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**Why There Is Never Peace In
International Trade: The Case of
Canada-U.S. Economic Relations**

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CASE STUDY

WHY THERE IS NEVER PEACE IN INTERNATIONAL TRADE: THE CASE OF CANADA-U.S. ECONOMIC RELATIONS

BY

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I. Introduction and Overview

The trading relationship between independent countries is always characterized by conflicting interests. National governments are ready to liberalize trade in those sectors where the removal of trade barriers leads to a growth in output, increasing employment and more income, while they often wish to maintain trade protection in areas which would be subjected to negative growth, restructuring and unemployment. Thus, the basic principle underlying the theory of comparative advantage is ignored: Each country should specialize in the production of those goods for which it has relatively lower opportunity cost. Obviously, specialization implies necessarily the reallocation of resources and sectoral restructuring.

North America has followed this pattern fairly closely. After a long period of political inaction and protectionism, Canada and the United States finally concluded the Canada-U.S. Free Trade Agreement (CUSFTA) in 1989. Just a few years later, Mexico was added to the free trading bloc with the conclusion of the North American Free Trade Agreement (NAFTA). While these agreements intended to remove most tariffs and a number of non-tariff barriers, a fairly large number of trade conflicts have erupted since the implementation in recent years - surprising only to those who naively believed that national governments and individual firms would not take advantage of any imperfections built into the agreements.

Our focus is the trading relationship between Canada and the United States. In particular, we will analyze why and how trade quarrels continued to erupt as both countries moved towards freer trade. After a brief overview over the developments prior to 1989, we will review the accomplishments and deficiencies of CUSFTA and NAFTA and will explain how these deficiencies can explain the trade disputes in timber, wheat, culture, beer, steel, and so on.

CUSFTA and NAFTA have united 362 million consumers in a single trading area with an aggregate GNP of approximately \$6 trillion (Moss 1992, p. 40). NAFTA therefore represents a larger market than the European Union (EU). The EU is however still a few steps ahead on the road towards regional integration. NAFTA, as a **free trade area**, aims at eliminating all barriers to trade between member countries. The EU has actually started as a **customs union** which is, in addition, characterized by a common external trade policy. With the implementation of its 1992 program (the Single European Act), the EU has moved towards the establishment of a **common market** by eliminating a variety of persistent non-tariff barriers (especially differences in technical standards and discriminatory government procurement) and by permitting the free movement of all factors of production within the EU. With the Maastricht Treaty, the EU has now set course towards the establishment of an **economic union** with a common currency, a harmonized tax system and a common monetary and fiscal policy.

Countries can reap a variety of benefits from furthering economic integration. There are **static** benefits in the form of (1) scale effects due to a larger market size and (2) more intense competition as national industries begin to compete against each other. Economic integration also entails **dynamic** benefits as competitive pressures provide a stimulus for technological change. The presence of such benefits explains why more and more countries move towards regional economic integration and no longer rely exclusively on multilateral liberalization within the General Agreement on Tariffs and Trade (GATT, recently superceded by the World Trade Organization - WTO). The magnitude of the benefits from integration and the scope for conflict depends on the similarity of the countries involved. Canada and the United States are fairly equal with respect to their economic development but the U.S. economy is approximately ten times as large as the Canadian one. In comparison, Mexico, as a newly industrializing country, has a much lower aggregate capital/labor ratio and a

greater abundance of inexpensive, unskilled labor. Table 1.1 highlights some of the socioeconomic differences between the NAFTA member states. The more unequal economies are prior to trade liberalization, the greater is the scope for adjustment along the lines of comparative advantage. While the potential for conflict may be greater as well, the differences in bargaining power can serve as a correction mechanism.

Table 1.1: Socioeconomic Indicators

<i>Indicator</i>	<i>Canada</i>	<i>U.S.A.</i>	<i>Mexico</i>
GNP per Capita, 1990	\$20,470	\$21,790	\$2,490
Average Annual Population Growth, 1980-90	1.0%	0.9%	2.0%
Average Growth of the Urban Population 1980-90	1.1%	1.1%	2.9%
Average Hourly Compensation, 1992	\$17.02	\$16.17	\$2.35
Inflation Rate (% Annual Change), 1989	5.0%	20.0%	4.8%
Real Growth Rate (% Annual Average), 1980-9	3.3%	3.3%	0.5%
Adult Illiteracy, 1990	<5%	<5%	13%
Life Expectancy, 1990	77	76	70

Source: Belous and Lemco (1993), p. 2-3; Conference Board (1991), p. 10.

Conflicts between Canada and the United States arose for very specific reasons. CUSFTA and NAFTA contained a number of gaps, i.e., issues that were explicitly excluded from the agreements: (1) agriculture was generally excluded from liberalization, (2) textiles, clothing and steel were given a special treatment, and (3) regulations for government procurement and standards were left vague. In addition, there were a number of loopholes included in the agreements such as the maintenance of national safeguard procedures and the firms' ability to lobby for assistance from domestic governments. In general, we need to carefully distinguish between the *de jure* and *de facto* interpretation of liberalization agreements. It may very well be the case that one country chooses to tolerate the violation of a free trade agreement for political reasons, for instance because it recognizes the precarious political situation for the partner government and does not want to jeopardize the liberalization process as a whole.

Gaps and loopholes do not appear by accident. They are built into a trade agreement for economic motives such as the protection of growth industries (infant industry protection) or the protection of struggling industries. U.S. protection was for instance also determined by the size of the sector's labor force and the level of import penetration (Cline 1986, pp. 214-215). An overvalued domestic currency or high wage levels can also act as a trigger for protection. As will be explained in subsequent sections, we will probably never encounter a case where trade liberalization is not accompanied by conflict. The trading relationship between Canada and the United States has however been particularly burdened by a variety of trade disputes and serves as a perfect illustration for some of the fundamental dynamic issues that arise in international trade even under the best of circumstances.

