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## **The Role of State and Provincial Governments in Canada-U.S. Sectoral Integration\*\***

*by Earl H. Fry\**

### **I. INTRODUCTION**

**T**he United States and Canada have the most complex and expansive trade relationship of any two nations in an increasingly interdependent world. Trade between these two North American countries in 1983 and 1984 actually surpassed that of total two-way trade between the United States and the ten members of the European Community. In 1984, two-way merchandise trade between the United States and Canada topped (U.S.) \$120 billion. U.S. exports to Canada are two times greater than to its number two trading partner, Japan. Canada's exports to the United States, including trade covered by the AutoPact, are four times greater than exports to Japan, which ranks as its second largest export market. The United States and Canada also rank as the number one and two host nations in the world for foreign direct investment.

In spite of the magnitude of economic ties between the two nations, significant barriers continue to inhibit trade and investment flows. In December, 1983, representatives from Ottawa and Washington held the first in a series of discussions on the feasibility of sectoral free trade arrangements. From the outset, both sides expressed reservations, and some trepidation, about the roles which provincial and state governments would play in influencing the course of future bilateral economic relations. Canadian officials were somewhat hopeful that meaningful guidelines for action could be hammered out between Ottawa and the provincial capitals in Federal-Provincial Economic Conferences. Their U.S. counterparts worried that the process would be much more complicated and convoluted on the southern side of the border. Not only would federal officials have to cope with the demands emanating from fifty State Houses, but they would also confront numerous pressures from Congress, where state and regional interests have a much stronger voice than provincial and regional interests enjoy on Parliament Hill in Ottawa. The U.S. representatives were not overly concerned about the Constitutional dimensions of the problem, but rather by the political costs involved in trying to force states to change policies linked to government

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\*\* Paper presented at Conference.

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procurement, export financing, foreign investment incentives and restrictions, unitary taxation, trade sanctions and related areas. The problem for U.S. officials was further complicated by the Reagan Administration's strong rhetoric in favor of a New Federalism which would transfer various areas of responsibility to the state level.<sup>1</sup>

Both Canadian and U.S. representatives clearly recognized that liberalized trade ties would be dependent not only on changes in federal regulations, but also on modifications in state and provincial laws. Leaders of state, provincial, and municipal governments in the United States and Canada are aware that international trade, investment, and tourism linkages are crucial to maintain and enhance the economic well-being of their constituencies. As a result of this awareness, these subnational governments are very actively involved overseas and compete against one another in an effort to facilitate international economic opportunities for their local businesses. The lobbying efforts by the government of Ontario, for example, were pivotal in 1984 in winning the repeal in the United States of the 25% "Buy America" preference on cement used in highway projects.<sup>2</sup> On the other hand, in order to protect important industries at the local level and to increase revenues, these subnational governments have enacted numerous regulations which impede certain types of trade and investment activity.

Most people tend to underestimate the strength and importance of these subnational governments as actors in the international arena. For example, California and New York rank individually among the top dozen economic powers in the world, with California's production base equal to that of all of Africa, and its annual governmental budget of nearly \$30 billion larger than that of most countries around the world. In 1983, California's two-way trade with the rest of the world was \$71 billion, with 75% of this attributable to trade with Pacific Rim nations. California was Japan's second largest trading partner in 1983, ranking only behind the rest of the United States.<sup>3</sup> Leaders of both California and New York have discussed the need to represent the interests of their constituencies overseas.

The governor of Texas, addressing the Council on Foreign Relations in New York City, spoke of the need for Texas to develop, within limited spheres, its own foreign policy priorities. Texas by itself outproduces all of Mexico, and decisions by its leaders affecting trade and investment flows can certainly have an impact on North American economic relations. Quebec leaders have called for the creation of a free-trade zone between Quebec and the United States, a suggestion publicly rebuffed by

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<sup>1</sup> Professor Fry served as Special Assistant in the Office of the U.S. Trade Representative during the 1983-84 period and took part in the early meetings between U.S. and Canadian officials.

<sup>2</sup> GOV'T OF ONTARIO, 2 ONTARIO'S INTERNATIONAL RELATIONS: A PERSPECTIVE 6 (Feb. 1985) (available from Ontario Ministry of Gov't Affairs, Toronto).

<sup>3</sup> See Kotkin, *In This New Age of Entrepreneurs, We're Number One Again*, *The Wash. Post*, Apr. 29, 1984, at B1, col. 1.

the U.S. State Department. The governor of Florida has proposed the establishment of a "Southern Common Market" to promote trade, investment, and regional banking.<sup>4</sup> To say the least, subnational governments in the two North American nations are involved in international economic activities to a far greater extent than ever before and their actions will certainly have an impact on any trade arrangement worked out by officials in Ottawa and Washington, D.C.

This paper will examine the impact which state and provincial government regulations might have on bilateral trade and investment ties under a sectoral or across-the-board free-trade arrangement. Some of the research material which will be cited was derived from an investment policy questionnaire sent to each of the state, provincial, and territorial governments in 1982 and 1983.<sup>5</sup> Forty-four state, seven provincial, and two U.S. territorial agencies responded to either the original or the two follow-up letters asking for their assistance in completing the questionnaire. In addition, personal interviews were conducted with representatives of the Office of the U.S. Trade Representative, the National Association of State Development Agencies (NASDA), the National Governors' Association, the U.S. Department of Commerce, the U.S. Embassy in Ottawa, the Canadian Consulate General in San Francisco, the Conference Board, the Foreign Investment Review Agency (FIRA), the Department of Regional Industrial Expansion (DRIE), and the governments of Quebec, Ontario, Alberta, and Utah. Publications from the U.S. Department of Commerce, the National Governors' Association, and Canada's Foreign Investment Review Agency also provided some

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<sup>4</sup> See Bus. Wk. 60, 64 (June 13, 1983); Savoye, *States, Cities Look for Ways to Help Small Businesses Sell Goods Abroad*, Christian Sci. Mon., June 21, 1983, at 4, col. 1.

