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The Canada-U.S. Free Trade Agreement and Canada's Agri-Food Industries

Alan M. Rugman and Andrew Anderson

The food processing industry is Canada's second-largest manufacturing industry. It employed 226,579 people in 1986, and shipments were valued at CDN \$47 billion, or 15 percent of the value of total manufactured output that year. More significantly, the food and beverage industries together ranked highest among all manufacturing industries in terms of value added, at CDN \$15 billion or approximately 14 percent of total value added in Canadian manufacturing industries in 1986 (Statistics Canada). Given the high degree of competition in this industry in the United States, the history of "comfortable" competition in the food industry in Canada, and the significant contribution of this industry to the Canadian economy, it becomes important to look more carefully at how this industry has been and will be affected by the Canada-U.S. Free Trade Agreement (FTA).

During the FTA negotiations, several interest groups in Canada and the U.S. lobbied hard to be exempted from the agreement (Rugman and Anderson 1987c). Given its strength, both federally and provincially, the Canadian agricultural lobby succeeded in having marketing boards exempted. In so doing, the burden of adjustment to the FTA was placed squarely on the shoulders of Canadian-based food processors, who now need to either rationalize production in Canada or move to the U.S. This problem has been aggravated by the size asymmetry that characterizes the U.S. and Canadian markets. Although this problem has a bearing upon the effects of the FTA upon the Canadian food processing industry, the FTA is obviously not to be blamed for differences in the size of the Canadian and U.S. markets.

This article will focus upon the following sectors: dairy (milk), feathers (chicken, turkey, eggs), pork processing, fish processing, and beef and veal processing. In 1986, the total numbers of farms in Canada were grouped in the census as follows.

Cattle and small-grain farms accounted for the highest numbers, with 59,000 farms each. Wheat ranked second, with 47,000 farms, followed by dairy, with 34,000; pigs, with 12,000; and, finally, poultry with 5,000 farms. Table 1 examines the extent to which Canadian agriculture is involved in trade with the U.S. It reports the import and export percentages in 1986 as well as the importance of the U.S. to each major agricultural sector. These data do not distinguish between trade of raw versus processed products. However, it does indicate Canada's dependence on the U.S. market, since nearly 61 percent of the value of Canada's exports of agricultural products, excluding grains and oilseeds, went to the U.S. over the 1981 to 1987 period.

Supply Management and the FTA

Many of Canada's food industries are highly regulated by supply-management programs at the farm level. The most common mechanisms used are production quotas, mandatory pricing, import controls, and restrictions on interprovincial trade. In the FTA, supply management and the rest of this structure were retained, including import controls that keep out potentially cheaper U.S. products. Article XI of the General Agreement on Tariffs and Trade (GATT), which permits import controls, reinforces this aspect of the FTA but is currently being negotiated in the Uruguay Round. Certain processed products were not included in the import control list, including frozen pizzas and frozen chickens. As a result, these products are no longer economical to produce in Canada, since U.S.-produced imports are cheaper. These product lines are being lost to U.S. producers.

In addition, Canadian food processors are being forced to purchase more expensive inputs from Canadian suppliers, leading to severe adjustment costs as tariffs are reduced on processed food, leading to potential problems for future investment and plant location decisions, especially for larger firms. Companies like George Weston, Labatts, McCain

Alan M. Rugman is a professor of international business and Andrew Anderson is a research associate, both of the Ontario Centre for International Business (OCIB), University of Toronto. The authors are grateful to the research assistance provided by Michael Gestin of the OCIB.

Table 1. Canada-United States Agricultural Trade, 1986

Product Traded	Percentage Share of Trade by Volume		Percentage of Total Exports Going to the U.S.* (As a percent of value)
	Exports	Imports	
Animals and products	43.9	17.8	23 (other animal products) to 89 (live animals)
Grains and products	10.8	7.1	64 (products) to 3 (grains)
Animal feeds	4.1	2.6	49
Vegetables	3.6	16.5	36
Potatoes	2.1	1.3	49
Fruits and nuts	0.8	24.1	70
Oilseeds and products	3.9	10.7	26 (products) to 7 (oilseeds)
Other	30.8	20.0	NA
Total	100.0	100.0	60.5 ^b

Source: Agriculture Canada, Communications Branch, "The Canada-U.S. Free Trade Agreement and Agriculture: An Assessment," 1988, p. 10.

^a Where two numbers appear, this represents a range since each category contains a variety of crops.

^b Canadian agricultural exports (excluding grains and oilseeds) to the U.S. from 1981 to June 1987 as a percent of total dollar value. With grains and oilseeds, this figure drops to 32% in 1986.

