Backgrounder

BP-182E

Canada - U.S. Free Trade Agreement: Major Issues

Anthony Chapman
Economics Division

December 1988

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CANADA-U.S. FREE TRADE AGREEMENT: MAJOR ISSUES*

INTRODUCTION

On 2 January 1988, Canada and the United States signed a free trade agreement (FTA) to be implemented over a ten year period beginning 1 January 1989. This paper discusses the major issues arising out of that agreement.

FREE TRADE VS. ECONOMIC UNION

Does the FTA create free trade or an economic union? Understanding the difference between these forms of association is key, because the latter form implies the harmonization of a number of economic policies that is not required under free trade. The following definitions of various types of economic association are arranged in ascending degree of economic integration:

- Limited Trade - countries limit the flow of trade between each other with tariffs and non-tariff barriers
- Free Trade - countries eliminate mutual tariff and non-tariff barriers to trade
- Customs Union - countries drop mutual trade barriers and apply common tariffs against outside countries
- Common Market - countries allow free movement of goods, services, labour and capital within the trading bloc
- Economic Union - countries unify national, social, monetary and fiscal policies

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* An in-depth review of the FTA implementing legislation introduced in the last Parliament can be found in Library of Parliament Legislative Summary 23E, The Canada-United States Free Trade Implementation Act.

While a particular economic association is unlikely to be completely congruent with any one of these definitions, the Canada-U.S. FTA can be described as a classic example of a free trade arrangement. Mutual tariff and many non-tariff barriers will be eliminated but both countries will maintain their respective trade barriers with third countries. Some changes will be made to the rules governing the transfer of capital and the temporary entry of business persons but substantial restrictions will remain, particularly with respect to the international movement of labour.

RULES OF ORIGIN

Will the FTA's rules of origin permit the duty-free entry to Canada of low-cost Mexican-made goods disguised as American in origin?

Because a free trade agreement does not require signatories to harmonize their external trade barriers against goods from non-participating countries, rules of origin are needed to prevent goods from circumventing the external tariff of the higher tariff country by entering from the territory of the lower tariff country.

The strict rules of origin in the FTA (Chapter 3) require goods to be wholly produced in either Canada or the U.S. or both; if they incorporate offshore raw materials or components, these must be sufficiently processed in either country to be placed under a different tariff classification from the original imported materials. Some goods will also be required to incur a certain percentage of manufacturing cost in one or both countries in order to qualify for the FTA's preferential tariff treatment. As under current law, it will be up to exporters to certify the level of national content in goods. Failure to provide the proper documentation will disqualify goods for the preferential tariff treatment of the FTA. Further, once materials from Canada or the U.S. enter a third country for processing, they will forfeit their FTA-origin status. This provision is to exclude from the FTA's preferential tariff treatment those American goods which, under the so-called Maquiladora Program, are sent to Mexico for further processing before being returned to the U.S.

NATIONAL TREATMENT

In accordance with Article III of the GATT, the "national treatment" provisions of the FTA require that imported goods be treated no less favourably than domestically-produced goods (Article 501). Except for those explicitly mentioned in the Agreement, existing exceptions to such national treatment of trade in services and investment may continue but future changes in government regulation will have to incorporate the national treatment principle.

Does national treatment require that foreign goods, services and capital be accorded the same treatment as they receive in their home market? Actually, these items may be regulated in any manner the Government chooses, providing that this is no less favourable than that for domestic goods, services and capital.

TECHNICAL STANDARDS

Will the FTA force Canada to alter its safety and health standards? Article 603 of the Agreement prohibits the introduction or maintenance of standards that "would create unnecessary obstacles to trade." However, the same article states that measures or procedures with a legitimate domestic objective, and that do not exclude foreign goods which meet that objective, would not be considered unnecessary obstacles. Clearly, the issue is one of establishing "legitimate domestic objectives."

AGRICULTURE

Article 710 of the FTA affirms both countries' rights and obligations under Article XI of the GATT, which permits import restrictions on agricultural and fisheries products. The FTA will not alter current restrictions on dairy imports but will effectively raise import quotas on poultry, turkey and eggs by a small amount.

Although it is evident that Canadian supply management programs will be maintained under the FTA, some argue that competition from lower-cost U.S. food imports will cause Canadian food processors to pressure the Canadian government to remove the programs eventually. The government has not yet fully resolved the food processors' problem but has announced its intention to allocate the increase in import quotas for feather products amongst Canadian food processors.

ENERGY

Few sections of the FTA have raised as much controversy as those related to energy. The two provisions of most concern are found in Article 904, which requires that: a) proportional access to the other country's energy supplies be maintained and b) the government not impose a higher price on energy exports than is charged for these goods when consumed domestically.

