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9 September 1987

MEMORANDUM FOR: Distribution

SUBJECT: Inter-Agency Meeting

TYPE OF MEETING	Economic Policy Council
DATE	~~Monday~~, ~~14~~ Wed, 16 Sept September 1987
TIME	~~1400~~ 1100
PLACE	Roosevelt Room
CHAIRED BY	Baker
ATTENDEE(S) (probable)	NIO/Econ
SUBJECT/AGENDA	Canada FTA
PAPERS EXPECTED	~~N/A~~
INFO RECEIVED	Per Cabinet Affairs memo, dtd 4 Sept

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EXECUTIVE SECRETARIAT

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Remarks

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Executive Secretary

16 Sept '87

Date

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THE WHITE HOUSE
WASHINGTON

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CABINET AFFAIRS STAFFING MEMORANDUM

Date: 9/15/87 **Number:** 490, 692 **Due By:** _____

Subject: Economic Policy Council Meeting -- Wednesday, September 16, 1987 -- -- 11:00 a.m. -- Roosevelt Room

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☑	☐
Justice	☑	☐
Interior	☐	☐
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☐
HUD	☐	☐
Transportation	☑	☐
Energy	☑	☐
Education	☐	☐
Chief of Staff	☐	☐
OMB	☑	☐
UN	☐	☐
USTR	☑	☐
CIA	☑	☐
EPA	☐	☐
GSA	☐	☐
NASA	☐	☐
OPM	☐	☐
SBA	☐	☐
VA	☐	☐

	Action	FYI
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Carlucci	☑	☐
Cribb	☑	☐
Bauer	☑	☐
Dawson *(For WH Staffing)*	☑	☐
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REMARKS: The Economic Policy Council will meet on Wednesday, September 16, 1987 at 11:00 a.m. in the Roosevelt Room. The agenda and background papers are attached for your review.

RETURN TO:

☑ **Nancy J. Risque**
Cabinet Secretary
456-2823
(Ground Floor, West Wing)

☐ **Associate Director**
Office of Cabinet Affairs
456-2800
(Room 235, OEOB)

THE WHITE HOUSE

WASHINGTON

September 15, 1987

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: EUGENE J. McALLISTER EM

SUBJECT: Agenda and Papers for the September 16 Meeting

The agenda and papers for the September 16 meeting of the Economic Policy Council are attached. The meeting is scheduled for 11:00 a.m. in the Roosevelt Room.

The single agenda item will be a discussion of the negotiations for a free trade agreement with Canada. There are five papers attached, with reports on the status of the negotiations and the investment, energy, and automotive issues. The final paper is a report from the working group examining the implications of the Canada FTA for the FCN treaties we have with other nations.

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ECONOMIC POLICY COUNCIL

September 16, 1987

11:00 a.m.

Roosevelt Room

AGENDA

1. Canada FTA

FTA NEGOTIATIONS: STATUS AND TRADE-OFFS

Issues

A US/Canada agreement still appears possible before the early October deadline, but the two sides are far apart in many areas. We have shown flexibility on the key Canadian demands on subsidies and countervailing duties, but still need concessions in areas important to us. Following is the background for the negotiations, a summary of US and Canadian objectives, an outline of the shape of a possible agreement and the trade-offs involved. Attached are papers on auto trade, investment, and energy; some of the areas where EPC decision is required.

Background on Free Trade Area Negotiations

On March 17, 1985, President Reagan met Prime Minister Mulroney in Quebec and issued a joint declaration of their desire to negotiate the "broadest possible package of mutually beneficial reductions in barriers to trade in goods and services." The negotiators' goal is to eliminate tariffs and substantially reduce regulatory barriers to the flow of goods, services, and investment. These are the most comprehensive trade negotiations we have ever undertaken.

The negotiations, which are taking place under special "fast track" negotiating authority, have a target completion date of early October 1987, when the Administration must notify Congress of its intent to enter into an agreement.

The negotiations are complicated by several factors: the need to break new ground on many issues (services, intellectual property, subsidies, investment, dispute settlement); state and/or provincial jurisdiction in many key areas; outstanding bilateral trade and investment irritants; and the overall Congressional debate on trade. (The close vote in the Senate Finance Committee that allowed "fast track" negotiations, a 10-10 tie, reflected disagreement with overall Administration trade policy and not the Canada initiative.)

Complete elimination of trade and investment barriers would require controversial policy changes in both countries. Canadians believe their exports are unfairly harassed under US trade remedy laws, and seek to limit their application. At the same time Congress seeks to tighten these provisions in general. On the other hand, US interest in a free, open investment regime raises Canadian fears of US domination of business and industry.

The US interest in an FTA is to promote efficiency on both sides of the border, set an example for multilateral trade talks, and to prevent Canada from backsliding to the restrictive, inward-looking policies of the 60's and 70's. In Canada, Prime Minister Mulroney has staked his leadership credentials on his proposal for a comprehensive trade agreement. He appears convinced that an agreement is in Canada's fundamental interest, both to avoid the protectionist push of Congress and to make Canadian industry more competitive.

US Objectives

- Elimination of Tariffs: Canadian tariffs are about twice as high as ours.

- Reduction of Nontariff Barriers; including technical agricultural and industrial standards; elimination of discriminatory energy restrictions and pricing; elimination of discriminatory distribution and pricing practices affecting wine, spirits, and beer.

- Open and Secure Investment in Canada: Guarantees reducing Canada's ability to screen and prevent US investment; prohibition of performance requirements, uncompensated expropriation, and restrictions on sales and acquisitions;

- Improved Protection for Intellectual Property: Improved patent, trademark, and copyright protection, particularly for pharmaceuticals and broadcasting.

