

Trade Theory, Trade Policy, and Cross-Border Integration

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Introduction

In a 1992 article, economist Paul Krugman asked whether the new trade theory required a new trade policy. He concluded that it did not, arguing that since existing trade policies were unrelated to long-established trade theories¹, it was difficult to see why such policies needed to accommodate new theoretical insights. In his view, “GATT-think [is] a simple set of principles that is entirely consistent, explains most of what goes on in the negotiations, but makes no sense in economic terms.”² Krugman’s point was clever but also misleading because it did not fully appreciate either the nature or the genius of the international trade regime, or the challenges it needed to address in the

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¹ Theories first developed by, *inter alia*, Adam Smith and David Ricardo (specialization and comparative advantage) and refined over the years by economists like Eli Heckscher, Bertil Ohlin, and Paul Samuelson (the factor proportions theory) and Ray Vernon (the product cycle theory), and now supplemented by theories to take account of imperfect competition, increasing returns to scale, and other factors.

² "Does the New Trade Theory Require a New Trade Policy?" *The World Economy* 15:4 (July 1992), p. 429. See Douglas Irwin, *Against the Tide: An Intellectual History of Free Trade* (Princeton: Princeton University Press, 1996) for a full discussion of the development of trade theories and the broad commitment of economists to the doctrine of free trade.

face of deepening global integration. The system of rules and procedures worked out and applied in the period from the founding of the US Reciprocal Trade Agreements program in 1934 through the Uruguay Round of GATT negotiations in the 1990s embodied more sensible economic content than Krugman cared to admit. At the same time, he seemed to discount the extent to which there needed to be new thinking about trade policy, some of it in response to new trade theories developed over the past few decades, but even more to take account of the changing nature of international production and exchange.

The new thinking needs to learn from insights developed in industrial organization theory, economic geography, business economics, and other domestically oriented sub-branches of micro-economics, suggesting that there are fewer differences between international trade and domestic commerce than was long assumed. As Krugman himself explained in a later article, “the trend in manufacturing has been to slice up the value chain—to produce a good in a number of locations, adding a little bit of value at each stage.”³ This kind of fragmentation was originally confined to the firm and then to spatially proximate and, often, related firms. Increasingly, however, neither geography nor ownership remain as serious obstacles to the fragmentation of production and its subsequent integration. Even more pertinent to international trade, national borders are no longer significant barriers to the organization of production. Insights into the nature of production and the operations of private firms have opened up new ways of explaining international trade and investment. They have also suggested the need for new thinking about the object and purpose of trade and related negotiations among governments.

The old trade policy, despite Krugman’s dismissal of GATT-think, was firmly grounded on the theory of comparative advantage. It assumed that trade is largely a matter of exchanging goods, that it takes place between national economies, reflecting each country’s resource endowments and comparative

³ Paul Krugman, “Growing World Trade: Causes and Consequences.” *Brookings Papers on Economic Activity*, 1 (1995), p. 334.

advantage. It further implicitly assumed that national production was associated with the use of mostly domestic resources, meaning that export expansion was associated with a commensurate increase in domestic value-added, jobs and profits. The old trade policy sought to remove national barriers to trade in goods on a progressive, i.e., politically sustainable, basis and to make the rules of the game fair, transparent, and non-discriminatory. Those were the means; the objective was to let markets work in order to take advantage of specialization and thus contribute to growth in national and global welfare. It worked: among OECD economies, trade grew at a rate that far outstripped growth in production to the point that an increasing share of national welfare was being derived from international exchange. Interestingly, as international trade and investment flourished, more and more could not be explained solely on the basis of comparative advantage and national endowments. Economists responded with a range of more sophisticated explanations, including insights derived from analysis of the domestic economy⁴.

Of course, Krugman was reluctant to admit that the global economy was beginning to operate more and more like the large, continental US economy of the early post-war years. In the 1990s, he popularized sophisticated economic arguments to demonstrate the extent to which production in the United States was still largely focused on goods and services consumed at home⁵. In terms of a traditional reading of trade statistics, he was right, but in pointing out that some of the economic problems being experienced in the United States at that time were

⁴ See, for example, Patricia Dillon, James Lehman, and Thomas D. Willett. "Assessing the Usefulness of International Trade Theory for Policy Analysis," in John S. Odell and Thomas D. Willett, eds., *International Trade Policies: Gains from Exchange between Economics and Political Science* (Ann Arbor: University of Michigan Press, 1990), pp. 21-54 for discussion of some of the newer trade theories.

⁵ See, for example, "Competitiveness: A Dangerous Delusion," *Foreign Affairs*, vol. 73, no. 2 (1994); 'Does Third-World Growth Hurt First World Prosperity?' *Harvard Business Review*, July-August 1994; and with Robert Lawrence, 'Trade, Jobs and Wages,' *Scientific American*, April 1994.

homegrown, he missed another point: traditional ways of interpreting trade statistics no longer captured the extent of international economic interdependence. As Douglas Irwin points out, “A close analysis of the merchandise trade figures indicates that trade is substantially more important now than in the recent past for those sectors engaged in trade.”⁶ He calculated that US merchandise exports as a share of merchandise production grew from 15 percent in 1970 to nearly 40 percent in 1999, even though the share of merchandise trade to GDP grew much more modestly, largely because of the growth of service production as a share of GDP. In Canada, the exports of goods in 1999 represented 125 percent of the value of goods production, consistent with the high level of imports in Canadian exports and the much more export-intensive nature of production in Canada. The comparable figure for 1970 was 65 percent, suggesting a similar rise in the export intensity of the economy.⁷

Cross-border fragmentation and integration of production between Canada and the United States started well before it had become commonplace on a global scale. As a result of the 1965 Autopact, automotive production in the two countries was reorganized in the 1960s to allow the major assemblers and their suppliers to integrate their facilities on both sides of the border and thus provide scope for more specialization and the benefits that flow from economies of scale and larger markets. As border barriers came down, other industries followed suit, a process that deepened and accelerated following the implementation of the 1989 Canada-US Free Trade Agreement (CUSFTA) and the 1994 North American Free Trade Agreement (NAFTA).

In this paper, we consider the implications of deepening and accelerating cross-border integration for North American trade policy. We argue that the benefits that flowed to the two economies from the conventional trade negotiations of the past have now been largely realized. More benefits have flowed

⁶ Douglas A. Irwin, *Free Trade Under Fire*, 2nd edition (Princeton: Princeton University Press, 2005), p. 8.

⁷ Values calculated from Statistics Canada GDP and Balance of Payments data.

from the more innovative provisions in the CUSFTA and NAFTA. Nevertheless, there remain barriers to the full exploitation of cross-border integration. To achieve these additional benefits, a concerted effort will be required to address the combined impact of dated, dysfunctional, and intrusive border administration, the haphazard process leading to deepening regulatory convergence, and the frail institutional capacity to govern accelerating integration, together with an expansion of the reach of binational policy-making to address investment, intellectual property rights, labour, services, and other economic transactions.

Thus, while the trade policy of the past may have reached the point of diminishing returns, new challenges have arisen that we believe to be amenable to resolution through bilateral negotiations. Progress on these issues requires a better understanding of the successes and limitations of the old trade policy, the contribution of regional trade negotiations, the nature of modern production and exchange, their cross-border manifestation between Canada and the United States, and the barriers to their full development. Following a discussion of these factors, we will consider the new trade policy issues that need to be addressed between Canada and the United States and the benefits that should flow from their successful resolution.

The Old Trade Policy

Over a period of some fifty years—from its first deployment in the US Reciprocal Trade Agreements Program in the 1930s through the conclusion of the Tokyo Round of multilateral trade negotiations in the 1970s and into the opening of the Uruguay Round in the 1980s—trade negotiations grounded in mercantilist bargaining and negative prescription proved an unqualified success for those countries prepared to take advantage of this strategy. The result provided the basis for a tremendous increase in international trade and a major boost in productivity and prosperity. Mercantilist bargaining offered a politically acceptable way to pursue politically difficult economic goals.

Through such trade negotiations, governments sought to increase economic welfare by reducing discrimination, removing barriers, disciplining potentially distorting policy measures, and providing greater scope for the operation of the market, unencumbered by artificial policy barriers. They also sought the order and stability that come with clear rules and equitable dispute settlement provisions. In short, both legal and economic maxims suggested that international trade agreements were mutually beneficial. Every barrier removed or rule established would benefit all participants.

Such trade negotiations, however, were in fact pursued on the basis of pre-economic and pre-legal concepts: every “concession” granted by one party had to be matched by a “concession” from another. Ministers and their officials, while they knew better, behaved as if they were engaged in a zero-sum game. Reason told them that the removal of barriers and the establishment of rules made sense, but politics dictated that they could only achieve these goals by seeking greater export opportunities while minimizing the prospect and benefits of increased import competition. Political discourse was based on the conceit that the strength of the nation required a positive trade balance, an ability to do without imports, and the promotion of strategic advantage over all other nations. British economist Martin Wolf first called this process mercantilist bargaining and suggested that, perversely, it was only through mercantilist bargaining that progress could be made⁸.

Mercantilist bargaining also proved superbly suited to the architecture of the US-inspired reciprocal trade agreement: an interlocking set of negative prescriptions by which governments undertook self-denying ordinances disciplining their capacity to impose trade barriers at the border and to discriminate among domestic and imported goods or among their trading partners.

⁸ See Martin Wolf, “A European Perspective,” in Robert M. Stern, Philip H. Trezise and John Whalley, eds., *Perspectives on a U.S.-Canadian Free Trade Agreement* (Washington: Brookings Institution, 1987). In *Why Globalization Works* (New Haven: Yale University Press, 2004), he provides a much more complete picture of the role of trade negotiations in spreading the benefits of globalization.

Its substantive obligations required participants to refrain from applying their trade policies in ways that were contrary to these fundamental rules. The obligations did not require adherence to absolute standards of behaviour, nor did they impose rules and procedures for the detailed administration of trade policy. There was no obligation in the GATT, for example, to set maximum tariff rates. GATT members remained free to negotiate such rates and free to apply them at lower levels or not at all. The basic national treatment obligation did not guarantee a standard of treatment for imports, for example, respecting the level of indirect taxes, but rather required that such taxes or other regulations affecting internal trade not be higher or more burdensome than those applied to products of domestic origin.

With respect to non-tariff barriers, the GATT did not require its members to apply countervailing or antidumping measures, marks of origin, quantitative restrictions on trade, or subsidies, but rather established disciplines on the use of such measures. The articles allowing exceptions for balance-of-payment reasons, tariff preferences, or import surges were similarly encumbered with disciplines and in some cases surveillance, all intended to make their use difficult. While the articles on customs administration and valuation set out prescriptive rules and procedures, the need for such measures arose from the application of an import regime which the GATT did not substantively require⁹. The arch over all these obligations was the general requirement of most-favoured-nation treatment.

The focus of these negotiations was barriers to the exchange of goods. Barriers to the flows of services, investment capital, the internationalization of intellectual property rights, temporary business travel, labour, and other cross-border transactions were governed, if at all, by separate international instruments, none of which included the kinds of rights and obli-

⁹ Article X on the publication and administration of trade regulations is an exception to the paradigm of negative prescription. It should be added, however, that the existence of a body of norms (rather than requirements), did lead to a gradual convergence in the trade policies of the core GATT members, the industrialized countries clustered around the North Atlantic.

gations that became the basis of the trade-in-goods regime. International air services, for example, were governed on the basis of a series of interlocking bilateral arrangements that were crafted not only on the basis of mercantilist bargaining, but pursued in order to achieve mercantilist results. Unlike the equality of opportunity that was critical to the goods regime, the patchwork of other international arrangements was much more geared to specific outcomes. The intellectual property regime embedded in the arrangements administered in the World Intellectual Property Organization (WIPO) relied on comity rather than enforceable contract.

