THE CANADA-U.S. FREE TRADE AGREEMENT AND THE AUTO PACT:
A HISTORY OF THE AUTOMOTIVE PROVISIONS AND AN EXAMINATION
OF THE STATE OF THE CANADIAN AUTOMOTIVE INDUSTRY

by

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Thesis submitted to the Faculty of the
Virginia Polytechnic Institute and State University
in partial fulfillment of the requirements for the degree of

MASTER OF ARTS

in

Economics

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December 1990
Blacksburg, Virginia
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(ABSTRACT)

Before 1965, Canadian automotive manufacturers were producing a wide variety of models for a limited market in an industry in which economies of scale are very important. Tariffs and a Canadian content requirement protected this high cost industry from being overwhelmed by the more efficient U.S. manufacturers.

The efficiency of Canadian firms was expected to improve under the Auto Pact with the U.S., which allowed duty free passage of new automotive equipment subject to certain conditions designed to protect the weaker Canadian industry. The Auto Pact was prevented by these Canadian safeguards from being a true free trade agreement (FTA), but it was an important step towards reducing the barriers to bilateral automotive trade.
Canadian manufacturers were pleased with industry performance under the Auto Pact. Specialization allowed the efficiencies of longer production runs. Tariffs on imported production parts and new vehicles were eliminated, lowering costs even further. Retail prices decreased to U.S. levels.

The unprecedented global changes of the 1970s, however, caused serious alarm. The Canadian Government examination of the state of the industry led to complete restructuring within Auto Pact principles and continued improvements in modernization and efficiency.

Gains under the Auto Pact are expected to expand under the FTA, which eliminates the remaining barriers to bilateral automotive trade. The safeguards are to be phased out over a period of ten years and the Canadian and U.S. industries will be further integrated into a single North American market, fully competitive in the new global environment.
ACKNOWLEDGEMENTS

I would like to thank the following for their extraordinary helpfulness in my research.

Without the generosity of the Canadian Embassy in Washington, particularly the staff of the Academic and Cultural Library, I could never have begun this paper. In response to the first telephone conversation, they sent a copy of an extensive bibliography listing all known publications pertinent to the Free Trade Agreement. During lengthy visits, they made available not only the documents cited in the bibliography but also extensive files of articles and explanatory materials. These helped to provide a firm grounding in the chronology and impact of the events surrounding the legislation.

During a visit to the Department of External Affairs and International Trade Canada in Ottawa, the Library provided documents and articles not otherwise available and permitted unlimited copying of nonsensitive materials. The Canadian Government statistics and working papers provided a depth of understanding that would never have been obtained through other, more easily obtained sources.
The Public Relations Departments of General Motors of Canada, Limited and Ford Motor Company of Canada, Limited provided speeches, notes, and other working papers as background material. These explored the expectations of those most closely affected by the changes in the automotive provisions: the automotive manufacturers preparing to do business in the new environment.

Very special thanks goes to David C. Adams of the Motor Vehicle Manufacturers' Association of Canada. Following several telephone conversations, the first of which must have been quite a surprise, he went to great effort to prepare a package of materials that he thought (correctly) to be most helpful to the stated purpose and intent. The articles, studies, statements, and charts he compiled were of central importance to the research as they expressed the unique perspective of the Canadian automotive industry.
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PREFACE

This paper is primarily an economic history of the automotive provisions of the Auto Pact and the Free Trade Agreement (FTA): why they were specified in their present form and how the automotive industry in Canada was affected by the new business environment, particularly in light of the unprecedented global changes of the 1970s. The nature of the topic and the available literature necessitate a descriptive paper. Because of the short length of time that the FTA has been in effect, no data are available for testing quantitative hypotheses.

It is demonstrated that the Auto Pact was an important step towards reducing the barriers to bilateral automotive trade. The Canadian automotive manufacturers have made enormous gains in modernization and efficiency in the environment of freer trade and, as the remaining trade barriers are eliminated under the FTA, are expected to expand upon these improvements and further integrate the industries of Canada and the U.S. into a single North American market, fully competitive in the new global environment.

It should be noted that while the Canadian manufacturers are subsidiaries of U.S. firms (100 percent equity ownership
in the cases of Chrysler and General Motors and approximately 90 percent in the case of Ford), they are considered independent enterprises; management offices in Ontario, not Detroit, retain full responsibility. Additionally, in-house parts and product transfers are required to be priced at market value and are regularly audited for compliance by Revenue Canada.
CHAPTER ONE
INTRODUCTION

In the late 1950s, Canadian automotive producers became increasingly concerned about the condition of their industry. Wages were about 30 percent less than in the U.S. but Canada was still a high cost producer protected by a 17.5 percent tariff on automobiles. A Canadian Government study concluded that the root of the problem was the short, fragmented production runs inherent in trying to manufacture a complete fleet. The Canadian firms were producing almost as wide a range of models in Canada as was available in the U.S. but for a market of only one-tenth the size.¹

In 1962, Canada established a duty remission program in an effort to increase Canadian production and generate increased automotive trade with the U.S. Under this program, automotive manufacturers operating in Canada were accorded tariff rebates on imported automotive parts in exchange for increased exports of finished products. After a U.S. company filed suit under U.S. law against the duty remission program, the two Governments entered into negotiations to design a

mechanism to allow for the development of a more efficient Canadian automotive industry. The result was the Automotive Products Trade Agreement of 1965 (Auto Pact – Appendix A).²

The Auto Pact provided for duty free passage of new automotive equipment subject to certain conditions. The first of these conditions committed Canadian automotive manufacturers to assemble at least as many automobiles in Canada as they sold there. In additional letters of undertaking, the producers pledged to increase Canadian value added by at least 60 percent of the growth in their Canadian sales.³

These conditions, known as the Canadian safeguards, were intended to prevent the weaker Canadian industry from being overwhelmed by the larger, more efficient U.S. manufacturers as the barriers to trade were reduced. Previously, rising demand in Canada had been met with increased imports from the U.S., resulting in a large trade deficit in automotive products. Through this combination of more open trade and some protective barriers, the Auto Pact was expected to create a new business environment in which Canadian producers

²ibid.

³ibid., pages 1-2.
could specialize in the limited number of parts and models that could be produced most efficiently in Canada. Those remaining parts and models demanded by Canadian consumers could be imported from the U.S. at lower cost. As the efficiency of the Canadian industry increased, it was expected that exports to the U.S. would increase and the trade balance in automotive products would improve.

After 1965, the Auto Pact became a centerpiece of Canadian commercial policy, resulting in nearly total integration of the North American automotive industry. Bilateral trade grew to 60 times its pre-Auto Pact levels and accounted for more than one-third of the entire Canada-U.S. trade relationship.\(^4\)

The special conditions that accompanied the Auto Pact prevented it from being a true free trade agreement but it was nevertheless an important step towards more open bilateral trade in automotive products. The automotive provisions of the FTA (Appendix B) eliminate the remaining barriers to automotive trade over a period of 10 years. In the new business environment under the FTA, the vehicle and parts manufacturing industries in both Canada and the U.S.

\(^4\)ibid., page 2.
are doing extremely well. The FTA is expected to enlarge upon the gains under the Auto Pact by making bilateral trade more open and secure, benefitting both economies and integrating them further into an expanded North American market.

Because of the short period of time that the FTA has been in effect, there is not an extensive body of literature in the traditional sense. Most of the reference materials for the present paper were provided by the Canadian Government or automotive industry representatives. Some economics work has been done by Paul J. Wonnacott of the University of Maryland, Richard G. Lipsey of the C.D. Howe Institute in Toronto, Murray G. Smith of the Institute for Research on Public Policy in Ottawa, and Jeffrey J. Schott of the Institute for International Economics in Washington. These gentlemen write independently or in collaboration and often their papers are included as chapters in one another's books.

Wonnacott is preeminent on the subject of Canadian automotive policy and practice and has written extensively

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5 Department of Industry, Trade and Technology Canada, Business Development Branch, Strategic Issues in the Canadian Automotive Industry: Current Situation, page 4.
about the Auto Pact and the FTA. Lipsey, Smith, and Schott are more concerned with the macroeconomics of the FTA: the objectives and expectations of the two Governments, the process of negotiation and ratification, and the dynamics of the new environment from a global perspective.

Schott's book, *Free Trade Areas and U.S. Trade Policy*, is a collection of 16 papers prepared for a conference hosted by the Washington-based Institute for International Economics from 31 October - 1 November 1988. Trade experts from major trading nations discussed the desirability and feasibility of more free trade areas and considered the effects of such arrangements on potential participants, third nations, and the world trading system.

Lipsey and Smith presented a paper that is relevant to the present topic, "The Canada-US Free Trade Agreement: Special Case or Wave of the Future?" They conclude that the FTA conforms to General Agreement on Tariffs and Trade (GATT) practice and is consistent with the spirit of a multilateral trading system. An additional agreement between Canada and a third nation would have minimal impact on the global system but there would be far reaching consequences of an agreement between the U.S. and another large economy.
Schott and Smith's book, *The Canada-United States Free Trade Agreement: The Global Impact*, contains papers prepared for a conference hosted by the aforementioned Institute and the Ottawa based Institute for Research on Public Policy on 11 January 1988. In "The Free Trade Agreement in Context: A Canadian Perspective," Smith states that the U.S. sees the FTA as part of a larger effort to manage other international liabilities, whereas Canada is primarily concerned with managing economic relations with the U.S. The FTA offers substantial economic benefits to both nations and may facilitate progress in the GATT negotiations.

In "The Free Trade Agreement: A US Assessment," Schott believes that the U.S. has much to gain from the expected increase in bilateral trade but that Canada stands to gain even more. He explains that Canada is obtaining better access to a market 10 times its size but that the U.S. is gaining only a small increment to an already large home market.

In "Services and Investment," Schott and Smith state that the FTA fills a major gap in bilateral economic relations and breaks new ground in international agreements by incorporating provisions that cover transactions in services and investment. Many Canadians believed that these
provisions went far beyond the requirements of Article 24 of the GATT and limited the Canadian Government's ability to intervene in its own economy. The authors argue that the agreed framework allows business people to adapt quickly to the trade reforms; historically, a long transitional period had been required. Schott continues the analysis in "Implications for the Uruguay Round," stating that GATT accords on dispute settlement, services, and investment will be facilitated by the precedents set by the Canadian and U.S. FTA negotiators.

