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# The Free Trade Agreement: Reflections of a Market Nationalist

Thomas J. Courchene

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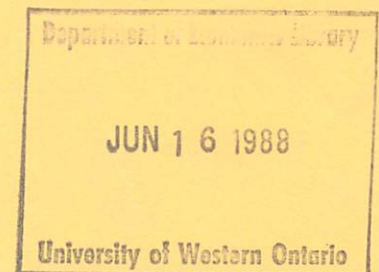
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REFLECTIONS OF A MARKET NATIONALIST

Thomas J. Courchene



This paper contains preliminary findings from research work still in progress and should not be quoted without prior approval of the author.

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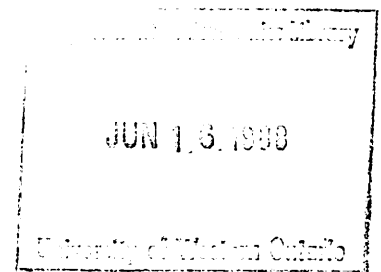
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**THE FREE TRADE AGREEMENT:  
REFLECTIONS OF A MARKET NATIONALIST**

by

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## I INTRODUCTION

With Meech Lake promoting political federalism and free trade promoting commercial continentalism many Canadian elites, particularly the nationalists and centralists (typically Ontarians) who draw ideological comfort if not economic gain from a protectionist and interventionist central government, now find themselves drawn into a nightmarish and perhaps irreversible process of "country warp". "Who speaks for Canada?" is their Meech Lake refrain as they fear that Ottawa has devolved internal sovereignty onto the provinces and the often-used label "Sale-of-Canada Act" effectively captures their associated fear that the FTA hands over aspects of national sovereignty to the Americans. On substantive grounds, I disagree strongly with the critics of these accords (see Courchene, 1987, with respect to Meech Lake and the ensuing analysis for the FTA). On process grounds, however, I have more sympathy. That these momentous decisions were undertaken by a government which, despite its overwhelming Commons majority, at times during the negotiations ranked fourth in the opinion polls (behind "undecided") lends an aspect of "political immorality" to these initiatives. Moreover, the underlying issue is frequently seen as not only free trade but as well the utilization of the free-trade agreement to entrench and perhaps make irreversible the Conservative government's initiatives with respect to enhancing the role of market-driven policies. One result is that the ongoing public debates which coningle substance, ideology and process are, in my view, far more destructive of national cohesion and identity than anything that would or will arise from the accords themselves. In any event, it is obvious that the ballot box will be the ultimate arbiter.

While not attempting in any way to downplay these concerns (but at the same time duly noting that the processes for all their potential faults are formally unassailable) centre stage is now occupied by the deals themselves. The thrust of this paper, which henceforth focuses on free trade rather than on Meech Lake, is that the FTA is a unique and historic opportunity for Canada and Canadians. However, the range of the ensuing arguments to this effect may, in several respects, depart from the mainstream position of the free-trade advocates. I begin with the underlying pressures leading to the FTA.

## II THE ORIGINS OF THE FTA

That there are gains from free trade with the U.S. has been one of the most consistent and well-documented tenets of post-war Canadian economics. This theme was also reflected in countless "think tank" publications over the last couple of decades (C.D. Howe, Ontario Economic Council, Economic Council of Canada, and so on). More recently, Harris and Cox's "state-of-the-art" empirical study for the Ontario Economic Council (1983) rekindled interest in free trade among economists and the Macdonald Royal Commission (1985) apprized the Canadian public of the potential gains from Canada-U.S. free trade. Nevertheless, important as these analytical and empirical underpinnings are to the free-trade debate, they do not represent triggering forces in terms of the FTA: if free trade won solely on its own merits, why 1987? Why not 1967 or 1977?

Far more important as a triggering mechanism was and is the realization that the status quo is no longer sustainable. In other words, the debate now

encompasses not only the traditional gains from free trade but more importantly the costs associated with an eroding status quo. There are at least two aspects of these costs.

The first relates to recent global developments -- the two world energy price spikes and the devastating recession in the early 1980's which, because of the inappropriate manner in which we handled the earlier energy shocks, took a much greater toll on us than on our trading partners. Occurring simultaneously was (and is), arguably, the most significant process of Schumpeterian "creative destruction" that the industrial world has every experienced. The dramatic shift in world comparative advantages and payments imbalances, combined with the computational and telecommunications revolution, is leading industry everywhere to restructure, to downsize, to adopt more flexible management techniques, etc. Canadian industry faced a further hurdle -- recapitalization of corporate balance sheets resulting from the "great stagflation" of the early eighties -- the most severe recession since the 1930's accompanied by interest rates that at times exceeded 20 per cent. Given this most sobering experience, if Canadian industry were to join fully in this enormously more competitive global game, the very substantial outlays and costs required for both restructuring and recapitalization could not be placed in jeodardy by arbitrary actions of the 1980-84 Liberals, clearly Canada's most interventionist post-war government, e.g., the resurgence of FIRA, the NEP and MacEachen's retroactive 1981 budget. One result of all of this was that Canadian capital and enterprise began to move south in astonishing magnitudes.

The second factor, more important in its own right but surely reinforcing the first, is the growing U.S. protectionism. This aspect needs

no elaboration because it features front and centre in the arguments of the pro free traders. Suffice to say that the spectre of U.S. protectionism altered rather dramatically the domestic political environment with respect to free trade since it effectively brought the business community on side: any adjustment costs associated with free trade would pale in terms of the costs of being locked out of the critical U.S. market.

Not surprisingly, therefore, the FTA controversy no longer has all that much to do with the underlying economics (here is where the post-war efforts of the economics profession are bearing fruit). Rather, the FTA battle ground has shifted to the non-economic aspects of the FTA, e.g., culture, social policy, regional development, federal-provincial relations and sovereignty. More on this later.

Prior to taking leave of this section, it is essential to recognize that, in terms of the internal politics of the FTA, the last-minute inclusion of energy in the agreement amounts to a political "tour de force". The FTA is now much more than a Canada-U.S. free-trade agreement. In effect, it is also a repudiation of the NEP and as such effectively muzzles much of Ontario's potential criticism. Peter Lougheed made the point most forcefully when he asserted the energy provisions in the FTA were Alberta's "auto pact". In the view of many, perhaps most, westerners, Ontario's opposition to the FTA cannot be disassociated from Ontario's role in the promulgation of the NEP itself. This is part and parcel of why I referred earlier to the FTA as embodying aspects of the "wicked problem" syndrome.



### III THE ECONOMICS OF THE FTA

The FTA is typically cast as a win-win situation on economic grounds for both the U.S. and Canada. In this section I shall argue that this is clearly the case for Canada, but I remain skeptical that the prospect for substantial long-term efficiency gains was driving the U.S. side. To be sure, enhanced market access will result in important gains for the Americans. So will "trade diversion", to be defined later. And the U.S. obtained access to Canadian energy (but I shall argue later that they could have got most of this without an FTA because energy free trade is also in the producing provinces' interests). In my view, the real U.S. gains from the FTA are geo-political, e.g., moving the global trading community toward another significant GATT round, this time focusing on commercial (as distinct from tariff) barriers and on services.

In the first instance Canada's trade benefits arise from the efficiency gains that will come from access to a "domestic" market of nearly 300 million people. It is true that we will be competing with U.S. firms that have already rationalized and to this extent they will, in selected areas, outperform Canadian industry. However, the essential issue boils down to a ten-fold increase in the Canadian "domestic" market and a 10 per cent increase in the U.S. domestic market. Moreover, all Canadian firms are by now fully aware of the FTA and the challenges and opportunities it presents, which in turn reflects the incredible effort by the Mulroney government to involve both sectoral interests (via nearly twenty sectoral advisory groups) and the provinces in the negotiation process. This is clearly not the case in the U.S. Nor should this be surprising since even most large U.S. firms likely

have untapped domestic market segments well in excess of the entire Canadian market and which can be accessed without the hassle of bilingual packaging, etc. Computable general equilibrium simulations by Markusen and Wible (1987) indicate that over the long term the absolute gains from the FTA will be roughly equivalent for Canada and the U.S. In per capita terms this converts a ten-fold gain for Canada relative to the U.S. All in all, a very rosy picture for Canada, the details of which will be elaborated in the context of evaluating the various criticisms levelled against the FTA. Prior to addressing these criticisms it is appropriate to focus a bit more on the nature of the FTA itself.

#### A: The FTA vs. Multinational Free Trade

Multinational Free Trade (MFT) is very different from the bilateral FTA. Economists would presumably argue that, over the long term, the benefits to the world economy from MFT would exceed those arising from any bilateral pact. However, I shall argue in this section that:

- over the medium term the net benefits to Canada from the FTA almost certainly exceed those from MFT;
- the FTA may be welfare-reducing from the rest-of-world vantage point; but
- the FTA is an absolutely essential first step for Canada in embracing MFT.

With some degree of misrepresentation, the gains from MFT for a small open economy like Canada arise from rationalization (economics of scale) and comparative advantage. Because MFT would require Canada to open its borders to "competing" economies (i.e., those with very different endowments of resources, labour and capital), the potential long-term gains are large.

However, the accompanying adjustment costs are likely to be horrendous since full integration with "competing" economies typically involves inter-industry adjustment, e.g., moving out of textiles and into industries where we have a global comparative advantage.

The FTA, on the other hand, represents integration with a "complementary" not a "competing" economy. Apart from resources for Canada and defense-related activities for the U.S., our economies have roughly comparable product ranges, at least potentially. In such complementary economies, adjustment is typically intra-industry in nature. Whole industries do not disappear: rather, each country exploits selected niches and as a result trade typically flows both ways in each industry. This is likely what will happen in industries such as textiles. More importantly, since neither country opens its doors to labour-intensive, third-world textile production and since both Canada and the U.S. will favour each other at the expense of other industrialized textile producers, the combined Canadian-U.S. textile industry will increase in size under FTA, whereas it would decrease if not largely disappear under full-blown MFT.

This leads directly to a further "advantage" from a bilateral pact like the FTA -- trade diversion. Under an effective MFT regime, all trade is efficiency- and welfare-enhancing from a global perspective. Not so under the FTA. The Japanese might be the low-cost producers of a product, but under the FTA we may divert import purchases from Japan to the U.S.A. because the removal of the tariff only against the Americans may result in their product being cheaper. This is trade diversion, i.e., a directing of trade away from the least-cost producers and toward one of the FTA partners, triggered by the elimination of tariffs within the FTA.

Because the FTA dramatically extends market size and access, much of the gains on the Canadian side will be driven by rationalization or economies of scale. (This is typically referred to as trade creation.) Some, however, will clearly result from trade diversion. Consider, for example, the following passage from a recent speech delivered by Tom Siddon (1987), Federal Minister of Fisheries and Oceans:

"Let's compare the picture for ground fish imports to the U.S. from Canada and our competitors. In 1986 Canada accounted for 43 per cent of those imports. Our main competitors, Iceland, Norway and Denmark accounted for 20 per cent. All other countries made up the remaining 37 per cent. The elimination of tariffs will give us a big advantage over these nations." (underlining added)

This is clearly trade diversion and, from the perspective of the global economy, it is welfare decreasing, at least in the short term.