Food, and other multinational enterprises will find it more attractive to locate future production in the U.S. than in Canada. This is because the U.S. market, both for processed foods and for the industry's inputs, is ten times larger than Canada's, leading to greater economies of scale for U.S. producers over Canadian producers. Thus, even if U.S. dairy and poultry producers receive the same production subsidies as Canadian farmers, the larger multinational food processors would be more efficient in the larger U.S. market. If, in practice, U.S. subsidies in these agricultural sectors are lower than in Canada, then this economic factor is reinforced.

That this is in fact the case was suggested by a report released by the Organization for Economic Cooperation and Development (OECD). Although the Canadian federal government disputed the report's estimates of Canadian agricultural subsidization, its own revised estimates still indicated that U.S. subsidies to the agricultural sectors were lower than Canada's (Drohan).

Press reports on plant closures due to the FTA reinforce this argument. While much of the media coverage listing plant closures due to the FTA is superficial and biased (as plant openings are routinely ignored), some facts can be derived. At least five plants appear to have been shut down: St. Lawrence Starch Co., Ltd. in Mississauga; Gobi Foods in Port Williams, Nova Scotia; Gerber (Canada) International in Toronto; and two Campbell Soup plants in Montreal and Portage la Prairie. Of these, St. Lawrence Starch closed because of a Canadian-imposed countervailing duty on imports of fresh grain corn. This has absolutely nothing to do with the FTA. In addition, several other plants are alleged to have taken action to meet the chal-

lenge of heightened competition south of the border.

The most recent news highlighting the attempts by the industry to cut costs comes out of H. J. Heinz Co. of Canada Ltd. in Levington, Ontario, where workers recently voted to accept a wage freeze over two years when faced with the real possibility of plant closure (*Globe and Mail*). Other companies that have taken measures to cut costs include Borden Inc. of Montreal, the Hunt-Wesson division of Beatrice Co., Inc. of Chicago, E.D. Smith, Cadbury Schweppes Canada, Campbell Soup, and Labatt's Ault Foods.

Several recent reports have confirmed the theoretical analysis of this paper. In February 1989 the Ontario Ministry of Agriculture and Food released a report of the Food Industry Advisory Committee on the food industry. It stated that supply-management policies would make it more difficult for food processors to compete under the FTA. The report stated that marketing boards serve to stabilize producers' income rather than achieve competitiveness. The nature of strategic management in multinational enterprises, including the food processing industry (especially multinational fish processors), has been examined by Rutenberg and by Rugman and Verbeke.

Trade Law Actions against Canadian Food Processors

The Canadian pork industry is not affected directly by the FTA. Indeed, it was doing well until the rival U.S. industry essentially imposed a prohibitive entry barrier by winning a trade-law action against Canadian producers. This countervailing

duty goes back to the "live swine and pork" case of 1985 where the U.S. agencies placed a duty on imports of live swine but not on processed pork products. Accordingly, the Canadian industry switched more to processing the pork before exporting it to the U.S. However, those in the U.S. industry kept up their legal harassment of Canadian pork exporters, alleging subsidies were now going to the Canadian pork processors. In 1989, the U.S. side won an affirmative ruling from both the U.S. International Trade Commission and the U.S. Commerce Department against the Canadian processors. This has been appealed

to one of the new Chapter 19 binational panels set up in the FTA, and its decision will be of great interest. For an overview of the comparison of U.S. and Canadian unfair trade laws, see Rugman and Porteous (1989). The process by which U.S. trade law results in an administrative bias against Canadian producers is discussed in Rugman and Anderson (1987b). They show that a variety of Canadian agricultural and fish products have been harassed since the changes in the GATT Subsidies and Antidumping Codes were adopted by the U.S. in 1979. Table 2 shows that there were a total of sixteen U.S. countervailing duty cases and twenty-two antidumping cases over the last ten years against Canada. Of these, eight countervailing cases were against agricultural and fish products, while there were six antidumping agricultural cases. It is obvious that Canadian food producers and processors could face more trade-law-related actions in the future given the high degree of dependence on the U.S. market for certain agricultural and fish sectors. The softwood lumber industry learned how devastating the misuse of U.S. trade laws could be when it was forced to adopt a 15 percent export tax as settlement on a preliminary countervailing duty case decision made in 1986 (Rugman and Porteous 1988). The Atlantic fish processing industry had been subject to five U.S. countervail actions before the FTA. The most significant was the 1986 fresh groundfish countervail of 6.2 percent. Many in the industry felt that without the FTA, action would be taken against exports of frozen fish (the great bulk of fish exports to the U.S.). There were two hard smoked herring fillet cases, since the first case was terminated and then restarted a month later by a new claim that the Canadian producers were subsidized. For a discussion of the trade-law fish cases, see Rugman and Anderson (1987a). The FTA will eliminate all tariffs by the end of a ten-year phase-in period. For some fish exports of prepared meals (fish sticks, etc.), these tariff cuts (of 10 to 25 percent) offer significant benefits.