Wonnacott's work, particularly The Canada-U.S. Free Trade Agreement and the Auto Pact and The United States and Canada: The Quest for Free Trade - An Examination of Selected Issues, forms the theoretical nucleus of the present paper. He believes that the most important objective of the FTA from the perspective of the Canadian automotive sector was to make trade with the U.S. more stable, secure, and predictable. Under the Auto Pact, most automotive trade between the two nations had been duty free but the agreement was growing unstable and the global environment was changing at an unprecedented rate. The major sources of strain under the Auto Pact were a long lasting disagreement over Canadian export based duty remission schemes, Canadian moves to extend Auto Pact membership to overseas producers selling in Canada,
and Canadian and U.S. competition for overseas plants. Wonnacott concludes that the automotive provisions of the FTA strengthen the Auto Pact in some ways and weaken it in others but, overall, represent a fair compromise between the two nations. Neither nation won everything it wanted but the compromise managed to avert the pending explosion over the issues of tariffs and countervailing duties.

The prevailing impression from the formal literature is that the Auto Pact, which included safeguards for the relatively weaker Canadian automotive industry, was an important step towards bilateral free trade and allowed the Canadian automotive manufacturers to make great progress in modernization and efficiency. The FTA is expected to enlarge upon these gains by making bilateral trade more open and secure, thus benefitting both economies and further integrating them into an expanded North American market.

The informal literature, defined here to include articles and Government and industry studies, presents a different perspective on the changes in the Canadian automotive industry during the first 13 years under the Auto Pact.
The present paper is primarily an economic history of the automotive provisions of the Auto Pact and the FTA: why they were specified in their present form and how the automotive industry in Canada was affected.
CHAPTER TWO
HISTORY AND OBJECTIVES OF THE AUTO PACT

Before 1965, automotive production in Canada was almost entirely in the hands of Canadian subsidiaries of U.S. motor vehicle manufacturers: General Motors, Ford, and Chrysler. The value of Canadian automotive output in 1963 was C$1.4 billion. Sales in 1963 amounted to about 600,000 units. In 1964, total sales exceeded 700,000 units. The Canadian market, as a proportion of the North American market, was growing rapidly. This expansion was expected to continue as the number of automobiles per capita in Canada was relatively smaller than in the U.S. and Canadian incomes were growing at a faster rate than U.S. incomes.\(^6\)

Canadian consumers overwhelmingly chose automobiles of U.S. design and make: 91 percent of all cars purchased in Canada before 1963 were U.S. models and the range of body types and models available in Canada was almost as wide as that in the U.S. Canada was the U.S.'s major export market

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for automotive products. In 1963, the U.S. sold C$560 million in automotive equipment to Canada but imported only C$33 million.7

Although Canada produced and consumed the same automobiles under much the same conditions as did the U.S., costs and prices were significantly higher than in the U.S. despite lower Canadian wages and certain other Canadian cost advantages. A principal reason was the lower volume of Canadian output. In an industry in which economies of scale are very important (high costs of capital, plant, and equipment need to be spread over large numbers of units of output), Canadian manufacturers typically operated at levels too low to permit the full advantage of such economies. For example, the Ford Motor Company of Canada, Limited was producing 60 different models of 5 distinct passenger car lines; in the U.S., Ford's Great River Rouge assembly plant produced only 3 models of the Mustang line. Similar disparities existed for the other producers; in only a few automotive parts and in none of the vehicles was the volume of Canadian output large enough to bring unit costs down to U.S. levels.8

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7 Ibid.
8 Ibid., pages 29-30.
This relatively high cost industry was protected by customs tariffs and by the Canadian content requirement. Tariffs on finished vehicles were 17.5 percent and ranged from duty free up to 25 percent on component parts. The content requirements called for up to 60 percent of Canadian parts and labor and other costs in the finished automobile. These restrictive devices had helped to screen producers located in Canada from U.S. competition and maintain a Canadian automotive industry. However, they also perpetuated uneconomic production runs, higher unit costs than in the U.S., higher priced cars for Canadian consumers, and a smaller total North American market.\(^9\)

As long as there were tariffs and other barriers to the automotive trade between Canada and the U.S., there was no possibility of achieving the full potential of an integrated North American automotive industry and market. U.S. tariff duties were considerably lower than Canadian duties, about 6.5 percent on vehicles and 8.5 percent on most parts, but they were an additional burden on the flow of trade in the automotive sector. With the higher Canadian tariffs they helped to shape a pattern of trade and production that fell

\(^9\)ibid., page 30.
far short of the efficient pattern that could otherwise have been developed.\textsuperscript{10}

With tariffs and other restrictions eliminated, the Canadian manufacturers would have been able to concentrate on the limited number of models and parts which could be most efficiently produced in Canada while supplying the Canadian consumer with a full range of other models from U.S. plants. Canadian management naturally would have worked toward getting high volume production of specific components and models in Canada. The result, over time, would have been an integrated North American industry. With lower costs and prices, the Canadian industry would have grown faster than ever before and the total of North American production and the total of Canada-U.S. trade similarly could have been expected to expand.\textsuperscript{11}

Canadian and U.S. officials worked together over several months to see whether the abstract concept of a North American market and industry, unimpeded by tariffs and other barriers, could be given substance and reality. Their talks took place against the background of serious differences

\textsuperscript{10}ibid.

\textsuperscript{11}ibid.
between the two nations over a Canadian program initiated in
November 1962 and extended a year later. Under this program,
automotive companies operating in Canada were accorded,
through rebates, the benefit of tariff free treatment on
certain automotive parts in return for increased exports of
automobiles or parts. This Canadian program was challenged
by the U.S. as contrary to a section of the basic Tariff Act
concerned with foreign bounties or grants on exports to the
U.S. If the Canadian plan fit the statutory definition of a
bounty or grant, then the U.S. Secretary of the Treasury
would be required to assess countervailing duties on Canadian
automotive equipment entering the U.S. to compensate for the
export incentive offered by Canada.\textsuperscript{12}

The applicability of countervailing duties was a legal
question but the issue and the Canadian program from which it
was derived was clouding the future of Canada-U.S. automotive
trade. If the differences between the two nations were to
have ended in trade retaliation and counter-retaliation, the
consequences for North American commerce and commercial
relations could have been harmful for both nations,
particularly for the automotive industry.\textsuperscript{13}

\textsuperscript{12}ibid., pages 30-31.
\textsuperscript{13}ibid., page 31.
This situation underscored the urgency of a mutual attack on Canadian and U.S. barriers to trade in the automotive sector. The technical and economic problems involved were analyzed extensively by both Governments with input from representatives of industry and labor. The negotiators on both sides found that the mutual advantage of both nations lay in freeing the Canadian-U.S. trade in motor vehicles and original parts for the production of new vehicles. Terms for achieving this were agreed and became the Auto Pact.\textsuperscript{14}

The two Governments agreed to work for the early achievement of a broader market for automotive products within which the full benefits of specialization and large scale production could be achieved. They also agreed to the early liberalization of automotive trade in respect to tariff barriers and other factors tending to impede it so that the industries of both nations could participate on a fair and equal basis in the expanding market in North America. Additionally, they agreed to develop conditions in which market forces could operate effectively to attain the most economic volume of investment, production, and trade. Each

\textsuperscript{14}ibid.
Government agreed to avoid actions which would frustrate the achievement of these objectives.\textsuperscript{15} The outcome of the ensuing discussions was the Auto Pact, signed by Prime Minister Pearson and President Johnson on 16 January 1965.\textsuperscript{16}

\textsuperscript{15}ibid.

\textsuperscript{16}Canada–United States Automotive Agreement, notes provided by the Canadian Embassy in Washington, dated July 1980, page 1.
CHAPTER THREE
AUTO PACT PROVISIONS

The Auto Pact not only provided a solution to a difficult problem, but was also a positive development for the North American automotive industry and for Canadian-U.S. trade. It was warmly welcomed by the automotive manufacturers of both nations. Under the Auto Pact, tariffs were to be removed. North American production was expected to become substantially more efficient and, as efficiency increased, both nations were to benefit from increased consumption of automobiles and from increased trade.17

If Canadian industry was to participate effectively in the U.S. market, it was necessary to take into account the institutional barriers to trade arising out of the corporate structure of the industry as well as formal Government barriers. The Canadian sector of the industry at that time was much weaker than the U.S. sector and special arrangements were made to cover the transitional period. Under Canadian

tariff procedures, duty free treatment was accorded to manufacturers maintaining their assembly operation at existing rates, subject to market developments. Customs duties on replacement parts were not reduced under the Auto Pact. Removal of duties and other barriers was expected to result in a North American market substantially larger than would have developed otherwise. Canadian manufacturers made plans to expand their production and assured the Canadian Government that Canadian production would fill a substantial part of the increased demand.\textsuperscript{18}

The specific conditions of the Canadian safeguards were the following:\textsuperscript{19}

(1) For each class of vehicle (i.e., cars, trucks, and buses), the ratio of Canadian vehicle production to vehicle sales in Canada achieved by a manufacturer during each model year, expressed in net sales value, must be at least 75 percent, or the percentage achieved in the 1964 model year, whichever was higher.

\textsuperscript{18}ibid.

\textsuperscript{19}Canada–United States Automotive Agreement, notes provided by the Canadian Embassy in Washington, dated July 1980, page 2.
(2) The Canadian content (value added) in vehicles produced in Canada by a manufacturer, with each vehicle type again taken individually, must be no less than the absolute dollar amount achieved in the 1964 model year.

The manufacturers who met these conditions were permitted to import vehicles and original equipment parts duty free. Other importers were required to pay the tariff of 15 percent. In addition to these conditions within the Auto Pact, two additional commitments to the Canadian Government were incorporated within separate letters of undertaking:

(1) To increase value added in Canada in each model year by an amount equal to 60 percent of the growth in the value of car sales in Canada and 50 percent in the case of commercial vehicles.

(2) Over and above the value added floor stipulated in the Pact and the value added growth arising from increased vehicle sales in Canada covered by the

20Ibid., pages 2-3.
letters of undertaking, there was to be a supplementary increase in Canadian value added of C$260 million by the manufacturers, here in the aggregate, by the end of the 1968 model year.

While the Auto Pact provided for duty free passage of new vehicles and most original equipment parts, the assembly and value added targets that Canadian producers were required to meet kept it from being a free trade agreement. The Canadian safeguards led to a source of friction between the two nations because of quite different perceptions of the Auto Pact. The U.S. viewed it as a step to free trade, with the safeguards providing only transitional protection to the Canadian automotive industry. Canada, however, viewed the Auto Pact as a way of increasing efficiency while still offering protection to its industry and intended that the safeguards should remain permanently. In the years to follow, these differing views would lead to serious strains between the two nations.

