From Protectionism to Regionalism: Multinational Firms and Trade-Related Investment Measures

Kerry A. Chase*

*Tufts University, k.chase@tufts.edu

Copyright ©2004 by the authors. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher, bepress. Business and Politics is produced by The Berkeley Electronic Press (bepress). http://www.bepress.com/bap
From Protectionism to Regionalism: Multinational Firms and Trade-Related Investment Measures*

Kerry A. Chase

Abstract

Trade-related investment measures (TRIMs) have been a key issue in regional and multilateral trade negotiations, but they have received little attention in theoretical work to date. This article analyzes the political economy of TRIMs to illuminate why regional arrangements have been a popular framework for eliminating them. The main argument is that multinational firms often demand safeguards when TRIMs are being liberalized, particularly if they have large sunk costs due to asset specificity. In general, regional arrangements are better equipped than multilateral rules to incorporate the safeguards these firms demand: regionalism requires governments to make binding commitments, and it creates opportunities to discriminate against outsiders. A case study of lobbying by U.S. companies with FDI in Canada from the early twentieth century to the negotiation of the Canada-United States Free Trade Agreement illustrates these points. The article concludes that regional arrangements are likely to remain more active, and more successful, than multilateral discussions in managing the commitment problems inherent in liberalizing TRIMs.

KEYWORDS: Trade-related investment measures, foreign direct investment, regional trading arrangements, World Trade Organization

*The author would like to thank the editors of Business and Politics and two anonymous reviewers for their constructive comments.
1. Introduction

Multinational firms are the principal stimulus for international trade,¹ and foreign direct investment (FDI) has been a focal point of multilateral and regional trade negotiations. Yet FDI is “now relatively neglected” in theoretical work in international political economy.² The dominant approaches to the political economy of trade remain rooted in the study of tariffs and other border barriers, even though national industrial policies and regulatory regimes have become significant issues for multinational actors.

Trade-related investment measures (TRIMs) specifically have not received the analytical attention they deserve. Curbs on TRIMs were a central feature of the North American Free Trade Agreement (NAFTA) and the Mercosur protocols, and TRIMs also have been discussed in the WTO and the Organization for Economic Cooperation and Development (OECD). It is therefore important to understand the political economy of TRIMs, the interests at stake when they are employed, and the motives for regional and multilateral agreements to regulate their use.

This article examines the political behavior of multinational companies in the presence of TRIMs. Asset specificity, sunk costs, and barriers to entry are the key factors in my analytical framework. In general, TRIMs create concentrated costs and benefits for foreign investors, which earn rents by committing themselves to production strategies designed to satisfy regulations rather than maximize efficiency. As a result, foreign-owned firms develop vested interests in the regulatory regime in place at the time fixed investments are sunk.

Building from these principles, the article shows that even when eliminating TRIMs would improve productivity in the long run, foreign-owned firms committed to a preexisting regulatory regime often will discourage liberalization until protections for established companies are in place. Because multinationals generally are reluctant to reorganize without assurances that sinking capital into new production structures will be profitable, they have incentives to seek credible commitments to the policy regime, entry barriers to compensate for the costs sunk to comply with outmoded regulations, and transitional protection while restructuring takes place. In practice, more localized bilateral and regional treaties are better equipped than multilateral agreements to provide the assurances that foreign investors desire. Thus, multinational firms often seek regional arrangements to ensure that regulatory liberalization is durable, gradually implemented, and biased to favor incumbent investors.

The article illustrates these points in a case study of trade lobbying by U.S.

---

1. The world’s 500 largest companies are responsible for 70 percent of all trade. About one-third of world trade is intra-firm; multinationals trading with unaffiliated firms account for another third. World Trade Organization (WTO) website, [http://www.gatt.org/trastat_e.html](http://www.gatt.org/trastat_e.html).
firms with FDI in Canada. This lobbying culminated with the negotiation of the Canada-United States Free Trade Agreement (CUSFTA) in 1987. Because the CUSFTA treaty eliminated most TRIMs, it is an important case of bilateral FDI liberalization. But to date an explanation of the treaty’s trade and investment provisions has not been attempted. Moreover, this is an interesting case because in the first half of the twentieth century U.S. multinationals in Canada strongly opposed trade liberalization. The analysis shows that these firms pushed for a comprehensive arrangement to regulate bilateral trade and FDI only after the rents they could earn by satisfying TRIMs declined substantially. The case suggests that foreign investors often are not powerful agents for liberalization, and when they are, they tend to prefer to phase-out TRIMs and related trade barriers on a bilateral or regional rather than multilateral basis.

The first section of the article reviews explanations of regional arrangements as institutional devices to manage externalities and spillovers or signal commitment when state incentives are time-incompatible. The section that follows describes TRIMs and discusses their significance as a policy issue. The third section presents an analytical approach to corporate preferences when there are TRIMs. The fourth section applies this framework to explain the shift from protectionism to regionalism by U.S. multinationals in Canada. The final section draws general implications for regional and multilateral efforts to liberalize FDI.

2. Transaction costs, commitment, and regional arrangements
What market activities motivate states to form regional trading arrangements? One set of answers explains regional arrangements as supranational regimes to manage economic interdependence. In regional integration theory, a threshold level of market integration produces “functional spillover,” which generates political pressure for institutions and rules to manage these economic interactions. In liberal institutional and regime theories, growing transborder flows of goods, services, and capital have external effects as one state’s policy actions impose costs on nearby countries. Policy coordination and regulatory harmonization internalize these negative externalities by allowing each country some control over the behavior of others. In this context, regional arrangements provide an institutional mechanism to minimize transaction costs among countries with recurrent and complex economic interactions. Limiting negotiations to a few participants and easing contractual monitoring and enforcement in turn facilitate trade liberalization in a region.

In these accounts, economic interdependence broadly operates as a sufficient

condition to motivate the formation of supranational institutional regimes. Yarbrough and Yarbrough (1992) propose that a distinct form of interdependence, investment in “dedicated assets,” requires regional arrangements to manage cross-border trade.\footnote{They distinguish three types of “relation-specific investment.” The first is “site-specificity,” such as a gas pipeline that transports energy supplies from one country to another. The second is “specialized vertical production linkages,” for example when a company manufactures intermediate parts in different countries and transports these components across borders for final assembly. The third is “dedicated export capacity,” when one country expands domestic production capacity to service specific foreign markets. In their argument, “dedicated assets” are particularly susceptible to opportunism and most in need of special safeguards. Yarbrough and Yarbrough (1992), pp. 25-29.} Fixed investments in dedicated assets, they argue, are susceptible to opportunism due to the holdup problem: governments can capture rents from private actors by threatening to restrict cross-border trade, because dedicated assets are less valuable in their next-best use. Thus, recurrent transactions involving dedicated assets require formal mechanisms to safeguard against this risk. Regional arrangements provide a governance structure to sustain mutually beneficial cooperation when it is otherwise difficult for governments to credibly commit to trade liberalization.

In a similar vein, there is now a large economic literature on how regional and bilateral trade agreements anchor investor expectations by providing a credible signal that policy reforms are irreversible.\footnote{Staiger and Tabellini (1987); Rodrik (1989); Tornell (1991); De Melo, Panagariya and Rodrik (1993); Maggi and Rodriguez-Clare (1998); Hefeker and Gros (2000).} Because commitment to a regional arrangement raises the reputational costs of policy reversal, this signal effectively communicates to private actors that existing policies are “locked in.” It also can help to insulate policymakers from protectionist domestic lobbies, which may attract foreign investment or encourage domestic firms to reallocate resources more efficiently. For example, the Salinas administration’s decision to negotiate the NAFTA treaty is often explained as a domestic commitment technology.\footnote{Tornell and Esquivel (1997); Whalley (1998), pp. 71-72.}

Arguments that emphasize market failure, transaction costs, and contracting in the formation of regional arrangements are appealing analytically, but weakly substantiated empirically. First, while economic interdependence and functional spillover may be necessary triggers for regional integration, they are not sufficient. As this article will show, extensive investment and trade ties between Canada and the United States did not lead to institution building or policy harmonization until the late-1980s. Interest in regional institutions also has lagged behind the development of cross-border production linkages in East Asia.\footnote{Bernard and Ravenhill (1995); Kahler (2000).} Even in the European Community, the path to deeper integration was not the self-
sustaining, incrementally linear process depicted in functional theories.\textsuperscript{11}

Second, credible commitment does not appear to be necessary for private actors to sink capital in dedicated assets or engage in FDI. A high risk of \textit{ex post} opportunism should deter rational, forward-looking actors from investing in dedicated assets \textit{ex ante}. Given the holdup problem, it is not clear why private actors would make dedicated investments first and seek governance structures later. Yet the more plausible suggestion that governments must pre-commit to policy reform to attract investment finds little empirical support. In Mexico— the paragon of the commitment technology— the accumulated FDI stock quadrupled in 1980-90,\textsuperscript{12} even though NAFTA negotiations did not begin until 1991; reform without an institutional device to ensure its durability apparently was enough to reassure foreign private actors.\textsuperscript{13} In short, the causal sequence is puzzling: a credible mechanism to prevent policy reversal is not necessary to attract FDI; the absence of a governance structure to restrict opportunism is not sufficient to deter it.