II. History of United States - Canada Trade Relations

The movement towards the freeing of Canada-US trade is not a recent development in the bilateral relations of the two countries. In fact, the first effort to liberalize trade between Canada and the United States dates back to 1854, when Governor General Lord Elgin of Canada traveled to Washington to negotiate a reciprocity pact with its Southern neighbor. The resulting Elgin-Marcy Treaty removed tariff and volume restrictions for primary products such as coal, fish, grain and lumber and granted reciprocal access to the Atlantic fishing grounds and the Great Lakes - St. Lawrence waterways (Rugman 1990, p. 16). Overall, approximately 55% of U.S. exports to Canada and 90% of Canadian exports to the U.S. were covered by a free trade regime as a consequence of the treaty.

The movement towards freer trade was reversed in 1866 when the United States refused to renew the Elgin-Marcy Treaty - a direct consequence of the tariff

measures introduced by Canada in 1859 in order to protect its infant manufacturing industry. The following decades were characterized by unsuccessful efforts to restart the process of trade liberalization. Up to the 1880s, the Canadian government attempted a number of times to renew the Elgin-Marcy Treaty but failed to gain U.S. support in every instance. In later years, U.S. negotiators developed an interest in forming a customs union with its Northern neighbor but were rebuffed by the Canadian government which had no interest in weakening its economic ties with Great Britain.

Both countries plunged into an era of protectionism during the interwar period. The United States introduced the Fordney-McCumber tariffs in 1922, mainly in support of U.S. agriculture, and, with a much wider reach, the Smoot-Hawley tariffs in 1930. Nevertheless, the economic ties between the United States and Canada were considerably strengthened during and after World War I. During the war period, for example, government war bonds crowded Canadian borrowers out of the domestic financial markets and forced them to raise funds in the United States. The cross border financing of private investments lowered the de facto barriers between the two countries and furthered financial integration. In addition, the United States' share of foreign direct investment carried out in Canada increased at a rapid pace over this time period.

As illustrated in Table 2.1, the foreign investment shares for the United States and the United Kingdom display a striking negative correlation. U.S. investors started to establish a presence in the Canadian market and thereby circumvented existing trade restrictions while the British became increasingly caught up in the turmoil of war and post-war recession in Europe.

Table 2.1: Foreign Investment[†] in Canada (in %)

<i>Year</i>	<i>U.S. Share</i>	<i>UK Share</i>
1900	14*	85*
1910	19*	77*
1916	30*	66*
1922	50*	47*
1926	50	44
1933	61	36
1945	70	25

[†] Foreign direct and portfolio investment

* Estimates

Source: Rugman (1990), p. 19.

New avenues for greater economic integration opened up as President Roosevelt was empowered by Congress to negotiate bilateral tariff reduction agreements under the Reciprocal Trade Agreements Act of 1934. This resulted in the Cordell-Hull Agreement of 1935 in which Canada and the United States granted each other "most-favored-nation" status and rolled back tariffs to pre-1922 levels. Follow-up agreements in 1938 and 1941 lowered or abolished production quotas on both sides of the border and introduced defense production sharing as part of the joint war effort between 1941 and 1945.

The process of trade liberalization continued at a rapid pace after World War II. As signature nations of the General Agreement on Tariffs and Trade (GATT), the United States and Canada were required to phase out all quota policies. The GATT agreement itself and the subsequent negotiation rounds were instrumental in reducing tariff levels between the two countries over the next few decades. The effect of the elimination of trade restrictions on U.S.-Canada trade is illustrated in Table 2.2. In summary, multilateral negotiations have played a key role in deepening economic integration on the North American continent.

However, the efforts to advance the free-trade agenda continued to work on a bilateral level. Automobiles and auto parts have traditionally made up the largest fraction of total trade between Canada and the United States - in most cases involving subsidiaries of the Big Three (GM, Ford, Chrysler).

Table 2.2: Bilateral Trade Shares for Selected Years (in %)

<i>Year</i>	<i>U.S. Share of Canadian Exports</i>	<i>Canadian Share of U.S. Exports</i>
1926	37.4	N/I
1945	32.6	N/I
1960	56.4	18.1
1970	64.8	22.5
1980	63.9	18.0
1987	76.3	23.7

N/I = no information

Source: Rugman (1990), p. 22.

The Automotive Products Trade Agreement of 1965 allowed for the first time tariff-free passage of most auto parts between the two countries. The agreement had been prompted by American complaints that the Canadian government was offering export subsidies to unfairly encourage auto production in Canada. The joint elimination of tariffs and subsidies helped both governments to achieve their objectives. Nevertheless, the automobile sector continued to be a source of much friction between the two governments. For one, Canada began to offer *overseas* firms the same preferred status as U.S. producers which triggered complaints from U.S. government officials that Canada was unfairly diverting foreign direct investment to its market.

Subsequent years saw the advent of economic nationalism in Canada. The Canadian government began to actively discourage the sale of Canadian companies to foreign buyers. In 1973, Prime Minister Trudeau succeeded in passing the Foreign

Investment Review Act which enabled Canadian officials to block foreign direct investment beyond a certain capital threshold. The actual impact of this provision depended greatly on the cabinet minister in charge. The acceptance rate for new acquisitions reached an overall low in 1981 with 73% for aggregate foreign direct investment and 53% for acquisitions in the energy sector. The effect of these policies on foreign control of Canadian corporations is illustrated in Table 2.3. It should however be noted in this context that the U.S. share of total foreign direct investment in Canada remained relatively constant at approximately 76% over this time period.

Table 2.3: Foreign Control of Canadian Industry for Selected Years (in %)

<i>Year</i>	<i>All Non-Financial Corporations</i>		<i>All Manufacturing Corporations</i>	
	TOTAL U.S.	FOREIGN	TOTAL U.S.	FOREIGN
1970	28.4	37.0	46.0	56.0
1974	27.9	36.7	46.0	57.0
1978	26.2	33.5	45.0	55.5
1980	24.1	31.7	40.5	51.2
1983	22.6	29.6	40.5	50.3
1985	21.9	29.0	39.8	49.2

Source: Rugman (1990), p. 27.