In the six rounds of multilateral trade negotiations between the provisional entry into force of the GATT in 1948 and the completion of the Tokyo Round in 1979, there was no significant change in this fundamental architecture. The focus of each negotiation was the reduction of tariffs on industrial goods through mercantilist bargaining. While the Kennedy and Tokyo Rounds expanded negotiations beyond tariffs to the development of disciplines on export and internal subsidies, the application of countervailing and antidumping duties, and separate agreements on trade in civil aircraft and government procurement, the results were fully consistent with the principle of negative prescription¹⁰. In two areas of the Tokyo Round, however, there was already evidence of the pending shift in the centre of gravity from negative prescription to positive rule-making. Agreements governing customs valuation and technical barriers made a tentative start at requiring adherents to administer regulations along specified lines. Neither agreement, however, required countries to impose a tariff on imports or to maintain a products standards regime.

The Uruguay Round fundamentally altered the nature of the GATT-based trade relations system¹¹. In addition to some ma-

¹⁰ For an analysis of the Tokyo Round, its origins, its objectives, issues and results see Gilbert R. Winham, *International Trade and the Tokyo Round Negotiation* (Princeton: Princeton University Press, 1986).

¹¹ For a useful summary, see Jeffrey J. Schott, *The Uruguay Round: An Assessment* (Washington: Institute for International Economics, 1994). See

major achievements within the traditional framework, it made a decisive shift toward positive rule-making as the basis for a new architecture of international trade rules. It also sought to extend the ambit of the rules to other economic transactions, particularly trade in services, some trade-related aspects of investment, and intellectual property rights. The shift into rule-making is particularly apparent in the agreements governing trade in services, the protection of intellectual property, technical barriers, and sanitary and phytosanitary measures, and in parts of the agriculture agreement¹². When combined with the positive obligation to ensure conformity with WTO rules, a more potent dispute settlement system, the trade policy review mechanism, and the new disciplines on services and intellectual property rights, the WTO institutionalized a degree and intensity of intervention into domestic governance which exceeds anything possible or contemplated under the GATT.

The stalemate at the Doha Round of negotiations suggests that the transition from a regime of negative to positive rules was not fully thought through. The bargaining techniques that had worked so well for more than fifty years proved less well suited to the emerging architecture and the much more comprehensive ambit of the rules. As discussed further below, regional negotiations relied less on mercantilist bargaining and proved more adept at dealing with the politically tricky issues inherent in positive rule making. Nevertheless, the GATT trade relations system, now encompassed in the 1995 World Trade Organization Agreement, proved an enduring idea and continues to be at the centre of the modern trade relations system. It was based on several key assumptions:

- trade policy should be non-discriminatory, as expressed in the principles of unconditional most-favoured-nation treatment and national treatment;

also John Croome: *The Results of the Uruguay Round: A Guide*, (Geneva: WTO, 1995).

¹² We explore the detail of what this entailed in "Post-Modern Trade Policy: Reflections on the Challenges to Multilateral Trade Negotiations After Seattle," *Journal of World Trade* 34:3 (June 2000).

- the primary regulator of trade should be the highly visible mechanism of the tariff, a mechanism that affects prices, rather than other mechanisms such as quantitative restrictions;
- tariffs and other barriers to trade should be progressively reduced so that the gains from trade can be realized and economic welfare increased;
- trade results largely from the activity of private entrepreneurs rather than governments;
- governments should be allowed to impose barriers against dumped or subsidized or otherwise politically intolerable levels of imports; and
- disputes between members should be resolved through a process of consultation and negotiation; retaliation and counter-retaliation should be avoided.

Over the years, the system became increasingly complex in order to compensate for the failure of the more ambitious International Trade Organization (ITO) to come into being. Despite these difficulties, the cumulative impact of the GATT—and now the WTO—was significant. Merchandise trade was liberalized, particularly among the advanced industrial economies; tariffs were cut; old-fashioned discriminatory quantitative restrictions were eliminated; and many potentially harmful practices were restrained by its rules¹³.

¹³ Its impact was much more limited in curbing the protectionist instincts of developing country governments. As a result, their participation in the benefits of international trade was much more limited, a reality that is only now beginning to be addressed by some developing countries through unilateral measures and bilateral arrangements. We explore the perverse impact of special and differential treatment for developing countries and their governments' approach to multilateral negotiations in "Special and Differential Treatment and the Doha 'Development' Round," *Journal of World Trade* 37:2 (April 2003). Gary Hufbauer sarcastically points out, "everyone 'knows' that trade ministers representing poor countries can't be asked to dismantle their barriers because ... well, because they like to use muddled infant industry arguments to confer favours on well-connected constituents." "Inconsistency between Diagnosis and Treatment," *Journal of International Economic Law*, 8:2 (June 2005), p. 293.

Mercantilist bargaining proved a politically successful way to harness the power of comparative advantage and its benefits can be clearly explained on the basis of conventional trade theories, particularly the Heckscher-Ohlin-Samuelson model. But these models rely on a stylized explanation of the mechanics of production and international trade that is increasingly far removed from current experience in the real economy. The way firms are organized to produce goods and services for either domestic consumption or export is of little moment to trade theory; industrial organization (IO) theory can be used to describe it, but few bridges were built to integrate the theories developed in these two branches of micro-economics until recently. Industrial organization theories explain the organization of production while international trade theories explain the exchange across national borders of the resulting goods and services. Traditional trade policy thinking and practice continues to rely on this division of labour and remains poorly informed on emerging IO theory.

The old trade policy assumed that international trade, investment, and other cross-border transactions took place largely between firms and individuals in one country and unrelated firms and individuals in another. It regarded the large, vertically integrated, horizontally diversified, managerially coordinated enterprise famously described by Alfred Chandler as typical¹⁴. With the exception of raw materials, machinery, and luxury products, experience suggested that goods and services were primarily consumed in the country in which they were produced by such firms. Goods and, to some extent, services were also produced for export but the successful penetration of a market often led to import-substituting investments and a return to the

¹⁴ Alfred Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge: Harvard University Press, 1977) and *Scale and Scope: The Dynamics of Industrial Capitalism* (Cambridge: Harvard University Press, 1990). Chandler's work was given important theoretical underpinnings in Oliver Williamson, *The Economic Institutions of Capitalism* (New York: The Free Press, 1985), relating the structure and operation of these firms to emerging theories about transaction costs, imperfect competition, and more.

dominant pattern of domestic production for local consumption. International transactions thus largely involved sales of primary goods, machinery, and luxury goods, exports of excess production, establishment of foreign affiliates through foreign direct investment, transfers of technology through affiliates and licensing arrangements, and the provision of various supporting services such as transportation, communication, and insurance. Nevertheless, in response to market liberalization, particularly among members of the Organization for Economic Cooperation and Development (OECD), exports steadily increased as a share of global output, rising from about 7 percent in 1950 to about 15 percent by the mid-1970s¹⁵.

Lessons from Regional Negotiations

Mercantilist bargaining was not the basis upon which the members of the European Union negotiated the treaties that formed the basis for their increasingly integrationist project, nor was it the basis for concluding the Canada-United States Free Trade Agreement or the North American Free Trade Agreement. Each of these negotiations sought a much more thorough approach to rule-making and the resulting agreements reflect a detailed construction of rules to govern deepening integration among its members. They set out to cover the full range of cross-border transactions, from labour and capital to services and intellectual property rights. From the outset, these negotiations aimed at encouraging efficiency and integration, rather than simply the mercantilist goal of increased exports. In some ways, these re-

¹⁵ The WTO calculates that the ratio of world trade in goods and services to output increased from 7 to 15 per cent over the period 1950 to 1974, and from 15 to 28 per cent between 1974 and 2004, i.e., it has quadrupled since 1950. It grew most rapidly in the first two decades, slowed perceptibly during the 1970s and 1980s, and again grew rapidly since, consistent with, first, the impact of post-war recovery, and second, the impact of regional and global integration. See WTO, *International Trade Trends and Statistics* (Geneva: WTO, 1996 and 2006), accessed at wto.org. A recent *Economist* survey focuses on the extent to which the more recent surge has integrated developing country producers more fully into global production, trade, and investment patterns. "The new titans," *The Economist*, September 14, 2006.

gional negotiations reflected the full implementation of the logic of the old trade policy, but in other ways tried to come to grips with the demands of promoting and governing deeper integration.

Against a background of nearly half a century of depression and war, European governments in the 1950s embarked on an ambitious program of political cooperation and economic integration. Based on the deeply held conviction that countries that trade with each other and have an interest in each others' economic welfare are less likely to go to war or engage in destructive protectionist strategies, western European governments pursued top-down, policy-induced economic integration¹⁶. Over the course of the past five decades, the European integration movement has steadily expanded from the original six to now 27 member states, plus association arrangements with neighbours, potential members, and former colonies.

Simultaneous to the widening of the EC/EU, member governments steadily worked to deepen its impact. The 1957 Treaty of Rome committed members to implement the four freedoms: free movement of goods, services, capital, and people. Implementation of the free movement of goods was effected by removing intra-European tariff and non-tariff barriers and by adopting a Common External Tariff and a Common Agricultural Policy. This was accomplished by the original six members by 1968 and became a condition of entry for all subsequent members. The free movement of the other factors of production, however, proved a much more daunting challenge. In effect, it required a high degree of convergence in the regulatory regimes that are at the heart of the modern welfare state and that, either directly or indirectly, operate to segment national markets and frustrate integration. Over the past 20 years, through a process of both legislation and litigation, members of the EU succeeded

¹⁶ Noted Jean Monnet, the father of European integration, in one of the most-quoted passages from his Memoirs "There will be no peace in Europe if States reconstitute themselves on a basis of national sovereignty. ... European States should form themselves into a federation or a 'European entity' which would make them a joint economic unit." *Memoirs* (Garden City, NJ: Doubleday, 1978).

in creating the rules and structures required to govern a continent-wide single market. As Michelle Egan points out, by closely emulating the US experience in creating an integrated, continent-wide market in the 19th century, the EU succeeded in erasing borders and creating a similarly integrated market in Europe. In the United States, the Constitution's Commerce clause and the courts proved critical, while the EU relied on the Treaty of Rome and the European Court of Justice¹⁷.

The two North American Agreements, on the other hand, reflected an effort by first Canada and the United States, and then Mexico, to catch up to the reality of market-driven, cross-border integration by negotiating a framework of rules consonant with that reality. Rather than the push of government action, Canada-US integration has been driven largely by the pull of market forces: proximity, consumer choice, investment preference, and firm behaviour. Government policy has been largely responsive, motivated by efforts to resolve problems generated by market-driven integration. Rather than seeking deeper integration, governments only gradually accepted the need to facilitate it by addressing problems experienced by private traders and investors. The result is a much more piecemeal and less deliberate approach to rule-making and institution-building. Unlike in Europe, the governmental response in North America has been prompted by commercial and economic considerations and has been at pains to keep geopolitical and security considerations at arm's length in forging new rules and arrangements to address deepening economic integration.