This raises an important issue, namely the morality of the FTA from a global vantage point, particularly if Canadian gains are at the expense of developing countries and regions. This argument has been put most cogently by Maureen Irish (1988). One response, not particularly satisfying, is that if the Europeans can form trading blocks -- the ECC and the EFTA -- so can we. A second level of response is the following: while Canada does have restrictive policies toward the products of the third world, it seems to me that the trade diversion embodied in the FTA will be directed more toward other industrial or industrializing countries rather than toward the third world. (This statement is not based on in-depth research.) However, the strongest response to this global morality issue is that the FTA is likely to lead to greater MFT (elaborated below). Nonetheless, the concern is clearly valid and at the very least Canadians should consider diverting some of the FTA gains toward

third-world considerations. As Irish (1988) notes, we have progressively backtracked on our 1970 commitment to devote 0.7 per cent of GNP to foreign aid.

This leads to the following observations and/or conclusions:

- Because the FTA so dramatically increases Canada's domestic market, it compares reasonably well with MFT on these efficiency or economies-of-scale grounds;
- Because the U.S. is a "complementary economy", most of the adjustment will be intra-industry. Phrased somewhat differently, the adjustment costs under the FTA are substantially less than under MFT because both nations will maintain trade barriers against goods from "competing economies" (those with vastly different resource endowments) and against products from their major trading partners;
- The gains for Canada from U.S. trade diversion plus those from trade creation under the FTA are likely to exceed those under MFT, particularly over the medium term. This results from the fact that Canada will not open its doors to competition from the LDG's or the NICs, let along the rest of the OECD;
- While the U.S. will also gain from trade creation and from Canadian trade diversion, the larger "gains" for the U.S. may arise from the pressures the FTA will exert on the policies of other trading blocks;
- To the extent that the overall result is the extract gains at the expense of the third world, Canadians have a moral imperative to "return" these gains in other ways;

- It is not at all obvious that the FTA is efficiency enhancing from the perspective of the rest of the global trading economy. Indeed, estimates by Markusen and Wigle (1987), indicates that the "rest-of-world" does suffer welfare losses, although these are overshadowed by the welfare gains of Canada and the U.S.

Two related observations are warranted. First, without initially being subjected to economic rationalization of the sort that will occur under the FTA and without the necessary shift in values from an interventionist mentality to a trading mentality, Canada could literally be blown away, short-term, by full MFT. This is, of course, reflected in part by our current protectionist bias against third-world products (i.e., the "morality issue" alluded to earlier is hardly limited to the FTA). Canada did play an important role in Punta del Este (the beginning of the GATT Uruguay round), particularly in the area of agriculture and services. My best guess is that with the market access and rationalization provided by the FTA, the Canadian voice in the Uruguay round will push for greater trade liberalization than would otherwise be the case.

Second, and relatedly, I believe that the FTA is likely to add pressure to bring the global trading group to the GATT bargaining table. The FTA reveals that very considerable progress can be made in the area of trade in services. It has made some breakthroughs in agriculture. If all goes well, it will also show the way in terms of achievable "subsidy pacts" and, more generally, mutually acceptable arrangements with respect to other anti-competitive measures. But the carrot as well as the stick is operating here. The FTA will generate considerable trade diversion and this may inspire the losing countries to pressure their trading partners with respect, say, to

the obviously trade-diverting aspects of the ECC agricultural policy. Finally, the omnibus bill itself may well erode the international status quo to the same degree as U.S. protectionism has eroded the domestic status quo. In any event, the point here is that the FTA will represent a powerful initiative and incentive for bringing all parties to the bargaining table for another GATT round.

I recognize that among those that oppose the FTA are some genuine free traders who believe not only that the multilateral route is preferable to the bilateral one but also that the proliferation of bilateral deals makes multilateral accommodation more difficult. This is in contrast to those Canadians who use GATT as an indirect argument against the FTA. Knowing full well that the on-going GATT round may not amount to much, these closet protectionists argue for GATT over the FTA. Thankfully, however, this element that touts GATT as the panacea was forced out of the woodwork recently in calling upon the Canadian government not to honour GATT when it ruled against Canada.) My view is that the FTA is not only consistent with MFT but will serve to broaden the expectations of what the Uruguay round might accomplish. As Lipsey (1988a) has emphasized, most of the provisions of the FTA replicate GATT provisions or at least are GATT-consistent (but with stronger compliance measures) so that the FTA is clearly not offside with respect to GATT. The larger issue comes down to the question of whether further trade liberalization, particularly in the area of non-tariff barriers and services, is likely to be achieved through the GATT process or through bilateral blocks. I believe that MFT is most likely to come about as bilateral blocks liberalize trade between themselves, eventually encompassing all blocks or nations. Others may well disagree.

**B: We Are Already Too Dependent on the U.S.**

One criticism of the FTA is that we are already too dependent on the U.S. and we ought to be looking for ways to diversify, not intensify, our trading relationships. In an abstract sense (i.e., setting aside geography, relative size, etc.), this is probably correct. Moreover, it is likely that the result of the FTA will, at least over the short term, be greater cross-border flow of goods and services. However, there are two important points to be made in this context. The first relates to what it means to be "dependent on the U.S.". One can make a convincing case that the whole point of the FTA is to reduce the dependence on U.S. subjectivity and arbitrariness in our trade relationships and to transfer this to the realm of objectivity and treaty. It is because we trade so much with the U.S. that arbitrary actions on their part make us so vulnerable. The FTA reduces this aspect of "dependency", even though it is likely to increase trade flows.

The second point is that it is largely by gaining the rationalization or economies of scale flowing from the FTA that we will be able to compete effectively with the Americans in Brazil, the Japanese in the Pacific Rim, the Germans in Europe, etc. Intriguingly enough, the FTA is likely to be the preferable way (the only way?) to gradually decrease our dependency (this time in the sense of trade flows) on the U.S. market.

A much more sophisticated version of this argument (articulated by my Western colleague, Bob Young, among others) focuses on the fact that while our dollar has appreciated recently relative to the U.S. dollar, it has depreciated substantially relative to most of our other trading partners. Thus, we have potentially unexploited avenues for enhanced trade outside the U.S. market. While this is surely an appropriate observation, I fail to see



why it is inconsistent with the FTA, unless for some reason Canadian industry becomes blinded to all opportunities other than those in the U.S. And since we have negative trade balances with many of these other countries, they are presumably not going to react all that negatively to our participation in the FTA, so that future trade with them is not jeopardized.

**C: Why Hitch Your Wagon to a Falling Star?**

A second criticism levelled at the FTA is that while linking up with the Americans may have made eminent sense in the 1950's or 1960's, when the U.S. economy was the industrial leader, it does not make much sense in the 1990's when the U.S. is no longer in its ascendancy. Presumably this is meant as a plea to keep our options open and not a recommendation that we hitch our wagon to a rising star like Japan. (The short-term adjustment costs of eliminating all trade barriers with Japan would be staggering!) However, this criticism merits comment because it directs attention to at least two relevant concerns.

First, the gains from trade do not depend on linking up with the leading industrial economy. The ten-fold increase in our domestic market will generate scale economies whether or not the U.S. remains at the cutting edge of the technological revolution.

Second, the U.S. is big enough that it could contemplate turning inward on a major scale, including closing its borders to products generated from foreign leading-edge technology. What this would amount to is a dramatic increase in U.S. protectionism, which in turn would feed directly into the hands of the Canadian pro-free-trade group who base much of their case on the problems related to the existing degree of U.S. protectionist sentiment. It is theoretically possible, under this very hypothetical scenario, that the

Americans might attempt to coerce Canada into an equivalently protectionist commercial policy. However, my reading the details of the FTA suggests that in such (unlikely) circumstances Canada would benefit substantially from technology transfer since we would be the obvious avenue through which to penetrate the U.S. market.

But all of this is highly unrealistic. It is true that the U.S. is reeling under dual macro imbalances -- fiscal and balance-of-payments -- but the notion that this pre-ordains that the giant is evolving into a dinosaur is far-fetched, to put it mildly.

#### D: The FTA Will Lead to the Maritimization of Canada

The argument here is that just as the integration of the two Maritime provinces with the two Canada's in 1867 led to the transfer of economic activity to the heartland, so too will the FTA lead to a southern migration of economic activity. Under the FTA, firms can access and service the Canadian market from anywhere in North America, so why locate or remain in Canada? In large measure, arguments along these lines are at the heart of the economic concerns (as distinct from non-economic concerns) of the anti-FTA proponents.

My response to this is only partly based on economics. The remainder involves wrapping oneself in the flag, as it were. This is in line with the "market nationalist" phraseology in the title: I refuse to cede to the anti-FTA group the monopoly over nationalist sentiments in the FTA debate. To be sure, thus far they have managed effectively to corner the market -- for example, selecting If You Love This Country as the title of a book of anti-free-trade articles is admittedly a public relations triumph. The counter argument, developed partially in this section and in more detail

later, is that it is precisely those characteristics which give us our distinct Canadian identity that will prove to be among our most important assets in the inevitable process of gearing Canada up to greater foreign trade.

In terms of the issue at hand, it is no doubt the case that some firms will decide to close down domestic plants and service our market from south of the border. But it is also the case that it is no longer necessary to locate behind the U.S. tariff wall to access the American market. It seems to me that the latter effect has to dominate. First of all, Canada is an excellent place to do business. Relative to the U.S., our cities are clean. Our public schools are better. So are our public universities, except for aspects of graduate studies. In general, our labour force is more highly educated and our work ethic is superior. More importantly, not only do our social policies reflect a greater concern for the less fortunate among us, but programs for the elderly and for health are generally financed from the consolidated revenue fund which in turn confers a substantial benefit on our industry relative to the U.S. where industry bears a substantially greater funding role (to be elaborated later). And our abundant resource base generates a clear comparative advantage in terms of key commodities/services such as water and electricity and, more generally, the environment.

Second, and relatedly, prior to the FTA if the Europeans or Japanese wanted to establish a North American production presence to access the U.S. market the obvious route, and the only secure route, was to establish the plant in the U.S. This is no longer the case. Moreover, it is surely also the case that under the FTA more foreigners will want a North American production presence in order to get behind the FTA protective wall. In both these contexts it is hard to imagine scenarios where the attraction of a

Canadian location is not now substantially enhanced. After all, relative to the U.S., Canada is very "European" in terms of our social policy network and in terms of our multicultural emphasis and diversity (in contrast to the U.S. "melting pot" approach). And if the goal is also to service the Central and South American markets, Canada is arguably a preferred location, geo-politically.

The basic point is that it would take a set of very peculiar circumstances indeed to configure a scenario where Canada could be worse off under the FTA in terms of attracting new industries and investment.

Offsetting all of this is that aggregate wage costs are lower in some (non-union) areas of the U.S. and the generally held view that the U.S. has a more favourable business and entrepreneurial climate. This latter point -- the supposed non-entrepreneurial character of Canadians -- deserves further attention. At a general level, it is clear that by dint of geography, history, culture or whatever, Canadians do have a greater tendency to look to government as a first recourse when adversity strikes and Canadian governments for their part have only too frequently been willing to respond. The FTA will likely have an impact on all this partly because some previously accepted initiatives will run afowl of the agreement but moreso because the opportunities that arise under the FTA are likely to alter our traditional conception of the role of government and the traditional relationship between the citizen in the state. The following paragraphs elaborate on this theme, with special emphasis on recent developments in Quebec.

