COMMENT AND ANALYSIS

FREE TRADE YEAR FOUR: ONE STEP FORWARD?

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Nineteen-ninety-two may prove to have been free trade's year of calm before the storm as

- a number of major trade disputes with the United States will not be resolved before the middle of next year;
- the North American Free Trade Agreement (NAFTA) has been signed but the implementing legislation will not be introduced until next year;
- the GATT round of multilateral trade negotiations (MTNs) is on track for an agreement next year;
- finally, the Canadian electorate will have their opportunity to pronounce on these issues in the general election which may come as early as next Spring.

This fourth annual **Strategico Report** reviews the year's developments and sketches the free trade agenda for the year to come.

IMPACT OF THE FTA

The economic impact of the FTA continues to be swamped by the prolonged recession. Solid evidence on the impact of the FTA itself is starting to come in, but the issue remains highly controversial.

There is no dispute that the last few years since the FTA have been years of severe hardship for many Canadians. The economy shrank measurably in 1990 and 1991 and has failed fully to regain the lost ground. More than 1,600,000 Canadians are without work. Many have been permanently laid off. Many more have been unable to find work in 12 months of searching. Many others have become discouraged and dropped out of the work force entirely.

Hardest hit has been the manufacturing sector. Employment in this sector has been shrinking in importance for nearly two decades. The past two years have seen cutbacks unprecedented since the Great Depression. It may be politically irresistible to attribute these terrible human consequences to the FTA. From there it is only a step to conclude that these problems would all disappear with the abrogation of the FTA. The truth is more complex.

Direct FTA Impact

We now have full statistics for the first three years of free trade, covering 1989 through 1991 as well as partial data for 1992. This evidence has not for a moment stopped critics from castigating the FTA[1] and government supporters from making equally exaggerated claims of success.[2] In most instances, the statistics themselves are unexceptionable—it is the interpretations that are misleading.[3] The interested citizen is left to her own devices to sort out the truth.

What is the best test to determine whether the FTA is working to Canada's benefit?

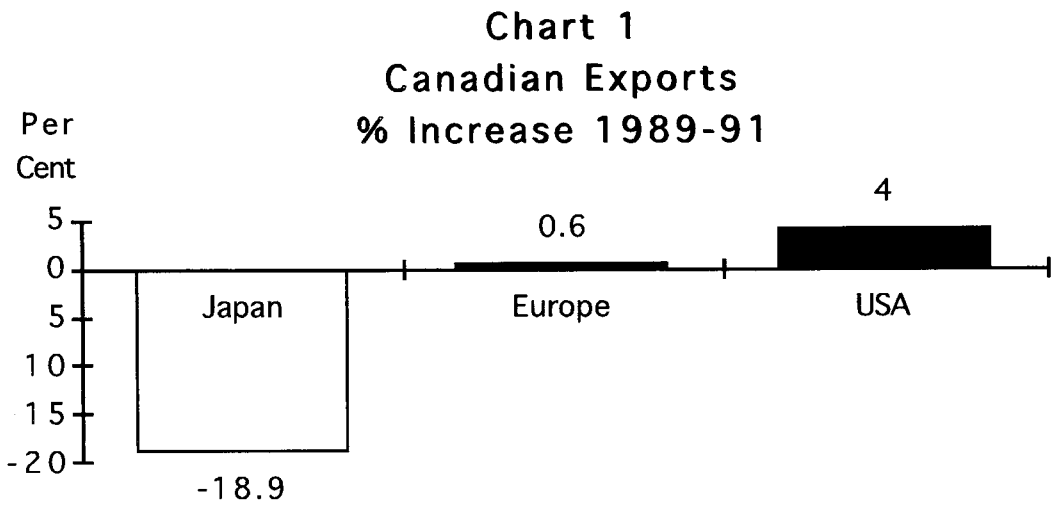
The FTA did not, obviously, affect the entire economy with equal force. It liberalized trade in many goods with the United States. Most exports and imports of goods already faced no customs duties prior to the FTA—the FTA reduced or eliminated tariffs on the remainder. It also froze the rules for trade in services, to prevent further restrictions in the future. The FTA must presumably be working as planned if the facts show that:

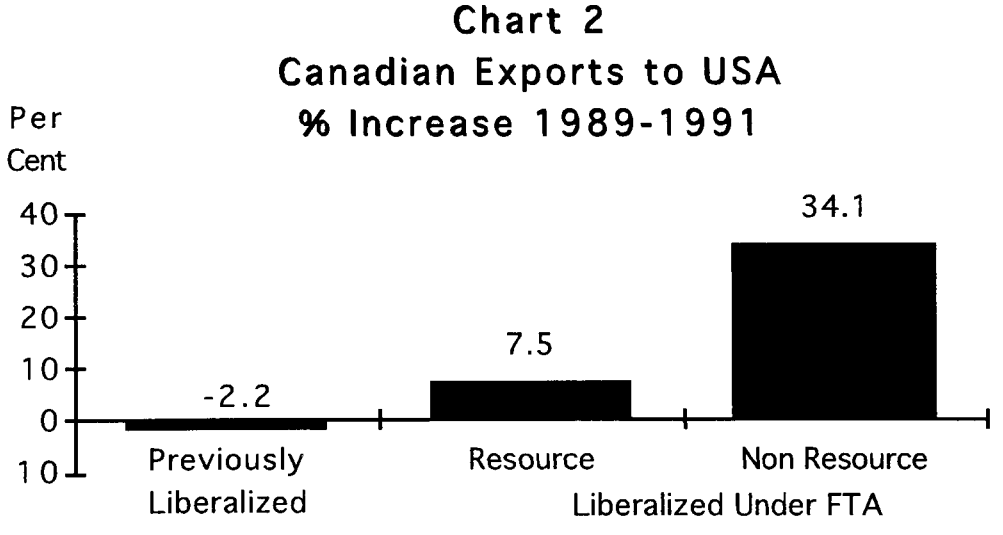
- exports to the USA have increased more than imports and more than exports to other countries;
- the biggest gains have come in those sectors which were directly liberalized by the FTA;
- the higher value-added sectors have gained even more than the resources products; *and*
- there has been some increase in exports and imports of services liberalized by the FTA.

