Canadians were genuinely committed to the objectives supported by the regulations in question and to the particular distribution of tax obligations that might also be involved. Canadians at large, for example, are increasingly conscious of their plight as victims of acid rain. It seems improbable, therefore, that they would very readily support a relaxation of air-pollution controls simply because the industries affected were complaining that the pertinent regulations were placing them at a competitive disadvantage in the American market. This is an unusually dramatic example, however, and it is not inconceivable that in many other areas, a free-trade arrangement would generate political forces which, over time, would bring Canadian taxation and industrial regulation much closer to the American pattern than they are at present. In some instances, this development might result in an improvement. In others, however, it would not, and a public authority determined to resist what might be considered a change for the worse could find itself in confrontation with opposing forces stronger than those it had faced in the past.

Furthermore, under a bilateral free-trade agreement with the United States, Canadian governments, both federal and provincial, would find themselves subject, even more than they are now, to conflicting demands arising from competing principles or interests. A government might be tempted, for instance, to relax or abandon a particular policy either because interests in the American private or public sector (perhaps aided by Canadian allies) pressed it to do so in the interests of freer trade, or because Canadian entrepreneurs had argued their need to compete on an equal footing in the American market. If it gave way to the temptation it could face a strong backlash from constituents who disapproved. To the extent that the change in policy could be traced directly to American pressure or even to the logic of the free-trade agreement, such a reaction would probably be fuelled and strengthened by nationalist sentiments. This, in fact, is precisely the syndrome supporting the "posture of permanent vigilance", which is one of the bases of Commissioners' confidence that Canada-U.S. free trade could be safely instituted without damaging Canadians' sense of political, social and cultural independence. It does not, however, create a situation which governments would necessarily welcome, since it would force them to deal with incompatible demands. Administrators could be pardoned for thinking that they have enough of this to do even now, without the addition of further complications to their task.

This problem of "cross pressures" could be particularly acute in matters bearing on foreign affairs. In those areas, it could even arise as a result of foreign-policy decisions taken in Washington, without any reference whatever to Canadian interests or concerns. Unpopular foreign-policy behaviour on the part of the United States could cause angry Canadian constituents to charge authorities with a kind of "guilt by association" firmly established by the creation of the free-trade area. During the Vietnamese War, for instance, the Canadian government was accused of complicity in American policy. This accusation was based, in part, on the practical implications of the Defence Production Sharing Arrangement, and Canadian firms known to be exporting military materiel to the United States under this arrangement became targets of vigorous demonstrations. A sectoral trading agreement that seemed to make good sense at a time of general consensus among the Western powers on "Cold War" issues thus came to be regarded in some quarters as totally unsatisfactory when consensus broke down. Canadians who have shared a more general belief that our foreign policies in the politico-security field have been too closely linked with those of the United States have argued for years that the problem, as they see it, is ultimately rooted in our heavy dependence for our prosperity on our links with the American economy. Once a Canada-U.S./free-trade area had been formally established, this sort of complaint could be expected to recur, and discontent might become a particularly difficult problem if the United States were to embark on controversial military interventions in Latin America or elsewhere. It is possible, indeed, that concerns about such issues are well-founded, for a Canadian government, in circumstances of this kind, would be tempted, at the very least, to moderate its criticisms in order to preserve the amity of the all-important bilateral Canada-U.S. relationship.

Once again, this problem of cross pressures is not new in Canadian politics. It comes down, therefore, to a question of whether or not a free-trade arrangement would appreciably enhance its importance with the United States. In practice, the answer would depend, in part, on the nature of American policy and on political conditions in the entire international community. It is certainly possible that the formation of a Canada-U.S./free-trade area would increase, at least moderately, the potential for controversy over foreign-policy issues of this kind. At the same time, however, we should recognize that Canada is already closely linked with the United States through a variety of associations, and that some of these are far more directly related to international political and security matters than a free-trade arrangement would be. Since 1949, Canada and the United States have been members of the North Atlantic Treaty Organization (NATO), a formal institutionalized alliance. Moreover, the technical requirements of military operations in this nuclear age have compelled both nations to integrate many of their practical preparations for continental defence, an arrangement that is most visible in the North American Aerospace Defence Command (NORAD) arrangement. In such circumstances, it seems unlikely that a bilateral free-trade agreement would have more than a marginal effect on complications which are already very much in evidence, and which cannot, in any event, be avoided.

Some Canadians may be concerned with the broader possibility that a Canada-U.S./free-trade agreement would lead in time to an erosion of the distinctive characteristics of Canada's "political culture". These characteristics include such fundamental matters as the way we Canadians view our political system and the political process; how we assess the proper role of the state in relation to individuals; the manner in which we approach the resolution of our internal political conflicts; and the overall objectives that we think it appropriate for our various levels of government to pursue. While our collective attitudes on questions of this sort are not always clearly expressed, they are nonetheless centrally important determinants of our style of political life and our expectations of public policy. If, under the influence of an American example strengthened by free-trade connections, they were fundamentally to change their character, a subtle but significant transformation of Canadian political practice would result.

Commissioners have already indicated that there are powerful reasons for concluding that bilateral free trade would not, in fact, jeopardize Canadians' perceptions of the ways in which our political culture differs from that of the United States. Our politico-cultural distinctions are too well secured by our historical experience, our linguistic duality, and other factors. The issue is sufficiently complex, however, to warrant further discussion, if only because our political values are difficult to define, and because the question of what they are, both in theory and in practice, is open for argument.

At the broadest level of political philosophy, there is little, if any, reason to anticipate a noticeable change in Canada's political norms. Canadians subscribe, in general terms, to the principles and practices of liberal democracy as sustained by representative parliamentary institutions; to the concepts of responsible government and of government through political party; and to the rule of law. We share the essential values of the liberal democratic position with the citizens of the United States, and to the extent that Canadians differ from Americans in putting these values into practice, the difference arises from distinctive institutional arrangements that are now firmly embedded in constitutional history and practice. In recent years, some analysts have argued that the Canadian style of political leadership in the executive branch of government has become similar to that of the American presidential system. Others have suggested that Canada's new Charter of Rights will eventually help us to become much more "rights-conscious" than we have been in the past. This change, they suggest, will make us more "American" in our view of the way in which individuals and groups ought to react to the exercise of authority. If this process occurs, it may "Americanize" the role played by Canadian courts. Given our system of "parliamentary sovereignty" as modified by the federal-provincial division of powers, Canadian courts have traditionally interpreted their functions much more narrowly than have their counterparts in the United States, where a constitutional arrangement of "checks and balances" applies. Cases arising from the Charter, however, may compel our Justices to adopt a more typically American view. It has also been argued, however, that the particular characteristics of the Canadian Charter, including the various caveats attached to its provisions, will combine with the conservatism of our courts to produce a uniquely Canadian constitutional jurisprudence. In these matters, certainty comes only with hindsight, but if our courts are changing in the direction of American practice, the changes are originating in forces that appear to be operating quite independently of the American example. Certainly, in this Commission's view, it would be difficult to argue convincingly that such changes are the result of the American orientation of

Canadian trade. Neither is there any intrinsic element in the proposal for a formal bilateral free-trade area that would accelerate Canada's constitutional "Americanization", even if our current political evolution is taking us in that direction.