<sup>5</sup> The following questions were posed to state, provincial, and territorial representatives:

1. What are the specific incentive programs available to foreign investors willing to invest in your state or province? Are the same incentives available to domestic investors?
  2. What are the specific restrictions governing foreign investment in your state or province (including investment in farm, ranch, and commercial properties)? Is there pending legislation which might adversely impact upon foreign investment?
  3. Does your state or province have any offices opened abroad for tourism, trade, and investment purposes? If so, where are these offices located, when were they opened, and how large is the current overseas staff?
  4. Does your state or province sponsor trade and investment missions abroad? If so, how frequently? In addition, please provide some of the highlights of recent missions abroad.
  5. What is the dollar value of foreign direct investment in your state or province, and how many jobs have been created because of this investment?
  6. What specific changes would your government like to see made in the federal government's policy toward foreign investment?
  7. Do municipalities in your state or province also actively attempt to attract foreign direct investment? Please provide some specific examples.
  8. Please include any additional comments or observations which you believe should be made about foreign direct investment in your state or province. In addition, please send a sample kit which your state or provincial agency would forward to a foreign resident or corporation expressing an interest in investing in your state or province.
- Six states and three provinces did *not* respond.

pertinent information about states and provinces whose officials did not respond to the questionnaire.

## II. THE THEORETICAL DIMENSION

Within an increasingly interdependent world setting, subnational government units have become acutely aware of the influence which international actors such as transnational corporations may have on the economic well-being of their constituencies. Moreover, as a result of significant differences among subnational units in terms of economic development, class, ethnicity, political preferences, or even historical linkages to external entities, one or more subnational governments may well wish to pursue international policies which differ significantly from policies preferred by the central government or other subnational government units. These differences may therefore lead to disparate pressures being placed on the central government in terms of foreign policy priorities or may even prompt the subnational government units to establish their own international linkages.

Without a doubt, the mixture of increasing global interdependency, major societal differences among subnational units, and constitutional ambiguity concerning the international competency of subnational government units provides a great deal of impetus for such units to expand their international contacts. In the case of the democratically elected Parti Québécois provincial government, the forging of international linkages has been considered, at least until recently, as a key facet in its quest to create a politically sovereign Quebec nation. Yet even for subnational government units with less ambitious goals, the expansion of their international activities further complicates the effort to determine what "policies" are being pursued by a "nation-state" abroad, particularly in view of organizational process, bureaucratic politics, and transnational considerations. The questions are: what are the implications of subnational government activities in the international sphere? and, can national governments cope with the evolving "many voices" phenomenon in an interdependent world?

The efforts of the international business community to decipher political trends within nation-states have certainly been complicated by the recent emergence of subnational governments as salient international actors. James Rosenau has pointed out that a new feature in the transformation of world politics is the growing coherence and importance of subnational groups and a corresponding increase in divisiveness within national communities. In looking at Quebec, Scotland, the Basque section of Spain, and other regions, Rosenau concludes that "sub-groupism" has become a strong rival of nationalism. Where the rights, welfare, and aspirations of subnational groups "were once strictly domestic matters, now they are an integral part of the global system, rendering its structures more volatile as well as adding to the tendency toward

decentralization.”<sup>6</sup>

Scholars such as Keohane and Nye have identified three basic types of interactions within the international system.<sup>7</sup> “Interstate interactions” pertain to official exchanges between representatives of national governments. “Transgovernmental relations” are linked to “sets of direct interaction among sub-units of different governments that are not controlled or closely guided by the policies of the cabinets or chief executives.”<sup>8</sup> The final category, which has been labeled “transnational interactions,” deals with “the movement of tangible or intangible items across state boundaries when at least one actor is not an agent of a government or an intergovernmental organization.”<sup>9</sup>

The international activities of subnational governmental units, a special variant of the transgovernmental interaction typology developed by Nye and Keohane, represent a phenomenon which has thus far been largely overlooked even in scholarly works devoted to the influence of internal pluralisms on international relations.<sup>10</sup> Subnational government units, particularly in federal systems, generally possess a constitutionally derived area of policymaking competency. However, the division of authority between a central government unit on the one hand and regional government units on the other is often tinged with grayness and is at times subject to intense controversy, particularly if significant societal cleavages are found within a nation.

### III. THE GROWTH OF SUBNATIONAL ACTIVITIES IN THE INTERNATIONAL ARENA

The evidence of a vast increase in subnational interactions in the

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<sup>6</sup> J. ROSENAU, *THE STUDY OF GLOBAL INTERDEPENDENCE* 87 (1980). He adds: [T]his fragmentation, of course, has contributed substantially to both the proliferation of macro units and the decline in governmental effectiveness. No less important, it has also altered the basic structures of world politics by bringing questions pertaining to the internal fabric of societies much more fully onto the global agenda.

<sup>7</sup> Keohane and Nye, *Transnational Relations and International Organizations*, 27 *WORLD POL.* 39 (1974).

<sup>8</sup> *Id.* at 43.

<sup>9</sup> Keohane & Nye, *Transnational Relations and World Politics: An Introduction* in *TRANSNATIONAL RELATIONS* xii (1972). The authors place transgovernmental and transnational interactions together into a category known as “transnational relations” in order to differentiate these two phenomena from the state-centric connotation of the term “international relations.”

<sup>10</sup> For example, the subnational government dimension is either glossed over or ignored entirely in such important works as R. KEOHANE & J. NYE, *POWER AND INTERDEPENDENCE: WORLD POLITICS IN TRANSITION* (1977); and R. MANSBACH, Y. FERGUSON & D. LAMPERT, *THE WEB OF WORLD POLITICS* (1976).