This is precisely what has been found by the independent C.D.Howe Institute, one of Canada's leading economic research bodies. Specifically, the study[4] found that over the 1989 to 1991 period:

- Despite slower growth in the USA than in other markets, and a sharp increase in the value of the Canadian dollar relative to the American, **Canada's merchandise exports to the USA rose by 4 per cent**, compared to imports from the USA at 0.3 per cent, and compared with exports to Europe which increased at 0.6 per cent and exports to Japan which *shrank* by 18.9 per cent.
- **The biggest gains came in exports of merchandise directly liberalized by the FTA increasing by 16.2 per cent** over the period while exports in sectors not previously liberalized actually decreased by 2.2 per cent.
- Among the liberalized exports, the resource based products increased by 7.5 per cent while **the non-resource based higher value added exports increased by 34.1 per cent.**

CANADIAN COMPETITION RECORD





- Exports of services in sectors liberalized by the FTA increased by 13.5 per cent over the period, slightly above the rate of increase for services in other sectors.

These data suggest that the FTA is, indeed, performing as expected. **Indeed, in an otherwise gloomy economic landscape, FTA related exports represent one of the few bright spots.** While the detailed numbers are not yet available, there is some indication that this trend is continuing, as overall exports to

the USA are up by 10.5 per cent for the first three quarters of 1992.

It would be an error to translate this improved export performance directly into increased jobs, as the government propaganda mill is inclined to do. First, jobs gained in increased exports may be largely offset by increased imports—another result (indeed, another benefit, to the consumer) of free trade. Second, increased output may, in large measure, be achieved through increased productivity rather than increased employment.

The bottom line is simply this: the main direct impact of free trade is not, and was never honestly expected to be, increased employment. The main impact is to expand exports (and imports) and thus generate increased productivity, increased consumer choices and, finally, increased real incomes for Canadians. The principal employment gains will come well down the road, if at all, in the provision of services resulting from these increased incomes.[5]

Coherent Economic Policies

We therefore believe this is a false debate. The attempt to determine the precise share of job gains or losses attributable directly to free trade may be politically rewarding but misses the point. **Free trade, whether with the USA, NAFTA or the GATT is only part of what must be a coherent set of economic policies designed to meet short term problems and lay the basis for long term prosperity.**

There are some grounds for hoping that, finally, the overriding need for this policy coherence is understood in Ottawa. It is, regrettably, coming rather late. Many key decisions about plant location within the Canada-USA free trade zone have already been made.

The ideal environment for those decisions would have been a Canadian economy in which there was solid economic growth, relatively low unemployment, moderate inflation, low interest rates and a relatively cheap Canadian dollar. Instead, the opposite has been the case. **In the first few years of free trade, we have faced a serious recession, rising unemployment, disinflation and in some cases deflation, high nominal and real interest rates and a Canadian dollar in the stratosphere.**

Clearly, Canadian governments, federal and provincial, have not been responsible for all of these problems. The recession has affected not only Canada but the United States, the United Kingdom and other countries, from Australia to Sweden. Given the erosion of Canadian competitiveness through rising unit labour costs, it is also clear that policies of fiscal and monetary restraint were required to bring costs back into line. It is now obvious, however, that Canadian monetary authorities seriously overshot their own highly ambitious targets. **The result was to double our competitive cost disadvantage through the escalation of the value of the Canadian dollar during the crucial first few years of massive structural adjustment to the FTA.** Furthermore, the recession may not have been "made in Canada," as the Conference

Board of Canada has alleged, but excessively tight monetary policies certainly exacerbated the length and severity of the recession and slowed the path of recovery.

In any event, there is now good reason for believing that Canada is well positioned, in the short run, to take advantage of new opportunities, whether under the FTA, the NAFTA or the GATT. There is, finally, solid evidence of recovery with steady if unspectacular real growth in prospect for 1993 and beyond. Employment levels are rising although the rate of unemployment will remain unpalatably high for some years ahead. Inflation is of the order of 2 per cent, or a good deal less if the sectors controlled by government are excluded. Interest rates have resumed their descent following a post referendum hike. Last but not least, the Canadian dollar is now positioned at a more realistic level in the high-70¢ ($US) range.

IMPLEMENTATION OF THE CANADA-USA FTA

On both sides of the border, the barriers continue to come down. By 1 January 1993, tariffs will have been eliminated on the great bulk of two-way trade: two-thirds of this trade was already duty free before the FTA; tariffs on the rest were eliminated during the first four years plus one day of the FTA.

The remaining tariffs, on the most sensitive items, have been cut in half and will be phased out entirely over the next five years. Now that the dispute over plywood standards is finally resolved, even the tariffs on plywood, waferboard and strandboard will be reduced on schedule.