- Rules for Services: National treatment for US services, including the motion picture industry.

- Discipline over Canadian Subsidies

- Energy: Long-term secure access to Canadian supplies on a non-discriminatory basis.

- Auto Trade: Elimination of remaining tariffs and duty remission programs.

- Resolution of Outstanding Bilateral Trade Irritants: including proposed film distribution restriction, discriminatory broadcast media policies, and restrictive plywood standards.

Canadian Objectives

- Assured access to the U.S. Market: "Predictable" trade rules and a bilateral mechanism for the binding resolution of trade disputes, including subsidy and countervail disputes; substitution of antitrust law for antidumping laws; exemption from US safeguard actions (section 201), Section 232 (protection of the defense industrial base), and Section 337 actions on intellectual property; elimination of customs user fees; assurance that Canada will not be hit by restrictive elements of the trade bill.

- Binding Bilateral Dispute Settlement: an institutional mechanism to enforce the agreement and deal with any individual disputes that may arise.

- Government Procurement: Waiver of Buy America provisions at both the federal and state level.

- Border Crossing: Simplified procedures for business travelers; additional access for some service sector professions.

- Cultural Exclusion: Exemption from FTA disciplines for cultural industries (broadcasting, films, publishing, music) in order to maintain Canada's "cultural identity."

- Agriculture: Partial exemption from US restrictions on sugar and sugar-containing products; prior consultation on subsidized grain exports; shielding of marketing boards, and horticultural industries.

- Energy: Guaranteed access to US market, for example, removal of restrictions on exports of Alaskan North slope crude; access to Bonneville power grid; exemption from uranium enrichment restrictions.

- Services: Access to U.S. coastwise trade for Canadian built vessels with Canadian crews; protection for all current practices from 301 actions.

- Financial Services:Ten year moratorium on the application of Glass-Steagall restrictions for Canadian financial institutions;

Status of the Negotiations

Going into the final three weeks of this negotiation, the U.S. and Canada remain far apart on major issues. If it were possible to conclude an agreement of the basis of the issues which have been resolved to date, plus those which appear resolvable, we might have an FTA that looks something like that described in "Core Package" below. We do not know if Canada would accept a core package.

To expand the core package, both countries must make some painful political decisions which will give rise to domestic opposition both in Congress and the private sector. The TPRG and the EPC must consider how far we can go.

I. CORE PACKAGE:

- o Tariffs: eliminated, mostly over 5-10 years.
- o Customs: tight rule of origin; elimination of duty waivers/inward processing/duty drawback/duty remission schemes; improved border cooperation, facilitation and enforcement.
- o Investment: review only of large take-overs; ending of performance requirements and forced divestiture.
- o Subsidies: improved discipline in exchange for a role for dispute settlement and technical changes in the application of US CVD laws.
- o Dispute Settlement Mechanism (DSM): bilateral version of the GATT, plus voluntary binding arbitration.
- o Dumping: commitment to consider replacing national dumping laws with competition laws at the end of 10 years when tariffs are eliminated.
- o Services: standstill on current practices; few or no rollbacks; possibility of sectoral agreements on tourism and insurance.
- o Border Crossing: facilitated procedures for business travelers and services providers.
- o Agriculture: Progress in reducing technical barriers; exclusion from each others' meat import laws.

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- Financial Services: some liberalization possible, including 10/25 limit on acquisitions; Glass-Steagall still major impediment.

- Government Procurement: perhaps nothing; possibility of small expansion of GATT Code coverage at federal level, coupled with lower threshold (e.g., $25,000 vice 170,000 SDRs).

- Intellectual Property: possibly some improved patent protection for pharmaceuticals, but not as much as we want; compulsory licensing would remain; new copyright protection for cable retransmission; perhaps nothing unless we neutralize 337.

- QRs/Standards: some rollbacks and harmonization, sharing of resources in short supply possible.

- Alcoholic Beverages: improved market access and reduced discrimination on wine and distilled spirits; little or nothing on beer.

- Auto: elimination of tariffs and duty remission schemes, but major controversy regarding Auto Pact.

- National Security Exceptions: continue GATT rules.

- Safeguards: provision for 201-type actions during the transition period, but Canada may insist on being excluded from global restraints.

II. BROADER PACKAGE: The Canadians say they want a major package and are prepared to pay for it. We must be prepared to reciprocate if we expect to achieve our major goals. The principal issues are these:

- Subsidies: Canada says it will undertake meaningful discipline in exchange for replacing U.S. CVD laws with common rules and binding dispute sttlement. Assessment: If Canada does accept some real discipline, we can provide some limited dispute settlement. We are currently testing the Canadians flexibility on this issue.

- Dispute Settlement: Canada wants an independent, binational tribunal to replace national trade remedy laws with binding arbitration. The U.S. has offered a binational version of the GATT, plus voluntary binding arbitration. Recent public statements by various GOC ministers suggest they have not backed away from their demand, as we had thought. Mulroney will try to press this view with the President at the UNGA, as he did during their private meeting at the Venice Summit. Assessment: This could be the deal maker or breaker.

- Investment: Canada has linked what we want on investment to what they want on subsidies/DSM. We have denied any such linkage but to no avail. We have much to gain. This issue is our sine qua non. Canada knows it. Assessment: Canada appears ready to deal.