Taking into account the effects on foreign investors of “inside the border” TRIMs challenges the assumption that credible commitments are required before substantial costs and investments are risked. The research in this article indicates that this simply is not the case. Rather, once large costs have been sunk, foreign investors often become involved in working with the host countries to secure protection before cross-border trade is liberalized. In practice, this has even led multinational companies to discourage free trade agreements until safeguards are in place for already established investors. As the remainder of the article demonstrates, consideration of TRIMs in the political economy of institutional regimes significantly modifies existing theories about the desire for contracts and credible commitments in foreign investment.

3. What are TRIMs?
TRIMs are not tariffs; rather, they are contracts (explicit or implicit) between a foreign-owned firm and its host government. As such, TRIMs are usually more targeted in their application and more concentrated in their distributional effects than tariffs and other border measures. Moreover, TRIMs structure the investment decisions of multinational companies in ways that have second-stage effects on production-related trade flows. As a result, the interaction of TRIMs with traditional border measures is critical to the policy preferences and lobbying

\textsuperscript{12} Hufbauer and Schott (1992), p. 73.
\textsuperscript{13} Mexico began to reform and open its economy in 1983, and it joined the GATT in 1986. However, credibility and signaling models generally suggest that regional commitments are more binding— hence more credible— than multilateral commitments. Thus, the reforms adopted in the 1980s were not “locked in” until the NAFTA treaty’s implementation in 1994.
behavior of foreign-owned firms.

TRIMs are a broad class of investment incentives and disincentives with no common definition. The WTO TRIMs Agreement singles out local content rules, trade-balancing requirements, foreign exchange-balancing requirements, and export limitations as measures with “trade restrictive and distorting effects.” Member countries also have identified at least ten other measures that constitute TRIMs. Table 1 presents an illustrative list of TRIMs classified according to whether they primarily target an enterprise’s local production and trade or its capital structure and management.

<table>
<thead>
<tr>
<th>Type of TRIM</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local production and trade</td>
<td></td>
</tr>
<tr>
<td>Local content requirements</td>
<td>Require foreign investors to use a specified percentage of local inputs in production.</td>
</tr>
<tr>
<td>Trade-balancing requirements</td>
<td>Limit foreign investors’ imports to a certain percentage of their export revenues.</td>
</tr>
<tr>
<td>Foreign exchange restrictions</td>
<td>Restrict foreign investors’ access to foreign exchange for the purchase imports.</td>
</tr>
<tr>
<td>Import-substitution requirements</td>
<td>Require foreign investors to manufacture certain products or perform certain processes in the host market.</td>
</tr>
<tr>
<td>Export performance requirements</td>
<td>Require foreign investors to export a specified percentage of their output.</td>
</tr>
<tr>
<td>Domestic sales restrictions</td>
<td>Limit foreign investors’ host market sales to a specified percentage of their exports.</td>
</tr>
<tr>
<td>Capital structure and management</td>
<td></td>
</tr>
<tr>
<td>Local equity requirements</td>
<td>Require that host country nationals hold a specified equity stake in foreign-owned firms.</td>
</tr>
<tr>
<td>Technology transfer requirements</td>
<td>Require foreign investors to transfer or license certain technologies to host country firms.</td>
</tr>
<tr>
<td>R&amp;D requirements</td>
<td>Require foreign investors to perform certain R&amp;D operations in the host market.</td>
</tr>
<tr>
<td>Hiring and employment rules</td>
<td>Require foreign investors to hire host country nationals for certain employment positions.</td>
</tr>
<tr>
<td>Remittance restrictions</td>
<td>Limit foreign investors’ ability to repatriate funds or profits earned in the host market.</td>
</tr>
</tbody>
</table>

To be sure, TRIMs are an understudied policy domain. Industrial and

15. While this list covers the most familiar TRIMs, it is by no means exhaustive. For other illustrative lists, see UNCTAD (1991), pp. 11-12; Guisinger (1986), pp. 82-83; Greenaway (1992), p. 141.
regulatory policies toward FDI, though persistent issues for years, have not received analytical attention commensurate with their practical importance. When TRIMs emerged on the Uruguay Round agenda, Guisinger noted, “our level of ignorance of investment incentives and performance requirements is unacceptably high.” Though there have been several legal and policy-oriented studies of late, there are few formal models of TRIMs and their effects. TRIMs also have not been introduced into the political economy of trade, which exclusively focuses on trade barriers at national borders.

Many TRIMs are confidential undertakings negotiated between foreign investors and host governments on a case-by-case basis; frequently arrangements between foreign investors and host governments are neither published nor publicly known. Some are required for a firm to secure an advantage, such as subsidies or tax breaks; others must be satisfied to avoid penalties, such as taxes, import tariffs, denial of foreign exchange, or fines. Specific measures vary from numerical targets that are easily monitored to more general goals that a company must attempt in good faith to satisfy as circumstances permit. Certain TRIMs, such as local content rules, depress international trade; others, notably export performance requirements, promote it; still others, such as mandates to transfer technology or conduct research and development (R&D) locally, may not discernibly affect trade. TRIMs therefore defy simple classification.

By themselves, TRIMs are disincentives for local production, but typically they “interact with other interventions” to manipulate the stream of rents available to foreign investors. One study details Thai government practices to illustrate this dynamic:

The Board of Investment of Thailand… negotiates a package of incentives with foreign investors that includes (i) protection from competing imports through tariffs and quantitative restrictions, (ii) tariff concessions on intermediate imports and (iii) tax holidays… as well as other fiscal incentives. The Board can, and indeed does, substitute freely within its menu of policy options to achieve the appropriate after-tax rate of return with the foreign investor.

Thus, host governments offer inducements in the form of trade barriers, subsidies, tax breaks, loan guarantees, and other rewards to compensate foreign investors for

17. Graham and Krugman (1990); Greenaway (1992); Maskus and Eby (1993); Mutti (1994); Low and Subramanian (1996); Low (1997); Moran (2000).
19. Guisinger (1986), p. 86, notes, “investors usually wish to avoid alerting competitors or the public to any special treatment which they receive, [so they] are likely to prefer an opaque jumble of incentives and disincentives to transparent forms of public subsidy.”
the costs of complying with performance requirements.

The incidence of TRIMs falls heavily on a few industries, notably automotive products, chemicals, and electrical and electronic equipment. TRIMs follow the general distribution of FDI, with its bias toward automotive products, computers and information technology equipment, chemicals and petrochemicals, and processed foods. In short, TRIMs are widespread, though today they are more prevalent in the developing world. While the measures employed vary across host countries and time, existing data supports the presumption that TRIMs have significantly impacted the activities of foreign-owned firms. The next section examines the nature of this impact more precisely.

4. Multinational firms and TRIMs: an analytical framework
The analytical framework proceeds in three steps. The first step explains how host country policies shape multinational corporate strategies. The second step addresses corporate trade preferences once foreign investors have sunk capital in host country production. The third step examines the process through which foreign-owned firms update their trade preferences when host country trading conditions change.

Multinational production strategies
Multinational firms follow ‘bifurcated’ production strategies based in one of two organizational forms.\(^{22}\) In one form, foreign affiliates are closely linked to the corporate parent as part of a global or regional supply chain. Because these integrated production networks produce large amounts of intra-firm trade, they encourage anti-protectionist corporate preferences.\(^{23}\) In the second method, foreign affiliates operate as self-contained units that produce and sell in discrete host markets. These ‘cash cows’ are disconnected from the corporate parent and detached from the global supply network. In this case, foreign-owned firms have few incentives to favor open trade.

These alternative structures tend to arise in very different investment climates. Integrated production strategies depend on having few impediments to trade across the borders that connect a firm’s investments. Local content rules, trade-balancing formulas, and other import limitations inhibit the development of vertical supply chains and production for markets abroad. Because proprietary technology must be shared with foreign affiliates specialized in the products or processes that employ these assets, integrated production also is more prevalent when host countries do not limit foreign equity shares or mandate technology transfer to local entrepreneurs. Multinationals therefore tend to develop offshore procurement networks in open economies and export processing zones where

---

TRIMs are not present and other barriers to trade are low.

Detached production strategies, on the other hand, are a response to restrictive trading conditions. When host governments use FDI to promote import substitution, they often employ TRIMs to force foreign-owned firms to limit imports, develop domestic sources of supply, and increase local content. Because prospective foreign investors cannot integrate foreign affiliates into global or regional supply chains, they will begin local production only if there are sufficient incentives to compensate for the costs of complying with these measures. As a result, import-limiting TRIMs typically coincide with substantial trade protection. Under these circumstances, foreign affiliates function as autonomous units disconnected from the multinational corporate network—they are tariff-jumping investments in export markets that are too important to give up when foreign governments block trade.