With respect to the issue of entrepreneurship and the general business climate, the recent Quebec experience appears highly relevant. Quebecers, or rather French Canadians, have typically been viewed as the least

entrepreneurial of Canadians, directing their abilities toward professions such as medicine, law and the public sector. Gilles Paquet (1987) has challenged this interpretation, arguing that the combination of "opportunities" and "ethos" (the demand and supply sides of entrepreneurship as it were) were, historically, antagonistic toward market-related activity so that the French Canadians directed their "entrepreneurship" elsewhere (e.g., toward preserving their culture and language within the "sea of anglos" on this continent). Beginning with the Quiet Revolution (and educational reform) through to Bill 101, the opportunities open to Quebecois expanded dramatically. In turn this expansion of the "opportunity set" has led to a dramatic change in the "ethos" or citizen-state relationship. Financial deregulation, a series of privatizations, the push for free trade and the swarming of young Quebecois to business schools are all evidence of a marked shift in the way in which Quebecois have come to view the role of markets and, at a deeper level, the interaction between citizens, government and markets. A decade or so ago most Canadians would appropriately have labelled this province as being the most dependent in government. Today, Quebecois are generally viewed as the most entrepreneurial of Canadians.

Thus, the perception that Canadians are less entrepreneurial than the Americans and that the business climate is more hostile has to be interpreted very carefully. Specifically, the FTA will have a substantial impact on the "opportunity set" facing Canadians. Already there are impressive signs that Canadians are increasingly embracing the notion of free trade.

There is, however, a second message that can be drawn from the Quebec experience, namely the role of government in economic development. Among the arguments of the anti-FTA forces is that the emphasis on individuals and

markets, which they perceive will flow from the FTA, is last generation's approach to entrepreneurship and economic development. The success story of the Japanese, among others, points out the advantages of a much closer relationship between business and government than that which is embodied in the "American Creed". Yet, in many ways the Quebec model is much closer to the Japanese than it is to the American philosophy. The role of the Quebec government in the economic process has not so much been diminished as transformed: the state as "entrepreneur" has given way to the state as "catalyseur" in order that people and markets can now fulfill the entrepreneurial role. With initiatives such as the Quebec Stock Savings Plan and the Caisse de dépôt, the Quebec government maintains a critical presence in the economic sphere. What this suggests is that there is likely plenty of room under the FTA to accommodate alternative visions or versions of government within the context of an enhanced role for the interplay of market forces.

Finally, it very much appears that this outward-looking and market-related approach is the latest version of Quebec "nationalism" -- a concerted effort to enhance the ownership and control of Quebec enterprises both by Quebecers and from a position within Quebec (see Courchene, 1986). What is intriguing about all of this is that Quebec views free trade as being fully consistent with its broader "nationalist" objectives whereas in the rest of Canada nationalist sentiments or expressions tend to be associated exclusively with those that oppose the FTA and frequently with protectionist policies.

By way of conclusion to this discussion of government, entrepreneurship, and the citizen-state relationship, it is instructive to reflect on the views

of Robert Reich from his influential book, The Next Americal Frontier (1983):

"The success of modern Japan, in particular, seems to contradict Max Weber, the German sociologist, who attributed the West's economic progress to the demise of traditional relations like guilds, parishes, and clans and to the simultaneous rise of individualism. Japan's emphasis on community, consensus, and long-term security for its workers -- based squarely on traditional communal relationships -- appears to have spurred its citizens to greater feats of production than has the rugged individualism of modern America..." (Reich, 1983, p. 16).

"A social organization premised on equity, security, and participation will generate greater productivity than one premised on greed and fear. Collaboration and collective adaptation are coming to be more important to an industrialized nation's well-being than are personal daring and ambition." (Reich, 1983, p. 20).

One need not agree with Reich to recognize that the FTA need not straightjacket the manner in which the Canadian and provincial governments in their policy actions incorporate this enhanced role for market mechanisms. This is by way of arguing that it is far from clear that the U.S. business or entrepreneurial climate under the FTA will be more inviting than that which will develop in Canada.

#### E: The Dispute-Settlement Mechanisms

As Debra Steger of Fraser and Beatty notes:

"The dispute settlement mechanisms of the Canada-U.S. Free Trade Agreement are not perfect. However, they are a significant improvement over the current system for resolving trade disputes between our two countries. They are also markedly better than the dispute settlement mechanisms of other free trade arrangements and the...GATT. Most importantly, they represent a break with the pattern of unilateralism that has characterized Canada-U.S. trade relations in the last few years." (Steger, 1988, p. 1)

Even if this is an appropriate representation of what the FTA has achieved along these lines, as I believe it is, critics are correct in noting that the Mulroney government did not deliver on its promise to obtain absolutely binding dispute-settlement mechanisms. Actually this promise was doomed from the start: one cannot exempt regional initiatives from the FTA and at the same time expect to have binding dispute mechanisms. Neither country was willing to commit itself immediately to a new set of uniform and predictable rules regarding subsidies (which would have allowed a move in the direction of an authoritative binational arbiter), although both nations have committed themselves to such a goal over a five- to seven-year period.

One has to maintain perspective here. Since sovereign governments cannot bind future sovereign governments, there is no such animal as an absolutely binding resolution mechanism because, at base, there is nothing "binding" about the FTA on future governments. On the other hand, a dispute-resolution mechanism that is mutually acceptable is obviously key to a successfully operating FTA. One which merely reproduces the status quo would be unacceptable to Canada. This much is clear. But I suggest that it is also clear that a mechanism which is fully binding at the outset is in practice, if not in principle, unachievable and in any event probably undesirable. This is so because the FTA by its very nature and breadth must be an evolutionary document. If both sides show a willingness to make free trade work (and later I suggest that the U.S. will do so) then the stage will set for the dispute-resolution mechanisms to evolve in the direction of becoming more and more binding. Apart from the initial ratification process, nothing is likely to trigger the six-month opting out clause more than a binding dispute-settlement scheme that is biased in one direction or the other.



F: The Exchange Rate and Free Trade

The pro-free-trade forces argue that the exchange rate is our ace-in-the-hole. If, for some unexpected reason, free trade leads to a depressed level of economic activity in Canada, the argument is that the exchange rate will depreciate and re-equilibrate the situation. While I regard the underlying premise (that free trade will lead to a downturn in Canadian economic activity) to be highly unrealistic, the notion of the exchange rate as an equilibrator of, say, only the employment implications of free trade is also stretching things a bit. The Canadian reality is more complicated than this. Given the geo-economic configuration of the country -- resources in the peripheries and secondary manufacturing in the centre -- the exchange rate is not only an international arbiter, it is also an interregional arbiter. Phrased differently, the exchange rate is a very "delicate" price in a small economy that aspires at the same time to be a major secondary manufacturing exporter and a primary resource exporter, particularly when these activities are differentiated regionally.

This is not an issue that is particularly related to the FTA. In advance of the FTA, Quebec has already signed electricity export contracts that will generate roughly \$40 billion in exports before the year 2000, and more appear to be in the wings. Natural gas producers in the west apparently are in the process of preparing to apply for export licenses for several trillion cubic feet of gas. Both of these developments will put some upward pressure on the exchange rate.

Free trade might exacerbate this, if "secure access" to U.S. markets leads, for example, to the construction of mega projects for "synfuels" designed for export. If the financing of these synfuel (and/or hydro)

projects is from foreign sources, the resulting surplus on the capital account will require a current-account deficit. But if primary energy exports also increase, this may imply substantial exchange rate appreciation in order to bring our overall international payments into balance. In turn, this will place the manufacturing sector under considerable pressure. With or without the FTA, a substantial world energy price increase (however unlikely) would clearly exacerbate all of these trends.

One obvious alternative is to decouple Canada's regional economies in terms of wage and income expectations. But this is easier said than done, as the NEP indicates all too clearly. While the FTA eliminates the possibility of another NEP in the sense of utilizing lower-than-U.S. prices to distribute energy rents interregionally, it does not prevent the use of the tax-transfer system from accomplishing these same goals. And faced with another energy price spiral, Canadians would surely demand some form of rent transfer, with or without the FTA.

I am not denying that the exchange rate will respond to the prospects of the manufacturing sector under free trade. But the secure access under the FTA for energy and for resources generally suggests that the underlying level of the exchange rate (as distinct from changes in the level) may not be driven by what happens to secondary manufacturing income or employment. While this is not a new issue for Canadians (Western concerns with respect to the overvalued dollar in the early 1930's were an important part of the pressure leading to the establishment of the Bank of Canada!), it is one that could flair anew under the FTA as resource-rich regions attempt to reap the benefits of their own "auto pacts". In any event, it does complicate somewhat the assertion that the exchange rate is the automatic "safety value" for any potential employment losses under the FTA.

### G: Recapitulation

On economic grounds, therefore, the FTA stands up rather well against its critics. In addition to the likely employment and production benefits outlined above one must add the real-income benefits to consumers in terms of lower prices. This is not to deny that there will be losers under free trade (who will have to be covered by new or existing socio-economic programs in any transition to new employment). But what it does imply is that on average the FTA will enhance, likely substantially, the real income of Canadians.

One might argue that the existence of economic gain is sufficient reason, of and by itself, to lend full support to the FTA. No doubt some Canadians take this position. However, for the vast majority of pro-free traders (or more accurately the vast majority of those of my acquaintances who are in favour of the FTA), economic gain is a necessary condition, not a sufficient one: the FTA must also be consistent with furthering generally accepted Canadian goals and values in terms of a wide range of associated areas. As noted earlier it is in these areas -- the ones left out of the FTA -- that the real battle lines are forming. While it is obviously critically important and indeed encouraging that Canadians are concerned about these issues, most of the remainder of this paper argues that these concerns are ill-founded. Since these fears are, to some degree at least, driven by American protectionism and what this could imply in terms of forcing us to buckle under with respect to sensitive Canadian policies, it is instructive, as a bridge between the analysis of the economic and non-economic aspects of the FTA, to focus on current U.S. protectionist tendencies in the context of the longer term.

#### IV U.S. PROTECTIONISM: THE LONGER TERM

In a few short years the Americans have moved from being the world's largest creditor nation to being the largest debtor nation. Even with hindsight, the underpinnings of this dramatic transformation are not fully clear. My own interpretation is that what triggered all of this was their high fiscal deficit on the one hand and their low domestic savings rate on the other. In tandem, these factors meant that the U.S. had to resort to very substantial external financing for their budget deficits, which in turn led to the exchange rate appreciation in the early 1980's. Not surprisingly, U.S. goods began, progressively, to be priced out of foreign markets, i.e., the budget deficit ultimately led via the exchange rate appreciation to the record balance-of-payments deficits on current account. Many U.S. corporations responded by moving production offshore, which effectively guaranteed that the response of the current account to the recent even-more-dramatic depreciation would not be symmetrical, at least in the short term. This unprecedented depreciation became inevitable once the U.S. became the world's largest debtor, although the fact that the industrial world's surpluses were concentrated in Japan and Germany probably heightened the perception of the problem and shortened the reaction time.