Implementation has not been without its difficulties. Most of these problems will be addressed in 1993 with the resolution of a number of key trade disputes by FTA panels.

Unfair Trade Laws

The most serious disputes arise from the application of so-called "fair trade laws." Under these laws, both Canada and the USA reserve the right to slap duties on imports judged to be subsidized or dumped or otherwise unfairly traded. Under the FTA, both countries committed to establish a new and better set of rules to govern this trade by the end of 1993. Meanwhile, the decision to apply these duties was subject to review by binational panels under Chapter XVIII of the FTA. These panels are designed, not to prevent unfair trade disputes—that would be unrealistic—but to resolve them fairly.

The good news is that these FTA panels have, without exception, rendered what we consider to be fair and reasonable decisions.

In the handful of cases involving decisions by Canadian authorities, some questions have been raised about the fairness of the proceedings but the Canadian decisions have been allowed to stand.

Many more cases have involved decisions by American authorities. The Canadian exporters have lost some cases—cases we believe they deserved to lose since the American decision was justified. Most cases have resulted in partial or complete victory for the Canadian exporter as the panels have determined that the Commerce Department overstated the amount of subsidy or dumping involved and/or that it was wrong for the International Trade Commission to have concluded that the American industry was injured.

Insofar as the work of these panels is concerned, the FTA has been highly successful—more successful even than most of its proponents could have expected.

The bad news is that these panels have demonstrated that the American trade law system is continuing to operate unfairly. It was hoped and expected that the FTA panels would find few cases of abuse and that the offending party would move expeditiously to correct these abuses. Instead, the situation is as follows:

- The Administration itself has become increasingly active in initiating unfair trade cases (e.g., lumber) or in championing cases brought by domestic industry (e.g., magnesium).
- In three out of four panel decisions where Commerce has found a significant subsidy or dumping margin, the panels found Commerce had overstated the margins.
- Many cases have dragged on, well beyond the 315 day outside deadline set by the FTA, through delays in approving panels and panelists, procedural delays and the need for repeated remands before the trade authorities take the correct action.
- The Americans have resorted to an "extraordinary challenge" of the panel decision in one case (the case was rejected) and are contemplating a challenge in another, thus adding further delay and expense.
- Even when a panel decision in one case has clearly established that a determination by the Commerce Department was improper, Commerce has continued to apply that same ruling in other, similar cases (e.g., live swine).

These are serious problems. It is in the interest of both countries to work to correct them. That said, this in no way diminishes the importance of the panels' achievement: **Canada is clearly better served with the panel system under the FTA than without it! It represents a marked improvement over the untrammeled operation of American unfair trade law prior to the FTA. It is clearly superior to the GATT system's attempts to deal with these issues.**

Getting Down to Cases

The critical tests of the FTA system are yet to come in the case of flat-rolled steel and, above all, softwood lumber.

CANADIAN COMPETITION RECORD

1. Flat Rolled Steel

The steel case amply demonstrates the perversity of protectionism. Over the past few years, the North American steel market has become highly integrated. Canadian mills have shipped a significant proportion of their output to the United States, consistently accounting for 3 to 4.5 per cent of the American market. Meanwhile, American mills have discovered Canada, increasing their share from 4.5 per cent in 1986 to more than 16 per cent of the Canadian market today. This increased two-way trade benefits both countries. In mid-1992, elements of the American industry decided to instigate a massive countervailing and anti-dumping duty case against foreign suppliers. Imports from Canada were included in the dumping investigation because, according to some reports, it was necessary to bulk up the import statistics to dramatize the case. The Commerce Department is expected to release its preliminary determination in the dumping case in late January. If Canada is implicated, the case will be headed for the FTA panels.

In response, the Canadian industry has sensibly brought its own cases against American imports before the Canadian authorities. These cases, too, may end up before the FTA panels.

Meanwhile, efforts are being made to resolve the issue outside the panels through some form of bilateral understanding on trade in this important and integrated industry. To date, they have been unsuccessful.

2. Softwood Lumber

The most important case involves American imports of Canadian softwood lumber. The background to this long-running saga was covered in previous annual **Strategico Reports**. On 15 May 1992, the Department of Commerce finally determined that Canadian lumber was subsidized, but at less than half the amount it had originally found.

In a related development, the International Trade Commission found these imports were injuring an American industry that was enjoying an increased share of market at significantly higher prices and registering high (and in the case of the principal complainant, Georgia Pacific, record) profits!

These determinations are now before the FTA panels. There have been substantial delays: it took several tries to agree on the panelists; an American panelist then withdrew, requiring the process be restarted; meanwhile, the American industry is challenging the jurisdiction of the FTA panels even to consider the case. These delays may succeed in postponing the final panel decisions until the Summer (or even the Fall) of 1993.

(Meanwhile, a GATT panel finally ruled in December that the American authorities acted quite improperly in imposing penalty duties—under the infamous Section 301—on Canadian imports even before the preliminary subsidy determination. The GATT panel, characteristically, avoided dealing with the substantive

issues in the case. The finding came more than a year after the original offence and has yet to be adopted by the GATT Council.)

Despite these and other frictions, the implementation of the FTA has proceeded remarkably smoothly. It now forms the base for the proposed North American Free Trade Agreement.