Simply stated, multinational companies orient production and trade around the incentives and disincentives in host country policy: free markets promote specialization for trade, while the proffering of rents attracts rent-seekers. This discussion leads to my first hypothesis, which is that host country trading conditions when FDI is made shape multinational corporate strategies. Investments in open markets with no TRIMs tend to be integrated into global or regional production networks, with high levels of intra-firm trade; investments subject to TRIMs tend to minimize trading linkages across borders, particularly when there is significant trade protection.

**Corporate trade preferences**

The key principle in the trade preferences of foreign-owned firms is asset specificity. All FDI involves some degree of asset specificity. In theoretical work on the motives for firms to produce outside their home country, a multinational company is simply an institutional structure to facilitate the transfer of firm-specific assets across borders. Such assets include brand names, distribution networks, managerial capabilities, and knowledge, skills, and equipment proprietary to the company. At the limit, foreign affiliates might specialize in products or services for which no external market exists.

All else equal, asset specificity increases with the costs sunk in host market production in terms of capital requirements for plant and equipment, and information, search, and negotiation costs. Once sunk, these costs are largely non-salvageable. Foreign affiliates normally cannot be sold without substantial loss of value, so FDI is illiquid—it represents a lasting stake in the host market. As a

---

24. Moran (1998), pp. 41-42, reports effective rates of protection ranging from 50 percent to more than 600 percent in industries with local content rules.
25. On asset specificity generally, see Williamson (1985), pp. 52-56.
result, asset specificity determines the extent to which foreign-owned firms are locked in to a production structure. Studies find that foreign investors tend to stick to prearranged strategies “even as information gaps are filled, even as new hosts distinguish themselves as cost-effective production sites, even as competitive pressures to alter old production patterns mount, and even as indications that change would be in the firms’ own long-term self-interests become apparent.” When capital has been sunk, foreign-owned firms are committed to specific production arrangements, and they have vested interests in the preservation of the status quo trading environment that facilitated the initial investment.

Because of asset specificity, it is straightforward that foreign-owned firms will oppose new TRIMs or trade barriers when they have been integrated into global or regional supply chains. Adjusting to policies that disrupt the flow of specialized inputs across borders requires a company to externalize the market (that is, share proprietary technology and information with local suppliers, which raises the risk of opportunism and market failure) or interrupt the production process altogether. Both options are costly. Thus, foreign-owned firms involved in production sharing strongly favor the maintenance of open trade.

The implications are different when foreign investors are subject to TRIMs. For one, measures binding foreign investors to specific production and trading strategies force multinational companies to distribute resources in ways that differ from their preferred profit-maximizing allocation. Though the costs may be spread across the multinational corporate network, in practice the regulated affiliates bear the greatest burden. TRIMs thereby impose burdens on foreign investors to accomplish national objectives that host governments have deemed socially preferable. In the process, they shift rents from foreign locations to the host market, and potentially from multinational companies to domestic firms.

Analysts have identified numerous sources of inefficiency when foreign-owned firms must satisfy TRIMs. Most important, large economies of scale typically are left unexploited. Particularly when there is pressure for import substitution through local content rules, foreign-owned firms tend to operate small plants with too many product lines. They also are inclined to use older technologies and delay the introduction of new products and processes. Finally, foreign-owned firms often must buy “overpriced locally produced inputs” or sell “unprofitable exports” to comply with host country mandates. In theory, removing these requirements would allow foreign-owned firms to produce more efficiently and enhance competitiveness.

In practice, however, foreign investors have incentives to seek to preserve the status quo regulatory and trading environment. Normally they earn substantial rents, despite high unit costs, due to trade protection. Though trade barriers block foreign affiliates from integrating into the parent firm’s supply chain, they also shelter “the operation’s inefficiencies from the discipline of international competition.” Moreover, foreign-owned firms are locked into an uncompetitive production structure due to specific assets. In this case, specificity inheres not only in the proprietary assets the multinational company transfers to its foreign affiliates, but also in the costs sunk to comply with host country regulations. The investments that foreign-owned firms make to satisfy TRIMs create entry barriers for prospective investors, which must likewise fulfill local content minimums, export rules, or other performance criteria in return for the right to invest. These entry barriers generate rents for established firms—but so too they make it more difficult for incumbents to adapt to a loss of protection, or to exit production altogether.

These premises are the basis for my second hypothesis: even when eliminating TRIMs would improve productivity in the long run, foreign investors with regulation-specific investments are likely to exhibit a status quo bias. In particular, foreign-owned firms with large unexploited scale economies and high local content will be more inclined to oppose relaxing TRIMs or reducing trade barriers. At the limit, foreign-owned firms have incentives to lobby to implement new TRIMs or tighten existing ones to augment barriers against potential new entrants.

Response to change

In the political economy of trade, asset specificity enables producers to capture rents that accrue to their economic activity. This creates motives for producers with specific assets to seek sector-specific policies; the more specific the assets to their current use, the larger the rents and the stronger these incentives. But because producers dependent on sector-specific policies are locked in, they are vulnerable to being held up. In the economics of industrial organization, internalizing arm’s-length exchanges limits the risks of market opportunism, as firms can integrate with their suppliers to reduce contractual monitoring and enforcement costs. Preventing policy opportunism is not so easy, however. Thus, TRIMs are a mixed blessing: on the one hand, they create rents for foreign investors that have fulfilled host government directives; on the other hand, they

33. The status quo bias is stronger the more that TRIMs lead to inefficient scale and low productivity. Not all TRIMs necessarily have these effects, and the motives described here will be weaker if TRIMs have had little influence over sunk investments.
raise contractual issues when foreign-owned firms have structured investments around the expectation that past practices will continue.

In effect, TRIMs are part of an implicit contract in which a foreign-owned firm’s interaction with its host government resembles a regulated utility’s relationship with a government agency. Whether the parties are utilities and regulatory agencies or foreign investors and host governments, specific assets heighten contractual complexity due to the potential for opportunism. In the case of utility regulation, administrative contracts tend to be “vague or silent on a number of issues” because it is difficult to enumerate precise terms when firms enter the market. Instead of formal documents that outline the obligations of agencies and firms, regulations are collections of agreements, rules, hearings, precedents, and proposals, with “both express and implied provisions.” As a result, firms risk being held up through unfavorable administrative actions.

TRIMs create a similar problem. A host government retains the sovereign right to change its regulatory practices, so there is nothing to prevent it from reneging on past promises. Foreign investors therefore face uncertainty about future trade and industrial policies. As long as they are locked in to regulatory compliance, their interests are fixed. But changes in investment and trading conditions can undercut the viability of established arrangements, forcing foreign-owned firms to undertake costly adjustments.

For example, suppose a host government relaxes trade barriers or eliminates TRIMs. This action dissolves the regulatory rents available to incumbent firms, which confronts foreign investors with a choice: reorganize or divest. Because the value of plant and equipment cannot be recovered if production is terminated, multinational firms may benefit from integrating self-contained foreign affiliates into global or regional supply chains. However, there is an appropriability problem: foreign investors do not know if restructuring will generate a return sufficient to justify the additional cost. In the face of such uncertainty, there are incentives to delay restructuring and milk whatever profits can be gained from existing investments.

A central thesis of this article is that foreign investors facing a loss of

35. In the regulatory setting, public officials manage the rate structure of utility providers and establish service obligations to prevent market failures that would harm consumers. In return, the utilities receive regulated entry barriers (such as exclusive or protected franchise rights) to guarantee fair returns on their assets. This bargain protects the interests of both the utilities and the regulatory agency (acting on behalf of the public) in the presence of specific assets, imperfect markets, and contractual complexity. See Sidak and Spulber (1997). Similarly, foreign investors gain opportunities to capture rents to their specific assets through entry barriers against prospective investors (in essence, protected franchise rights) as long as they meet performance requirements.
regulatory rents will seek to channel liberalization into regional and bilateral trade agreements. For multinational companies, regional and bilateral arrangements are superior to unilateral actions on the part of the host government and multilateral undertakings in international institutions for three reasons: they provide a commitment technology; they allow for transitional protection; and they make it possible to impose entry restrictions. The following discussion addresses each of these considerations in turn.

**Credible Commitments.** Integrating foreign affiliates into a vertical supply network requires foreign investors to sink capital into new production structures. Foreign investors tend to be reluctant to make “irreversible decisions under uncertainty,” so they are inclined to stick with existing strategies after the conditions that motivated them have changed.\(^{38}\) To undertake new investments, firms prefer “binding legal commitments” to ensure that rules and policies will not be opportunistically changed *ex post.*\(^{39}\) Particularly when a host government has reneged on an implicit contract to provide TRIMs with trade protection, unilateral commitments simply are not credible enough for multinational companies to undertake expensive long-term investments to rationalize and streamline foreign affiliates.

As a result, foreign investors are likely to seek an external institutional device to limit the scope for administrative discretion and prevent future policy reversals. In this context, regional arrangements offer assurances of policy durability and fair treatment. In a multilateral setting, by comparison, national positions are diverse, identifying and punishing defectors is more difficult, and the reputational costs of backsliding are lower. In the WTO, for instance, dispute settlement is cumbersome and uncertain, and FDI codes are “a ‘patchwork’ marked by gaps, overlaps and inconsistencies.”\(^{40}\) Since the issues are quite specific and the economic spillover is limited to host and home countries, foreign investors incur few opportunity costs from the failure to establish multilateral investment rules. Rather, they will tend to prefer regional and bilateral arrangements as institutional mechanisms to lock in policy commitments.