Several implications follow from this series of events. First, in order that the U.S. be able to continue to draw in foreign capital to finance its budgetary deficit, it is likely that the U.S. dollar will have to overshoot (depreciate more than) its equilibrium level. For offshore holders of U.S. bonds, overshooting implies that there will be an expectation of a future appreciation in the U.S. dollar (or a sharply diminished scope for a further

depreciation). If this were not the case, domestic interest rates in the U.S. would have to incorporate fully any expectation of a further depreciation. Secondly, the degree of overshooting is probably larger than it otherwise would have been, given that so much of the production of U.S.-based companies is now being done offshore. Phrased differently, the dramatic depreciation is leading only very slowly to improvements in the trade balance. Repatriating takes time. Third, the U.S. is now the world's bargain basement, ripe for takeovers by Japanese, Germans and other countries with appreciated currencies. In this context, the changes in the FTA with respect to FIRA or rather Investment Canada loom less important than is typically believed since it is non-U.S. corporations that are well positioned for takeovers in both Canada and the U.S.

Fourth, faced with these two stubborn deficits, the U.S. has become increasingly protectionist. In some areas, we probably gain from this protectionism: the American quotas (or voluntary export restrictions) on Japanese autos help maintain auto production in our industrial heartland, although this is inimical to Canadian consumers. In other areas, such as the U.S. attack on the agricultural subsidies in the EEC (by mounting substantial domestic subsidies in the U.S.), we clearly have got caught in the crossfire. And because of our very favourable overall trade balance with the Americans, without the FTA we would be very vulnerable in terms of the looming omnibus trade bill. In this context we obviously did not endear ourselves to the Americans in terms of policies such as FIRA, the NEP and the 1981 budget, all part of Trudeau's Second Coming.

As noted earlier, this fear of side-swipe or worse, direct hits, is propelling the FTA. However, in my view, the U.S. protectionism is likely to

be relatively short-lived. The underlying macro economics suggest that at some point the world's largest debtor has to begin running current-account surpluses. Likewise, unless the Japanese continue to buy out the world (i.e., run capital-account deficits), they will soon have to begin running current-account deficits to offset their rentier income. Just how all of this is likely to come about (e.g., continued appreciation of the yen) is less clear than the fact that the adjustments must occur. When this happens, the U.S. is going to become a "free trader" again -- it will need access to foreign markets and in return will have to open up its own market. Thus, unless the U.S. intends to become isolationist economically (a highly unlikely scenario), the current protectionist stance is, in my view, basically a temporary phenomenon. To be sure, there may still exist some long-standing problems (e.g., agriculture and perhaps perceived access to the Japanese domestic market), but the protectionist sentiment will fade, even to the point where I believe that were it not an election year the omnibus bill would have many fewer teeth than would have been the case a year ago. Intriguingly, however, it is likely that the concern over foreign takeovers of U.S. companies will rise. Thus, the Americans are likely to move from "protectionism" to "nationalism".

All of this suggests that the optimal strategy for Canada may have been to delay the FTA for a few years when the U.S. would be more receptive to Canada-U.S. free trade and freer trade generally. If the status quo could have been "preserved" in the interim, this would have been a viable policy strategy. But even a few years is in effect a lifetime for most enterprises, so that this luxury was not really available in practical terms. Relatedly, however, once the FTA is in place, Canada will presumably be dealing with a

country that is more committed to free trade than it is now. This bodes well for the FTA, assuming it passes its initial hurdles.

A final point here. At the time of writing the powerful U.S. lobbies, industrial and political, appear to be forcing the U.S. Administration's hand in terms of opening up the FTA for further negotiations. This is inherently a most difficult process, since each element in the FTA has been "bought" or "sold" with corresponding elements elsewhere. There may be room for mutually agreeable (Canada-U.S. and within-Canada) trades, but my best guess is that any such changes will substantially erode domestic support for the FTA: it is all too easy to view such American-driven changes as a caving in on Canada's part and only the first of a series of such concessions. In short, while obviously not precluding such mutually agreeable changes, once one brick becomes unstuck the likelihood is that the entire wall will come tumbling down.

Thus the Mulroney Government has little alternative but to hold tight to the original bargain. If the U.S. rejects the deal, this is far and away the best route for rejection from the domestic political standpoint (assuming for the moment that the deal is to be rejected). However, the U.S. rejects this pact at its own peril: the consequences, geo-politically, of isolating Canada economically in the northern half of the continent are potentially very high for the Americans. There is a substantial undercurrent of anti-Americanism (much of it healthy!) that already exists in our country. If the U.S. rejects the FTA this undercurrent will not only surface in a dramatically altered form but will count among its numbers a goodly number of those that currently support the FTA.

The message for the remainder of the paper is that the current tensions are likely to be less intense over time. In other words, there will likely be

a growing desire on both sides of the border to see that the FTA "works", which will include accommodations, again on both sides, to any unforeseen problems. This is admittedly an optimistic view but it is grounded not on wishful thinking but on the impending change in the U.S. trade figures.

## V VALUES, IDENTITY AND THE FTA

The typical line of the pro-free-trade element is that the FTA is essentially a commercial agreement and that it will have little impact on those aspects left out of the agreement (e.g., regional policy, social policy, cultural policy) let alone issues such as identity and sovereignty. Indeed the full line of the argument goes further: Canadians are more likely to trade-off sovereignty and identity concerns if they someday find themselves as second-class economic citizens within the North American continent. Free trade ensures that we will not be economically disadvantaged and, therefore, these societal goals and concerns are in effect secured or assured by the FTA, not the reverse. Or so the argument goes.

### A: Dueling Paradigms

While I too shall argue that the FTA does not constrain our goals on the various policy fronts (although it will affect our choice of instruments), the issues at stake here are not as clear-cut as the above approach suggests. Even though the FTA is basically a commercial treaty, its implications could very easily spill over into the non-economic realm. Implicitly, if not explicitly, this was the essence of an insightful op-ed piece by Globe & Mail columnist Jeffrey Simpson (October 9, "Choosing the Lesser of Two Evils").



Simpson focused on the FTA from the vantage point of the two countries' defining constitutional rhetorics -- "Peace, Order and Good Government" for Canada and "Life, Liberty and the Pursuit of Happiness" for the Americans. History, culture, language, geography and a sparse population have all played a role in developing among Canadians a more benign approach to government and a heightened concern for collective rights, in sharp contrast to the individualism which is the hallmark (moreso recently under Reagan) of the "American Creed". Even the Canadian Charter of Rights and Freedoms (while arguably very "Americanizing" because it transfers power to individuals, via the Courts, thereby introducing a checks-and-balances feature into our previous Parliament-is-supreme approach to governance) differs from its U.S. counterpart in that it enshrines aspects of collective rights -- sexual equality rights, aboriginal rights, multicultural rights and soon, perhaps, the "distinct society" of Meech Lake fame.

However, nowhere do these dueling paradigms appear to apply with more force than in relation to the two countries' approaches to social and regional policy, and, more generally, national identity. On the social policy front Canada's publicly-funded and administered health care system stands in sharp contrast to the more individualistic or market-oriented U.S. approach. The contrast is even more evident on the regional front: although the Americans engage in very extensive regional policy on the expenditure side (e.g., defense contracts), there is nothing in the U.S. that even comes close to section 36 of the Constitution Act, 1982. Section 36(2) requires Parliament to ensure that all provinces have access to sufficient revenues (via equalization payments) such that they can provide "reasonably comparable levels of public services at reasonably comparable levels of taxation" while

section 36(1) commits both levels of government to reduce regional disparities in opportunities and, more generally, to promote equal opportunities for the well being of all Canadians. Neither of these collective-rights aspects features prominently in the U.S. policy: indeed, it is not evident that the U.S. constitution would even allow Washington to engage in such regional-specific initiatives.

Despite these acknowledged and entrenched differences, concerns remain and are compounded by the reality that the FTA with its enhanced emphasis on markets resonates more, as Simpson notes, with Life, Liberty and the Pursuit of Happiness than it does with Peace, Order and Good Government. Thus the underlying issue can be rephrased as follows: Is the FTA with its express market orientation in terms of allocation likely to overwhelm the more sharing and collective-rights approach of Canadians on the distribution front? More bluntly, is the FTA about the "Americanize" Canadians. My answer, elaborated below, is a confident "NO".

But this is not the view that greets one, almost on a daily basis, in the nation's newspapers. Today's version (February 9, 1988) is that by 1999 when the FTA will be fully implemented Canada will have "privately run hospitals and libraries, no pollution controls or pay equity, exclusive universities and money-hungry day-care centres". While I believe that these assertions are entirely without foundation, I also believe that the ensuing arguments to this effect are unlikely to make many converts since there appears to be precious little in the way of any "middle ground" in the debate over the non-economic impacts of the FTA. Thus, probably the most appropriate interpretation of what follows is that it may provide the free trade advocates with enhanced assurance that the implications for the non-economic areas are

such that they need not dampen their enthusiasm for the economic aspects of the FTA.

While the analysis will focus selectively on various policy areas, it is important as backdrop to define a bit more precisely just what it means to say that the FTA will influence or predetermine the non-economic environment, particularly areas like social and regional policy.

#### B: Policy Evolution and the FTA

As sociologist Hugh Heclo noted in his survey of social policy in industrial nations, the era of expansion in the social policy network in the 1950's and 1960's coincided with, and was driven by the unanticipated and sustained economic and fiscal surpluses:

"After a generation of more of expansion, the democratic welfare states had produced a policy system that was admittedly attuned to -- and presumed -- continuous economic growth. Politically, it was a low cost system whose operation generated minimum conflict and maximum, if somewhat passive, support. Economically, it was in rough harmony with conventional thinking about fiscal management. Socially, it avoided raising difficult questions about social values. Commitments on the welfare state rose as commitment to it fell." (Heclo, 1984, p. 399, emphasis added)

With the 1970's and the altered global economic reality, countries everywhere began to rethink their social policy networks. In particular the fact that social policy had tended to be viewed as a "residual luxury supported by the nation's economic surplus" (Ibid., p. 403) and tended as well to be "aimed exclusively as solving social problems" (Ibid., p. 397) left it far easier prey than would have been the case had the expansion of social policy networks developed as part of an integrated economic and social policy framework.

Heclo's general survey clearly applies in spades to our social policy history. The emphasis on universality, the existence of "poverty traps" associated with the fact that the aggregate tax rate (on the combined income and expenditure fronts) in the transition from welfare to work typically exceeds 100 per cent, the regional aspects of UI and the confiscatory tax on earnings while on UI, etc., reflect a set of incentives more consistent with entrenchment than adjustment. Not surprisingly, Canadian social policy is evolving in ways that ameliorate these problems. For example, several provinces have now inaugurated earnings-supplementation programs that serve to decrease the tax rate in the transition from welfare to work. Over the last decade increasing emphasis has been placed on the income-tested component of social security (GIS) rather than on the universal payment (OAS). In the late 1970's, Ottawa converted much of the universal family allowance to an income-tested refundable child tax credit. More recently, the conversion from exemptions to credits under tax reform sets the stage for an eventual negative income tax. Thus far, unemployment insurance has remained untouched, but not for lack of critical evaluation by provincial and federal studies alike. In terms of health provision, New Brunswick has been experimenting for some time with "extra mural" hospitals (modelled after the New Zealand experience). Ontario has experimented with HMO's (health maintenance organizations) as an alternative to the traditional fee-for-service approach to physicians' care. And so on.