In his article “*Foreign*” *Policies of U.S. Publics*, 21 *INT’L STUDIES Q.* 277 (June 1977), Chadwick F. Alger looks briefly at the activities of local and state governments in the international sphere. Other preliminary research on this topic is found in E. FRY & G. RAYMOND, *IDAHO’S FOREIGN RELATIONS: THE TRANSGOVERNMENTAL LINKAGES OF AN AMERICAN STATE* (1978); and Fry, *Provincial Politics and Canadian Foreign Policy*, in *ENCOUNTER WITH CANADA* (W. Reilly ed. 1980).

international arena is voluminous. In 1970, four American states had opened offices overseas for the purpose of attracting foreign investment and enhancing trade and tourism opportunities. Today, more than thirty of the states have opened one or more offices abroad. During the same period, the number of states having international trade and development programs increased from 15 to 49.<sup>11</sup> State expenditures for overseas promotion quadrupled from 1976 to 1980 and the number of offices abroad mushroomed from 19 to 66 during the same period.<sup>12</sup>

When Volkswagen announced a few years ago that it was searching for a plant location in the United States, thirty-five states expressed a strong interest. Pennsylvania finally landed VW, but the bidding war among the states became so intense that the Pennsylvania state government had to piece together an incentive package worth between \$65 and \$100 million for the German-based transnational corporation which is partially owned by the federal government in Bonn. Thirty-nine states entered the bidding war for Nissan Motor Company's proposed truck assembly plant. Tennessee won the contest, but will spend \$66 million in incentives. Kentucky touts itself in Canadian newspapers as Canada's "eleventh province," and New York proclaims to domestic and foreign investors alike that "the ninth economic power in the free world isn't a country," and that it has established a special hotline to service potential investors.<sup>13</sup>

Canadian provinces have engaged in the same type of heated competition for investment projects and have now opened more than forty offices overseas for trade and investment promotion activities. Recently, Quebec and Alberta have both created Departments of International Trade. Ontario buys space in European magazines, claiming it is the "strategic location in North America."<sup>14</sup> There may be some truth to this claim, for trade between Ontario and the United States in 1983 was actually greater than U.S. trade with Japan. Ontario was also the largest market in the world for U.S. exports in 1983, with Japan ranking second and the rest of Canada third.<sup>15</sup>

Australia, which has attracted hundreds of millions of dollars in new foreign investment over the past few years, has seen state pitted against state, and state governments in sharp disagreement with the federal government over investment and economic development priorities.<sup>16</sup> The state of Western Australia has placed full-page advertisements in foreign newspapers trumpeting the fact that the "time is ripe" to invest in a resource-rich state four times larger than Texas.<sup>17</sup>

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<sup>11</sup> Neuse, *State Activities in International Trade*, 55(2) STATE GOV'T 57 (1982).

<sup>12</sup> BUS. WK. 25 (Mar. 2, 1981).

<sup>13</sup> See N.Y. Times, Oct. 13, 1980, at D3.

<sup>14</sup> ECONOMIST 40 (Feb. 25, 1984).

<sup>15</sup> ONTARIO ECONOMIC COUNCIL, FREE TRADE 1 (March 13, 1985).

<sup>16</sup> Toronto Globe and Mail, Aug. 17, 1981, at B14.

<sup>17</sup> See, e.g., Christian Sci. Mon., July 27, 1981, at B1-2, B20.

Not only regional governments are involved in what has been termed a "civil war for foreign money," but municipalities have also entered the fray.<sup>18</sup> For example, Mayor Andrew Young has stated that he will make his city of Atlanta the gateway for trade with Africa. The mayor of Dallas has plans to turn the Texas metropolis into an "international city." He has established a task force on international trade and wants to develop a free-trade zone in part of the city.<sup>19</sup> In an effort to provide more jobs for local people and to diversify its economic base, the South Carolina city of Spartanburg began actively recruiting foreign investors almost two decades ago. This campaign has paid big dividends with more than 50 foreign firms investing in excess of \$1.2 billion in the city and creating thousands of new jobs.<sup>20</sup> Another American city, Danville, Illinois, was nosed out by an Indiana city in attracting a West German-owned factory because the latter city could offer better incentives for defraying the costs of unemployment insurance and worker's compensation. Altogether, 60 U.S. cities competed for this one factory. Danville is now prepared to offer stiffer competition in the future because it finally convinced the Illinois legislature to authorize local communities to offer up to one million dollars in tax abatements over a ten-year period.

In the autumn of 1981, the U.S. Conference of Mayors agreed to sponsor a five-day "Investment in America's Cities" program and exhibit in Zurich, the first of its kind. Direct mailings containing advertisements and invitations were sent to 2,000 potential investors in Europe. Approximately eighty U.S. cities signed up to rent booths at the trade fair, ranging from huge New York City to diminutive Bastrop, Louisiana. Six hundred potential investors attended the sessions.

In March, 1983, sixty municipal governments in the United States sponsored an investment conference in Hong Kong with the hope of attracting considerable investment from the Asian rim countries. In trade magazines and journals, it is now quite commonplace for municipal and county governments such as Saint-Laurent, Quebec, and Seward County, Kansas, to advertise investment opportunities in their areas of jurisdiction.<sup>21</sup> With over 22,000 county and municipal governments in the United States alone, the competition for investment dollars both at home and abroad may become much more intense in the years ahead.<sup>22</sup>

To enhance cooperative ties and facilitate economic linkages, certain

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<sup>18</sup> *ECONOMIST* S-14 (Oct. 25, 1980).

<sup>19</sup> Savoye, *supra* note 4, at 4, col. 1.

<sup>20</sup> See Ricks, *The Impact of Foreign Direct Investment in Spartanburg*, *BUS. AND ECON. REV.* 29 (Dec. 1982).

<sup>21</sup> See e.g., *Plant Sites, and Parks: The Newsmagazine of Economic and Office Development* (Jan./Feb. 1985).

<sup>22</sup> According to the U.S. Census Bureau, 82,341 governments existed in the United States in 1982, an increase of 2,428 from 1978. Approximately 30,000 of these are special districts which provide one or more particular services. See *USA Today* 1 (Oct. 17, 1983).



subnational governments have also strengthened relations with their counterparts in other nations. This is particularly the case between the United States and Canada. Several New England governors now meet on an annual basis with the premiers of Eastern Canada and have established a broad range of institutional agreements. For example, at the eleventh annual meeting of this group held in June, 1983 on Prince Edward Island, the leaders agreed to look at the feasibility of a regional free-trade arrangement for high technology products.

Quebec has entered into agreements with New York and New England to export more than \$10 billion in electricity to these regions over the next several years. Governors from eight states and premiers from two provinces have recently agreed on a charter to protect water rights in the Great Lakes.<sup>23</sup> Representatives of Alaska, British Columbia, and the Yukon also meet on a regular basis, as do officials of several other provinces and border states. These cross-border exchanges prompted the U.S. State Department, for a time, to station an officer in Ottawa to monitor subnational linkages between the two nations.

