EDITORS' INTRODUCTION

The Canada–U.S. Free Trade Agreement in Context

This book examines some of the economic implications of freer trade between Canada and the United States, looking at the issue from several different perspectives. Part I considers global and bilateral trade opportunities within the context of the recently implemented Canada–U.S. Free Trade Agreement (FTA). Part II focuses on regional economic opportunities of freer Canada–U.S. trade within the St. Lawrence River valley geographic area. Part III looks at implications of freer Canada–U.S. trade for individual business firms, with emphasis on the management consulting, engineering, computer software, and telecommunications industries. The book concludes by considering the agreement between Canada and the United States within the context of the Uruguay Round of the GATT negotiations and by discussing future implications.

The intent of this introduction is to provide background information to put the FTA in perspective. The following sections provide information regarding Canada–U.S. trade and investment flows, a historical look at Canada–U.S. trade agreements, an overview of the changes proposed under the new trade agreement, and a discussion of unresolved bilateral trade issues. While we consider some of the major implications of the FTA, we do not attempt to provide a detailed review or assessment of it, as that has been done exceptionally well elsewhere (Lipsey and York, 1988; Schott and Smith, 1988; Smith and Stone, 1988). In a postscript following the appendix, we discuss implementation of the FTA and Canada–U.S. trade through late 1990.

Trade and Investment Between Canada and the United States

Bilateral Merchandise Trade

Even before the FTA was implemented, Canada and the United

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States were the world's largest bilateral trading partners, exporting and importing approximately $158 billion (U.S.) of goods in 1988. Most Americans are unaware of the magnitude of this relationship, while Canadians hold few illusions about the role of the United States in commercial transactions. To put the matter in perspective, U.S. commodity trade with the entire European Community in 1988 measured about $120 billion, while trade between Japan and the United States totaled $128 billion. While Canada is indeed the United States' largest trading partner, the merchandise trade deficit of the United States with Japan ($52 billion in 1988) far overshadowed its nearly $11 billion trade deficit with Canada (U.S. Department of Commerce, *Survey of Current Business*, May, 1989). Another reason why most Americans are unaware of the magnitude of Canada–U.S. trade is that Japan is the largest individual supplier of merchandise imported into the United States.

Tables 1 and 2 provide an overview of the importance and composition of foreign trade in Canada and the United States. Merchandise exports of the United States to Canada rose from 18 percent of total U.S. exports in 1980 to more than 24 percent of total U.S. exports by the middle of the decade, remaining at about that level through 1988. During the same period, merchandise imports from Canada increased from 17 percent to nearly 19 percent of total U.S. imports. In contrast, exports from Canada to the United States were about 74 percent of total Canadian exports in 1988, up from 62 percent in 1980, while imports from the United States in 1988 represented 69 percent of total Canadian imports.

An even more dramatic difference between the two countries is their respective demands on each other's national output. Over the three-year period from 1986 to 1988, about 19 percent of Canadian gross domestic product (GDP) was exported annually to the United States, while only slightly more than 1 percent of U.S. GDP was exported to Canada annually during the same period.

Currency exchange rate shifts account for much of the increased orientation of Canadian exports to the U.S. market during the 1980s. In the first half of the decade, a weak Canadian dollar relative to the U.S. dollar, together with relatively strong North American currencies vis-a-vis the rest of the industrialized world, meant that Canadian goods enjoyed greater price competitiveness in the United States than in offshore markets. In addition, the strong U.S. recovery from the

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1981–82 recession boosted demand for Canadian raw materials and manufactured goods, particularly automobiles, Canada's highest value export. Bilateral intraindustry trade in motor vehicles also helped account for the shift in U.S. exports toward Canada in the mid-1980s.

Throughout the 1980s, the United States consistently ran merchandise trade deficits with Canada. However, the magnitude of these deficits varied greatly, as shown in Table 2. In 1980, the bilateral merchandise deficit amounted to $1.3 billion. The deficit peaked in 1985 at $15.7 billion, again reflecting a stronger U.S. dollar, U.S. recovery from the 1981–82 recession, and a lingering recession in Canada which depressed spending for imports. By 1988, the United States' bilateral merchandise trade deficit with Canada had fallen to $10.9 billion as Canadian import demand responded to domestic economic growth.

The top ten bilateral merchandise exports from each country in 1988 are listed in Table 3. Since World War II, manufactured goods such as producer equipment, consumer goods, and motor vehicles and parts have dominated U.S. exports to Canada, while U.S. imports from Canada have consisted of resource-based raw and semiprocessed materials such as forest products (lumber, wood pulp, and newsprint), petroleum and natural gas, nonferrous ores, and minerals. In the last two decades, automobiles, motor vehicle parts, and other transportation equipment have emerged as important Canadian exports. These trade patterns reflect the significance of intrafirm exchanges, particularly in the major North American automobile companies under the Canadian–U.S. Automotive Products Agreement of 1965. The Auto Pact, as it is commonly known, permits duty-free trade in parts and vehicles, subject to some restrictions. Canada traditionally runs a large surplus on bilateral automobile vehicle trade ($6.8 billion [U.S.] in 1988), which offsets its deficit on automobile parts trade ($4.6 billion [U.S.] in 1988).

