

1983

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Citation of this paper:

Bird, Richard M., Donald J. S. Brean. "Canada-U.S. Tax Relations: Issues and Perspectives." Centre for the Study of International Economic Relations Working Papers, 8329C. London, ON: Department of Economics, University of Western Ontario (1983).

ISSN 0228-4235
ISBN 0-7714-0487-5

CENTRE FOR THE STUDY OF INTERNATIONAL ECONOMIC RELATIONS

WORKING PAPER NO. 8329C

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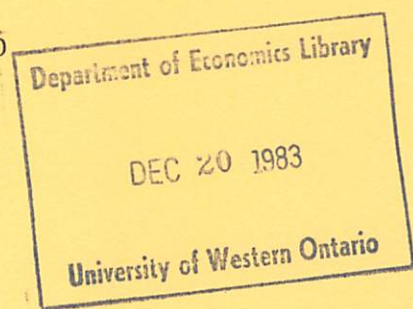
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Donald J.S. Brean

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

Prepared for The Second Annual Workshop on U.S.-Canadian Relations held November 18-19, 1983. Sponsored by the Centre for the Study of International Economic Relations of the University of Western Ontario and the Institute of Public Policy Studies of the University of Michigan with financial support from the Ontario Economic Council, and assistance of the Institute for Research in Public Policy.

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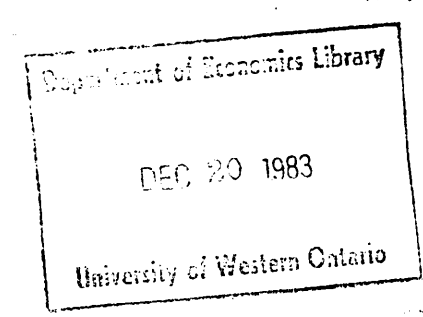
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CANADA-U.S. TAX RELATIONS: ISSUES AND PERSPECTIVES

by

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September 1983



Paper prepared for the Second Annual workshop in U.S.-Canadian Relations, University of Western Ontario, November 18-19, 1983.

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Few questions are more complex, technical, and intractable than those arising with respect to international tax relations. The inevitably simplistic models conventionally used in economics to explain and understand reality often bear so little relation to the real world of international economic affairs as to be useless. On the other hand, attempts to depict the reality of the international tax scene in institutional and legal detail quickly become so complex as to be equally useless as a guide to analysis. Furthermore, international tax issues cannot really be understood or analyzed meaningfully except in the context of a much broader range of questions concerning international, economic and political relations.

In no country can tax policy be understood solely in economic or technical terms: when two countries and the relations between them are involved, matters tend to become even more complicated. And when two countries interact on as many dimensions as do Canada and the United States, attempts to compartmentalize any one issue such as tax policy, are more likely to obscure than to facilitate understanding -- as indeed the catalogue of apparently irrelevant issues that has held up ratification of the latest Canada-U.S. tax treaty for several years illustrates.

International taxation, like most other aspects of international relations, has become even more complex and interdependent in recent decades. The national economies of the industrial world have, for better or worse, increasingly become linked through flows of goods,

capital, and people, while at the same time the role of governments (and consequently of taxes) has expanded everywhere. How any one country chooses to tax (and to spend) thus increasingly affects other countries through its effects on trade and factor flows. To paraphrase John Donne, so far as taxes are concerned, today more than ever "no country is an Island, entire of itself, every country is a piece of the Continent, a part of the main."

No two countries are more closely related economically than Canada and the United States. Trade and factor flows across the U.S.-Canadian border exceed in volume and value those between any two countries in the world. In terms of the number of individuals and firms affected, the impending U.S.-Canadian tax treaty is the single most important tax treaty in the world today. Moreover, U.S. domestic tax policy probably has even more important effects on the welfare of Canadians through its effects on trade and factor flows than do formal Canada-U.S. international tax relations -- although given the great difference in the size of the two countries there is much less reason for U.S. concern with Canada's domestic policy.

Our concern in this paper is to place in better perspective a few selected issues in current U.S.-Canadian tax relations. Treaty shopping, the unitary approach, and a few of the other issues we mention in this brief and selective review may be at the forefront of international tax discussion today, but they are in our opinion substantially less important in determining the state of Canada-U.S. tax relations than the basic economic facts of life on the North American Continent and the general vagaries

of life in a volatile world. These factors of course affect both countries though hardly equally in view of the much greater size of the United States -- a difference which goes far to explain both the state of Canada-U.S. tax relations and their future prospects.

The Canada-U.S. Tax Treaty

Perhaps the best place to begin a discussion of Canada-U.S. tax relations is with the most recent concrete manifestation of those relations -- the impending revised income tax treaty. It is now eleven years since negotiations for a new tax treaty to replace the 1942 treaty began, and almost four years since they were, it appeared, concluded. Despite the recent conclusion (in June 1983) of an important Protocol amending the treaty agreed in 1980, the treaty has still not been ratified, with the result that the tax aspects of the most substantial cross-border flows in the world are still governed by a treaty drawn up in wartime over forty years ago. There can be few other areas in the modern world where the game has changed so much but the rules have remained unaltered^{1/}: it is as if the tax authorities were air traffic controllers guiding 747s into New York with rules designed for Kitty Hawk.

Any tax treaty can be viewed from several perspectives. In its legal dimension, for example, it is a contract between nations which does not come into effect unless and until appropriate legislation is enacted

within each nation: the resulting legal documents, like all laws, of course reflect the political objectives and constraints in each country. As far as international investors and entrepreneurs are concerned, a tax treaty is a comprehensive set of rules defining their tax liabilities. In this sense, a tax treaty is a bilaterally-coordinated tax system. In effect, a tax treaty complements or accommodates the basic international aspects of different domestic income tax systems -- those relating to the taxation of foreign-source income and income of non-residents. Its purpose is both to preserve the integrity of the domestic tax system and to reconcile that system with different systems of other countries. Finally, the rules, rates and regulations embodied in a tax treaty have international economic implications. The terms of a treaty both affect the international allocation of capital, labour and technology and determine the international division of the tax base.

Each country's approach to treaty negotiations thus reflects its attitudes and interests with respect to international flows of capital, its desire to get a good share of the tax revenues generated by foreigners, the political influence of its capital exporters and importers, and -- by no means least -- the strength of its desire for better relationships in general with its potential treaty partner. Since these factors may change from time to time, and negotiation to negotiation, it is not always easy to pin down exactly why provision A appears in Treaty X but provision B appears in Treaty Y. In the case of the recent Canada-U.S. treaty negotiations, however, each side appears for the most part to have played its customary and expected role, albeit with a few twists here and there.

Canada's approach, for example, appears to have been shaped largely by its traditional desires as a significant importer of capital from abroad both to safeguard its revenue position and to strengthen domestic ownership (Coulombe, 1977; Cantor, 1981). For these reasons, for example, Canada reserved its position on the "non-discrimination" article of OECD model tax convention and asserted its intention to levy higher withholding taxes on dividends, royalties and interest (OECD, 1977). The OECD model treaty -- like the closely related U.S. "model" unveiled a few years later -- clearly reflects the dominant influence of capital-exporting nations in that it generally favors tax reductions in the country of source and unrestricted taxation in the country of residence. Net capital importers obviously stand to lose tax revenue from shifting to taxation based on residence rather than source or from any equal reciprocal reduction in withholding tax rates. Even though Canada has in fact been a net capital exporter for a number of years now, the stock of foreign-owned capital in Canada is still much larger than the stock of Canadian-owned capital abroad, and it is the relative size of these stocks that governs the size of the flows subject to tax.^{2/} Canada therefore was bound to lose from the reduction in the withholding tax on dividends to 10% that was negotiated in the treaty. Moreover, the revenues thus forgone for the most part would flow directly to the U.S. Treasury, not to the taxpayers, and would have little or no effect on capital flows (Deutsch and Jenkins, 1982).