**Transitional Protection and Entry Restrictions.** Because TRIMs bind foreign investors to production strategies that are not viable in a free market, foreign-owned firms have a vested interest in the status quo policy regime once they have paid the costs of regulatory compliance. It follows that a lowering of entry barriers or liberalization of trade benefits outsiders and prospective foreign investors at the expense of incumbent firms: reducing trade barriers allows

---

imports to more easily penetrate the host market; eliminating TRIMs enables new entrants to produce free of regulatory constraints.\textsuperscript{41} The problem for foreign investors is that affiliates oriented to protected host markets cannot be abruptly integrated into global or regional sourcing networks.\textsuperscript{42} This leaves foreign-owned firms vulnerable to external competition while affiliates are being restructured.

Foreign-owned firms will be more exposed the larger the returns to scale in production. TRIMs and trade barriers thwart efforts to concentrate production because they force firms to operate plants in the market of final sale. When these measures are phased out, multinational companies are left with geographically dispersed factories that are functionally separated from one another and scaled for national rather than regional markets. Because manufacturing must be integrated regionally, functions specialized by location, and production concentrated, incumbents face heavy short-term restructuring expenses. To compensate for this vulnerability, foreign-owned firms are likely to seek transitional protection against imports and new entrants while they adjust their operations to a new regulatory climate.

It is easier to establish these sorts of safeguards in regional and bilateral trade agreements. On the one hand, regional trade liberalization opens up opportunities for intra-firm trade previously denied. This allows multinational companies to freely trade intermediate goods with foreign affiliates, which facilitates the development of regional supply chains as plants located in different countries specialize in discrete inputs.\textsuperscript{43} On the other hand, barriers against imports from outside the region remain in place. Moreover, staging periods for tariff elimination make it possible for foreign affiliates to gain increased access to the home market even as they remain protected in the host market. Multinational companies seeking to reorient unproductive foreign affiliates therefore are likely to favor regional arrangements over multilateral trade liberalization.

Foreign-owned firms also have motives to seek new entry restrictions while they are reorganizing their operations. When FDI has fragmented manufacturing

\textsuperscript{41} In the case of regulated utilities, this is known as a “deregulatory taking.” In brief, deregulation can reduce or destroy the value of existing investments because new entrants do not have to pay the fixed costs that incumbents already have incurred. As a result, they may be able to implement more efficient production methods or otherwise exploit the inability of incumbents to reorient specialized investments to the competitive environment after deregulation. Sidak and Spulber (1997), pp. 25-26.

\textsuperscript{42} There are three reasons for this. First, these affiliates tend to use outmoded technologies--for instance they may employ manual welding (for autos) or hand soldering (for electronic equipment) rather than automated production lines. Second, generally they are smaller in size, and it is difficult to expand “boutique plants” into world-scale factories. Third, substantial re-tooling and new plant and equipment often are needed to reorient affiliates to produce intermediate components in place of finished goods. Moran (1998), pp. 44-45.

\textsuperscript{43} This may not be possible for firms that do not already have other plants in the region; such firms may prefer continued national protection to regionalism.
in a region, it is difficult for established firms to concentrate production if new entrants can gain market shares. In industries with large returns to scale, entry pushes producers up their cost curves and inhibits cost reduction. Moreover, incumbents are at a disadvantage if competitors can build state-of-the-art factories. In this case, restrictions on inward FDI allow incumbents to capture a larger share of the gains from liberalization. Absent policy guarantees that new entrants will not be able to share in these benefits, foreign-owned firms are not likely to undertake costly investments to reorganize their operations.

Regional arrangements restrict foreign entry through rules of origin. Like TRIMs, origin rules are discriminatory: they target firms that produce a significant share of final value outside the region—usually (though not necessarily) foreign multinationals. Origin rules are attractive to finished goods producers because they deny trade privileges for foreign competitors that have not achieved minimum content levels. Forcing outsiders to pay an entry fee (that is, to source higher-cost local inputs) channels rents to incumbent firms that already have met these criteria. Excludability in turn limits free riding, so the potential for entry barriers against outsiders makes it easier to mobilize lobbying efforts to liberalize trade and FDI regionally. Multilateral trade agreements cannot impose entry requirements on outsiders because they conflict with WTO rules requiring most-favored nation (MFN) and national treatment.

To sum up, regulatory and trade liberalization are forms of hold-up for foreign investors that have been subject to TRIMs. Because of specific assets and sunk costs, foreign-owned firms cannot abruptly transition from protected markets and regulated entry to open markets and free entry. Policy change raises two concerns: the risk of policy reversals, and the likelihood of increased competition from outsiders and new entrants. A dissipation of regulatory rents therefore creates incentives for foreign-owned firms to seek formal arrangements to lock in policy commitments, provide transitional protection, and impose entry restrictions. Foreign-owned firms facing the most costly adjustments—those with large unexploited scale economies and high local content— are likely to exert the most pressure for assurances as they reorient operations to the new policy climate. However, neither multilateral agreements nor unilateral host government actions can provide sufficient safeguards for foreign investors to sink capital into new production structures. As a result, my third hypothesis is that foreign-owned firms will tend to lobby for bilateral or regional agreements when trade protection and TRIMs are being phased out.

5. From protectionism to regionalism: U.S. multinationals in Canada
The analytical framework has three observable implications. First, foreign

44. Horstman and Markusen (1986).
investors will accept TRIMs provided that affiliates can earn rents by complying with regulatory rules. Second, foreign-owned firms will resist policy liberalization as long as the TRIMs-for-rents bargain remains in place. Third, if the stream of rents declines, foreign investors will seek formal arrangements to lock in policy commitments, establish transitional protection, and create barriers against new entrants. In general, foreign-owned firms will be more insistent about assurances and safeguards the greater the investment they have sunk, the larger the scale economies that remain unexploited, and the higher their local content.

The behavior of multinational companies in North America,45 Mercosur,46 and the Association of Southeast Asian Nations (ASEAN)47 displays elements of this dynamic. The analysis here examines U.S. multinationals with investments in Canada. This is a good case study for several reasons. First, it illustrates that extensive bilateral trade and FDI per se are not significant motives for regional trade agreements. U.S. FDI in Canada dates to the late-nineteenth century, but it was not until changes in Canadian policies after 1960 that U.S. firms began to push for formal arrangements. Second, the provisions relating to FDI in the CUSFTA treaty and the Automotive Products Trade Agreement (APTA) were unprecedented at the time they were negotiated. Indeed, the Canada-U.S. example provides a model for how TRIMs have been phased out more recently (in NAFTA) and how they are likely to be dealt with in the future. Third, historical materials and papers at the U.S. National Archives demonstrate that U.S. firms in Canada changed their trade preferences from protectionism up to 1960 to regionalism in the years that followed. Most of the evidence of lobbying activity is firsthand, and the association between corporate trade preferences and regional policy regimes is unmistakable.

In the pre-1950 period, U.S. multinationals established branch plants behind Canadian tariff walls, often subject to local content rules and other TRIMs. For many years, this was a stable arrangement in which neither side required a formal governance structure. In fact, U.S. multinationals resisted market integration between the United States and Canada because the branch plants earned substantial rents. In the 1960s, however, the Canadian government began to reduce trade protection for the branch plants and encourage entry by multinationals from Europe and Japan. The loss of regulatory rents caused U.S. multinationals to seek bilateral agreements to help them integrate their Canadian operations into U.S.-based supply networks. The CUSFTA treaty reflected these pressures, as it committed Canada to liberalize TRIMs, established rules for the treatment of FDI, and created a system for settling disputes. U.S. multinationals strongly approved of this arrangement due to provisions that discriminated against

45. Chase (2003), pp. 165-68.
47. See Noble (2001); Yoshimatsu (2002).
outsiders and new entrants through the inclusion of transitional protection and rules of origin.

Courting investment: the branch plant movement in Canada

The incentives for U.S. FDI in Canada were simple: high tariffs made exporting difficult and local production attractive. Under Canada’s National Policy, automobiles and farm machinery, two important U.S. exports, paid 35 percent duties, and engines and parts were taxed at 30 percent. In response, U.S. automakers set up assembly plants in Windsor, just across Lake Ontario from Dearborn, Michigan, the hub of automobile production in the United States. Producers of tires, tractors, farm implements, machinery, and electrical equipment soon followed.

While the branch plants enjoyed generous trade protection, they also experienced pressure to increase local content. For example, Canada increased tariffs on automobile parts in 1926 to force U.S. affiliates to produce components locally or develop linkages with domestic suppliers. When foreign investors complained that taxing parts at higher rates than finished vehicles encouraged imports at the expense of domestic production, the Canadian government introduced tariff rebates on imported parts for branch plants with 50 percent local content; foreign components used in exported vehicles received a full duty drawback. Firms equipped to meet this target—notably, Ford—lobbied for and embraced the new rules, which raised entry barriers for competitors. In fact, several branch plants supported strict rules of origin for imperial preference on exports to the British Commonwealth. In contrast, those with “primitive assembly operations” sought to delay or block local content mandates.