NORTH AMERICAN FREE TRADE AGREEMENT

The NAFTA was formally signed on 17 December and is intended to come into effect in January 1994. Canadian negotiators had two objectives in the NAFTA. First and foremost, to preserve the gains achieved in the Canada-USA FTA. Second, to move toward free trade with Mexico and, possibly, in future, other countries in the hemisphere.

L'Apertura—The Mexican Opportunity

The secondary objective has largely been achieved. The NAFTA will phase out the remaining tariffs and, more significant, non tariff barriers against Mexico's imports from Canada. Regulations restricting direct investment and the provision of services from Canada and by Canadians will be relaxed over time. **These are substantial gains.**

The 1980s were difficult for Mexico as GDP per capita actually declined significantly over the decade. Mexico began the 1990s with a population of just over 80 million and a gross domestic product of about $325 billion for an output per person of around $4,000—less than one-sixth Canada's. Recent years have, however, seen a turn around as President Salinas's policy of *l'apertura* has begun to bear fruit in rising growth rates and living standards. This has been achieved through the massive liberalization of the Mexican economy. The next step is to open that economy through the NAFTA.

Under NAFTA, Canada stands to participate in Mexico's success over the years ahead. As Canada is a "bit player" in the Mexican market today, a rapid rate of growth is entirely achievable. To put it in perspective, Canada last year exported just over $500 million in merchandise to Mexico but achieved close to that level in the first three quarters of 1992 alone. Canada today accounts for just over 1 per cent of foreign investment in Mexico—a figure which could be doubled in short order if one of several acquisitions now under negotiation were concluded.

That said, it will be decades before the results make a significant impact on Canada's overall economic performance. Even if our exports to Mexico doubled this year, they would still represent less than 1 per cent of our exports to the United States.

The Primary Objective

Given these magnitudes, the *primary* Canadian objective was clearly to preserve the access we had negotiated on a preferential basis to the American market under the Canada-USA FTA. The government took the position that Canada had no choice but to participate in the NAFTA to defend our interests. Left to her own devices, it was argued, the United States would be able to use her bargaining leverage to establish a preferential relationship with Mexico and, possibly, other countries, like the spokes of a wheel radiating from an American centre. Canada had to participate in the architecture of this new regime as a central player or risk being left behind.

In addition, it was announced that Canada would be seeking to improve access to the United States market in important sectors, notably financial institutions and government procurement, while preserving the access we now enjoy in other fields, notably the automotive industries. We would also seek to strengthen the dispute settlement provisions under the FTA and resolve the mounting friction over administration of the rules of origin governing eligibility for cross-border access.

Did the NAFTA meet these Canadian objectives for improving cross-border access to the United States? **In our judgment, the NAFTA does generally address Canada's negative objectives of preserving access to the U.S. It fails to achieve Canada's positive objectives of further liberalizing cross-border trade.**

Canada has indeed maintained her charter membership in NAFTA. As we forecast in last year's **Strategico Report**, in some fields, agreements are bilateral, e.g., agriculture. For the overwhelming bulk of the NAFTA, however, the agreement is trilateral, applying fully to all three partners. Other countries aspiring to join the arrangement will be obliged to conform broadly to the terms set out by the charter members, and to obtain their approval.

Furthermore, the agreement does preserve important elements of the Canada-USA FTA. There are, however, substantial changes. **These changes overwhelming reflect the American, not the Canadian, negotiating agenda.** Provisions governing the regulation of investment and services have been greatly increased in bureaucratic weight and the opportunity for legal challenge by private parties extended. An entire chapter has been added to meet American demands on intellectual property rights: these provisions are targeted directly at Canada's regime for generic licensing of pharmaceutical patents; they are designed to restrict, not liberalize, competition and trade in these products; these demands were rejected in the FTA negotiations.

Trade rules in key sectors of Canadian opportunity under the FTA have been modified. Industry leaders in these sectors maintain the NAFTA is more restrictive. In the apparel sector, a significantly more restrictive rule of origin has been introduced although the impact has been offset, at least initially, by expansion of

the quotas allowed to escape this rule. Trade in automotive products not covered by the AutoPact is also subject to a new origin rule which American authorities claim is at least as restrictive as the highly prejudicial—and in our view, clearly unjustified—interpretation they had placed on the FTA rules to penalize shipments from the Canadian plants of Honda and Toyota. In both industries, there is also a temporary cash "sweetener" in the form of the extension, for another two years, of the right to receive duty drawback on overseas imports.

Attempts to open cross-border access in other sectors generally fell short of the mark. In financial services, the Americans were unprepared to move. In government procurement, the final deal opens up only modest opportunities and, in some important fields (e.g., purchases by electrical utilities) American concessions are conditional upon commitment by the provincial authorities, notably Hydro Québec and Ontario Hydro. In sectors where American harassment at the border had created serious frictions—e.g., meat inspection—no progress was made in disciplining these activities. It remains to be seen whether the proposed new rules of origin will curb the excesses of the American customs authorities.

Dispute Settlement under NAFTA

Finally, the NAFTA incorporates a number of modifications in the FTA regime for the settlement of disputes. For disputes of a general nature, the NAFTA chapter has been trilateralized, renumbered and includes some ingenious and untested procedural novelties. For example, each party now chooses panelists from the other countries' rosters.

In the critical system for resolving disputes over unfair trade laws, a number of changes have been made. Despite the government's claims, it is our judgment that these changes certainly do not strengthen and may arguably weaken the system established by the FTA.[6] Of particular concern are:

- the formal abandonment of the commitment to reach a new and better set of unfair trade rules; and
- modifications to the panel system which we believe risk adding uncertainty, delay and expense to the process.