The overall thrust of U.S. states and municipalities abroad has also precipitated the establishment within the State Department of a Liaison Office with State and Local Governments. Representatives of this office help to monitor and coordinate the many one-on-one relationships established between officials of U.S. state and local governments and their foreign counterparts.<sup>24</sup> Plans are also under way for the Office of the U.S. Trade Representative to establish an Advisory Committee composed of state and local government and port authority representatives. This action was prompted in part by a request from the National Governors' Association that the U.S. Trade Representative consult with the states on international economic policy matters which might impact upon the states, and that no policy be implemented which might be injurious to the state's efforts to attract foreign direct investment.

#### IV. THE INVESTMENT INCENTIVE AND RESTRICTION POLICIES OF THE CANADIAN PROVINCES

Canada has one of the most decentralized federal systems in the world, with the provincial governments exercising a wide range of policymaking powers. Regionalism has also been a very strong factor in Canada's historical evolution and Canadians continue to have a very weak sense of national identity. Moreover, the presence of two major language groups has caused its share of problems. Lingering in the back

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<sup>23</sup> The Great Lakes Charter was signed in February, 1985, by governors of New York, Pennsylvania, Ohio, Michigan, Indiana, Illinois, Wisconsin and Minnesota, and by the premiers of Ontario and Quebec.

<sup>24</sup> An overview of the responsibilities of this State Dept. office will be found in: W. B. Carter (Ambassador-at-Large for Liaison with State and Local Governments), *State and Local Governments as Partners in the International Community* (distributed by the U.S. State Dep't).

of many French Canadian minds is the fear that the six million or so French-speaking North Americans will eventually be swallowed up and assimilated by the 240 million English-speaking people who inhabit the continent. Quebec has increasingly been viewed by francophones as the homeland for French-speaking people who desire to preserve their language and culture. A siege mentality has in some respects developed with Quebec being viewed as an island sanctuary in a sea of English-speaking people. Consequently, what is viewed as good for Canada, which is dominated by English Canadians, is at times viewed by French-speaking Quebecers as bad for their province. The struggle through most of the 20th century to modernize and to find an acceptable amendment formula for the Canadian constitution clearly illustrates the differing perceptions and priorities of the Quebec provincial government and those of Ottawa and the remaining nine provinces.

Uneven economic development and the emergence of a heartland-hinterland syndrome have also attributed to occasional breakdowns in relations between Ottawa and the provincial capitals. Far too often, these governments have viewed their relations in zero-sum terms—the perception that if one level of government wins, the other must automatically lose. Moreover, the fact that more than 60% of the entire population resides in just two provinces, Ontario and Quebec, and that 85% of Canada's developed oil and gas reserves are concentrated in Alberta, has not helped to mitigate the problem.

Ontario is also far and away the dominant manufacturing, financial, and communications center in Canada, with Toronto playing a much more pivotal role in the Canadian system than do New York and Los Angeles combined in the U.S. system. In addition, per capita income levels and unemployment rates differ dramatically from province to province, with the Atlantic region in much worse shape than Ontario and the Western provinces. Furthermore, the government institutions in Ottawa are poorly equipped to articulate provincial interests and concerns. In spite of the sweeping electoral victory by the Progressive Conservatives in September, 1984, Canada's federal party structures continue to be regionally-based, rather than nationally-based organizations.

It may be argued that in certain limited instances, the European Community, which is composed of ten distinct nation-states, has provided for a freer flow of goods, services, capital, or human beings than the Canadian confederation. However, Canada's 1982 constitution should ameliorate some of the negative economic effects of regionalism.

Most provinces currently have preferential purchasing policies and some show favor to local institutions in their securities laws. Some provincial statutes also mandate favoritism to local labor and make it extremely difficult for workers from other provinces to seek out local employment opportunities. Although changes are now being instituted because of court challenges linked to Canada's new Charter of Rights and Freedoms, Quebec law has stipulated that French must be the lan-

guage used by large businesses in that province. Any enterprise not complying with this edict could suffer major civil penalties and forfeit its contracts with agencies of the Quebec government.<sup>25</sup>

Pierre Trudeau intended that the Constitution Act of 1982 and the Charter of Rights and Freedoms would solidify national economic linkages in Canada. Yet even this endeavor has left much to be desired. For example, the "notwithstanding clause" in the Canadian constitution permits provinces to override any provision of the Charter of Rights and Freedoms for five years and then to renew that override indefinitely at five-year intervals. In contrast, no provision in the U.S. Bill of Rights or its subsequent interpretation by the federal court system can be set aside by a state government.<sup>26</sup> The "notwithstanding" provision in the Canadian system means that mobility rights and other tenets which would foster the development of a national economic system could be ignored by provincial governments more interested in protecting and enhancing local economic development.

The "opting out" provision in Canada's new constitution will also permit provincial governments to ignore duly ratified constitutional amendments if these amendments impact upon provincial authority. This loophole could lead to a system of checkerboard federalism and frustrate efforts to develop a national consensus on "rules of the game" for the economy. The preliminary progress report issued by the Macdonald Commission on the Canadian Economy has expressed disappointment with the many provincial barriers to the movement of goods, capital, and workers. The report also criticizes the new constitution for its failure to confront head-on the economic balkanization of Canada, and suggests that because of the GATT and other international agreements, sovereign nations have a better chance of eliminating trade barriers among themselves than do Canada's provinces.<sup>27</sup>

This economic and cultural balkanization has done little to facilitate improved channels of communication between and among the national and subnational government units. Indeed, Quebec held an historic referendum in 1980 to determine whether or not it wanted to begin the formal process of separating from Canada. Although the referendum was soundly defeated by a 59% to 41% margin, and the Parti Québécois has recently made an about face and dropped its separatist platform, there continues to be great resentment and suspicion among many French-speaking Quebecers concerning how well the English-speaking majority in the rest of Canada will treat them. Francophones make up 80% of the population of Quebec, but only 25% of the overall population of Canada.

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<sup>25</sup> See series of articles on provincial barriers to trade, *Toronto Star*, Mar. 23-25, 1985.

<sup>26</sup> For a discussion of this issue see Esman, *Federalism and Modernization: Canada and the United States*, 14 *PUBLIUS* 37 (Winter 1984).

<sup>27</sup> *Toronto Globe and Mail*, Apr. 17, 1984, at 1.