One reason Canada was nevertheless willing to make this concession was probably to fend off the constant U.S. criticism of its refusal

to extend the dividend tax credit to non-resident shareholders as "discriminatory" (Patrick, 1981; Bunge and Brown, 1979). In treaty negotiations, the U.S. generally follows its traditional line -- unsurprising in the world's largest capital-exporter -- of attempting to bargain down withholding rates and in general to follow the established principles of nondiscrimination and reciprocal concessions. The U.S., for example, successfully persuaded the United Kingdom to extend its similar dividend credit to certain American investors in the U.K.-U.S. treaty concluded in the 1970s and has in general steadfastly maintained its position that "nondiscrimination" requires countries providing dividend relief to domestic shareholders to do the same for foreign shareholders (Carlson, 1980).^{3/} The lower treaty withholding tax rate was thus, in the words of one of Canada's principal negotiators, "a resolution of a fundamental issue by way of a concession in the rates of tax."^{4/} No single feature of a complex international agreement like the Canada-U.S. treaty can really be understood in isolation from the document as a whole -- or, for that matter, from the prevailing context of Canada-U.S. relations at many levels.^{5/}

As in all bargaining situations, at the end of the tortuous and prolonged negotiation process in 1980, both sides no doubt felt they had "lost" in some respects and "won" in others, but that on the whole they could live with the results. Why, then, has the treaty not been ratified? The original reasons for delaying ratification were basically not connected with tax issues as such, but rather with such fundamentally extraneous issues as disputes about fisheries, the resolution of which

was linked to ratification of the treaty by some. The U.S. political system, with its requirement for Senate approval of treaties, almost invariably results in delays of this sort as hard-won international agreements are reargued in terms of U.S. domestic political concerns, often by dragging in technically irrelevant "linkage" arguments. All countries recognize this fact of life in dealing with the U.S., however, and it is probable that in time the tax treaty will survive the fray and be ratified with at most minor amendments, rather than suffering the fate of the equally hard-won East Coast fisheries agreement -- an early victim of what one Canadian author has rather tendentiously labelled "the Reagan challenge" (Clarkson, 1982).

The willingness of countries to restrict their tax jurisdiction by treaty essentially depends upon the reciprocal nature of the agreement and their desire to encourage the free flow of international investment. When investment flows between countries are approximately equal, or when there is a strong desire to encourage the free movement of capital, there is a strong incentive to negotiate tax treaties. The less these conditions hold, the less strong the incentive to make a deal. In the case of Canada and the U.S., the volume of trade and investment flows virtually mandates some sort of international tax convention to provide a certain degree of stability to these important external relations. The lesser importance of these flows to the U.S. than to Canada was perhaps offset in part by their traditionally greater desire to encourage international capital flows: Canada is more dependent on such flows but, for that very

reason perhaps, is more ambivalent about them.^{6/} The basic imbalance in the position of the two countries makes an acceptable division of tax base and agreement on general rules particularly difficult, however, so it is hardly surprising that it took so long to reach even the present flawed compromise. Moreover, since international tax affairs are never static, it is also not surprising that several new issues have surfaced since the treaty was originally concluded. Two such issues are discussed briefly here: treaty shopping and treaty calcification.

Treaty Shopping

Recently, for example, the U.S. has become so worried about "treaty shopping" -- a term applied to the search for soft spots in international tax law -- that it has succeeded in having a new "anti-shopping" provision adopted in the June 1983 Protocol to the Treaty. Although the U.S. seems to be more concerned about Canadians being "third parties" to U.S. treaties with other nations than they are about fiscal subversion through the Canadian treaty, they are also obviously concerned to ensure that the U.S.-Canadian treaty cannot similarly be "subverted" by others.

The scope for international tax planning by firms, in principle constrained by legal definitions and rules and tax rates, is in practice broadened considerably by the fungibility of international capital, by the inherently imprecise and arbitrary nature of accounting methods, and by the difficulties of international tax auditing and verification. The importance of international tax planning through such third-party

manoeuvres is evidenced, for example, by the swollen Canadian investment position in tax havens. For example, the U.S. Treasury reports that in 1981 \$7 billion (U.S.) of corporate income was paid from U.S. sources to non-resident aliens (i.e., corporations outside the U.S.). \$2.5 billion (36 percent) was delivered to the Netherlands and the Netherlands Antilles (more than half went to the latter). If we bring in four additional tax havens (the Bahamas, Bermuda, Panama and Switzerland), the share of U.S. corporate income paid from U.S. sources flowing to these countries is 49 percent of the total (Carson, 1983).

Canadian companies certainly play these games. Consider, for example, the so-called "Dutch Treat", a typical arrangement under which a Canadian corporation channels its investments in the U.S. through a holding company in the Netherlands or Netherlands Antilles (McCart, 1982). Under the terms of the U.S.-Netherlands treaty, dividends paid from the U.S. to the Netherlands bear only a 5 percent U.S. withholding tax. Normally, no additional tax is incurred on the second leg of the financial transfer to Canada. In contrast, under the present treaty a U.S. withholding tax of 15 percent is levied on U.S. source dividends flowing directly to Canada (10 percent in the new treaty).

Canadian corporations have also made extensive use of the so-called "Double Dip". Through this triangular arrangement -- again involving a parent company, an offshore financial subsidiary in a tax haven and an operating subsidiary in a third country -- Canadian companies again exploit favourable terms in a bilateral treaty between other nations. The parent corporation borrows in Canada and takes the usual interest deduction.

The funds are then transferred at zero interest to a financial subsidiary -- typically located in, say, the Netherlands Antilles -- which in turn on-loans the funds at commercial rates to the operating subsidiary in the U.S. The latter is then able to claim an interest deduction in the U.S. on the same debt for which a deduction was previously claimed by the parent in Canada. The second flow of interest payments accrues as tax-free income to the financial subsidiary in the tax haven. The net effect of the Double Dip is that foreign investment is financed with Canadian debt capital which, because of the double deduction of interest, is effectively costless to the corporation.

Regardless of the intermediate financial manoeuvre -- to take advantage of the Dutch Treat or the Double Dip or both -- the income of an operating subsidiary in the U.S. can be repatriated tax-free as intra-corporate dividends to the Canadian parent under Canada's tax exempt surplus provision. Furthermore, the interest income which accrues in the tax haven may also eventually be repatriated to Canada tax-free. These tactics obviously increase the consolidated after-tax income of the multi-national corporation and impose a corresponding tax revenue cost on Canada and/or the U.S., split in a way that is not very clear.

The U.S. now apparently intends to ensure that the new U.S.-Canada treaty does not create additional opportunities for such circuitous tax planning which could be costly to the U.S. Treasury. Significant tightening of the anti-abuse provisions of the new treaty with respect to third party use in the form of protective clauses -- so-called "control tests" -- similar to those already in force in the U.S.-Australia and U.S.-New

Zealand treaties has therefore become a tenet of U.S. policy and, as noted above, has now been accepted by Canada in the 1983 Protocol. Although one may wonder why the U.S. is so concerned with third party use of the U.S.-Canada treaty in view of its higher than average withholding tax rates, since a third party looking for a good deal would likely go elsewhere, for certain categories of international payments there may be some potential abuse. Copyright royalties, for example, are exempt from withholding tax between Canada and the United States.