The safeguards presented an additional problem to the Canadian manufacturers. Although they were intended to

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protect the Canadian industry while it improved in
efficiency, the design and wording of the safeguards promoted
inefficient solutions. Increased Canadian value added in
each model year was not sustainable beyond a certain period
but, more importantly, the value added requirements actually
discouraged specialization and efficiency. If it was more
efficient for Canadian manufacturers to assemble parts
imported from the U.S. at lower cost, the value added
requirements would still have limited them to using a certain
percentage of less efficiently produced Canadian parts. By
pursuing two courses at once, reducing barriers to bilateral
trade yet retaining some protective devices, the Canadian
industry could not take fullest advantage of the efficiencies
of a truly open trading arrangement.
CHAPTER FOUR

CHANGES IN THE GLOBAL ENVIRONMENT

At the time of the Auto Pact, the North American automotive industry overall was a comfortable oligopoly concentrated in the U.S. Profits were high and reasonably stable and the advantages of oligopoly power were shared by the labor force in the form of high wages and relatively large fringe benefits. Imports of passenger automobiles from overseas accounted for only 7.6 percent of the U.S. market. The North American industry made over half of the total worldwide production of cars and had little to fear from overseas competition. Differences in driving conditions between Europe and North America provided a natural protection for the North American market, which resulted in North American automobiles being much larger than those in Europe. European cars competed only for the low end of the market and specific luxury niches and Japan was then only a minor player. Annual Japanese production of automobiles was less than 100,000 units in 1956 and slightly over 500,000 in 1960. Although Japanese output had quintupled in only 4 years, attempts to enter the North American market had not
been successful (Toyopet in 1956) and Japanese firms were not viewed as a challenge to North American producers.22

This comfortable state of affairs continued into the 1970s and then changed drastically, mainly as a result of the two oil shocks of 1973-74 and 1979-80 and increasing competition from Japanese firms. The 1970s began with sales of North American passenger automobiles rising to a record high of 10.4 million units in 1973, 9.6 million in the U.S. and 780,000 in Canada. An interesting sign of the times was an issue of the General Motors strike of 1973: automotive workers were tired of the long hours of required work and wanted overtime to be voluntary. These conditions ended abruptly with the first oil shock. The industry was caught in a double bind: the short run effects of the recession caused a sharp decline in total new automobile sales in the U.S. from 11.4 million in 1973 to 8.3 million in 1975 and U.S. demand was moving away from the larger North American automobile to more fuel efficient imports. The share of overseas imports rose from 15.2 percent of the U.S. market in 1973 to 18.2 percent in 1975 and Japan's share was rising

rapidly. By 1980, 79 percent of U.S. imports came from Japan and only 13 percent from Germany.23

The industry made a partial recovery. By 1977-78, new automobile sales in the U.S. had recovered to almost 11 million, near the 1973 peak of 11.3 million. Overseas import share stabilized at about 18 percent and profits rose above the 1972-73 level.24

But where the first oil shock was disturbing, the second was devastating. The combination of soaring gasoline prices and recession led to a decline in U.S. automobile sales from 10.3 million in 1979 to 7.8 million in 1982, and from one million to 710,000 in Canada. Furthermore, the higher oil prices caused a sharp shift away from North American automobiles to overseas imports. The share of imports in the U.S. market rose from 17.8 percent in 1978 to 22.7 percent in 1979, 28.2 percent in 1980, and 29.3 percent in 1982. In Canada, the increase was even sharper. Import share of the automobile market rose from 17.5 percent in 1979 to 20.2 percent in 1980 and a startling 31.4 percent in 1982.25

23 Ibid., pages 3-4.

24 Ibid., page 12.

25 Ibid.
Canadian manufacturers had been pleased with the progress made under the Auto Pact. According to conventional measures of the automotive industry, Canadian production and exports were increasing and costs were decreasing. Canada seemed well on its way to a modern, efficient automotive industry capable of holding its own in the North American market. These new developments in the global environment, however, were cause for serious alarm. The underlying principle of the Auto Pact, that the U.S. would continue to predominate in the global environment, was clearly no longer the case. Concerned that the gains under the Auto Pact may be too quickly lost, the Canadian Government commissioned a study of the state of the automotive industry.
CHAPTER FIVE
STATE OF THE CANADIAN AUTOMOTIVE INDUSTRY

In 1978, the Canadian Government received the report of the Commission of Inquiry into the Automotive Industry from Commissioner S. Simon Reisman. The Reisman Report did not recommend reopening the Auto Pact negotiations at that time, but recognized that the Canadian safeguards would figure prominently in future negotiations and so should be the subject of serious study.26 At the time of the inquiry, however, Canada was primarily concerned with strengthening her automotive industry under the existing agreement.

Unfortunately, the imprecise language of the Auto Pact lacked meaningful quantitative targets and effective monitoring procedures. The underlying concept of the Auto Pact was that Canadian production of automobiles and components should match Canadian consumption. Since this implied a neutral trade balance, the logical criterion for evaluating the success of the Auto Pact seemed to be the balance of payments resulting from bilateral automotive trade. The number of finished vehicles produced was chosen

as the primary measure but did not accurately reflect the value added in the respective exports and imports.\textsuperscript{27}

It seemed from the 1977 figures (Table I) that the Auto Pact had failed to achieve overall trade balance and that the Canadian deficit in automotive trade was steadily increasing. The number of finished vehicles exported to the U.S. should have improved the balance of trade but instead was more than offset by a growing trade deficit in automotive parts.

The financial performance of the three major vehicle producers (Table II), based on 1976 corporate reports, was even more enlightening. The rate of return on investment of Canadian operations was almost double that of the major manufacturers' global operations but the rate of new plant investment was less than half of that expected on the basis of output volume.\textsuperscript{28}

According to the conventional measure of automotive production, the number of finished vehicles, it appeared that the output of the Canadian industry had increased.


\textsuperscript{28}Ibid, pages 4-6.
Table I. Canadian-U.S. Automotive Trade Balance (CS Million).29

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<td>+1,210</td>
<td>+644</td>
<td>+2,048</td>
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<tr>
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Table II. Performance Data for the Major Automotive Producers - 1976.30

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<th>Global Operations</th>
<th>Canadian Share</th>
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<td><strong>General Motors</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of Vehicles Produced</td>
<td>715,000</td>
<td>8,568,000</td>
<td>8.3%</td>
</tr>
<tr>
<td>No. of Employees</td>
<td>31,600</td>
<td>748,000</td>
<td>4.2%</td>
</tr>
<tr>
<td>Investment in New Plant</td>
<td>C$39M</td>
<td>C$1,000M</td>
<td>3.9%</td>
</tr>
<tr>
<td>Payroll as % of Sales Cost</td>
<td>12.5%</td>
<td>33.9%</td>
<td>-</td>
</tr>
<tr>
<td>Return on Capital (1971-1975)</td>
<td>11.1%</td>
<td>8.9%</td>
<td>-</td>
</tr>
<tr>
<td><strong>Ford</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of Vehicles Produced</td>
<td>708,000</td>
<td>5,422,000</td>
<td>13.1%</td>
</tr>
<tr>
<td>No. of Employees</td>
<td>15,600</td>
<td>443,900</td>
<td>3.5%</td>
</tr>
<tr>
<td>Investment in New Plant</td>
<td>C$36.4M</td>
<td>C$551M</td>
<td>6.6%</td>
</tr>
<tr>
<td>Payroll as % of Sales Cost</td>
<td>11.2%</td>
<td>27.1%</td>
<td>-</td>
</tr>
<tr>
<td>Return on Capital (1971-1975)</td>
<td>12.7%</td>
<td>5.1%</td>
<td>-</td>
</tr>
<tr>
<td><strong>Chrysler</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of Vehicles Produced</td>
<td>329,600</td>
<td>3,310,000</td>
<td>10.0%</td>
</tr>
<tr>
<td>No. of Employees</td>
<td>16,000</td>
<td>244,900</td>
<td>6.5%</td>
</tr>
<tr>
<td>Investment in New Plant</td>
<td>C$15.8M</td>
<td>C$227.4M</td>
<td>6.9%</td>
</tr>
<tr>
<td>Payroll as % of Sales Cost</td>
<td>9.3%</td>
<td>25.0%</td>
<td>-</td>
</tr>
<tr>
<td>Return on Capital (1971-1975)</td>
<td>6.2%</td>
<td>1.0%</td>
<td>-</td>
</tr>
</tbody>
</table>

substantially in the 13 years under the Auto Pact (Table III). The number of vehicles produced greatly exceeded the number of vehicles consumed by the Canadian market. This was not a surprising development: one of the efficient solutions encouraged by reducing the barriers to trade would have been the assembly in Canada of parts imported from the U.S. As the Canadian industry became more efficient as an assembly operation, the number of finished vehicles produced would have increased.

The true measure of output, however, was the Canadian value added to the expanding North American retail market. Canadian manufacturers had assured the Canadian Government that Canadian production would expand to fill a substantial part, their "fair share," of the expanding North American market. However, the figures (Table IV) indicated that, although Canadian value added to production was increasing, this increase was not keeping pace with the growth of Canada's share of the retail market. The value of Canadian production (A) was substantially lower than the Canadian share of the North American retail market (B) and that ratio of Canadian output to retail market share (A/B) was rapidly

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Table III. Canadian Motor Vehicle Sales and Production (Thousands) and Share of North American Market.\textsuperscript{32}

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Sales</th>
<th>Passenger Cars</th>
<th>Commercial Vehicles</th>
<th>Total Production</th>
<th>Passenger Cars</th>
<th>Commercial Vehicles</th>
<th>Total Production</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>592</td>
<td>503</td>
<td>99</td>
<td>754</td>
<td>639</td>
<td>115</td>
<td>754</td>
</tr>
<tr>
<td>1971</td>
<td>592</td>
<td>503</td>
<td>99</td>
<td>754</td>
<td>639</td>
<td>115</td>
<td>754</td>
</tr>
<tr>
<td>1973</td>
<td>592</td>
<td>503</td>
<td>99</td>
<td>754</td>
<td>639</td>
<td>115</td>
<td>754</td>
</tr>
<tr>
<td>1975</td>
<td>592</td>
<td>503</td>
<td>99</td>
<td>754</td>
<td>639</td>
<td>115</td>
<td>754</td>
</tr>
<tr>
<td>1976</td>
<td>592</td>
<td>503</td>
<td>99</td>
<td>754</td>
<td>639</td>
<td>115</td>
<td>754</td>
</tr>
<tr>
<td>1977</td>
<td>592</td>
<td>503</td>
<td>99</td>
<td>754</td>
<td>639</td>
<td>115</td>
<td>754</td>
</tr>
</tbody>
</table>

Table IV. Canadian Value Added (C$M) to the North American Automotive Retail Market.33

<table>
<thead>
<tr>
<th>Year</th>
<th>Value Added</th>
<th>Value Added (A)</th>
<th>Retail Market (B)</th>
<th>Difference Ratio (A/B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972</td>
<td>1773</td>
<td>6.5%</td>
<td>6.7%</td>
<td>0.97</td>
</tr>
<tr>
<td>1973</td>
<td>2066</td>
<td>6.5%</td>
<td>7.5%</td>
<td>0.87</td>
</tr>
<tr>
<td>1975</td>
<td>2179</td>
<td>7.7%</td>
<td>11.0%</td>
<td>0.70</td>
</tr>
<tr>
<td>1976</td>
<td>2669</td>
<td>6.9%</td>
<td>8.9%</td>
<td>0.775</td>
</tr>
</tbody>
</table>

---

decreasing (from 0.97 in 1972 to 0.775 in 1976). It was this steady deterioration that was reflected in the steadily growing deficit position in automotive parts.  