The nature of Canada's constitutional processes would thus be unaffected by the new trade relationship *per se*. The consequences could be very different, however, in relation to Canadians' concept of how and for what purpose the powers of the state ought to be used. Americans, for example, have been attracted to the principle – if not always to the policy – of free trade, not merely because they have thought that principle to be in their overall economic interest, but also because it appeals to the *laissez-faire* values of free enterprise that have been so prominent a feature of their particular interpretation of liberalism. At the admitted risk of overgeneralization, it can be argued that one of the basic differences between the political cultures of Canada and the United States appears in the greater willingness of Canadians to encourage direct state intervention in the operations of the economy to attain those objectives of society that they consider more important than maintaining economic efficiency. This difference, of course, is a matter of degree, and not every example fits the general pattern.

In some quarters, changes would doubtless be welcome, but welcome or not, it seems clear that they would eventually make Canadian society less distinguishable from that of the United States. Of course, processes of this sort would be influenced by a great variety of different factors, and if they materialized at all, they would do so over a long period of time. It is not obvious, therefore, that a bilateral free-trade regime would make the most significant contribution to change, either directly, through its effect on the distribution of real political forces, or indirectly, by way of its influence on Canada's public philosophy. As Commissioners have already argued, it seems probable that countervailing reactions would quickly emerge. Yet the issue is no less important because it is relatively subjective and its outcome uncertain. Indeed, a judgement concerning it must be part of any responsible calculation of the possible costs and benefits to Canada of a bilateral free-trade agreement.

Another possible political implication of a Canada-U.S./free-trade arrangement is of the possibility that it would influence the structural distribution of power within the Canadian political system. Some analysts have suggested, in particular, that such an agreement might enhance the power of the executive branch of government at the expense of the legislative branch – a phenomenon commonly described by political scientists as "executive dominance" – and that it might also increase the powers of the federal government in relation to those of the provinces.

The European Community certainly offers evidence that common market arrangements can amplify the executive's role. It is important to remember, however, that the Community is just that: a common market, and not merely a free-trade area. Moreover, its operations extend into an impressive range of regulatory activities under the administration of an elaborately developed, supranational, public service. It has a directly elected parliament and an intricate system of intergovernmental meetings. In short, it is a much more ambitious, and certainly much more highly institutionalized, arrangement than Commissioners contemplate for Canada and the United States. The founders of the Common Market set about deliberately to encourage economic and political integration and, if anything, are disappointed at its slow pace. There seems to be no reason to assume, therefore, that the European pattern would be replicated automatically in any Canada-U.S./free-trade arrangement.

Conversely, many of the non-tariff barriers (NTBs) that would be negotiated in discussions leading to a bilateral Canada-U.S./free-trade regime clearly fall within the jurisdiction of our provinces rather than of our federal government. Thus these NTBs reflect provincial rather than federal policies. For this reason, Canada could not pursue a free-trade agreement with the United States without extensive discussions between our federal and provincial authorities. Since it would be difficult for either the federal or the provincial legislative branches to play an active role in this process, and since the successful conclusion of a free-trade agreement would confront both levels of government with a *fait accompli*, it is clear that "executive federalism" would be reinforced at least temporarily. That is to say, important public policy issues would be settled through behind-the-scenes bargaining by executives at both levels of government, to the effective exclusion of the legislatures. Trade policy has always been conducted in this manner, and will continue to be managed in this way, whether we Canadians pursue our interests bilaterally or multilaterally.

A free-trade agreement would require the provinces to give up some of their latitude in the use of public policies that made use of NTBs. This constraint would certainly deprive them of some of their freedom of political and governmental manœuvre. In fact, the prospect could represent one of the most difficult obstacles in the way of a successful agreement between the federal governments of the United States and Canada. Provincial opposition to some of the specific provisions that the Americans would expect to have included in a free-trade arrangement could seriously impede the progress of negotiations. Presumably, this difficulty could be overcome only if provincial authorities were satisfied that their interests, including their jurisdictional rights, were being adequately protected. It is conceivable, nonetheless, that in the long run, a free-trade arrangement would reduce the power of the provinces in relation to that of the federal government and of the market, as well. Such a process, however, appears to Commissioners to be in prospect for multilateral negotiations also, given the issues on the GATT agenda.

Finally, it is possible that a bilateral free-trade agreement would raise the general level of conflict in Canadian politics. Our trade policy in relation to the United States has always been a major source of domestic political controversy. Canadians have commonly assumed, for instance, that our tariff structures have been designed to serve the interests of the industrial heartland at the expense of the rest of the country. Debate on this issue is bound to revive with any proposal for radical policy change, and such conflicts could persist after an agreement was established if the distribution of its costs and benefits was perceived in some quarters to be inequitable. The problem could be complicated if economic hardships later developed from other causes, but were attributed to the workings of the free-trade agreement. In effect, that agreement could become the scapegoat for economic difficulties, the origins of which were located elsewhere. If these difficulties were concentrated in particular regions or industrial sectors, as seems likely, significant cleavages over the merits of the arrangement could easily occur, and they could seriously complicate our political process.

Whether or not some such sequence of events would actually occur over the longer term is impossible to determine in advance, since the eventuality would depend on conditions which cannot now be predicted. The critical question, in any event, is whether the intensity of the problem would be significantly greater under bilateral free trade than it is at present, or under another trade-policy option. There is a sense, of course, in which conflicts of this kind are endemic in liberal democracies everywhere, and it would be utopian to expect them to disappear. Such conflicts are therefore an overriding cause for concern only if they become so severe that they exceed the capacity of normal political processes to resolve them. The conclusion of this Commission is that they will not reach this level. On the contrary, Commissioners are sufficiently confident of the economic rewards that would come from the establishment of a bilateral free-trade area that we believe a Canada-U.S./free-trade agreement would ultimately reduce, rather than increase, the general degree of disaffection within Canadian society. A far more serious danger would result from persisting in our present course which, under current conditions of international trade, is certain to isolate our economy further and to cause Canadians significant hardship.

Although these arguments represent this Commission's point of view, we recognize that the questions we have raised in this section of our Report are ultimately matters of judgement. We realize, too, that there are few political (as contrasted with economic) arguments that can be mounted in favour of the bilateral free-trade option, except for those rooted in regional harmony and in the economic prosperity that a free-trade area would help to promote and maintain. The question, therefore, is whether the political arguments that can be deployed against a Canada-U.S./free-trade agreement should be regarded as decisive. Since we find many of these arguments unpersuasive, and since we are convinced that in cultural and other fields they can be countered by aggressive public policy responses of a kind with which Canadians are already very familiar, we do not consider them compelling. Under a free-trade arrangement, problems would doubtless remain, but there are problems even now, and it does not seem to us that their weight would be greatly increased by the conclusion of a formal free-trade agreement with the United States.