Table 2. U.S. Countervailing Duty and Antidumping Duty Cases Against Canada: 1980-89

Year	Products Covered	Positive or Negative ^a
Countervailing Duty Cases		
1980	Frozen potato products	Negative
1980	Fish (fresh, chilled, or frozen)	Positive
1981	Hard smoked herring filets	Negative
1981	Hard smoked herring filets	Negative
1982	Certain rail passenger cars and parts	Positive
1982	Softwood lumber	Negative
1982	Softwood shakes and shingles	Negative
1982	Softwood fence	Negative
1984	Live swine and pork	Positive
1985	Certain raspberries	Positive
1985	Oil country tubular goods	Positive
1985	Certain fresh Atlantic groundfish	Positive
1986	Softwood lumber	Positive
1986	Certain fresh-cut flowers	Positive
1988	Thermo, cntrlld. appl. plugs/probes	Negative
1989	Fresh, chilled, and frozen pork	Positive
Antidumping Cases		
1980	Sugars, syrups	Positive
1980	Clams in airtight containers	Negative
1980	Asphalt roofing shingles	Negative
1981	Sheet piling	Positive
1982	Chlorine	Negative
1982	Frozen french-fried potatoes	Negative
1983	Certain fresh potatoes	Positive
1983	Choline chloride	Positive
1984	Certain red raspberries	Positive
1984	Certain dried salted codfish	Positive
1984	Egg filler flats	Positive
1985	Rock salt	Positive
1985	Welded carbon steel pipes/tubes	Positive
1985	Iron construction castings	Positive
1985	Oil country tubular goods	Positive
1986	Certain brass sheets and strips	Positive
1986	Certain fresh-cut flowers	Positive
1986	Color picture tubes	Positive
1987	Potassium chloride	Suspended
1987	Certain line pipes and tubes	Negative
1988	Certain fabricated structural steel Appl.	Negative
1988	plugs/probe thermostats	Positive

Source: United States International Trade Commission, *Annual Reports*, 1980-88.

^a A positive case is one found against Canada; a negative case is one in favor of Canada.

On the West Coast, the ruling of the Chapter 18 panel on the landing of salmon and herring was a reasonable decision, reflecting the panel's independence on a very political issue. The Canadian case for landing salmon and herring for inspection was a thinly disguised protectionist device, illegal under both the GATT and the FTA. The panel found this to be so, but still ruled that 75 percent of the fish could be landed for inspection. The Canadian government was forced to accept this decision.

The FTA was of benefit to beef producers since it removed import laws and other restrictions and all U.S. tariffs on red meat. This encouraged exports of processed high-value-added Canadian meat products. We now turn to a more detailed analysis of the impact of the FTA on these key food processing sectors.

Effects of the Canada-U.S. FTA on Food Processing

The Canada-U.S. FTA has resulted in a variety of changes to the laws governing the import and export of processed and unprocessed agricultural products between Canada and the U.S. In order for a thorough examination to be made of the FTA's effects on food processing in Canada, we also need to examine other indirect effects as well as exemptions and future negotiations that are contained in the agreement. Most of the provisions contained in the FTA governing agricultural products will result in the opening of markets between the two countries in the long run. There are, however, a variety of provisions that will continue to severely restrict the import of agricultural products into Canada and exports to the U.S. These provisions will affect Canadian food processors. Before examining these effects, it is necessary to review the relevant chapters and articles contained in the FTA.

The Direct Provisions of the FTA Affecting Agriculture

The articles governing trade in agricultural products between Canada and the U.S. are contained in Chapter 7 of the FTA (Canada 1988a). The first of these articles (701) is neutral in its effect on the opening or closing of markets, but it does encourage a more even playing field by prohibiting the use of agricultural export subsidies and by eliminating the transportation subsidies previously given on shipments of grain to the U.S. under the Canadian Western Grain Transportation Act.

Four of the articles are oriented towards the opening of agricultural markets. These include Article 702 (in combination with Article 401), which will involve the phased elimination of all tariffs over a ten-year period, excluding a twenty-year snapback provision on fresh fruits and vegetables due to any depressed price conditions, combined with declining or constant acreage of the crop under cultivation. Article 704 exempts restrictions by Canada and the U.S. on imports of beef and veal. As well it provides for consultations on third coun-

tries meat imports that are reexported to either Canada or the U.S. Canada has also been excluded from any future restrictions on products containing 10 percent or less sugar under Article 707. Article 708 will open markets by the gradual elimination of technical barriers through continuing negotiations by the two countries on the harmonization of their technical regulations on agricultural products.

Article 705 has the potential to open the markets for wheat, barley, and oats, as well as their products, through the elimination of Canadian import licenses. This may not occur for a number of years, since it requires U.S. grain support levels to become equal to Canadian grain support levels. Even then, there is a provision built into the agreement to permit the reimposition of import restraints if U.S. imports increase significantly.