Another recent development in bilateral trade is the appearance of telecommunications and related equipment in the list of high-value Canadian exports. Canadian companies have developed product niches in such areas as satellite equipment (for example, Spar's Canadarm on NASA space shuttles) and communication systems (for example, Northern Telecom's digital telephone equipment which services private-branch exchanges). Manufactured goods in 1988 accounted for about 52 percent of Canadian exports to the United States, up from 45 percent in 1970.

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Bilateral Services Trade

During the 1980s, the U.S. merchandise trade deficit with Canada was offset by a surplus in services trade (Table 2). The U.S. surplus in services trade averaged about $10 billion annually from 1980 to 1986, but increased significantly beginning in 1987. In 1988, a $14.3 billion surplus in services trade along with a $10.9 billion merchandise trade deficit resulted in a $3.4 billion bilateral current account surplus for the United States.

Table 4 illustrates bilateral services trade in recent years. Trade in services is allocated between nonfactor and factor services. The latter represent investment income from domestic assets employed abroad, while nonfactor services include travel, transportation, business services, and miscellaneous government services. Exports of nonfactor services and receipts of income from U.S. assets held in Canada were $25.5 billion (U.S.) in 1988 and represented 12 percent of total U.S. service exports. Imports of nonfactor services and payments of income on Canadian assets held in the United States equaled $11.2 billion in the same year, or 6 percent of total U.S. imports of services (U.S. Department of Commerce, *Survey of Current Business*, September, 1989).

Several features of bilateral trade in services are noteworthy. Trade in travel and transportation fluctuates noticeably, following business cycles, movements in the exchange rate, and special events (for example, the 1988 Winter Olympics in Calgary). Disaggregating bilateral trade in business services reveals areas of comparative advantage for both countries. For the United States, management and administrative services, research and development, and royalties, patents, and trademarks dominate service exports. While payments generally exceed receipts in Canadian business services trade with the United States, Canada enjoys a (relatively small) surplus in the areas of communications, refining and processing, and commissions. However, investment income favors the United States, which is not surprising given the stock of its financial capital in Canada.

Bilateral Investment Flows

In addition to being the world's largest trading partners, Canada and the United States also share the world's largest reciprocal investment flows. Since the early years of this century, the United States has been the most important source of

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foreign direct investment entering Canada. Initially, U.S. mining and petroleum companies sought access to Canadian natural resources, while major manufacturing firms established production and distribution facilities in Canada to avoid relatively high Canadian tariffs. This transfer of foreign savings, particularly in the resource extraction industry, supplemented domestic savings in a large, sparsely populated country and facilitated Canadian economic growth. By the mid-1980s, Canada hosted nearly 20 percent of U.S. direct investment abroad and the United States accounted for about 73 precent of the stock of foreign direct investment in Canada.

Table 5 provides data on the stock of bilateral direct investment, showing year-end book values of debt and equity financing received by domestic affiliates from their foreign parents. Forty-five percent of U.S. direct investment in Canada is located in the manufacturing sector, while 21 percent is in the mining and petroleum industries. The largest shares of Canadian direct investment in the United States are in manufacturing (34 percent), banking and finance and insurance (18 percent), and real estate (15 percent).

By the mid-1970s, net inflows of foreign direct investment to Canada began to diminish, while Canadian direct investment abroad began to grow, particularly in the United States. From 1980 to 1988, U.S. direct investment in Canada increased by 40 percent, while Canadian direct investment in the United States rose by 179 percent. Measured by debt and equity financing from foreign sources, Canadian direct investment constituted about 8 percent of total foreign investment in the United States by 1988 (U.S. Department of Commerce, *Survey of Current Business*, August, 1989).[1] The growing presence of Canadian capital in the United States has been attributed to several factors, including closer proximity to consumers in a larger market, productivity differences, local investment incentives, and the availability, skill levels, and relative cost of labor (Rugman, 1987).

Regional Trade

Unique in its location, New York State borders Canada's two most populous provinces. About 65 percent of Canada's gross domestic product (GDP) is generated within Ontario and Quebec. With 36 percent of the nation's population and 41 percent of its GDP, Ontario—particularly Toronto and the "Golden Horseshoe" encircling Lake Ontario—is an industrial heart-

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land. Quebec, by contrast, accounts for 25 percent of Canada's population and produces 24 percent of its GDP. Clearly, the Montreal–Windsor corridor accounts for the vast majority of Canada's manufacturing activity.