¹⁷ See Michelle P. Egan, *Constructing a European Market: Standards, Regulation, and Governance* (New York: Oxford University Press, 2001). The American parallel is instructive, particularly in light of Canada's own more difficult progress in effecting a more integrated market through the Internal Trade Agreement. For Canadians, perhaps the most instructive lesson from Europe does not lie in efforts to create first a customs union and then a single market, but in the efforts of the Outer Seven—the members of the European Free Trade Association (EFTA)—first to maintain their separate markets, then to negotiate individual free-trade agreements followed by the short-lived European Economic Area (EEA) arrangement and finally full participation in the single market for most EFTA members. The logic of the market drove decisions about its governance.

British economist David Henderson defines integration “as a tendency for the economic significance of political boundaries to diminish.”¹⁸ It takes place when one or more formerly separated markets combine to form a single market, leading to increased flows of cross-border trade of not only final consumer products but also intermediate inputs and raw materials, as firms reorganize their activities around regional markets for both inputs and outputs. Integration enables producers and consumers to benefit more fully from their relative strengths and to respond more efficiently to changing economic conditions. It may open new territories for an economy’s output, strengthen exploitation of economies of scale, increase access to potentially cheaper suppliers of inputs, and create new opportunities for foreign direct investment, as firms restructure the vertical and horizontal arrangements of their enterprises. Greater competition is also likely to make goods and services more affordable, thereby expanding consumer purchasing power, and add to consumer choice.

Whether driven by the push of government policy or the pull of market forces, deepening integration between two or more countries disposes them to create common policies to regulate the production and distribution of goods and services and a joint approach to external trade and investment. Canada and the United States, while nominally committed to no more than a free-trade area, have in reality already implemented aspects of a customs union and even of a common market. Based on broadly shared goals and perspectives and common needs, the two governments have developed a dense framework of formal and informal networks and relationships that ensures a high degree of convergence in the design and implementation of a wide range of rules and regulations.

Both the European treaties and the North American agreements are built on an architecture of positive rules rather than negative prescriptions, and neither was the product of mercantil-

¹⁸ David Henderson, “Putting ‘Trade Blocs’ into Perspective,” in Vincent Cable and David Henderson, eds., *Trade Blocs? The Future of Regional Integration* (London: Royal Institute of International Affairs, 1994), pp. 179-80.

ist bargaining. Both are much more ambitious in their coverage. Both anticipate the new trade policy and both reflect the much more intensive nature of exchange within the territory covered by the rules. In the case of Europe, the treaties helped to forge more integrative business strategies. In the case of North American, the agreements reflected the extent to which business was pursuing more integrative strategies. In both instances, the architecture and bargaining strategy of the old trade policy proved ill-suited.

The effective market today is global and its reach is increasingly reflected in the organization of production. The United States in the 19th century and the EU, and to a lesser extent, Canada in the closing years of the 20th century, saw a need to forge rules and governance structures consonant with the emergence of larger markets and more widely integrated production strategies. The focus of these efforts was divergent regulatory regimes that artificially segmented markets and frustrated achieving the benefits of wider markets and more efficient production structures. Today, both markets and production have gone global, while governance remains largely national in scope and reach.

The New Industrial Context: Fragmentation and Integration

Over the past few decades, traditional international exchange has gradually begun to give way to a much more integrated kind, with more and more transborder transactions taking place within firms, among related parties, or within integrated networks¹⁹. Many more goods traded internationally today are parts and components for assembly into end-products closer to the point of final consumption. Production is being geared to a much wider market, the range of goods and services that are

¹⁹ The UNCTAD Division on Transnational Corporations and Investment reports that by 2005, some 77,000 firms qualified as multinational in their activities, each accounting for an average of ten separate foreign affiliates. World-wide sales by foreign affiliates had reached US\$22.2 trillion in 2005, nearly double world-wide exports of goods and services at US\$12.6 trillion. See World Investment Report (Geneva: UNCTAD, 2006).

exchanged internationally has widened considerably, and capital and technology move between nations not only to promote import-substituting, but also export-oriented production. Global competition, scientific and technological breakthroughs, as well as consumer sophistication are shortening the product cycle and placing a premium on quality, manufacturing fluidity, and innovation. International exchange now involves a much more complex and sophisticated range of economic transactions and is as likely to involve dealings among related than unrelated parties. The vertically integrated firms of the early postwar years have given way to much more flexible, horizontally organized enterprises²⁰. Production is steadily being re-organized on a global basis and the nature of extra-national economic transactions reflects this change. In the words of the University of Manchester's Peter Dicken, the global economy has been transformed into "a highly complex, kaleidoscopic structure involving the fragmentation of many production processes, and their geographical relocation on a global scale in ways which slice through national boundaries."²¹

The literature suggests that there were three basic catalysts to the acceleration of globalization: the steady liberalization of trade and investment among industrialized countries after the Second World War, the more recent rapid industrialization of the third world, and the impact of technological breakthroughs that have brought down the costs of transportation and communication. The impact of these three factors has been mutually reinforcing and cumulative. Duke University sociologist Gary Gereffi insists, however, that "of far greater significance are several novel features in the nature of international trade that do not have counterparts in previous eras. ... The three new aspects

²⁰ See Naomi R. Lamoreaux, Daniel M.G. Raff, and Peter Temin, "Beyond Markets and Hierarchies: Toward a New Synthesis of American Business History," *American Historical Review* 108 (April 2003), pp. 404-33. Much of the article is a critical analysis of the lessons of business history since Chandler wrote *The Visible Hand*.

²¹ Peter Dicken, *Global Shift: Reshaping the Global Economic Map in the 21st Century* (4th edition, London: Sage, 2003), p. 9.

of modern world trade relevant here are (1) the rise of intra-industry and intra-product trade in intermediate inputs; (2) the ability of producers to ‘slice up the value chain,’ in Krugman’s phrase, by breaking a production process into many geographically separated steps; and (3) the emergence of a global production networks framework that highlights how these shifts have altered governance structures and the distribution of gains in the global economy.”²²

The fragmentation of production through a process of out-sourcing and subsequent re-bundling within large and technologically sophisticated supplier networks has become increasingly prevalent in industries from food processing, aviation, and motor vehicles to apparel, electronics, and house-hold products²³. Both value-chain fragmentation and the sophistication of the firms that make up the fragments have made it easier to relocate specific nodes of production and to take advantage of a range of distant factors, from low-cost labour and specialized skills to access to critical inputs and public policy considerations. As the production of manufactured goods becomes ever more disaggregated, varied, and sophisticated, the cost of developing and manufacturing new products has increased exponentially. More and more, the costs are concentrated in developing the product—both the product and the most cost-effective process by which to manufacture it—rather than in production, devaluing the labour content in many products and increasing the risk in producing it. MIT geographer Tim Sturgeon points out: “In both manufacturing and service industries, ... many

²² Gary Gereffi, “The Global Economy: Organization, Governance, and Development,” chapter 8 in Neil J. Smelser and Richard Swedberg, eds., *The Handbook of Economic Sociology*, 2nd edition (Princeton, NJ: Princeton University Press and Russell Sage Foundation, 2005), p. 166.

²³ Sven W. Arndt and Henryk Kierzkowski note “fragmentation is not a new phenomenon; nor is out-sourcing. ... In the modern era, however, both have acquired international dimension and complexity and probably represent one of the most important distinguishing features of contemporary globalization.” “Introduction,” in Arndt and Kierzkowski, eds., *Fragmentation: New Production Patterns in the World Economy* (Oxford: Oxford University Press, 2001), p. 2.

companies have been shifting specialized activities out-of-house to an increasingly competent set of suppliers, contract manufacturers, and intermediaries. ... While offshore assembly was initially done by the subsidiaries of multinational firms, growing capabilities in the supply-base led to the emergence of independent and highly sophisticated developing country suppliers in places like Taiwan, Korea, and Singapore as well as a cadre of huge 'global suppliers' headquartered mainly in developed countries but with extensive worldwide operations."²⁴

Li & Fung of Hong Kong is a prime example of a modern specialist in managing the economics of fragmentation and agglomeration. It has access to a network of about 7,500 contract suppliers all over Asia employing as many as 1.5 million workers, providing a critical mediating service bringing brand-name firms together with highly efficient contract manufacturers. Li & Fung takes orders from companies all over the world to "make things" for them, from ballpoint pens and golf clubs to computers and televisions. It in turn finds the right contract manufacturer and organizes the logistics to supply the ordered "thing" to the customer, based on the customer's specifications. Many contract suppliers maintain offices in Hong Kong to liaise with Li & Fung and provide it with product development and engineering information²⁵.

Firms like Li & Fung are key to understanding the increasing role of China in the value-added chain: the location of choice for "making things." India, on the other hand, has become the favoured place for service inputs. An increasing range

²⁴ Timothy Sturgeon, *Measuring the Offshoring of Service Work and its Impact on the United States*, accessed at <http://web.mit.edu/ipc/owg2005/summary.html>.

²⁵ See Victoria Curzon Price, "Some Causes and Consequences of Fragmentation," in Arndt and Kierzkowski, *Fragmentation: New Production Patterns in the World Economy* (Oxford: Oxford University Press, 2001), p. 96. As its website boasts, "Li & Fung is today one of the premier global consumer-products export trading corporations managing the supply chain for high-volume, time-sensitive consumer goods. Our mission is to deliver the right product at the right price at the right time." www.lifung.com. See also "Manufacturing Survey," *The Economist*, June 20, 1998.

of service inputs are being sourced in India, taking advantage of its wealth of IT professionals and English-speaking, well-educated office workers. Its contribution began with low-value-added activities, such as back-office transactions and call centers, but steadily expanded to include software programming, engineering, design, accounting, legal and medical advice, and a broad array of other professional services. “The computerization of work, the advent of the Internet, the standardization and automation of a range of business processes, and the availability of very low-cost, high-speed data networks have made it easier for firms in advanced economies like the United States to connect to the capabilities that exist in developing countries like China, Ireland, Australia, Canada, India, and the Philippines, and this combination of factors appears to be causing a wide range of ‘knowledge work’ to become more footloose.”²⁶

Fragmentation and integration combine to increase the extent and intensity of international transactions, allowing slices of the production process to be moved to the best possible location. The speed and efficiency with which these slices can be integrated clearly have a bearing on the optimal degree of fragmentation. Fragmentation thus allows firms to specialize to a much greater degree and reap greater advantages from economies of scale and scope. Gereffi points out that “today, we live in a world in which deep integration, organized primarily by transnational corporations (TNCs), is pervasive and involves the production of goods and services in cross-border value-adding activities that redefine the kind of production processes contained within national boundaries. ... While the postwar international economic order was defined and legitimized by the United States and the other core powers that supported it in terms of the ideology of free trade, it was the way in which transnational corporations linked the production of goods and services in cross-border, value-adding networks that made the

²⁶ Sturgeon, *Measuring the Offshoring of Service Work and its Impact on the United States*, op. cit.

global economy in the last half of the twentieth century qualitatively distinct from what preceded it.”²⁷

Systematic data on the extent of this integration is difficult to find, in part because official statistics cannot capture the full value of cross-border service links or the input of services provided through proprietary and other networks, e.g., design, engineering, and marketing, whether done in-house, outsourced locally, or outsourced internationally. Statistical agencies have no way of counting the value of Italian design and German engineering in a toilet ultimately manufactured in Mexico and imported into Canada through a US distribution network. They count the computer on which this is being written as a Chinese import, rather than as the fruit of the design, engineering, and marketing input of the brains at Apple’s Cupertino, California campus²⁸. The data collected by statistical agencies thus does not always accurately capture the origin of value-added in a complex multi-country production process²⁹.