In my own writings on social policy (e.g., 1987a) I have argued that whereas the 1960's cushion of sustained economic growth allowed Canada to develop a comprehensive social policy network, the message of the 1990's is one that will call for a rationalization of this network both in terms of

re-integrating social and economic policy and in terms of re-orienting the system to accommodate the altered needs of Canadians. More generally there are at least three formidable challenges facing our social policy architects -- the fiscal challenge, the economic challenge (both domestically in terms of improving incentives and globally in terms of international competitiveness) and the socio-demographic challenge (e.g., the aging of the population and changing role of the family as reflected, say, in the increased number of single parent families in the work force). In terms of the traditional trade-offs in the system, addressing these challenges will likely require (on positive rather than normative grounds) that social policy evolution be in the direction of favouring adjustment over entrenchment, of favouring a greater reliance on ability-to-pay than on universality and of favouring, at least in some areas, decentralization over centralization.

Others may see the future differently, although it is important to recognize that virtually all of the on-going developments, including those enumerated above, are consistent with these directions. In any event, the relevant point is that our social programs will continue to evolve with or without free trade. Thus, the critical issue is not so much what these programs will look like in 1999 but, rather, how much, if any, of this evolution will be the direct and inevitable result of the FTA.

In this context, many Canadians focus on the recent federal day-care initiatives as evidence that the FTA will erode our social policy fabric. Setting aside the positive aspects of this initiative (i.e., that it is the only new shared-cost program to be inaugurated in the last two decades), I recognize that many Canadians would probably prefer that day care be uniform across the provinces and that it exclude the possibility of private-sector

provision. At base, this has nothing to do with the FTA (indeed, the FTA does allow us to restrict day care solely to the public sector). Rather, at one level, it is a lament that Canada is a federation, not a unitary state, and that day care is a provincial responsibility. From this perspective, the criticism ought to be directed against section 92 (provincial powers) or section 93 (education) of the Constitution Act, 1867 and not against the FTA.

Yet, at another level, it is likely that Canadians are making a link between day care and the FTA. The essence of this link is what the Toronto Star's Carol Goar has aptly termed the "blueing of Canada", namely the Mulroney Government's overall emphasis on markets. These market-related initiatives include such things as the unwinding of the NEP, the softening of FIRA, the decentralization of regional development initiatives, the lowering of marginal tax rates under tax reform and, presumably, day care and Meech Lake. Even though the Tories appear to have backed off, temporarily at least, from their commitment to social policy reform, their overall policy agenda is dramatically different from (and actually overturning) the agenda of the 1980-84 Trudeau Liberals. In this context, the FTA can be viewed as fully consistent with the current policy agenda -- entrenching, as it were, certain aspects of this enhanced reliance on markets.

The FTA critics are surely correct to point out that the free-trade initiative differs in both degree and substance from the other agenda items, largely because the implications of the FTA, and the FTA itself, may be very difficult for future governments to reverse. Will this in turn imply that certain aspects of the evolution of, say, social policy will also be locked into irreversible directions? The answer is both "yes" and "perhaps not". On the yes side is the obvious fact that in certain areas the FTA will constrain

the choice of policy instruments. The best example here is the NEP. The FTA effectively precludes another NEP-type policy where the price system is utilized as an instrument for redistributing energy rents within Canada. However, the FTA does not preclude the federal government from garnering a significant chunk of energy rents in the event of another energy price spike. But the instrument this time around will have to be the tax-transfer system. Most every policy analyst would argue that if the policy goal is distributional (e.g., capturing energy rents), then the appropriate instrument ought to be a distributional one (the tax-transfer system) and not an allocative one (the price system). But this does not detract from the fact that the FTA will constrain instrument choice for domestic policy initiatives.

On the "perhaps not" side, the argument is, as one might expect, rather complicated. Because the FTA will focus attention on efficiency and competitive advantage vis-a-vis the U.S., Canadians will be more attuned to eliminate inefficiencies whether they occur on the economic or social policy fronts. Offsetting this is the fact that the FTA removes one of the major handicaps constraining Canada's ability to become competitive internationally, namely market access. For example, writing on social policy prior to the FTA, I argued (1987a) that addressing the economic challenge facing our country would probably place immense pressure on our social policy network in order to "compensate" for Canada's small domestic market. The FTA removes this constraint. Moreover, the production and real income gains arising from the FTA will allow Canadians more freedom to maneuver in terms of social policy. Where this will all come out is not at all clear.

Hopefully what is clear, however, is that introducing adjustment or incentive-to-work concerns in the social policy framework is fully consistent

with maintaining or even enhancing the genuine notions of sharing that set us apart from the Americans. More importantly, a strong case can be made that moves towards selectivity and increasing incentives will increase the equity aspects of the social policy network. Two examples will suffice here. First, eliminating "welfare traps" by ensuring that the overall tax rate in the transition from welfare to work is no longer confiscatory must surely qualify as equitable, even though it is a move in the direction of income testing (not means testing) and selectivity. Second, when a wealthy couple crosses the 65-year threshold the tax system provides them with an extra \$6,000 or so of after-tax income (actually, the value of the tax break increases with increasing income). This is clearly inequitable from virtually any vantage point. Converting the new "age" tax credit (under Finance Minister Wilson's reform) to a refundable credit based on income (or folding it into the GIS) would transfer income from the elderly rich to the elderly poor, again consistent with the general conceptions of equity, but again a move away from universality. Phrased differently, the FTA does not constrain Canadians in terms of setting social policy goals. Indeed, nothing in the FTA prevents future governments from reversing recent trends and re-establishing universality as the cornerstone of Canadian social policy.

This overall issue of policy evolution has been addressed recently in a very perceptive paper by Osgoode Law School's Peter Cumming (1988):

"A move towards a set of public policies which promotes change in response to world economic changes is a move away from current policies such as the current UI, or regional development practises, that some critics of the FTA maintain are absolutely essential to our notion of what it is to be Canadian. I am certainly not advocating a dismantling of our social welfare system. Rather, I am arguing the opposite -- the enhancement of the social welfare system. Indeed, I think it imperative that an



efficient and equitable guaranteed annual income scheme be implemented. I am arguing only that we should look seriously at how such social policies are delivered, and the FTA provides us with the incentive. The negotiation of a subsidy code with the U.S. under the FTA will allow us to maintain our social policy goals, while changing methods of implementation that are too costly, grossly inefficient, and generally counter-productive. Such a development will allow Canadians more opportunity and freedom to maximize their social welfare, while offering the Canadian government fewer occasions for actions which have the appearance of increasing national welfare, while actually reducing national welfare in fact. Calling these programmes "Canadian" helps no one.

...

Therefore, any pressure for harmonization of policies in a free-trade area may really be pressure for a country to revamp outdated policies and adopt policies based upon contemporary notions of economics and achieve efficiency and equity; that is, policies that are in [our] own best interest and hence not so much a challenge to [our] national sovereignty as a challenge both to use [our] sovereignty more intelligently and also in doing so, to ultimately truly enhance [our] sovereignty through having a more productive and efficient, but also more a much more equitable society."

By way of a brief summary:

- With or without the FTA, Canadian social policy will continue to evolve. If recent trends continue, this evolution will be in the direction of enhancing adjustment, of increasing selectivity and, in many areas, of increasing decentralization;
- The notion, apparently widely held, that only those programs which are universal are equitable is patently false. On analytical grounds, the opposite is clearly the case and recent policy initiatives, such as the introduction of the refundable child tax credit, clearly reveal that this notion is also false in terms of actual policy initiatives;

- The FTA is consistent with these recent directions and may hasten this evolution;
- While the FTA may constrain instrument choice in some areas, it will in principle have no constraining influence on the choice of social policy goals. For example, there is nothing in the FTA that would prevent future governments from resurrecting universality as the cornerstone for future social policy;
- The FTA effectively eliminates the argument, common in some quarters, that the small domestic market requires as partial compensation that Canadian social policy become more "mean and lean" to maintain Canadian competitiveness;
- The employment and real income gains under the FTA imply that any level of social policy will be more affordable in the future.

With this as backdrop, I now turn in more detail to the implications of the FTA for individual policy areas, beginning with social policy.

### C: Social Policy and the FTA<sup>2</sup>

Social policy is defined for present purposes to encompass the range of policies and programs designed to maximize the opportunities for Canadians to enhance their human capital. In what follows, I shall deal in turn with policies related to post-secondary education, employer-financed social programs, health and income supplementation (welfare).

#### 1. Education

Canadians are placing a great deal of emphasis and more recently a reasonable amount of funding on human capital formation, R and D, and technology and in particular on the notion that increasingly our competitive

edge in the world economy must come from our knowledge base. Given our history, it is perhaps not surprising that we are experiencing some difficulty in making the transition from a resource-based culture (i.e., "if we don't cut it, or gut it, or dig it -- we don't do it") to a research or human-capital-based culture. However, complicating any cultural barriers to this are trade barriers -- tariffs, quotas and a protectionist environment which tend in general to enhance last generation's skills. If we maintain this inward-looking stance we should not be surprised that our biggest export will eventually be human capital. What is required here is a willingness and a confidence to challenge the world head-on in the knowledge-based sector which, in turn, implies opening our economy to freer trade.

Investment in human capital and R and D is a natural winner under free trade. Not only will the returns to such investment be enhanced (and the incentives increased for educated and skilled Canadians to remain at home), but with secure access to the U.S. market Canada now stands to benefit to a far greater degree from the whole process of technology transfer.

## 2. Employer-Financed Social Programs

In terms of employee contributions to social benefits, I argued earlier that removing the competitive disadvantage associated with access/market size would diminish pressures for "scaling down" in this area. Others have argued the opposite, namely that an open border will enhance the ability of Canadian business to pressure governments to erode our social benefits.

Hopefully, a bit of data will show that this latter scenario is highly unlikely. Based on payroll data for manufacturing (from the National Product Accounts for the U.S. and from unpublished Statistics Canada sources) employer benefits account for about 11 per cent of payroll in Canada and 17 per cent in

the U.S. If one excludes UI and workers' compensation payments (which are slightly higher for Canada), the employee shares of pensions and of health and life insurance are about 7 1/2 per cent in Canada and 14 1/2 per cent in the U.S. On the pension side the difference arises because the CPP is not as yet fully matured and because OAS and GIS payments are funded out of consolidated revenues. On the health and life side, medicare is clearly the major difference. There may well be cases where firms in some locations in the U.S. can avoid some of these charges, but on a national-average basis Canadian firms enjoy an overwhelming (and non-countervailable) advantage here.

Where will the pressure for change come from? One answer might be from firms that end up as losers under the FTA. However, paring down employer-related financing of social programs is a very inefficient and ineffective way of assisting those Canadians that may suffer under free trade. In general, therefore, I see little or nothing to be concerned about here in terms of our social programs.