Inside the small Canadian market, branch plants generally manufactured broad product lines in low volumes. Under pressure from tariffs and TRIMs, two-thirds of U.S. affiliates surpassed 75 percent Canadian content in 1932. Due to “the loss from reduced scale of operations, the lower efficiency of labor, and the duplication of plant and management,” productivity was low: two out of every three U.S. affiliates in Canada reported higher unit costs than their corporate parents. But FDI nevertheless was profitable because tariff walls and entry restrictions allowed branch plants to pass off elevated costs to Canadian customers by marking up prices 30-40 percent.

---

This arrangement was stable as long as Canada did not cut tariffs after branch plants were locked in to increased production and local content. Table 2 shows the industries with the largest fixed investments—in essence, those with the greatest sunk costs, and hence the strongest motives to defend the status quo. Several U.S. firms in these industries attained leading positions in the Canadian Manufacturers Association and joined together to defend trade protection before the Canadian Tariff Board.\footnote{55 Marshall et al. (1936), pp. 275-76; Scheinberg (1973), pp. 229-32.} Ford opposed proposals to reduce automobile tariffs, arguing that “the present margin of protection should be continued” since the industry was “still in the formative stage.”\footnote{56 Wilkins and Hill (1964), pp. 131-32.} International Harvester and Deere, the leading producers of farm machinery, also turned protectionist once they had factories inside Canada’s tariff wall.\footnote{57 Radosh (1967), pp. 48-50; Wolman (1992), pp. 91-92.}

<table>
<thead>
<tr>
<th>Industry</th>
<th>Fixed investment per plant</th>
<th>Number of plants</th>
<th>Percentage of U.S. FDI in Canada</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automobiles</td>
<td>9.35</td>
<td>6</td>
<td>10.4</td>
</tr>
<tr>
<td>Rubber products</td>
<td>5.94</td>
<td>8</td>
<td>8.8</td>
</tr>
<tr>
<td>Electrical equipment</td>
<td>2.54</td>
<td>22</td>
<td>10.3</td>
</tr>
<tr>
<td>Iron and steel</td>
<td>2.35</td>
<td>13</td>
<td>5.7</td>
</tr>
<tr>
<td>Cereal products</td>
<td>1.84</td>
<td>12</td>
<td>4.1</td>
</tr>
<tr>
<td>Industrial and farm machinery</td>
<td>1.31</td>
<td>46</td>
<td>11.2</td>
</tr>
<tr>
<td>All other industries</td>
<td>0.64</td>
<td>417</td>
<td>49.6</td>
</tr>
</tbody>
</table>

Note: Fixed investment per plant measured in million U.S. dollars.

In the United States, these firms fought plans to liberalize bilateral trade—even as they pushed for reciprocal trade treaties with European countries and the British Empire (other than Canada). The U.S. Tariff Commission reported, “American manufacturers with branch establishments in Canada were opposed to reciprocity because it promised to open the Canadian market to other American products in competing lines.”\footnote{58 U.S. Tariff Commission (1920), p. 76.} The Commerce Department advised against trade talks with Canada because, officials argued, “American capital invested in Canadian industries is due to the Canadian protective tariff policy” and “free trade... would naturally detract from the value of the investment.”\footnote{59 Scheinberg (1973), p. 233.} When the Roosevelt Administration considered trade negotiations with Canada, advisors again warned that the “branch plants have tended to support the maintenance of a
high tariff wall by Canada."

Trade agreements between the United States and Canada in 1935 and 1938 were carefully crafted to avoid upsetting this status quo. The State Department’s objective was not to liberalize Canada’s general tariff, but to attack imperial preference. While Canadian duties against the United States helped the branch plants and harmed U.S.-based exporters, imperial preference exposed both to greater competition from Britain. U.S. multinationals therefore pushed to reduce the preferences British goods enjoyed under the Ottawa Agreement. Some also sought to reduce Canadian duties on parts exported from the United States— but none wanted Canada opened to imports of finished goods. Indeed, too much trade liberalization aroused protests from companies invested in the branch plant system: for instance, U.S. firms in the Canadian Automobile Chamber of Commerce petitioned the Tariff Board to reverse tariff cuts in the 1935 treaty and restore the old duties because, they argued, “reduced protection will undermine the stability of the industry.”

Trade deficits and Canadian industrial policy

The collapse of the multilateral payments network and the restructuring of the world economy during and after World War II disrupted Canada’s economy and the branch plant system. During the war, Canada accumulated sterling balances on exports to the British Commonwealth while payments for imports from the United States drained its foreign exchange. This problem worsened after the war, as European countries facing a dollar shortage continued wartime restrictions on the use of hard currency for imports. Without a system to transfer balances on exports to the British Empire to pay for imports from the United States, Canada needed either to export more to or import less from the United States to stem the loss of dollar reserves and prevent a balance of payments crisis.

The loss of imperial markets was troublesome for the branch plants. Before the war, firms used their Canadian affiliates as export platforms and granted...
exclusive rights in Commonwealth trade to gain scale economies.\textsuperscript{63} After the war, U.S. multinationals opened new factories or enlarged existing ones in Britain and Western Europe because they had to produce inside the sterling area and the European Payments Union to sell there. Export opportunities for Canadian branch plants disappeared.\textsuperscript{64} In automobiles, the effect was dramatic: in 1948-49, Ford’s exports from Windsor declined from 41,141 to 17,415.\textsuperscript{65}

As U.S. affiliates confined their sales to the Canadian market while continuing to rely on imported parts, Canada’s trade deficit soared. Some Canadian officials believed that this persistent strain on the balance of payments could be relieved if the branch plants could serve a wider market by specializing for export. Barriers to trade with the United States, the Department of Trade and Industry argued, perpetuated an inefficient industrial structure; removing these barriers would encourage branch plants to “develop specialized production in Canada for export to the U.S. domestic or export markets as an offset to Canadian industry’s imports from the U.S.”\textsuperscript{66} Soon after the 1947 GATT conference, Canada approached the U.S. government to negotiate “further tariff cuts, particularly in the manufacturing goods field, which would make possible a better balance in the enormous one-way trade associated with our branch plants.”\textsuperscript{67} Canadian nationalists and U.S. firms in the Canadian Manufacturers Association countered that without tariffs the branch plants would lose their raison d’être and migrate back to the United States. Fearing a repeat of the 1911 Reciprocity Treaty debacle, Canada’s Prime Minister, Mackenzie King, abruptly broke off these negotiations in the spring of 1948.

With trade policy unchanged, the “miniature replica” branch plant structure endured. The limited range of the Canadian market left room for only a few plants large enough to take advantage of scale economies. In many sectors, however, the leading U.S. firms all owned Canadian affiliates; once one entered the market, competitors followed so the first-mover could not capture the benefits of producing behind the tariff while others had to export over it.\textsuperscript{68} As a result, branch

\textsuperscript{63} In the interwar period, Ford, GM, and Chrysler factories in Canada exported 25-50 percent of their production because sales to Australia, New Zealand, and South Africa boosted output during winter down periods. In fact, Ford-Canada exported three times more than Ford-U.S., even though it produced one-tenth as many cars. Wilkins and Hill (1964), pp. 44, 120.

\textsuperscript{64} Safarian (1966), p. 116.

\textsuperscript{65} In the same period, exports from Dearborn dropped from 88,559 to 53,700. Ford’s United Kingdom factory received top priority in Commonwealth markets previously serviced from the United States or Canada because mass production required exports of nearly 100,000 vehicles. Wilkins and Hill (1964), pp. 374, 407-8.

\textsuperscript{66} Williams (1986), p. 110.

\textsuperscript{67} Granatstein (1985), p. 39.

\textsuperscript{68} Eastman and Stykolt (1967), pp. 7-10. For example, the Canadian market could not support a single minimum efficient scale plant for electric ranges and refrigerators, yet ten and twenty-three factories, respectively, produced these goods. Eastman and Stykolt (1967), pp. 253-55.
plants produced well short of U.S. output levels. Those with high unit costs reported that “production runs were shorter, or volume was lower, or that these, in turn, led to relatively less tooling and mechanization.” As Ford’s chairman told the House of Commons in 1953: “Without the tariff, we could not possibly compete with the United States manufacturers, and the reason is solely one of volume… Because the volume in the U.S. is thirteen times that in Canada, unit costs of production are substantially lower.

In an attempt to fix its balance of payments problems and reform its antiquated industrial structure, the Canadian government began to apply industrial policy more aggressively after 1960. These moves upset the regulatory bargain that attracted FDI and, with growing frequency, caught the branch plants in the middle of disputes with the United States. As these conflicts threatened to provoke a trade war, efforts to reorganize the branch plant system and discipline Canada’s use of TRIMs gradually produced a formal governance structure to manage bilateral trade and investment. The APTA provides an early example of this dynamic at work.

The APTA: a commitment device for Canada and the Big Four

The APTA established important precedents for future trade discussions between Canada and the United States. Its negotiation illustrates how foreign investors are inclined to seek precise commitments from host governments and exclusive entry barriers before sinking capital into new production strategies.

