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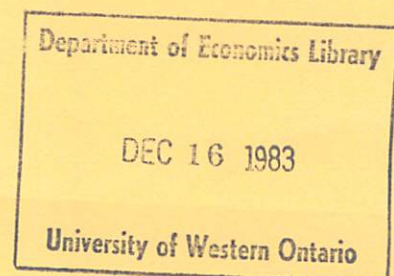
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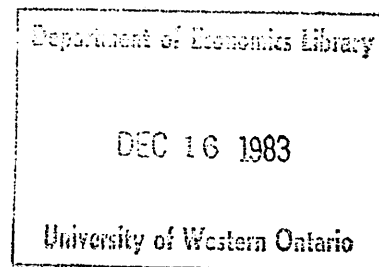


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R. J. Wonnacott

December, 1983



The Report of the Federal Task Force on the Canadian Motor Vehicle and Automotive Parts Industries (co-chaired by Patrick Lavelle and Robert White and referred to hereafter as LW) has come up with a proposal that seems to be a simple extension of the Canada-U.S. Auto Pact: All foreign manufacturers with substantial sales in Canada should now be required to achieve the same levels of Canadian domestic content as U.S. firms operating under the Pact. On the face of it, and to the public at large, this may seem like a reasonable proposal. Why shouldn't the Canadian government require other foreign manufacturers such as the Japanese to play the same game--to compete on even terms with North American manufacturers?

Unfortunately, on more careful examination, this apparently reasonable proposal raises a number of serious problems:

1. It is not a simple extension of the Auto Pact at all; it's a completely different animal. Under the Auto Pact any foreign firm (U.S. or Japanese) that wishes to sell in Canada has the option of meeting Canadian content requirements or exporting to Canada over the existing Canadian tariff. (At present, U.S. firms meet the Canadian content requirements; the Japanese export over the Canadian tariff.) Under the LW proposal, the alternative to meeting Canadian content requirements would be not to sell in Canada at all--which can be viewed as equivalent to facing a prohibitive Canadian tariff. For Canada to introduce such a change would break our Tokyo Round tariff binding on autos--and, from the U.S. point of view, would unilaterally alter Canadian commitments under the Auto Pact. (True, the U.S. companies are not now exercising the option of exporting to Canada and paying the Canadian tariff. But they might

in the future. Closing off an option--even though it's not currently being exercised--does indeed unilaterally alter the terms of the Auto Pact.)

2. There is another reason why enacting the LW proposal would jeopardize the Auto Pact: In satisfying the LW content requirements for selling in the Canadian market, the Japanese manufacturers would automatically achieve the 50% North American content that would give them, under the Auto Pact, freedom to sell in the U.S. market. In other words, if the Canadian government forces the Japanese manufacturers into a Canadian production location, they will then be able to use the Auto Pact to bypass the present voluntary export restraints that limit their entry into the U.S. market. In these circumstances, it seems essentially certain that there would, either formally or informally, be a critical reconsideration of the Auto Pact in Washington. (In any case, LW would eventually guarantee a U.S. review of the Auto Pact, because LW would require an eventual increase in Canadian content even by U.S. auto manufacturers. More about this in a moment.)

3. If a Washington review of the Auto Pact is triggered by Canadian implementation of the LW proposals, it is hard to see how the Pact could possibly survive. Strong objections will almost certainly be raised in Washington not only because of the problems described in points (1) and (2) above, but also because of (a) the long-standing discomfort of the Americans with how Canada has interpreted the Pact's provisions protecting Canadian employment¹; (b) the current level of unemployment in the U.S. auto industry; and (c) the large U.S. trade deficit with Canada in autos and parts. (According to LW, the previous U.S. surplus with Canada

had in 1982 turned into a \$2.8 billion deficit--a deficit which has continued through 1983.)

Given these five causes for U.S. opposition, one can only be pessimistic about the Pact's chances of surviving a U.S. review even in its present form, let alone the form (providing even more protection for Canada) that is sought by many of those now calling for renegotiation of the Pact.

4. Putting the Auto Pact at risk would be an extremely costly policy for Canada because of the substantial benefits this Pact has provided. It is not, as sometimes advertised, a free trade arrangement; instead it is a mixture of free trade and protection, with the free trade gains (coming from Canadian exploitation of economies of scale based on free access to the U.S. market) substantially exceeding the costs of protection. (These costs, arising from the safeguards that have guaranteed continued production in Canada, have been of little consequence, since following the initial period of adjustment there has been little difference in the cost of producing cars on the two sides of the border.)

In comparison, LW incorporates and greatly extends the protectionist aspects of the Auto Pact, with little emphasis on potential free trade gains. True, LW calls for removal of Canadian duty on e.g. Japanese cars, once full content requirements have been achieved; but there is no mention of free access to a new foreign market (in this case, the Japanese) that provided the major source of free trade gain for Canada from the Auto Pact.

5. To sum up, a major claim of LW--that their proposal would simply extend the Auto Pact--cannot be sustained. To the two

reasons already cited [namely, (1) LW would extend the protection of the Auto Pact, but not the major source of free trade gain, and (2) LW would change the Auto Pact by prohibiting imports from companies not achieving Canadian content] we should add another: LW recommends that once the Japanese achieve the content levels now required of U.S. companies, content requirements should be unilaterally increased on all suppliers to the Canadian market (both Japanese and American). Thus, unlike the reciprocal, negotiated Auto Pact, LW would be a unilateral action by Canada against both Japan and the U.S. This would raise serious problems with respect to both of these trading partners.