### 3. Medicare

Canadians view our medical and hospital insurance system as a "sacred trust". As noted above, the nature of our health-care financing bestows a substantial cost advantage to our industry. Moreover, our system is more efficient than that in the U.S., as measured by costs as a percentage of GNP. Certainly, it is more equitable. Finally, it is inherently non-countervailable because it is a "national" program. Just who is it among Canadians that will cast the first stone? It is correct to note that the competitive advantage that medicare bestows on Canadian auto-makers was emerging, prior to the FTA, as a major American concern in terms of the Auto-Pact. With the FTA, however, this issue is diffused, not heightened.

All of this is not to suggest that the status quo with respect to our health care system is viable over the longer term. Indeed, I am sure it is not. But the inevitable evolution is not likely to be influenced by the FTA. As a matter of fact, it is the American system that will surely undergo the more profound changes.

#### 4. Welfare and Income Security

The evolution of our welfare and income-support system is in full flight, as it were, and quite independent of either the prevailing American model or the FTA. As noted above, the provinces, led by Quebec, are becoming very concerned about the "poverty traps" that are created by the current system, e.g., situations where the "full" tax rate (including expenditure benefits) in the transition from welfare to work typically exceeds 100 per cent. Several provinces now provide various versions of earnings-supplementation programs for the working poor. Moreover, under federal tax reform, the most tax deductions have now been converted to credits. The obvious next step is to make these tax credits refundable. If, or rather, when this occurs Canada will be well on its way toward a negative income tax or an income-tested guaranteed annual income. It is true that the work incentives in such a system are consistent with free trade, so that the impact of the FTA may be to hasten its arrival -- but the building blocks have long been firmly put in place both at the federal level (with the introduction in the late 1970s of measures like the refundable child tax credit) and at the provincial level (with wage subsidization programs for low-income individuals and families) and this evolution will proceed with or without the FTA.

Thus, I find suggestions that the FTA will overwhelm our social policies difficult to fathom. In 1945 our exports to the U.S. were roughly 37 per cent

of our total exports. In 1985 they were more than double this -- 75 per cent. Presumably one could have made an argument in the immediate post-war period that this massive increase in our export dependency on the U.S. was sure to force our social policies into harmony with those of the U.S. Yet this is the very period when Canadian social policy took on a life of its own, quite independent of what the Americans were doing. It is hard to see why formalizing our exporting arrangements will suddenly make us vulnerable to U.S. views on social policy.

Moreover, it is not clear just how this undermining of our long-standing and firmly entrenched social philosophy is supposed to come about. One frequent argument is that it will result from a gradual altering of our social mores as more trade begins to flow north-south rather than east-west and in the process we become more "Americanized". But until recently the largest two-way flow of international trade in history was between Ontario and the U.S.A. (only very recently surpassed by U.S.-Japan trade). Have Ontarians, as a result, abandoned the Canadian traits of greater sharing and a larger role for government in the social policy area? Pay equity, among other things, is clear evidence that they have not. Why should it be different for Manitobans and Nova Scotians if the FTA allows them to engage in more north-south trade?

I turn now to the likely implications of the FTA for regional policy initiatives, including the area of countervail and the proposed "subsidy pact" under the Agreement.

#### D: Regional Development Initiatives

By far the most important point to emphasize in terms of the interaction between the FTA and regional policy is that the FTA itself is, apart perhaps

from equalization, probably the most significant "regional development initiative" in the post-war era and perhaps ever. Consumers will obviously benefit (i.e., real incomes will increase). The resource sectors -- e.g., energy in the west (and Quebec) and fishing in the east -- are also clear beneficiaries. Moreover, by opening up north-south trade the FTA addresses in one fell swoop both the "distance" and "market size" burdens of the regional economies (i.e., their "centre-periphery" destiny within Canada).

In turn this leads to a second important aspect. With the advent of the regional development agencies, which transfer more control over regional development to the regions themselves, the opportunity now exists for the regions to direct these new initiatives in a manner consistent with capitalizing upon and enhancing the gains that will derive from the FTA. All in all, a very upbeat picture.

Turning now to the future of regional initiatives under the FTA, the first point to note is that the bulk of our commitments on the regional front are enshrined in the Constitution and, therefore, they transcend the FTA and even an abrupt about-turn by Canadians with respect to regional sharing. However, as noted above, the FTA may constrain the manner by which we implement certain regional initiatives, but it does not constrain the goals which Canadians set for regional policy.

#### 1. The FTA and Countervail

In terms of countervail under the FTA, the status quo prevails -- what was countervailable pre-FTA remains countervailable post-FTA, with the important caveat that these disputes will now go before the new and presumably more objective binational panel. However, both Ottawa and the provinces have long recognized that high-profile subsidies targeted to an exporting plant or

industry will risk countervail. Governments remain free, pre- or post-FTA, to subsidize or provide incentives for specific industries which produce for the domestic market and they may also have considerable leeway when it comes to import-competing industries. The essential point is that Canadian governments have already been backing away from those regional development incentives that will trigger countervail. The FTA merely entrenches this development.

Second, recent initiatives on the regional front (e.g., the Atlantic and Western Agencies) have begun to place less emphasis on boards and mortar and more emphasis on "mortar boards". Part of this policy shift presumably reflects the general consensus that the old boards and mortar approach has not worked. Part also probably reflects the fact that Prime Minister Trudeau and the other architects of the Constitution Act, 1982 cast the regional commitment less in terms of physical infrastructure than in terms of equalizing well-being and opportunities for all Canadians. Thus, to the extent that our regional policies became directed toward providing individuals and communities with this "human capital infrastructure" (providing expertise, training, R and D, etc., rather than direct subsidies, to facilitate the development, production, packaging and marketing of regionally-based products) the likelihood of countervail diminishes substantially. To be sure, this is consistent with the dictates of the FTA, but the enhanced emphasis on putting "people" rather than "things" at the centre of regional development is, in my view, most welcome in its own right.

## 2. UI and Countervail

The generalized UI program is not subject to countervail since it is a national (i.e., not an industry-specific) program. However, a few years ago the U.S. brought countervail measures against the ground-fish industry.



Surprisingly, the Americans lost this countervail case. Perhaps it was because they focused their case on the "regional" aspects of UI (which are not specific to the fishing industry) rather than on the fact that fishermen are the only self-employed workers eligible for UI. The "good news", here I suppose, is that if the fishing component of UI is not countervailable (even under the pre-FTA procedures) Canada may well have substantial leeway in terms of regional development initiatives. This "bad news" is that the U.S. should have won this case for two reasons. First, the self-employed provisions in UI for fishing are an industry-specific subsidy. Second, while UI as an income replacement program is an essential and integral part of an overall income security system, that component of UI which has as its goal income support or maintenance rather than income replacement ought to be folded into a generalized income-support program (i.e., an income-tested GAI). This was the view of the recent Newfoundland Royal Commission on Employment and Unemployment which argued that the impact of UI in the Newfoundland economy, among other things: undermines the intrinsic value of work, undermines good working habits and discipline; undermines the importance of education; is a disincentive to work; discourages self-employment; distorts local development efforts; is vulnerable to manipulation, etc. The underlying point here is not so much to argue that UI needs some rethinking but rather to emphasize that if, a few years down the FTA road, Canadians do modify UI this will have little to do with the FTA, per se.

### 3. The Subsidy Pact

Finally, the FTA provides that over the next 5 to 7 years both countries will attempt to develop a mutually acceptable set of rules relating to subsidies and other anti-competitive measures. The prevailing wisdom in

Canada is that this will constrain us much more than it will the Americans. This is far from obvious. If, as I suspect, our new initiatives on the regional policy front will be more successful than our past forays in this area, we may be quite prepared to agree to such a subsidy pact, since these new regional initiatives represent a movement away from measures that are countervailable to those that inherently are not. In contrast, a substantial number of American states have, over the period of the 1980s, suddenly "discovered" regional development initiatives in the wake of the recession and also of the rust-belt, sun-belt shift, so that they are likely to be much more difficult to bring into line. In some ongoing research, McNiven (1988) has found that at least 20 U.S. states have developed industrial policy strategies, post-1980. Therefore, it may well be the U.S. states rather than the Canadian provinces that will be the ultimate stumbling block for the subsidy code. In any event, my best guess is that our two countries will approach the subsidy-pact negotiations with the view that it will eventually serve as the model for a general GATT pact.

#### E: Culture

The Canadian government made firm commitments prior and during the negotiations that our culture and cultural industries would be exempt from the FTA. For better or worse, the government has delivered on this commitment. Under the FTA, the definition of cultural industries includes publishing, film, video, music and sound recording, broadcasting and cable. Article 2005 of the FTA confirms that these cultural industries are indeed exempt from the agreement, except for four very specific provisions:

- the elimination of tariffs on sound recording and film (Article 401);
- the elimination of the "print in Canada" requirement for Canadian periodicals (Article 2007). At base, this is really a "manufacturing" issue, not a "cultural" one;
- an undertaking to introduce retransmission rights (Article 2006);<sup>3</sup>
- an undertaking by Canada to offer to purchase a business in the cultural sector if divestiture is required as a result of an Investment Canada review of an indirect takeover (Article 1607, para. 4).<sup>4</sup>

No other provisions of the FTA apply to the cultural sector.

It is better to view this issue from the opposite vantage point: what can we continue to do in the cultural area? The answer is almost everything, including (not exhaustively) the following:

- maintain the discriminatory second-class postal rates between U.S. magazines printed and mailed in Canada and comparable Canadian general interest magazines;
- maintain Canadian content rules in broadcasting as well as simultaneous substitution of cable signals;
- maintain Telefilm Canada;
- maintain the CRTC's ability to supervise the Canadian system and encourage more and better Canadian programming;
- maintain the ability to review all direct and indirect acquisitions in the cultural sector, i.e., culture is exempt from the investment provisions of the FTA, except for footnote 3 above;
- and on and on.

Exemption from the FTA means effectively that the status quo prevails, including the ability of either Canada or the U.S. to take unilateral action against the other for what it considers to be unfair trade practices in the cultural area. Actually, the FTA provisions serve to constrain the existing ability of the U.S. to retaliate here. Specifically,

- the U.S. can only take action against a Canadian cultural measure that, but for the cultural exemption, would contravene the terms of the agreement; and
- any such U.S. retaliation must be limited to a measure of "equivalent commercial effect".

Earlier, I prefaced a sentence by "for better or worse". The issue here is that it is not at all clear that protectionist domestic policies foster "culture". What they clearly do is entrench the existing cultural elites and in the process probably inhibit new entrants. In large measure, this is the message of a recent Fraser Institute publication by John Metcalf (1988) on the Canadian literary "establishment". Apart from an inappropriate preface (which argues that there are no public good aspects to Canadian literature), the essay is intriguing. Metcalf argues that the "sheer size of subsidies and their attendant bureaucracies combine to give the illusion of cultural health" (p. 5) and that the Canada Council, "[because] it is a thing apart with its own logic and its own dynamic and because it wields a huge budget, it skews and distorts the nature of our literature and the workings of our literary world" (p. 6). In other words, "small-c culture in Canada is becoming Culture -- a possession and expression of the State" (p. 4).