Commissioners wish to make it clear that our reference here to the need for "aggressive public policy" in cultural and other fields as a concomitant of a bilateral freer-trade initiative is not merely incidental to our main argument. We are convinced that freer trade with the United States, whether achieved multilaterally or bilaterally, is the only sound choice for Canada in the years ahead, and we are persuaded that in the end, it would serve to strengthen our economic policy at home and thereby enhance our effectiveness abroad. Given the economics of Canadian cultural activity, however, it is clear that in this field, active government support will still be required.

This support should not, in Commissioners' view, take the form of restrictions on the flow into Canada of cultural, intellectual and informational communications from the outside world. Barriers of this kind are increasingly impracticable to administer and enforce, as broadcasting regulators would be the first to agree. More important, they come dangerously close to violating the basic principles of a free society, and for this reason they are properly resented by Canadians who wish to maximize their own freedom of choice in such matters. They tend, in addition, to protect our artists, writers, entertainers and educators from the "quality control" that results from exposure to international standards of performance. Inevitably, perhaps, they also cause irritation abroad.

What Canadians do require, however, is a willingness on the part of public authorities to provide support for those forms of indigenous cultural expression that would otherwise give way to the impersonal forces of the market. It has not been the function of this Commission to examine these matters in depth. (They are considered at length in the 1982 *Report* of the Federal Cultural Policy Review Committee.)[3] It does, however, seem to us essential that programs designed to encourage both the production and the dissemination of Canadian contributions to the visual, applied and performing arts, to creative and academic literature, and to quality enterprises in film, broadcasting and musical recording, should be maintained and, indeed, expanded. Our opinion is reinforced by the obvious success of the Canada Council and other granting agencies in stimulating the extraordinary growth, over the past 20 years, of a thriving Canadian community of artists, writers and scholars, many of whom have international reputations of which all Canadians can be proud. The Canadian Radio-television and Telecommunications Commission (CRTC), the Canadian Broadcasting Corporation (CBC), the National Film Board, various programs in support of book publishing and film and record production, the maintenance of national and provincial museums and archives – all these and more, with varying degrees of success, have contributed to the overall objective of sustaining and promoting the indigenous cultural and intellectual creativity of Canadians, despite almost overwhelming pressures from abroad and, most notably, from the United States. The need for their activities persists. If a bilateral free-trade agreement is successfully negotiated, it will become even more acute.

Different Canadians are certain, of course, to have different views on all these various matters, interrelated as they are. Given the importance to Canada's future of the issues involved, it is critical that Canadians articulate those views in the debate to come. Commissioners believe that for a public body, we have been unusually frank concerning matters that are often left just below the surface of official – but not private – debate. Indeed, if we have erred in our political analysis, it has been towards the negative viewpoint, and yet we are confident that the balance of argument comes down on the side of further trade liberalization. This is particularly so when our contentions are weighed against the other options. Slow progress towards multilateralism or a drift towards a more protectionist stance would, we believe, cause further deterioration of our economic foundation and unleash even greater political dangers than we have addressed above. To maintain the *status quo* on the political front, as well as within the economy, is not without risk.

Notes

1. Denis Stairs and Gilbert R. Winham, "The Politics of Canada's Economic Relationship with the United States: An Introduction", in *The Politics of Canada's Economic Relationship with the United States*, vol. 29, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).
2. Canada, Senate, Standing Committee on Foreign Affairs, *Canada's Trade Relations with the United States*, vol. 3 (Ottawa: Minister of Supply and Services Canada, 1982), p. 107.
3. Canada, Communications Canada, Federal Cultural Policy Review Committee, *Report* (Ottawa: Minister of Supply and Services Canada, 1982).

Federalism and Achieving National Consensus

To understand fully the politics of Canada's external economic policies requires some knowledge of the workings of our federal constitutional system. Although it is doubtful whether the Fathers of Confederation intended to create such legally powerful provincial governments, the present constitutional strength of the provinces in economic matters is generally accepted by most Canadians. Each provincial government has the authority to tax, subsidize and otherwise regulate economic activities which are carried on primarily within the province. Provinces also hold ownership rights over their land and natural resources. These areas of authority provide provincial governments with strong levers for shaping the development of their regional economies.

The federal government, for its part, is responsible for regulating both inter-provincial and foreign commercial activities, and for coping with problems of national policy. In the field of foreign economic relations, there was little possibility for jurisdictional conflict between the federal and provincial governments until the 1960s. Before that time, the only significant legal instrument employed in the conduct of Canada's external economic relations was the customs tariff, which the Constitution reserves exclusively to the federal government. Since that government also holds the exclusive right to conduct Canada's foreign affairs, which includes the power to bind Canada to international agreements, it was under no legal necessity to consult with the provinces on matters of international trade and commercial policy. This situation changed in the 1960s and 1970s, when trade-liberalization initiatives under the General Agreement on Tariffs and Trade (GATT) came to focus increasingly on various non-tariff barriers (NTBs) to trade. Many of these NTBs arise from laws and regulations adopted by provincial governments, such as government procurement practices, subsidies to local industries, and consumer-product regulations.

During the Tokyo Round of GATT negotiations, Canada's federal and provincial governments consulted on the prospects for mutual commitments to limit discriminatory procurement practices and trade-restrictive product standards. They agreed that it would not be advantageous to offer specific provincial promises to implement the codes governing these NTBs. Rather than offer a binding legal commitment on behalf of the provinces, our federal government promised the other GATT signatories to use its "best efforts" to promote provincial compliance with the NTB agreements.

The expansion of international law-making activity into areas of provincial jurisdiction has coincided with an expansion of provincial government programs and regulations covering such economic activities as agriculture, manufacturing and resource development, which are closely linked to external trade and investment flows. This steady growth in provincial regulatory and promotional activities expands the provinces' ability to control inward flows of goods and capital, as well. There is a risk that jurisdictional disputes may arise if provincial economic or social policies conflict with federal initiatives to remove, or reduce the restrictive effects of, laws and regulations which limit access to the Canadian market. This risk is heightened by the legal uncertainty about the locus of powers to regulate international trade and commerce. For example, do provincial subsidies which either increase exports or reduce imports amount to an unlawful invasion of federal jurisdiction over foreign trade? Similar questions arise concerning provincial purchasing practices that discriminate against foreign suppliers, and provincial product standards that increase the cost and price of imported products.