Two of the articles either have the potential to restrict markets or permit the same conditions to continue as were in effect prior to the signing of the FTA. The first of these, Article 706, maintains U.S. market access to Canada for chickens, turkeys, and eggs but only at the traditional average levels of actual imports over the five years prior to the signing of the FTA. The second of these, Article 710, is probably the most important section for restricting the opening of agricultural markets between Canada and the U.S. This article maintains the restrictive trade practices negotiated under GATT Article XI(2)(c) that permit a national government to (1) restrict the quantities of agricultural products to be produced or marketed or their substitutes, (2) remove surpluses of the domestic product by restrictions on production or through giveaways or price reductions, and (3) restrict production of animal products that are directly dependent on an imported commodity for their production (i.e., reducing import dependence). These provisions permit the federal governments of Canada and the U.S., as well as the provincial and state governments, to control the pricing and supply of food products. In the case of Canada, this perpetuates the existence of agricultural marketing boards.

Indirect Provisions of the FTA Affecting Agricultural Trade

As well as the provisions contained in Chapter 7 of the FTA, there are a number of other provisions in the agreement which will also have an effect on the food processing sector in Canada. Chapter 8 contains provisions that relate strictly to the production and distribution of wine and spirits in Canada and the U.S. In general, the articles contained

under Chapter 8 will eliminate the pricing differential between imported and domestic distilled spirits immediately and by 1995 for wine. Also, any blending requirements of import with domestic product will be eliminated by both countries. The chapter does, however, permit private wine outlets in the provinces of Ontario and British Columbia to continue their present levels of discrimination against imported products.

Two of the articles contained in Chapter 12 also have some impact on food processing under the FTA. The first of these, Article 1203(c), permits restrictions to be maintained on the export of unprocessed fish products as contained in the existing statutes of New Brunswick, Newfoundland, Nova Scotia, Prince Edward Island, and Quebec. The second of these, Article 1204, excludes national treatment from applying to products containing beer or malt. In effect, Canada, or the provinces in this instance, as they are responsible for the regulation on products containing alcohol, can continue to discriminate against beer or malt products from the U.S. Canada is not, however, exempt from prohibitions placed against it through any GATT rulings that find Canadian practices discriminatory (including provincial regulations) and therefore GATT illegal (Article 1205).

Dispute-Settlement Provisions in the FTA

Three other chapters in the FTA are also of importance to the opening up or closing down of trade in agricultural products. These are the two dispute-resolution chapters, Chapters 18 and 19, and the emergency-action provisions contained in Chapter 11. For a more thorough overview of the dispute-settlement mechanisms in the FTA, see Anderson and Rugman (1989a), and for a discussion of the extension of net-net to the Canada-U.S. Subsidies Code, see Anderson and Rugman (1989b).

Chapter 18 is responsible for providing the institutional structure—the Canada-United States Trade Commission—that will manage the agreement as well as settle any trade disputes that arise between Canada and the U.S. concerning the interpretation or application of any element of the agreement. Chapter 19 is responsible for settling trade disputes that pertain strictly to the use of antidumping or subsidy-countervailing duties by undertaking the final review where the parties disagree, rather than having a federal court in Canada or the U.S. do the review.

Chapter 19 is also responsible for the statutory review of any changes to the antidumping or countervailing duty laws by either country, while under

Article 1907 it is also responsible for the establishment of a working group that will develop more effective rules and disciplines concerning the use of government subsidies, including agricultural export subsidies that are banned under Article 701.

Tables 3 and 4 indicate the cases under Chapters 18 and 19 that have been handled to date. There have been a total of eight cases under Chapter 18 to date. Of these cases, six have been or are concerned with agricultural and fish products. The lobster case has already resulted in the restriction of sales of small live Canadian lobsters to the U.S. There have been twelve Chapter 19 cases to date. Four of these cases have been concerned with fish or agricultural products. As already mentioned, the countervailing duty processed pork case by the U.S. against Canada has been appealed to a Chapter 19 panel for review. A decision on this case is expected by August 1990. The red raspberries case was settled by the panel in Canada's favour, resulting in the overturning of dumping duties against British Columbia raspberries exported to the U.S.