The marked U.S. concern with the potential use of tax treaties by third parties may in part reflect a new recognition by the United States that since it is now a net capital-importer, its interests no longer automatically lie on the side of the most open and tax free flow of international investment funds as they were perhaps thought to do in the heyday of American economic dominance of the western world.

The fiscal integrity of an open economy obviously requires vigilance with respect to the opportunities taxpayers have to shift income internationally to avoid tax. And defense of its tax system is unquestionably a national prerogative. However, no set of bilateral tax treaties can be expected to effectively and permanently compartmentalize international capital flows, i.e., to eliminate the scope for intermediate manoeuvres involving third parties. More to the point, in the complex real world bilateral compartments are as arbitrary as they are insecure. International investments frequently involve pools of capital and a maze of intermediaries with a holding company serving as a nexus. The principles and application of international source rules are insufficiently precise

to provide an unambiguous answer to the "correct" allocation of the cost of highly fungible international intra-corporate finance. Strict rules to exclude third -- or fourth or fifth -- parties are likely to create administrative nightmares, with no assurance of improved efficiency. Furthermore, even if a heavy-handed approach succeeded in blocking certain international financial manoeuvres, desirable international investment flows might well suffer in the process. For example, a stricter U.S. policy could impose serious, and probably undesired and undesirable, penalties on Canadian corporations that have arranged Eurobond financing of U.S. investments.^{7/}

Perhaps it is also time to reconsider Canada's position in the treaty game as well. In particular, Canada's recent shift in net international investment position may mark at least the beginning of the end of its prolonged dependence on capital imports and its emerging maturity as a capital exporter. If so, it may become less desirable for Canada to maintain its traditional insistence on high withholding rates as well as its reservations on the non-discrimination rule. While it seems hard for any reasonable person to argue that Canada is not within its sovereign rights in trying to alter the exceptional degree of foreign ownership and intervention in its economy, Canadians are hardly in a position to complain about the resulting complaints about the discriminatory treatment of foreign investors e.g. in the national energy program. Demands such as the extension of the dividend tax credit to American investors -- although successfully fended off by Canada in the recent treaty negotiations -- may thus be reopened. As argued

later in this paper, since international tax decisions, like all tax decisions, are hardly made in an atmosphere of analytical purity, one can perhaps expect Canadian discrimination in one area -- even if grudgingly accepted -- to elicit demands for offsetting "nondiscrimination" elsewhere.

Treaty Calcification

A tax treaty spells out in detail what specific items -- expenses, deductions, royalties, revenues, sub-jurisdictional taxes -- enter the source tax calculation and how they do so. Once the treaty is in force, these explicit definitions and regulations form the basis for calculating tax liability in the source country and foreign tax credits in the residence country. Such definitions therefore ultimately determine both the effective tax rates applied to international investment and the international distribution of tax revenue.

Unless there is provision for change in interpretation, a signed and ratified treaty thus virtually stops the clock on accounting. Over time, accounting anachronisms may creep in, introducing inconsistencies, violations of national treatment, unintended double taxation or international loopholes with subsequent real and distributive consequences. In 1942, for example, provincial taxes were deductible in determining Canadian federal tax liability; in 1983 they are not deductible. Under the terms of the 1942 U.S.-Canada treaty, a U.S. investor in Canada might therefore be entitled to demand the deduction even though the federal rates have already in effect been adjusted to allow for the provincial taxes.

A recent decision by the Supreme Court of Canada on the Melford case clearly establishes the legal position in Canada (McDonnell, 1982). The court ruled that undefined words in a tax treaty are to be understood to have the meaning they had at the date the tax treaty came into force. The high court's view was that a tax treaty is a contract between the participating states, and its terms ought not to be open to unilateral amendment.

The implication of this Supreme Court decision is that the subsequent amendment of Canadian tax law in any fashion which compromises the terms of the treaty -- including all undefined words and expressions -- as interpreted at the date of signing has no effect on activities falling within the scope of the treaty. In view of the threatening scope of this decision to a wide range of international business activities -- not least between Canada and the U.S. -- it is not surprising that soon after the Melford decision the Minister of State (Finance) tabled a Ways and Means Motion relating to the interpretation of Canada's tax treaties with other countries.

The proposed Income Tax Conventions Interpretations Act provides that to the extent a term in a tax treaty is not defined, or is defined by reference to Canadian domestic law, the term is to be given the meaning that it has for the purposes of the Income Tax Act as amended from time to time. The intent is obviously to ensure that for purposes of determining Canadian tax, the meaning of undefined words and expressions contained in Canada's tax treaties will evolve with changes made in Canadian tax law.^{8/}

Most recent conventions concluded by Canada already contain a specific provision regarding interpretation patterned on the 1977 OECD Model Double Taxation Convention. This general guideline does not, however, deal specifically with the problem addressed by the Supreme Court in the Melford case, namely, the relevant time at which the meaning of a word or expression is to be interpreted. The proposed Interpretations Act therefore provides that for the purposes of Canadian taxation the terms of a treaty are to be given the meaning that they have under the current reading of the Income Tax Act. The general language of a treaty is thus rendered fluid rather than petrified.

This new approach is of course not designed to supplant the general rule of interpretation -- the so-called "treaty override" -- which provides that in the event of any consistency between the provisions of a treaty and domestic law, the provisions of the treaty shall prevail.

In contrast, this rule appears to have been less respected by some recent U.S. legislation and judicial decisions. Most bilateral tax treaties with the United States, for example, explicitly grant the country of residence the exclusive right to tax capital gains in real property. Thus, under the current (1942) Canada-U.S. tax treaty, gains in value of property in the United States owned by Canadian residents are taxable by Canada. In December 1980, however, the United States passed FIRPTA -- The Foreign Investment in Real Property Act -- which in effect overthrew the residence country's priority right to tax capital gains in real property effective in 1985 or in some cases earlier (Feder and Parker, 1981). Although by far the most numerous group of foreigners, individual and corporate, affected by this legislation are probably

Canadians, the U.S.-Canadian discussion of this legislation prior to its passage appears to have been confined to attempting to accommodate its envisaged shape within the new treaty.^{9/} The subsequent tangled history of the FIRPTA legislation and regulations (Alpert, 1983) makes it hardly surprising that further adjustments to attain this end had to be included in the June 1983 Protocol to the Treaty.

A recent U.S. court decision also raises some questions about U.S. treaty interpretation rules. In Great-West Life the U.S. Court of Claims interpreted a section of the existing U.S.-Canada treaty in a very restrictive fashion, based largely on its interpretation of the U.S. legislative history. As Roberts (1982) has noted, this decision raises some question about the extent to which the U.S. judiciary can in effect revise treaty provision to reflect developments in subsequent treaties and domestic law and whether, in light of the Vienna Convention on the Law of Treaties -- signed but not ratified by the U.S. -- such judicial interpretations of treaties should properly follow the usual U.S. judicial pattern of interpreting legislation guided by unilateral legislative history.