The sectoral effects of these policies are illustrated in Table 2.4. There was a pronounced trend towards more domestic control over sectoral output in Canada between 1970 and 1987. Given that we do not control for changes in the economic environment, it is however **not** possible to speak of a **causality** between nationalistic policies and domestic control over sectoral output.

Nevertheless, economic theory would predict that the economic developments of the time -- the increasing globalization of markets and a shifting comparative advantage away from industrialized countries for certain sectors (steel, textiles, knitting, clothing etc.) -- would have led to a trend into the opposite direction.

Table 2.4: Domestic Control of Canadian Output for Selected Sectors, 1970-1987
(in %)

<i>Sector</i>	<i>1970</i>	<i>1981</i>	<i>1987</i>
Mining	20	52	60
Agriculture and Forestry	93	96	98
Total Manufacturing	39	51	52
Tobacco	18	0	0
Leather Products	73	78	84
Textile Mills	50	48	54
Knitting Mills	78	82	93
Clothing Industries	90	84	91
Machinery	22	49	47
Electrical Products	36	37	42
Chemicals	16	24	24
Construction	85	89	95
All Utilities	89	93	95
Wood Industries	76	83	78
Paper and Allied Industries	55	72	73
Primary Metals	58	85	82
Metal Fabrication	50	64	74
Petroleum and Gas	1	24	26

Source: Twomey (1993), p. 78.

The rise to power of the Conservatives under Brian Mulroney in 1984 was symptomatic for a change in attitudes in trade matters also. By 1986, the acceptance rates for acquisitions had increased to 99%. New establishments were de facto no longer threatened by government disapproval. Shortly after coming into power, Prime Minister Mulroney initiated talks over a free trade agreement with the United States which was eventually implemented in 1989. Interestingly enough, trade liberalization in North America was not an isolated event. With the easing of the Cold War, the powers of the Northern Hemisphere established a „new world order“ while the European Community finally overcame the period of Erosclerosis and took a first decisive step towards a Common Market with the passage of the Single European Act.

III. The Canada - United States Free Trade Agreement (CUSFTA)

CUSFTA was put together within the short period of 4 years - a remarkable achievement given the 120 previous years of inaction and protectionism. Prime Minister Mulroney and U.S. President Reagan had agreed to explore avenues for freer trade during the „Shamrock Summit“ in March 1985. The free trade agreement was ready to be initialed in October 1987, signed in January 1988, approved by both legislators during the same year, and went into effect on January 1, 1989 (Twomey 1993, pp. 123-4).

As of 1988, the Canadian economy had become highly dependent on trade with the United States (Trebilcock/Howse 1995, p. 40). Approximately 2/3 of Canada's imports originated in the United States while 3/4 of Canadian exports had the United States as their destination. The corresponding figures for the United States were 1/5 for U.S. imports and 1/4 for U.S. exports. Karema/Koo (1994) have shown that the U.S. demand for Canadian imports is much more price elastic than the Canadian demand for U.S. imports. The increasing Canadian dependence on the U.S. economy has also implied some loss of political control over macroeconomic developments. Hence, Canada had much more to lose from a disruption of trade than her Southern neighbor. The free trade agreement eliminated some of that downside risk. The fact, that CUSFTA sailed through the U.S. Senate but triggered a federal election in Canada, however illustrates the potential detrimental effect that vested interests can have on trade liberalization.

The agreement contained four key provisions (Conference Board 1991, p. 18):

- All tariffs (including agriculture) were to be eliminated over a transitional time period of 10 years.
- Some non-tariff barriers to trade in agricultural products were to be removed as well.
- U.S. and Canadian antidumping as well as countervailing duties provisions were unaffected by the free trade agreement.
- Both countries agreed to further negotiations over eliminating discriminatory government procurement policies.

The immediate effect of the agreement was a reduction of tariffs affecting 15% of U.S.-Canada trade, the elimination of export subsidies for agricultural products and the partial removal of the Canadian embargo on imports of used cars and aircrafts from the United States. Both countries agreed to implement non-discriminatory procurement procedures for all federal agencies covered by the GATT procurement code with a minimum threshold for individual purchases of \$25,000 -- compared to the GATT threshold of \$171,000 (Trebilcock/Howse 1995, pp. 40-1).

According to CUSFTA, tariffs were scheduled to be phased out by January 1, 1998 with discrete reductions at the beginning of every year. As part of the agreement, Canada was also committed to raising the thresholds for government review of U.S. direct investment takeovers to \$150 million and the elimination of government review of U.S. indirect investment takeovers by January 1, 1992. Finally, both countries agreed to implement a joint mechanism for the resolution of trade disputes by January 1, 1996.

The contracting parties aimed at liberalizing trade for goods originating in the other country and not for indirect imports from third countries. Thus, the United States and Canada specified detailed rules of origin which would prevent third countries from automatically extending their privileged access to one country's

market to the other's market (the so-called „trojan horse“ problem; Weekly 1993, p. 19). In order to be covered by CUSFTA, traded products with foreign components had to either undergo substantial processing (reflected by a change of the product's tariff classification) or had to satisfy specific local content requirements (Trebilcock/Howse 1995, p. 40; Weekly 1993, p. 21).

CUSFTA consists of over 300 pages of text with 21 chapters in 8 parts. The complex details of some of the provisions stands in direct contrast to the simplicity of the term „free trade.“ The numerous gaps and loopholes contained in the agreement help explain the seemingly endless series of petty trade disputes that have survived CUSFTA as well as NAFTA. It is already quite telling if one considers the sectors for which tariffs were not to be eliminated until 1998. These include most agricultural products, softwood plywood, textiles and apparel, steel, beef, tires, rail cars and appliances (Conference Board 1991, p. 19). Without question, vested interests constitute a large part of the equation to explain why the two countries agreed to postpone liberalization for these sectors into the - at the time - distant future.