Chapter 11 permits either country to nullify any tariff reductions that have taken place with regard to the duty reductions negotiated on goods under Chapter 4, where surges in imports cause serious injury to domestic production. Any increase in duty cannot exceed the most favoured nation (MFN) rate

Table 3. Chapter 18 Dispute Panels and Cases

Dispute Process Used To		
Handle the Case	Outcome*	Date
Handled by the Commission		
Cases initiated by the U.S.:		
1. Wine and spirits	Not completed	Unknown
2. Plywood	Not completed	June 1990
3. Cable retransmission	Not completed	July 1990
4. Wool	Not completed	Unknown
5. Fruits and vegetables	Not completed	Monitoring
Referred to an Arbitration Panel		
Cases initiated by the U.S.:		
1. Salmon and herring (CDA-01)	Positive	October 1989
Cases initiated by Canada:		
1. Lobsters (federal) (USA-01)	Negative	May 1990
2. Lobsters (state)	On hold	Unknown

Source: Binational Secretariate Canadian Section, "Status Report of Cases (Chapter 18 and 19)," Ottawa, May 14, 1990; various papers, etc. * Positive if it favors the initiators) and negative if it does not.

Table 4. Chapter 19 Dispute Panels and Cases

Cases	Outcome*	Date
Cases initiated by the U.S.		
1. Induction motors (CDA-01)	Case dropped	January 1990
Cases initiated by Canada		
1. Red raspberries (USA-01)	Positive	May 1990
2. Paving equipment 1 (USA-02)	Negative	January 1990
3. Paving equipment 2 (USA-03)	Negative	March 1990
4. Paving equipment 3 (USA-05)	Negative	March 1990
5. Salted codfish (USA-04)	Case dropped	—
6. Fresh, chilled, and frozen pork (USA-06)	Not completed	November 1990
7. New steel rails (Sydney Steel) (USA-07)	Negative	August 1990
8. New steel rails (Algoma Steel) (USA-08)	Negative	August 1990
9. New steel rails (USA-09/10)	Negative	August 1990
10. Fresh, chilled, and frozen pork (USA-11) ^b	Negative	October 1990

Source: Binational Secretariat Canadian Section, "Status Report of Cases (Chapter 18 and 19)," Ottawa, May 14, 1990; various papers, etc. (revised October 1990). * Positive if it favors the initiators) and negative if it does not. ^b Remanded back to ITC by panel which reaffirmed its initial ruling.

of duty in effect the day of the signing of the FTA, or in effect at the time Chapter 11 is invoked. The imposition of restraints can be for no longer than three years, and emergency action cannot be invoked beyond 1998 when Chapter 11 becomes defunct. In terms of agricultural products, Chapter 11 is extremely important since it eliminates the ability of either country to use quotas. Even when restrictions are imposed, quantitative restrictions cannot be applied below "...the trend of imports over a reasonable base period with allowance for growth (Article 1102(4)(b))."

A Model of the Effects of the FTA on Food Processing

In order to examine the long-run effects of the provisions of the FTA on the Canadian food processing industry, the framework outlined in Figure 1 is used. Three different effects that will occur simultaneously are examined: the price effect, the

trade-protection effect, and the import-competing effect. Two of these effects involve actual trade flows—the price and import-competing effects—while the trade-protection effect is an institutional mechanism that can enhance or reduce the effects of the other two. These effects are found on the right-hand side of Figure 1 and correspond to the "windows" of opportunity of market growth, or the loss of opportunity through increased protectionism, indicated by the opening in the "border" as permitted by the FTA.

The circular nature of the apparent flows of both goods and institutional protection, or assistance measures to producers and processors, is designed to reflect the reality that the provisions contained in the FTA have a continuing effect and are not one-time shots that adjust the trade flows of agriculturally based products between Canada and the U.S. This dynamic interpretation is extremely important since it can dramatically reverse a static interpretation of the long-run effects of changes brought about due to an FTA provision. We will now examine each of the effects.

The Price Effect

Prior to the signing of the FTA, the normal distribution, or export channel, for agricultural products from Canada to the U.S. was through producers supplying Canadian processors with the final products being exported across the border. A secondary channel was by exporting unprocessed products, or products with marginal preparation for packaging purposes, directly to the U.S. for either final consumption or further processing.

Both channels were subject to U.S. tariffs and other border measures, some of which have been changed by the FTA. These two flows can be seen at the top of Figure 1. With the FTA, agricultural exports are enhanced over the long term by the reduction of duties on agricultural products agreed to under Chapter 4. This is further aided by Chapter 11 of the FTA, which can restrict the imposition of duties should the U.S. apply for emergency relief, and for certain agricultural products by the immediate acceptance of either country's technical standards, particularly for beef and veal under Article 704. In the longer run, these standards will be harmonized across all agricultural products with the negotiations undertaken under Article 708.