Like many Canadians, I suspect, I have a much better feel for culture (defined here rather awkwardly as the totality of traits and tastes of

Canadians, whether based on national, regional, provincial, ethnic or other shared experiences that eventually filter up to form the Canadian psyche) than I do for Culture (defined, again awkwardly, as a top-down rather than as a bottom-up process), and I do not claim to understand the nature of the symbiotic relationship between the two. The market nationalist in me has little trouble in terms of using public funds to further the expression of Canadian culture, because culture does have public-good attributes. This is especially the case given that the constitutional basis for linguistic duality, let alone multiculturalism. Public policy in the context of a "melting-pot" mentality is quite different from that in a framework designed to preserve, if not promote, our cultural diversity. But it also argues for a very open and competitive process in accessing these funds even to the point of believing that aspects of Canadian culture would have benefited from coming under the perview of the FTA.

Presumably, it is some of these same concerns that are surfacing in the current "cultural controversy" in the nation, namely the "public-sector-versus-private-sector" and the "Toronto-versus-the-regions" arguments relating to the awarding of the contract for an all-news T.V. channel. Neither of these arguments has anything to do with the FTA.

These particular or peculiar views aside, the bottom line is that culture is, for all intents and purposes, exempt from the FTA. Hence, I am at a total loss when it comes to understanding why cultural issues continue to feature prominently in the arguments of those opposed to the FTA.

**F: Energy**

The energy aspects of the FTA have tended to be viewed not so much as a trade issue but rather as a sovereignty issue, i.e., we have bought U.S. compliance with the overall FTA by "selling out our energy patrimony". While it is clear that the Americans need our energy whether in the form of primary energy (oil, gas, coal, uranium) or in "manufactured" form (electricity, synfuels), this interpretation of the agreement appears to me to be way off base.

First of all, if it is true that it was energy that clinched the FTA, it is an extremely small price to pay, if indeed it is a price at all. It is in the U.S. interest to contract for our energy with or without an FTA and in the current economic and political climate we would obviously be willing to deal with them. Phrased differently, if the FTA runs aground, for whatever reason, it is likely that Canada and the U.S. will strike separate "energy pacts". Premier Bourassa's massive electricity sales (prior to the FTA) are one obvious example. The concerns of the western energy provinces, setting aside the schizophrenic domestic energy policy history, are the equally arbitrary and discriminatory U.S. measures that over the recent past have wreaked havoc with government and corporate energy policy and planning. What this has effectively implied is that the U.S. has been able to get our energy on their terms, not on mutually acceptable terms. The Accord lays down new and binding "rules of the game" -- essentially secure access -- that henceforth will govern energy trade.

Second, Canadians have won or rather maintained some very substantial concessions in the energy area:

- Petrochemical producers now face tariffs ranging from 12 per cent to 18 per cent on exports into the U.S. (the world's largest petrochemical market). These tariffs will be eliminated.
- Canada will be exempt from any future U.S. oil import fee (a likely scenario in the U.S. for both energy and fiscal rationales).
- U.S. restrictions on enrichment of uranium will be eliminated on our uranium exports.
- In terms of "national" goals, we retain the ability to (a) disallow any foreign takeovers of healthy Canadian-controlled energy companies; (b) screen takeovers in the energy sector from the \$5 million (pre-FTA) level, rather than the new \$150 million level; (c) continue the 50 per cent Canadian ownership requirements for issuance of a production license in frontier lands (offshore and NWT); (d) restrict ownership in individual uranium mining properties to ensure Canadian control will be maintained; and (e) continue with existing or future incentives for oil and gas exploration and development. Phrased differently, most of Canada's policies in the energy sector have been "grandfathered".

Third, the FTA basically enshrines the policy status quo. This may not cut much ice with the FTA opponents, but the fact remains that the immediate impact of the FTA will be minimal because recent Canadian energy policy initiatives have emphasized deregulation and an enhanced role for market forces.

Fourth, contrary to much that has been written about energy and the FTA, Canadian producers can charge different prices in different markets. My interpretation is that this even applies to crown corporations, although not

all legal experts agree on this point. What the Accord forbids is government-imposed price discrepancies. Somewhat relatedly, Canada has agreed to suspend one of the three price tests related to exports, particularly electricity exports. Prior to the Accord, the NEP imposed the following price tests on exports:

- the export price should cover all costs;
- the export price should not be less than the cost to other Canadians (or in the case of electricity to the consumers of adjacent provinces); and
- the export price should not be materially less than the least cost alternative for the buying entity.

It is this third test -- the least-cost-alternative cost or the opportunity cost to the buying entity -- which is being eliminated. It is not clear that this will have much impact since electricity exports are in effect private bilateral negotiations with no obligation for the seller to deliver at a price that is not acceptable.

Fifth, the domestic security-of-supply concern is, in my view, basically a non-issue at both high and low energy prices. At low energy prices, say \$10 or \$12 a barrel, Western oil will be conserved since offshore supplies will displace domestic supplies. At high prices, say in the low twenties (perhaps not even this high) synfuels become economical and, given our production potential here, supply concerns again wane. Problems can arise under scenarios where world energy prices remain highly volatile or settle at levels beneath the viability for synfuels. These concerns will exist with or without the FTA. In this context, it is instructive that the various "open" conferences associated with on-going federal review of the energy economy



(Energy Options) revealed a general consensus in favour of allowing market forces to hold greater sway in the energy area. In part, this reflects an implicit, if not explicit, rejection of the dirigisme associated with the NEP but it also reflects a preference for market-based pricing in terms of resource allocation even where world prices remain volatile. To be sure, this does not lead automatically to embracing the FTA, but the FTA is consistent with these attitudes.

Natural gas security may pose more problems, particularly if Ontario does not follow the current (i.e., pre-FTA) policy of U.S. firms and utilities in seeking long-term contracts for Alberta gas. Even here, however, many experts suggest that the likely scenario is that while more Alberta gas will flow south, U.S. gas will also begin to flow into Ontario. Moreover, there is an ace-in-the-hole for Canada in this area. The gas pipeline to California is completely full. While U.S. firms can contract for long-term deliveries, more gas cannot flow out short-term unless a new pipeline is built. This requires full federal and provincial hearings with many avenues for triggering a "no-go" decision. In other words, Canada has an effective non-tariff barrier that, should it wish, it can probably deploy.

Sixth, while Canada has no overall security of supply problem, we have a regional (Atlantic) problem. This is true with or without the FTA since Western gas, for example, is not really accessible by the Atlantic provinces. Hopefully, Energy Options will focus in detail on this problem and offer some solutions.

Seventh, the secure energy access under the FTA will likely serve to lower the cost of capital in terms of any future energy mega projects (e.g., synfuel projects), even to the point where governments may be able to withdraw

from the financing or subsidy scene, though this is not required under the FTA. As noted earlier, however, there could be exchange-rate implications arising from such mega projects.

Finally, governments still retain considerable flexibility in overseeing energy activity. Provinces still retain the ability to alter incentives in the oil patch in order to control development and extraction whether for conservation, environmental or other reasons. As Lipsey (1988) points out, what provinces cannot do is use these policies as disguised ways of discriminating against foreign energy firms.

Despite these appealing features, energy concerns feature prominently in the FTA debate. A large part of this concern is centred on the "proportionality" provision. The provision states that if Canada (not a private producer) decides to implement measures to reduce the overall production of domestic oil we can only reduce the export component in proportion with the overall decrease. In such cases, we would be required to go offshore for any additional domestic needs. This basis for applying the proportionality provision is the most recent 36-month period, not what obtained in the last month, for example. While, one can drum up scenarios where this provision could put Canada in a bind, it is important to note that this is not an energy-specific measure. Under article 409 of the FTA, the provision applies across the board and to both Canada and the U.S. and it is also incorporated in GATT agreements. The rationale has to do with ensuring that governments are limited in terms of overturning private contracts in ways that shift the burden to the other partner. One might argue that energy is such a special commodity that it ought to have been exempt from this provision. In any event, energy was not excluded. In cases of a global

shortage, the IEA (International Energy Association) sharing principles apply to both partners and these are considerably more onerous than the proportionality provision. Nonetheless, this proportionality rule may prove to be binding, particularly for natural gas, and therefore does represent a legitimate concern.

Overall, however, I view the energy component of the FTA as an integral element of what makes the overall accord so appealing to the Americans and Canadians alike, or at least to the producing provinces.

There are obviously a number of other areas such as investment, agriculture, and services that merit attention in any comprehensive evaluation of the FTA. Equally obviously, the present paper, already rather lengthy, cannot strive to be exhaustive. In the final substantive section, attention is directed to the interaction between the FTA and sovereignty.

### G: Sovereignty

The introductory sentence referred to the FTA as "commercial continentalism". However, the FTA critics typically view the accord as "political continentalism", that is, an effective secession of sovereignty to the Americans. Some ceding of sovereignty is inherent in any treaty or international agreement, bilateral or multilateral, so in this respect the critics are correct. But the ceding is not to the Americans since they also cede sovereignty. Rather, it is to the provisions of and arrangements related to the accord. This general area is as contentious as it is important. In the following paragraphs I shall argue that ceding sovereignty on a broad range of fronts is the inevitable result of growing interdependence, domestically and internationally. The real issue is not whether we cede

sovereignty (because we must) but whether we do so in ways that ensures maximum domestic control over the process.

At this juncture, it is convenient to revisit Meech Lake. Quebec's Tremblay Report, issued in the mid-1950s, argued that meaningful decentralization within our federation required "watertight compartments", i.e., the classic form of federalism where responsibilities between orders of government are assigned in an exclusive manner and where each order of government has the ability to act independently of the other. As Bastien (1981) has pointed out, were the commissioners of the Tremblay Report writing today they would find that the "autonomy" of each order of government has generally given way to interdependence:

"They would find that in many fields of government activity, the federal government and the provinces are called upon to confer with one another regularly; that the number of mechanisms for federal-provincial consultation has increased enormously over the past decades; and that agreements, understandings and programs that involve both orders of government have multiplied dramatically. They would discover that the federal government has a continuing interest in many matters falling under provincial jurisdiction. At the same time, they would discover that the provinces also have an interest in many matters that are of federal concern, such as monetary policy, international trade, the law of the sea and that it is often difficult for the federal government to act on these matters without provincial cooperation. Finally, they would discover that certain policies, such as those concerning scientific research and development, environmental protection, industrial growth and regional development are not unequivocally under the sole jurisdiction of either order of government and require close federal-provincial collaboration." (Bastien, 1981, pp. 45-46)

Thus, "the concept of autonomy in a modern federation no longer refers to a form of independence in areas defined by the constitution but to an ability to act or influence the course of events" (*Ibid.*, p. 48). Accordingly, like

Bastien, I support Carl Friedrich's view of federalism:

"Federalism should not be seen only as a static pattern or design, characterized by a particular and precisely fixed division of powers between government levels. Federalism is also and perhaps primarily the process...of adopting joint policies and making joint decisions on joint problems." (Friedrich, 1968, p. 7, emphasis added)

In my view, much of Meech Lake falls into this category -- finding mutually acceptable processes whereby both levels of government can act jointly in areas where unilateral action by either order of government is increasingly difficult for economic, constitutional or political reasons. The spending power provision, the immigration provision, the procedure for appointing judges and probably the arrangements for Senate appointments are cases in point. Some Canadians have argued that Meech Lake is decentralizing. I have argued the opposite (1987). But whether "sovereignty" or "autonomy" is transferred up or down is the wrong way to approach Meech Lake. In my view Canadian sovereignty is enhanced because we have found mutually acceptable means or processes to deal with the growing interdependence which, of and by itself, erodes autonomy.