Some Canadians argue that the existing uncertainty about the scope of federal authority creates serious impediments to the effective management of our external economic policies. Foreign nations might well be reluctant to conclude agreements with Canada if our government cannot assure them of provincial compliance. The legal necessity to obtain provincial agreement to proposed treaty obligations would mean that even a single dissenting province could block major portions of an arrangement that would confer substantial net benefits on our entire nation. This may become a serious problem because our regionally diverse economy will inevitably create some national-provincial conflict over foreign economic issues. Those who argue for expansion, or at least clarification, of federal legislative powers to implement foreign economic agreements also contend that there are strategic reasons for managing foreign economic relations differently from internal economic policies. Matters of timing and of bargaining strategy may be crucial to Canada's success in negotiating with other nations. Therefore the necessity to hold elaborate federal-provincial consultations before concluding an agreement might seriously handicap Canadian negotiators. It might, for example, force the disclosure of strategically valuable information or prevent a swift response to last-minute initiatives.[1]

While these concerns about jurisdictional conflicts seem warranted, the recent history of federal-provincial co-operation on trade and foreign-investment policies has been relatively satisfactory; in general, it does not justify a pessimistic forecast for future relations in these fields. The single exception – and it may indicate a need to examine existing mechanisms to promote co-operation – is the liquor-pricing dispute which arose several years ago between the federal and Ontario governments. At the time of the Tokyo Round, British Columbia, Ontario and Quebec all maintained pricing policies for alcoholic beverages that discriminated against foreign products. Federal officials proposed an end to higher mark-ups for foreign beverages in return for improved access for Canadian liquor exports to the European and U.S. markets. After an extensive process of consultation, a joint "statement of intent", endorsed by all ten provincial governments, gave assurance that the discriminatory mark-up practices would be withdrawn or, at least, that existing mark-up differentials would be frozen at current levels. Shortly after the negotiations, however, the Government of Ontario imposed new "handling charges" which, in effect, discriminated against foreign products. When the European Community (EC) and the United States complained about these charges, the Ontario government withdrew them, but it soon levied new "minimum reference prices" that imposed equivalent discrimination. The Government of Ontario has insisted that the Tokyo Round "statement of intention" was only that, and not a legally binding commitment.

The stage has thus been reached at which provincial involvement in issues affected by the international trading system must be dealt with as a matter of course. Provincial governments wish to be involved – indeed, they are demanding a voice in those aspects of foreign economic policy which affect their interests. Although our federal government has been reluctant to encourage too much involvement, hesitant first steps have been taken. Official machinery has been developed to exchange information and co-ordinate positions on matters including trade relations, negotiating objectives and major developments in off-shore markets. Since 1982, there have been periodic federal-provincial trade ministers' conferences that have significantly increased the level of communication among governments. Close intergovernmental co-operation is likely to become an increasingly important dimension of foreign economic policy making. It will be especially important in any future free-trade negotiations.

Commissioners have considered several possible options for reducing federal-provincial jurisdictional conflicts in the field of international economic relations. One solution would be to adopt a constitutional amendment giving the federal government the legislative authority necessary to implement international economic agreements. Many federal nations, such as Australia and the United States, have enacted constitutional provisions which give their central governments broad and plenary powers to implement treaties. In Canada, such a constitutional amendment would require the consent of at least seven of the provinces, and, of course, would be subject to the opting-out procedure. In order to secure the required margin of provincial support, it would probably be necessary to provide some explicit, judicially reviewable standard to protect the provinces against abuse or restraint exercised by means of any broad federal treaty-making power.

Rather than depend exclusively on the courts to strike an acceptable balance between the two levels of government, Canadians might also consider possible arrangements for the representation of provincial or regional interests in the federal process of formulating international economic policies. One possibility would be to assign a role in the conduct of foreign economic affairs to a new elected Senate redesigned to give greater weight to regional representation. An elected Senate could be given responsibility for approving or ratifying international agreements before their implementation by the federal government. This arrangement would require a constitutional amendment to provide that treaties approved by a majority of the Senate be self-executing: that is, such treaties would prevail over conflicting provincial legislation.

A third option, one which Commissioners describe at greater length in Part VI of this Report, would be to apply the general constitutional amending formula to sections of a treaty imposing obligations on provinces. A variation of this option would be to establish a joint federal-provincial commission on international agreements. Before the implementation of any international agreement dealing with matters within provincial jurisdiction, the federal government would apply for approval to a commission composed of federal and provincial representatives. A voting rule specifying a two-thirds majority would protect provincial interests and, at the same time, limit the potential problem of one or two dissenting provinces exercising a *de facto* veto over new international agreements. This arrangement might give the provinces more responsibility for foreign economic matters than they have exercised in the past, but it would also place them under a legal bond to implement treaties approved by the joint commission. Its implementation, however, would require an amendment to the Constitution, since it would limit existing provincial legislative powers.

A complement to any of these three options would be the creation of a permanent consultative committee, consisting of federal and provincial representatives. This committee would provide an established forum for the discussion of both pending international negotiations and the implementation of agreements concluded by the federal government. It would not exercise any formal constitutional authority concerning treaty implementation, nor would it possess the legal power to issue binding directives to either level of government. Both the federal and the provincial governments have strong incentives to compromise their differences over treaty implementation rather than to pursue the risky process of constitutional litigation. Nevertheless, in the matter of the division of legislative powers governing foreign economic relations, recourse to the committee would be optional for all parties. This non-binding process of consultation has worked well in Australia, for instance. A federal-state agreement, concluded in 1977, provides for prior consultation with the states when the treaty to be implemented affects matters which would otherwise be within their sphere of legislative competence. The Australian process also gives the states the first chance to enact legislation implementing international treaties which affect their areas of constitutional jurisdiction.

In choosing an option to recommend, this Commission considers it essential to ensure that the division of powers inherent in Canada's federal system should not impose undue constraints on Ottawa's ability to conduct foreign economic relations. As a principal power dependent on foreign markets, Canada cannot permit federal-provincial conflicts to dissipate its bargaining power in bilateral and multilateral negotiations. If the provinces desire deeper involvement in Canada's foreign economic affairs, they will need to demonstrate a willingness to assume obligations and make concessions. Ontario's administration of its commitment on liquor-pricing is not likely to convince the United States and the European Community of the value of similar commitments on government procurement or industrial subsidies. Over the past 20 years, the tendency of our provincial governments to open offices abroad has raised concern in some foreign capitals as to who speaks for Canada. The scope for intergovernmental rivalry is increasing, and such rivalry could seriously impede the effective management of our foreign economic relations. An effective federal-provincial partnership in matters of foreign economic policy will require that information, participation and co-operation be reciprocal, and that it be based on a clear understanding of accountability.