From a policy perspective, governments are particularly interested in the intersection of firm-specific value and location-

²⁷ Gereffi, “The Global Economy: Organization, Governance, and Development,” op. cit., at pp. 163-64.

²⁸ As *Business Week* points out, the statistical wizards at national statistical agencies “have no way of tracking the billions of dollars companies spend each year on innovation, product design, brand-building, employee-training, or any of the other intangible investments required to compete in today’s global economy.” Michael Mandel, et al., “Why the Economy is a Lot Stronger than You Think,” *Business Week*, February 13, 2006. The increasing proportion of services in national accounts reflects not only a more prosperous economy with an increasing desire for services rather than goods, but also the disaggregation of production into increasingly smaller slices, many of which are counted as the production of services rather than as part of the goods in which they are embedded, as well as the service links required to bring the spatially separated slices together.

²⁹ Alexander Yeats, by analyzing data for selected industries and extrapolating the results more widely, estimates that a third or more of world trade is made up of parts and components. “Just How Big is Global Production Sharing?” in Arndt and Kierzkowski, eds., *Fragmentation: New Production Patterns in the World Economy* (Oxford: Oxford University Press, 2001), pp. 108-143.

specific value. Firms are now less constrained in their choices of geographic location by distance and policy, and seek to enhance value by dispersing their value-added activities spatially. Governments, in the interest of attracting value-added activity to their location-specific jurisdictions, now compete in promoting policy settings that are congenial to increasingly mobile slices of production by removing barriers and providing positive incentives. In this quest, they are learning that the trade agreements of the past may have been critical to providing the framework of rules that initially promoted fragmentation and integration, but are no longer sufficient.

Canada-US Cross-Border Integration

The integration that increasingly characterizes the global economy has a longer history at a bilateral Canada-US level. In an earlier era, proximity disposed Canadians to develop a trade and investment dependence on the US market and US capital. The exploitation of Canada's storehouse of raw materials and the establishment of miniature-replica branch plants both developed with heavy doses of US capital. Today, Canada exhibits a high level of both production and consumption dependence on the United States³⁰. Its earliest modern manifestation involved the automotive industry. A unique set of circumstances at the time, captured in the Autopact, encouraged the development of integrated, cross-border production³¹. Much of what is now commonplace was pioneered in the auto sector: in-house fragmentation and outsourcing on a continental rather than regional or national basis, followed by out-of-house cross-border fragmentation. The successful introduction of lean, just-in-time production techniques, pioneered in Japan and introduced in North

³⁰ For a description of the geography of production in Canada, see Iain Wallace, *A Geography of the Canadian Economy* (Toronto: Oxford University Press, 2002).

³¹ On the origins and evolution of the Autopact, see Michael Hart, *A Trading Nation: Canadian Trade Policy from Colonialism to Globalization* (Vancouver: UBC Press, 2002), pp. 240-47.

America in the 1980s, further accelerated this fragmentation process³².

Since the implementation of the CUSFTA and NAFTA, fragmentation has become commonplace throughout North American industry, involving both manufacturing and service industries³³. High levels of both two-way intra-industry trade and foreign direct investment indicate continued cross-border integration and rationalization of production between Canada and the United States, as well as a deepening interdependence of manufacturing industries. Canada is the second-leading destination for US foreign direct investment while the United States is the prime destination of Canadian FDI. Proximity of the US and Canadian industrial heartlands, well-developed infrastructures, and transparent legal systems all contribute to the highly integrated nature of the two economies. In turn, this integration contributes to a high level of trade as each country is the other's largest foreign market and leading supplier of imported goods³⁴.

Discussion of Canadian international economic patterns often focuses on trade in goods and emphasizes exports. A more realistic picture emerges, however, by looking at imports and exports of both goods and services, at inflows and outflows of

³² See James P. Womack, Daniel T. Jones, and Daniel Roos, *The Machine that Changed the World* (New York: Macmillan, 1990).

³³ For example, the Canadian and US agri-food sectors have become much more integrated. Canadian and US fresh fruit and vegetable consumption is growing and increasingly involves two-way trade, with the direction dependent on the season. Cross-border production by Canadian and US multinational food companies has steadily risen, lowering production costs and giving consumers access to a wider variety of products. See Steven, Zahniser, ed., *NAFTA at 11: The Growing Integration of North American Agriculture* (Washington, USDA Economic Research Service Outlook Report No. WRS0502, February 2005), accessed at www.ers.usda.gov/Publications/WRS0502/.

³⁴ See U.S. International Trade Commission, *Production Sharing: Use of U.S. Components and Materials in Foreign Assembly Operations, 1995-1998*, Publication 3265 (Washington, 1999), for a detailed assessment of the extent and nature of cross-border production sharing in the motor vehicle, aircraft, rail locomotives and rolling stock, computer hardware, semiconductor, and telephone equipment industries.

investment capital, at sales by foreign affiliates, and at exports of goods as a share of domestic shipments. As Howard Lewis and David Richardson point out, “it is becoming increasingly meaningless, if not outright impossible, to think of trade as something separate from cross-border investment, or of exporting as something separate from importing products and innovative ideas. All are tied together in the extended family of global commitment.”³⁵ As such, Canada’s involvement in the global economy is much more diversified and the full importance of international exchange becomes clearer. It also makes clear why, as the US economy moves further up the value chain, so does the Canadian economy, increasing trade opportunities for foreign exporters to North American markets and investment opportunities in overseas economies.

Preliminary figures for 2006³⁶ indicate that Canadian firms and individuals produced \$524 billion in goods and services for export and imported \$486 billion in goods and services from all sources. The United States remained by far the most important destination for Canadian merchandise exports at \$362 billion (78.9 percent), and the principal supplier of Canadian merchandise imports at \$265 billion (65.5 percent). The increasing value of the Canadian dollar relative to the US dollar as a result of rising resource prices appears to have had a larger impact on diversifying merchandise imports rather than exports. China has become the second largest supplier to the Canadian market, while the EU remains the second largest destination for Canadian exports.

On the investment front, Canadian direct investment abroad, with a cumulative book value of \$465.1 billion in 2005, continued to outpace the cumulative book value of foreign direct investment in Canada at \$415.6 billion³⁷. The value of Ca-

³⁵ Howard Lewis III and J. David Richardson, *Why Global Commitment Really Matters* (Washington: Institute for International Economics, 2001), p. 11.

³⁶ Figures from Foreign Affairs and International Trade Canada, <http://www.international.gc.ca/eet/balance-payments-en.asp>.

³⁷ Figures from Foreign Affairs and International Trade Canada, <http://www.international.gc.ca/eet/foreign-statements-en.asp>.

nadian direct investment abroad exceeded the value of foreign direct holdings in Canada for the first time in 1997 and has remained that way ever since. As a result of increasing cross-border investment, Canadian firms are increasing their presence in the United States through sales by affiliates, particularly in the services sector, just as US-owned affiliates continue to have an important place in the Canadian market place. Analysis of cross-border investment patterns indicates that much of it is trade-enhancing as Canadian and US firms strengthen their position in supply chains and distribution networks while overseas investment is geared more to substituting for trade. McCain's, for example, invests in Europe to process locally sourced inputs while it invests in the United States to enhance its ability to distribute product from its Canadian operations. Canadian firms have become increasingly involved in cross-border mergers and acquisitions, the principal vehicle for FDI flows and for seizing the advantages of deepening integrative trade. From the beginning of 2003 through the first quarter of 2006, Canadian firms acquired more than 1,000 foreign firms, while foreign firms acquired 373 Canadian firms.³⁸

In 2003, the latest year for which such data are available, about 43,310 Canadian-based firms were engaged in exporting. Of these, 27,747 (64.2 percent) exported to the United States alone, 5,802 (13.4 percent) exported only to non-US destinations, and 9,671 (22.4 percent) to both. Fewer than 4 percent of these firms, accounted for more than 80 percent of total exports, and 12 percent accounted for 93.5 percent of Canada's total merchandise exports. The profile of successful exporting firms is also highly skewed toward foreign-controlled firms. Of the 44,469 firms which registered as exporters in 2002, only 3,597 (9 percent) were foreign-controlled, but they were responsible for nearly half of merchandise exports³⁹.

³⁸ Robert Yalden, "Gobble Means Grow," *National Post*, June 28, 2006, p. FP23.

³⁹ Statistics Canada, *A Profile of Canadian Exporters 1993-2003*, Catalogue No. 65-506-XIE, and Craig Byrd, *Foreign Control of Canada's Merchandise Exports, 2002* (Statistics Canada Catalogue No. 65-507-MIE, No. 4)

Similar data are not available on the number of Canadian-controlled exporting establishments with assets or affiliates in foreign markets, particularly the United States, or of the ownership and investment profile of importing establishments, but the data on the dominant position of foreign-controlled exporters suggest that firms active in international markets as traders are also active in those markets as investors. As Lewis and Richardson discovered, internationally engaged firms are more productive and innovative, pay higher wages, and are more profitable, not just in the United States, but in most other economies⁴⁰.

Both cross-border and global supply chains today depend critically on relationships that extend well beyond arm's-length transactions between customer and supplier. As US business economist Stephen Blank notes "Ottawa and Washington talk about the world's largest bilateral trading relationship. But we really don't trade with each other, not in the classic sense of one independent company sending finished goods to another. Instead we make stuff together; ... [we] share integrated energy markets; dip into the same capital markets; service the same customers with an array of financial services; use the same roads and railroads to transport jointly made products to market; fly on the same integrated airline networks; and increasingly meet the same or similar standards of professional practice."⁴¹

Philip Cross and his colleagues at Statistics Canada have done extensive work trying to understand the changing nature of cross-border trade, production, and investment patterns. They have calculated that the import content of Canadian exports has risen steadily over the past two decades. It was 25.5 percent in 1987 and peaked at 33.5 percent in 1998. The rapid rise in trade in the 1990s was in large part the result of rationalization, with imported components replacing domestic components, with the final product exported to a broader market base. More significant than the rise in exports as a share of GDP was the rise in

⁴⁰ Lewis and Richardson, *Why Global Commitment Really Matters*. Op. cit.

⁴¹ Stephen Blank, "It is Time for Canada to Think Carefully about North America." *Embassy*. September 7, 2005.

value-added content of exports in GDP, which rose from 21.4 percent in 1987 to reach 28.8 percent in 1999⁴². The recent increase in the value of sales of energy products has had a dampening effect on a further rise in the import content of Canadian exports, but not on their Canadian value-added content.

The extent of the import content of Canadian exports varies considerably from industry to industry. Not surprisingly the auto sector, benefiting from high levels of cross-border ownership since its inception and, since 1965, the impact of the Canada-US Autopact, is by far the most integrated, with the import content of Canadian exports exceeding 50 percent, followed by machinery, equipment, and electronics at over 40 percent, and textiles, other manufacturing, metals, oil refining, and chemicals exceeding 30 percent. Even food, forestry products, and agriculture exceeded 10 percent⁴³. Economist Glen Hodgson concludes that “trade has evolved beyond the traditional exporting and importing of goods, and has entered the next generation of trade—integrative trade. Integrative trade is driven by foreign investment and places greater weight on elements like the integration of imports into exports, trade in services and sales from foreign affiliates established through foreign investment.”⁴⁴ Nowhere has this process of integration been more pronounced than between Canada and the United States.