Article 904 does not entitle the U.S. to a fixed proportion of Canadian energy supplies; it places restrictions on government interference in cross-border energy trade. Providing the U.S. is permitted to bid freely on Canadian energy supplies, there is no requirement to supply it with a minimum share of this country's energy. If, for example, Canadian energy demand eventually rises relative to the available supply, as foreign contracts expire Canadians may bid on, and obtain, up to 100% of the domestic supply. Only in the event of a sudden emergency would the Canadian government be likely to impose export restrictions on energy but in that case the more stringent sharing requirements of the International Energy Agency would probably apply.*

Part (b) of Article 904, which appears to preclude maintaining domestic oil prices below world prices through government action,

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* Canada is a founding member of the IEA (1974). The IEA has developed an emergency sharing system which may be activated when one or more of its member countries experiences a reduction in normal oil supplies. The emergency sharing system applies to oil resources only, whereas the FTA includes all energy sources.

would restrict future government policy actions. However, the cost imputed to such a limitation depends on the practical usefulness of the policy. There is some debate about this.

TRADE IN AUTOMOTIVE GOODS

The FTA will eliminate all bilateral tariffs on automotive trade between the two countries. Does this effectively "gut" the Auto Pact by removing the incentive for automotive manufacturers in Canada to continue to meet the minimum production levels required in the Auto Pact safeguards?

Providing that Canadian automakers continue to comply with the minimum production safeguards, the FTA will still permit them to import automotive products from third countries duty-free. This is estimated to be worth about $300 million a year in unpaid duty to automakers.

GOVERNMENT PROCUREMENT

Under the provisions of Chapter 13 of the FTA, the rules respecting government procurement will be liberalized by reducing the threshold from the U.S. $171,000 level set in the GATT Procurement Code to U.S. $25,000. With the exception of certain exempted departments in each country, government purchases above the new lower threshold will be open to competition. In the U.S., procurement by the Departments of Energy and Transport and much Defense Department purchasing would be exempt. In Canada, procurement by the Departments of Transport, Communications and Fisheries and Oceans would not be included nor would a large share of Canadian defence procurement. In addition, purchases by provinces, states, local governments or agencies are not covered by the FTA procurement provisions. Under these rules, it is estimated that approximately U.S. $500 million in procurement opportunities will be opened up to U.S. firms wishing to bid on Canadian government contracts while about U.S. $3 billion in U.S. government contracts will be available to Canadian firms.

SERVICES

Except where necessary for "prudential, fiduciary, health and safety, or consumer protection reasons," the principle of "national treatment" must guide future changes to legislation governing U.S. firms providing "covered" services. (Chapter 14) Canadian governments would be at liberty to impose any restrictions they might wish on those services which are not covered by the FTA; for example, cultural industries, transportation, basic telecommunications, medical, dental, legal, childcare and government-provided services such as health, education and social services. (Health care facilities management services are covered in this chapter while financial services, except insurance, are included in a separate chapter.) Not only will existing exceptions to national treatment of service industries be allowed to continue, but governments will be permitted to make the rules respecting exempted industries more discriminatory. For instance, provincial governments could decide not to subsidize U.S.-owned child care services or they could ban their operation entirely.

TEMPORARY ENTRY FOR BUSINESS PERSONS

The measures in Chapter 15 of the FTA will ensure that business visitors, traders and investors, certain professionals and intra-company transferees from each country have quick and easy access to the other country's market, thus facilitating freer trade in goods, services and investments. The FTA does not permit the free flow of labour between Canada and the U.S. since it restricts access to temporary entry only. (Temporary entry is defined as "entry without the intent to establish permanent residence.")

INVESTMENT

The investment chapter of the FTA will raise the threshold from $5 million to $150 million for review of direct acquisitions of Canadian firms by U.S. investors. (Chapter 16) Further, it will require the application of the national treatment principle to future changes in each country's legislation governing the establishment, acquisition and operation of businesses. Do these changes represent reasonable restrictions on the Canadian government's ability to regulate foreign investment? Consider the following key points:

- cultural industries, financial services (except insurance), government procurement, and transportation services are exempt from all provisions of the investment chapter;

- the obligation to provide national treatment with respect to the conduct and operation of business enterprises does not apply to services excluded from the FTA (i.e. medical, dental, childcare, health, education, social services etc.) but all other provisions of the investment chapter do apply to non-covered services;

- all existing investment rules are grandfathered but any legislative or regulatory changes must be consistent with the national treatment provisions of this chapter;

- the FTA's higher threshold for review of acquisitions of Canadian firms by U.S. investors does not apply to the oil and gas and uranium-mining industries;

- approximately three-quarters of non-financial assets that are now reviewable as foreign investments will remain reviewable under the FTA;

- while still substantial, the share of U.S. ownership and control of Canadian industry has been declining since 1970. The stock of Canadian investment in the U.S. has been increasing several times faster than the stock of U.S. investment in Canada.

FINANCIAL SERVICES

Under the FTA, Canada has agreed to lift the restrictions on purchases of Canadian-controlled financial institutions by U.S. investors. (Chapter 17) Does this mean that U.S. investors will be permitted to acquire all of Canada's financial institutions?

The 25% limit on foreign ownership of chartered banks (Schedule A) will be lifted for U.S. investors but, like Canadians, individual U.S. investors (or a related group) will not be permitted to own more than 10% of these institutions. Foreign ownership restrictions on provincially-incorporated financial institutions will be permitted to continue since the financial services chapter relates only to federally-regulated financial institutions. With the exception of insurance companies, which are subject to the national treatment provisions covered in the services chapter of the FTA, the provinces could also choose to limit the entry of foreign-owned federally-regulated financial institutions by denying these institutions a licence to operate within their jurisdiction. As far as investment dealers are concerned, the Ontario and Quebec governments had announced the end of foreign ownership restrictions before negotiations on the FTA were completed.