- Energy: a major package including open market and supply access appears possible. Canada wants to limit our ability to impose import and export restrictions for national security purposes. Any deal on energy, however, is dependent on our ability to provide limited access to Alaska North Slope oil (50,000 to 200,00 barrels/day) and access to U.S. uranium enrighment facilities. Assessment: do-able, but at a domestic political cost. Chairman Dingle of House Energy Committee is opposed, as are others.

- Services: There will not be major package no matter what we do. However, we are trying to salvage what we can. We want improved market access on trucking and busing. Canada has said all transportation and telecommunications must be included. There is fierce Congressional opposition on maritime (Jones Act). Assessment: small agreement possible.

- Telecom: we are unlikely to get non-discriminatory procurement from Bell Canada unless we commit our regional Bell companies to provide similar treatment. Assessment: we may get nothing regardless of what we do.

- Auto Pact: politically explosive in Canada. GOC wants to retain the Auto Pact and its local content and other performance requirements imposed on local investors (GM, Ford, Chrysler, Others). The Big-3 also want to keep the Pact which now gives them an advantage in Canada over Japanese-oned US plants. The auto parts manufacturers, the UAW, and at least seven state governors and their Congressional delegations are opposed to this arrangement because it is skewed in Canada's favor. Assessment: a very contentious issue. Some way has to be found to strike a compromise between the interests of the Big-3 and the auto parts people.

- Agriculture: The Canadians have raised the prospect of dropping agriculture (including alcoholic beverages) from the agreement unless US import restrictions on sugar and sugar-containing products are limited. The EPC is scheduled to review the sugar program on September 24. A larger package on agriculture involving removal of Canadian grain import licenses, termination of freight rate subsidies in grain exports to the US, and removal of Canadian restrictions on consignment sales and bulk shipments to processors, has been linked to US concessions involving prior consultations with Canada on EEP sales and exemption of Canadian imports from state marketing orders. Assessment: uncertain, depends on ability of US to make painful concessions.

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U.S.-CANADA FTA: INVESTMENT

ISSUE

Can the EPC accept in principle some Canadian screening of foreign takeovers, narrowly circumscribed, in return for all the other undertakings from Canada to improve the foreign investment climate?

BACKGROUND

The investment negotiations were at a procedural impasse until last Friday, when Canada gave us a draft investment chapter at the same time the U.S. gave them a revised subsidies/ countervail proposal. Canada has explicitly linked formal progress on the Investment Chapter to progress satisfactory to Canada on the Subsidies/Countervail/Dispute Settlement issues.

Prior to Friday's procedural breakthrough, a Canadian draft text was shown to and discussed with our group negotiator. These discussions advanced the substantive negotiations considerably. Both negotiators believe an agreed text can be developed rapidly, now that Simon Reisman has given his authority to move to closure.

A. STRUCTURE OF THE AGREEMENT

The emerging agreement will accomplish the three main U.S. goals:

(1) It substantially narrows Investment Canada's screening authority. Most U.S. investments in the future will not be screened and will receive national treatment. The small group of direct acquisitions remaining, a narrowly defined class of politically sensitive (i.e. large) acquisitions, will still be screened but only above a significantly higher threshold (asset value of acquired firm) than at present. Canada also will retain screening for new establishments and direct acquisitions in "cultural industries", because the cultural sectors are generally carved out of the whole FTA. (The Canadians have agreed, however, to end practices in "cultural sectors" that have been particular irritants, such as forced divestiture and discriminatory taxation --see (2) below.)

(2) Certain problematic Canadian practices will be banned. These include:

-- Forced divestiture, including in book publishing and energy.

-- Minimum Canadian equity requirements.

-- Expropriation without due process and prompt, adequate and effective compensation.

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Declassify: OADR

-- Most performance requirements.

-- Discriminatory postal rates for foreign-controlled publications and discriminatory tax practices for advertisements and small businesses.

(3) It prohibits Canada from backsliding on the substantial liberalization already achieved by the Mulroney Government.

B. KEY UNRESOLVED ISSUES

Four main issues remain for final negotiation:

(1) Level of the screening threshold for direct acquisitions--i.e. size of acquired firm below which no screening will occur. The U.S. side has laid down a non-negotiable requirement that the threshold go to three digits--i.e. above C$100 million, in constant C$. The Canadian side has spoken of a "significant multiple" of the present C$5 million threshold. In our view, all that is negotiable is where the threshold settles above C$100 million.

(2) U.S. demand that "indirect" acquisitions not be screened when Canadian subsidiaries change hands as a result of changes in ownership of U.S. parent corporations. The Canadians instead want a minimum threshold (i.e. size of Canadian subsidiary) above which screening would occur. We believe that ultimately the Canadians will agree to our demand.

(3) What performance requirements (PR's) are banned. Canada has agreed to end trade-related requirements (e.g. local content, export, and import-substitution requirements). Still under discussion are product-mandate, R&D, and technology transfer requirements, which the U.S. insists be banned. Also unresolved is the issue of banning PR's on third-country investors that could indirectly affect U.S. trade. The U.S. wants these banned, while the Canadians do not.

(4) U.S. demand that Canadians cease screening all sales of Canadian firms already owned by U.S. investors. The U.S. wants this right to sell freely so that U.S. investors may receive full value for their assets. The Canadians counter that U.S. sellers should receive national treatment--i.e. like Canadian investors, U.S. investors selling to foreigners should be subject to screening.

ACTION NEEDED: an EPC decision to accept a narrowly circumscribed amount of Canadian screening in return for all the other undertakings Canada would make to liberalize and stabilize the investment climate.