It is a well-documented result in the industrial organization literature that predatory pricing does rarely enhance firm profits because short-term losses tend to outweigh the present value of long-term gains under any set of reasonable assumptions (Martin 1994, ch. 16). Dumping is nothing else but predatory pricing on an international scale (Trebilcock/Howse 1995, pp. 115-117). It follows that antidumping statutes will generally restrict competition by protecting inefficient domestic competitors from being phased out of the market (Hoekman/Leidy 1989 and 1992). First, it is *ex ante* unreasonable to expect an individually rational firm to engage in dumping. Second, the frequently used legal test for the presence of dumping - the sign and magnitude of the difference between home and export market prices - represents a methodology with a significant Type I and Type II error probability since

we do not control for differences in market conditions and do not test for deviations from static profit maximization directly. Thus, Canada and the United States have left the door open for continued protectionism by leaving their national antidumping statutes intact. The same is true for countervailing duties and retaliation provisions.

We can basically identify five general problem areas associated with CUSFTA:

- CUSFTA did not include an automatism for further liberalization. Thus, it was in principle possible to halt the liberalization process with a shift in one country's political majority.
- The countries were left with considerable discretion regarding the interpretation of CUSFTA rules which created considerable potential for conflict. The decision of the United States to impose tariffs on Honda Civic imports in 1991 serves as an example.
- CUSFTA made very little progress towards eliminating the discriminatory effects of standards on trade. The adopted provisions display great similarity to the GATT standards code.
- Specific sectors such as the Canadian cultural industries, hydroelectricity and air travel were exempt from the agreement.
- The safeguard provisions permit lawful violations of the CUSFTA in protection of vital national economic interests.

A detailed discussion of specific trade disputes is deferred to Section 5.

Overall, the agreement consisted of a series of political compromises with both sides scoring some victories and accepting some losses (Twomey 1993, p. 126). Canada won in agriculture by maintaining protection on dairy and poultry products, in energy by freeing the market for the energy rich western provinces, and in dispute settlement by committing the United States to arbitration. Clear victories for the United States were achieved in automobile trade due to the phase-out of the "duty

remission scheme" (where Canada rebated duties to automobile producers who imported components from third countries), in foreign direct investment by raising the threshold for government review, in energy by securing supply during periods of crisis and in wines by eliminating Canadian protectionism.

CUSFTA has turned out to be a success story for Canada. While Canada's aggregate exports to the United States increased by a mere \$5 billion between 1988 and 1991 (with a 1991 trade surplus of 13.9 billion), the sectoral effects are quite remarkable (Stacey 1992, p. 72). Exports of pharmaceutical products increased by about 90%, chemical products by 33%, plastics by 16%, manmade filament fibres by 133%, clothing (not knitted) by 89%, electrical machinery by 74% railway equipment by 126% and aerospace products by 77%. Overall, Canadian exports to the United States in product areas liberalized by the CUSFTA increased by 33% between 1989 and 1992. Similarly, the United States could realize export gains in Canada of more than 100% for 45 out of 98 product areas where tariffs were cut between 1987 and 1991.

The most important victory for Canada was the establishment of binding arbitration as a final resolution mechanism for trade disputes. Between 1989 and 1992, disputes between the two countries affected 5% of all trade conducted but seven of twelve completed dispute cases were decided in favor of Canada. Without question, the United States alone would have decided most of these cases in its own favor.

IV. The North American Free Trade Agreement (NAFTA)

Exploratory discussions on a U.S.-Mexico free trade agreement commenced in March 1990. The U.S. Congress signaled its support for the initiative by extending President Bush's „fast track“ negotiation powers for another two years. Canada decided to join the initiative soon thereafter. The agreement was ready to be initialed by August 1992 but was followed by a considerable debate over the negative employment effects of adding Mexico with its abundance of cheap labor to the free trade area. Presidential candidate Ross Perot coined the by now famous phrase of „the big sucking sound“ of jobs going South. Hence, the ratification of NAFTA was slowed down by fierce political opposition on both sides of the Rio Grande, because the treaty was opposed in Mexico, too, namely by industrialists who were rightly concerned about the competition from US consumer products and by the traditional nationalists who were always worried about political, economic and cultural domination from the North.

In February 1993, Prime Minister Mulroney resigned from office after he failed to obtain a popular majority for the Canadian constitutional accord which was supposed to reform Canada's relationship with the native Nations and the Québécois. Public opinion polls indicated that Mulroney's government had reached the lowest level of public support in Canadian history. While the constitutional problems actually triggered Mulroney's resignation, many considered Canada's recession whose peak unfortunately occurred right after the adoption of CUSFTA as the actual reason for his downfall (Yoffie/Gomes-Casseres 1994, p. 399).

President Bush had faced the same fate a month earlier. He had not been able to extend his foreign policy competence to domestic issues and lost the election to his successor Bill Clinton in January 1993. President Clinton's commitment to NAFTA

was initially less clear. He came into office with a pro-labor agenda and seemed to endorse Perot's „sucking sound“ hypothesis. U.S. Congress was still ruled by a Democratic majority unwilling to act against labor interests.

To placate some opponents the U.S. Government insisted that Mexico would agree to a trilateral side accord, the North American Agreement on Labor Cooperation, in order to limit negative employment consequences of NAFTA for the United States (Yoffie/Gomes-Casseres 1994, pp. 399-401; Trebilcock/Howse 1995, pp. 184-7). As a result, Mexico had to strictly enforce its domestic labor laws, in particular occupational safety regulations, child labor laws and minimum wage laws. The effectiveness of this side agreement has been questioned from the very beginning given that Mexico had already complied with the corresponding International Labor Organization (ILO) conventions and given that enforcement of the side accord was not guaranteed - despite the creation of a Commission for Labor Cooperation (Gruben/Welch 1994, p. 65). Non-enforcement of labor standards was probably also not a source of competitive strength for the Mexican economy.