Table 6 lists leading commodity exports from Quebec and Ontario and the percent going to the United States. While these provinces share status as Canada's traditional manufacturing center, clear differences characterize the two economies, as reflected in their commodity exports. In 1988, Quebec exported $22.6 billion (Cdn.) worth of goods, with 75 percent destined for the United States. Meanwhile, Ontario shipped three times that amount ($67.4 billion) to foreign countries, with 86 percent going to the United States. Automobiles, trucks, and motor vehicle parts account for about one-half of Ontario exports, reflecting bilateral intrafirm exchanges under the Auto Pact. Ontario accounts for about 90 percent of Canada's automotive exports and 97 percent of its automotive parts imports (Ontario, Minister of Industry, Commerce, and Technology, 1988).

The direction of New York State trade with Quebec and Ontario closely parallels U.S. trade with these two provinces and also reflects the high value of trade in automotive goods. Exports to Ontario represented 75 percent of New York's total exports to Canada in 1988 while exports to Quebec accounted for another 21 percent. Ontario supplied 68 percent of New York's imports from Canada while Quebec accounted for 21 percent. Commodity composition is discussed in some detail in the papers by Gandhi and by McGahey and Doh in this volume.

Many analysts have suggested that the FTA will increase north-south trade within the different regions of North America, diverting Canadian trade from traditional east-west flows (see, for example, the paper by Pettigrew in this volume). However, statistics clearly indicate that significant north-south linkages already exist between Canada and the United States. For example, while close to one-half of the shipments of Ontario manufacturers are within the province, fully 28 percent are exported to foreign countries, mostly to the United States. Only 10.5 percent of Ontario manufacturers' shipments are destined for Quebec and slightly more than the 9.8 percent are bound for the western Canadian provinces (Ontario, Minister of Treasury and Economics, 1987).

As this brief overview of bilateral trade and investment flows suggests, the Canadian and U.S. economies are highly integrated, with extensive cross-border regional activity taking

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place even prior to implementation of the FTA. The magnitude of this international economic activity has generated bilateral friction, in part, as two sovereign governments seek to defend their interests. The recently implemented trade agreement formalizes the existing economic relationship and imposes new constraints and obligations upon both governments, thereby reducing uncertainty about future government intervention which might restrict international economic activity. The FTA creates a more predictable policy environment which, together with the elimination of remaining tariffs, is essential for further economic specialization and growth.

Canada–U.S. Trade Agreements: Historical Context

The idea of freer trade—or reciprocity as it used to be called—has been the subject of negotiations between Canada and the United States for well over one hundred years. The Canadian provinces have depended on foreign trade to provide markets for their abundant natural resources and foreign exchange for their import requirements. In the 1840s, with Britain's repeal of the Corn Laws and its abandonment of mercantilist policies, the provinces began to lose their preferential status in the British market. From time to time since then, a formal preferential trading arrangement with the United States has appealed to several Canadian governments. In particular, economic recessions have generally prompted Canadians to seek closer ties with their neighbor to the south.

The first major step towards freer trade with the United States was the Reciprocity Treaty of 1854 which eliminated tariffs on unprocessed products including fish, cheese, animals, butter, coal, grain, and timber, while retaining national tariffs on manufactured goods. Trade between British North America and the United States increased sharply, but the treaty was abrogated by the United States in 1866, partly as retaliation for higher Canadian tariffs on manufactured goods and for British support of the Confederate states during the U.S. Civil War.

Confederation in 1867 created an east-west preferential trading area by eliminating trade barriers among the Canadian provinces and by creating a central government which aggressively tried to build a national economy. After several unsuccessful attempts by Canada to restore bilateral reciprocity in the 1870s, Sir John A. MacDonald introduced the protectionist National Policy in 1879. The National Policy was a program for economic development consisting of a comprehensive tariff

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structure to stimulate domestic manufacturing activity, particularly in eastern Canada, and generous subsidies for railroad construction and land settlement to develop primary industries and an agricultural economy on the western prairies. The intent of the National Policy was to build a distinct economic base for Canada in North America, but Canada's geography and market size continued to constrain its economic growth and promote north-south trade. Unrestricted reciprocity between the two nations was proposed as an alternative to the National Policy during the election of 1891 by the Liberals, but MacDonald and the Conservatives narrowly defeated the Liberals in the election and the National Policy remained in place.