These changes do not destroy the usefulness of the panel system—far from it. They do, however, represent a step backward by the NAFTA and, above all, an opportunity missed to correct problems with the working of the system under the FTA.

MULTILATERAL TRADE NEGOTIATIONS

There are high hopes that the multilateral trade negotiations under the GATT—which began around the same time as the FTA negotiations—are finally nearing an end.

The central confrontation is between the United States and Europe over the issue of agricultural support programs. The negotiations were at a standoff until the Americans took action to break open the issue this Fall by threatening retaliatory action against French white wines. The resulting agreement with the Commission of the European Community not only defused the immediate controversy but laid the basis for successful completion of the MTNs themselves.
The chief obstacles will, as always, be the inefficient farmers in Europe, in Japan—and in Eastern Canada! The French farmers are storming the ramparts of the Commission, aided and abetted by the French Government, in an attempt to undo the deal. The Japanese have been very quiet, but face serious domestic difficulties with their highly protected and subsidized rice farmers. Nonetheless, given the overwhelming interest of these parties in a successful MTN result, prospects are reasonably good that the agreement will proceed.

That will leave the Canadian Government in a very difficult position. Canada has sided with other agricultural exporters in the interests of the Western grain farmer, who faces a chaotic world market distorted by subsidies and quotas. On the other hand, the protected dairy and poultry farmers, concentrated in Eastern Canada, are deeply fearful about an MTN result which would replace the existing cosy system of quotas and embargoes with tariffs—initially very high tariffs but coming down over the years.

The existing GATT agreement is unquestionably of critical importance to Canada. It constitutes the basic framework for Canada's trade with virtually all other countries. Even the FTA, and its proposed successor NAFTA, operate within the GATT framework or international trade rules. **Improvements in these GATT rules and in the machinery for their enforcement are in Canada's interest.** Canada has led the effort to accomplish this in the MTNs.

That said, the direct economic benefits to the Canadian economy from the completion of the current multilateral trade negotiations should not be overstated. As noted, even in the field of agriculture, the impact will be mixed: grain farmers may gain but dairy and poultry farmers will feel very threatened.

For most industrial products and for services, the impact of the MTNs is not dramatic nor uniformly positive. In the MTNs, the plan is to reduce remaining tariffs on industrial products by about one third over several years. This will be of benefit to Canadian exporters to overseas markets, notably in Europe and Japan which took about $20 billion of Canadian products in 1991.

In previous GATT rounds, however, overwhemingly the main benefits for Canada stemmed from improved access to the American market for Canadian products—five times bigger than Europe and Japan combined, nearly 20 times bigger for finished goods. This time, of course, free access to that market has already been obtained under the FTA. **The impact of the MTNs will thus be not to improve our access, but to reduce the margin of our preference, in the American market!**

For services, too, far the biggest market is in the United States which is already covered by the FTA. The extent to which the MTNs *increase* overseas competition for Canadian firms in that market may offset the gains in improved access for Canadians in overseas markets.

1993: DECISION TIME

Next year promises to be the Year of Decision on free trade. A number of critical trade disputes, notably over lumber and steel, will come to a head around mid year. The NAFTA legislation will be submitted for approval by Parliament. If the GATT deal is concluded it will also face parliamentary ratification. All this may come together about the time of a federal general election in which at least one party will be calling for abrogation of the existing FTA and rejection of the NAFTA and possibly the GATT deal.

Abrogation of FTA

Is abrogation a serious option? We have studied this question. **Our conclusions point to the serious adverse consequences of any move to abrogate the FTA.** The main findings are the following:

- technically, the abrogation of the FTA would be a simple matter requiring six month's notice of Canada's decision;
- this would be accompanied by the repeal of some—but not necessarily all—of the provisions of the legislation originally implementing the FTA;
- the most serious impacts would fall on Canada's principal exporting industries, i.e. the resource-based industries (which would lose the benefit of the FTA dispute settlement provisions) and the transportation equipment industries (which would see pressures to terminate the Auto Pact);
- the overall impact would be highly adverse as
  - firms that have closed Canadian branch plants to rationalize in American locations would have no incentive to return to the *status quo ante*;
  - business confidence would be shaken by such a fundamental reversal of the economic framework and this could result in the drying up of funds for direct investment, significantly higher interest rates for private (and public) borrowers and the consequent loss of jobs;
  - this capital flight could assume serious proportions if, as expected, the United States responded aggressively with an array of protectionist counter-measures including the threat of terminating the Auto Pact and other bilateral arrangements;
- finally, the abrogation of the FTA would substantially undermine Canada's international credibility and seriously weaken our position with the other leading industrial countries and the other members of the international trading community.

The inescapable conclusion is therefore that proposals unilaterally to abrogate the FTA are profoundly unconstructive at this juncture. Even if one believes that we should not have entered the FTA with the United States, that does not mean we should turn back the clock and repeal the arrangement. Abrogation would not protect Canadian jobs but would, in fact, seriously undermine employment and investment in this country.

That is not to suggest that the FTA could not be improved. There remain important areas of unfinished business and others where experience has uncovered serious problems. Some of these were addressed in the NAFTA, notably in attempting to clarify the rules of origin. Others were abandoned, notably the definition of new fair trade rules. With or without NAFTA, Canada should press for improvement in these areas and should expect a reasonable American response.