The Reisman Report recommended that urgent corrective action be taken in the following areas:

1. Because the industry was undergoing rapid change over the short to medium term, better statistical data covering the industry was needed on a regular basis for a more comprehensive analysis of the developments in trade and production. The Commission recommended that an independent advisory body keep the Government abreast of industry developments.

2. The investment climate was perceived as risky because of fears that changes in commercial policy could disrupt sales in the U.S. market. The


Commission recommended a trade insurance program to indemnify investors affected by unexpected policy changes.

(3) The duty remission program negotiated with Volkswagen and used as a model for similar programs with other foreign manufacturers introduced the risk of attracting countervailing duty from the U.S. The Commission instead recommended duty free entry for designated vehicle importers who met specified value added targets: 60 to 75 percent of the cost of sales in Canada of the foreign producers' vehicles.

(4) The Commission also recommended that the Government prepare to assist automotive parts manufacturers seeking to restructure the industry. Recommendations ranged from loans and loan guarantees to new tariff provisions for duty free import of materials needed for parts production.

(5) Finally, the Commission recommended that technical and financial resources be made available for research and development efforts, particularly those undertaken by smaller Canadian owned firms.
From the Canadian perspective, one of the most serious defects of the Auto Pact was that it did not take into account technology in developing a viable industry nor the profound effects of technological change on future demand and production requirements. Within the first few years under the Auto Pact, all research, development, and engineering activity was being concentrated within the U.S. parent firms. Eventually, the Canadian automotive producers were incapable of any original product development and entirely dependent upon the U.S. firms for all technical and most procurement functions. Essentially, they were largely job shops and assembly subcontractors for the U.S. parents and, as such, very vulnerable to changing market demands or technology.\textsuperscript{36}

While the U.S. was the world leader in large scale production techniques, it was no longer the clear leader in vehicle design and performance technologies. Most of the significant innovations were coming from Europe or Japan, such as safety construction, front wheel drive, fuel injection, nonpolluting engines, and radial tires.\textsuperscript{37}


\textsuperscript{37}ibid., pages 13-14.
Unfortunately, the Auto Pact had locked the Canadian industry into U.S. technology by eliminating any independent technological capability in the Canadian subsidiaries. U.S. industry was spending an enormous amount of money on research and development (U.S.$2.1 billion in 1975) but most of this was directed toward meeting safety and environmental standards. Meanwhile, the Canadian subsidiaries were contributing approximately C$230 million per year to these U.S. programs.\textsuperscript{38}

At the time of the 1978 evaluation of the Auto Pact's impact on the Canadian automotive industry, technological changes were beginning to have a profound effect on the production techniques, material inputs, and labor skills employed. These advances led to new requirements for safety, durability, environmental pollution control, and fuel economy, making new design concepts and power plant development necessary and expanding the use of lighter weight and corrosion resistant materials.\textsuperscript{39}

\textsuperscript{38}ibid., page 14.

\textsuperscript{39}ibid., pages 14-15.
To respond to these technological changes, the existing production plants, although for the most part already modern and well equipped, had to be restructured. Parts and accessories had to be redesigned and workers retrained. The Canadian plants had to make rapid and effective adjustments to avoid losing the race to more progressive producers in the U.S., Europe, and Japan.

Revolutionary changes in the industry and the uncertainties of the future introduced other elements of concern. The sudden and dramatic consumer shift to smaller, more fuel efficient vehicles resulted in a major increase of vehicle imports into North America. These developments, combined with the impact of an economic recession, had serious effects on employment and production in the Canadian automotive industry.

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Converting existing model lines to produce the new generation of vehicles required unprecedented capital expenditures just as manufacturers were facing severe cash flow problems resulting from sharply decreasing consumer demand. Product obsolescence took a particularly heavy toll on Canadian parts producers, resulting in facility closings. The manufacturers began restructuring, production shifts, and the introduction of new technologies required to adjust to the new environment.43

As a leading automotive manufacturer remembered this period:44

"Competition, currency imbalances, costs, and our own complacency had combined to hit us very hard indeed, and there were those who thought we were down for the count. The Seventies had been a tough decade. We'd struggled through two oil shocks, endured two recessions, and nearly drowned in a sea of federal regulations, ...only to surface and find ourselves in the most brutally

43ibid.

competitive market in the industry's history. It's like jumping from a burning ship, only to find yourself surrounded by sharks -- hungry sharks. Believe me, it was a grim management group that met to contemplate the company's future -- or lack thereof -- as we entered the Eighties. But what a difference a decade makes."

In the decade between 1978 and 1988, Canadian vehicle and parts manufacturers invested more than C$12 billion in plant and equipment and new production processes (Table V). Approximately C$2.5 billion was invested in 1988 alone. Total capital spending by Canadian automotive parts producers during this period was more than C$4.5 billion. Canada ultimately entered the upper ranks of the world's automotive industry and became the seventh largest producer of motor vehicles (Table VI). Canadian consumers benefitted through greater product choice and availability and better prices than before.46


46 Remarks by George A. Peapples, President and General Manager, General Motors of Canada, Limited, at the University of Massachusetts at Amherst, November 7, 1989, tenth viewslide.
Table V. New Capital Expenditures in Canadian Automotive Industries, 1977-1988 (C$M).\textsuperscript{47}

<table>
<thead>
<tr>
<th>Year</th>
<th>Motor Vehicle Manufacturers</th>
<th>Truck Body Manufacturers</th>
<th>Parts &amp; Accessories</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>153</td>
<td>24</td>
<td>110</td>
<td>287</td>
</tr>
<tr>
<td>1978</td>
<td>84</td>
<td>15</td>
<td>204</td>
<td>303</td>
</tr>
<tr>
<td>1979</td>
<td>111</td>
<td>42</td>
<td>331</td>
<td>484</td>
</tr>
<tr>
<td>1980</td>
<td>136</td>
<td>47</td>
<td>781</td>
<td>964</td>
</tr>
<tr>
<td>1981</td>
<td>273</td>
<td>32</td>
<td>667</td>
<td>972</td>
</tr>
<tr>
<td>1982</td>
<td>203</td>
<td>34</td>
<td>189</td>
<td>426</td>
</tr>
<tr>
<td>1983</td>
<td>463</td>
<td>13</td>
<td>141</td>
<td>617</td>
</tr>
<tr>
<td>1984</td>
<td>256</td>
<td>13</td>
<td>171</td>
<td>440</td>
</tr>
<tr>
<td>1985</td>
<td>714</td>
<td>9</td>
<td>332</td>
<td>1055</td>
</tr>
<tr>
<td>1986</td>
<td>1897</td>
<td>19</td>
<td>403</td>
<td>2319</td>
</tr>
<tr>
<td>1987</td>
<td>1584</td>
<td>27</td>
<td>755</td>
<td>2366</td>
</tr>
<tr>
<td>1988</td>
<td>1917</td>
<td>20</td>
<td>624</td>
<td>2561</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Japan</th>
<th>USA</th>
<th>W. Ger.</th>
<th>France</th>
<th>U.S.S.R.</th>
<th>Italy</th>
<th>Canada</th>
<th>Spain</th>
<th>U.K.</th>
<th>S. Kore.</th>
<th>Brazil</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965</td>
<td>1,176</td>
<td>634</td>
<td>1,157</td>
<td>852</td>
<td>229</td>
<td>1,157</td>
<td>1,157</td>
<td>229</td>
<td>1,177</td>
<td>185</td>
<td>0</td>
</tr>
<tr>
<td>1970</td>
<td>2,976</td>
<td>8,991</td>
<td>3,186</td>
<td>3,842</td>
<td>1,642</td>
<td>1,642</td>
<td>1,642</td>
<td>814</td>
<td>536</td>
<td>2,177</td>
<td>2,098</td>
</tr>
<tr>
<td>1975</td>
<td>6,941</td>
<td>8,991</td>
<td>3,186</td>
<td>3,842</td>
<td>1,642</td>
<td>1,642</td>
<td>1,642</td>
<td>814</td>
<td>536</td>
<td>2,177</td>
<td>2,098</td>
</tr>
</tbody>
</table>

Table VI. World Automotive Production (Thousands) by Nation.48

CHAPTER SIX

AUTOMOTIVE PROVISIONS OF THE FREE TRADE AGREEMENT

During the 1970s, changes in the world environment and the responses of the Canadian and U.S. automotive industries were raising new questions about the stability of the Auto Pact:49

(1) Japanese automotive firms began production in the U.S. and announced projects in Canada that would affect automotive investment and employment.

(2) The North American vehicle market continued at high levels but was not expanding.

(3) Changes in the U.S.-Japan currency exchange relationships shifted Japanese priorities from production at home for export to investment and production abroad.

(4) The Canadian initiative to negotiate bilateral, comprehensive free trade with the U.S. focused

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attention, much of it negative, on the Auto Pact, 
the Canadian trade surplus with the U.S., duty 
remission schemes, and Canada as a conduit for 
Asian vehicle producers into the U.S. market.

(5) Tariff reductions negotiated under the Tokyo Round 
of the GATT multinational trade negotiations were 
completed and arrangements for a new GATT round of 
multinational trade negotiations were begun.

(6) Japan allocated the production of more vehicles to 
Canadian Auto Pact subsidiaries, causing the U.S. 
to question the multilateral aspect of the Canadian 
version of the Auto Pact.