In both Atlantic and Western Canada, there is also considerable resentment toward Ottawa and Central Canada (namely Ontario). Many people in these provinces perceive that their regions have been treated as hinterlands and that they have had to make major sacrifices, such as paying for historically high tariffs on manufactured products, in order to build up the industrial base in Central Canada. Albertans have especially felt this way, and when the dispute over oil pricing could not be resolved with Ottawa, the provincial government in Edmonton ordered a phased curtailment of oil production. Associations were soon formed in various parts of the province calling for Alberta's independence or for the four Western provinces to join together to form a new nation.

Lacking the cultural and ethnic impetus found in Quebec, the separatist movement in Alberta never did attract widespread support. The pricing agreement finally worked out by Edmonton and Ottawa in September, 1981, helped to defuse the separatist issue. The Liberal government made Edmonton even happier when it agreed in July, 1983 that "old" oil discovered before 1974 would be valued at about 80% of the current world price and "new" oil discovered after 1974 would be allowed to increase to the world price. Tensions were further eased as a result of the energy package agreed to by the Mulroney government and the Western provinces in the spring of 1985. Nonetheless, resentment is still apparent in the West and other parts of Canada that regional economic demands will continue to strain relations between Ottawa and many provincial capitals.

In the arena of investment policy, some provinces never approved of the now-defunct Foreign Investment Review Agency (FIRA) and asked for complete autonomy over investment decisions within their own areas of jurisdiction. In the meeting of the provincial premiers held in the deep recession days of the autumn of 1982, eight of the ten provincial leaders demanded that FIRA restrictions be suspended or eliminated permanently. FIRA officials recognized that they were not considered as kindred spirits in certain provinces and labored diligently to seek provincial approval before passing along their investment recommendations to the federal cabinet in Ottawa.

According to FIRA's chief official, Ottawa and the provincial governments disagreed on only 3% of the decisions rendered by the federal cabinet.<sup>28</sup> Some provincial representatives take exception with this statement, but it is still very clear that if a foreign investor were able to gain the support of the local and provincial government for a new project, the chances were excellent that FIRA and the federal cabinet would grant the necessary approval. In the cases where investment proposals must still be submitted for review to the new Investment Canada organization, an effort aimed at garnering initial support from local and provincial gov-

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<sup>28</sup> G. Howarth (former Commissioner of FIRA), Remarks given at the Canadian-American Society, San Francisco (Feb. 9, 1981).

ernment units will continue to be a smart strategy for many prospective foreign investors.

Support for investment restrictions differs dramatically from province to province. Ontario has traditionally provided the backbone of support for investment screening and for Canadianization. Because 10% of Ontario's work force is employed by foreign-owned firms, the Ontario government has even set aside a modest amount of money to provide loans to Canadians wanting to buy back firms from foreign owners.<sup>29</sup>

As enunciated in the Quebec government's 1979 publication, *Challenge for Quebec*, provincial leaders in Quebec City would also seem, on the surface, to be rather nonreceptive to various types of investment, but a close reading of the situation shows that Quebec recognizes the role which foreign direct investment must play in the expansion of the province's economic base. Several other provincial governments are also somewhat hostile to foreign direct investment in selected extractive industries. On the other hand, the Atlantic region and parts of the West would heartily support any type of investment which would provide jobs for local people. In addition, during times of economic difficulties, all provincial governments become much less selective toward direct investment proposals, recognizing that keeping people gainfully employed may well determine the government's success or failure at the next election.

Foreign investors must recognize, however, that provincial governments are more interventionist than state governments in the United States or their subnational counterparts in most other countries. Saskatchewan, which is home to 40% of the world's known reserve of high quality potash, began the process of nationalizing a good share of that extractive industry in 1975.<sup>30</sup> Under the threat of expropriation, Asbestos Corporation, a subsidiary of General Dynamics Corporation of St. Louis, finally agreed in the latter part of 1981 to sell a majority of its stock to the Quebec government.

Several of the provincial governments directly control significant parts of key extractive, insurance, and financial industries and often maintain monopolies over hydroelectric and other utility sectors. Saskatchewan, for example, has approximately thirty Crown (state controlled) corporations. Quebec government holding companies have purchased a controlling interest in a large Canadian firm, Domtar, and have been seeking out large equity positions in other major private firms with significant operations in Quebec. The 450,000 member Quebec Federation of Labor has also initiated a plan to build up a multimillion dollar union fund to buy into Quebec companies with the help of seed money provided by the provincial government. Union members would make

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<sup>29</sup> The Ontario government buy-back arrangement has, thus far, been largely symbolic. Only \$10 million was set aside during the first year and, as an opposition party representative pointed out, at that rate Ontarians could buy out the foreign firms in approximately 250 years.

<sup>30</sup> Molot & Laux, *The Politics of Nationalization*, 12 CAN. J. OF POL. SCI. 227 (June 1979).

voluntary weekly payroll deductions for investment in the fund, and the provincial government would provide tax-free incentives to make the investment more attractive to the workers. The proposal is almost unparalleled in the Western industrialized world, and the fund could attain \$200 million within five years, providing Quebec workers with a greater say in the business decision making process in the province.<sup>31</sup>

The Parti Québécois government has also passed major amendments in the labor code which restrict the operating leeway of labor-troubled companies. For example, a company is prohibited from using non-management employees or management personnel who normally work outside the affected facility to fill the jobs of striking or locked-out union members.<sup>32</sup> Through the intermediary of the Ontario Energy Corporation, the Ontario government has also purchased a controlling interest in Suncor, a subsidiary of Sun Company of Radnor, Pennsylvania. Suncor holds valuable oil leases and operated Canada's first oil sands extraction plant in fort McMurray, Alberta. All of these examples underline the fact that provincial governments are not timid about intervening in the economic sector. Likewise, foreign investors can often anticipate that some of their major competitors for business in Canada will be enterprises partially or wholly owned by provincial governments.

Conversely, each and every provincial government desires to attract some or most types of foreign direct investment and more than forty foreign offices have been opened by provincial governments. Every province also provides incentive packages to foreign investors, as do several municipalities. When combined with regional industrial grants from the federal government, these incentive packages can be worth tens of millions of dollars to prospective foreign investors.