Serious discussions between the two countries were held again in 1910, resulting in a reciprocity agreement that was approved by the U.S. Congress in 1911. However, the agreement faced stiff opposition in the Canadian House of Commons and fears of closer economic integration with the United States dominated the ensuing election campaign. The agreement's Liberal Party sponsors, led by Prime Minister Wilfred Laurier, were defeated in the election. Trade liberalization was again the subject of negotiations between Canada and the United States in the mid-1930s, largely in response to high tariffs associated with the Smoot-Hawley Act, which had been passed by the United States in 1930. Significant bilateral tariff reductions were negotiated in 1935 and again in 1938, as both countries came to realize that protectionist trade policies were detrimental to their economic welfare.

The impetus toward freer trade was confirmed again in 1947 when both Canada and the United States became charter members of the General Agreement on Tariffs and Trade (GATT). GATT members meet periodically to negotiate mutually advantageous reductions in tariffs and other barriers to world trade. This multilateral forum has benefited Canada over the years because it reduces the asymmetries of bargaining bilaterally with the United States. The GATT has also served to structure trade relations between the two countries and provides a process by which some types of bilateral trade disputes can be resolved. Nonetheless, Canadian concern about increasing U.S. protectionism, cumbersome GATT procedures, and U.S. preoccupation with third country issues at the GATT led Canada to consider special bilateral arrangements with the United States while it continued to support multilateral trade negotiations (see the paper by Shannon in this volume).

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In 1983, Canada and the United States explored the possibility of liberalizing trade on a sectoral basis. Discussions focused on reducing trade barriers in steel, urban transportation equipment, agricultural implements, and traded computer services. The talks ended after one year without agreement when the difficulty of balancing concessions and benefits within the narrow confines of specific sectors became apparent. In 1985, the Canadian government asked the United States to begin comprehensive trade-liberalizing negotiations, and the Canada–U.S. Free Trade Agreement was the outcome of those negotiations. The FTA can be viewed as elaborating the commitments of the two countries to each other under the rules of the GATT while at the same time significantly extending the scope of coverage and the process of dispute resolution. Many observers believe that the agreement's innovations will serve as a model for the current round of GATT negotiations —the Uruguay Round—which is scheduled for completion in 1990 and has focused on the growing worldwide use of nontariff barriers and the need to reform rules for trade in services, intellectual property, and agriculture.

Several papers in this volume discuss factors that prompted the Canada–U.S. free trade negotiations. The negotiations ended with the signing of a preliminary agreement in October 1987 by President Reagan and Prime Minister Mulroney. Enabling legislation to implement the terms of the FTA was approved by the U.S. Congress and signed by President Reagan in the fall of 1988. After being passed by the Canadian House of Commons, the agreement was blocked in the Canadian Senate. Free trade became the dominant issue in the Canadian federal election held in November 1988. The reelection of a Progressive Conservative majority government resulted in approval of implementing legislation by the Canadian Parliament in December 1988, thereby completing the ratification process in the two countries.[2] The FTA was implemented according to schedule on 1 January 1989.

Overview of the Canada–U.S. Free Trade Agreement[3]

The basic objective of the FTA is to further open markets for trade and investment in goods and services between the world's two largest trading partners. The FTA sets up principles and procedures for resolving trade disputes and lowering barriers to trade, ultimately enhancing efficiency, income, and economic growth for both countries. The agreement provides national

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treatment for a wide range of firms to operate in both countries, meaning that the other party is entitled to the same treatment that each government gives its own nationals. National treatment allows both Canada and the United States to follow their own domestic policies in certain areas (for example, with respect to agriculture and energy), so long as these policies are not used to discriminate solely on the basis of nationality. National treatment provisions apply to goods and, with certain exceptions, to investment and to firms providing services. An important implication of the FTA is that it forces future governments in both countries to be less interventionist in matters of international trade. However, a few major industries are not covered within the FTA, notably beer, transportation, and some cultural enterprises, including publishing, broadcasting, and related communications. As well, only services specifically enumerated in the FTA are covered by the agreement; in addition, intellectual property, a major U.S. concern, is not addressed.

Tariff Removal

It has been estimated that about 75 percent of Canada–U.S. trade was duty free prior to the FTA. Canadian tariffs on dutiable U.S. imports averaged about 9–10 percent, while the average U.S. tariff on Canadian dutiable imports was 3–4 percent. Nevertheless, one of the most important achievements of the FTA is the elimination of virtually all tariffs on merchandise trade between the two countries over a ten-year period ending in January 1998. To be entitled to duty-free treatment, goods must be wholly produced or obtained in either Canada or the United States or must be sufficiently transformed in either or both of the countries so as to be subject to a change in tariff classification. Furthermore, for certain goods such as automobile products, at least 50 percent of the direct cost of manufacturing must be attributable to Canadian or U.S. materials.