A similar side accord was concluded for environmental standards. Again, while marginal firms (such as some Californian furniture companies) may have relocated to Mexico because of laxer environmental regulations, empirical studies were unable to find a statistically significant relationship between the U.S. firms' location choice and environmental abatement costs (Gruben/Welch 1994, P. 64). It can be argued that these side accords merely represented political smokescreens to appease labor and environmental interests.

In many respects, NAFTA represents an extension of CUSFTA to Mexico (Trebilcock/Howse 1995, pp. 45-8). Tariffs between Mexico and its Northern neighbors were to be phased out over a 10-year period. Most import restrictions, in particular import licenses and quotas, were to be eliminated. Non-tariff barriers on

agricultural products were to be converted into tariff-like barriers and then included in the tariff reduction program. Sectors most sensitive to import competition were granted a fifteen-year transition period and individual countries had the ability to reintroduce tariffs in response to damaging import pressures. These safeguard provisions for instance enabled the United States to return to pre-NAFTA tariff levels for a period of up to four years if imports of Mexican goods threaten to cause serious injury to domestic industries. Similar safeguard provisions remained in place with respect to Canada.

As under CUSFTA, detailed rules of origin are used to determine whether a particular product falls under the jurisdiction of the free trade agreement. Products have to undergo substantial processing reflected by a change in the product's tariff classification in order to be considered of North American origin and to receive preferred tariff treatment. NAFTA however implemented stricter origin requirements for certain products, in particular for motor vehicles, apparel and textiles. „Free riders“ from third countries should be prevented from using Canada and Mexico as a „trojan horse“ platform for exports into the U.S. market (Weekly 1993, p. 23; Section 3). It can be argued that these regulations have actually raised trade barriers above pre-NAFTA levels and therefore represent a step towards more protection rather than more trade liberalization. Along similar lines, the stretched phase-in time of trade liberalization for certain sectors - agriculture, textiles and apparel, minerals and banking - represent another protectionist element of the NAFTA agreement (Gruben/Welch 1994, pp. 59-60).

Similar to CUSFTA, the agreement introduced arbitration for the settlement of trade disputes (Lipsey et. al. 1994, ch. 8). Disputes have to be brought before the Free Trade Commission, which consists of cabinet-level representatives of the parties or their designates. If the Free Trade Commission is unable to resolve the issue, the

matter is settled by an arbitration panel under NAFTA or, if the complaining party so chooses, under GATT. As under CUSFTA, each country reserves the right to apply its dumping and countervailing duty laws to imports from any other contracting party. The national prerogative to change these provisions within the bounds of the GATT agreement was also not affected (Lipsey et. al. 1994, p. 115-6). The detrimental effect on the liberalization process is obvious. The unfair trade procedures offer individual firms and producer groups a revealed preferred path to protection (Hoekman/Leidy 1993, p. 235). As R. MacLaren, Canada's Minister for International Trade, puts it, „the ability of member countries to apply their own national trade remedies, particularly antidumping, is incompatible with the free-trade area and remains the unfinished business of NAFTA.“ (ADD CITATION)

It was of vital interest for Canada to be included in the free trade agreement with Mexico. Had the United States been successful in negotiating a bilateral rather than a trilateral treaty, there would have existed a natural bias for firms to locate in the United States rather than in Canada. U.S. locations would have guaranteed tariff-free access to all of North America while Canadian production sites would have faced tariff barriers in trade with Mexico. Canada could realize a number of specific benefits implied in NAFTA (Wonnacut, R. in: Belous/Lemco 1993, pp. 129; Twomey 1993, pp. 143-4):

- Canada gained access to the rapidly growing Mexican market on terms as favorable as those of the United States.
- Canada secured access to Mexican supplies of inexpensive goods (especially inputs). Thus, it leveled the playing field with Europe and Japan (and their low wage sources in the Mediterranean and Asia).
- Canada was able to open up the Mexican market for red meat and grains while retaining its protective shield for dairy and poultry.
- Québec received the added benefit that NAFTA offers her an economically viable way out of Canada

Not surprisingly, the implementation of NAFTA was accompanied by Canadian fears that domestic firms would pack their bags and head South, where wages and taxes are lower, unions weaker and winters milder. In fact, many firms have done so since Ottawa and Washington signed their first bilateral free trade agreement. The Québécois were especially hurting since the uncertainty over the political future of French-Canada had already led to an enormous capital drain for the province and a long-term relocation movement towards English-speaking Ontario over the past two decades.

Nevertheless, Canada appears to have cornered the more lucrative long-term investments of multinational corporations. Philips, a Dutch electrical products group decided last autumn to shift two light-bulb production lines from Mexico to London, Ontario. Chrysler is setting up a research unit in Windsor, Ontario, across the river from Detroit. Toyota is spending \$427 million to more than double the capacity of its Corolla assembly line near Cambridge, Ontario to 200,000 cars per year. All the extra cars will be exported to the United States. Two Swedish firms, Astra Pharmaceuticals and LM Ericsson (a telephone equipment maker), have chosen Montréal as the site for large research facilities with international mandates. Thus, the cold North seemed to have something to offer after all! These firms have discovered that the lure of low wages in the Southern United States and Mexico can be outweighed by the productivity of a loyal, well-educated, albeit highly paid, work force, whose medical expenses and other social costs are absorbed by Canadian taxpayers in general.

Strange as it may seem to some Canadians, free trade has helped make their country a more attractive place to invest. Lower tariffs on output sent South from Canadian factories are one reason. Another is that competition from the United States and Mexico has spurred Canadian firms to improve productivity, mainly by investing in new plant and machinery. A transformation in official attitudes has also improved

the climate for foreign investors. With several provinces likely to hold elections and economic concerns being high on the list of the electorate, even the left-of-center New Democrats now crave for new jobs even more than the approval of labor and environmental groups.

Despite all these positive developments, it is never quiet along the world's longest undefended border. Why do so many quarrels erupt? Part of the reason is the day-to-day jostling of a David with a Goliath. But another is the failure of either CUSFTA or NAFTA to prevent the use of short-sighted domestic trade laws to settle international disputes.