The major assumption behind the Auto Pact had been that 
the U.S. automotive industry would continue its world 
predominance. This was clearly no longer the case but the 
stability and accessibility of the U.S. market was critically 
important to Canadian efforts to specialize in large scale 
production aimed at capturing segments of the North American 
market. The rise of overseas challengers and the Canadian
and U.S. responses were additions to existing strains on the relationship.\textsuperscript{50}

Specifically, the sources of strain had been a long lasting disagreement over the Canadian safeguards, which the U.S. had assumed to be only transitional in nature, and competition for overseas plants. This included incentives provided in both nations aimed at attracting new plants and a Canadian duty remission program based on export performance. Furthermore, the Canadian automotive industry was insisting that the safeguards be extended to overseas competitors such that foreign firms would be required to meet Canadian production targets if they were to sell in Canada.\textsuperscript{51}

Although the Auto Pact generally had contributed to bilateral trade and efficiency, there were dangers of a U.S. reaction to recent Canadian policies. Particularly, the Canadian Government feared U.S. countervailing duty actions


\textsuperscript{51}ibid., pages 73-74.
in response to the duty remission programs based on export performance.

Under the duty remission program, Japanese and other overseas producers operating in Canada had an incentive to export from Canada because they would be rewarded in the form of a rebate of duties on imports. For example, a Japanese firm could get back the duty paid on imports of cars from Japan by exporting automotive parts to the U.S. or elsewhere. This program raised three problems:

1. The program represented a rather clear subsidy to exports, just as the pre-Auto Pact programs had done with bilateral trade between Canada and the U.S.

2. The program was even more objectionable to the U.S. than the pre-Auto Pact programs had been because, under the new program, Japanese firms operating in Canada were using exports to the U.S. as a way of earning remission of duties on imports from Japan. This tended to attract more imports from Japan and

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push subsidized exports to the U.S. This became even more important as Canadian production by Japanese owned firms increased.

3. The history of the issue raised the question whether Canada was acting in good faith towards the U.S. When the two nations signed the Auto Pact in 1965, the U.S. obtained an end to the troublesome Canadian duty remission programs of 1962-63. Now the issue was reopened in a much more objectionable form.

It is important to note that the automotive provisions of the FTA grew out of the same dynamic process as the Auto Pact itself: unilateral Canadian action to deal with an unsatisfactory situation and the threat of a U.S. countervailing duty. The automotive provisions of the FTA leaves most of the Auto Pact provisions undisturbed, with three notable exceptions:

53ibid., page 11.

54ibid., page 9.
(1) There is a phased elimination of remaining duties on Canadian-U.S. automotive trade, including tires and replacement parts.

(2) After the 1989 model year, the Auto Pact was closed to new members. No new firms are able to qualify for duty free imports into Canada from third nations. A firm remaining outside the Auto Pact is treated as a nonautomotive company. It pays duties on materials and components imported into Canada from third nations and exports products duty free to the U.S. if they meet the 50 percent North American content rule. Similarly, the firm is entitled to import parts duty free from the U.S. if they have 50 percent North American content.

(3) The basis for calculating 50 percent North American content was redefined, resulting in an effective increase.

The first change meant that after 1998, U.S. firms operating in Canada would no longer have to pay duties on imports from the U.S. However, they still face duties on their imports from a third nation. On the Canadian side, an important aspect of multilateralism remains: current Auto
Pact firms that meet the safeguards were still able to import duty free from any nation.\textsuperscript{55}

The second change represented a significant departure from equal multilateral access to the Canadian market since present members were predominantly U.S. and those to be excluded were predominantly foreign. However, there seemed to be no need for Canada to obtain a GATT waiver. Under GATT Article 24, preferences are permitted in the case of a free trade agreement covering substantially all products and the FTA met this criterion.\textsuperscript{56}

Clearly, both nations had chosen to integrate the North American automotive industry further rather than deal with the new world market independently, trying to outbid each other for production, investment, and employment. Ten years into the FTA, all trade in automobiles, trucks, buses, and automotive parts will be duty free. This applies both to the traditional North American companies operating under the Auto Pact and to the newly established automotive companies with

\textsuperscript{55}ibid.

\textsuperscript{56}ibid.
plants in either nation, provided that they meet the 50 percent North American content rule.\textsuperscript{57}

The following are the specific automotive provisions of the FTA:\textsuperscript{58}

(1) Tariffs
   Motor vehicle manufacturers participating in the Auto Pact continue to trade freely under the FTA. Duties on vehicles produced by foreign companies which are not members of the Auto Pact are to be phased out over a 10 year period. Additionally, Auto Pact companies have the option of continuing to operate under the provision of the Auto Pact or under the FTA. Companies choosing to operate under the FTA are freed from the performance requirements imposed by Canada under the Auto Pact.

(2) Duty Remission Programs
   Canadian duty remission program, both export and import based for foreign vehicle manufacturers,

\textsuperscript{57}Motor Vehicle Manufacturers Association of the United States' Senate Staff Briefing on the U.S.–Canada Free Trade Agreement, 17 February 1988, page 3.

\textsuperscript{58}\textit{ibid.}, pages 3–5.
were terminated immediately or will be phased out over 10 years. When the Legal Counsel of the U.S. Trade Representative's Office issued an opinion that the export based duty remission programs were a violation of the GATT subsidies code and therefore contrary to the articles of agreement each nation committed to in Auto Pact, the Canadian Government argued that the U.S. misunderstood the program and insisted that it was similar to a U.S. program that gives preferential tariff rates to products assembled in a third nation from U.S. parts. The FTA reaches a compromise in which a majority of these remission orders given to third nation automotive manufacturers operating in Canada were terminated immediately. The remaining few to which the Canadian Government had committed in exchange for the companies' establishment of plants in Canada will expire at the end of their contract, no later than 1996.

(3) Duty Drawback/U.S. Foreign Trade Zones

Drawback and Foreign Trade Zone benefits were eliminated for products traded between the two nations. Those that incorporate North American components into their products no longer receive
duty drawback for tariffs paid on these components and those that use Foreign Trade Zones no longer obtain the tariff benefit on imported components that are incorporated into products exported to Canada. However, the costs to companies from these changes are more than offset by the benefits derived from the elimination of duties and U.S. customs fees under the FTA.

(4) U.S. Customs User Fee
The U.S. Customs user fee imposed on imports will be ended by 1 January 1994. This will eliminate additional costs for manufacturers, especially those which ship components back and forth between the two nation in their manufacturing operations.

(5) Rule of Origin
For automotive companies which are not covered by the Auto Pact, the FTA contains a rule of origin establishing the criteria for their products to qualify under the FTA. A 50 percent North American "direct cost of manufacturing" rule for automotive products was a compromise among the differing content levels suggested. This rule is stronger than the U.S. content requirements in effect under
the Auto Pact and provided an increased incentive for North American manufacturing. It also guarantees that simple assembly or kit production of vehicles will not be enough to qualify for duty free status as an American or Canadian product.

(6) Used Vehicles
The Canadian embargo on the importation of used vehicles will be phased out. This will give manufacturers more flexibility to respond to shifts in supply and demand in both nations for used vehicles, which affect the supply and demand for new vehicles.

(7) Automotive Panel
The FTA established a select panel on automotive trade and production in Canada and the U.S. The stated purpose of the panel is "to assess the state of the North American industry and to propose public policy measures and private initiatives to improve the competitiveness in domestic and foreign markets."
CHAPTER SEVEN
ANALYSIS

The economist is faced with two questions:

(1) Was the original objective an economically efficient outcome?

(2) Was the process of attaining the goal efficient?

The original objective was to modernize and increase the efficiency of the Canadian automotive industry so that it could hold its "fair share" of the expanding North American market. It is difficult to judge whether this was a worthy goal: the idea of opening the economy to freer trade with the U.S. became an important part of the political agenda, particularly in the elections of the late 1980s, and the concept of Canada's "fair share" was never adequately defined. Basically, an improved automotive industry was expected to become the centerpiece of Canadian commercial policy; contribute to expanding social programs; and secure Canada's position as a developed, modern, industrial nation. Opening and improving the economy, therefore, was never strictly a question of economics but also of politics and a unique social agenda. Whether or not another large
automotive producer in the world market was economically efficient from the collective international perspective, it has been an important Canadian policy objective for more than 30 years.

The central question, then, is whether beginning to remove barriers to trade was the most efficient vehicle for attaining the original objective. This may be analyzed by comparing the advantages of free trade with the alternatives of barriers to trade.\(^{59}\)

Tariffs are the traditional, and most obvious, barriers to trade. For the limited Canadian market, the Canadian producers were driven to produce a wide variety of products, each in small numbers, to meet consumer demand for choice and style. Specialization and economies of scale could not be achieved in this environment. Without the tariffs, Canadian manufacturers could have concentrated on producing some products efficiently for both the domestic and export markets and left the others to be imported.

\(^{59}\)Much of the theory of this chapter was derived from Paul J. Wonnacott's book, The United States and Canada: The Quest for Free Trade - An Examination of Selected Issues, Policy Analyses in International Economics Series, Number 16 (Washington: Institute for International Economics, 1987).
As tariffs are gradually lowered, other barriers to trade gain in relative importance. These include quotas; voluntary export restraints; and, occasionally, prohibitions on imports. These barriers can be numerous and others may occasionally be very subtle. An obvious example would be the Canadian ban on importing used cars. A more subtle barrier would be Government procurement policies where national or local suppliers are given preference over others.

As tariffs are negotiated downward, nations become increasingly concerned that their domestic industries may become subject to excessive or unfair foreign competition. In response, they may extend or tighten trade remedy laws. In the U.S., these laws take four major forms:

(1) Escape clause actions are used where imports cause or threaten serious injury to a domestic industry

(2) Antidumping duties prevent foreign suppliers from overloading the market with cheaper goods.

(3) Countervailing duties compensate for foreign export subsidies.
(4) Restrictions on imports are used where foreign nations are engaging in unfair practices, such as patent infringements.

All four forms are generally grouped together but there is a fundamental difference between the first one and the last three. Escape clause actions provide temporary protection against severe foreign competition and the domestic industry does not need to prove any misbehavior on the part of the foreign suppliers. The last three, in contrast, provide relief from foreign practices that are considered to be unfair, such as dumping or subsidies. The first is temporary in nature and provides a cushion in the process of adjusting to a changing international pattern of comparative advantage. The last three compensate for foreign subsidies and other distortions, allowing trade patterns to correspond more closely to underlying forces of comparative advantage.

These considerations are important here because Canada believed that the U.S. was using trade remedy laws as a backdoor form of protection. This was especially true in the case of the countervailing duty law, which Canadians saw as a tendency on the part of the U.S. to define subsidies more and more broadly as an excuse for imposing protective tariffs.
Canadians believed that the application of countervailing duties interfered with efficient international specialization.