Tariffs on some products were eliminated entirely when the FTA was implemented in January 1989, but most will be phased out over five to ten years in equal annual installments, according to a transition schedule designed to minimize employment adjustments in import-sensitive industries. The FTA also allowed the process of tariff elimination to be accelerated by mutual consent. In response to industry petitions, provisional agreement was reached in November 1989 at the second meeting of the Canada–U.S. Trade Commission to accelerate the elimination of tariffs on more than 400 goods.

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Canadian and U.S. tariff levels and trade flows for selected commodities in 1988 are shown in Table 7. Tables 8 and 9 show the staging of tariff cuts and dutiable values for major bilateral merchandise trade categories at the two-digit Standard Industrial Classification (SIC) level. Duties were eliminated in January 1989 on about 7 percent of U.S. dutiable imports from Canada and 13 percent of Canadian dutiable imports from the United States. Included in this category were such products as computers and related equipment, motorcycles, leather and fur garments, vending machines, ice skates, and certain kinds of telecommunications equipment.

Tariffs on commodities that account for 58 percent of U.S. dutiable imports from Canada and 34 percent of Canadian dutiable imports from the United States were to be eliminated over a period of five years. This group included paper and paper products, printed matter, paints, furniture, chemicals including resins, after-market automotive parts, precious jewelry, most machinery, petroleum, and subway cars. Tariffs on the remaining 35 percent of U.S. dutiable imports from Canada and 53 percent of Canadian dutiable imports from the United States were to be phased out over a ten-year period. Included in this staging category were plastics, rubber, most wood products, base-metal products, textiles and apparel, footwear, railcars, pleasure craft, steel, watches, and most agricultural and food products. Tariff reduction will be accelerated for many of these commodities as a result of the Canada–U.S. Trade Commission decision in November of 1989. Scheduled to take effect in April 1990, these reductions apply to approximately $3 billion of Canadian exports to the United States and to the same value of U.S. exports to Canada. Goods for which tariff reductions will be accelerated include printed circuit boards, chemicals, electric motors, pharmaceuticals, scientific instruments and other industrial products. In the majority of cases, the tariff was to be eliminated entirely in 1990.[4]

It should be emphasized that before January 1989, tariffs applied to only about 25 percent of Canada–U.S. trade. The impact of tariff cuts on actual trade between the two countries depends on the existing levels of tariffs and volume of trade, the staging of the reductions, the responsiveness of demand to lower import prices, and, ultimately, the effect of the increase in consumers' real incomes, productivity and other economic gains resulting from freer trade between the countries.

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Agriculture

Under the FTA, all agricultural tariffs between the two countries will be eliminated over 10 years. Provision is also made to abandon use of export subsidies on bilateral trade and to restrict some nontariff barriers on grains, meat, poultry, eggs, and sugar. However, the FTA does not restrict the ability of either country to maintain their subsidy programs or to legislate changes in their supply management policies. Both countries also recognize that the multilateral GATT negotiations are critical for further liberalization of agricultural trade. By eliminating tariffs, however, the FTA begins to whittle away at agricultural protection, but significant nontariff barriers remain to distort bilateral agricultural trade.

Energy

The United States and Canada share the world's largest bilateral trade in energy products, totaling $10.6 billion (U.S.) in 1988. Most of this trade involves Canadian exports of petroleum, natural gas, electricity, and uranium. Canada itself is the largest export market for U.S. coal. The FTA ensures that Canada–U.S. trade in energy products will be based on commercial considerations, with prices for trading purposes determined by market forces. Each country remains free to pursue its own domestic energy regulatory policies so long as they are not discriminatory against the other country.

The agreement contains broad-based commitments not to impose restrictions—including quotas, export taxes, and minimum price requirements—on Canadian and U.S. exports and imports of energy products. The agreement also prohibits either country from restricting energy exports except during emergencies such as supply shortages or for military-related requirements (a narrower criterion than "national security purposes"). If either country imposes supply restrictions, the other country must be given access to the same proportion of the total domestic supply that it received in the most recent 36-month period prior to the imposition of the restriction. Essentially, the United States has increased its dependence on Canadian energy by ensuring free access to its market. Canada, by accepting this guaranteed access, has pledged to share supplies in times of crisis and not to use government policy to distort prices charged in the two countries.

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Automotive Trade

The FTA permits the continued existence of the Auto Pact. Qualified producers will be able to import duty free into Canada from third countries if they meet production and Canadian content requirements in Canada and, with very few exceptions, are original members of the Auto Pact. Bilateral trade in automotive goods and vehicles will be duty free under the FTA as long as at least 50 percent of the direct cost of manufacturing is U.S. or Canadian content. Designed to protect parts producers from offshore competition, this requirement is more stringent than the previous one which permitted inclusion of overhead and other indirect production costs. Canada also agreed to terminate its export-based and production-based duty remission programs. Both programs generated significant U.S. opposition as companies which were not original members of the Auto Pact were able to earn import credits into Canada by exporting to the United States. Canada will also phase out its embargo on imports of used cars. Finally, both countries agreed to establish a binational working group to study the future of the North American automotive industry and to recommend policy changes.