The treaty interpretation issue is relatively new on the scene and may seem relatively minor. Yet it is critical to the raison d'être of a tax treaty to reduce uncertainty in international tax matters. Uncertainty -- especially if it entails unilateral modifications of the terms of a treaty -- not only discourages the private sector but also prompts the tax authorities to protective posturing and destructive game playing. While it is a little hard to reconcile some recent U.S. developments

with the traditional American insistence on the need for stable international tax rules favoring the free flow of capital -- as evidenced by their current concern for the Melford issue in Canada -- it seems unlikely that uncertainty on this matter will long delay the implementation of the pending treaty. What the treaty interpretation issue does suggest, however, is that some important aspects of the current treaty system still remain surprisingly unsettled. As one commentator has said: "Since resolution of these issues may not be soon forthcoming, tax advisors and their clients are left in the uncomfortable position of knowing what the treaty provides but often of not knowing what it 'means'" (Roberts, 1982, p. 766). The reduction in investor uncertainty resulting from this state of affairs may not be very great.

Subnational Governments and the Unitary Approach

An important and virtually unique aspect of Canadian-U.S. fiscal relations is that both countries are federal states, in which subnational governments -- states and provinces -- play an important, and largely independent, role in determining and implementing tax (and subsidy) policies.^{10/} Indeed, both countries explicitly entered reservations to the provision of the OECD model tax treaty which would have brought within the scope of international tax conventions the income taxes levied by state and provincial governments (Coulombe, 1981). Nevertheless, the pending treaty clearly tries to encompass subnational taxes wherever possible, presumably in recognition of the problems that have arisen in

the past with regard to such provincial levies as the Ontario mining tax (Deutsch and Jenkins, 1982) and some state income taxes (Coulombe, 1981).^{11/} The treaty does not, however, attempt to deal with the latest problem area in respect to subnational taxes -- the so-called "unitary approach".^{12/}

The division of tax base amongst different jurisdictions has long been a central issue in international taxation. Traditionally, the principles followed in allocating tax base to different jurisdictions have been transactional, that is, they have depended upon the characteristics of particular transactions. The problems arising in this area include both those labelled "transfer pricing" and such matters as the allocation of central overhead expenses. Both Canada and the United States have legislative provisions providing for the revenue authorities to adjust international transfer prices and expense allocations to reflect "arm's length" transactions -- that is, the amounts that would be reasonable in the circumstances had the parties had been dealing at arm's length. Inevitably, however, the integrity of national tax systems is at risk since the inherent arbitrariness of such accounting exercises attempting to untangle the network of intrafirm transactions tends to favour multinational firms. Subnational governments are seldom as sanguine as national governments that they will receive their "proper" share of tax revenue through this approach. In recent years, a number of U.S. states, led by California, have therefore taken a new tack in establishing their fair share of the corporate tax base -- the unitary approach.

Conceptually, the unitary approach is simple. Income from any corporation taxed in jurisdictions employing this approach is assumed to be derived from a larger network of divisions/subsidiaries/affiliates (traditional intra-corporate distinctions fade in this exercise) scattered throughout the world. The taxable share of worldwide consolidated income is then calculated by applying a formula based on such standard apportionment factors as local sales as a percent of consolidated sales and/or similar ratios for property and payroll, regardless of what conventional tax accounting statements might indicate.

One rationale for this approach is that since the profits of a unitary business arise from the operations of the business as a whole, it is misleading to characterize the income of such business as being derived from a set of distinct sources as under the traditional approach (Carlson and Galper, 1982). Another rationale is that states are simply not in a position to evaluate the accounting data given them by multijurisdictional corporations and hence need to adopt some arbitrary approach such as this which does not leave them wholly at the mercy of the taxpayers.

The unitary approach contrasts sharply with conventional "separate accounting" rules for appropriating corporate income among jurisdictions. Under the traditional approach, individual jurisdictions in effect do not look beyond their respective boundaries in calculating corporate income. Affiliated foreign corporations are thus treated as unrelated parties, and domestic-source income is measured as if all "off-shore" dealings reflected arm's length transactions between separate entities. In many instances, however, this approach does not provide a very satisfactory

division of the income of an integrated business among various distinct tax jurisdictions and sets the stage for abuse of transfer pricing. Because formula apportionment, as under the unitary approach, relies on direct measures of the share of selected income-producing factors located in the taxing jurisdiction which can be quantified on a relatively objective basis, tax administrators can avoid the detailed and difficult enquiry into particular transactions characteristic of separate accounting.

On the other hand, formula apportionment may also obviously introduce significant distortion to the division of the tax base, especially if the productivity of factors differs substantially among the various jurisdictions involved. Differences in wage scales and in property costs are examples of disparities which may cause any apportionment formula to be distortive.

The unitary question has generated heated debate within the United States. The political issue is whether or not individual state governments have the right to tax on the unitary basis in light of potential extraterritoriality which could violate inter-state commerce clauses of the Constitution and trespass on the federal mandate to maintain national uniformity in international commerce. Recently the U.S. Supreme Court affirmed states' rights in a landmark decision which upheld California's unitary method of taxing multinationals following a challenge from Container Corporation of America, a unit of Mobil Corporation. This ruling also upholds the way a number of other states treat multinationals and has apparently encouraged other states to jump on the unitary bandwagon. Since the Supreme Court Ruling explicitly pertains to U.S.-

based multinationals, and does not apply automatically to state taxes on domestic subsidiaries that have parent companies based in other countries. Nevertheless, the unitary tax has already been applied in some states (e.g. California) to subsidiaries of foreign companies (e.g. Alcan) operating in those states. The Supreme Court position seems to leave the states and the companies involved to deal with such problems among themselves: in reality, however, both federal governments are also involved, as is the painfully-arrived-at compromise on various international tax issues already embodied in the treaty. So far, however, the treaty mechanism has not been able to resolve the impasse in dealings with the U.S. caused by the apparent fundamental conflict between intranational jurisdictional arrangements (involving states' rights to tax) and the national commitment to international tax harmony.

As noted earlier, the unitary question is really only one instance of the broader question of the role of sub-national governments in determining national policies in an open world economy. Just as the attempts of some Canadian provinces to devise particular systems of taxing natural resource industries (the Ontario Mining Tax) have to a considerable extent been shut down by American rules, so in the end the attempts of U.S. states to extend their jurisdiction beyond the "water's edge" may be thwarted by international pressure.

Recently, the Canadian tax authorities reaffirmed their emphasis on the transactional approach and made the following comments on the alternative of the unitary (or global) approach: "we are reluctant to adopt a global approach to evaluating interaffiliate transactions because it is

not specifically provided for in our legislation: it does not effectively highlight double charging: it does not ensure that Canada receives a fair share of tax haven profits: and, finally, we often do not have access to global corporate information" (Robertson, 1982, p. 777). Perhaps for these reasons, Canada has never pushed this issue very hard, in contrast to the U.K., for example.

It is unlikely the unitary approach is going to go away, however. Quite apart from U.S. politics, for example, the obvious attractiveness of the unitary approach to some developing countries may well lead to continued discussion on these matters in international forums in years to come. Even if the U.S. federal government takes a strong stand -- and can enforce it -- to prohibit states from applying such rules to foreign-based companies, the growing complexity of international business and finance and the consequently increasing artificiality of the traditional transaction-based separate accounting approach would seem to urge much more serious consideration of these issues raised by the unitary debate. When any accounting rendition of a separate structure is in a sense necessarily illusory in part, as must be the case with integrated multinational firms, the pressure for a formula approach internationally to the allocation of tax base will probably in the long run become as strong as similar pressure has within the U.S..