Approval of NAFTA

The signing of the North American Free Trade Agreement represents the successful conclusion of a massive undertaking under great pressure and in quick time. Outgoing president Bush was clearly determined to reach an agreement in time to gain credit in the November election; he will now taste the bittersweet fruits of his efforts as he signs the agreement which it will be up to his successor to bring into law.

Much attention has been paid to the difficulties in obtaining legislative approval from the U.S. Congress under the exigencies of the labyrinthine "fast track" procedures. **We do not foresee any insuperable difficulties in American approval.** President-elect Clinton may wish to accommodate his congressional allies by supplementing the NAFTA with "parallel accords" on environmental and labour standards. Reasonable proposals should be acceptable to Mexico and Canada. Clinton may also wish to follow through on Bush's commitment to provide significantly increased adjustment assistance for displaced American workers. These elements could form part of a package which could accompany the NAFTA implementing legislation itself in going to the Congress before the Summer (around June) for approval well before the end of the year.

The much more serious, and largely ignored difficulties may instead come in Canada. **If Prime Minister Mulroney decides to step down, all bets are off: his successor may not be able to accommodate the NAFTA within the very tight legislative timetable before a Fall general election and may well not be prepared to fight the election on free trade.**

If Prime Minister Mulroney stays to fight, free trade may well again be the centrepiece of the election and, despite the devastating results of recent opinion polls, his victory cannot be discounted. He will, however, have serious difficulty in pushing the NAFTA legislation through Parliament before an early Spring election.

Furthermore, passage of the Canadian implementing legislation before the American laws are passed or, possibly, even submitted to Congress would be a dangerous course. Too often in the past, draft American implementing legislation has contained nasty surprises which Canada has expunged only through protracted negotiations and then only with the leverage of our own implementing bill in hand.

Approval of MTN

The approval of an MTN agreement could also be highly controversial. Dairy and poultry farmers may be few in number. Their political influence is substantial as they have proved in past elections, particularly in Québec. The timing could be very awkward for a government dependent for its re-election upon a very strong showing in that province. For these reasons, we suspect the legislation to implement a GATT deal may be deferred at least until after an election.

CONCLUSIONS

Over the past seven years, Canadian trade policy has been centred on free trade—with the United States, in North America and through the GATT. This has been central to the Conservative Government's economic agenda. It is the basis of planning by business.

This basic policy orientation is far from solidly entrenched. Many Canadians are dissatisfied with the results of the Canada-USA free trade agreement—the critics have clearly done a better job of communication than have the FTA's defenders. This will colour the debate over whether the FTA should be abrogated and whether the North American and, possibly, the GATT, agreements should be approved. A number of trade disputes will come to a head.

These issues may play a significant role in the upcoming federal election. Amidst the clash of personalities and the flurry of competing issues, that election may well call Canadians to decide the free trade questions. Should Canada continue to pursue free trade? If so, what are the best instruments to use—bilateral, trilateral, multilateral? The choice will shape the country's economic future.

* Reprinted with permission. Mr. Ritchie's previous annual assessment of the FTA appeared in (1992) 13:1 C.C.P.R. 40.

[1] Cf. Bruce Campbell, A Critique of "The Global Trade Challenge" A Tory Trade Tabloid, The Canadian Centre for Policy Alternatives, October 1992.

[2] Government of Canada, The Global Trade Challenge.

[3] Seasonalized data are matched with non-seasonalized, constant dollars with current dollars and the merchandise and the current trade accounts confused—by both sides in the debate.

[4] Daniel Schwanen, "Were the Optimists Wrong on Free Trade?", C.D.Howe Institute *Commentary*, No. 37, October 1992.

[5] This was the essence of Ambassador Gordon Ritchie's testimony as the government's chief witness during the parliamentary hearings on the FTA and its implementing legislation.

[6] Gordon Ritchie, "Trade Remedies under the NAFTA", submission to the sub committee on international trade of the Standing Committee on External Affairs and International Trade, 24 November 1992.

FTA AND NAFTA

RULES OF ORIGIN - A COMPARISON

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FTA

Rules of origin in trade treaties are driven by economic, commercial, political and social agendas. In fact, the more these forces influence the negotiators the more likely the rules will be burdensome, unclear and in some instances a tool for trade barriers by the parties. The trade agreement between Canada and the United States (FTA) which came into force on January 1, 1989, affects the largest volume of trade between any two nations. The driving forces behind the negotiations created rules and administrative burdens that had not been foreseen by business interests.

The purpose of the FTA rules of origin is to determine whether products which are manufactured with third country raw materials that are substantially transformed through production processes undertaken in North America qualify for a preferential duty rate. Products made entirely of North American materials (Canadian and USA) of course also qualify for the preferential rate.

The USA and Canadian negotiators undoubtedly set about to establish a simple set of origin rules for which regular business records could be used both for self-assessment by a producer and for audit purposes by the customs authorities of each country. After all, onerous administrative requirements placed on manufacturers and/or changes in production processes to "meet" the origin rules can defeat the purpose of any trade agreement. The FTA negotiators attempted to create a set of origin rules that would rely on information that was: (1) already in place; (2) readily available; and (3) common to both parties.

The FTA rules are patterned after the EC rules of origin which provide for the concept of substantial transformation of third country raw materials through a tariff change process based on the Harmonized System of tariff coding (HS). Depending on the HS code for a finished product, all third country materials used must undergo specified movements in HS coding ranging from a change in chapter to a change in sub-heading. A change from one HS code to another (depending on the finished product) theoretically entails a substantial transformation of raw materials derived from labour and production processes, both of which are local economy boosting inputs.