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U.S./CANADA FTA NEGOTIATIONS:
ENERGY

Issue: Elimination of barriers to trade in energy is agreed by all agencies and by both the United States and Canada to be in the long-term interest of both countries. However, achieving this objective will require taking certain politically sensitive actions on both sides. Canada has now indicated a willingness to make commitments on their side and is looking to our side for comparable commitments.

Objectives/Benefits for U.S.: As a significant net importer of energy, the U.S. seeks to assure long-term secure access to Canadian energy supplies on a nondiscriminatory basis. This is consistent with the March 1987 DOE report to the President on energy security and will provide an important counter to future increased dependence on OPEC oil. By establishing free and fair trade in energy between the two countries, we will encourage the investment necessary to allow the most economic development of North American resources and thus lower energy costs for industry and other consumers of both countries. This will improve the international competitiveness of energy-intensive industries such as petrochemicals and basic metals, as well as improving our overall energy security. Failure to achieve such nondiscriminatory access to Canadian oil and gas will, on the other hand, cause the U.S. chemical industry and other energy-consuming industries to oppose approval of the FTA by the Congress.

Concessions Necessary to Achieve Objectives: Access to Canadian resources is a very sensitive political issue in Canada. To allow U.S. purchasers access to these resources on terms comparable to Canadians, Canada is asking for balancing concessions which would assure Canadian energy suppliers nondiscriminatory access to the U.S. market and reduction of U.S. barriers to bilateral energy trade. The Canadians have requested (1) limiting the national secury exception on import restrictions to situations which relate directly to national defense (as opposed to broad interpretation to cover the entire industrial base); (2) avoiding energy regulatory actions which discriminate against Canada; and (3) reducing restrictions on energy exports to Canada (ANS oil). This last item would generate opposition from U.S. maritime interests.

Current Status of Negotiations: Both countries have agreed to have no barriers to imports or exports except under very narrow conditions (conservation of finite resources, short supply, requirements for military installations) and, in the event of supply restrictions based on conservation or short supply, to share energy supplies proportionately and without price discrimination (attached language still being reviewed by legal drafting group). The attached language on energy regulation has also been agreed to. Negotiators have agreed to eliminate/phase-out

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Declassify on: OADR

existing restrictions on uranium trade in a manner to be agreed to. Negotiators have also agreed that energy trade restrictions on national security grounds should be limited (language still being reviewed).

Canada has requested elimination or modification of ANS oil export restrictions and the U.S. has noted the sensitivity of this issue, stating that at present we are not in a position to offer concessions in this area. However, Canada has made clear that concessions on access to Canadian energy supplies must be balanced by similar actions on the U.S. side (even though the volumes of oil from Canada to the U.S. are much larger) to achieve the necessary reciprocal balance of openness on both sides. Thus, the broader U.S. objective of assuring long-term future access to Canadian energy supplies is clearly dependent on some concession on the ANS oil export restriction. A paper discussing possible options with respect to this issue is attached.

Background: Canada is by far the largest supplier of energy imports to the U.S. (1986 imports: oil, $4.5 bil.; natural gas, $1.9 bil.; electricity, $760 mil.; uranium, $200-250 mil.). Canada is also our largest export market for coal and coke ($890 mil.). In the past this trade relationship has been characterized by government intervention and trade restrictions on both sides. We now have a unique opportunity to put our bilateral energy trade on a more secure, long-term basis, to the mutual benefit of both countries. The President and the Prime Minister recognized this objective and in the March 1985 Quebec Summit Declaration on Trade committed to "strengthening our market approach to Canada-United States energy trade by reducing restrictions, particularly those on petroleum imports and exports, and by maintaining and extending open access to each other's energy markets, including oil, natural gas, electricity and coal."

Attachments

9/3/87

ENERGY REGULATORY REQUIREMENTS

[The Parties seek to broaden and secure the free trade in energy commodities between them and to avoid energy regulatory actions inconsistent with this objective. To this end, if either Party believes energy regulatory actions by the other Party would as a direct effect discriminate against its energy commodities, nationals, or companies in a manner inconsistent with this Agreement, that Party may initiate direct consultation with the other Party. The consultation shall be between, for Canada, the Ministry of Energy, Mines, and Resources and, for the United States, the Department of Energy. For purposes of this provision, "energy regulatory actions" means any action taken for Canada by the National Energy Board and for the United States by either the Federal Energy Regulatory Commission or the Economic Regulatory Administration.]

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ANS OIL EXPORTS

Issue: Canada has requested elimination or modification of the current ban on exports of Alaskan oil as part of the FTA. This would be opposed by U.S. maritime interests, which some believe could jeopardize the entire Agreement. However, failure to make concessions on Alaskan oil will mean Canada cannot make commitments on access to Canada's oil and gas in Alberta on the same terms as Canadians have access to these supplies, with the result that the U.S. chemical industry will oppose the Agreement, as they have stated in writing.

Background:

-- Approximately 1,600 to 1,700 thousand barrels per day (MB/D) of crude oil is produced at Prudhoe Bay on Alaska's North Slope (ANS); this oil is transported across Alaska through the Trans Alaska Pipeline System (TAPS) to Valdez, where most of it is put on tankers for consumption outside Alaska.

-- Section 7 of the Export Administration Act effectively bans exports of ANS crude oil by establishing criteria for its export that are virtually impossible to meet; since demand in Alaska is relatively small, this means most of the oil must be used in the Lower 48.

-- Because of the Jones Act, ANS oil must be carried to the Lower 48 on U.S. bottoms; this trade accounts for about 60% of total U.S. flag tanker tonnage.