However, with the maintenance of marketing boards under Article 710 and the ongoing limitations on imports of chickens, turkeys, and eggs under Article 706, there is the possibility that Canadian food processors could find themselves non-competitive due to the higher prices imposed by

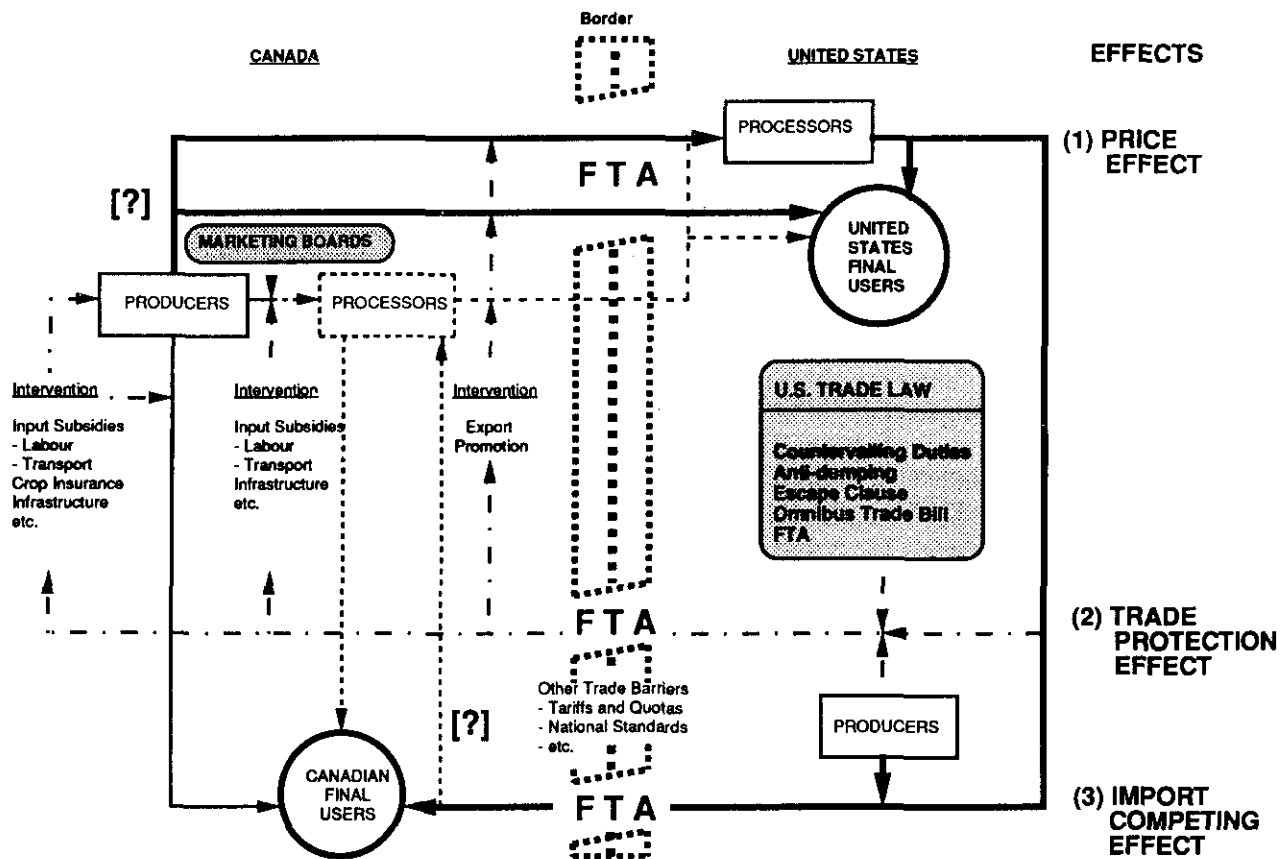


Figure 1. Effects of the Canada-U.S. FTA on Food Processing

these marketing boards. This could lead to the scenario depicted in Figure 1.

Due to the marketing boards, the export channel from food processors in Canada shrinks, or even disappears for some types of food processing. If the Canadian food processor is producing under scale economy conditions (where price is of the utmost importance and there is extensive import competition, either presently existing or stimulated by the FTA), then the higher input costs of marketing boards could well put this type of food processor out of business. Only if the Canadian food processor is niche oriented and is primarily servicing the Canadian market, and also faces limited price competition from U.S.-based producers, could the Canadian firm be expected to survive.

Canadian producers face a number of possibilities if the scenario outlined above is correct. First, those producers already exporting directly to the U.S. as input suppliers to U.S. processors in such areas as potatoes, fresh fruit, grains, and other unprocessed crop forms may gain if the U.S. processors increase their output to supply processed food products directly to Canada. This is assuming

that first they are not already servicing the Canadian market, and second that the FTA stimulates them to now serve the Canadian market or increase their service to the Canadian market if they are presently doing so, perhaps due to tariff reductions under Chapter 4. If, on the other hand, U.S. marketing boards or programs provide the same sort of restrictive trade or pricing practices as the Canadian boards do, then the market opening generated by duty reductions under Chapter 4 will not permit the Canadian producers to increase their exports directly to the U.S.