Unlike most European companies, North American firms are not very familiar with the workings of a Customs tariff system, especially the HS code which was introduced in Canada on January 1, 1988, and

a year later in the USA. To enable the politicians to sell the FTA to the public, the negotiators were forced to compromise on this very technical tariff change system by introducing the concept of North American content in highly visible and politically sensitive product areas (automobiles, high tech electronics, wearing apparel, etc). For the automotive industry (principally automobiles, light trucks and parts) a content level of 50% was chosen, largely because the Auto Pact provides for a 50% content level for duty free entry from Canada to the USA. This was deemed to be saleable to Congress and the public. The rules to achieve the 50% level were then negotiated taking into consideration material, labour and processing input costs. Certain costs normally included such as cost of goods sold (COGS) in financial reporting systems were specifically excluded from the calculation. The result is an origin determination calculation that has required separate reporting systems for income tax, management accounting and the FTA. In fact, many companies have had to create new positions, assign additional computer time and engage outside advisors just to satisfy the calculation and annual reporting requirements of the FTA.

The FTA provisions are incorporated in the national laws and regulations of both countries. Despite the uniformity of written provisions, however, the administration of the FTA in both countries has, in certain highly visible and "political" instances, been far from uniform. The differing treatment of interest[1], intermediate materials[2] and royalties[3] are prime examples of this inconsistency.

USA Customs was overruled by the Binational Panel decision on interest which stated that interest was a cost of processing provided it was attributable to the production process. The USA Customs Service had held that the debt for which the claimed interest was being paid must be secured by a mortgage for a specific machine or other asset used in the production of the subject goods. On the other hand, Canada argued that interest from non-mortgage debt was a territorial cost and that position prevailed with the Binational Panel.

The concept and question of acceptability of intermediate materials in vertically integrated manufacturing together with a discussion of the differing treatments by the two customs administrations deserve a separate paper. Suffice it to say that it is highly controversial and one major investigation may lead to another Binational Panel dispute resolution.

The treatment of license fees paid for the right to access production know-how (royalties) is another area of contradictory treatment by the two governments. Canada Customs treats these payments as processing costs although the Canadian administrative guidelines differentiate between territorial and non-territorial recipients of the fees. In contrast, the FTA origin rules appear to provide for processing costs without differentiating between territorial and non-territorial recipients. A simple reading of the provision for royalties leads one to assume that royalty payments made with respect to production in Canada or the USA would be counted both as territorial (numerator of the fraction) and in the total cost (denominator of the fraction). The Canadian interpretation places third country royalty payments solely in the denominator and, as a result, companies that contract for third country know-how are penalized by Canada Customs

for attempting to localize production. This disincentive to investment may prove to be detrimental to Canada's ability to attract new industries which have licensed foreign know-how.

In a surprising move, USA Customs has indicated that such royalties are to be treated as a territorial cost of processing placed equally in both sides of the fraction.

Canada and the USA also differed in the pre-January 1, 1989 education process and in the assignment of the audit functions. The Canadian government spent untold thousands of dollars educating not only importers in Canada but also USA exporters through numerous public seminars, explanatory literature and written and verbal responses to questions of interpretation and reporting requirements. Canada issued its origin regulations in December 1988, late in consideration of the January 1, 1989 implementation, but quickly when one considers the eleventh hour approval by the Canadian Parliament.

The USA Customs Service public information program was in sharp contrast and, there were few, if any, public sessions held in Canada. Although there were some USA-based seminars, most detailed questions went unanswered or were incorrectly answered. Moreover, many requests for written rulings, opinions and policy guidelines from importers and exporters did not even receive responses. In fact, the first USA Customs Service ruling was not issued until more than 18 months into the agreement and the USA Customs regulations promulgated almost a year after the FTA came into effect simply mirrored the text contained in chapter three of the FTA. Guidelines similar to Canada's Customs Memorandum D11-4-12 were not provided either to the public or USA Customs officers in the field.

The administration of the origin section of the FTA was assigned to a newly created section in Canada Customs headquarters, the Origin Determination Directorate. There are some 20 officers assigned to the task of conducting audits and providing guidance to more than 20 additional field officers across Canada. The USA Customs Service placed the FTA origin responsibility on the Regulatory Audit team. Imagine the sole Buffalo Customs officer in the Regulatory Audit section trying to complete his normal tasks and then being saddled with FTA origin rules at one of the busiest commercial ports of entry on the Canada-USA border.

After four years of experience one can speculate that Canada, by disseminating so much information and conducting more or less efficient, effective reviews, has encouraged USA exporters in industries such as carpets and furniture to expand their market in Canada. In the meantime, Canadian industries, particularly the automotive sector (excluding the Big Three), have been subject to long and expensive audits with results which have not been favourable or have required a Binational Panel challenge to correct the situation. One wonders whether the USA has achieved its protectionist goals and also discouraged further foreign investment in Canada.

NAFTA Origin Rules

Armed with input on FTA experience from companies and Customs services, negotiators from Canada and the USA recognized the need for amendments in certain product areas, more clarity in the rules and a set of standard operating procedures and policies. The result contained in the NAFTA Bill presented to the House of Commons on February 25, 1993, is a move from two basic rules of origin (tariff change and content calculation) to three: one based on tariff change and two based on content. Tariff change remains for most products and in fact has been expanded to include some goods that were content-based in the FTA (eg. major appliances). Increased product specificity has also been introduced resulting in the rules of origin expanding from just over seven pages in the FTA to more than 130 pages in NAFTA. The larger set of rules should be easier to work with as there should be no need to understand all the rules of a particular tariff section to determine which one applies to a specific good.