V. There is Never Peace in International Trade!

Free trade agreements represent legally binding contracts which promise an increase in domestic welfare for the country as a whole. Nevertheless, the signing of free trade agreements often represents the starting point for many political quarrels, domestically as well as between the participating countries. Several factors account for this observation.

First and foremost, the political and economic environment is changing continuously and we are not able to write complete contracts which specify the payoff for each country in each state of nature. The world is a changing one and not all changes are fully predictable. Somebody is bound to be unhappy with the consequences of the free trade agreement at some point in time. It also implies that **loopholes** are bound to exist, with the consequence that the existing contractual framework is not readily able to deal with a particular contentious issue. Loopholes emerge, in particular, in the context of escape or safeguard provisions, including the

unfair trade provisions, and from the possibilities to use discretion in the specification and enforcement of standards and other non-tariff barriers (Hoekman/Leidy 1993, p. 219).

Second, free trade agreements do **not** represent what economists call „Pareto improvements,“ i.e., it is not possible to make some people better off while making nobody else worse off. As individual countries take full advantage of their comparative advantage within the free trade area, sectoral restructuring will be inevitable and some input providers will be faced with a decline in income. Hence, distributional conflicts will arise between the winners and losers of trade liberalization. Not surprisingly, the political struggle between these vested interests will already commence at the time the free trade agreement is negotiated.

It follows, third, that interest groups with a negative stake in freer trade will use political pressure to obtain an exemption from liberalization early on. Postponed sectoral phase-ins of liberalization measures represent temporary exemptions while outright exclusions of certain sectors are exemptions of a more permanent nature. We also speak in this context of **gaps** in the free trade agreement.

It is an essential feature of the political economy of economic integration that the holes and loopholes in free trade agreements are to a large extent created by vested interests. The ability of interest groups to influence political processes is however altered once liberalization agreements are implemented. Free trade agreements enlarge the political community and therefore intensify interest group competition. We can expect a temporary interruption of rent seeking activities until the interest groups have reorganized on a national or even regional level.

The interests of consumers are however more difficult to defend in regional trading blocs. While their collective stake clearly outweighs those of individual

producer groups, consumers have great difficulty to organize themselves in political pressure groups given that the negligible stake for each individual consumer makes free-riding appear to be optimal. While national producer groups tend to be sufficiently organized to permit log-rolling, consumers will, with all likelihood, be the odd party out (Hoekman/Leidy 1993, p. 223). If, on top, trade is regulated by supranational authorities, then the lack of accountability and transparency of political decision-making will reduce the influence of consumer groups even further.

It is critical to understand that the direct welfare effects of trade liberalization tell only part of the story. While costs of production and market prices should fall in response to freer trade, the political struggle over how to divide the adjustment burden resulting from sectoral restructuring can imply substantial indirect costs for certain groups in society, in particular for consumers. Thus, while consumers may benefit from wider product availability at lower prices, their net benefit may actually be negative once we account for higher taxes and lower transfer payments.

In this context, it matters greatly how national governments deal with the unemployment resulting from sectoral restructuring (Trebilcock/Howse 1995, p. 178). On the one hand, they can follow the trampoline approach and try to prop up the struggling firms. On the other hand, they can provide a safety net for released workers without saving the declining industries or firms. The former is obviously much more costly than the latter without promising any notable efficiency gains.

Our discussion of CUSFTA and NAFTA has illustrated that the direct benefits of regional integration must not necessarily be positive (see also Hoekman/Leidy 1993, pp. 221-222). The rules of origin may imply tariff equivalents larger than the pre-agreement tariff structure. Regional economic integration may weaken the judicial governance of internal trade by eliminating adequate antitrust enforcement or by

increasing the likelihood that we falsely accuse firms of violating unfair trade provisions.

Finally, regional integration may eventually lead to a reduction of the number of suppliers and therefore reduce overall competitiveness in particular markets. It must however also be recognized in the context of freeing trade in North America that free trade agreements are the weakest form of regional integration - compared to customs unions, common markets and economic unions - and therefore suffer the least from the described shortcomings.

In the remainder of this section, we will discuss a number of different industry examples which serve as an illustration for the continued political and economic struggles between Canada and its powerful Southern neighbor.

A. THE TIMBER/SOFTWOOD LUMBER DISPUTE

The dispute started more than ten years ago with allegations from U.S. timber companies that Canadian rivals were able to buy state-owned timber in British Columbia at below-market prices. The sale of inputs to domestic firms at less than market prices would constitute an implicit government subsidy which would allow Canadian timber suppliers to ship their output at lower prices to U.S. markets. The U.S. International Trade Commission sided with the plaintiffs and imposed countervailing duties on Canadian timber imports - eventually totaling \$450 million (Keatley 1994). In 1993, Canadian softwood lumber exports to the United States were valued at \$4.6 billion and accounted for approximately one-third of U.S. demand (Tamburri 1994).

Canada resorted to the dispute resolution mechanism of CUSFTA to nullify these extra tariffs and recover the tariff revenue. Two dispute resolution panels sided

with Canada, in each case the Canadians constituted the panel majority and the vote was split along national lines (Pierson 1994) - coincidentally, voting along national lines was a rare occurrence in the brief history of panel decision-making (Frum 1993). At this point, the U.S. side should have revoked the countervailing duties and should have returned the \$450 million. Some of the U.S. timber companies however turned around and began to challenge the dispute resolution mechanism on constitutional grounds.

Under the terms of CUSFTA and NAFTA, the binational arbitration panels are supposed to apply the laws of the country directly concerned, in this case Section 303 of the 1930 Tariff Act together with the substantive changes implied in later provisions, most recently the modifications introduced by the Omnibus Trade and Competitiveness Act of 1988. The panel members are generally private citizens, often former judges of the respective countries, appointed by the two governments involved. U.S. timber companies, represented by the Coalition for Fair Lumber Imports, contested that the make-up of the panels and their ultimate purpose represent a violation of the appointments clause - Section 3 of the U.S. Constitution (Kelmar 1993). In particular, the U.S. President and Congress have only been able to nominate a minority of the panelists while the Constitution requires that all officials administering federal laws (and not a subset thereof) are appointed by the U.S. federal executive and legislative branches. In addition, the panel members fail to qualify as life-tenured judges with guaranteed salary protection which puts the independence of the judiciary in doubt.