Generally, significant incentive packages will be offered by one or more of these governments, especially in the manufacturing and high technology sectors. The Quebec government agreed early on to modify its revered "Bill 101" language law in order to permit children of temporary residents in Quebec to attend English schools, regardless of the parents' language background. This modification was prompted entirely by Quebec's desire to entice more foreign businesses to establish facilities in the province as a way to offset the loss of an estimated 130 major companies and at least 40,000 jobs since the Parti Québécois came to power in 1976.<sup>33</sup> Canada's new Charter of Rights and Freedoms is currently being

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<sup>31</sup> Toronto Globe and Mail, June 1, 1983, at 1.

<sup>32</sup> MACLEANS 56 (Oct. 17, 1983).

<sup>33</sup> Olive, *Montreal, Mon Amour*, CAN. BUS. 25 (Aug. 1983).

It is difficult to determine the exact reasons for this exodus from Quebec. The Quebec government, and some Quebec University studies, contend that the number of departed companies and lost jobs is much less than reported in the English-language media sources. Nonetheless, the language legislation, high individual taxes, and Canada's general westward drift, account for most of the business loss. In particular, the language legislation has generally received a bad press in North America, with attention drawn to such incidents as the "tongue troopers" (nickname given to those

used to further dilute many of the language requirements imposed by Bill 101.

## V. THE INVESTMENT RESTRICTION AND INCENTIVE POLICIES OF THE AMERICAN STATES

Regional governments in the United States have their own special restriction policies and legal codes which may prove highly disadvantageous to unwary investors. For example, approximately forty American states have "Buy American" laws of one type or another, and nearly a dozen states are imposing a worldwide unitary system of taxation on transnational corporations, in spite of intense negative pressure from foreign-based multinational corporations, foreign governments, and many trade officials in Washington. In June, 1983, the U.S. Supreme Court upheld the right of the states to impose at least some of the provisions in the unitary taxation arrangement. Under such an arrangement, a corporation with one-tenth of its worldwide sales, payroll, and property in a certain subnational region would find that one-tenth of its overall income would be subject to taxation by that subnational government.<sup>34</sup> For California alone, the unitary tax brings in approximately \$500 million a year and other states collect an additional \$250 million. However, because of negative publicity both at home and abroad, and the desire to attract new direct investment, states such as Oregon, Indiana, and Florida have recently dropped the world wide unitary taxation formula and other states such as Utah will soon move to a water's edge taxation formula acceptable to foreign-based corporations.

Many subnational units are also turning towards high royalties and special severance taxes on the extraction of resources, an issue which has especially provoked animosities between resource-producing and resource-poor states and provinces in the United States and Canada. Federal officials also fear that unitary taxes and other related measures will lead to retaliation against U.S. investors abroad and will thereby precipitate periodic investment wars.

Furthermore, each subnational unit may have its own special requirements concerning manufacturing standards, labor regulations, property usage, and consumer protection. As an illustration, the state of Maine has enacted implied warranty laws which override any written warranty between a buyer and seller and insist that consumer goods must be of "fair, average quality," free of material defects and "fit for the ordinary purposes" for which the goods are used. Large automobile manufacturers have vehemently criticized the law as going beyond the bounds of reasonability and argue that present consumer protection provisions

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officials in charge of enforcing Bill 101) confiscating 10,000 Dunkin Donut bags because they were labeled in English only. Much media attention has also been accorded to the departure from Quebec of 100,000 to 140,000 anglophones since 1976.

<sup>34</sup> See San Fran. Examiner, June 27, 1983, at 1.

offered by the industry are adequate. In spite of these assertions, several other states have implemented implied warranty laws similar to Maine's which apply to a broad range of product lines.<sup>35</sup>

Court systems in several subnational units are also being used increasingly to thwart takeover bids by overseas investors. Hobart utilized the Ohio court system as part of its successful strategy to fight off Canadian Pacific. Many other companies are now using local and regional courts in an attempt to block hostile takeover efforts.<sup>36</sup> French-based Elf Aquitaine was forced, in its acquisition bid for TexasGulf, to file lawsuits in the federal courts in Louisiana, Nebraska and Utah in order to enjoin the use of those states' takeover laws to delay its tender offer.<sup>37</sup> The Supreme Court has recently overturned some of these state-level takeover restrictions, but state activities in this area continue to cause consternation for both domestic and foreign investors.

A checkerboard pattern of restrictions and incentives definitely exists among subnational units in the United States and investors must carefully survey this very complicated situation. New York may disapprove of a takeover by Arab investors of a U.S. bank holding company, whereas several other states would approve such a transaction. Some American states prohibit or severely limit foreign investment in agricultural properties. The attorney general of Oklahoma even attempted to prohibit such investment, in both agricultural and commercial land, and to force the divestiture of previously owned foreign properties. On the other hand, many states have no restrictions whatsoever in terms of the acquisition of property by overseas investors. Indeed, an investment which is prohibited by one state government may well qualify for an incentive package in another.

A wide variety of incentives, including tax breaks, loans, outright grants, free training of workers, free site selection and site preparation services, and research and development subsidies, are now provided by many state governments to job-creating foreign investors. The state of Georgia, for example, offers these types of services and promotes many missions overseas to publicize the trade and investment opportunities in that state. Georgia's well-financed Department of Industry and Trade operates international offices in Bonn, Brussels and Tokyo. As of the beginning of the 1980's, twelve foreign governments had opened trade offices in Georgia and forty-one had consulates or honorary consulates in the Atlanta area. Twenty thousand new jobs have been created as a result of \$1.3 billion in foreign direct investment facilities in Georgia at the beginning of the decade. One hundred of these were major manufacturing plants.<sup>38</sup> The sweepstakes to attract new investment has now spread

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<sup>35</sup> N.Y. Times, Jan. 11, 1981, at L23, col. 1.

<sup>36</sup> See e.g., N.Y. Times, Jan. 26, 1981, at D1, col. 1.

<sup>37</sup> Wall St. J., June 29, 1981, at 14.

<sup>38</sup> Dorsey, *Georgia's Industrial Revolution*, SKY 14 (Sept. 1979).



to most state units, and a few have enjoyed the same measure of success as Georgia.