The rise in Canada’s export dependence on the United States in the 1990s was, therefore, to some extent overstated. As a result of double counting, net exports to the United States as a share of GDP only rose to reach 24 percent by 1999, as com-

⁴² See P. Cross and G. Cameron, “The Importance of Exports to GDP and Jobs,” *Canadian Economic Observer*, 12:11 (November 1999) and Cross. “Cyclical Implications of the Rising Import Content in Exports.” *Canadian Economic Observer*, 15:12 (December 2002).

⁴³ See Figure 2 in Cross “Cyclical Implications of the Rising Import Content in Exports.”

⁴⁴ Glen Hodgson, “Trade in Evolution: the Emergence of Integrative Trade,” *EDC Economics*, March 2004, p. 5; http://www.edc.ca/english/docs/030104_integrative_e.pdf. See also Hodgson, “Integrative Trade and the Canadian Experience,” *EDC Economics*, May 2004, http://www.edc.ca/english/docs/Canadian_Benefits_050104_e.pdf.

pared to the 36 percent suggested by the gross numbers⁴⁵. In other ways, however, these numbers may understate the degree of interconnectedness. Canadian merchandise exports as a share of domestic shipments have steadily increased over the past thirty years as Canadian firms have become much more engaged in cross-border and international supply chains. In the 1970s, the value of Canadian merchandise exports was equivalent to about two-thirds of the value-added in the production of goods in Canada. In the opening years of the 21st century, merchandise exports now represent about 125 percent of the value added in the goods-producing sectors of the Canadian economy, indicating nearly a doubling in the export intensity of production in Canada over the past thirty years, as well as the increasing role of imported components in that production⁴⁶. Additionally, as a result of increasing cross-border investment, Canadian firms are increasing their presence in the United States through sales by affiliates, particularly in the services sector, just as US-owned affiliates continue to have an important place in the Canadian market place. Canadian-owned affiliates in the United States rang up \$192 billion in sales in 2003⁴⁷, roughly 60 percent of the value of Canadian-based exports. In the other direction, US-owned affiliates in Canada reported 2003 sales of \$560 billion⁴⁸.

Deepening integration has allowed Canadian industry to become more specialized and has contributed importantly to the growth of value-added sectors. As Industry Canada economist Surendra Gera and his colleagues explain, “while in the past domestic demand was the dominant factor influencing the

⁴⁵ Cross and Cameron, “The Importance of Exports to GDP and Jobs.”

⁴⁶ Values derived from Statistics Canada, CANSIM Tables 376-0007, 379-0022, 379-0024, and 380-0012 reporting Gross Domestic Product and Balance of Payments data.

⁴⁷ Statistics Canada, “Foreign Affiliate Trade Statistics.” *The Daily*, May 25, 2005, at <http://www.statcan.ca/Daily/English/050525/d050525f.htm>.

⁴⁸ US Bureau of Economic Analysis, *U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and Their Foreign Affiliates: Comprehensive financial and operating data*, <http://www.bea.gov/bea/ai/iidguide.htm#link12b>; US dollar data converted to C\$ at Bank of Canada average rate for 2003 of 1.4015.

growth of industries, trade is now becoming much more important. High-knowledge industries in the tradable sector seem to have benefited the most from export performance; low-knowledge industries have seen their relative decline hastened by import competition.”⁴⁹

The changing intensity and composition of bilateral trade have contributed significantly to making Canadians better off both as consumers and as producers. Canadians employed in export-oriented sectors have consistently been better educated and better paid than the national average. As University of Toronto economists Peter Dungan and Steve Murphy report, “Canada is replacing low-productivity employment with high-productivity employment through expanded international trade, and is thereby made better off.”⁵⁰ Similarly, greater access to internationally competitive goods and services allows Canadians to stretch their earnings further. As Cross and his colleagues point out: “The importance of trade to the economy does not come from an excess of exports over imports: rather, it is from the productivity gains that accrue with increased specialization.”⁵¹ Specialization, in turn, increases, as markets expand in response to the increased openness fostered by trade agreements.

Emerging Cross-Border Trade Policy

The relationship with the United States is thus the indispensable foundation of any Canadian policy to maximize benefits from engagement in the global economy. With no other country does Canada have as intense a relationship embracing virtually the whole range of public policy, security, economic development,

⁴⁹ “The Knowledge-Based Economy: Shifts in Industrial Output,” *Industry Canada Working Papers*, Number 15, January 1997, accessed at strategis.ic.gc.ca.

⁵⁰ “The Changing Industry and Skill Mix of Canada’s International Trade,” *Industry Canada Research Publications Program, Perspectives on North American Free Trade Series*, Paper Number 4, April 1999, available at [http://strategis.ic.gc.ca/epic/site/eas-aes.nsf/vwapj/P4-ang.PDF/\\$FILE/P4-ang.PDF](http://strategis.ic.gc.ca/epic/site/eas-aes.nsf/vwapj/P4-ang.PDF/$FILE/P4-ang.PDF)

⁵¹ Cross and Cameron, “The Importance of Exports to GDP and Jobs,” p. 3.3.

and human contact. For a growing number of Canadians, the time has come to achieve a seamless border with our neighbour, embraced within a new agreement implementing rules, procedures, and institutions consonant with the reality of ever-deepening, mutually beneficial cross-border integration.

While some might express horror at any policy explicitly aimed at helping integration, there are no voices calling for the alternative—creating barriers to integration, establishing distance from the United States, and seeking other partnerships to replace this vital relationship. Who would support imposing barriers to the millions of visits that Canadians make to the United States each year, to the annual pilgrimage of several million snowbirds to Florida, Arizona, California, and other sunnier climes, to the thousands of trucks that cross the border every day, to the billions of cross-border phone calls, to the dozens of US TV channels beamed into Canadian homes, to the millions of US books, movies, CDs, and magazines delivered to Canadian homes every year? Who objects to building more cross-border roads, bridges, pipelines, and electrical grids? At a practical level, therefore, the default position is implicitly a gradual deepening of integration, whether stated in those terms or not.

The need for an integrated approach to managing the Canada-US relationship and for the focus upon border management is echoed by the Canadian business community. The Canadian Chamber of Commerce has called for the government to put in place the proper machinery to ensure the cross-border flow of goods and people. The Canadian Association of Manufacturers and Exporters similarly gives priority to improving border efficiency, eliminating border infrastructure bottlenecks, and reducing regulatory barriers to trade. The Canadian Council of Chief Executives argues the need to move beyond border management and reinvent the concept of North American Borders. It, moreover, places the border challenge in the context of reinvigorating the Canada-US defence and security relationship⁵².

⁵² See Chamber.ca for proceedings of its 2003 conference and the resolution calling for improved customs procedures. The position of the manufacturers is contained in a joint letter from it and its sister US group,

Canadians and Americans are now trying to come to grips with the fact that their extensive network of trade arrangements has worked exceedingly well, but that they no longer address directly the needs related to the circumstances in which the two countries find themselves. More profoundly, there is a need for new instruments. It is evident that neither the WTO as a body of rules nor the Doha Round of trade negotiations provide a way to address the emerging issues in the relationship in a timely or effective way. The issues are peculiar to the relationship, do not lend themselves to multilateral solutions, and, given the determination of developing countries to shape multilateral negotiating agendas, have no possibility of finding a place even if Canada and the United States were inclined to go down this road.

While a bilateral context offers the chance to shape the agenda and focus uniquely on Canada-US issues, it is far from certain, however, that a conventional new trade agreement, for example, a customs union,⁵³ would yield results significant enough to justify the investment of political capital necessary to

the National Association of Manufacturers, to the Prime Minister and President in April 2004, available at cme-mec.ca. See ceocouncil.ca for the Council's publication "New Frontiers: Building a 21st Century Canada US Partnership in North America."

⁵³ The past few years have witnessed a growing interest in what would be involved in negotiating either a bilateral or trilateral customs union involving Canada, the United States, and perhaps Mexico. We prepared an overview for the Policy Research Initiative, "Policy Implications of a Canada-US Customs Union," PRI North American Linkages Project, February 2005. See also Danielle Goldfarb, "The Road to a Canada-US Customs Union: Step by Step or in a Single Bound," *CD Howe Institute Commentary*, No. 184 (Toronto, 2003); Rolf Mirus and Nataliya Rytska, "Should NAFTA Become a Customs Union?" in Edward D. Chambers and Peter H. Smith, eds., *NAFTA in the New Millennium* (Edmonton: University of Alberta Press, 2002); Axel Huelsemeyer, "Toward Deeper North American Integration: A Customs Union?" *Canadian American Public Policy*, No. 59 (Orono, ME: University of Maine, October 2004, and Hart "A New Accommodation with the United State: The Trade and Economic Dimension," in Thomas J. Courchene, Donald J. Savoie, and Daniel Schwanen, eds., *Art of the State II: Thinking North America: Prospects and Pathways*, No. 2 (Montreal: Institute for Research on Public Policy, March 2004).

achieve success. A customs union would build on the existing contours of the NAFTA, but extend it to include:

- a single customs territory, allowing for the free circulation of all goods within the customs union.
- a common external tariff (CET) created from merging the two tariff schedules and harmonizing on the lowest current rate of either country, with flexibility to maintain separate external rates over a transition period for a small list of products.
- provisions for sensitive sectors such as clothing (likely transition periods), agriculture (leaving the hardest issues to WTO resolution), culture (similarly leaving aside the principal issues not already covered by the WTO), and recognition of the importance of the energy sector;
- reconciling the differences in the two countries' current free-trade and preferential-trade arrangements with other countries respecting product coverage, rules of origin, and possible future free trade partners.
- a common approach to trade remedy laws that would imply a single regime for third countries, and recognizing that Canada-US cases are rare, concern largely resource products, notably softwood lumber, and point to the need to pay attention to resource management issues.
- a common external trade policy with respect to multilateral and regional negotiations (which, given the degree of policy convergence, should not prove difficult) and more generally for the conduct of trade relations with third countries; with respect to trade sanctions for foreign policy reasons, it should be possible to maintain policy flexibility and devise practical instruments for this purpose without compromising the integrity of the union;
- dispute settlement within the customs union based upon the current NAFTA provisions with, as necessary, some major updating; and
- institutions for administering the union, resolving disputes, and facilitating dynamic, joint policy development to govern accelerating economic integration, drawing upon existing models such as the International Joint Commission.

Each of these would pose technically complex challenges but none would raise insurmountable barriers. The major policy issues inherent in implementing a customs union have essentially been resolved by a process of policy convergence and multilateral and bilateral trade agreements. This conventional approach would, in effect, clean up the leftovers from earlier negotiations but fail to address emerging issues flowing from deepening integration. The advantage of convention is the high level of comfort that Canadians have with the tried and true. The constraint is that the returns from such an approach promise to be minimal. Conventional trade policy provided an appropriate answer to the policy challenges of the past. It provides at best a partial answer to the challenges and problems that flow from the deep integration that now characterizes exchange between Canada and the United States. At its most basic, it would be limited to the exchange of goods, and not address issues related to the exchange of services, capital, or intellectual property rights, and not cover the movement of people.