-- Any concession at all on ANS oil is opposed by maritime interests, which have attempted in H.R. 3 to extend existing restrictions to oil not now covered; there is also some concern regarding impacts on development of oil and gas in the Alaska Natural Wildlife Reserve (ANWR).

-- Canada has expressed interest in bringing some ANS crude into British Columbia because their alternate sources are either Alberta crude transported over the Rockies or imports from Asian sources.

-- Canada's particular concern regarding possible retention of the ban by the U.S. if Canada were to relax its oil export restrictions in the FTA is that this lack of reciprocal treatment would be very difficult to sell politically in Canada.

-- Canada has been the largest supplier of oil to the U.S. in recent years, with current exports totalling nearly 800 MB/D; it is anticipated that Canada will remain an important source of oil and other energy imports into the next century.

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-- Total refining capacity in British Columbia is about 165 MB/D, which defines the theoretical effective upper limit on ANS exports that could result; however, because of existing contractual relationships, refinery processing limitations and other economic and technical constraints, it is believed the actual amount of ANS oil that might go to British Columbia is between 35 and 50 MB/D.

-- Depending on how the oil is transported, the maximum maritime effects for 50 MB/D are estimated to be three tankers (about 327,000 dwt) and about 190 jobs. (The Canadians have indicated that they may be willing to agree to conditioning of the export on transportation on U.S. tankers to Cherry Point, Washington, and subsequent lightering to British Columbia, thus reducing the potential maritime impact.)

Options:

While total elimination of the ban on all ANS oil exports is clearly most consistent with our overall trade and energy policy objectives and would respond not only to the Canadian request but also to longstanding requests from Japan and Korea, it is not a viable option in light of the strong opposition of maritime interests and the negative effects on maritime employment and USG loan guarantees on tankers. If it is decided to make some concession to Canada on ANS oil, the following appear to be the most feasible options:

1. Exempt Canada from ANS oil ban if certain conditions are met which result in overall increased U.S. energy security (e.g., commitments on nondiscriminatory access to supply on oil, gas, electricity and uranium).

Pros:

-- Simplest approach to responding to Canadian request.

-- Would not open up ANS oil for significant exports to Pacific Rim countries.

-- Would meet Canadian concerns, but only to the degree our own concerns on longer-term energy supply security are also met under the terms of the Agreement.

-- Would satisfy Canadian need for reciprocal concessions on energy exports on both sides.

-- Would not involve the administrative problems of volumetric limits or requirements such as those listed in Option 2.

Cons:

-- Would still generate significant maritime opposition, although not as much as total elimination of the ban.

-- Could be read to open up to large exports beyond the requirements of British Columbia, although this possibility is viewed as unlikely, and we would require a ban on reexports.

3. Allow exports to Canada subject to certain specific restrictions, e.g., up to a certain volumetric limit, possibly tying the exports to a requirement that equal volumes of crude oil be exported from Canada to the U.S. in a barrel-for-barrel exchange, and/or requiring U.S. flag tanker transportation.

Pros:

-- Would probably encounter less maritime opposition than Option 1 (though some opposition could be expected in any case).

Cons:

-- Would likely be viewed as inadequate by the Canadians when considered in comparison to the concessions we are asking on access to Canadian energy supplies, resulting in failure to achieve balance of commitments needed to win U.S. chemical industry support or at least neutrality.

-- Would be administratively complex compared to other options.

Discussion:

There is a clear trade-off of political risks here. On the one hand, trying to accommodate Canadian desires and concerns regarding exports of ANS oil could result in a major effort by the maritime lobby to defeat the entire Agreement. On the other hand, if we do not provide some concessions on our side that are perceived to be comparable to those we are requesting from Canada, we will not get the commitments necessary to assure equal access to oil and gas supplies at comparable prices on both sides of the border. Since this is a basic condition without which there cannot be free and fair trade in energy, petrochemicals and other energy-intensive products between the two countries, we will lose the support of significant U.S. industries unless we get Canadian commitments on supply access and pricing. These industries are being asked to give up some fairly substantial tariffs as part of the Agreement. They have made it clear that these U.S. concessions must be contingent on certain Canadian concessions, specifically including discipline on energy supply and price as a "must have."

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U.S.-Canada Free Trade Negotiations

Automotive Issues

ISSUE:

The EPC needs to decide two issues related to the automotive sector: (1) whether to seek the elimination of Auto Pact safeguards/performance requirements; and (2) an appropriate standard of preference for duty free treatment of automotive products under the FTA.

BACKGROUND:

Assembled automobiles and automotive parts for use as original equipment currently enter the U.S. and Canada duty-free under the terms of the 1965 Auto Pact. Imports from Canada qualify for duty-free entry into the U.S. if they meet a 50 percent North American value added test. Imports into Canada qualify for duty-free treatment only if the importing company meets two safeguard/performance requirements.

Briefly, companies must (1) maintain a production-to-sales ratio of 1:1 (for every car sold in Canada, one must be produced in Canada); and (2) a Canadian value added/sales ratio of 60 percent (for every dollar of sales in Canada, the company must generate 60 cents of Canadian value added in Canada). As long as the two performance requirements are met, qualified companies can import assembled autos and automotive parts for use as original equipment from any source, not just from the U.S. Hence the Big-3 save tens of millions of dollars in duties annually on imports from non-U.S. sources. Since elimination of safeguards would likely lead to the elimination of this duty-free multilateral sourcing, the Big-3 strongly oppose it.