6. With respect to the Japanese, would they retaliate? Canada is very vulnerable to such action because our exports to Japan now far exceed our imports from Japan. (We'd be violating a basic principle: don't impose trade restrictions on a country with which you have a large trade surplus.) Since bound up in this Canadian surplus are large resource exports from the western provinces, LW would be likely to seriously exacerbate the East/West division within Canada.

7. With respect to the U.S., we've already argued that the Americans would almost surely respond, were the LW proposals unilaterally introduced by Canada. Indeed it is just not reasonable for us to count on the Americans to resist protection, if we can't. (One reason why the U.S. government may have more difficulty than the Canadian in resisting protectionist pressure is that the U.S. now has a large trade deficit; compare this to the Canadian trade surplus with Japan that should deter us from protectionist moves such as LW.) Specifically, if we can't resist the LW content

proposal, how can we expect the U.S. to resist the content proposal now before Congress? This is potentially a very serious matter, since very little change in this U.S. content proposal would be required to put it in conflict with the Auto Pact's Canadian content provisions. In any case, if the U.S. were to respond to LW in this way or in some other, such unilateral action by the U.S. in combination with the triggering unilateral LW changes by Canada, would be likely to destroy the Auto Pact.

Conclusions. Even without examining the cost to Canadian car buyers of the LW form of protection,² it is still reasonable to conclude that it would be a serious mistake, because of its potential hidden costs. In particular, it would raise serious risks for the Auto Pact, and might well exacerbate interregional East/West strains within Canada. Accordingly the LW proposal should be resisted, despite its superficial appeal. This may not be easy for a government to do in a year preceding an election, especially since the costs of LW (in particular those having to do with our trade with the U.S., rather than with Japan) may be too subtle for the public to understand. Instead, the simplest, clearest and most persuasive appeal to the public which the government can use in rejecting LW is that it can be interpreted as breaking our Tokyo Round binding on our auto tariff and hence would violate GATT; in other words, it would be illegal, given our present trading agreements³. No further elaboration would be required.

Three final observations: First, this example illustrates how non-tariff barriers such as content requirements may often inherently be a more dangerous form of protection than tariffs,

because NTBs lack transparency; indeed some of their effects may not become clear until after they have been implemented--at which point, they may be very difficult to get rid of because of a government's natural resistance to reversing its own decisions. Second, the government of Canada should stop paying special interest groups to lobby itself--in the process endowing them with the authority of a fancy name like "Task Force". (It may be difficult for the public to understand that the "Report of a Federal Task Force" may be simply the brief of a special interest group.) Whatever the government may perceive as the short run advantages of such a strategy, in the long run it makes a decision in the public interest much harder to reach--if for no other reason than that the government may find it difficult to reject the recommendations of its own Task Force. By any observed rate of discount this sacrifice of long term policy freedom is a bad bargain from the point of view of the Canadian public. Third, we should be very critical of the LW proposal (p. 130) for "the Minister of ITC/DREE to establish an Automotive Council to provide a forum for discussion, consultation and advice on automotive policy matters." Would this be just a way of formalizing and making permanent the government policy of encouraging special interest groups to lobby itself?

Footnotes:

¹The premise (p. 1) of LW is that the Auto Pact "established the fundamental policy that automotive companies that participate in the Canadian market invest, provide employment and create value added within that market commensurate with the benefits they derive from it." This sounds as though, in signing the Auto Pact, the Americans accepted the principle of permanent safeguards for Canadian employment. Not so; at the time, all the U.S. negotiators thought they were arranging was temporary safeguards. Canada's subsequent interpretation of these safeguards as permanent came (to put it mildly) as a surprise. Indeed this misunderstanding over safeguards has remained a lingering source of U.S. concern with the Auto Pact.

Accordingly it cannot be implied that the Auto Pact has established that permanent Canadian safeguards are acceptable to the Americans, let alone the Japanese. (As already noted above, LW calls for Canadian safeguards that are not to be eventually phased out, but are instead to be increased.)

²On this issue, LW argue (p. 117) that "recent statements about probable vehicle price increases...have no basis in fact"; as supporting evidence they note that during the period since 1981 when Japanese VERs have been in effect, auto prices have increased by only 3.6% while the CPI has risen by 8.4%. While this is an interesting observation, it's not clear how it supports their claim quoted above. True, this data on inflation is consistent with the LW position (that auto prices are little affected by protection). But it's also consistent with the opposite position--specifically, with the standard, broadly-held view that Japanese competition has had a favourable influence in moderating auto price inflation; and

the reduction in Japanese competition due to VERs has reduced this favourable influence.

³LW argues (p. 114) that its content proposal could "be implemented without prejudicing any of our current trade obligations" because there is an alternative GATTworthy policy that could have been used instead. Specifically, LW state that as an alternate to their content proposal, "it would appear that the Canadian government could have invoked Article 19 against vehicle imports from Japan." But what does that establish? Surely LW are not implying that an action of questionable legality can be justified by the existence of a legal alternative. (One need only briefly reflect on the wide variety of actions--either international or domestic--that such a principle might justify.)

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