Canadian trade policy, which in the past has provided answers to the conundrums of the relationship with the United States, is stuck in neutral. During the 2006 election, there was no public discussion of the deep integration that already exists and the broad patterns of cooperation and policy coordination with the United States that have emerged beneath the radar screens of political approval or formal agreement. The logic of Canada's economic interest makes a compelling argument to focus energies upon reinventing the US relationship to conform to modern realities. Yet, time stands still for no policy and unless answers are found to the quandaries of economic integration and the implications that flow from it, Canadians will begin to pay increasingly heavy economic costs from policy paralysis.

Reaping the full benefits of deepening cross-border economic integration will require that Canada and the United States address three fundamental, and interrelated, issues: reducing the impact of the border, accelerating and directing the pace of regulatory convergence, and building the necessary institutional capacity to implement the results of meeting the first two challenges. Each of these will prove difficult and solving the prob-

lems associated with either of the first two will prove illusory without addressing the other two.

Border Administration

The first challenge is to address the increasing dysfunctional border administration⁵⁴. The intensity of the cross-border relationship is apparent from the 36,000 trucks and 400,000 people who cross the border every day. Nevertheless, even after 15 years of “free” trade, the Canada-United States border continues to bristle with uniformed and armed officers determined to ensure that commerce and interaction between Canadians and Americans complies with an astonishing array of prohibitions, restrictions, and regulations. The list of rules and regulations for which the border remains a convenient, and even primary, enforcement vehicle has grown, rather than diminished, since the implementation of free trade, particular in response to the new security realities created by 9/11. Administering the physical border imposes high costs on the two governments, on firms and individuals who use the border frequently to conduct their affairs in the integrated North American economy, and on the two economies in terms of opportunities missed to reap the full benefits of deep integration⁵⁵. The result is a not an integrated,

⁵⁴ For more detail, see William B. P. Robson and Danielle Goldfarb, “Risky Business: U.S. Border Security and the Threat to Canadian Exports.” *C.D. Howe Institute Commentary*, No. 177 (Toronto, March 2005).

⁵⁵ Firms in considering fragmentation strategies consider tariff and other border barriers, wage differentials, transport and other integration costs, input costs, government policies, and more. For example, a Canadian firm supplying customers throughout North America, designs and engineers its products in Canada, sources high-end components in the US and Japan, lower-end components in Malaysia and Korea, and contracts for final assembly in China. Product is then shipped to North America for distribution to customers in both Canada and the United States, who rely on local distributors for after-market service. Location of the central distribution facility will in part be determined by the MFN tariff and rules of origin that will apply, and will likely take place in the United States, even if a Canadian location has clear logistic and other cost advantages, because the bulk of product can be distributed on the basis of one customs clearance rather than two. The result is not important to US policy makers but is critical to Canadians.

single North American market, but two markets with many cross-border ties that remain hostage to the efficiency and reliability of customs clearance, an issue of greater importance to Canadian-based than US-based firms.

In addition to routine customs and immigration activities, both Canada and the United States use border controls to interdict illegal immigration, drugs, terrorism, and other criminal activities. Experience, however, suggests that the cost of border administration to pursue these goals is out of proportion to the results⁵⁶. The border is simply too long and too porous to prevent determined cross-border criminal activity. Devoting even more resources at border checkpoints along the bilateral border seems unlikely to achieve additional results absent extraordinary further investments in human and physical infrastructure. Increasing resources to such an extent, however, risks causing considerable collateral damage to economic interests in an effort to find solutions to a problem that can be handled more effectively and efficiently through other initiatives.

To that end, ways need to be found to reduce the impact of the border. The two governments could, for example, strengthen institutional contacts, enhance cooperation, and share information on matters small and large. They could explore further investments in intelligence gathering and gradually focus ever larger parts of that effort at initial entries into North America. They could also make greater investments in infrastructure and in technology (both at ports-of-entry and the corridors leading to such ports). Both types of investments are critical components of any comprehensive effort at improving the management of the border and reducing its commercial impact. Such investments need not proceed on the basis of current inspection methodologies, but could rely much more on risk assessments and random inspections⁵⁷. They could also focus more on tar-

⁵⁶ This, of course, is not a view shared by all; some hold that no cost is too large to protect the country from illegal drugs, immigrants, and other criminal activity. This perspective was well represented by Tim Naumetz, "Summer border policy: take operational risks," *National Post*, 22 July 2003 A2.

⁵⁷ To combat terrorism and other illegal activity, for example, Canada and the United States need rapid and timely exchanges of information on

getting resources toward pre-clearance programs for goods, vehicles, and people. Finally, the two governments could enhance discussions about increasing the level of convergence in US and Canadian policies governing such matters as cargo and passenger pre-clearance programs, law enforcement programs of all types, and immigration and refugee determination procedures.

The issues raised in this section, of course, apply largely to problems experienced in the exchange of goods. The cross-border exchange of services takes place to a significant extent without much government notice at the border. Some of it is exchanged electronically; some is eventually embedded in goods; and its extent is difficult to measure. Nevertheless, there are elements of border administration that are pertinent to trade in services, particularly professional services, entertainment services, and similar economic transactions that require the movement across the border of “natural” persons, i.e., real people. The CUSFTA and NAFTA include provisions to facilitate the temporary movement of business people, but these are a far cry from allowing the free movement of labour. Unlike the Schengen Agreement in Europe allowing for the free movement of people throughout the area covered by the arrangement, Canada and the United States still maintain stringent controls on the cross-border travel of each other’s residents⁵⁸.

Given the extent of cross-border integration, the two governments have taken steps to address border congestion, but

criminals and other individuals who may pose a security risk. Although there is information sharing at the moment, it may need to be significantly upgraded and some of the information databases need to be combined and made available at the border. Information from law enforcement agencies, immigration agencies, the courts, and other institutions may need to be jointly accessible, at the border, in real time. There is need for much greater collaboration and better information management. Modern database management tools, as well as leading-edge networking software, can be deployed at the border and connected to main databases in Canada and the United States.

⁵⁸ See Michael Hart, *Is There Scope for Enhancing the Mobility of Labour Between Canada and the United States?* Paper prepared for Industry Canada, March 2004. Working Paper Series: Working Paper 2004 D-04, available at strategis.ic.gc.ca/epic/internet/ineas-aes.nsf/en/ra01934e.html.

with limited results to date. Efforts to make the border less intrusive and more efficient were integral to the 1996 *Shared Border Accord*, the 1999 *Canada-United States Partnership Forum*, the 2001 *Smart Border Accord*, and now the 2005 *Security and Prosperity Partnership*⁵⁹. These initiatives, however, have been limited by the decision to work within the confines of existing legislative mandates. Furthermore, they assume continued need for current levels of border administration and thus are not aimed at eliminating or limiting the impact of the border, but at making border administration more efficient. Adding this effort to a broader commitment to negotiate a deep integration agreement would provide officials working on this file with the strategic vision they need to move beyond existing legislative mandates and provide them with greater scope to make useful trade-offs among competing priorities. Creating such a framework, investing in infrastructure and in technology (both at ports-of-entry and the corridors leading to such ports), and targeting resources toward pre-clearance programs for goods, vehicles, and people are critical components of any comprehensive effort at improving the management of the border and reducing its commercial impact. Ultimately, in our view, the objective should be to create a border that is considerably more open and less bureaucratic, within a North America that is more secure. If Canadians and Americans want a smarter and less intrusive border between them, they will also need to cooperate to create a more secure perimeter. The result should be a more open, more prosperous, and more secure continent.

⁵⁹ Pressure to be seen to be doing something disposes governments to artfully repackage earlier efforts in order to create new “announcables.” Students of this phenomenon would do well, for example, to study the evolution of these four initiatives. Each promised concerted action at the level of the executive branch of government to address a series of border-related problems within existing legislative frameworks. All four shied away from any commitments that might lead to new treaty-level obligations that would require legislative approval. More may not have been politically feasible, but it is unrealistic to expect substantive results without a willingness to invest in more robust projects that might require legislative implementation.

Regulatory Cooperation

A key component to trimming border congestion lies in meeting the second challenge: reducing the impact of regulatory differences between Canada and the United States. As the Canadian Council of Chief Executives points out, “most of the administrative costs and delays at the border come not from the need to assess customs duties, but from myriad rules and regulations that are simply convenient for governments to handle at the border.”⁶⁰ As Europeans learned, regulatory cooperation and reducing border formalities are two sides of the same coin. There may be a long tradition of pragmatic, informal problem solving between the regulatory authorities of the two federal governments, as well as among provincial and state governments, but the time has come to ask how much regulatory enforcement needs to be exercised at the border and how much can be exercised behind the border. More fundamentally, as regulatory cooperation and convergence proceed, the question becomes whether the two governments are ready to proceed to a more formal, treaty-based process of regulatory cooperation aimed at eliminating to the largest extent possible what has been characterized as the tyranny of small differences. By eliminating those differences, much of the rationale for border administration disappears. As well, it would increase the benefits of deepening integration.

The need to produce multiple versions of the same good, for example, can increase design and production costs, and prevent firms from enjoying the economies of scale that would flow from producing to satisfy a single globally accepted standard. An ever-growing range of goods have to be tested and certified to exacting standards and regulatory requirements before they can be sold. An equally exploding range of services faces onerous and often repetitive qualification and certification requirements. Compliance with different national rules, together with the repetition of redundant testing and certification of

⁶⁰ Canadian Council of Chief Executives, “New Frontiers: Building a 21st Century Canada-United States Partnership in North America.” At www.ceocouncil.ca/en/view/?document_id=365&area_id=7.

products and providers for different markets, raises costs for manufacturers and providers operating in the North American economy. Additionally, complex and lengthy product- or provider-approval procedures can slow down innovation, frustrate new product launches, and operate to protect domestic producers and providers from foreign competitors. For small- or medium-sized firms, the cost of acquiring knowledge of and access to another country's regulatory regime can also effectively dissuade them from attempting to develop that market altogether.

While well-conceived regulations can be trade promoting and facilitating, regulatory divergence with the United States undermines Canadian competitiveness and results in lost investment. Recent research shows that the benefits of convergence between Canada and the United States are positive and significant. At the same time, Canada's regime, even allowing for important reforms that occurred over the last two decades, imposes significantly heavier burdens on the economy than that of the United States. If the burden of regulation in Canada had been the same as that of the United States, there would have been an average increase of investment in Canada of about US \$1 billion annually. If the rate of change in the Canadian regime had been the same as that in the United States, the total investment would have been about \$400 million higher resulting in an average of 30 percent more investment annually than the level that occurred. One consequence of such increased investment would have been a 6 percent increase in the research and development share of the GDP⁶¹.

These impacts can be divided into two broad categories: those intended to discriminate in favour of local producers, and those that are the incidental result of regulations aimed at other objectives. The first represents the residual elements of traditional trade liberalization negotiations, and includes such measures as remaining tariffs, government procurement restrictions, trade remedy laws, and similar measures. The second involves a

⁶¹ See Fidele Ndayisenya, "Economic Impacts of Regulatory Convergence Between Canada and the United States," In *Horizons*, 7:1 (June 2004), Canadian Policy Research Initiative.

wide range of measures that reflect the increasing complexity of modern economies and the response of governments to demands ranging from consumer protection to environmental stewardship and human rights. The trade and investment effects of the first could continue to be addressed with the traditional approach embedded in trade and investment liberalization agreements; the second would require higher levels of cooperation to identify those regulations that no longer serve any useful public purpose, those that can be implemented and administered on a basis that limits or eliminates the impact of differences, and those where differences are profound and important. Only the latter may need to continue to create any substantive barriers to trade and investment, but on a much more limited basis than is often the case today.