In general, the price effect is a result of internal domestic regulations governing agricultural input prices. They segment production into either a predominantly export-oriented food processing sector that has to compete on price, or a Canadian-based sector selling mainly in the domestic market, but facing lower-cost competing products from the U.S. This includes substitutes brought about by the lowering of customs duties under Chapter 4. The price effect applies primarily to economies-of-scale producers who are price dependent to sell their product. Scope processors' operations in Canada, which

sell only one or two products across North America, will be similarly affected. This could include U.S. subsidiaries which have been given North American food product mandates. This would occur if the majority of their inputs are supplied in Canada and the costs of these inputs are priced higher than for similar inputs in the U.S. due to the control of a marketing board.

Trade-Protection Effect

The trade-protection effect consists of three elements. The first element is the ability of all levels of government in Canada and the U.S. to supply aid to their agricultural producers and food processors. The second is the ability of the FTA to nullify government assistance that artificially distorts production or sales of food products in both Canada and the U.S. The third element is to what extent the FTA restricts or enhances the use of trade laws as trade-restricting or protectionist instruments.

Chapter 19 of the FTA contains institutional provisions under Article 1907 to develop an agreement that will control the use of subsidies and other government intervention by both Canada and the U.S. The government interventions can be seen in the middle of Figure 1 and can apply at the production, processing, or export stage. Interestingly, even though direct export subsidies on agricultural products are banned under the FTA (Article 701), there are still a variety of programs in both countries that encourage the export of both processed and unprocessed food products.

The eventual decrease in subsidies should permit agricultural prices of inputs to more closely reflect the real cost of their production. This will be of benefit to some products in Canada that receive lower subsidies, or none at all, as compared to their counterpart products in the U.S. Conversely, for those Canadian products that without subsidies are noncompetitive, it could mean a shift for agricultural producers in Canada away from protected crops and also the closure of any Canadian processors who were dependent on the artificially lower-priced input.

Neither Canada nor the U.S. has been exempted from the use of GATT-based Anti-dumping and Subsidy-Countervailing Duty Codes in the FTA. Therefore, while governments may subsidize, or firms price-dump, any artificial benefits received that permit the imported product to be favoured over the domestically produced one can be reduced by the imposition of antidumping or countervailing duties. If Canadian producers are primarily affected by the price effect and are subsequently reduced

in number, the level of government support may be reduced. Therefore, U.S. agricultural producers or processors would have less initiative to invoke the unfair trade laws of antidumping and countervailing duty against Canadian food processors. On the other hand, Canadian food processors could invoke the emergency relief (escape clause) provisions of the FTA against any surges in U.S. imports that are due to the FTA. In any case, whether raw products or processed products are imported or exported to the U.S. is irrelevant, as they can both face punitive actions if they are being dumped or subsidized.

The use of the antidumping and countervailing duty trade laws can become anticompetitive and result in market closure for both processors and producers when they are captured by interest groups in either country in order to reduce market competition rather than to genuinely stop the practices of subsidization or dumping. (For a more detailed explanation, see Rugman and Verbeke.) In this case, the increased competition in food processing brought about by the reductions in duties under Chapter 4 could result in the trade laws being used to restrict the sale of Canadian products in the U.S. market and vice versa. Canada sought an exemption from the use of antidumping and countervailing duty laws by the U.S. since it believed that U.S. "unfair" trade laws were increasingly being used by interest groups in the U.S. to restrict trade (Rugman and Anderson 1987; Rugman 1986 and 1988). This situation may not be entirely an American phenomenon but can also occur in Canada (Porteous and Rugman 1989).

While Canada did not obtain this exemption, it did gain somewhat by the establishment of the right to jointly review the appeals of the decisions of the national authorities on dumping and countervailing in the U.S. These Chapter 19 panels of the FTA are an important gain. The dispute panels set up under Chapter 19 to review the decisions consist of five members, with either two or three Canadians sitting on each panel. Americans can similarly sit on the dispute panels where U.S. producers appeal the decisions of Canadian antidumping and countervailing duty cases. In general, if the panels work properly, they should help to mitigate any unfair use of the trade laws by vested interests in both Canada and the U.S. (Anderson and Rugman 1989 and 1990). At this stage, it is still too early to say whether the dispute panels are working.

Import-Competing Effect

The import-competing effect can be seen in the lower part of Figure 1. This effect is due strictly

to the reduction in the barriers to trade, including duties under Chapter 4 and technical-standards barriers under Chapter 7 that have been eliminated with the FTA. These reductions in barriers permit the increased import of U.S. processed and unprocessed agricultural products to Canada. This effect is somewhat mitigated by Canadian controls on raw products governed by marketing boards and by the special provisions contained in the FTA on chickens, turkeys, and eggs under Chapter 7. This is similar to the situation facing some types of Canadian exports to the U.S. where state governments directly restrict imports through their own types of market control mechanisms.