Commissioners have considered the various arguments for a constitutional amendment governing the implementation of economic treaties, but we are not convinced that any fundamental legal reforms are required *at this time* to safeguard against future federal-provincial conflicts. We do, however, foresee some risk of heightened conflict in future years if the federal government aggressively pursues trade-liberalization both multilaterally and bilaterally. For example, the easing of existing restrictions on trade in services and agricultural products will require more closely co-ordinated federal and provincial policies affecting these industries. Trade negotiations will probably focus on the restrictive effects of provincial policies concerning government procurement, on industrial subsidies that substantially increase exports, and on discriminatory product standards. These future trade talks will provide Canada with major opportunities to improve our access to export markets. In order to take advantage of these opportunities, both levels of government must co-operate and agree to accept the binding commitments likely to be demanded by our major trading partners.

Canada has no established or permanent intergovernmental mechanism for mediating and ultimately co-ordinating combined federal and provincial policies on foreign economic relations. While periodic federal-provincial trade ministers' meetings are helpful, Commissioners favour the commitment of additional resources to ensure the efficient co-ordination of government policies in this field. We recommend sustained and continuous consultation by federal and provincial ministers on foreign economic policies. Before Canada begins multilateral or bilateral negotiations, there should be close consultation between ministers about provincial, as well as federal, objectives and the binding commitments required to achieve them. During international trade negotiations, provincial representatives should be on hand to counsel the federal delegation. The delegation should also keep provincial governments informed and request their advice on specific proposals advanced during the bargaining process.

During trade talks, there should be continual consultation between the private sector, provincial officials and federal representatives. Commissioners recommend as a model the discussions and meetings organized by the federal government during the GATT Tokyo Round. These meetings, chaired by a senior official with extensive experience in trade policy, took place both at regular intervals and as need arose during the more intensive periods of negotiation, and canvassed systematically the views of all interested parties. Moreover, after the conclusion of a trade agreement, federal and provincial governments should continue to work together for effective implementation of treaty commitments. We believe it essential for the federal government to employ a similar process of consultation as a complement to future bilateral and multilateral trade initiatives. This co-ordinating role has implications for the structure of federal departments, and it may be that a special trade negotiator for a Canada-U.S./free-trade arrangement should be appointed and should report directly to the Prime Minister.

Primarily, we Commissioners base our view of achieving federal-provincial consensus in international economic relations on pragmatic considerations. These matters have not caused major conflict in the past. Thus, in the short term, we recommend that modest improvements be made in federal-provincial mechanisms for consultation. This strategy, we believe, should also be satisfactory in the context of our recommendations for negotiation of a Canada-U.S./free-trade arrangement if that negotiation should be undertaken soon. We are of the opinion, however, that over the long term, pressures will grow as a result of the constitutional gap in treaty making. For this reason, we have treated this problem in more detail in Part VI of this Report, where we recommend a constitutional solution.

Note

1. See George J. Szablowski, "Treaty-Making Power in the Context of Canadian Politics: An Exploratory and Innovative Approach", in *Recurring Issues in Canadian Federalism*, vol. 57, prepared for the Royal Commission on the Economic Union and Development Prospects for Canada (Toronto: University of Toronto Press, 1985).

The Prospect of Freer Canada-U.S. Trade

Geography, combined with similar cultural and ethnic backgrounds has given rise to an interrelationship between the industry, energy, agriculture, fisheries and intercorporate relationships characteristic of Canadian and U.S. economies. This interconnection is immeasurably more extensive than Canada's relationship with any other country or group of countries. Canadian economic well-being thus depends substantially on our relations with the United States. There is significant scope for the reduction or removal of barriers to cross-border trade and for improving the management of bilateral issues in a variety of areas. More fundamentally, Canada needs to engage the United States directly and formally in the fight to resist new trade barriers, eliminate the old barriers, and generally place cross-border trade on a more secure footing. Many of our industries are competitive and prepared to grow, but they cannot do so in the face of protectionist barriers to their most important market. They are prepared to invest and create new jobs, but they need to be assured that their efforts will not be frustrated by old or new barriers.

Existing barriers to trade, including tariffs, are real. The rosy expectation of 80 per cent duty-free trade by 1987 masks the fact that trade takes place through "holes" in the tariff. While a tariff of 5 to 10 per cent may not prevent trade, it will deter investment beyond that necessary to service the Canadian market. Futhermore, non-tariff barriers, especially in the form of contingent protection, are most effective in denying exporters the kind of security they need to make large-scale, job-creating investment. On the Canadian side, our tariff remains significant and, in addition to protecting producers, raises costs to consumers and producers, and thus retards development of a more competitive economy.

Successive rounds of GATT negotiations have traditionally provided Canada and the United States with the main opportunities to liberalize cross-border trade. Future negotiations could well offer new oportunities to liberalize and secure Canada-U.S. bilateral trade. Such negotiations, however, are unlikely to take place soon enough or to be thorough enough or provide the kind of environment Canadian producers will need by the end of the decade and beyond. We need, therefore, to engage the United States more directly in bilateral free-trade negotiations.

Commissioners' review of the various elements of what would be involved in developing an effective new framework for Canada-U.S. free trade leads us to conclude that a successful agreement would include the following arrangements:

- It would establish a free-trade area, rather than a customs union or common market.
- It should be a broad agreement, covering substantially all trade between the two countries, rather than a collection of sectoral agreements.
- Some sectors could be excluded from the agreement's coverage.
- It should be consistent with Canada's continued participation in GATT.

- It should apply to tariffs, contingency protection and other forms of non-tariff barriers.
- The elimination of tariffs should be phased in over a period of several years. In recognition of the relatively greater effect on the Canadian economy, the phase-in period of the elimination of the Canadian tariff should be longer than that for the United States.
- Non-tariff barriers should be neutralized or reduced by means of common procedures and controlled by codes of conduct; these codes should provide for decision making and implementation by a joint tribunal.
- It should provide for agreed measures of transitional adjustment assistance and safeguards.
- It should include effective dispute-settlement procedures whereby national politicians jointly arrive at final decisions; compulsory arbitration by a neutral panel should be stipulated as a procedure of last resort.
- It needs to be guaranteed by national laws, and it should provide adequate room to involve provincial and state interests.

A bilateral agreement constructed along these lines would make our manufacturing sector competitive by encouraging a process of restructuring and rationalization of Canadian industry to serve the North American market and, from that base, to penetrate overseas markets. It would also increase the security of our access to our most important market, a condition essential for growth and new investment, given the relatively small domestic Canadian market. Finally, it would improve the access we now enjoy in the U.S. market and thus allow Canadian industries presently shut out of that market to grow and invest with renewed confidence. Overall, such an arrangement would make Canadians richer. How much richer is a question best left to the specialist, but on the basis of analyses made for this Commission by competent professionals, we are prepared to say that it would be in the order of a 3 to 8 per cent increase of our national income.

Despite this assurance, a bilateral free-trade agreement would not operate without cost. The new circumstances would inevitably require adjustment, but that is an ongoing process which will affect Canadians whether we move to free trade or not. Again, on the basis of studies done by competent professionals, Commissioners are confident that long-term gains will be many times greater than short-term adjustment costs. Such costs, moreover, can be cushioned by the introduction of appropriate transitional adjustment assistance.