Perhaps the only way to avoid the problems that have given rise to this approach completely in any federal country would be to centralize the corporate income tax (McLure, 1982). If so, it follows that the only way to avoid the development of a parallel movement internationally

might be to move in some sense towards a "world" tax authority. This prospect is no doubt sufficiently remote as to warrant no further discussion here: but what does perhaps bear more attention is the impossibility in an increasingly integrated world economy of any nation's resolving such issues unilaterally, or even bilaterally in conjunction with another nation. As with "treaty shopping", what really seems to be required to deal with the problem is a more multilateral approach, perhaps even a multilateral tax treaty and not just a multilaterally-agreed model treaty (with many reservations^{13/}).

In the absence of a more fundamental agreement on such matters among the major participants in the world capital market, however, it seems unlikely that any significant changes in the present, rather messy, system can be expected in the future.

Returning to the more parochial concerns with which we started, for example, the growing strength of the unitary movement in the U.S., like the growing interest in more independent provincial income taxes in Canada, seems likely to continue to confuse and confound any attempt by the respective national governments to tie a neat treaty ribbon around international tax relations at any point in time. The need for continued, reasonable, informed discussion of the impact in one country of measures in the other will therefore continue to be as or more important to U.S.-Canadian tax relationships than any words set down in any treaty.^{14/}

Subsidies and Trade

The preceding discussion focussed on a few relatively technical issues affecting international investment and for the most part discussed them within the context of the pending Canada-U.S. income tax treaty, the primary format for formal discussion on fiscal issues between the two countries. From a purely "tax" point of view, matters such as treaty shopping and the unitary method are indeed both important current issues and significant in their own right. In terms of broader Canada-U.S. relations, however, such issues may seem minor, especially in view of the apparently increasing use in both countries -- and by both national and subnational governments -- of various protectionist and subsidy measures intended to affect trade and investment flows in particular ways. The present section therefore surveys, much more selectively and more rapidly, a few issues arising from the fiscal manifestation of what has been called the "new-protectionism" (Lazar, 1981).^{15/}

One area of continuing and potentially escalating conflict between Canada and the U.S., for example, concerns the subsidization of investment, both directly and through the tax system. The U.S. has long taken the position in international negotiations that many if not all industry (or firm) specific tax incentives are in some sense unacceptable subsidies to exports, and this position won a substantial amount of acceptance in the recent GATT agreement on subsidies.^{16/} Given the substantial amount of cross-border trade and investment flows it is not surprising that this issue has often arisen in U.S.-Canada relations.

From the U.S. view, the central issue here appears to be the allegedly unfair distortion in trade and factor flows resulting from what it considers excessive subsidization abroad (which often appears to mean any subsidization). From Canada's view, the problem is that the equity of the proposed U.S. remedies depends too often on the assumption that all countries are equal, when in the real world they clearly are not -- perhaps reflecting not solely the pursuit of national interests by U.S. negotiators but also a certain American tendency to think (to paraphrase a former president of General Motors) that what is in the interest of the United States must be in the interest of the world.

A classic example of the application of U.S. position is the well-known Michelin case, where the United States condemned as unfair and excessive export subsidization the regional development subsidies given to the Michelin company to locate its tire factory in Nova Scotia. Obviously, a world-scale tire manufacturing facility cannot be located in a region such as eastern Canada without most of its output being exported. On the other hand, several such plants could exist in the United States, given the greater size of its domestic market, with a much smaller part of their output being exported -- even if those exports swamped the Canada market. So long as the United States considers subsidies to export-oriented firms and industries to be selective export subsidies, the system is obviously heavily biased against countries with a smaller domestic market such as Canada (Grey, 1980). Unless this basic asymmetry

in international trading and investment relations is recognized in some way, the continuing problems in this area between Canada and the United States seem unlikely to be worked out amicably.

What makes U.S. attempts to purge the international economic world of subsidization a bit hard to take is the uniquely U.S. invention of the Domestic International Sales Corporation -- DISC (or in its latest incarnation, the Foreign Sales Corporation or FSC). This explicit marginal subsidy to exports through the tax system has no direct parallel in any other industrial country and amounts, in effect, to an application of the so-called territorial principle of income taxation -- the principle under which some countries (e.g. France) exclude from income the income their resident corporations earn abroad -- to activity which takes place entirely within the territorial jurisdiction of the U.S. As far as Canada is concerned, most of the allocative effects on Canadian industry that would have been exerted by this subsidy have probably been offset by the manufacturing and processing credit (which, unlike DISC) is not an export-related subsidy -- see Hyndman, 1972; Eden, 1983^{17/} -- but it is hard to see how a country which maintains a device like DISC in the face of repeated international condemnation can be quite as purist in its international economic discussion as the United States has been with respect to subsidies.

Many Americans seem understandably reluctant to accept that the U.S. too is an open economy which must constrain its domestic tax actions, at least to some extent, for fear of international tax consequences. More surprisingly perhaps, some Canadians also, and even more

unrealistically, refuse to accept that Canada is, in world terms, only a small country. A former federal minister of finance for example, recently recommended that Canada should (1) grant a five year tax holiday on profits earned on incremental exports of manufactured goods over and above those of some base period.^{18/} (2) increase appreciably the withholding tax on interest, dividends, management fees and royalties paid to foreigners; (3) impose a substantial tax on interest, dividends, etc., earned abroad whether such income is returned to Canada or not; and (4) give Canadian-controlled companies a 10 percentage point reduction in their tax rates to offset the alleged advantages of foreign-controlled subsidiaries (Gordon, 1982). The trouble with such recommendations is that, in the first place, they severely underrate the potential retaliatory scope of American (and other foreign) reaction,^{19/} and secondly -- and more importantly -- they neglect completely the reality of Canada's linkage to the North American capital market and the probable severe effects on Canadian investment and savings as a result of such measures. An increased withholding tax on interest payments abroad, for example, will force up the cost of corporate capital in Canada, suppress the volume of foreign-source capital, and, through the erosion of the tax base as a result of the increased financial costs, may in the end yield little if any revenue. As Brean (1983) concluded, "the evidence that 'small' countries in international capital markets should not impose such taxes seems as clear as any issue in the field of international tax."

Moreover, proposals such as those listed above completely leave out of account the important reality that most such protectionist

measures are likely to hurt Canadians as a group more than they will help particular subgroups. Even in the case of the United States, for example, the most recent study of DISC suggests that this subsidy has, on balance, resulted in a fall in total U.S. income and an outflow in capital from the United States (Mutti and Grubert, 1983).^{20/} Curiously, if the DISC program hurt the United States through its effects on the terms of trade it probably helped Canada. It does not follow, however, that a DISC-like program in Canada would help Canada: on the contrary, applying the same sort of reasoning suggests it might harm Canada. Why should Canadians offset the possible gain from the follies of others by indulging in similar antics of their own?

More broadly, the result cited above with respect to DISC is consistent with such other results of general equilibrium analysis as the argument in Whalley (1980) that the United States probably gains from the existence of distorting taxes on capital which improves its terms of trade. If it is correct that distorting taxes on capital in the United States lead to a welfare gain, it of course follows that removal of these distortions will lead to a loss. Since Canada probably does not exert the same degree of influence upon its international terms of trade, however, it does not follow that the similar distorting taxes on the capital in Canada -- mainly the corporate income tax -- are equally beneficial. In the topsy-turvy interdependent world in which we live, what you see with regard to the immediate incidence and effects of tax-subsidy measures is very often not what you get in the long run. In particular, lessons drawn from the experience of such

"price-makers" as the U.S. still is (at least to some extent) can be applied only with great care, if at all, to the case of such "price-takers" as Canada.^{21/}

So long as protectionism continues to run rampant in the world -- that is, at least as long as the depressed state of most major economies persists -- there will no doubt continue to be competitive subsidization games played. Canada is bound to be the loser in any such contest with the U.S. (especially to the extent the U.S. sets the rules) because of the basic asymmetry in its economic relationship with its powerful neighbor.