U.S. trade remedy laws were further perceived by Canada as making access to the U.S. market less predictable and secure. Predictable and assured access to the U.S. market was necessary if Canadian industry was to specialize in large scale production aimed at capturing segments of the North American market.

So where there were policy alternatives for promoting the improved efficiency of the Canadian automotive industry, none was as attractive as that of beginning to eliminate the barriers to trade. The question now becomes, what is to be gained by doing so?

Reducing the barriers to bilateral free trade was generally expected to result in higher real incomes in the two nations, particularly in Canada. However, the estimates of the size and distribution of the gain differed widely among the empirical studies because they were based on different assumptions and used different methodologies. Traditionally, the gain from reducing trade barriers have been estimated within the relatively simple framework of
perfectly competitive markets and constant returns to scale. The problems of using this model for the present analysis is obvious: the Canadian manufacturers were seeking economies of scale in a protected market. However, this simple model remains useful because the standard tools of supply and demand may be used to illustrate the effects of changes in tariff rates.

The first consideration is a unilateral reduction in tariff rates within the Canadian economy: producers who compete with imported U.S. goods are worse off as the tariffs are cut and the prices of the imported products fall. It is harder for them to remain competitive. Canadian consumers, however, are better off because they can purchase the good at a lower price. The Canadian Government also is worse off because of the reduction in tariff revenue.

The overall effects of a tariff on efficiency may be illustrated by the following demonstration of the various gains and losses (Figure I). In a simple case where Canada faced a fixed world price of $60, a tariff of $10 may be imposed and the price to Canadian consumers rises from $60 to $70. Canadian manufacturers respond by increasing their output from 800 to 1000 units and gain from the $10 windfall on each of the 800 units they would have produced anyway, for
Figure I. Triangular Efficiency Effects of a Tariff. 60

the total of $8000 shown by area 1. There is an additional gain on the 200 units that would not otherwise have been produced. The marginal cost of production of unit 900 is $65 but it is sold for $70 and a windfall profit of $5. The total of such gains on units 800 through 1000 is shown as area 2. The total benefit of the tariff to the producers is the total of areas 1 and 2.

Canadian consumers are made worse off by the tariff. They respond to the higher price by reducing their consumption from 2300 units to 2000. On the 2000 units that they still consume, the burden imposed by the tariff is $20,000 ($10 more on each of the 2000 units), represented by the total of areas 1, 2, 3, and 4. Consumers also lose on the units from 2000 to 2300 that they no longer purchase. If a consumer would have purchased unit 2200 at $63, where the world price in the free trade case would have been $60, the consumer loses $3. The loss to consumers of the 300 units not purchased because of the tariff is shown as area 5. The total loss to Canadian consumers from the tariff is the sum of areas 1 through 5.

The Canadian Government collects the tariff equal to area 4 ($10 collected on each of the 1000 imported units).
The net result of the tariff is determined as follows: producers gain areas 1 and 2, the Government gains area 4, and consumers lose areas 1 through 5. The net cost of the tariff is represented by triangles 3 and 5.

The tariff may also have an adverse effect on the U.S. producer. In the earlier example, it was assumed that the tariff causes no change in the world price, that it remains stable at $60 and the Canadian consumer bears the full burden of the $10 tariff when the domestic price rises to $70. But, since Canada is now purchasing less on the world market, the international price may fall. For example, the tariff may have been $15, represented as the dashed line at K. The $15 tariff (KC) results in a $5 fall in the world price (KB) and a $10 rise in the domestic price (BC). In this case, the Government's tariff falls not only on the domestic consumer (area 4) but also on the U.S. producer receiving $5 less on each of 1000 units (area 6). As a result, Canada may be made better off if the amount extracted from the U.S. producers (area 6) exceeds the triangular efficiency losses (areas 3 and 5). The U.S. producers are made worse off (Figure II) because, as the world price of their exports decreases by $5,
Figure II. Cost of the Tariff to the Exporting Nation.\textsuperscript{61}

they lose areas 7 and 8 for the same reasons that Canadian producers gained areas 1 and 2. This loss exceeds the gain to U.S. consumers (area 7) enjoying the lower price. The net cost to the U.S. producers (area 8) imposed by the Canadian tariff explains in part the mutual benefit to the two nations of negotiating a reduction or elimination in tariffs.

Introducing economies of scale complicates the model as the amounts at stake from changes in commercial policy become much larger. Also, it belies the neat theoretical case of free trade in a world of constant returns to scale and perfect competition. In this world, prices equal marginal costs and the free market process leads to efficient solutions. Once economies of scale and imperfect markets are introduced, however, marginal cost is generally less than price and the free market solution is no longer optimal. For these reasons, nations with less developed industries have an incentive to adopt protectionist policies but, paradoxically, they have more to gain from an agreement to reduce trade barriers.

Economies of scale may be illustrated (Figure III) as average cost falls over an extended range. In a large
Figure III. Costs and Market Size.62

domestic economy, there generally are strong pressures to expand quickly to point A, where per unit cost is at or near the minimum. Failure to do so is to remain the high cost producer and lose market share to large, low cost competitors. Some markets too small to support production at point A may perform very well at point B, where per unit costs are still falling significantly and the producer is not at risk of being eliminated by a competitor capable of producing at point A. Where the domestic market is too small to support efficient scale producers, as was the case of the Canadian automotive sector, very large gains may come from international trade. For example, the Canadian manufacturer at point C may be making three different products at small scale for the domestic market, protected from import competition by a tariff wall. When these barriers to trade are eliminated, the producer is faced with a major danger but also a major opportunity. The danger is from the competition of high volume U.S. producers who have the advantage of scale economies and can undercut the Canadian producer at point C. The Canadian producer, however, may turn this into a major opportunity by cutting back on his product line and concentrating on a single item. He can now move down along the cost function toward point A, exporting his surplus production to the U.S. The Canadian manufacturer enjoys
economies of scale production of his single item and lower costs of importing the other two items he had manufactured previously.

Under the Auto Pact, the Canadian automotive manufacturers expected to enjoy the full benefits of specialization and economies of scale. The safeguards, however, prevented the Auto Pact from being a true free trade agreement and placed limits on such efficiencies. By requiring the use of a certain percentage of Canadian parts, even if less efficiently produced than those imported from the U.S., the safeguards prevented the manufacturers from enjoying the full benefits of a truly free trading arrangement.

The gains from free trade can be very large but without detailed information on market conditions and the broader economic adjustments occurring at the same time, it is not possible to determine how this gain will be divided among the producers or the consumers of the two nations. However, the magnitude of the gains may be illustrated in the simple case where producers price at their average cost. Canadian consumers can now purchase the good at $P_A$ instead of at $P_C$, resulting in a gain of area 1. Canadian consumers also enjoy large gains on the other two products formerly produced
domestically but now imported at low prices from the U.S. Unlike the tariff situation, though, this gain to the Canadian consumer does not come at the expense of the producer. The producer can afford to sell at the lower price because economies of scale are lowering per unit costs.

As demonstrated, reducing barriers to trade would result in greater efficiency of production through economies of scale. Producers and consumers of both Canada and the U.S. would enjoy lower prices and greater variety. Most importantly, both economies would enjoy the benefits of increased trade instead of one nation being better off by making the other worse off. These were the results expected under the Auto Pact.

The case against Canadian export subsidies, which were in danger of attracting U.S. countervailing duties, should also be noted here. Export subsidies, like tariffs, distort market forces and lead to trading patterns that do not correspond to comparative advantage. Unlike tariffs, however, export subsidies do not necessarily harm other nations. The importing nation gains if there are no domestic producers of the imported good. There are no competitors to be harmed and consumers enjoy the lower price. Even if there are domestic competitors injured by subsidized imports, the
importing nation as a whole benefits (Figure IV). The foreign subsidization makes the price of the imported good fall from \( P_1 \) to \( P_2 \), inflicting a loss of area 1 on domestic producers. Domestic consumers, however, gain the total of areas 1 and 2.

Under these conditions, the U.S. should not have objected to Canadian subsidies, especially to long run, consistent subsidies to which adjustments may be made. Canadian manufacturers benefitted by selling its exports on world markets at higher prices than commanded in the domestic economy and then using the proceeds to buy imports at lower prices than available at home. The U.S. consumers enjoyed the same benefits from the lower price whether the good was available cheaply because Canadian producers have a comparative advantage or because the Canadian Government subsidized the exports. Where no harm was done, the U.S. had no reason to assess countervailing duties.

For these reasons, export subsidies may might have been considered an attractive alternative to tariffs. For Canada, however, it would not have been efficient to use public funds to subsidize an uneconomic industry. The subsidizing Government was helping not only Canadian producers but also
Figure IV. Effect of a Subsidy.63

U.S. consumers. Canadian consumers, by paying the taxes that funded the subsidies, were being made worse off.
CHAPTER EIGHT
CONCLUSIONS

The provisions of the Auto Pact were warmly welcomed by the automotive manufacturers of both nations since removing the barriers to trade was expected to result in an expanded, integrated North American market. The U.S. automotive industry was the recognized world leader and the Canadian manufacturers relied heavily upon imported U.S. automotive products. Canada viewed the Auto Pact as a means of modernizing and increasing the efficiency of its automotive industry while the safeguards protected it from being overwhelmed by its neighbor. The benefits of specialization and economies of scale were expected to result in lower costs and greater levels of production in Canada, lower prices for Canadian consumers, and a balance of trade between the two nations in the automotive sector. Canadian manufacturers assured the Government that increased production would fill a substantial part of the increasing demand and looked forward to maintaining their "fair share" of the expanding North American market.

Unfortunately, however, the Auto Pact did not include precise effectiveness measures or monitoring procedures. The rule of thumb was "one car produced in Canada for every car
consumed in Canada" and the logical criterion for determining progress under the Auto Pact seemed to be an increase in the number of finished vehicles. Under the Auto Pact, production costs were indeed declining as the tariffs were removed and the number of finished vehicles increased. Canada was finishing more vehicles than the Canadian consumers were demanding and exports to the U.S. were steadily increasing. For 13 years, the Auto Pact seemed to be contributing to the improvement of the Canadian automotive industry.

But the real issue was Canadian value added to the North American retail market. Canadian manufacturers expected that, in the new business environment under the Auto Pact, increased efficiency would lead to an increase in Canadian value added to an expanding market. The safeguards were intended to protect the industry while it improved in efficiency but actually limited the benefits of reducing the barriers to trade. If it was more efficient for Canadian manufacturers to assemble parts imported from the U.S. at lower cost, the value added requirements still limited them to using a certain percentage of less efficiently produced Canadian parts. By pursuing two courses at once, reducing the barriers to trade yet retaining some protective devices, the Canadian industry could not take fullest advantage of the efficiencies of a truly open trading arrangement.
The Canadian Government, seriously alarmed by the unprecedented global changes of the 1970s, commissioned a study of the state of the Canadian automotive industry. The Reisman Report concluded that Canadian value added as a share of the North American retail market was steadily decreasing. The rising number of finished vehicles for domestic consumption and export was obscuring the underlying dynamics of the new business environment and blurring the true meaning of the rising trade deficit in automotive parts.