In 1962, the Canadian government established a duty remission program that offered automakers a dollar in tariff rebates for each dollar increase in exports over their monthly average for the previous year. The main purpose was to reduce Canada’s $500 million deficit in automotive products, which accounted for one-third of its overall trade deficit. Subsequently the U.S. Treasury Department opened a countervailing duty inquiry when a radiator producer, Modine Manufacturing, complained that the duty remissions were unfair export subsidies. Treasury’s preliminary inquiry indicated that the refunds constituted illegal “bounties” or “grants” under U.S. law.

Eager to avoid a trade war, U.S. automakers urged the two governments to negotiate a bilateral agreement on automotive trade and investment. Though the Big Four had not been enthusiastic about the duty remission scheme, they

70. Safarian (1966), pp. 204-05. Eastman and Stykolt (1967), p. 13, explain:
   The scale of output is below the modern best-practice scale. Runs of single products in Canadian factories are short, with the result that excessive time is used in changeover for each unit of output. The machinery used is often inefficient because indivisibilities in the use of the most modern methods of production can be overcome only at higher scales of production for individual plants than exist in Canada.
accepted it as “the least objectionable of the several alternative proposals,” because they feared Canada would tighten local content rules. Countervailing duties would make this worst-case scenario inevitable. A memo to President Johnson by Secretary of State Dean Rusk noted:

The major United States automobile manufacturers have told us that such a decision by Canada would require them to make additional investments in Canada of several hundred million dollars, in order to protect the $600 million investment they already have there. For this reason, Ford, GM and Chrysler have stated that they would be placed in serious difficulty by the imposition of countervailing duties.

The Big Four’s preference was for Canada and the United States to establish bilateral free trade. In testimony to a Canadian Royal Commission, Ford, GM, and American Motors advocated mutual tariff elimination so “the full cost benefits of U.S. mass production... would then be passed on to Canadian consumers.” These firms also appealed to U.S. officials to negotiate a free trade agreement. In contrast to 1935 and 1948, when automakers were satisfied with high Canadian tariffs, now they had strong motives to support free trade. Because of consolidation, only the Big Four remained in business (Studebaker had just closed its last U.S. factory), so high-cost Canadian affiliates no longer faced competition from automobiles exported from the United States. As a result, outsiders could be excluded from sharing in the benefits of free trade– provided that it was not extended to third countries through the MFN clause. The State Department

72. RG 59 Subject Numeric Files 1960-63, Box 3474, Memorandum of Conversation, Mr. Lilley (Vice President, Ford Motor Company)… et al. and Mr. G. Griffith Johnson (Assistant Secretary of State), “Canadian Motor Vehicle Export Expansion Scheme,” 21 October 1963.

73. Ford calculated that an increase in content requirements to 60-75 percent would require additional investment of $200-300 million, and an increase to 90 percent would cost $400-600 million. RG 59 Subject Numeric Files 1964-66, Box 991, Memorandum of Conversation, Mr. John Meininger (Washington Representative, Ford Motor Company) and Mr. John F. Shaw (Assistant Chief, Trade Agreements Division), “Financial Impact of Increase in Canadian Content,” 22 May 1964.


75. Royal Commission on the Automotive Industry (1961), pp. 40-41. These firms argued that tariffs perpetuated the assembly-plant structure because low volume forced branch plants to import components with large economies of scale, such as engine blocks and automatic transmissions. Without trade barriers, branch plants could specialize in a limited range of models for both markets, and import models not produced in Canada from the United States. (Canada’s tariffs were 17.5 percent on finished vehicles and up to 25 percent on parts: U.S. tariffs were 6.5 percent on complete vehicles and 8.5 percent on most parts.) The Royal Commission’s report agreed that bilateral free trade offered an “escape from low-volume production in Canada,” but the Canadian government instead chose the duty remission scheme. Royal Commission on the Automotive Industry (1961), p. 50.

76. Chrysler pushed for more tariff protection for its affiliates in its Royal Commission testimony, but it subsequently joined the majority and supported mutual free trade.
therefore decided that the United States should seek a waiver under GATT rules for automotive trade with Canada to ensure “that there would be no free riders, e.g. Volkswagen,” because under MFN, “the Europeans would get a free ride on $300 million of finished vehicle exports.”

The sticking point in the negotiations was the commitment problem for the Canadian government and U.S. automakers. Canadian officials worried that free trade would cause the branch plants to close: without tariffs and industrial policy to guide investment, they argued, production would concentrate in the larger market. The Big Four wanted guarantees that Canada would not backslide on free trade or impose new TRIMs ex post. Thus, both sides “agreed that any intergovernmental arrangement for duty free treatment should be as durable as possible, since the investment decisions of the automobile industry would depend... on the degree of certainty attached to the tariff arrangements.”

Separate letters of undertaking with the Canadian government outlined a series of conditional promises: in return for free trade privileges, the Big Four agreed to maintain 60 percent Canadian value added in their domestic sales and to assemble one vehicle in Canada for every vehicle sold there.

The final terms of the APTA satisfied the complicated needs of U.S. automakers. The treaty defused the immediate threat of countervailing duties, and the Canadian government made precise commitments to abstain from opportunistic future measures. The production safeguards, while a new obligation, created entry barriers for prospective investors. Moreover, free trade applied only to original equipment manufacturers already in Canada– it was an exclusive privilege of the Big Four. Thus, National Security Adviser McGeorge Bundy

77. RG 59, Bureau of European Affairs, Country Director for Canada, Records relating to Economic Matters 1956-66, Box 2, “Negotiations with Canada on Automobile Trade,” Memorandum for Luther Hodges, Secretary of Commerce, and George W. Ball, Under Secretary of State, 29 September 1964.

78. A Commerce Department official explained:
Because of the small size of their industry, the Canadians believed that unlimited free trade would result in their industry being swallowed up by the much larger and efficient industry south of the border. They therefore sought... assurances... We on our side saw no such need because of the size of our industry, its very great efficiency, its lower cost, and its great ability to compete.


80. U.S. firms agreed to maintain local content levels established in 1964 and to collectively increase Canadian value added by $260 million by 1968. In practice, this amounted to 60 percent local content.

81. In addition to free trade in automotive products originating in the United States, the APTA allowed Canadian affiliates to import duty free from third countries.
reported to President Johnson: “The big companies are all in line, Ford and Chrysler with gusto.”\textsuperscript{82} Ford executives told Congress that “the limited free-trade approach” was “entirely reasonable” given the risk of new regulations to shift production to Canada and increase exports to the United States. GM officials agreed that the APTA, while “not free of difficulties,” was a “workable plan.”\textsuperscript{83} With new restraints on entry and tariffs still in place on imports from outside North America, U.S. automakers could internalize the full benefits of free trade to compensate for the costs of reorganizing the division of labor between affiliates and the corporate parent.

The conditions that promoted the APTA were unique to the automotive industry in 1965. For the most part, the \textit{New York Times} observed, “U.S. subsidiaries have been organized as branch offices behind Canadian tariff walls and are little interested in, or equipped for, free trade.”\textsuperscript{84} Even so, U.S. multinationals such as Dupont, Procter and Gamble, U.S. Steel, and IBM issued calls for bilateral free trade.\textsuperscript{85} After the APTA was negotiated, several industry groups approached the Canadian government to obtain special tariff arrangements, with the U.S. Embassy in Ottawa reporting that “the greatest interest has been shown by the chemical and machinery industries.”\textsuperscript{86} But for U.S. automakers the motive to seek free trade had been not only the traditional gain from specialization, but also the desire to discipline industrial policy toward FDI. As Canada increasingly employed TRIMs to achieve national objectives in the 1970s, pressure for a comprehensive trade agreement grew accordingly in other industries.

\textit{The Foreign Investment Review Agency}

Ongoing concern in Canada with the inefficient structure of domestic manufacturing motivated the shift to a more aggressive policy toward FDI. The 1972 Gray Report recommended the creation of a government body, later named the Foreign Investment Review Agency (FIRA), to screen new investments and regulate foreign-owned firms.\textsuperscript{87} Under the FIRA law, foreign companies required

\begin{itemize}
  \item \textsuperscript{82} U.S. Department of State (2001), p. 692.
  \item \textsuperscript{83} U.S. House of Representatives (1965), pp. 127-96.
  \item \textsuperscript{84} \textit{New York Times}, 24 January 1965, p. 7.
  \item \textsuperscript{86} RG 59, Subject Numeric Files 1964-66, Box 991, U.S. Embassy Ottawa to Department of State, “Functioning of U.S.-Canadian Automobile Arrangement and Possibility of Other Special Trade Arrangements,” 26 February 1965.
  \item \textsuperscript{87} Gray (1972) concluded that screening would alleviate “truncation,” a symbolic term selected to suggest that companies conducting administration, management, and R&D elsewhere were incomplete entities in Canada. Truncation, the Gray Report asserted, resulted in import dependence; a bias against exports; lower productivity; less innovation and R&D; and fewer
\end{itemize}
cabinet approval to establish a new business, or to merge with a firm valued at more than $250,000 or with annual revenues over $3 million. The review process allowed FIRA to extract commitments from foreign investors to satisfy performance rules for local content and exports, transfer technology or patents to indigenous firms, hire Canadian management and labor, and conduct more R&D in Canada.