In the final analysis, however, many of these differences are marginal in their regulatory outcomes, particularly between Canada and the United States, but annoying and even dysfunctional in their economic impact. For companies exporting to multiple markets, the promise of “one standard, one test, accepted everywhere” has become increasingly more attractive⁶². Despite populist notions to the contrary, US regulatory requirements are often more stringent than those in Canada. To take one politically salient example, US responses to environmental degradation, from carbon emissions to water pollution, are often ahead of Canadian efforts. Notes George Hoberg: “as a result of policy integration through emulation, common science and technology, and shared values and politics, environmental policy in Canada and the United States has witnessed a substan-

⁶² The OECD’s Philip Wagner indicates how everyone would benefit from achieving this goal: “With harmonised standards and certification procedures, consumers can be confident that products sold throughout the global marketplace meet the same high safety standards everywhere. Manufacturers can avoid costly and unnecessary testing, and their innovative products will gain access to markets more speedily. Regulators can deploy increasingly scarce resources elsewhere, confident that products have been adequately tested and meet exacting requirements.” Christopher Wagner, “Safe Products and Global Trade,” *The OECD Observer*, No. 202 (October/November 1996), 16.

tial amount of convergence.”⁶³ But, as Nancy Olewiler points out, Canada’s “kinder, gentler route to improving the environment ... also means that Canada may not be moving as fast as it could toward reaching environmental targets.”⁶⁴ A coherent program of cross-border cooperation is thus likely to strengthen Canadian regulatory outcomes, even one that will require Canada to do much of the heavy lifting and adjustment.

More to the point, bilateral regulatory convergence is more likely to involve adoption of best practices than reliance on the lowest common denominator. As an Industry Canada survey of Canadian regulators notes: “All of those surveyed indicated that their broad policy objectives were similar to those of their US counterparts. However, many stressed that differences in the respective systems of government and authorizing legislation complicate efforts to cooperate, effectively limiting what can be achieved without significant legislative changes.” The same survey also indicated that “most cooperation takes place at the operational level.”⁶⁵ At the same time, as the survey notes: without an external prod such as a trade negotiation, regulatory cooperation among those operationally responsible quickly grinds to a halt; without the involvement of regulators in the negotiations, however, the required objectives and means may not be well framed, leading to sub-optimal results.

The default option in addressing regulatory convergence between Canada and the United States has been to stay on the very Canadian path that has gradually emerged: cooperation if necessary but not necessarily cooperation. The results have not been uninteresting: Canadian jurisdictions align their regulatory goals and objectives with those of their US counterparts, work with US regu-

⁶³ George Hoberg, “Governing the Environment: Comparing Canada and the United States,” in Keith G. Banting, George Hoberg, and Richard Simeon, eds., *Degrees of Freedom: Canada and the United States in a Changing World* (Montreal and Kingston: McGill-Queen’s Press, 1997), p. 384.

⁶⁴ Nancy Olewiler, “North American Integration and the Environment,” in Richard G. Harris, ed., *North American Linkages: Opportunities and Challenges for Canada* (Calgary: University of Calgary Press, 2003), p. 619.

⁶⁵ Industry Canada, *North American Regulatory Cooperation*, draft, February 2002, authors’ files.

lators in many areas, but maintain sufficient regulatory autonomy to chart their own path. The result is two very similar but autonomous regulatory regimes involving extensive duplication and redundancy. The extent of regulatory convergence and cooperation is often influenced by bureaucratic agendas and preferences at the expense of broader goals from economic development to regulatory efficiency. This default position also avoids confronting the two related issues: the border and institutional capacity.

The External Advisory Committee on Smart Regulation (EACSR) appointed by Prime Minister Chrétien concluded that this model was inadequate to address Canada's needs and recommended a proactive approach. It recognized that Canada is "enmeshed in a dense web of international relations," but wondered "whether the government's international regulatory activity is well aligned with national priorities and whether resources are being put to best use." It recommended that "the federal government should work to: achieve compatible standards and regulation in areas that would enhance the efficiency of the Canadian economy and provide high levels of protection for human health and the environment; eliminate small regulatory differences and reduce regulatory impediments to an integrated North American market; move toward single review and approval of products and services for all jurisdictions in North America; and put in place integrated regulatory processes to support key integrated North American industries (e.g., energy, agriculture, food) and provide more effective responses to threats to human and animal health and the environment."⁶⁶

The Committee also recognized two policy traps that continue to appeal to some Canadians:

- Canadians can align their regulations with those in the United States to the extent they collectively judge it to be desirable on their own and do not need to complicate this process by tying it to a bilateral program; and

⁶⁶ External Advisory Committee on Smart Regulation, *Smart Regulation: A Regulatory Strategy for Canada* (Ottawa, Privy Council Office, 2004). At http://epe.lac-bac.gc.ca/100/206/301/pco-bcp/committees/smart_regulation-ef/2006-10-11/www.pco-bcp.gc.ca/smartreg-regint/en/08/rpt_fnl.pdf; pp. 17 & 22.

- Canadians should make a strategic judgment of where they want to be competitive, and then decide whether it is best to achieve that by being the same, being better, or being different.

While there is a superficial appeal to both points, experience suggests a unilateral approach is less likely to yield the desired result: reduce the impact of the border on Canadian trade and investment patterns. This goal will not be achieved in the absence of US confidence that Canada's regulatory regime is substantively equivalent to its own, a confidence that will require its active engagement. The existence of an agreed bilateral program, even one that may require Canada to adapt and adjust much more than the United States, has the additional clear advantage of bringing political pressure to bear on a process that would otherwise become too easily captive of bureaucratic agendas. The prime objective of such a program would not be to promote regulatory convergence for its own sake, but to enhance the performance of the Canadian economy by reducing barriers to reaping the full benefits of North American integration.

The government broadly accepted the recommendations of the EACSR and, in the context of the *Security and Prosperity Partnership* (SPP) adopted by the Presidents of the United States and Mexico and the Prime Minister of Canada in Waco, Texas in March 2005, took important steps to move the agenda along. It appointed a group in the Privy Council Office (PCO)⁶⁷ to pursue the path charted by the EACSR. Additionally, the federal government's Policy Research Initiative (PRI) was charged to consider ways and means to implement the EACSR recommendations. In his meeting with the two presidents in April 2006, Prime Minister Stephen Harper confirmed his government's commitment to the continued pursuit of the SPP agenda. What has emerged to date is a commitment to what might be characterized as accelerated incrementalism. The result is a higher level of awareness of regulatory developments in the

⁶⁷ As part of its effort to decentralize decision-making and reduce the PCO to its traditional role of policy coordination, the Harper government assigned work on regulatory reform to Industry Minister Maxime Bernier and his officials.

United States among Canadian policy makers leading to enhanced opportunities to align Canadian regulatory policy with developments in Washington. What is missing is a strong political commitment to regulatory cooperation and a plan to put it into effect. Not surprisingly, the pace in achieving regulatory rationalization has been glacial.

The current Canadian approach also appeals to American regulators, who have to date exhibited little appetite for more. The US decision-making system is extraordinarily resistant to centralized control and thus a very difficult target for more than piecemeal, regulator-to-regulator cooperation. The US President, for example, may appoint the Commissioners to the Securities and Exchange Commission, but once in office, they act fully independently of his direction.

Nevertheless, in both Washington and Ottawa, efforts at regulatory reform and streamlining have gained a growing number of adherents. Congress in 1980 established an Office of Information and Regulatory Affairs (OIRA) in the Office of Management and Budget (OMB) and successive presidents have, through Executive Orders, set out the basis for OIRA to provide systematic, centralized review and appraisal of all federal regulations. Much of this effort has been coordinated with broader international initiatives, particularly at the OECD. Canadian efforts parallel those in the United States. Since 1978, Canadian federal regulatory activity has been subject to a constant, comprehensive, centralized process of review, housed initially in the Treasury Board and subsequently in the PCO, with a view to eliminating duplication and redundancy and promoting best international practice. The guiding policies developed in both capitals for rule making and review are remarkably similar in tone and intent and reflect the high level of ongoing discussions at the OECD and bilaterally⁶⁸. A sound foundation has, therefore, been created for a more formal program of cross-

⁶⁸ See, for example, "Government of Canada Regulatory Policy" at http://www.tbs-sct.gc.ca/ri-qr/ra-ar/docs/publications/regulatory_policy_e.pdf and United States. "Economic Analysis of Federal Regulations Under Executive Order 12866." At <http://www.whitehouse.gov/omb/inforeg/riaguide.html>

border regulatory cooperation and even coordination. To go to the next level, however, the two governments would need to adopt a program leading to an enforceable agreement, and the institutional capacity to make it work⁶⁹.

Governments must think carefully about any initiatives that may compromise their ability to discharge their responsibility for the security and well-being of their citizens. Canadian experience in negotiating international rules and pursuing regulatory cooperation, both multilaterally and bilaterally, suggests that there is no inherent conflict between these responsibilities and such rule-making and cooperation. Nevertheless, vested interests can mount emotional campaigns questioning the extent to which regulations made jointly with others can respond to Canadian responsibilities. Fortunately, it is not difficult to refute such claims. Canadians, for example, routinely travel in the United States, comfortable in the reliability of US safety regulations. They eat and drink in the United States on the same basis as they do at home. If they are sick, they often can and do rely, at considerable expense, on US medical advice and US-approved drugs. From almost any perspective, Canadians have few if any qualms about the goals and efficacy of US regulations when in the United States. There are few other countries about which Canadians routinely exhibit such confidence. The reason is simple: Canadian and US regulatory regimes are, in almost all respects, closely aligned. The differences are matters of detail that may matter to individual regulators, but have little impact on residents in either country.

Initially, the two governments could build confidence and gain experience at the federal level, but given the federal structure of the two countries, the sooner they engage provincial and state regulatory authorities in a similar process of mandatory information exchange and consultations, the sooner the two countries would arrive at a “North American” approach to meeting

⁶⁹ For more detail on what this would involve, see Michael Hart, “Steer or Drift? Taking Charge of Canada-US Regulatory Convergence,” *C.D. Howe Institute Commentary*, No. 229 (Toronto, March 2006). This *Commentary* also includes a discussion of the experience in Europe in transforming its customs union into an integrated market.

their regulatory goals and objectives. Because of the large number of jurisdictions involved, this is an area that would require some creative decision rules as well as institutions to make them work. Fortunately, as at the federal level, extensive regional networks of collaboration already exist between Canadian and US regulators. Any successful federal strategy on economic integration and regulatory convergence would need to both complement and take advantage of these existing cross-border institutions.

Institutional Capacity

Integral to any progress in addressing the governance of deepening integration is the need to build sufficient institutional capacity and procedural frameworks to reduce conflict, and provide a more flexible basis for dynamic rule-making and adaptation for the North American market as a whole. It may well be necessary to consign traditional aversion to bilateral institution building to the dustbin and look creatively to the future. While the European model of a complex supranational infrastructure may not suit North American circumstances, there are lessons Canadians and Americans can learn from the EU experience.