A level of 35 percent direct cost of processing (factory floor cost, harder to meet than value added test) has been proposed to cover all assembly industries across the board under the FTA. In order to encourage increased North American content in automotive products, U.S. interests have urged a higher threshold for the automotive sector. The Motor Vehicle Manufacturers Association supports 50 percent, requests from parts manufacturers range from 35-70 percent, and the UAW urges 75 percent. A 50 percent cost of processing test equals about a 65 percent value added test.

The higher the North American content, the more protected from import competition will be U.S. suppliers to the auto assemblers. The Big-3 also favor a high standard, even though it limits their ability to source offshore, because many Japanese-owned producers would not qualify.

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OPTIONS: Safeguards/Performance Requirements

1. Seek Total Canadian Elimination of Safeguards

PROS

- Consistent with U.S. policy seeking elimination of performance requirements bilaterally in the FTA and multilaterally in the Uruguay Round;
- Would eliminate investment distortions, possibly prompting more future investment in the United States;
- May increase parts sourcing from North American manufacturers;
- U.S. firms in Canada that have not always met the safeguards on the margin would no longer need to be concerned about them;
- Would totally free-up North American automotive trade;
- Would satisfy some U.S. part manufacturers, labor interests, and a number of Midwestern Congressmen and Governors.
- Would strengthen our arguments against the UAW effort for legislation to impose performance requirements on auto assembly operations in the U.S.

CONS

- U.S. subs in Canada are likely to lose duty-free multilateral sourcing, estimated to be worth C$100 million by 1990 (about 10 percent of annual net income);
- U.S. subs in Canada will probably continue sourcing multilaterally; their competitiveness would be diminished by the Canadian tariff they pay;
- U.S. parent firms would strenuously object, perhaps to the point of lobbying the Hill against the FTA;
- Would totally eliminate Auto Pact, creating political firestorm in Canada (unless a "better deal" were to replace the Pact);
- U.S. auto assemblers have already made the large investments required to meet the safeguards, and they want to preserve their advantages over foreign equity firms which have not made similar investments.

2. Allow Canada to Retain Safeguards

PROS

- U.S. assemblers in Canada would continue to benefit from multilateral sourcing (they report a 27-33% price advantage by sourcing overseas), enhancing their competitiveness;
- Allows Canada to retain the Auto Pact -- a big political plus in Canada;
- Position is endorsed by major U.S. assemblers and their Canadian subs, which would support the overall FTA;
- Eliminating bilateral tariffs in the FTA will reduce the penalty for not meeting the safeguards and enable us to argue that we allowed Canada to keep the safeguards but we reduced their effectiveness;
- Bilateral trade would no longer be contingent upon meeting any safeguards/performance requirements.

CONS

- Inconsistent with U.S. efforts to eliminate performance requirements worldwide;
- May increase investment in Canada (vice U.S.);
- Would be opposed by aftermarket parts manufacturers, State of Michigan, and the UAW;
- May strengthen UAW effort for legislation imposing performance requirements on auto assembly operations in the U.S.;
- One U.S. manufacturer (Navistar), and possibly others, have difficulty meeting the performance requirements, which force them to source in Canada, when they may prefer sourcing elsewhere;
- Might limit the opportunities for U.S. parts manufacturers to supply more of the North American market for parts (since multilateral sourcing would likely continue).

3. Seek Total Canadian Elimination of Safeguards Over a Phase-Out Period

PROS

- A compromise which permits the U.S. Government to have a consistent policy on performance requirement but reduced financial impact on U.S. auto companies.

CONS

- o Would not satisfy Canada and maybe not U.S. firms unless coordinate with MTN tariff reductions.

OPTIONS: Standard of Preference

1. A Standard of Preference of 35 Percent Direct Cost of Processing (about the same standard as under the current Auto Pact) Would:

PROS

- o Allow the USG to have one standard of preference for all assembly industries under the FTA;
- o Be sufficient to prevent transshipment;
- o Provide maximum foreign sourcing flexibility to North American automotive producers;
- o Allow most motor vehicle assemblers and parts producers to participate in duty-free trade;
- o Allow customs to continue clearing entries on a product-by-product basis.

CONS

- o Be easy to meet with very little local manufacturing;
- o Allow significant volumes of products from third countries to be incorporated into U.S. and/or Canadian products and then benefit from bilateral duty-free treatment;
- o Be opposed by the majority of the U.S. and Canadian automotive industry which favors a higher number as an inducement to further U.S./Canadian sourcing.

2. A Standard of preference of 50 Percent Direct Cost of Processing Would:

PROS

- o Be closer to what the majority of U.S. motor vehicle and parts producers want under an FTA;
- o Allows considerable foreign component sourcing by U.S. automotive producers;
- o Encourage an increase in domestic component sourcing;

- Be more likely to be accepted in Canada.

CONS

- Probably temporarily exclude the U.S./Canadian operations of foreign producers from duty free trade under an FTA;
- requiring more North American content in the Auto Pact, while the Big-3 are increasing their use of imported components because of market factors, could in the long run increase their costs and decrease their competitiveness;
- Be inconsistent with the Canadian-proposed rule of origin for all other products;
- Probably exclude a significant number of products manufactured by traditional U.S. automotive producers unless applied by broad product classes -- e.g. passenger cars, commercial vehicles, etc.;
- Probably result in other industries more easily making the case for a special rule of preference.

The Compatibility of a U.S./Canadian Free Trade Area with Other International Agreements

Issue:

- What is our potential liability to countries with which we have bilateral most-favored-nation (MFN) obligations as a result of special treatment for Canada in a free trade area (FTA) and how can this liability be minimized?