The combination of reducing the barriers to trade while simultaneously retaining certain protective measures had created an environment in which the efficient outcome was not that originally sought by the Canadian negotiators. Essentially, in the first 13 years under the Auto Pact, the Canadian manufacturers came to act as assembly shops for imported U.S. parts. As the number of finished vehicles for domestic consumption and exports increased, so too did the Canadian trade deficit in automotive parts. The original objective, therefore, to increase the efficiency of the industry so that it would contribute an increasing level of Canadian value added to the North American retail market was really split by the design of the Auto Pact and the wording
of the safeguards into two different objectives. The first was being satisfied at the expense of the second.

The conclusions of the Reisman Commission led to a restructuring of the Canadian automotive industry in an effort to become less dependent on the declining U.S. industry and more competitive in its own right. Canada did not wish to abolish the Auto Pact but to achieve the original goal: to increase its contribution to the expanding North American, now global, market.

In the following 10 years, the Canadian automotive industry was completely realigned within Auto Pact principles. Enormous amounts of capital were invested in new technologies, processes, plants, and equipment at a time when decreased demand was causing severe cash flow problems. The industry was completely turned around and, as a result, Canada entered the upper ranks of the world's automotive industry and became the seventh largest producer of automotive products. The Canadian consumer benefitted from greater choice and availability and lower prices than before.

Other benefits from the improvements under the Auto Pact included increased export levels for all categories of
automotive products (Table VII) and greater Canadian value added in production (Table VIII).

In light of the original expectations of the Auto Pact, increasing its share of the expanding North American retail market (Table IX) and improving the Canadian deficit position with the U.S. in automotive products (Table X), the Canadian automotive industry has performed very well.

Whether or not achieving the original objective was efficient from the collective international perspective or even the national perspective, the expansion and improvement of the Canadian automotive industry produced several benefits. Greater efficiency of production through economies of scale and longer production runs have resulted in increased output (both in terms of finished goods and Canadian value added) and exports, resulting in a better balance of trade with the U.S. in automotive products. A greater variety of automotive goods is available to the Canadian consumer at lower prices than before. Canadian consumers were pleased enough with the overall gains that the ratification of the FTA became a central issue in the political elections of the 1980s.
Table VII. Value of Canadian Automotive Exports (C$M).  

<table>
<thead>
<tr>
<th>Year</th>
<th>Motor Vehicle Manufacturers</th>
<th>Truck Body &amp; Trailer Manufacturers</th>
<th>Parts &amp; Accessories Manufacturers</th>
<th>Total</th>
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<tbody>
<tr>
<td>1976</td>
<td>7,276</td>
<td>749</td>
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<tr>
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<td>8,610</td>
<td>713</td>
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<td>1979</td>
<td>10,724</td>
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</tr>
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<td>4,879</td>
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<td>743</td>
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<td>1983</td>
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<td>1,302</td>
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<tr>
<td>1987</td>
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<td>1988</td>
<td>26,795</td>
<td>1,433</td>
<td>13,684</td>
<td>41,912</td>
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</table>

64 Department of Industry, Science and Technology Canada, Statistical Review of the Canadian Automotive Industry: 1988, Table 2.1, page 18.
Table VIII. Total Canadian Value Added by Category of Production (CSM).  

<table>
<thead>
<tr>
<th>Year</th>
<th>Non-Rents CVA in Vehicle Production</th>
<th>Parts CVA in Original Equipment Production</th>
<th>CVA in Original Equipment Production</th>
<th>Total CVA Production</th>
<th>Parts CVA of Total CVA Production as Percent of Total CVA Production</th>
</tr>
</thead>
<tbody>
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<td></td>
<td>A</td>
<td>B</td>
<td>C</td>
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<td></td>
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<tr>
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<td>380</td>
<td>576</td>
<td>100</td>
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<td>483</td>
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<td>651</td>
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<td>1,087</td>
<td>1,755</td>
<td>4,164</td>
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<td>5,124</td>
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<td>2,877</td>
<td>5,044</td>
<td>11,035</td>
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Table IX. North American Production of Automotive Vehicles (Thousands). 66

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<tr>
<th>Year</th>
<th>Canada Volume</th>
<th>Canada Percent</th>
<th>U.S. Volume</th>
<th>U.S. Percent</th>
<th>North America Total Volume</th>
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<td>1965</td>
<td>846</td>
<td>7.1</td>
<td>11,114</td>
<td>92.9</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Cars</td>
<td>74</td>
<td>1,538</td>
<td>2,858</td>
<td>4,452</td>
<td>13,085</td>
<td>15,277</td>
<td>16,428</td>
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<td>68</td>
<td>231</td>
<td>598</td>
<td>592</td>
<td>675</td>
<td>661</td>
<td>520</td>
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<tr>
<td><strong>Total</strong></td>
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<td>5,903</td>
<td>10,306</td>
<td>29,850</td>
<td>33,803</td>
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<td><strong>Canadian Imports from U.S.</strong></td>
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<td>146</td>
<td>345</td>
<td>264</td>
<td>227</td>
<td>310</td>
<td>351</td>
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<tr>
<td><strong>Total</strong></td>
<td>961</td>
<td>3,065</td>
<td>7,724</td>
<td>12,351</td>
<td>23,915</td>
<td>28,838</td>
<td>29,314</td>
<td>28,680</td>
<td>27,380</td>
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<td>Cars</td>
<td>(20)</td>
<td>879</td>
<td>675</td>
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<td>6,711</td>
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<td>(10)</td>
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<td>3,841</td>
<td>3,852</td>
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<td>Parts</td>
<td>(646)</td>
<td>(980)</td>
<td>(2,380)</td>
<td>(4,195)</td>
<td>(5,159)</td>
<td>(5,926)</td>
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<td>(4,818)</td>
<td>(3,596)</td>
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<td>Tires &amp; Tubes</td>
<td>(6)</td>
<td>(9)</td>
<td>(106)</td>
<td>85</td>
<td>253</td>
<td>328</td>
<td>448</td>
<td>351</td>
<td>169</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>(711)</td>
<td>204</td>
<td>(1,821)</td>
<td>(2,045)</td>
<td>5,935</td>
<td>4,965</td>
<td>5,170</td>
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It has been demonstrated that the alternative forms of protecting an industry, such as tariffs and subsidies, would not have been efficient to achieve the objective as was reducing the barriers to trade. The Auto Pact was an important step in opening the economy to freer bilateral trade in automotive products. The Canadian industry had risked not being able to compete in the expanding North American market and, in the restructuring that followed the release of the Reisman Report, took an even greater risk in investing unprecedented levels of capital in industry restructuring just at a time when decreasing demand was causing severe cash flow problems.

From the research and the analysis, it is concluded that the Canadian automotive industry has achieved the original goals of the Auto Pact and that the mechanism selected, that of reducing the barriers to trade, was the most efficient way of doing this. By eliminating the remaining barriers to bilateral automotive trade, the FTA is expected to expand upon the gains of the interim period of performance and restructuring under the Auto Pact and result in an expanded, fully integrated North American industry.
APPENDIX A

CANADA-UNITED STATES AUTOMOTIVE AGREEMENT

(AUTO PACT)

Agreement signed at Johnson City, Texas, January 16, 1965;
Entered into force provisionally January 16, 1965, and
definitively September 16, 1966.

With exchange of notes


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AGREEMENT CONCERNING AUTOMOTIVE PRODUCTS BETWEEN

THE GOVERNMENT OF THE UNITED STATES OF AMERICA

AND THE GOVERNMENT OF CANADA

The Government of the United States of America and the
Government of Canada,

Determined to strengthen the economic relations between
their two countries;

Recognizing that this can best be achieved through the
stimulation of economic growth and through the expansion of
markets available to producers in both countries within the
framework of the established policy of both countries of
promoting multilateral trade;

Recognizing that an expansion of trade can best be
achieved through the reduction or elimination of tariff and
all other barriers to trade operating to impede or distort
the full and efficient development of each country's trade
and industrial potential;

Recognizing the important place that the automotive
industry occupies in the industrial economy of the two
countries and the interests of industry, labor and consumers
in sustaining high levels of efficient production and
continued growth in the automotive industry;

Agree as follows:

ARTICLE I

The Governments of the United States and Canada,
pursuant to the above principles, shall seek the early
achievement of the following objectives:

(a) The creation of a broader market for
automotive products within which the full benefits of
specialization and large-scale production can be
achieved;

(b) The liberalization of United States and
Canadian automotive trade in respect of tariff barriers
and other factors tending to impede it, with a view to
enabling the industries of both countries to
participate on a fair and equitable basis in the
expanding total market of the two countries;
(c) The development of conditions in which market forces may operate effectively to attain the most economic pattern of investment, production and trade.

It shall be the policy of each Government to avoid actions which would frustrate the achievement of these objectives.

ARTICLE II

(a) The Government of Canada, no later than the entry into force of the legislation contemplated in paragraph (b) of this Article, shall accord duty-free treatment to imports of the products of the United States described in Annex A.

(b) The Government of the United States, during the session of the United States Congress commencing on January 4, 1965, shall seek enactment of legislation authorizing duty-free treatment of imports of the products of Canada described in Annex B. [79 Stat. 1016.] In seeking such legislation, the Government of the United States shall also seek authority permitting the implementation of such duty-free treatment retroactively to the earliest date administratively possible [Jan. 18, 1965. See U.S. Proclamation No. 3743, Sept. 8, 1966; 31 Fed. Reg. 12003.] following the date upon which the Government of Canada has accorded duty-free treatment. Promptly after the entry into
force of such legislation, the Government of the United States shall accord duty-free treatment to the products of Canada described in Annex B.

ARTICLE III

The commitments made by the two Government in this Agreement shall not preclude action by either Government consistent with its obligations under Part II of the General Agreement on Tariffs and Trade. [TIAS 1700; 61 Stat. (pt. 5) A18–A65.]

ARTICLE IV

(a) At any time, at the request of either Government, the two Governments shall consult with respect to any matter relating to this Agreement.