Services

The inclusion of services in an international trade agreement is one of the major accomplishments of the FTA. The agreement extends the principle of national treatment to certain listed services, requiring that regulations governing any covered service not be discriminatory in design. However, the liberalization is limited. While no new discrimination is allowed, the FTA does grandfather existing practices and licensing procedures. These two provisions effectively create a standstill arrangement for policies that restrict cross-border services transactions.

The agreement's provisions apply to services trade in such sectors as agriculture, forestry, construction, real estate, insurance, computers, tourism, and architecture. Not covered by the FTA are transportation, telephone service, child care, legal services, and government-provided services in health, education, and social areas. The principle of national treatment encompasses the production, distribution, and sale of the service; the right to establish a commercial presence in the other country; access to domestic distribution channels; and the investment necessary for providing the service, subject to restrictions on investment discussed in Chapter 16 of the FTA.

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Annexes to the services chapter of the FTA provide more detailed treatment for tourism, architecture, and computer-enhanced telecommunications services and begin the process of reducing existing restrictions.

An important provision concerning trade in services prohibits the use of occupational licensing and certification as a barrier to trade and encourages each country to recognize the other's licensing procedures for those who provide covered services. Current discriminatory practices in services are likely to be an issue addressed in future negotiations, along with lengthening the list of services covered by the agreement.

Temporary Entry for Business Persons

Another part of the FTA deals with "temporary entry provisions" for individuals from each country who desire to conduct business in the other country. The new rules streamline on a reciprocal basis the criteria for temporary admission for business purposes and should facilitate both short- and long-term entry, depending on the type of commercial activity involved. The agreement identifies four categories of business travelers: business visitors, professionals, traders and investors, and intracompany transferees. To qualify for temporary entry into either country, business travelers and professionals who satisfy normal health and immigration requirements must simply document that they fall into one of the covered occupations or professions and indicate the nature of their business. The agreement also sets forth less restrictive rules regarding temporary entry for intracompany transferees and traders and investors.

Investment

Chapter 16 of the FTA, with certain exceptions, applies the principle of national treatment to investment laws and policies enacted in the future in both countries. The provisions of this chapter do not apply to investment related to financial services, government procurement, transportation services, or cultural and publishing industries. While not creating a completely open environment for investment, the FTA generally permits investment funds to move across the border more freely than in the past. The national treatment provisions apply only to future laws and practices, thereby grandfathering any existing rules that now discriminate against investment in the two countries. By removing the threat of future investment restrictions in both countries, this chapter is viewed as a major gain for Canada;

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alone among other foreign investors, Canada will receive preferential treatment in the United States by being exempt from measures designed to regulate or restrict foreign investment.

Canadian rules for the acquisition of existing businesses will be relaxed by raising the threshold for review of U.S. direct acquisitions of Canadian firms from $5 million to $150 million by 1992.[5] The agreement eliminates altogether Canadian review of indirect acquisitions, which occurs, for example, when the U.S. parent of a Canadian subsidiary is taken over by another U.S. company. The FTA also prohibits new trade-related performance requirements pertaining to local content or the export of a given quantity of production. This feature is particularly important for the United States because past Canadian governments have favored such intervention in the hopes of increasing the benefits of foreign investment in Canada.

Financial Services

The FTA covers all future laws, regulations, and practices relating to financial institutions in both countries. The FTA allows Canadian and U.S. financial firms (including banks, securities firms, and certain parts of insurance companies) to compete on a more equitable basis on both sides of the border and gives them preferential treatment relative to third-country firms operating in either country. The United States agrees to allow domestic and Canadian banks to deal in Canadian government securities, including provincial and crown corporation obligations if fully guaranteed by a Canadian government. Current interstate banking operations of Canadian banks, grandfathered under the International Banking Act of 1978, are protected by the FTA. Should the Glass-Steagall Act be amended in the United States, Canadian banks would receive national treatment. Canada, for its part, effectively exempts the United States from the 25 percent ceiling on nonresident group ownership of individual banks; the 10 percent limit on individual nonresident ownership of federally chartered trusts, insurance companies, and investment companies; and the 16 percent aggregate capital limitation on foreign ownership of Canadian bank assets.