Summary:

- The working group concludes that the potential liabilities do not of themselves warrant changes in current U.S. negotiating proposals. However, the working group identified areas of potential agreement between the U.S. and Canada which would create liabilities if they are included in the FTA. These areas are only important if in the future the U.S. imposes restrictive trade measures affecting other countries but not Canada because of the FTA.

Legal Considerations:

- We have MFN obligations under agreements with a number of countries which entitle them under international law to certain benefits that might be accorded to Canada in an FTA without having to offer equivalent concessions. The statutory authority under which we are negotiating, however, prohibits extending MFN treatment to any third party and would prevail in domestic law.

- Violations of our international obligations arising out of this conflict between international and domestic law could lead to demands for compensation and/or compulsory ajudication by the International Court of Justice, including damages. Furthermore, such violations could reduce the credibility of our FCN treaties and other agreements and of the U.S.

- However, under current U.S. negotiating proposals, we would not appear to have significant problems immediately upon entry into force of an FTA agreement.

Potential Violations:

- Eight developing countries would have an MFN claim with respect to trade in goods, but the only significant product for there countries is petroleum with a potential liability of $25 million in tariffs. However, none of these countries have objected to similar U.S. discrimination in the past (e.g., in connection with the Caribbean Basin Initiative, the Generalized System of Preferences or the Israeli FTA). We do not expect them to object in this case.

- Proposals in the services and investment chapters of the agreement to exempt Canada from future restrictive measures pose the main risk, because they would create liabilities to several major trading partners should the U.S. impose further restrictions in certain sectors, e.g., transportation, banking, telecommunications and the exploitation of natural resources. Quantification of the liability would depend upon the nature of future restrictions. In the maritime sector, the Department of Transportation estimated an exemption for Canada could lead to claims as high as $1.6 billion, but acknowledged this was highly speculative.

- We anticipate objections from certain countries if we accord preferential treatment for Canada under our intellectual property laws after agreeing that our domestic legal regimes had been sufficiently harmonized. These objections would be made for political reasons and we believe there is not a legal basis to justify them.

Recommendations:

- To limit potential liabilities and minimize requests for compensation, the U.S. should:

  -- weigh carefully the implications for our MFN obligations of any further proposals in the FTA negotiations as well as any future proposed legislation or administrative actions;

  -- begin marshaling our defenses now, before claims are brought by our treaty partners, e.g., by:

     gathering evidence of failures to extend MFN treaty benefits to the U.S. by our treaty partners in order to establish counter-arguments;

     considering, particularly in the field of services and investment, whether and when to consult with major treaty partners;

     studying how our positions on services and investment in the Uruguay Round can be used to ward off claims.

Background:

- The interagency working group reviewed the practical implications of not honoring international legal obligations which could result from commitments to Canada in the following areas:

--trade in goods, including eliminating tariffs, applying U.S. trade remedy laws more favorably for Canada and exempting Canada from export controls on Alaska North Slope oil;

--trade in services, including offering a standstill on future derogations from national treatment for Canada in the transportation, telecommunications and financial services sectors;

--investment, including national treatment in some areas, a prohibition on preference requirements and granting Canadians in-state treatment;

--protection of intellectual property rights (IPR), including the possibility of excluding Canada from enforcement of Section 337 of the Trade Act of 1930 once national regimes for protecting IPR have been harmonized;

--cross-border movement of business personnel, including special treatment for Canada in the administration of the H (professionals, other occupations) visa category;

--government procurement, including expanded coverage for Canada.

Summaries of the group's analysis and conclusions in each area are attached.

Summary of Working Group Analysis

Trade in Goods:

We need not extend preferential treatment granted to Canada on goods to most of our trading partners because of exceptions for FTAs in our FCN treaties and in the GATT. However, we have non-standard FCN's with Saudi Arabia, Yemen, Liberia, Iraq, El Salvador, and Honduras, which contain MFN provisions but do not contain exceptions for FTAs. In addition, we have FCN's with Costa Rica and Bolivia which contain conditional MFN obligations without an FTA exception. Therefore, any special preferences we give Canada on trade in goods creates an international legal obligation to accord the first six countries similar treatment unconditionally and the last two if they offer equivalent concessions.

This same conclusion was reached during the negotiations for the U.S./Israel FTA. Nonetheless, a decision was taken at that time not to extend benefits granted to Israel to these countries. Only Saudi Arabia was consulted, primarily for political reasons, and apparently was satisfied since it has not protested. We also received no protests when we did not extend to some of the above countries benefits under the Caribbean Basin Initiative or the Generalized System of Preferences.

Since U.S. trade with Canada is much more extensive than with Israel, the working group felt we should assume that these countries might take a more serious look at the economic implications of any deal with Canada. To judge the potential compensation should these countries demand their MFN rights and not get them, the working group reviewed the recent history of our bilateral trade with these countries and compared the overlap between their exports and those goods that would receive duty-free treatment under an FTA with Canada.

Major exports from these countries are either not produced by Canada or already enter the U.S. duty-free under the Caribbean Basin Initiative or the Generalized System of Preferences. The only notable exception is petroleum, which the U.S. imports from Iraq and Saudi Arabia, and eventually perhaps from Yemen. We estimated that U.S. tariffs on imports of crude oil (at 10.5 cents/bbl) from Iraq and Saudi Arabia combined in 1987 will be about $25 million/year, primarily for imports from Saudi Arabia, but felt it unlikely that Saudi Arabia would press a claim for this.