The attitude of some countries to this problem might perhaps be stated as follows: "In a world of dog eat dog, a dog that doesn't eat gets eaten." This sort of "survival of the fittest" attitude is surely questionable from Canada's point of view, however. Indeed, Canada may in the short run be best off to continue to go along with the United States as far as we reasonably can. From a longer-term point of view, however, Canada might perhaps be better off to join with other smaller countries in arguing for greater transparency of protectionist measures -- a position which the U.S. supports -- but against linkage and reciprocity -- which the U.S. also supports.

Since, for example, goods differ from services because of the generally greater cultural content of the latter, the linkage of treatment on services and treatment on goods now being proposed by the U.S. is not a particularly good idea, especially for Canada with its traditional cultural concerns.^{22/} Similarly, the U.S. emphasis on "reciprocity"

in part appears to reflect the belief of many Americans that the recent poor showing of U.S. manufactured exports in world trade is the result of nefarious subsidization schemes in the rest of the world -- a belief supported by some exceptionally thin and superficial evidence.^{23/} As noted earlier, the American version of "reciprocity" is often in practice biased in favor of larger, more powerful economies.^{24/} In general, since it is not the biggest economies that most need a peaceful international environment for survival, it is perhaps unlikely that the U.S. can be expected to lead the way out of the present worldwide mercantilistic spasm. Canada can hardly do so either, but from Canada's point of view, even at the expense of some short-run economic pain, fostering a more altruistic and co-operative attitude in the world as a whole with respect to such issues may be a better strategy in the long run.

Confrontation or Cooperation

The United States and Canada differ with respect to international taxation on at least three levels: attitudes, perceptions, and realities. While these three levels are obviously interrelated, we focus here on the basic asymmetry of the Canadian and American position in these respects.

First, Canada's traditional attitude has been that it is fundamentally a relatively small capital-importing country which must above all fight in international negotiations to maintain its right to tap the profits of foreign investors in Canada and to encourage investment by Canadians in Canada. On the other hand, the United States has seen itself as a major

capital exporter which can only gain furthering the international flow of capital. The United States has also to some extent seen itself as the "tax policeman" of the world, in the sense that it has at times attempted to export its domestic notions of fiscal rectitude to other countries. In short, while Canada's attitude toward international tax negotiations has traditionally been defensive and inward-looking, the United States attitude has traditionally been offensive and outward-looking.

With respect to "treaty shopping", for example, while Canadian authorities hardly favour this practice, their general position has been that since Canada is in no position to shape the international rules with respect to multinational investment, their major task is to protect the tax base of Canada rather than to impose any sort of general reform on international capital flows. This attitude is perhaps easier to maintain since Canada has withholding taxes of 10% or 15% on almost every financial flow out of the country anyway, so there is very little potential for foreigners to play games with Canadian treaties.

The position in the United States, on the other hand, appears to reflect both an American tendency to try to impose their view of the world on the world rather than to conform to the world's view of itself, and the existence of withholding rates in the U.S. that range from 0% to 30%. Rather than face the domestic political problem of reducing the basic 30% withholding rate on international income flows -- particularly after the recent failure to impose a much lower withholding rate on U.S. domestic dividend payments (unfortunately the name is the same although the game is quite different) -- it may seem easier to tackle the rest of the world.

Part of the problem in dealing with treaty shopping is clearly that in a world of more than two countries, two countries alone cannot arrive at an agreement that deals with all the possible problems arising from third party developments. The only way to do this would be by a set of matching and reciprocal bilateral treaties between all relevant parties, or even better, a multilateral tax convention. The attempt to develop such a treaty under the auspices of the OECD thus had a great deal of merit, and it is unfortunate that in the end the model treaty was so heavily influenced by the interests of the capital-exporting countries that countries such as Canada, which have traditionally considered themselves to be primarily capital importers, felt unable to fully accept this convention as a basis for negotiations. Perhaps the somewhat changed reality of transborder capital flows between the U.S. and Canada in recent years may in the end lead to the development of a more generally acceptable and truly multilateral approach to this area -- though it is hard to see any real, long-term solution short of an international tax authority.

In terms of the second level mentioned above, there appears to be a shared perception in both countries that measures which favour particular business groups are in the interest of the country and those which penalize those groups are against the interest of the country. The United States, for example, has through its DISC program attempted to favour American exporters, thus offsetting what it considers to be the disadvantages suffered by this group as a result of certain features of the tax system in other countries. Similarly, Canadian nationalists

have long urged increased discrimination in favour of Canadian -- that is, against foreign (American) -- investors in various industries, particularly natural resource industries. Nationalists thus perceive measures favouring Canadian industry (or at least some of it) as favouring Canada, just as American business groups see measures favouring American business (or some of it) as favouring America. Both countries have therefore spent a lot of time and effort in attempting to offset foreign measures in support of their own interests, and in arguing against other countries' measures in international negotiation.

As might be expected, given the basic asymmetry in the economic and political weight of the two countries, the United States has been more successful in its efforts than has Canada, although Canada has been surprisingly effective in the tax field in maintaining a degree of favouritism for domestic residents through such measures as its small business deduction and the Canadians-only dividend credit as well as the more publicized National Energy Policy. The stubborn U.S. defence of DISC (and its currently advocated descendant FSC), illustrates the same forces at work in a different political context in that country. The perception in both countries of what is in the national interest -- more exports (U.S.), more Canadian investment (Canada) -- has thus been clearly manifested both in domestic tax policy and in the attitudes to international tax issues discussed above.

On yet another level, however, reality appears to be quite different than the perceptions underlying policy. As mentioned earlier, for example, the United States may well gain through the very distortionary

taxes on capital that are so often deplored by business -- since these taxes affect the U.S. terms of trade favourably -- while at the same time it appears to be a net loser through the DISC program, a favorite of business. In Canada, while much less work has been done on these matters, the indications are that Canadians gain less than they think from such measures as the interest withholding tax and have little or nothing to gain from export subsidization.

Canada has in the past, however, probably gained substantially from the export of U.S. capital as a result of such basic U.S. tax provisions as deferral. On the other hand, it has presumably lost from the terms of trade effect of the relatively high level of U.S. corporate taxation. Canadians would therefore seem to be well advised to favour lower U.S. corporate taxes and more U.S. subsidization of exports as well as continuation of the U.S. deferral system. Lower Canadian taxes, on the other hand, may well provide more benefit to the U.S. treasury than to Canada. There is, on the other hand, no evidence that Canadian taxes have adversely affected the United States: although the basic rates of return on savings and investment in Canada may to a large extent be determined by American rather than Canadian policy, the reverse is certainly not the case.