The United States eventually decided to stop harassing the Canadian softwood lumber producers following the successive losses in the CUSFTA dispute resolution panels (Weintraub/Sands 1995, p. 7). All levies collected prior to the final decision overturning the U.S. trade action have been returned by December 1994. The lawsuits

challenging the constitutionality of the dispute resolution system have also been withdrawn after a number of legal experts assigned a small probability to success.

B. THE WHEAT DISPUTE

The Canada-U.S. wheat dispute started as a grassroots campaign of local farmers in Northern Montana. Hank Zell became an instant local hero as he drove his truck to Shelby, a small railroad town near the Canadian border, and blocked the entrance to one of ConAgra Inc.'s grain elevators which was used to import of millions of bushels of Canadian grain. Hundreds of wheat farmers joined in the protest instantly and helped to keep up the blockade (Kilman 1994). Zell and others claimed that the Canadian wheat trucks pouring into Shelby made it more difficult and costly for them to transact business. Local farmers had to wait for hours in line to sell crop while prices were falling in response to more wheat pouring in from across the border.

As the media picked up on the grassroots campaign, politicians started to come out in support of Zell and his cause. At first, it seemed difficult to find a satisfactory solution for the Montana farmers. The United States has never managed to prove that the Canadian Wheat Board, a government-backed export monopoly, sells wheat abroad for less than what it pays Canadian farmers. The U.S. government eventually resorted to a rather obscure 1933 law which permits the curbing of imports that are depressing grain prices sufficiently to raise the cost of U.S. subsidy programs to protect farm incomes.

The wheat dispute appeared to be a local problem of the Northwestern part of the United States (especially Montana and North Dakota). Canadian shipments to the United States represented only 4% of total U.S. wheat production of 2.4 billion

bushels during the year ending May 31, 1994. While Canada's wheat exports to the United States increased sixfold over the previous five years, the absolute magnitude of Canadian exports, a total of 99.2 million bushels, appeared to be negligible compared to the total U.S. exports of 1.2 billion bushels.

The International Trade Commission handed down a split decision on whether Canadian wheat imports were interrupting the overall U.S. market. This decision cleared the way for the U.S. government to take action and negotiate a bilateral agreement with Canada to restrict wheat imports into the United States. An agreement was reached on August 1 of last year which restricts Canadian annual wheat imports to 55.11 million bushels. It also committed both countries not to initiate any unilateral action against the other within the next twelve months and to establish a joint commission to monitor future wheat disputes (Cooper 1994).

C. CANADIAN CULTURAL PROTECTIONISM

In recent years, Canada's political authorities have implemented a variety of protectionist measures for cultural reasons. The key issue to be analyzed in this context is whether the motive of a particular policy measure is indeed culture and not plain economics. The most explosive case revolves around a 1994 decision by the Canadian Radio-Television and Telecommunications Commission (CRTC) to remove the Country Music Channel (CMC) from the standard cable package and replace it with a newly formed domestic provider, the Canadian Country Network. At the time of the switch, CMC could look back to a ten year history of broadcasting in Canada and was distributed to two million homes.

There are many potential economic reasons why CRTC may have decided to drop CMC, but the action was officially justified on grounds of cultural protection

alone. One must certainly wonder why CMC had access to the Canadian market until a domestic substitute service appeared if culture is indeed the motive. It is also not clear what cultural benefits were created by replacing one country music provider by another.

The CRTC has proposed to define any audio-visual services (World Wide Web, CompuServe, etc.) as broadcasting rather than as enhanced telecommunication services. As broadcasting, these service activities would be exempt from the free trade agreements and could be regulated in favor of domestic providers. The potential for a major trade conflict in this area is obvious. Another proposed action is to end the tax write-down enjoyed by advertisers in split-run Canadian editions of U.S. magazines such as Sports Illustrated and Sports Illustrated Canada. If adopted, advertisers would no longer receive a tax deduction for ads in U.S. magazine editions.

The interpretation of the term „reciprocal treatment“ is always difficult in the context of economic integration. It could mean (1) that foreign firms receive the same treatment here as domestic firms receive abroad or (2) that domestic and foreign firms are treated equally independent of the regulatory regime implemented by the other country. It is obvious that (1) entails a much bigger threat than (2) if the other country's legislation is more restrictive or the market participants do not receive the same type of benefits from their activity. Canada for instance is considering a tax on audio and videocassettes to raise revenue for the royalties when the work of the performers is played on Canadian media. If Canada were to adopt the first interpretation of reciprocal treatment, then U.S. performers and producers would not receive any royalties since there is no similar system in place in the United States.

These examples have illustrated that free trade exemptions (or: gaps in the agreement) open the door for abuse, i.e., the actual effect of an exemption is likely to differ greatly from the original intent.

D. AND THE MANY OTHER DISPUTES AND BARRIERS

A number of other disputes have erupted between the United States and Canada since CUSFTA was signed into law by both countries. The incompatibility of national unfair trade laws and regional integration is illustrated by the following three cases.

- U.S. **carpetmakers** were accused of dumping in 1991. Canadian authorities disposed of the complaint swiftly and imposed punitive duties averaging nearly 12%. The U.S. firms appealed the decision to two special binational panels - one with three Canadians and two Americans, the other the reverse. Both panels ruled in favor of the defendants. The Canadian firms continued to challenge the ruling in Canada's courts (Frum 1993).