The working group further noted that several of these countries are members of preferential arrangements, including CARICOM, the Andean Pact and the Gulf Cooperation Council. Thus they may well be in breach of their MFN obligations to us, a point we should explore more carefully in anticipation of any complaints by these countries.

The working group also considered the possibility of complaints should the U.S. agree to provide special treatment for Canada in the application of U.S. trade remedy laws (countervailing duties, anti-dumping, escape clause, 301 etc.), grant access to Alaska North Slope oil or reach special understandings on standards, quantitative restrictions and so on. In all these cases, it was generally felt that the FCN and GATT exceptions for FTAs provide sufficient grounds for more favorable treatment of Canada. This would not necessarily be the case with respect to the same eight countries discussed above. Nonetheless, it was felt that these countries would be unlikely to complain against more favorable treatment for Canada in this area.

In sum, the working group saw no need to alter our FTA stance on goods to reduce obligations to third countries on trade in goods created by the FTA.

Trade in Services:

Even though the FTA services chapter's approach is fundamentally the same as that in the FCN's and BIT's with other countries, the working group felt there were two potentially significant problem areas:

(1) There is a difference between the FTAs current formulation of the national treatment principle and that in the FCN's and the BIT's. The FTAs formulation of the principle would require a U.S. state to treat a Canadian like it treats one of its own residents, whereas the FCN's and BIT's allow states to treat foreigners like residents from the most-favored other U.S. states.

In most cases, we believe that any difference in such treatment is unlikely to give rise to complaints. It would be theoretically possible to avoid complaints completely by changing the national treatment definition in the FTA services chapter to conform with the FCN's and BIT's. However, this would be a substantive loss for us. Canada's federal system is considerably weaker than ours, and its provinces discriminate against each other in a number of areas.

(2) Some of the chapter's obligations may be extended to services sectors, i.e., maritime, aviation, communications, banking and exploitation of natural resources, typically excluded from the national treatment obligations of other treaties but not from their MFN obligations.

Given that the U.S. maintains important restrictions on foreigners' activities in some of these sectors, preferential treatment for Canada could create significant obligations and major claims for compensation. For this and other policy reasons, although the Canadians have proposed more sweeping changes the only

option under serious consideration in the FTA talks would be to exempt Canada from future U.S. discriminatory actions in the maritime, aviation and telecommunications sectors. Such a freeze on discrimination against Canada, arguably creates an immediate MFN obligation, but estimates of its value would be highly speculative until we actually took a discriminatory action against a treaty partner without taking one against Canada. Therefore, it is doubtful that there would be claims for compensation immediately upon entry into force of the agreement, and if there were, we might have case specific defenses in addition to arguing that the claim was premature. A "contingent liability" would have been created, however.

In the maritime sector, where future discrimination is a real possibility, DOT's representative estimated the potential future liability to third countries at $1.6 billion, but acknowledged this figure is highly speculative. Moreover, a portion of this liability may already exist since the standard FCN already prohibits additional restrictions on companies already engaged in the service sectors excepted from national treatment.

Investment:

We are not proposing any general liberalization of U.S. investment law vis-a-vis Canada, but are trying to bring Canada toward more liberal U.S. practices. However, we expect to pledge a freeze on future discrimination against Canada, seek a prohibition on performance requirements and grant Canada in-state treatment. A freeze could create unknown contingent liabilities analagous to those discussed in the services sector above.

Protection of Intellectual Property Rights:

In addition to other relatively non-controversial proposals, the U.S. has proposed we and Canada harmonize our IP protection and enforcement provisions. Further, after we agreed sufficient harmonization had occurred, the U.S. would (1) amend Sections 337 and 526 of the Trade Act of 1930 to provide exceptions for Canada, (2) amend Sections 102 (g) and 104 of the Patent Act to recognize inventive activity in Canada, and (3) exempt Canada from section 42 of the Trademark Act and customs regulations relating to copyright and trademark infringement. If intellectual property protection and enforcement provisions are successfully harmonized and the exemptions are granted to Canada we do not see any MFN problems with section 337. With regard to the other provisions, we could deny any MFN claims on the basis of the same arguments we have already advanced internationally to deny claims for national treatment. For political reasons, however, we may expect strenuous objections from the EC, Japan and others to these prospective amendments on behalf of Canada alone.

The Canadians are proposing that the U.S. grant additional and immediate preferential treatment, including access to licenses resulting from federally supported R&D. The U.S. is not contemplating such actions for a variety of reasons.

Cross-border Movement of Business Personnel:

To facilitate trade in services, the FTA will include provisions to improve access for Canadian business personnel. Most of the U.S. proposals do not go beyond treatment which has been or is in the process of being accorded to other countries. Thus it does not appear that the FTA will create MFN obligations. One possible exception is a proposal currently under consideration to provide more favorable procedures for the administration of the H visa category with respect to Canadians. However, Canadians already benefit from more liberal procedures in the administration of other U.S. visa categories, and this has never been challenged by our FCN partners. Moreover, visa practices of most other countries are based on reciprocity not MFN treatment and it is questionable whether the FCN MFN obligations on customs treatment for business travelers extend to visas. Thus the working group did not feel it necessary to reconsider the H visa option.

Government Procurement:

There is only a requirement for fair and equitable treatment on government procurement in our FCN treaties, but there is an MFN obligation to parties to the GATT procurement code. The current draft FTA chapter on government procurement is designed to apply only to areas which are outside of the coverage of the GATT code. Thus the FTAs treatment of government procurement does not appear to create any MFN obligations at all.

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