Increased protectionism has influenced the content of the specific rules. Canadian garment manufacturers that had properly taken advantage of the FTA rule of origin to expand business into the USA will be dramatically affected under NAFTA. While garments under the FTA qualified if the fabric used was manufactured in North America, NAFTA will require garments to be made of fabric using North American yarn. In addition, the FTA origin rules for some products which appeared to be incorrectly drafted have not been amended with NAFTA. For example, coated electrical wire, even with the addition of some costly connectors, may not qualify unless the bare wire is of North American origin. A similar situation exists for unrecorded audio cassette and video tapes.

Qualification by content has been split with one rule for automotive or related party transactions where the transfer price is affected by the relationship and another for all other situations/products.

The Big Three in the automobile industry lobbied hard and successfully to change the automotive rules. The content percentage has gone from 50% to an eventual 62.5% by 2002. The rules, themselves, have been simplified and are based more on the regular business records of the producers although the biggest impact may come with the disallowance of the intermediate material concept for virtually all automotive products. Under NAFTA, North American content is to include "tracing" which will require producers to depend on suppliers and sub-suppliers to provide the actual North American content in materials and sub-materials. Such records must be maintained for a number of years failing which content may be denied. The tracing requirement will result in an extensive administrative record system for many companies in the Canadian automotive industry whose principal market is beyond the USA/Canada border.

Certain companies (non-automotive and those where the purchase price for import is not affected by an ownership relationship) whose products require content calculation will be able to choose between two methods. Similar to the FTA, the net cost method (NCM) is a fraction with the total cost as the denominator and total cost minus the value of non-originating materials inputs as the numerator. The resulting fraction

must be 1/2 or greater for qualification. Definitions are provided for all terms and are generally in accordance with the normal records of a producer. There is no provision for tracing.

To simplify the calculation, the same company could choose to calculate content as a percentage of the sale price for export (TVM). Qualification in most cases is achieved when the sum of the sale price minus non-originating material inputs divided by the sale price exceeds 60%.

These two methods, NCM and TVM, are basically simple and should allow companies with large processing, administration, marketing and profit amounts to be less concerned with the origin of materials in the content calculation. Provided a company reaches the 50 or 60% level (with some margin for error or change), calculation of content should be administratively less burdensome under NAFTA. The burden will be borne by the automotive companies forced to use tracing.

The NAFTA negotiators recognized the need for a uniform and consistent application of the rules of origin. They also agreed there should be conformity on audit procedures and certification forms. Canada Customs attempted this with its FTA policy guidelines in the D11 series of Customs Memoranda issued in December 1988. The USA, however, did not adopt many of the policies which has led to disputes over interpretation. NAFTA addressed this by providing that the countries would jointly develop a set of Uniform Regulations although these guidelines have yet to be released and could be crucial in the administrative requirements being placed on exporters, not to mention the question of whether a good qualifies.

NAFTA did introduce some added flexibility for qualification via the tariff change requirements. If the value of non-originating materials that did not change tariff sufficiently in a production process is less than 7% of the total cost or price for export, the product qualifies. The FTA has no De Minimis rule 100% of third country materials must undergo the required tariff change. This should qualify many products for which tariff anomalies resulted in unreasonable findings.

One major concept missing in the rules of origin for all goods except automobiles, is averaging. Both the FTA and NAFTA origin rules do not allow a company to calculate content on a yearly basis either by individual item or by product line. That is, each shipment of each product must satisfy the origin requirement. With swings in production capacity, forced changes of raw material supply (on an interim basis) or cost cutting measures in a certain period the qualification of marginal products could periodically fail. This missing element may cause unnecessary administrative costs for both companies and the Customs agencies and/or business decisions to be based on NAFTA qualification rather than sound commercial principles. One final element also missing from the FTA and NAFTA rules of origin is encouragement for a company to become more efficient and produce more competitive and technologically advanced products for export to third countries. If a Canadian producer's goods are subject to content rules, the majority of which are sold to the U.S.A., it could be in the company's best interest if the spread between FTA and non-FTA rates of duty is significant, to maximize local content. However, what does the same company do in the following

situation: The company has the opportunity to reduce processing costs by $1.00 but in doing so the product does not meet the minimum content levels for NAFTA or FTA. This would increase the U.S.A. duty cost by $3.00/unit making it less competitive with third country suppliers. Is this the purpose of the FTA or NAFTA?

The total impact of the change in origin rules between the FTA and NAFTA cannot be estimated without the Uniform Regulations. For some countries, NAFTA should facilitate trade and open new markets with a clearer set of origin rules and uniform administrative practices. For others, the effect of the change on those that administer, apply or interpret the rules is likely to correspond to the increase in the number of pages dedicated to origin determination between the FTA and NAFTA.

[1] See: In the Matter of: Article 304 and the definition of Direct Cost of Processing or Direct Cost of Assembling, FTA Panel June 8, 1992, Binational Secretariat Case Number USA-92-1807-01.
[2] See U.S. Customs Service Ruling, GLA-2:R:C:M:-000131 JLV, December 12, 1991.
[3] See Canada Customs Memorandum D11-4-12, Guidelines paragraph 55.

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