The increased imports of U.S. processed food products could have a negative impact on Canadian food processors based strictly on overall operating costs, regardless of whether there is any government assistance provided to the industry or whether the inputs are governed by a marketing board(s). Large-scale producers in the U.S. will in many cases be more efficient and be able to supply lower-priced products to the final Canadian users.

An example of a U. S. industry facing both lower operating costs as well as an advantage due to lower agricultural input costs is given by the frozen pizza industry. According to a report done for the Canadian Dairy Commission, the two largest Canadian frozen pizza manufacturers, McCain Foods and Pillsbury Foods, have stated that they will move their production facilities to the U.S. unless they can purchase their cheese requirements at competitive prices. The report argues that the Canadian industry, through investments in capital equipment, can increase the efficiency of the Canadian plants, thereby overcoming lower labor costs in the U.S. However, it cannot take corrective measures to reduce the total ingredient cost of a pizza, which is made up of approximately 50 percent mozzarella cheese. The only way the industry can be made competitive in this regard is by having the government adjust the dairy support program or by allowing the industry to purchase cheese at competitive prices so it can compete on an equal basis with imported frozen pizza.

According to the report, 75 percent of Canada's mozzarella cheese production is utilized by the pizza industry. Therefore, any loss of Canadian processing capability would also have serious implications for the dairy industry. The report indicated that Loblaw Companies Limited has already introduced a new frozen pizza, "Presidents Choice—The Decadent," which is imported from the U.S. This product, even including shipping costs, is approximately 5 percent cheaper than a similar Canadian product. Furthermore, there is the likelihood

that Loblaw's will increase its line of imported pizzas as the tariff decreases.

The above case is similar to the situation that Rugman and D'Cruz advance for Canada's service industries. While in many cases services are supplied locally, they often form an input into a larger production process that in many cases has to compete internationally. It is little solace for a Canadian manufacturer to make parts of the process globally competitive if many of the domestic inputs are uncompetitive. According to Rugman and D'Cruz, the whole system has to be made internationally competitive if the Canadian manufacturers are going to succeed.

The import-competing effect may, however, be somewhat mitigated to the extent that cheaper raw agricultural products can enter Canada. In this case, some Canadian food processors may find themselves quite competitive compared to their U.S. counterparts. In many cases it will depend on consumer demand elasticities and price elasticities. For some types of higher-priced processed food products, taste patterns can still permit market differentiation even if a strict niching strategy is not undertaken by Canadian food processors.

It is also not clear to what degree the marketing of products, rather than the consumer pricing decision, influences purchase patterns. It is not apparent that lower-priced processed food products will always have a competitive edge due to differences in taste and perceived quality by differentiating consumers. In this case, each type of food processor will have to determine its relative market positioning—whether as a low-cost price-driven processor, as a niche specialty-product player, or even as a combination player exhibiting some of the benefits of both a low-cost and niche player. In either case, it can be assumed that as barriers to trade come down between Canada and the U.S., there will be necessary adjustments in certain sectors of the Canadian food processing industry based strictly on U.S. comparative advantage in those processed food products sold in Canada.

Canadian Internal Adjustments

In addition to the direct FTA provisions governing trade in agriculture between Canada and the U.S. and the dispute-settlement procedures that may also have an effect on agricultural trade, there are other key considerations that must be taken into account. One is the decentralized nature of the political process in Canada that governs the regulation of agricultural production and processing in Canada. Overall there is no centralized strategy for agri-

culture. What one government in Canada does may be entirely different than the other provinces or the federal government. This can have the effect of creating market restrictions within Canada such that the FTA will encourage a north-south orientation in agricultural trade, permitting U.S. producers or processors to target the entire Canadian market with adjustments for the individual provinces.

In many cases, these U.S.-based producers or processors already have a distinct market advantage due to the larger consumer market areas in the U. S. Canadian producers, on the other hand, face restrictions on operating east-west at the same time they have to contend with smaller consumer market areas in Canada. Therefore, while the FTA is encouraging a more competitive environment in Canada-U.S. agricultural trade, agricultural market practices in Canada are restricting intra-Canadian trade. In the long run this noncompetitive market environment in Canada could be more detrimental to Canadian food processors and producers than the changes in the competitive environment that are actually due to the FTA.

In this context, agriculture is a microcosm of Canada. The decentralized nature of the Canadian federation led to many sectors being exempted from the FTA (Rugman and Anderson 1987b). The net result of this is simply to postpone economic adjustment to a later date, depending upon the suppressed degree of protectionism inherent in the exempted sector. In some cases, such as marketing boards in agriculture, the postponement was a lot shorter than anticipated. Now food processors will need to become stronger lobbyists in order to offset the protectionist farming lobby.

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