Dispute Settlement

Implementing free trade and resolving bilateral trade disputes are important issues addressed by Chapters 18 and 19 of the FTA. One of Canada's primary objectives in negotiating the FTA

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was to secure access to the U.S. market which, it believed, was impaired in increasingly arbitrary ways by numerous antidumping and countervailing duty investigations and protectionist pressures building in Congress. In essence, the agreement institutionalizes binational consultative procedures to avoid disputes and to expeditiously resolve issues when trade measures or proposed legislative or regulatory changes in either country threaten to distort bilateral trade and investment. The agreement creates two separate mechanisms for dispute settlement, one dealing primarily with matters of interpreting and implementing the FTA, the other dealing with the contentious issues of antidumping and countervailing duty determinations.

Chapter 18 of the agreement establishes the Canada–U.S. Trade Commission, comprised of cabinet-level appointees from both countries, to oversee the implementation of the FTA and to resolve disputes relating to its interpretation and/or implementation. If disagreements on particular issues cannot be expeditiously settled by consultation, either government can request a meeting of the Commission. The Commission can consult technical advisors; appoint a mutually acceptable mediator; establish a panel of experts to review the issue; or refer the dispute to a five-member binational panel for a recommendation (which may be binding only if both parties agree). If a government fails to comply with the final report of the panel or the Commission is unable to resolve a dispute after receiving the panel's report, the other government may retaliate by withdrawing trading benefits of equivalent effect.

The first panel constituted under Chapter 18 considered a trade dispute involving a Canadian requirement that West Coast salmon and herring be landed and counted in Canada prior to export. The panel's nonbinding decision issued in October 1989 stated that while a landing requirement is a legitimate conservation measure, 100 percent of the catch need not be landed and counted. Canada agreed to abide by the panel's ruling, but the two countries disagreed over the report's policy implications. A binational panel was also established to review a Canadian complaint against U.S. restrictions pertaining to the size of imported live lobsters.

Chapter 19 of the FTA establishes two important thrusts for dealing with bilateral disputes in antidumping and countervailing duty cases. Current U.S. and Canadian trade remedy laws will continue to be unilaterally applied, thus allowing private interests to make their case for duties against imports

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"dumped" or "subsidized" by the other country. However, under the FTA either country will now be able to appeal the administration of these laws to a binational review panel instead of to a higher court in the country in question. The panels are to be composed primarily of international trade attorneys selected from lists compiled by each government. If decisions made by the domestic administering authority (in the United States, either the Department of Commerce or the International Trade Commission; in Canada, either the Department of National Revenue or the International Trade Tribunal) are challenged, the review panel will determine whether domestic laws were correctly and fairly applied. Either government can initiate the review process and will automatically respond to an individual request to do so, if the individual could otherwise have challenged the decision and initiated the judicial review process in court. The panel decision must be reached within 315 days after the request for a panel is made, thus expediting review, and will provide a timetable for remedial action. Final decisions by the binational panel will be binding on both governments.

As of the end of 1989, Canada had filed the majority of the requests for Chapter 19 panel review. Three cases involving the alleged dumping of red raspberries from British Columbia were nearing completion in early 1990. The panel found that the U.S. Department of Commerce calculation of dumping margins was adequate in one case but defective in the two other instances. Under the terms of Chapter 19, the determination was remanded to the Commerce Department "for action not inconsistent with the panel's decision," that is, for recalculation of the margins. Other cases pending under Chapter 19 panel review include the 1989 determinations by the Department of Commerce that Canadian pork producers were subsidized and by the International Trade Commission that material injury to U.S. producers resulted from Canadian pork imports. The accumulated decisions in Chapter 19 cases will provide important precedents to complement national judicial review.

Chapter 19 also provides for binational panel review of changes in either country's current antidumping or countervail laws to ensure consistency with the GATT and the FTA. If the panel recommends legislative modifications and if remedial action is not enacted within a specified period, the government requesting review can take equivalent action or terminate the agreement. This provision is an important gain for Canada

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since Canada must be specifically named as subject to any new changes in U.S. trade laws.[6] The two countries also agreed that the provisions of Chapter 19 will apply for a period of five to seven years, during which time negotiators will try to develop mutually advantageous rules governing subsidies and antidumping and countervailing duties. Furthermore, either government may terminate the FTA on six-months notice if no agreement on this issue is reached after seven years.

While the FTA and its dispute resolution mechanism do not guarantee Canadian access to the U.S. market (an objective which may be unrealistic between two sovereign nations), the binational panels and Canada–U.S. Trade Commission represent important innovations in institutional development. Specific procedures for notification and consultation, timetables, and legally binding decisions are significant improvements over current GATT mechanisms (Steger, 1988).

Unresolved Issues in Canada–U.S. Trade

The FTA made notable gains in liberalizing bilateral trade in goods and services and investment flows and in introducing new standards in several areas of multilateral trade negotiations. Nonetheless, agreement could not be reached in negotiations on several difficult issues. We discuss some of the more significant unresolved bilateral trade issues in this section.[7]

Subsidies

Perhaps the most important issue outstanding is the question of subsidies. Domestic subsidies are permissible under GATT rules, but countervailing duties may be applied if an importing country's industry is injured by goods receiving a subsidy in the exporting country. The critical issue is to determine what constitutes a countervailable subsidy. The definition of subsidy is complicated by the various forms it can take: grants, interest–free loans, loan guarantees, and tax credits or concessions, to name but a few.