These same principles apply to the FTA. The growing interdependence globally has meant that the ability of any one nation to act alone in an increasing number of areas is rapidly being eroded. Not surprisingly, therefore, the result has been a growing number of international agreements, alliances, and understandings across a wide variety of fronts -- political, military, economic, environmental, etc. Each of these constrains (in differing degrees) what a signator can do and in this sense represents a "loss of autonomy". However, all other signators are equally constrained so that a given country can legislate with the knowledge that there are clear limits or

rules in terms of how other nations will behave or react. One may or may not want to view this as a corresponding "increase in sovereignty", but in some sense it clearly is. On the other hand, for a small open economy to have full ability to legislate domestically in an interdependent world where there are no rules of the game in terms of how and when others will respond or retaliate hardly classifies as sovereignty, if the term means an ability to act or influence the course of events.

One example of an area where this interdependence is dominant is the environment. Levels of CO<sub>2</sub> and acid rain are threatening the commons. Canadians are free, legislatively, to determine our own pollution standards. But this is a pyrrhic view of sovereignty. I am sure that most Canadians would welcome "loss of sovereignty" here and quickly sign a pact that bound other nations to similar restrictions on pollution or to environmental norms.

The global financial market is another area. Computational and telecommunications technology along with sophisticated financial instruments have combined to create a global financial market place. If the Americans want to maintain (or regain) some of their prior eminence in this area they really have little choice but to revamp their long-entrenched approach to their domestic financial sector (e.g., eliminating the McFadden Act prohibiting interstate banking and Glass-Steagall prohibiting the intermingling of commercial and investment banking). In other words, the very interdependence of world financial markets implies that even a superpower has effectively lost the freedom to determine the nature of its domestic policies! Moreover, all western nations will very quickly have to agree on how to regulate "offshore banking" in order to minimize the likelihood of a global finance disaster. Presumably this will involve all countries turning

substantial domestic regulatory powers over to some international agency.

The litany of such examples is virtually endless. Indeed, the hallmark of this growing interdependence has been a gradual ceding of selected aspects of sovereignty. And I see this process continuing. Thus the challenge is not to prevent it, since the process is inevitable. Rather, the challenge is how to manage and control this inevitable process.

This brings us back to the FTA. Given the staggering dependence of Canadian trade on U.S. markets, and more generally the combined U.S.-Canadian trade interdependence, it is absolutely critical in my view that this trade be governed by a commercial agreement which sets forth the rules of the game and eliminates arbitrary and discriminatory behaviour on the part of the Americans. As Peter Cumming (1988) notes:

"Not only are our current interventionist economic policies limited and usually of a detrimental effect, but prior to the FTA, the U.S. could unilaterally decide which Canadian practices it found offensive. Although under the FTA domestic law will continue to be applied, the cases will be heard by an independent bi-national tribunal. The significance of this development should not be understated. As Joe Clark has stated, Canada's problem has not been with the U.S. trade laws themselves but the way in which these laws have been applied and enforced. Determinations prior to the FTA were often the result of political pressures, and not subject to the rule of law. The FTA has therefore resulted in an expansion of Canadian sovereignty into an area of U.S. jurisdiction."

Our part of the bargain is to be constrained by these same rules.

Even if one were to agree with this observation, the more general question is whether or not the FTA represents the sort of commercial treaty that allows Canadians to manage and control this transfer of sovereignty. I believe that the FTA does precisely this because it enshrines the "Principle of National Treatment", namely that foreigners are subject to the same rules

as nationals. (It does not mean that American firms in Canada will be treated the same way as they are in the U.S.) As Lipsey (1988, p. 149) points out in his discussion of sovereignty and the FTA:

"National treatment allows each government to follow any policy it wishes, and to adopt policies that are totally different from the other government's policies, with only a single important proviso: that the government does not use these policies to discriminate solely on the basis of nationality, either overtly or covertly."

This principle of national treatment is not just another provision of the FTA: it represents the legal framework that underpins the entire agreement and, accordingly, appears in the first chapter of the agreement. Canada and the United States will treat each other's goods, services, investment, supplies and investors as they treat their own, insofar as the matters covered by the FTA are concerned. In other words, the FTA was designed to maximize policy sovereignty with the exception that these policies cannot be designed as disguised barriers to international trade or investment.

Moreover, as Lipsey (1988) emphasizes, and as has been elaborated above, the FTA applies national treatment in ways that further maintain our policy sovereignty:

"First, virtually all laws that affect things other than trade in goods are grandfathered, even when they offend the principle of national treatment...Second, a range of sensitive industries are completely exempted from any national treatment obligation -- examples are day care, health, education, any crown corporation, and all cultural industries." (Lipsey (1988), p. 150, emphasis added)

There are substantial concessions indeed.

One way to assess the likely impact in terms of domestic policy sovereignty is to focus on how other nations have managed to reap the benefits



from economic integration while at the same time preserving diversity. In a recent C.D. Howe publication, Victoria Curzon Price (1987) offers the following conclusion from the European free trade experience:

"The European experience suggests, and theoretical considerations confirm, that free trade is compatible with an amazing degree of diversity. In fact, one only has to look within federal states to see just how much diversity survives after decades, it not centuries of economic unity. Sweden can retain its extensive social welfare system -- and the high level of taxation that goes with it; Switzerland can remain at the other end of this spectrum, with a maximum of self-help and low levels of taxation; Austria can run its economy on largely state-owned lines; Finland can retain its special relationship with the Soviet Union...The point is that the locus of sovereignty does not change: it remains with the country, its government and its electorate. They remain free to choose."  
(Ibid., pp. 53-54.)

And so will we!

To conclude this section it is instructive to return to an earlier theme, namely that the major issue in this great debate is only partly free trade, per se: a corresponding issue is that the FTA is a vehicle for entrenching market-type policies. Don MacCharles (1988) made this very point in a Financial Post column: the debate is "not about free trade at all, but about whether politicians will have the power to intervene in markets for idiosyncratic reasons related to their views on industrial and social policies". Fred Lazar (1988) puts the issue squarely in terms of the "political immorality" referred to above:

"If the philosophy of the party in power favours a more limited role for government, it is one thing for the government to pursue this objective via purely domestic initiatives; it is another matter for the government to try to achieve this objective through an international agreement/treaty. Domestic policies are more easily reversible (i.e., less costly to change) than are

international agreements. A free trade agreement is not the proper vehicle for resolving a philosophical and economic dispute over the proper role of government."

One should add that this domestic policy sovereignty concern is also an issue in the U.S. in terms of the FTA. Nonetheless, this is another aspect of the "wicked problem" syndrome referred to earlier and a further reason why an election on the issue is inevitable.

With respect, however, I think that the real issue is free trade, not the role of markets. Canada is not unique in having to face up to this issue. Surely this must have been front and centre in the British referendum on joining the ECC and, of course, for the origins of the ECC itself. As Lipsey has noted (1987, p. 6) more than seventy other nations have already committed themselves to trade pacts of one form or another. He then adds:

"Just because everyone else is getting into free trade is not a sufficient reason for Canada to do so. It is worth noting, however, that Canada is the only member of the Organization for Economic Cooperation and Development (OECD), other than Japan, that is not in some form of free trade area or common market association...[The existence of these trade groupings] reflects the simple assessment that in today's highly integrated world, large markets really matter. Everyone is trying to make regional groupings work. Some have succeeded more than others, but Canada would be unique in the world if, given the chance, it said no." (Ibid., p. 5)

## VI CONCLUSION

This has been an unabashed endorsement of the FTA, not only on economic grounds but also in terms of the full range of associated areas. I recognize and respect that many of my fellow Canadians have a very different view of the

FTA. For this reason, much of the above analysis was directed to the set of issues that loom large in the arguments of the FTA critics. However, as I noted above, there is not much middle ground in the free trade debate and, therefore, probably little room for essays in persuasion.

Nonetheless, the fact remains that the FTA represents a unique, exciting and historic opportunity for Canadians. To be sure, the agreement is not perfect. The above analysis emphasized how well we came off in the deal. But there are things we did not get. For example, it is unfortunate that the Americans insisted on maintaining the Jones Act since Canadians are more than able to hold their own in Maritime transportation. But presumably the Americans "bought" this exemption by giving away to Canadians desires elsewhere in the pact. This "seamless-web" characteristic of the FTA effectively means that further negotiations are probably ruled out and we Canadians must accept or reject the deal as it now stands. On economic grounds the case is convincing. What much of the above analysis attempted to demonstrate is that the FTA does not compromise deeply-held Canadian aspirations relating to non-economic goals ranging from social and regional policy through to more intangible symbols of national identity. It may be trite to point out that despite decades of open borders and of incredible migration flows, Alberta and Saskatchewan have steadfastly maintained different approaches to automobile insurance, but it is certainly illustrative of the compatibility of differing social or cultural visions under free trade. The principle of national treatment, which underpins the entire FTA, ensures that those aspects of our shared Canadian experience which we as a community value most not only will survive but should continue to flourish under the FTA.

Reverting to an earlier theme as a concluding comment, I still remain baffled as to why the Americans, given their current international economic problems and their domestic political climate, are willing to open their borders to Canada under the provisions of the FTA. Self-interest cannot be the full answer since it is not difficult to generate scenarios in which the Americans could have driven a harder bargain. And no deal at all (with Canada coming under the provisions of any omnibus trade bill) is eminently viable for the Americans but not for Canadians. Part of the answer must be that somehow we got positively side-swiped in the ideological war between the Administration and Congress. Moreover, the FTA is a valuable "demonstration" project in the larger geo-political trade arena in which, despite its declining economic influence, the world's largest market still plays a formidable role. These issues along with many others raised above will eventually be sorted out by policy historians.

## ENDNOTES

1. In terms of the members of a free trade block, gains arise from both trade diversion and trade creation. From the global perspective, however, a free-trade association would be welfare reducing if trade diversion exceeds trade creation. But one has to be very careful here. For example, trade creation also includes the gains arising from expanding existing trade between the partners arising from lowering or removing tariffs. And some of the income gains will presumably be spent on imports from countries outside the free-trade association. Likewise, what begins as trade diversion may end up welfare-enhancing globally if market access and increasing returns to scale allow the partner to become the least-cost producer. And all of this assumes that the existing patterns of trade are not themselves influenced by trade diversion elsewhere in the system. In any event, what little empirical evidence that does exist (e.g., Markusen and Wigle, 1987) indicates that while the rest of the world does suffer welfare losses, these are overshadowed by the welfare gains from the FTA.
2. Substantial portions of this section and the following one as well are identical to Courchene (1988). Or perhaps the reverse, since these papers were written simultaneously.
3. In October 1985, a Parliamentary sub-committee recommended that changes should be made to our copyright law to compensate copyright holders for certain categories of programs that are retransmitted by cable

television companies. The government, in its February 1986 response, agreed to this recommendation. The FTA confirms this recommendation and it will be implemented as part of the revision to Canada's Copyright Act.

4. Under the FTA, Canada has retained the right to review all direct and indirect acquisitions in the cultural area. Where the result of such a review by Investment Canada is that U.S. companies are forced to divest their interests and a Canadian buyer cannot be found, the Government of Canada will offer to purchase the firm at a fair open market value.

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