More than 80 percent of investment proposals from 1974 to 1982 were approved. But in return most foreign investors had to accept performance requirements; a proposal’s denial or withdrawal signaled, in effect, that the applicant did not anticipate returns sufficient to justify the undertakings. Because TRIMs were formulated case-by-case, the commitments of foreign-owned firms often varied. In some cases, new entrants gained an advantage by negotiating less restrictive undertakings than incumbent firms had to satisfy; in others, latecomers were placed at a disadvantage. Moreover, multinationals already based in Canada could not escape review unless they eschewed mergers and expanded only in core product lines, because screening applied to incumbent firms and new entrants alike. As a result, foreign-owned firms could be subjected to a new set of regulations after substantial investment in local production already had been sunk.

At the same time, it became more difficult for the branch plants to prosper while manufacturing diverse product lines for the small Canadian market. In an effort to encourage industry (particularly the branch plants) to specialize and lengthen production runs, the Canadian government liberalized imports. After negotiating limited tariff reductions in the Kennedy Round, Canada still retained substantial trade protection in manufacturing; but it accepted deeper tariff cuts in the Tokyo Round. As lower tariffs were phased in, unproductive branch plants suddenly were exposed to competitive pressures, so they could no longer mark up prices to compensate for high costs.

Finally, Canada began to offer generous investment incentives to European and Japanese firms. In 1973, Michelin received $73 million in grants and low-interest loans to build two tire plants in a depressed area of Nova Scotia. Volkswagen secured tariff rebates on imported parts used in exported vehicles in 1978, an offer later extended to Honda and Toyota. In return for local content and value added commitments to establish a “significant” presence in Canada, foreign automakers could collect rebates of up to 100 percent on their imports.

---

89. Fuss and Waverman (1987), pp. 224-25. In return for duty-free imports, Volkswagen agreed to produce or buy parts in Canada equal to 64 percent of the value of its imports in 1984 and 85 percent in 1987. Honda achieved full tariff remission status in 1985; Toyota was scheduled to soon follow. In 1987, Toyota and seven other foreign firms received 70 percent rebates on their imports.
These measures subsidized rival firms as they developed modern production facilities. Once established, European and Japanese affiliates not only competed in the Canadian market with the outmoded branch plants, they also built substantial export capacity for the U.S. market. In the Michelin case, 90 percent of the firm’s Canadian exports went to the United States. Similarly, tariff rebates for Volkswagen, Toyota, and Nissan required the Big Three, already reeling from the energy crisis, to compete with foreign companies that were not bound by the APTA undertakings.\\(^90\)

This shift in Canada’s regulatory posture provoked complaints and occasional retaliation from the United States. A 1974 Commerce Department memo warned that Canada’s “aggressive application of industrial policy” threatened to “distort trade.”\\(^91\) In response to the Michelin subsidy, the Treasury Department imposed countervailing duties on steel-belted radial tires from Canada— the first time trade remedy laws had been used against investment incentives. The Carter administration demanded formal consultations to express its disapproval of Canada’s tariff rebates for foreign automakers, which were not designated for privileges under the APTA.\\(^92\)

These disputes peaked as the Reagan administration targeted FDI regulation as an unfair trade barrier. A number of bills in Congress sought to pressure foreign countries to grant reciprocity in investment and revised provisions of Super 301 authorized retaliation. At the 1982 GATT ministerial meeting, U.S. officials pushed, unsuccessfully, to have TRIMs placed on the agenda for the next trade round. The next year, the United States challenged Canada’s local sourcing, import substituting, and export performance rules in the GATT. The dispute settlement body, however, found that only local content rules violated GATT rules. When Canada subsequently renewed its undertakings with foreign automakers, the USTR concluded that countervailing duties could be imposed because firms were able to receive rebates on the import of one product by exporting a different product. Though U.S. officials did not know the scale of the probable damage (the remission agreements were confidential), an anti-subsidy

---

90. A Federal Task Force, which included the Big Three, the United Automobile Workers, and parts producers, recommended a framework to require new entrants “to make binding commitments comparable to the commitments now being made by the vehicle manufacturers operating under the APTA.” The report concluded: “an effective compliance procedure must be developed by the Canadian government that will ensure that these comparable commitments will be fulfilled by 1987.” Federal Task Force on the Canadian Motor Vehicle and Automotive Parts Industries (1983), p. 107.


complaint was inevitable once foreign-affiliated plants came on stream. 93

The CUSFTA treaty

As Canada reduced tariff protection, extracted new commitments from incumbent firms, and courted third-country investors, U.S. multinationals were stuck with sunk costs in inefficient, small-scale affiliates with high local content. A few companies attempted to streamline operations and eliminate duplication between parent factories and branch plants. GE-Canada, for example, closed down non-core product lines and expanded production runs to gain scale economies. 94 Dupont petitioned the Canadian government for a special license to import nylons duty free so it could phase out certain product types and rescale others for the North American market; when this request was denied, the firm decided that restructuring would not be profitable. 95 A report on the petrochemical industry from the U.S. Embassy in Ottawa highlighted the dilemma for U.S. companies:

Industry… prefer[s]… a solution to Canadian problems by means of construction of world-scale plants, greater product specialization, and access to world markets—notably that of the U.S…. If it cannot obtain access to the U.S. market in the near term, it looks to the GOC [Government of Canada] for assistance and protection. 96

Simply stated, the branch plants could not survive in the Canadian market without trade protection; the alternative, costly investments in restructuring to promote specialization and gain scale economies, was too risky as long as trade barriers existed between Canada and the United States.

The Conservative Party’s victory in the 1984 Canadian election created a favorable environment for measures to solve this problem. The next year, a Royal Commission report on Canadian industry recommended free trade with the United States. The Royal Commission found that manufacturing productivity was declining, as trade and industrial policies had failed to reorient the traditional branch plant structure. Many branch plants were likely to close down under competitive pressures. However, U.S. multinationals (and Canadian firms) indicated that there were considerable opportunities to exploit scale economies if they could specialize production for a larger market. The Chairman of Dupont-Canada testified:

93. The USTR explained, “Canada’s duty remission program is a subsidy to the export of Canadian-manufactured auto parts. As such it appears to be inconsistent with Article IX of the subsidies code.” Fuss and Waverman (1987), pp. 224-26.
96. RG 59 Subject Numeric Files 1970-73, Box 1055, Amembassy Ottawa to Department of State, “Petrochemicals: Bilateral Talks and GOC Policy,” 16 September 1972.
We, manufacturers, are caught in a catch-22 situation. On one hand, the tariffs in Canada are no longer high enough to offset the higher costs of producing solely for the Canadian market. On the other hand, even modest tariffs into the U.S. can make it difficult, if not impossible, to set up production in Canada to export into that market... Unless we can negotiate increased and assured access to the U.S. market, Canadian industry will be unable to take the risks involved in making substantial investments required to operate on a North American basis.97

For U.S. affiliates in Canada, integrating operations more closely with corporate parents required the ability to import products from the United States and to export there without having to face trade restrictions. This meant not only the elimination of tariffs and non-tariff barriers, but also disciplines on the use of trade remedy laws in the United States.98

In addition, U.S. multinationals wanted assurances regarding Canada’s treatment of FDI. Though the Conservative government had scaled back screening and assigned FIRA a more welcoming name, Investment Canada,99 this relaxed stance could be reversed with little warning. Based on interviews with U.S. affiliates in Canada, Daly and MacCharles found that “the lack of consistent, long-term government economic policies made it difficult for them to engage in long-range planning. A stable policy environment was preferred.”100 Companies would restructure their operations only after receiving credible assurances of policy liberalization—otherwise, long-term plans would be vulnerable to a resurgence of the regulatory activism of the 1970s. As long as the risk of policy reversals existed, it was safer to continue to operate Canadian affiliates as autonomous entities, even though they could be more productive if reorganized.

Free trade raised two problems, however. First, it could not be immediate: an abrupt removal of trade barriers would further expose foreign affiliates to competition. Instead, liberalization in stages would minimize the disruption and provide breathing room while restructuring took place. Second, there had to be a mechanism to exclude outsiders, because multilateral liberalization would make multinationals more vulnerable to external competitive pressures while they reorganized operations. If third-country firms increased exports or invested in the region, North American producers would be pushed up their cost curves. Without measures to prevent new entrants from capturing the benefits of trade liberalization, companies would have few incentives to undertake costly restructuring.