Canadians have long charged that U.S. trade remedy law, while consistent with the GATT, may be administered in unpredictable and often politically biased ways (see Rugman's paper in this volume and Rugman and Anderson, 1987). From 1980 to mid-1987, Canada and the United States each initiated 44 trade remedy investigations of the other country. While Canada initiated twice as many antidumping cases as the United States, there was only one Canadian countervail investigation of U.S.

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goods compared to eleven investigations of Canadian goods by the United States. Six of the U.S. investigations resulted in countervailing duties being assessed against about $4.2 billion (Cdn.) of Canadian exports over the period (Canada Department of Finance, 1988). Canadians argue that even if ultimately no countervailing duty is applied to Canadian exports, the expense of defending their interests and the uncertain outcome of the process can create substantial additional costs for firms wishing to conduct business in the United States.

The United States has a different perception of the subsidy problem, viewing it as a matter of controlling the pervasive use of Canadian subsidies which, directly or indirectly, enhance Canadian exports. The divergent perspectives—U.S. concern over the widespread use of subsidies and Canadian concern over the remedy of countervail—make bilateral negotiations on this issue difficult. Another complicating factor is that Canadian subsidies are perceived to have international ramifications, whereas U.S. subsidies are viewed as largely a domestic matter. Because of the greater relative importance of foreign trade in Canada, subsidies to Canadian firms are more likely to have a direct impact on bilateral trade. By contrast, U.S. subsidies may displace some imports by lowering production costs but are not often critical to export enhancement (Hart, 1989).

An example of the subsidy/countervail issue occurred in 1986 when the U.S. lumber industry alleged that Canadians unfairly subsidized exports of softwood lumber through low stumpage fees (payments for harvesting timber from government lands). Three billion dollars (Cdn.) of Canadian exports were at stake. The U.S. Department of Commerce investigation found that Canadian exports enjoyed a countervailable subsidy of 15 percent. However, a similar allegation three years earlier had resulted in a Commerce Department determination that Canadian stumpage fees were *not* countervailable. The different decisions seemed to rest on interpretation of the "specificity test": if a domestic practice is generally available and not specific in its benefits, then it is not considered to be countervailable. Canadians were irritated by the unilateral, narrower interpretation of this test by the United States in its later determination (Wonnacott, 1987).

Canadian negotiators had hoped that the FTA would identify allowable as well as countervailable subsidies, thereby removing a major bilateral trade irritant. Some progress was made in the automobile sector. In recent years, Canada has

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attracted Asian direct investment through duty-remission incentives based on export performance from Canada. The United States, the logical destination for such exports, argued that this policy amounted to an export subsidy to off-shore auto producers located in Canada. In the FTA, Canada agreed to eliminate this particular program. Agreement was also reached to eliminate export subsidies in bilateral agricultural trade, yet much less progress was achieved toward defining subsidies more generally. Because of unresolved issues involving the definition, visibility, and appropriate response to subsidies, both countries agreed to continue negotiations over a five to seven year period in an attempt to find a mutually acceptable definition of a trade-distorting subsidy and to impose more discipline on the use of subsidies and countervailing duties. However, both sides also indicated a desire to await the outcome of the current GATT multilateral negotiations before concluding an agreement bilaterally.

A factor complicating the ongoing subsidy negotiations is the differing visibility of subsidies in the two countries. Traditionally, Canadian government assistance has taken the form of industrial development grants, loan guarantees, regional development subsidies, and the like. While U.S. assistance also takes some of these forms, government assistance to the private sector, particularly at the federal level, is often less visible, appearing as tax credits, defense contracts, and low-interest loans.[8] At this time, there is little quantitative information on the extent of subsidies in the United States.[9] Thus, an important problem facing the negotiators is to come to agreement on the extent of subsidization in each country.

Other important trade policy disagreements face the negotiators. Canada is not alone among industrialized countries in making far less use of countervailing investigations than the United States. Indeed, U.S. trade remedy laws involving antidumping and countervail have become an important instrument of U.S. protectionism in the recent past (Hart, 1989). The Omnibus Trade and Competitiveness Act of 1988 continues this trend. This disproportionate use of countervail does not facilitate bargaining in the bilateral negotiations. Further, under Canada's Special Import Measures Act of 1984, consumer and user views of possible countervail determinations must be taken into account. These views are not considered in the U.S. investigation process, again complicating resolution of the subsidy issue in bilateral negotiations.

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