Finally, our review of the political consequences of a move toward free trade has convinced Commissioners that even here there are benefits. Free trade will strengthen Canada's economic fabric; it will reduce regional differences concerning the conduct of trade and industrial policy; and it will contribute to our growing sense of national confidence. Any adverse consequences can be managed by pursuing deliberate policies to strengthen cultural and other aspects of Canadian identity. Our government should also strengthen the objectives and administration of our foreign policy to reflect a more activist internationalist stance to the world community.

American Attitudes

It is only natural to question, as some Canadians have done, why the United States might be interested in concluding a bilateral free-trade arrangement with us at this time. After all, if successful negotiation is not assured, why raise this idea now, given all the debate which will follow in Canada? The answer is that there are good reasons to anticipate that the United States might respond favourably. Commissioners see both trade-policy and wider foreign-policy objectives for the United States that would make a favourable response likely. The United States has clearly indicated that any overtures toward free trade would, of necessity, have to come from Canada. Canadians have the largest interests at stake, but the Americans, we believe, would welcome a first approach from Canada. Recently the United States has indicated clearly its willingness to deal with its trading partners on a bilateral basis, not only through their trade arrangements with Caribbean countries and Israel, but in their declarations of broader trade-policy objectives.

In March 1985, the United States signed a bilateral free-trade agreement with Israel. This treaty calls for the phased-in abolition of all tariffs, export subsidies and other barriers to trade over a ten-year period. The American interest was to increase U.S.-Israel trade and also to show other countries, reluctant to open their markets, how much benefit there can be from freer trade. Trade Representative William Brock recently told the American Chamber of Commerce:

> *The failure of the [world trading] system to move has put the U.S. in the position where we have to contemplate defending our own vital interests. One of the ways we can do that is to take one or more countries and setting up* (sic) *a complete process by which we remove all trade barriers between us as an example of how good the world can be.*
>
> *The U.S. has to operate in its own self-interest and that means that priority has to be building up a global system . . . I would not be in the least reluctant to have several examples for those countries which seem to have chosen a different path for the moment.*[1]

The U.S. interest in freer bilateral trade with Canada is not casual or recent. It is not only based on the so-called "demonstration effect" noted by Brock, but it is also of interest in its own right. Better and more secure access to its most important market is not an advantage to be taken lightly. Since the mid-1970s, U.S. trade law has contained a provision authorizing the President to explore bilateral free trade with Canada. The United States welcomed the federal government's sectoral initiative in 1983, although both sides have since agreed that the scope for bilateral liberalization on a sectoral basis is limited.

The latest expression of U.S. interest appeared in the Declaration on Trade issued by Prime Minister Mulroney and President Reagan at the end of their March 17–18, 1985 meeting in Quebec City. In that document, the two leaders made a strong political commitment to consider all available means to liberalize trade between the two countries. As an indication of the seriousness of their interest, they adopted a specific work program and schedule to negotiate a number of particular agreements that will reduce barriers to the freer flow of trade and investment while the two governments consider whether to take the broader step. The interest of the American Administration in a full free-trade agreement is therefore clear.

The attitude of Congress is more problematic. While the U.S. Administration generally favours freer trade, Congress, influenced by individual lobbyists and interest groups, tends to be biased towards protection. Certain Senators and Congressmen have expressed support for Canada-U.S. bilateral free trade; nevertheless, the attitude of Congress as a whole would be greatly influenced by the interests of the American business community and by the sectoral costs and benefits assessed by individual firms. In making this assessment, both Congress and the American public would probably take longer-term considerations into account and not allow themselves to be overly influenced by such shorter-term circumstances as the current trade balance with Canada. Thus the Administration realizes that progress towards bilateral free trade requires a coalition of interests that expect overall benefit from such an arrangement. The American situation, in fact, is not all that different from our own.

A process of bilateral and multilateral negotiations would dampen protectionist initiatives, especially in the United States, and this development could damage important Canadian interests in the U.S. market. An ongoing process of negotiations focusing, during the coming years, on bilateral trade and trade-policy issues would direct attention to Canadian economic and trade problems, and to the important U.S. stake in the Canadian economy. In addition, by opening bilateral negotiations now, the two countries would encourage broader international agreement to begin a new round of tariff and trade negotiations within GATT. Finally, it seems strategically essential to launch such a process of negotiations in a period when the two governments have both been given new and strong electoral mandates, and before attention in the United States is diverted to mid-term Congressional elections.

An approach of the kind suggested represents recognition that there exists between Canada and the United States a closer, broader and more intricate economic and trade relationship than either country has with any third nation. Arising from this relationship and from changes in the international trade environment are unique trade problems that require bilateral solutions complementary to those provided within the multilateral framework: that is, bilateral solutions which have been worked out in the past to deal with special problems of trade in automotive products and defence arms procurement. Most important, a combination of bilateral and multilateral approaches, carried forward in parallel, could, in the end, prove to be the most effective way of moving towards freer trade between Canada and the United States.

Note

1. See Jennifer Lewington, "U.S. Free Trade Strategy Both Means and an End", *Globe and Mail*, March 6, 1985, p. 11.

Conclusions and Recommendations

The global environment presents Canada with enormous challenges and opportunities. Rapid growth of imports from the developing countries, a changing trade-policy environment and domestic pressures on our trading partners for new protection imperil Canadian jobs. By contrast, growth and technical progress abroad offer us new export opportunities and chances to benefit from access to cheaper and higher-quality products than we can produce. As Commissioners noted at the beginning of this Part, the challenge is one of change, adaptation and adjustment; the opportunities may be unlimited. In light of these developments, however, the choices Canadians must make are difficult.

We Commissioners have been frequently reminded, in the course of our task, that Canada's domestic economy is largely defined by its relationship to the wider global economic system. Canada's last Royal Commission on our economic prospects captured this point:

> *Something of Canada's essence is defined by its external relations. Much of its economic structure can be explained only in terms of its external trade . . .*
>
> *The ships loading lumber on Vancouver Island or aluminum ingots on the Saguenay are reminders of how deeply our material well-being is involved in the prosperity of other countries, even outside the boundaries of North America.*[1]

Canada's economic development, then, as well as our government's economic development policies, are significantly affected by conditions beyond our borders. As a relatively small, "open" economy, Canada is particularly vulnerable to outside influences on its trade and economic performance. In order to foster stability and predictability in some of these external forces, successive Canadian governments have sought to develop formal rules for conducting relationships with our trading partners. The pursuit of this objective has always involved an essential problem: How are we to reconcile conflicting priorities among national objectives and the requirements of a stable international economic system? To resolve inherent conflicts has required a continual process of negotiation and compromise at both the domestic and the international level. Governments have often had to adjust and put to positive use the constant tension between the forces of economic protection and trade liberalization.