Many U.S. state governments provide special assistance to municipalities in order to attract new industries and businesses. Both the Reagan administration and several state governments are also promoting enterprise zones in major urban areas, although federal legislation remains bogged down in Congress. As of late 1981, eight U.S. state legislatures had passed enterprise zone laws, and legislation was pending in several other state legislative chambers. A great variety of incentives are available to investors, ranging from a \$1,000 grant in Connecticut for each job created in the zone, to a credit on corporate income and school taxes in Florida.<sup>39</sup> Federal assistance to specially designated urban zones includes a 5% refundable tax credit for wages to low-income employees and an end to capital gains taxes for businesses within the zone. Additional tax relief is provided to new businesses that hire at least 40% of their work force from among low-income individuals.

Many businesses have thus far adopted a wait-and-see attitude toward the zones, suspicious about quality of life considerations within the depressed areas and problems with economic infrastructure development. On the other hand, some zones—benefiting from significant federal, state and local government assistance and from swift local government action to change zoning regulations—redefine land-use requirements, generally eliminate bureaucratic red tape, and have offered incentive packages irresistible to a large number of businesses.

## VI. SUBNATIONALISM, INDUSTRIAL POLICY, AND BILATERAL TRADE AGREEMENTS

State and provincial regulations must certainly be taken into account in determining the efficacy and practicality of any sectoral or across-the-board free trade arrangement between the United States and Canada. In effect, many states and provinces are in the process of developing their own grass-roots industrial strategies which may impact either positively or negatively upon cross-border transactions.

At the federal level, both governments have enacted a wide variety of tariff and non-tariff barriers. In the United States, trade restrictions have been placed on such products as automobiles, motorcycles, lumber, cement, uranium, flatware, shoes, rail systems, buses, steel, potatoes and fish. Petitions to the International Trade Commission for relief from imports have tripled over the past five years. With a massive trade deficit of over \$60 billion in 1983 and \$123 billion in 1984, it should be expected that pressure will mount at the federal level for additional protectionist measures.

The protectionism problem is compounded by various trade and in-

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<sup>39</sup> Carlson, *Cities Trying to Outrace Reagan By Forming Enterprise Zones*, Wall St. J., July 28, 1981, at 30, col. 1.

vestment restrictions at the state level. For example, a state court has determined that five nations have violated Pennsylvania's Trade Practices Act of 1968, so products from these countries cannot be used in state government-sponsored construction projects.<sup>40</sup> Most of the states also enforce Buy American Act provisions to one degree or another.

The original Buy American Act of 1933 provides for a general preference level of 6% for federal government purchases of U.S. products. This is increased to 12% for bids from small or minority-owned businesses located in areas with high unemployment rates. Some "set asides" are also permitted in the bidding process and this, once again, works against the interests of foreign-based firms.

The U.S. Surface Transportation Assistance Act of 1982 prescribes strict "Buy American" provisions for federally funded highway and mass transit projects. Canadian exporters of subway vehicles, structural steel, and buses have been particularly hurt by this piece of legislation. States have copied parts of the original Buy American Act for their own government procurement codes and at times even discriminate against U.S. firms that are not located within the boundaries of the impacted state.

"Buy Canada" provisions either restrict bidding to domestic suppliers or provide a 10% preference for bids with sufficient domestic content. A majority of the provincial governments also show favoritism either to provincial suppliers or Canadian suppliers. For example, a U.S. firm must almost always join with a Quebec firm in bidding for provincial government contracts. With the Quebec government's recent decision to suppress the call for tenders in major government contracts, the foreign contractor has been placed at an even greater disadvantage. Neither provincial nor state-level government procurement policies are currently covered by the GATT regulations.

American states also have a habit, from time to time, of suppressing trade with certain nations in order to make a point. As of mid-1983, five states limited the investment of public funds in South Africa. Massachusetts, for example, prohibits teacher and state employee pension funds from holding stocks or bonds of banks that lend money to South Africa or securities of corporations that do business with that nation. The pension funds were given three years to sell their existing investments in impacted banks and corporations.<sup>41</sup> In the mid-1970's in response to Arab boycott provisions, several states also set up complicated regulations which prohibited certain business practices which might be viewed as supporting the boycott movement. And following the downing of the KAL passenger jet in September, 1983 by Soviet aircraft, fifteen states placed an embargo on the sale of Soviet spirits (mainly vodka). One year

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<sup>40</sup> The Wash. Post, Apr. 19, 1984, at B4, col. 3.

<sup>41</sup> Wall St. J., Feb. 22, 1983, at 33, col. 1. The four other states are: Connecticut, Kansas, Nebraska and Michigan.

later, seven of these states were still enforcing this trade restriction.<sup>42</sup>

State governments continue to exercise broad powers in the areas of land use, insurance and banking, environmental controls, hazardous waste disposal, labor relations, civil rights, and corporate taxation and chartering—all of which may impact upon foreign investors or firms trading with these states.<sup>43</sup> States may also require broad disclosures from foreign individuals or corporations. As an illustration, the Ohio legislature passed a disclosure statute in 1979 which mandates that non-resident aliens and foreign-based corporations which acquire real estate, minerals, or mineral products over a certain value, must file certain information with the Ohio Secretary of State. Failure to do so could result in a fine of not less than \$5,000 nor more than 25% of the value of the investment.<sup>44</sup>

The worldwide unitary taxation formula used by several states has extraterritorial dimensions and may distort the faithful implementation of bilateral taxation treaties. Nevertheless, in the cases of *Container Corporation of America v. Franchise Tax Board*, *Shell Petroleum, N.V. v. Franchetti*, and *Alcan Aluminum Ltd.*, the U.S. Supreme Court has upheld the right of state governments to utilize this system of taxation. Ohio won a recent Supreme Court case which permits states to impose non-discriminatory property taxes on imported goods, whether finished or raw materials, when they are stored in the state. The Court ruled that the Constitution forbids states from levying imposts or duties, but not non-discriminatory taxes that are levied on domestic goods under similar circumstances. Thus, such taxes do not violate the Import-Export clause of the U.S. Constitution.<sup>45</sup>

State governments are also in the process of developing their own industrial policies and this will certainly have an impact on future trade and investment activity. Two dozen states are now directly involved in the venture capital game, committing over \$300 million for projects over the past few years. State agencies also provide low-interest loans, help in securing private financing, and technical managerial assistance. The Connecticut Product Development Corporation has invested close to \$12 million in approximately sixty small businesses. The state receives a 5% royalty on products sold by the companies backed by venture capital.<sup>46</sup> Several states have also set up industrial parks, enterprise zones, and greenhouse projects to spur on economic development. The greenhouse

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<sup>42</sup> Wall St. J., Sept. 18, 1984, at 33, col. 1.