(b) Without limiting the foregoing, the two Governments shall, at the request of either Government, consult with respect to any problems which may arise concerning automotive producers in the United States which do not at present have facilities in Canada for the manufacture of motor vehicles, and with respect to the implications for the operation of this Agreement of new automotive producers becoming established in Canada.

(c) No later than January 1, 1968, the two Governments shall jointly undertake a comprehensive review of the
progress made towards achieving the objectives set forth in Article I. During this review the Governments shall consider such further steps as may be necessary or desirable for the full achievement of these objectives.

ARTICLE V

Access to the United States and Canadian markets provided for under this Agreement may by agreement be accorded on similar terms to other countries.

ARTICLE VI

This Agreement shall enter into force provisionally on the date of signature and definitively on the date upon which notes are exchanged between the two Governments giving notice that appropriate action in their respective legislatures has been completed. [Definitively Sept. 16, 1966.]

ARTICLE VII

This Agreement shall be of unlimited duration. Each Government shall however have the right to terminate this Agreement twelve months from the date on which that Government gives written notice to the other Government of its intention to terminate the Agreement.
ANNEX A

1. (1) Automobiles, when imported by a manufacturer of automobiles.

(2) All parts, and accessories and parts thereof, except tires and tubes, when imported for use as original equipment in automobiles to be produced in Canada by a manufacturer of automobiles.

(3) Buses, when imported by a manufacturer of buses.

(4) All parts, and accessories and parts thereof, except tires and tubes, when imported for use as original equipment in buses to be produced in Canada by a manufacturer of buses.

(5) Specified commercial vehicles, when imported by a manufacturer of specified commercial vehicles.

(6) All parts, and accessories and parts thereof, except tires, tubes and any machines or other articles required under Canadian tariff item 438a to be valued separately under the tariff items regularly applicable thereto, when imported for use as original equipment in specified commercial vehicles to be produced in Canada by a manufacturer of specified commercial vehicles.

2. (1) "Automobile" means a four-wheeled passenger automobile having a seating capacity for not more than ten persons;
(2) "Base year" means the period of twelve months commencing on the 1st day of August, 1963 and ending on the 31st day of July, 1964;

(3) "Bus" means a passenger motor vehicle having a seating capacity for more than 10 persons, or a chassis therefor, but does not include any following vehicle or chassis therefor, namely an electric trackless trolley bus, amphibious vehicle, tracked or half-tracked vehicle or motor vehicle designed primarily for off-highway use;

(4) "Canadian value added" has the meaning assigned by regulations made under section 273 of the Canadian Customs Act;

(5) "Manufacturer" of vehicles of any following class, namely automobiles, buses or specified commercial vehicles, means, in relation to any importation of goods in respect of which the description is relevant, a manufacturer that

(i) produced vehicles of that class in Canada in each of the four consecutive three months' periods in the base year, and

(ii) produced vehicles of that class in Canada in the period of twelve months ending on the 31st day of July in which the importation is made,
(A) the ratio of the net sales value of which to the net sales value of all vehicles of that class sold for consumption in Canada by the manufacturer in that period is equal to or higher than the ratio of the net sales value of all vehicles of that class produced in Canada by the manufacturer in the base year to the net sales value of all vehicles of that class sold for consumption in Canada by the manufacturer in the base year, and is not in any case lower than seventy-five to one hundred; and

(B) the Canadian value added of which is equal to or greater than the Canadian value added of all vehicles of that class produced in Canada by the manufacturer in the base year;

(6) "Net sales value" has the meaning assigned by regulations made under section 273 of the Canadian Customs Act; and

(7) "Specified commercial vehicle" means a motor truck, motor truck chassis, ambulance or chassis therefor, or hearse or chassis therefor, but does not include:
(a) any following vehicle or a chassis designed primarily therefor, namely a bus, electric trackless trolley bus, amphibious vehicle, tracked or half-tracked vehicle, golf or invalid cart, straddle carrier, motor vehicle designed primarily for off-highway use, or motor vehicle specially constructed and equipped to perform special services or functions, such as, but not limited to, a fire engine, mobile crane, wrecker, concrete mixer or mobile clinic; or

(b) any machine or other article required under Canadian tariff item 438a to be valued separately under the tariff item regularly applicable thereto.

3. The Government of Canada may designate a manufacturer not falling within the categories set out above as being entitled to the benefit of duty-free treatment in respect of the goods described in the Annex.

ANNEX B

(1) Motor vehicles for the transport of persons or articles as provided for in items 692.05 and 692.10 of the Tariff Schedules of the United States and chassis therefor, but not including electric trolley buses, three-wheeled
vehicles, or trailers accompanying truck tractors, or chassis therefor.

(2) Fabricated components, not including trailers, tires, or tubes for tires, for use as original equipment in the manufacture of motor vehicles of the kinds described in paragraph (1) above.

(3) Articles of the kinds described in paragraphs (1) and (2) above include such articles whether finished or unfinished but do not include any article produced with the use of materials imported into Canada which are products of any foreign country (except materials produced within the customs territory of the United States), if the aggregate value of such imported materials when landed at the Canadian port of entry, exclusive of any landing cost and Canadian duty was--

(a) with regard to articles of the kinds described in paragraph (1), not including chassis, more than 60 percent until January 1, 1968, and thereafter more than 50 percent, of the appraised customs value of the article imported into the customs territory of the United States; and

(b) with regard to chassis of the kinds described in paragraph (1), and articles of the kinds described in paragraph (2), more than 50 percent of the appraised
customs value of the article imported into the customs territory of the United States.
Article 1001: Existing Arrangement

Each Party shall endeavour to administer the Agreement Concerning Automotive Products between the Government of Canada and the Government of the United States of America that entered into force definitively on September 16, 1966 in the best interests of employment and production in both countries.

Article 1002: Waiver of Customs Duties

1. Neither Party shall grant a waiver of otherwise applicable customs duties to a recipient other than those recipients listed in Annex 1002.1, nor shall either Party expand the extent or application of, or extend the duration of, any waiver granted to any such recipient with respect to:

a) automotive goods imported into its territory from any country where such waiver is conditioned, explicitly or implicitly, upon the fulfillment of
performance requirements applicable to any goods; or

b) any goods imported from any country where such waiver is conditioned, explicitly or implicitly, upon the fulfillment of performance requirements applicable to automotive goods.

2. Waivers of customs duties granted to the recipients listed in Part Two of Annex 1002.1, where the amount of duty waived depends on exports, shall:

   a) after January 1, 1989 exclude exports to the territory of the other Party in calculating the duty waived; and

   b) terminated on or before January 1, 1998.

3. Waivers of customs duties granted to the recipients listed in Part Three of Annex 1002.1, where the amount of duty waived depends on Canadian value added contained in production in Canada, shall terminate not later than:

   a) January 1, 1996; or
b) such earlier date specified in existing agreements between Canada and the recipient of the waiver.

4. Whenever the other Party can show that a waiver or combination of waivers of customs duties granted with respect to automotive goods for commercial use by a designated person has an adverse impact on the commercial interests of a person of the other Party, or of a person owned or controlled by a person of the other Party that is located in the territory of the Party granting the waiver of customs duties, or on the other Party's economy, the Party granting the waiver either shall cease to grant it or shall make it generally available to any importer. The provisions of this paragraph shall not apply to the waivers of customs duties to those recipients listed in Part One of Annex 1002.1 in accordance with the headnote to that Part or to the waivers of customs duties referred to in paragraphs 2 and 3 for the periods during which such waiver of customs duties may be conditioned upon the fulfillment of performance requirements set forth in paragraphs 2 and 3.

Article 1003: Import Restriction

Canada shall phase out the import restriction on used automobiles set out in tariff item 99215-1 of Schedule C to
the Customs Tariff, or its successor, in five annual stages commencing on January 1, 1989 in accordance with the following schedule:

a) in the first year, used automobiles that are eight years old or older;

b) in the second year, used automobiles that are six years old or older;

c) in the third year, used automobiles that are four years old or older;

d) in the fourth year, used automobiles that are two years old or older; and

e) in the fifth year and thereafter, no restrictions.

Article 1004: Select Panel

The Parties recognize the continued importance of automotive trade and production for the respective economies of the two countries and the need to ensure that the industry in both countries should prosper in the future. As the worldwide industry is evolving very rapidly, the Parties
shall establish a select panel consisting of a group of informed persons to assess the state of the North American industry and to propose public policy measures and private initiatives to improve its competitiveness in domestic and foreign markets. The Parties shall also cooperate in the Uruguay Round of multilateral trade negotiations to create new export opportunities for North American automotive goods.

Article 1005: Relationship to Other Chapters

1. Chapter Three (Rules of Origin) applies to:

   a) automotive goods imported into the territory of the United States of America; and

   b) automotive goods imported into the territory of Canada under this Agreement.

2. In determining whether a vehicle originates in the territory of either Party or both Parties under paragraph 4 of Section XVII of Annex 301.2, instead of a calculation based on each vehicle, the manufacturer may elect to average its calculation over a 12 month period on the same class of vehicles or sister vehicles (station wagons and other body styles in the same car line), assembled in the same plant.
3. The provisions of Article 405 apply to the waivers of customs duties affecting automotive goods except where otherwise provided in this Chapter.

4. The list of recipients in Annex 1002.1 and the definition "class of vehicles" may be modified by agreement between the Parties.

Article 1006: Definitions

For purposes of this Chapter:

automotive goods means motor vehicles and those goods used or intended for use in motor vehicles;

Canadian manufacturer means a person who manufactures automotive goods within the territory of Canada;

class of vehicles means any one of the following:

a) minicompact automobiles – less than 85 cubic feet of passenger and luggage volume,
b) subcompact automobiles - between 85 and 100 cubic feet of passenger and luggage volume,

c) compact automobiles - between 100 and 110 cubic feet of passenger and luggage volume,

d) midsize automobiles - between 110 and 120 cubic feet of passenger and luggage volume,

e) large automobiles - 120 or more cubic feet of passenger and luggage volume,

f) trucks, or

g) buses.

NOTE: A vehicle that may have more than one possible use (e.g., vans, jeeps) would be defined as either an automobile or truck based on whether it is designed and marketed principally for the transport of passengers or the transport of cargo.

comparable arrangement means arrangements whereby waivers of customs duties are granted to Canadian manufacturers upon the
fulfillment of conditions comparable to those described in the agreement referred to in Article 1001;

customs duty has the same meaning as in Article 410;

performance requirements has the same meaning as in Article 410;

used automobiles means used or second-hand automobiles and used or second-hand motor vehicles of all kinds that are manufactured prior to the calendar year in which importation into the territory of Canada is sought to be made; and

waiver of customs duties has the same meaning as in Article 410.
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VITA

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