All these statements really reduce to the basic fact that in the world of international trade and factor flows, the United States remains a price-maker, while Canada is undoubtedly a price-taker. A small country such as Canada is (in general) well advised not to attempt to tax international capital flows much, since by doing so it tends to

penalize the less mobile factors in its own country rather than to reap any national or sector gain. Since Canada has recently become a substantial net exporter of capital, however, the time is perhaps right for yet another reconsideration of U.S.-Canadian tax relations. Although the reality of the basic asymmetry in the position of the two countries has not altered, perhaps another decade of treaty negotiation would lead to quite different conclusions than the recently agreed convention. In particular, since neither Canada nor the United States exists in the world alone, both countries would perhaps be well advised to consider much more carefully the desirability of a joint (or even multilateral) approach to international tax negotiations as a whole. U.S.-Canadian tax relations must be considered in the context of the relatively integrated nature of the world capital market. Given this reality, there will inevitably be a tendency for a least common denominator rate of taxation on capital to come into being as time goes on (Bird, 1970). In addition to their possible common interest in this respect, Canada at least has a strong interest in working with rather than against the U.S. as much as possible in developing compatible approaches to accommodate -- and not to deny -- changes in the international economic environment. Finally, since both countries have very similar problems with respect to the international impact of developing divergencies in the tax and subsidy policies of state and provincial governments, there might also be considerable role for fruitful joint discussion on common approaches to this area.

Concluding Remarks

Carl Shoup (1982) has suggested that many of the interactions between tax systems in different countries might be characterized as either reaction effects or emulation effects. An example of a "reaction effect" in U.S.-Canadian relations is the introduction by Canada of the manufacturing and processing tax credit in reaction to the U.S. DISC system -- which was itself a reaction to the benefits U.S. authorities perceived as received by some European countries from their territorial income tax systems. Examples of emulation effects are the spread of VAT in the EEC and the investment tax credit in Canada and the United States. It is obviously true that increased international flow of tax information accompanying increased trade and factor flows has certainly influenced the nature of tax discussion in many countries (Bird, 1970): in no field has this been more true than in the area of international taxation -- an area in which policy which for long was the virtually exclusive preserve of a small and interactive group of experts (mostly lawyers in capital-exporting countries) -- and between no countries have such international spillovers been stronger than between the U.S. and Canada.

Useful though such reflections may be, however, it seems past time for discussion of international tax relations to put aside the notion that tax policies are designed and implemented by unified central bureaucracies attempting to satisfy clearly identified national social welfare functions.^{25/} In the real world, however, there are always conflicting interests within each country, and the resolution of these conflicts

domestically must also be taken into account in shaping the international dimension of policy.

One difference between the United States and Canada in this respect has been that traditionally different interests have been more open and more clearly articulated in the political process in the United States than in Canada. In no field has this been truer than in the field of taxation. As recent studies in Canadian tax policy have shown, business interests in the Canadian tax process tend for the most part to be articulated indirectly and without publicity, with the result that it is difficult to trace the players in the Canadian tax game (Good, 1980). Recent U.S. international tax policy in recent years for the most part appears to reflect the continued long-standing influence of the American business community on American public policy (Bauer, Pool, and Dexter, 1963), and the much greater salience of international economic issues in recent years. There is no reason to expect matters to be very different in Canada although the players are fewer and the game more quiet. The various international tax subsidies (and disincentives) which have been created in both countries in recent years are thus simply a subset of the general protectionist trend of current policy, which is itself a sub-species of government intervention in general.

Indeed, from one perspective, the principal role of government in modern politics is as an instrument of cross-subsidization and price discrimination (Migué) 1982; Stegemans, 1982). There is no reason to exclude international tax policies from the ambit of this statement. When a barrier to international factor or trade flows is erected, it

is thus attributable at least in part to the domestic political pressures exerted by those who will gain in terms of increased rents from the erection of that barrier. Similarly, when a barrier is demolished or reduced, that fact in itself can be read as an indication of the diminished influence of the group which originally had that barrier imposed, or the rise to power of some new group which gains from its reduction. From this perspective, perhaps the most useful way to approach the analysis of international tax relations is not with the normative tool of economic efficiency which dominates the economic literature but rather with the tools of the new economic theory of politics.

Economists tend often to take economic efficiency to be the overriding criterion in terms of which policy is to be assessed. As conventionally trained economists, we have no intention here of questioning the virtues of economic efficiency, particularly since these virtues are so often grossly underrated these days by the advocates of protection, subsidy, and special interest whose voice is now heard throughout both lands. In the international arena, however, as most spheres of life, a focus on efficiency alone affords little help in understanding what is done, or not done, in the real world of the politics of economic policy. From this perspective, international tax relations can probably best be analyzed within the framework of a general theory of government regulation as the outcome of conflicting private interests. This approach has sometimes been disparagingly labelled "pocketbook politics". But since taxation is, after all, in the end about whose pocket is picked for how much, it

seems likely that the answers to be found by pursuing this approach in the tax field will prove to be more illuminating than yet another exposition of the virtues of capital-export neutrality from the point of view of "world efficiency".^{26/}

When considered in this light, what is perhaps most surprising is not that there are so many complex, contradictory and unresolved issues in the field of international taxation, but rather that there is still such an apparently high degree of economic rationality underlying at least some key characteristics of the international tax system. Perhaps, however, this happy state of affairs reflects not so much the triumph of rationality over interest as the relative unimportance of international taxation in the period during which current policies were formulated. If so, both the greater salience of international fiscal relations in recent years and the apparently increasing acerbity of international economic relations in general -- not least between the U.S. and Canada where the days of the "special relationship" (if there ever was one) are clearly past -- suggest that the future may be quite different than the present as both domestic and international tax systems are more and more shaped to accommodate the clamour for protectionist policies of one sort or another. Since in our view both countries, but perhaps especially Canada, will lose from this trend, however, we can only hope this prognosis will prove to be too pessimistic and that perhaps the case sketched briefly earlier on the virtues of international cooperation will prove persuasive.

NOTES

1. Although there were amending conventions in 1950, 1956, and 1966, the basic treaty framework remains that established in 1942.
2. For a recent review of Canada's international investment position, with emphasis on tax factors, see Brean (1983).
3. The U.S. position is far from being accepted by every one -- see, for example, Bird (1975); OECD (1977, pp. 100-01) -- but this is not the place to pursue this abstruse (though important!) controversy.
4. R. Alan Short, in Report of Proceedings of the 32nd Tax Conference (Toronto: Canadian Tax Foundation, 1981), p. 412.
5. This observation may appear to lend some support to the common practice of the U.S. courts in turning to the legislative history in interpreting tax laws, including treaties. One trouble with the argument is, as Roberts (1982) rightly notes, that U.S. courts understandably look only at U.S. legislative history, thus ignoring completely the essence of a treaty as a bilateral agreement. Other aspects of treaty interpretation are discussed briefly later in the present paper.
6. As Alan Short said (in the comment cited in note 4 above) "Canada is a country which on Mondays, Wednesdays, and Fridays is very concerned with the degree of foreign ownership and on Tuesdays and Thursdays welcomes the amount of foreign investment we need."
7. For example, the current U.S.-Netherlands Antilles treaty discussions may leave the Eurobond window open for American investors while

closing the door to third-country "treaty shoppers" -- including Canadian parents financing identical U.S. investments through the Eurobond market.