BINATIONAL DISPUTE SETTLEMENT IN ANTIDUMPING AND COUNTERVAILING DUTY CASES

Chapter 19 of the FTA provides for the establishment of two binational panel procedures. Article 1903 permits setting up a binational panel to review amendments to a country's antidumping and countervailing duty laws while Article 1904 provides for a panel to review antidumping and countervailing duty final determinations. Are decisions by these panels binding?

The first of these (Article 1903) would rule on whether proposed amendments conform to the GATT, the Antidumping Code, the Subsidies Code and the object and purpose of the FTA. If a panel recommended changes to the amending legislation, the two countries would be required to consult to achieve a mutually satisfactory solution. If consultations failed and remedial legislation was not enacted, the country could take comparable legislative or equivalent executive action or could terminate the FTA on 60 days' notice. Thus, the decisions of this panel would be binding to the extent that both countries agreed to abide by its opinions.

Under the second binational panel procedure (Article 1904), either country could request that a panel be convened to review a final antidumping or countervailing duty determination by the International Trade Administration of the Department of Commerce or the International Trade Commission of the U.S. or the Department of National Revenue-Customs and Excise or the Canadian International Trade Tribunal in Canada. The binational panel would apply the domestic law of the respective ruling body. Only in the event of allegations of gross misconduct, bias or a serious conflict of interest on the part of a panel member, or if the panel had seriously departed from a fundamental rule of procedure or had manifestly exceeded its powers, could a country use the extraordinary challenge procedure set out in Annex 1904.13. Section 401 of the U.S. FTA implementing legislation, which amends section 516A of the Tariff Act of 1930, stipulates that a panel decision would not be subject to judicial review, and "no court of the United States shall have the power to review such action on any question of law or fact..." Similarly the Canadian implementing legislation which would amend section 77.2 of the Special Import Measures Act states that "a decision of a panel or committee is final and binding and is not subject to appeal."

CULTURAL INDUSTRIES

Article 2005 exempts cultural industries from the provisions of the FTA while permitting a country to "take measures of equivalent commercial effect in response to actions that would have been inconsistent with this Agreement but for paragraph 1."

Would this Article give the U.S. the right to take retaliatory action and thereby inhibit the ability of the Canadian government to adopt cultural policies that might disadvantage the U.S.? The U.S. already has this right under section 301 of the U.S. Trade Act of 1974. Indeed, this section was used in 1984 to justify retaliatory legislation against Bill C-58, which disallowed income tax deductions for expenses related to Canadian advertising placed in the U.S. media. The FTA formalizes this arrangement but limits retaliation to "measures of

equivalent commercial effect." In addition, the FTA's dispute settlement mechanism can be invoked to settle any differences with respect to the measurement of "equivalent commercial effect."

SOCIAL PROGRAMS

There is no explicit reference in the FTA to social programs. Concern about social programs is based rather on implied pressures that the FTA might generate.

Regardless of whether social programs are actually generally available subsidies or are generally imposed costs, economic theory indicates that they should not distort trade. Trade patterns are determined by international differences in relative production costs (comparative advantage) not by absolute cost differences. Any policy which evenly lowers (or raises) all firms' costs ultimately leads to an appreciation (or depreciation) of the country's exchange rate. This exchange rate adjustment mechanism is evident whenever the inflation rate in one country differs markedly from that of its trading partners.

The idea that generally available programs do not distort trade patterns carries over to the legal definition of a countervailable subsidy. Under U.S. law, for example, application of countervailing duties is restricted to cases where subsidies are provided to "a specific enterprise or industry, or group of enterprises or industries."

Article 1907 of the FTA provides for the establishment of a Working Group to develop a set of rules and disciplines concerning subsidies within the first five to seven years of the agreement's operation.

WATER EXPORTS

Does the FTA deal with Canadian exports of water on a large scale? Tariff item 2201 refers to "waters, including natural or artificial mineral waters..." One argument has been made that inclusion under this tariff item entitles the U.S. to receive a share of Canada's lakes and

rivers. The counter-argument is that, as the title of Chapter 22 of the tariff schedule suggests, this item refers only to "Beverages, Spirits and Vinegar." It should be pointed out that the government has amended the original free trade implementing legislation to exclude explicitly from the application of most sections of the Agreement, "natural surface and ground water in liquid, gaseous or solid state"; Article 401 of the FTA, however, providing for tariff elimination, would remain applicable to natural surface and ground water. There is some debate about the effectiveness of amending only the implementing legislation without also amending the original Agreement.

CONCLUSION

The debate in Canada over the Free Trade Agreement has been extremely active over the past several years. This paper deals with some of the issues most frequently raised during that debate.

Some concerns may be allayed as Canadians become more familiar with the content and implications of the Agreement;other issues remain to be resolved at the negotiating table.

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