- A decline in North American **steel** demand and unfair trading practices of foreign producers, especially from Western Europe, had created a precarious situation for U.S. and Canadian steel producers in the early 1990s. The United States filed antidumping and countervailing duty cases against imports from 21 countries in July 1992. Canadian firms were charged with dumping. As one industry official stated, „most companies on both sides of the border are losing money, so both sides are technically dumping.“ The Canadian firms countered the U.S. actions with same medicine, antidumping suits. The main purpose of these countersuits was to get the United States to the negotiating table in order to conclude a steel trade (two-sided voluntary export restraint) agreement. The conflict is still unresolved although the economic recovery in both countries has taken the urgency out of the issue.

- In 1992, a **beer dispute** erupted between the United States and Canada. Heilemann Brewing Co. and Stroh Brewing Co. had submitted a complaint against certain sales and delivery restrictions as well as charges on imported beer which discriminate unfairly against U.S. suppliers (Bacon 1992). After the complaint was first brought in 1990, all Canadian provinces except Ontario and Québec modified their practices. In response, the U.S. government implemented retaliation measures according to Section 301 of the 1974 Trade Act. All beer imported from Ontario was slapped with a 50% duty while no action was undertaken against the less discriminatory Québec. Canada promptly retaliated by imposing a 50% duty on all

Heileman and Stroh exports to Ontario. The problem could not be resolved on a federal level because these regulatory measures were within the jurisdiction of the province of Ontario. The issue is still pending.

CUSFTA and NAFTA were not very successful in harmonizing national standards (for instance by adopting the European Union's mutual recognition principle, i.e., what is legal in one country is also legal in the entire free trade area). The following examples illustrate the problems resulting from differences in national standards.

- The NAFTA regulations for the transport of **dangerous goods** varies from one member country to another. These differences in dangerous goods policies constitute a restraint to trade since cross border shipments have to comply with more than one set of rules. Canada's regulations are based on the recommendations of the United Nations (UN) while the U.S. Department of Transportation has decided to substantially reformat the UN guidelines. Similarly, Mexico is developing its own set of guidelines, based on the UN recommendations (Cancilla 1994).

- In 1992, the United States and Canada settled a long-standing dispute over performance standards for **plywood and other construction products**. The two countries had withheld tariff cuts when CUSFTA was implemented in 1989 because they could not agree on a compatible performance standard for these products.

Potential incompatibilities arise between a free trade agreement and bilateral agreements with third parties. In particular, sector specific arrangements may violate the most-favored-nations status of another NAFTA country.

- In 1994, Canada challenged an **uranium sales** agreement between Russia and the United States (Tamburri 1994). Under the agreement, U.S. electric utilities can buy

up to 43 million pounds of Russian uranium over the next ten years provided that they buy an equal amount domestically. Canada claimed that the agreement would crowd Canadian mines out of the U.S. market. Several European countries and Australia have protested as well. Russia had established large stockpiles of high-grade uranium and, given the sunk cost effect, was willing to sell the inventory at below-market prices.

Government procurement constitutes one of the most important non-tariff barriers. National political authorities and quasi-public agencies discriminate against foreign suppliers by either always choosing the domestic supplier after open bidding or by restricting the access to the bidding to domestic firms only. The following example illustrates that actions against discriminatory bidding practices may potentially lower market efficiency.

- In 1994, the United States finally succeeded in breaking up the **preferred-supplier relationship** between Bell Canada and Northern Telecom Ltd. (Chipello 1994). U.S. Trade Representative Mickey Kantor claimed that the agreement would open up the market for U.S. equipment producers. Northern Telecom heralded the agreement since it permits the company to service the Canadian market with its U.S. manufacturing units. Thus, this particular agreement seems to accomplish what it promises. It is however a well established result in corporate strategy that maintaining a single, long-term supplier relationship with a single upstream firm can be more cost efficient than repeated open-bidding. Breaking up preferred-supplier relationships is therefore not always a first-best policy.

The illustrations provided so far represent only a subset of the total number of trade disputes that have arisen between the United States and Canada since 1989. It was not until February 1995 that both countries could agree to an open-sky agreement for air travel. Canada continues to be upset over the high U.S. tariffs on sugar and peanut butter imports, and complains that Americans are overfishing the Pacific salmon. President Clinton's budget proposal to introduce a border crossing fee for

Canadians has burdened the relationship between the two governments even further. Problematic is also the U.S. position on Canadian unity. U.S. officials have stated repeatedly that Canada's future is a purely domestic issue but that NAFTA privileges would not be automatically extended to an independent Québec.

The United States complains about continued high tariffs on dairy, poultry and eggs, averaging 150-200% in 1995. The U.S. side would also welcome a reduction of the various direct and indirect subsidies received by Canadian exporters. In addition, the Americans are quite upset about the steady depreciation of the Canadian dollar via the U.S. dollar and the stimulus this gives to Canada's exports.

VI. Discussion and Study Questions

- . Are free trade agreements a step towards freer trade or a step away from it? Argue for and against.

- . Could the selective economic integration through economic unions of border states and provinces reduce the conflict potential between the United States and Canada? Why or why not?

- . Assume all NAFTA members would agree on the legality of trade protection if undertaken for cultural reasons. Suggest a general judicial test to determine the legality of a particular restriction in a court of law.

- . Comment on the following statement: „It is more difficult to liberalize trade between unequal countries than between more equal ones.“ Do you agree? Be sure to define „unequal.“

- . In the context of this case study, explain the difference between „de jure“ and „de facto.“

- . Should the United States have been worried if Canada and Mexico would have concluded a bilateral free trade agreement (without the United States)? Why or why not? How about Canada and the European Union?

- Trade liberalization is not a continuous process but occurs in discrete jumps, i.e., periods with substantial progress are followed by periods of political inaction or even protectionism. How can we explain this phenomenon?
- How should Québec's government and firms located in the province respond to President Clinton's statement that NAFTA privileges will not be automatically extended to an independent Québec? Should it trigger policy changes? How about economic changes independent of any policy adjustments?
- What economic and political arguments can be made in favor of the **mutual recognition principle** as a method of harmonizing technical standards.
- Does the beer dispute imply that federalism on the national level is incompatible with regional integration? Argue for and against.

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