98. A Procter and Gamble executive explained: “We share Canada’s concern about arbitrary and capricious application of U.S. ‘unfair trade’ laws… We can expect increasing use of such tools against us.” U.S. Senate (1987), p. 308.
99. The Investment Canada act raised the threshold for review from $5 million to $150 million for direct acquisitions, and from $50 million to $500 million for indirect acquisitions.
100. Daly and MacCharles (1986), p. 79.
The Royal Commission’s report persuaded Canadian officials to pursue free trade with the United States in 1986. To be sure, eliminating trade protection and ending FDI screening raised longstanding concerns that U.S. multinationals would close down their affiliates or return to the ‘truncation’ of the pre-1970 period. But officials believed that with mutual free trade, foreign investors would specialize for an enlarged continental market instead of downsizing or leaving.\(^{101}\) Canadian negotiators therefore made their willingness to liberalize FDI contingent on total free trade and measures to discipline the use of administrative trade remedies in the United States.\(^{102}\)

The 1987 CUSFTA treaty eliminated tariffs and non-tariff barriers in Canada-U.S. trade, opened government procurement markets, established standards to protect intellectual property, and created procedures for dispute settlement. The provisions of Chapter 16, which deals with FDI, are important but less well known. Notably, Article 1603 prohibited all TRIMs relating to export performance, import substitution, local content, and domestic sourcing. This ban extended to third country firms if such measures would affect bilateral trade.\(^{103}\) In Article 1607 and its annexes, Canada agreed to end screening for all indirect acquisitions, and it bound the threshold for reviewing direct acquisitions at $150 million. Finally, the two governments made extensive commitments to national treatment for foreign firms in Articles 1602, 1605, and 1606, including prohibitions on domestic equity requirements and forced divestiture on the basis of nationality, limits on profit remittances and other currency transfers, and expropriation without “prompt and fair” compensation.

These investment provisions were critical to U.S. multinationals, which wanted, as a Procter and Gamble executive put it, “assurances against a return to the FIRA-based deterrence environment.”\(^{104}\) Regulatory certainty was especially important to automotive firms. In particular, new rules requiring Canada to end export-based duty remissions and phase out tariff rebates for Japanese firms were integral to the support of the Motor Vehicle Manufacturers Association (MVMA).\(^{105}\) Trade groups such as the Chemical Manufacturers Association and the Computer and Communications Industry Association also cheered the elimination of export performance and local content requirements.\(^{106}\)

While multinational companies favored free trade with comprehensive rules for FDI, their support for the CUSFTA treaty was contingent on transitional

---

103. However, governments still could negotiate undertakings on local employment, R&D, and technology transfer.
protection and measures that discriminated against producers outside North America. Several firms emphasized that they had structured investments to comply with regulatory mandates in a protected market, and they did not want new entrants to establish modern facilities in the region to capture free trade benefits. Moreover, once trade protection was gone, branch plants would be at a competitive disadvantage until they were reorganized or closed. Multinationals therefore sought exclusive provisions, restrictions on outsiders, and transitional protection to place limits on external competition during the period when investments were being restructured.

The most important entry restrictions were origin rules that mandated 50 percent North American content to receive CUSFTA treatment. Canadian negotiators proposed a 35 percent requirement so foreign multinationals would not be deterred from making new investments. However, firms in automobiles, electronics, machinery, and chemicals insisted on tougher safeguards to prevent European and Asian companies from setting up screwdriver factories to earn free trade privileges. For example, Zenith and GE insisted on 50 percent local content to block Asian firms from expanding production of “snap-together” television receivers in Canada. Automakers also backed the 50 percent rule, though they preferred a 60 percent standard.107

In addition, special provisions were negotiated for automotive trade so that the Big Three’s longstanding production arrangements would not be upset. U.S. officials initially proposed that free trade in automotive products apply only to Canada-U.S. trade so that foreign automakers could no longer earn tariff rebates and export-based duty remissions through separate undertakings with the Canadian government. However, this position ran afoul of the MVMA, which told negotiators it was “extremely alarmed” by the proposal.108 Automakers also urged Congress to block any deal that changed “existing trade arrangements on which MVMA member companies have structured long-term competitive strategies.”109

As a result, negotiators agreed that the Big Three could continue duty free imports of non-U.S. parts into Canada as long as they adhered to the safeguards specified in the 1965 letters of undertaking. These provisions allowed the Big Three to


108. Wonnacott (1988), pp. 105-7. Because Canada had not sought a GATT waiver to deny MFN to imports not originating in the United States, U.S. automakers saved $300 million per year in tariffs on their Canadian imports from foreign suppliers, and they did not want to lose these benefits.

maintain their special treatment, while they also made Japanese and European firms ineligible for the same privileges.

Finally, the CUSFTA treaty included phase-out periods of up to ten years for eliminating trade barriers. Producers did not need transition periods to open the U.S. market to Canadian goods because their factories in the United States already produced on a large scale. But Canadian affiliates with high unit costs would suffer if they were exposed to free trade too quickly. Whirlpool, for instance, argued that rapid tariff elimination “would be unreasonable and not economically or politically acceptable to Canadian appliance manufacturers.”

To mitigate adjustment costs and prevent a flood of imports into the Canadian market, U.S. multinationals pushed to eliminate trade barriers gradually to allow the branch plants time to reorganize before facing free trade conditions.

6. Conclusion: liberalizing TRIMs

The argument presented in this article illuminates why multinational firms have been such a strong constituency for regional arrangements— to manage liberalization and deregulation in FDI. The political economy problem that TRIMs present is that foreign investors locked in to a particular trade and regulatory regime exhibit a status quo bias because they are vulnerable to being held up. As a result, multinational companies are inclined to demand safeguards before they will consent to having TRIMs relaxed or phased out. First, they want host governments to make ironclad commitments to liberalize trade and investment, lest old policy measures be restored later. Second, they need protection against new entrants while they adjust to a new policy climate. This requires formal treaties to enumerate explicit obligations, establish rules that discriminate between incumbents and new entrants, and provide transitional protection.

The APTA, which amounted to a regulatory contract between U.S. automakers and the Canadian government, was an early prototype of this dynamic. In the CUSFTA case, Canada’s pledge to liberalize bilateral trade and FDI, codified in a formal treaty with provisions to shelter incumbents against newly established competitors, made it desirable for U.S. multinationals to restructure manufacturing away from the branch plant model. Notably, U.S. multinationals did not push for arrangements such as the APTA and the CUSFTA until the regulatory rents they could earn by complying with TRIMs had declined substantially.

These investment bargains could not have been reached in the GATT or the WTO. Multilateral institutions work best for general rules that apply universally. This “one size fits all” approach is not appropriate for more detailed bargains that

require special provisions in different sectors to adapt to unique trade issues between countries with high levels of bilateral FDI. Liberalizing these measures requires specialized arrangements between host governments and foreign investors that are more easily negotiated bilaterally or regionally. Moreover, the compensation foreign investors normally demand to adjust their operations to a new regulatory regime runs counter to the MFN and national treatment rules at the core of multilateral institutions.

The weakness and ineffectiveness of multilateral rules to govern FDI therefore is not surprising. The 1983 FIRA case established the precedent that local content and trade-balancing measures violate GATT Article III national treatment obligations, but performance requirements are not covered under multilateral rules. The Uruguay Round TRIMs Agreement ratified this status quo, but did not institute comprehensive codes like those for intellectual property, services, and national standards. As a result, the TRIMs Agreement “is frequently interpreted to represent a failure of the Uruguay Round to make significant progress on investment issues.”111 Though WTO members have faced pressure to eliminate local content and trade-balancing rules, most developing nations failed to implement their commitments by the January 2000 deadline, and nine countries received extensions ranging from 5 months to 7 years.112 In several cases, multinational companies joined host governments in seeking delays.113 Pressure to postpone liberalizing TRIMs has persisted in the Doha Round discussions of “special and differentiated treatment” for less developed countries.

Because of these loopholes and delays, few dispute settlement cases have involved the TRIMs Agreement, as Table 3 shows. Over the last decade, moreover, “the use of investment-diverting and investment-distorting measures not covered in the current agreement has vastly increased.”114

<table>
<thead>
<tr>
<th>WTO Agreement</th>
<th>Number of dispute cases</th>
<th>Percentage of all dispute cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Antidumping</td>
<td>64</td>
<td>20.6</td>
</tr>
<tr>
<td>Safeguards</td>
<td>34</td>
<td>10.9</td>
</tr>
<tr>
<td>Intellectual property</td>
<td>26</td>
<td>8.4</td>
</tr>
<tr>
<td>Countervailing measures</td>
<td>19</td>
<td>6.1</td>
</tr>
<tr>
<td>TRIMs</td>
<td>9</td>
<td>2.9</td>
</tr>
</tbody>
</table>


In sum, the logic of investor-state interaction described here has made TRIMs

an important feature of regional trade agreements—which have, in turn, established detailed codes for FDI presently lacking at the multilateral level. From a political economy perspective, regional arrangements offer several advantages: they involve more binding commitments than are feasible multilaterally; they create opportunities to discriminate against and exclude outsiders; they limit bargaining to the countries on which the spillover of FDI regulation is concentrated; and they minimize the transaction costs and large number problems that plague multilateral discussions. Thus, progress toward liberalizing TRIMs is likely to continue at the regional rather than the multilateral level.

References


Cambridge University Press.


U.S. Senate, Committee on Finance. 1986. Negotiation of United States-Canada Free Trade Agreement.