<sup>43</sup> See J. KLINE, STATE GOVERNMENT INFLUENCE IN U.S. INTERNATIONAL ECONOMIC POLICY 216 (1983).

<sup>44</sup> Glaser, *Canadian Investment in the United States: Ohio's Limitations on Foreign Investment*, 4 CAN.-U.S. L. J. 107 (Summer 1981).

<sup>45</sup> Young, *States Given Nod to Tax Stored Imports*, J. of Commerce, Apr. 19, 1984, at 1A, col. 4.

<sup>46</sup> Armstrong, *States, Hungry for Business, Try Grubstaking*, Christian Sci. Mon., Nov. 20, 1984, at 37, col. 4.

program establishes special buildings which will house new businesses in the high-technology sector.<sup>47</sup>

Fifteen state governments are now offering export aid to local companies and another ten have legislation pending which would provide such assistance. This aid is both in the form of information and dollars. Within five years, annual state government export aid might reach \$600 million and would represent an important alternative to Export-Import Bank authorizations.<sup>48</sup> Whether or not some of this aid would be considered as an export subsidy, and would run afoul of the GATT agreements, remains to be seen.

Several states have signed special economic accords with subnational governments in other nations. As an illustration, Illinois signed a trade pact with China's Liaoning province in August, 1984. Both subnational governments have agreed to establish reciprocal trade offices and to foster trade and investment linkages.<sup>49</sup> Groups of states now cooperate in the regional banking sector and others are working to establish special trade zones and to facilitate research and development activities with private corporations and foreign governments.<sup>50</sup>

However, economic competition among state and provincial governments remains very tense and beggar-thy-neighbor tactics characterize some of the interactions among subnational units. For example, South Dakota actively seeks to lure companies from neighboring Minnesota. By eliminating personal income, corporate, and personal property taxes and offering moderately priced unemployment and workman's compensation insurance, South Dakota has lured more than sixty firms away from Minnesota over the past few years.<sup>51</sup>

Indiana's business development officers spend time in Michigan; Missouri's governor meets with business representatives in Illinois; North Dakota officials host receptions for businesses in Manitoba; and Ottawa works with various provincial governments to entice firms to locate in Canada instead of in neighboring U.S. border states.<sup>52</sup> A classic example of cross-border competition occurred a few years ago when the combined incentive package worth almost \$70 million was pieced together by Ontario and Ottawa in order to entice Ford to locate a new plant in Ontario instead of Ohio.<sup>53</sup>

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<sup>47</sup> Olson, *Industrial Policy From the Grass Roots*, Wall St. J., June 12, 1984, at 34, col. 3.

<sup>48</sup> Ericson, *States Launch Programs for Export Aid*, J. of Commerce, July 26, 1984, at 4A, col. 3.

<sup>49</sup> *Illinois Signs Trade Pact with China*, The Wash. Post, Aug. 11, 1984, at C2, col. 3.

<sup>50</sup> Brevetti, *Plan Posed for States and Japan to Share R&D*, J. of Commerce, June 21, 1984, at 23B, col. 3.

<sup>51</sup> Schellhardt, *War Among the States for Jobs and Business Becomes Ever Fiercer*, Wall St. J., Feb. 14, 1983, at 1, col. 6.

<sup>52</sup> See *id.*; Lancaster, *Competition by States to Lure Firms Turns Into a Fierce Struggle*, Wall St. J., Dec. 28, 1983, at 1, col. 6.

<sup>53</sup> See E. FRY, FINANCIAL INVASION OF THE U.S.A. 146 (1980).

In general, state governments are more involved than ever before in regulating businesses, whether domestic or foreign. A recent Conference Board study of 253 of the largest corporations in the United States reveals that 75% now engage in lobbying efforts in one or more states and nearly 50% of the companies which employ state-government relations specialists have hired them since 1975. Forty-three state legislatures met annually in 1981, compared to only 18 in 1960. State legislative staffs have increased dramatically and state legislators have shown an increasing interest in business activities. In 1980, seven times as many business-related laws and regulations were passed by state legislatures than by the U.S. Congress. Sixteen times as many bills of all categories are currently being passed at the state level than at the federal level. Moreover, the odds of a particular piece of legislation successfully being enacted by a state legislature are appreciably higher than legislation introduced in Congress.

## VII. CONCLUSION

In conclusion, state governments are now becoming very actively involved in economic matters in general, and international trade and investment issues in particular. However, in comparison to the overall power base of the provincial governments and provincial government involvement in the economic sphere, the states have a long way to go. The functional equivalents to Crown corporations, social welfare strategies, or to the role which such institutions as the Caisse de dépôt et placement du Québec play in the economic development of that province, are simply not to be found on the southern side of the border.

Nevertheless, it is quite clear that both provincial and state governments will be important actors in any free-trade arrangement between Canada and the United States. Any bilateral trade arrangement will certainly impact upon the framework of federal-provincial and federal-state relations. These governments at the subnational level must be consulted on the potential merits and demerits of any trade accord. The evolution in both countries of a new type of economic federalism based on increasing interdependence will impact upon most future trade and investment activity. On the whole, however, a great majority of the provinces and states have endorsed the concept of freer trade.<sup>54</sup> Therefore, the subnational economic challenge, although formidable, should not be viewed as an insurmountable obstacle to the conclusion of a workable trade agreement between the two North American nations.

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<sup>54</sup> See, e.g., GOVERNMENT OF ALBERTA, FREE TRADE WITH THE UNITED STATES: AN ALBERTA PERSPECTIVE, Report presented to the First Minister's Conference on the Economy, Regina (Feb. 1985).

In addition, the government of Quebec has offered vigorous support for the creation of a free-trade area. The Minister for International Relations and External Affairs has even suggested the possibility of a Common Market arrangement between the two nations. See *Le Droit* 5 (Mar. 26, 1985).