For almost forty years, Canada has pursued a largely multilateral approach to its foreign economic policy; indeed we have been one of the strongest supporters of the multilateral system centred on the GATT and the International Monetary Fund. This approach was the most effective way to improve and secure access for our products and to instil order, stability and predictability into that process. Even on the import side, we have found that we must negotiate multilaterally to open our own market, in exchange for access to foreign markets. This action has proved a useful tool of industrial policy and has allowed for orderly adjustment of the economy through foreign competition.

To a great extent, Canadian trade policy has been, and will continue to be, developed as a trade-off between the business objective of securing improved access to foreign markets, the economic need to promote efficiency and competitiveness in the domestic economy, and the political need to maintain our sovereignty and freedom of action. The international trade and payments system largely determines the design and use of particular policy instruments. For Canadian producers and investors, there are several tests of this international system. Can our government successfully improve market access for those sectors where Canadian production is, or can be, competitive in world markets? Will it maintain current access available to Canadian producers? Will it protect producers from unfair or injurious foreign competition? Because private sector investment is necessary for growth and job creation, Canadian producers need to be confident that their access is secure, and that foreign governments will not move to frustrate the efforts to market Canadian goods abroad.

The multilateral system of rules is intended to facilitate decisions favouring adjustment and to penalize decisions favouring protection, but it needs political will to make it work. Between 1973 and 1979, the Tokyo Round of trade negotiations provided a framework for organizing political will. The negotiators sought to reduce trade barriers and to move the ongoing management of trade relations in the direction of freer trade. For the past six years, however, there has been no such framework.

A new round of GATT negotiations may be initiated, to concentrate on elaborating world trade law and removing remaining barriers to world trade, and to provide a basis for organizing political will to resist protection. The results of a future GATT negotiation are not certain, however, nor are they just around the corner. A new round of negotiations requires complex co-ordination and revolves largely around the interests of three or four players: the United States, the European Community, the less-developed countries (LDCs) as a group, and, perhaps, Japan. Canada can make an important contribution, but we cannot control either the agenda or the outcome. Even to influence the outcome requires adroit negotiators. The Community is reluctant to come to the table. The United States is eager, but as yet has no negotiating authority. The LDCs are willing, but insist on some problematic pre-conditions and do not agree on the agenda. Japan is willing, but largely because a new round would facilitate management of its trade relations with the United States and the European Community.

Canada's economic growth is critically dependent on secure access to foreign markets. Our most important market is the United States, which now takes up to three-quarters of our exports. More, better and more secure access to the U.S. market represents a basic requirement, while denial of that access is an ever-present threat. We are extremely vulnerable to any strengthening of U.S. protectionism. Early bilateral negotiations with the United States could provide opportunities for the two countries to negotiate reduction or elimination of tariff and other barriers to cross-border trade, at a pace and on a scale not likely to be achieved multilaterally in a further GATT round. Such negotiations could also be used to win agreement on rules designed to deal with special or unique problems affecting cross-border trade; they would provide a more secure shield against a U.S. policy of protection.

The pursuit of Canada-U.S. free trade is not at odds with efforts to strengthen and improve the existing multilateral framework. Rather, Commissioners see it as a complementary approach, involving concentration of our efforts and scarce resources on our most important market. We see multilateral negotiations proceeding in parallel. In our view, such a two-tiered approach is the best way to ensure that Canadian industry will win sufficient access to foreign markets to invest and grow with confidence. At the same time, it will allow us to open our market in an orderly fashion and thus ensure that trade policy does its part in encouraging the development of a more competitive and more productive economy.

Commissioners see negotiations with the United States as neither panacea nor disaster, but as a prudent course which will help to make us richer and, by making us richer, strengthen the fabric of our country and increase our self-confidence. While this course may initially make Canada more dependent on the U.S. market, it will offer our nation a more secure relationship and thus make us less vulnerable. Ultimately, it should strengthen and diversify our economy, achieving for us goals that we have long sought, but which have eluded us, largely because our domestic manufacturing sector has been too weak to attain them.

Negotiations leading to freer trade, whether pursued bilaterally or multilaterally, will be of little use if they are not supported by the right domestic policies. Our support for freer trade, therefore, depends in no small way on the recommendations Commissioners develop later in this Report. These recommendations should contribute to strengthening the competitiveness and productivity of Canada's domestic economy. Trade policy alone will not be enough.

Commissioners, like others who have enquired into Canada's relations with developing countries, see a need for Canada to take more positive action to help these countries through aid and trade measures. We have reached this conclusion, not only on humanitarian grounds, but also on the basis of our perception of Canada's own interest. Development of stronger links with these countries through aid and trade will pay dividends to future generations of Canadians, by contributing to a more stable world environment and by nurturing future trading partners.

We believe that the approaches we recommend below will help to strengthen our country. They will allow Canadians to pursue the gradual transition from a staple economy to a fully-industrialized modern economy, living in harmony with, but distinct from, our friends and allies.

Recommendations

■ Having carefully considered the analyses presented above, Commissioners make the following general recommendations.

- Canadians have benefited from and contributed to the multilateral system of trade and payments developed primarily in the last 40 years, and we should continue to support that system as the mainstay of our foreign economic policy. Canada is sufficiently strong and independent, however, to pursue bilateral intitiatives, including better economic relations with the United States, within the framework of multilateral relations.

- Canadian import policy in general should be based on a recognition of its costs to consumers and the costs of delaying adjustment. Canada should minimize any new protection, reduce protection gradually as part of bilateral or multilateral negotiations, and accelerate adjustment processes.
- Export promotion should be pursued aggressively and with greater reliance on private sector mechanisms, but the degree of subsidization this may involve should be within internationally accepted rules and practices.

International Trade

International trade is the life-blood of the Canadian economy. It is a major contributor to Canadian growth, jobs and real incomes. In view of the changing nature and patterns of international trade, Canadians are now confronted with several options in formulating trade policy. This Commission has identified three major approaches, each of which has several variations. Canada might:

- Maintain its present policy. It might keep to the level and type of protection currently in place, but make selective efforts both to improve access abroad and to protect Canadian industry on a limited case-by-case basis.
- Participate actively in a new round of multilateral trade negotiations under the auspices of the GATT, in order to improve and secure our country's access to foreign markets, to open up our own market, and to strengthen the legal framework for international trade
- In addition to taking the initiative for the elimination of trade barriers at the multilateral level, open negotiations with the Government of the United States to reach an agreement on a substantial reduction of barriers, tariff and non-tariff, between Canada and the United States.

This Commission rejects any generalized move toward greater protection or toward import substitution as a general policy to insulate Canadian producers from the international economy. This approach, while perhaps the most comfortable in the short term, would lead, in the longer term, to major inefficiencies in the national economy, a loss of jobs and lower incomes, and would contribute to an erosion of the multilateral system. In our view, a policy of maintaining the *status quo* would carry the serious risk of taking Canada backwards to a more protectionist position.