8. This Act is not intended to affect the interpretation of terms that are fully defined in a convention. It pertains only to those words or expressions that are not fully defined or where the convention itself provides that the meaning of a term is to be determined, at least in part, by reference to domestic legislation.
9. See comment by H.D. Rosenbloom and R.A. Short in Report of Proceedings of the 32nd Tax Conference (Toronto: Canadian Tax Foundation, 1981), pp. 404-5. This legislation which was put through in response to domestic complaints about what was (by Canadian standards) a small amount of foreign investment in U.S. real estate, provides an interesting parallel to some recent Canadian legislation (e.g. the National Energy Program) also largely intended aimed at dealing with a much greater foreign involvement "problem". The contrasting attitudes of the two countries to their respective attempts to assert sovereignty and satisfy perceived domestic political needs suggest both that in international tax affairs, as elsewhere, what matters is whose ox is gored and also that, as might be expected, the U.S. is a lot more important to Canada than Canada is to the U.S.
10. In other federations -- West Germany, Australia, even Switzerland -- all international tax questions are explicitly the province of the national government: see (e.g. Duss and Bird (1979) on Switzerland.

11. Unsurprisingly, however, in view of the traditional direction of capital flows, it appears that the stronger hand on such matters is held by the U.S., with the result that even commentators who are strongly critical of such concessions to the U.S. such as the lower dividend withholding tax, have suggested that host governments will increasingly have to "change their tax laws to conform to the new [U.S.] guidelines "unless they want to erect significant barriers to U.S. investment (Deutsch and Jenkins, 1982, p. 233).
12. The U.K.-U.S. treaty, which was concluded while the Canada-U.S. negotiations were in process, did attempt to deal with this matter, in the end producing an article which was satisfactory to both parties (and which would have prohibited application of the unitary method to a U.I. parent corporation), but this provision subsequently had to be removed to satisfy U.S. domestic political needs before the treaty could be ratified.
13. A review of the 1977 OECD model treaty indicates that at least 21 of the 24 member countries entered a total of almost 130 reservations to its 30 Articles -- with the U.S. and Canada leading the list with over a dozen reservations each.

It is somewhat ironic that apparently the only real multilateral tax convention which has ever been signed is by the Comecon countries (Biehl, 1982, p. 204). Of course, given the controlled nature of trade and capital flows amongst the Comecon countries the significance of such a tax treaty is close to zero (Bird, 1964)).

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14. Parenthetically, from this point of view, given the much greater importance of U.S. developments to Canada than vice versa, it is a bit surprising that apparently no special effort is made in Ottawa to keep up with U.S. tax developments. It is true that it is hard in Canada to avoid being swamped with American information in every case; but this is not the same as a careful, systematic review and evaluation of U.S. tax developments with an eye to their implications for Canada. What the U.S. does is too important for what Canada can or should do to be left largely to chance and personal interests and contacts as now seem to be the case.
15. We do not review here such well-known arguments as those on GATT rules for border tax adjustments and the trade effects of value-added vs. corporate income taxes, however, both because we think these matters have been discussed more than adequately elsewhere -- including, at times, by us (Brean, 1983; Krauss and Bird, 1971) -- and because we do not consider them to be high on the list of "current" issues with which this conference is presumably concerned.
16. The U.S. insistence on the "improper" nature of such subsidization may perhaps be related to the traditional American position on "tax sparing" -- the term used to denote a practice (much sought by developing countries) under which if a host country grants a tax incentive to a firm, the residence country treats the profits of that firm for purposes of crediting tax as if it had been subject to host country tax. The United States has argued against this practice largely on the ground that tax incentives do not do any

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good anyway and that it is not in the interest of developing countries to give such incentives. (Actually, the American use of the "overall" rather than per country limitation for foreign tax crediting purposes, and the opportunities open to international firms to move money about in many different ways make this debate of more theoretical than practical importance for many firms -- but it is the principle that is at issue here.)

In sharp contrast to its long-standing concern that the tax policies of other countries should be "sensible" in this respect, however, the United States' attitude with respect to integration of corporate and personal taxes has generally been, in the name of the principle of non-discrimination, that the source country should treat residents and non-residents equally, that is, that non-residents should get the same imputation credits as residents. To quote a U.S. Treasury official: "The fact that it [the tax credit] may end up in the coffers of the other country's treasurer, rather than in the shareholder's pocket, is a choice properly left to the resident's country" (Carlson, 1980, p. 19). When the shoe is on the other foot, it appears, the United States can easily argue the other way.

The point of this comment is not that the U.S. is in any way hypocritical: it is rather that statements of principle can never be realistically considered in isolation from the position of those who make them. It is not the rules that matter for most purposes as much as the results of applying those rules in particular

circumstances -- circumstances that are in the real world, if not in the world of legal theory, generally known to those who propose the rules in the first place.

17. As noted later, whether or not the U.S. actually gains from DISC -- or Canada from its offsetting credit -- is quite another matter.
18. Actually, in the early 1960s for a brief period Canada had a program which in effect worked like this -- though not very successfully (see Bird, 1965).
19. With respect to the first (DISC-like) proposal, for example, Gordon (1982) says that if the U.S. complains Canada should simply enact "punitive legislation" similar to that in the U.S. While it is not wholly clear to what legislation he is referring, this comment neglects completely the inevitable basic asymmetry in Canada-U.S. economic relations. If matters degenerate to a battle of off-setting "punitive legislation", it is not hard to see who will win. This is by no means to say that Canada must passively accept whatever the U.S. chooses to do, but it does suggest that the "eye for an eye" spirit of Gordon's proposal is not likely to prove a useful approach to bilateral negotiations for Canada (except perhaps as a bargaining counter).
20. Interestingly, this analysis is cited approvingly in the most recent U.S. Treasury (1983) annual report on the DISC program. (The Treasury has never been very fond of this program in any case -- or so an examination of these annual reports suggests.)

21. A recent paper by Thirsk (1983) suggests that there may indeed be some welfare gain to Canada also from the existence of distortionary taxes on capital (see also Boadway and Tredenick, 1978), but these results depend primarily upon the fact that such taxes are higher in the U.S. (Murray, n.d.) which means that Canada can in effect reap part of the U.S. gain from such taxes partly through similar terms of trade effects and partly through the way the U.S. foreign tax credit system enables Canada to levy taxes on U.S. controlled firms at the expense of the U.S. treasury. The major lesson of the Thirsk analysis for Canadian policy-makers is thus in the end not very different from that in the quite different analysis in Deutsch and Jenkins (1982) -- namely, that to a limited extent Canada may have some room to gain through increasing taxes on U.S.-controlled firms, so long as the credits generated by the increased taxes remain usable. Of course, such advice to some extent ignores the reality of the continued international bargaining context and in particular the importance -- especially for Canada -- of avoiding explicitly discriminatory measures.
22. Although Doran (1983) suggests that Canada's traditional concern that commercial interdependence threatens its cultural autonomy is largely unsubstantiated, he nowhere distinguishes goods and services and uses some very weak and partial measures of cultural autonomy.
23. See, for example, Hartland-Thunberg and Crawford (1982).

24. Sato and Bird (1975) similarly argued for what they called "effective reciprocity" in place of the "nominal reciprocity" of the OECD model tax treaty but their concern was to look beyond withholding taxes to the underlying corporate and personal tax rate structures. The present comment is concerned more with the equitable division of international tax base when intercountry income flows are unbalanced and thus has more in common with the discussion in Musgrave and Musgrave (1972).
25. Most discussion of these matters appears to follow what Allison (1971) has called the "rational actor" approach to policy evaluation: for a particularly useful critique of this approach to Canadian public policy, see Hartle (1979).
26. An example of the sort of analysis that seems needed in this field is Gillespie (1983).

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