■ Commissioners recommend that multilateral trade negotiations under the GATT remain a central theme of Canadian trade policy; thus Canada should move quickly to define its objectives for the forthcoming round. The GATT has served Canada well, and our nation's participation in further strengthening this international system of co-operation is a general insurance policy for the future. Broadly stated, Canada's objectives should include:

- A more ordered world trading environment: that is, sufficiently stable, predictable and transparent international trade relations to instil a degree of business confidence that will lead to job-creating investment
- More secure access to our major markets, particularly the U.S. market
- Improved opportunity for the further processing of our natural resources before export, by reducing foreign barriers to manufactured goods
- Improved access and trading conditions for agricultural and fishery products
- An improved framework of international rules which will encourage orderly adjustment in the Canadian economy.

■ Commissioners recommend that the Government of Canada, at the same time it undertakes an initiative at the multilateral level to eliminate trade barriers, open negotiations with the Government of the United States to reach agreement on a substantial reduction of barriers, tariff and non-tariff, between Canada and the United States. Such an agreement would have to stand within the terms of Article XXIV of the GATT, and it would provide for a reduction of barriers between the two countries, but would leave each country with freedom of action to maintain separate trading policies with other economic partners. We do not recommend a more intensive arrangement such as a common market or an economic union, where even closer integration would take place between these two economies.

- Commissioners recommend that Canada negotiate a legal arrangement with the United States which incorporates strong safeguards to limit spill-over from the arrangement and thus to protect substantive policies, such as those pertaining to culture and defence, which are functionally unrelated to trade in goods and services. Indeed, a policy that creates no linkage should be explicitly confirmed in order to avoid surprises if the Government of Canada, as we recommend, were to pursue a more aggressive policy of support for indigenous cultural expression as a concomitant of a bilateral trade initiative.
- Commissioners recommend that this legal arrangement attempt to regulate three general types of barriers that currently restrict trade between the two countries. We recommend that:
  - Tariffs be phased down to zero over a period of perhaps ten years. Effective rules of origin must be developed.
  - An approach should be developed to use measures of contingent protection as follows:
    - For measures governing "fair" trade (such as safeguard action) and "unfair" trading practices (such as anti-

dumping and countervailing-duty proceedings), enforcement would be shifted from national administrative tribunals to a new Canada-U.S. intergovernmental body established under the arrangement; this body would be known as the "Canada-U.S. Trade Commission" (CUSTC).

- Detailed codes of national conduct would be required to govern resort to other non-tariff measures such as discriminatory federal and state-government/procurement practices, product standards and federal customs, classification rules and administrative procedures. Again, these matters should be subject to review of the CUSTC.

- This Commission holds that a free-trade arrangement should incorporate explicit provisions which reflect the proportionately greater costs of adjustment that Canadians will face. The Canadian economy needs more time for adjustment than does the U.S. economy. We therefore recommend a two-track approach to phasing in the tariff cuts to allow U.S. rates of duty generally to be reduced either at a faster rate or earlier than Canadian tariffs. The Canadian government should quickly develop strategies for adjustment which are compatible with the framework of adjustment assistance proposed in Part V of this Report, that is, the new Transitional Adjustment Assistance Program. The emphasis of government programs should be on assisting workers to adjust to new employment opportunities. In addition, a reoriented industrial policy, as set out in Part III, will encourage the flexibility and growth orientation required by a freer-trade environment.
- This Commission recommends that the Government of Canada urge the Government of the United States to implement the free-trade arrangement by amending U.S. federal and, if necessary, state legislation to conform to the arrangement, and that they do so under a "fast track" procedure which would require Congress to pass implementing legislation within 90 days of the President's formal declaration that he intends to sign an international agreement binding the United States. We also recommend, however, that a formal treaty eventually be struck once both governments have had sufficient experience with the arrangement.
- This Commission recommends that negotiations in Canada proceed on the basis of a broadly based, federal-provincial consensus, and that provinces be prepared to give legislative assent to the provisions of the arrangement, in keeping with the high degree of consultation that will be required to achieve federal-provincial consensus. We also recommend that in the longer term, Canadian governments establish a federal-provincial constitutional procedure: sections of the treaty that impose obligations on provinces would come into effect across

Canada when two-thirds of provincial legislatures, representing at least half of Canada's population, passed resolutions in support of the treaty.

- This Commission recommends the formation of a three-tiered Canada-U.S. intergovernmental institution to provide basic executive and administrative decisions; technical staff services; adjudication of complaints and appeals under the agreement. We further recommend the following mechanisms:
  - A committee of national officials at the ministerial level to be responsible for the enforcement of the agreement's obligations
  - A supporting body of officials known as the "Canada-U.S. Trade Commission" (CUSTC) to manage non-tariff barriers, but subject to appellate review by the Ministerial Committee
  - A standing arbitral panel with binding powers as a board of last resort, to resolve disputes arising from conflicting interpretations of the agreement. Such a panel would consist of two Canadians, two Americans and one neutral member to be chosen by the members of the panel.
- International trade and industrial policy are inextricably linked. In Canada, there is the added dimension of cultural and social implications. To undertake successful negotiations on freer trade with the United States will require an extraordinary management effort by the Government of Canada. Commissioners, while making no specific recommendation on how best to prepare the way for the negotiations, wish to express concern that the current federal departmental structure does not appear to provide the degree of integration required to carry out a major negotiation of this kind. It may be that an Office of the Special Trade Negotiator should be established, and that the incumbent should report directly to the Prime Minister.

Development Assistance

■ The motives of altruism and long-term national interest coincide in this Commission's recommendations for Canadian objectives pertaining to Canada's relations with developing countries. In pursuing these objectives, Canadians should be aware that the primary responsibility for development rests with the nations in question, and that although greater international efforts are required, difficult intranational, social and institutional issues are often the fundamental impediments to progress, just as they are in all nations. Commissioners recommend:

- An improvement in both the quantity and the quality of Canada's aid performance. Canada should advance to the Lima target of 0.7 per cent of GNP, not by 1995, but by 1990, and aim to achieve 1 per cent of GNP by the year 2000. The Canadian government should reduce the fraction of our aid which is tied, and to facilitate this reduction, we should rely more on multilateral than on bilateral aid.

- That Canada work within global institutions to improve the receptivity of these bodies to proposals helpful to developing countries. Canada should, for instance, systematically seek ways to involve developing countries more fully in a future round of GATT negotiations.
- That the Canadian government be ready to consider proposals for mitigating some of the more harmful effects of the international debt crisis on developing countries. Canadians should resist pressures for economic protection that would apply to exports from these countries. A more constructive and conciliatory approach to developing countries and their problems will not only help these countries, but also yield longer-term dividends for all countries. □

Note

1. Canada, Royal Commission on Canada's Economic Prospects, *Final Report* (Ottawa: Queen's Printer, 1957), p. 17.