The deep integration described above has occurred in the historical absence of an institutional infrastructure for managing this complex, multifaceted relationship. Unlike other bilateral relationships enjoyed by both Canada and the United States, there is no body to provide political or policy oversight of the relationship, no regular meetings between heads of government or foreign or trade ministers, no formal structure of committees looking at the relationship in a coherent and coordinated manner⁷⁰. The absence of formal structure results from a determined

⁷⁰ As former Canadian ambassador to the United States, Allan Gotlieb, observes, “the world’s largest bilateral economic relationship [is] managed without the assistance of bilateral institutions and procedures.” “A Grand Bargain with the US,” *National Post*, 5 March 2003. This paucity of institutions stands in stark contrast with a veritable cornucopia of institutional relationships with the European Union including biannual meetings of the Prime Minister, the President of the European Commission and President (in office) of the Council as well as a host of ministerial committees, official working groups etc. See www.dfait-maeci.gc.ca/canada-europa/mundi/menu-en.asp.

and largely successful effort to treat issues in the relationship vertically, rather than horizontally, and to build firewalls to prevent cross linkages. In part, this method of management derives from Canadian fears that, as the smaller partner, Canadian interests would be overwhelmed in any more formal relationship. In part, it originates in the US system of governance that makes coherence and coordination in both foreign and domestic policies extraordinarily difficult to achieve on a sustained basis.

The institutional gap is filled by inspired *ad hocery*. The inter-connected natures of the Canadian and American economies virtually require Canadian and US officials to work closely together to manage and implement a vast array of similar but not identical regulatory regimes from food safety to refugee determinations. Officials and, in some cases, ministers have developed a dense network of informal cooperative arrangements to share information, experience, data, and expertise with a view to improving regulatory outcomes, reducing costs, solving cross-border problems, implementing mutual recognition arrangements, establishing joint testing protocols, and more. On any given day, dozens of US and Canadian officials at federal, provincial, and state levels are working together, visiting, meeting, sharing e-mails, taking phone calls, and more. Virtually all of this activity takes place below the political radar screen. Little of it is coordinated or subject to a coherent overall view of priorities or strategic goals. Some of it is mandated by formal agreements ranging from the NAFTA to less formal memorandums of understanding. More importantly, much of this activity is the natural result of officials with similar responsibilities and shared outlooks seeking support and relationships to pursue them. This activity also reinforces, subtly and indirectly, the deepening integration of the two economies. The NAFTA and similar arrangements mark efforts by governments to catch up with these forces of silent integration and provide appropriate and facilitating governance.

The focus should be upon the functions that need to be performed for the efficient governance of deepening integration, rather than the creation of new institutions where none is needed. To some extent, these could be met by making creative

use of existing Canada-US cooperative arrangements, by investing officials in agencies on both sides of the border with new responsibilities, or by building on existing models that have worked well.

The two governments could, for example, stipulate that the Canadian Border Services Agency and the US Customs Service coordinate their efforts to ensure efficient administration of third-country imports. Similarly, an appropriate understanding could be reached requiring the Canadian Department of Transport and the US Department of Transportation to coordinate their efforts to ensure highway safety; before enacting any new rules and regulations, for example, mandatory coordination efforts would focus on ensuring compatible outcomes and mutual recognition of each other's approaches to the same problem. A good basis for this kind of cooperation already exists in both informal networks among officials, and in the relatively minor differences in regulatory approach. What is missing is an agreed mandate to resolve differences and a more formal institutional framework with authority to ensure mutually beneficial outcomes. Establishing a bilateral commission to supervise efforts to establish a more coordinated and convergent set of regulations governing all customs or transportation matters could prove critical to providing the necessary momentum and political will.

In both countries, labour mobility is hampered by provincial and state labour laws and delegated professional accreditation procedures. The NAFTA put in place a modest process to permit temporary entry for business and professional visitors and mutual recognition of professional accreditation. The latter has been hampered by the conflict of interest inherent in a system of self-regulation. As the EU learned, a more centralized approach was required to overcome conflicts of interest and bureaucratic inertia. From architects and accountants to doctors and dentists, there remains considerable scope for enhancing mutual recognition arrangements. An important step toward breaking the logjam would be to appoint a bilateral task force to develop model mutual recognition arrangements for consideration by state and provincial accreditation bodies.

Much can be achieved on the basis of existing networks of cooperation, with the addition as necessary of specific joint or bilateral commissions in instances where existing networks are inadequate. More will be achieved, however, if the two governments commit to the establishment of a limited number of bilateral institutions with a mandate to provide them with the necessary advice and information to effect a more integrated North American approach to regulation. An independent Canada-US Secretariat with a mandate to drive the agenda and report annually to the President and Prime Minister on progress could, for example, prove critical to overcoming bureaucratic inertia. Similarly, a Joint Advisory Board to the President and Prime Minister could contribute some creative drive to the development of new bilateral initiatives. As numerous studies have demonstrated, regulatory agendas are prone to capture, geared to serving the narrow interests of regulator and regulatee. Bilateral initiatives limited to regulatory authorities are unlikely to prove immune from this reality. Regular review by an independent advisory board of progress in implementing a bilateral program of “guided” regulatory convergence could thus prove a valuable addition in keeping the program focused on broader objectives.

The Mexico Question

In concluding the NAFTA in 1993, Canada and the United States opened a new era in their relations with Mexico. The NAFTA stands as testimony to the belief that the North American community involves three nations and that the destiny of all three nations is inextricably intertwined. Broad consensus is in our view emerging, however, that for the moment the Canadian challenge is to elaborate a bilateral rather than a trilateral agenda⁷¹. Successful implementation of the NAFTA ushered in

⁷¹ For some analysts, particularly those with legal training, the NAFTA now constitutes the indispensable foundation from which all future bilateral or trilateral trade and investment negotiations must proceed. Perhaps, but it is also possible to view the NAFTA as an agreement whose time came but is now largely gone. Between Canada and the United States, it is

expectations of closer trilateral relations, but the reality is that the NAFTA provides a common framework of rules to govern two robust and rapidly evolving relationships: between the United States and Canada and between the United States and Mexico. Canada-Mexico relations remain at a much less advanced stage, while the priority issues between Canada and the United States and Mexico and the United States are not of the same order. There are issue areas where there may already be scope for advancing toward trilateral rules and institutions, e.g., surface transportation, while in other issue areas much more will be gained from parallel bilateral efforts, e.g., energy. To that end, the three governments may wish to consider pursuing ways and means to network any bilateral and or efforts and ensure that any success at the bilateral level ultimately feeds into trilateral goals and aspirations⁷².

now fully implemented. Most of its provisions would be very difficult to undo. Its main continuing importance lies in the dispute settlement provisions set out in chapters 11 and 19; even chapter 20 has been largely superseded by the WTO Dispute Settlement Understanding. We do not mean to suggest that we can now abrogate the NAFTA, but rather that like the 1935 and 1938 Reciprocal Trade Agreements, the 1947 GATT, and the 1965 Autopact, the NAFTA's objectives have been largely realized. Any successor agreement may need to incorporate some of its elements (e.g., chapters 11 and 19), but need not be trilateral. Should Canada and the United States proceed to an agreement that moves well beyond the contours of conventional trade agreements, the precedential value of the NAFTA will be minimal.

⁷² In "A Trilateral Mirage: A Tale of Two Americas," a paper prepared for the Canadian Defence and Foreign Affairs Institute in June 2003, Jean Daudelin comes to a less accommodating conclusion: "Canada's bilateral relationship with the United States is vital and its management should not be cluttered by the massive complexity of Mexico-US affairs. ... Canada's relations with Mexico ... will remain marginal to the country's core interests." Jeffrey Schott, "Prospects for North American Economic Integration: An American Perspective Post-9/11," *Art of the State II: Thinking North America: Prospects and Pathways* (Montreal: Institute for Research on Public Policy, 2004), on the other hand, concludes that US political sensitivities make anything other than a trilateral initiative unrealistic. Discussions with US officials suggest that US political sensitivities are more nuanced, providing scope for differentiated approaches. The difficulties of a trilateral approach that considers both economic and security issues are also well illustrated by the paper prepared for The Art of the State II Conference by Stéphane Roussel and Athanasios Hristoulas,

The Security and Prosperity Partnership of 2005 and renewed in 2006, the official template for the discussion of emerging issues among the three federal governments of North America, specifically recognizes the reality of a “two-speed” approach. Future work on bilateral issues between Canada and the United States, therefore need not become hostage to whether or not Mexico is interested in, or has the capacity to pursue, a specific matter.

The Sovereignty Dimension

Canadian trade policy debates are virtually unique in their elevation of sovereignty as a critical issue of public policy⁷³. In the great debates of the past over free trade, notably the elections of 1891, 1911, and 1988, supporters of free trade with the United States found themselves under sustained attack on the grounds that the sacrifice of Canadian sovereignty was too heavy a price to pay. Any new trade negotiations with the United States is certain to revive this old, if increasingly quaint, discussion along a number of fronts.

One argument, advanced by the Senate Foreign Affairs Committee, is that concluding any deeper integration agreement, such as a customs union, would rob Canada of the capacity for setting tariffs on trade with third countries⁷⁴. The reality is that Canada has given up tariff autonomy through the progressive binding of its tariff in the GATT and WTO negotiations as well as the declining utility of the tariff as a policy instrument. A variant on this theme is the claim that a new agreement would prevent the pursuit of distinct industrial, energy,

“The Quest for trilateral security in North America” (Montreal: Institute for Research in Public Policy, 2003).

⁷³ With the exception of defence policy issues, where public discussion often veers into dead-end tangents divorced from the iron realities of protecting the two countries from external threats.

⁷⁴ Senate Standing Committee on Foreign Affairs, *Uncertain Access: The Consequences of US Security and Trade Actions for Canadian Trade Policy* (June 2003) at parl.gc.ca.

immigration, and environmental policies⁷⁵. This point also lacks substance. The scope for industrial and energy initiatives is already severely constrained by WTO rules on subsidies in the former and by the NAFTA rules in the latter. As regards issues such as immigration and environment, it is far from clear how creating an agreement to enlarge the benefits of economic integration would limit Canadian policy.

A second line of criticism is that a customs union agreement would tightly tether Canadian foreign policy to that of the United States. During the free trade negotiations in the 1980s, critics charged that the United States would threaten Canadian access to its market provided for under the agreement unless Canada embraced US foreign policy goals. Such criticism should be dismissed on a number of grounds. The United States has no modern history of withdrawing from trade agreements or reducing access to its market provided thereunder for foreign policy reasons. Second, the vulnerability of Canada to such a remote probability arises not from the existence of bilateral agreements, but from the deep integration of the two economies, an integration occurring principally because of the natural dynamics of economic integration, driven by the daily economic choices of individuals and firms and fostered by past multilateral and bilateral trade agreements. The only way to mitigate this vulnerability to the United States is to reverse the course of economic integration and accept the incalculable economic costs of such action as a price of insulation from US influence⁷⁶.

⁷⁵ For a sample of these views, see Andrew Jackson, "Why the 'Big Idea' is a Bad Idea: A Critical Perspective on Deeper Economic Relations with the United States" (Ottawa: Canadian Centre for Policy Alternatives, 2003). See also Stephen Clarkson, "Time to break free (trade)," *Globe and Mail*, 27 September 2002 and Peter Newman, "Beware of freer trade," *Maclean's*, 2 December 2002. A more thoughtful version of this view can be found in a series of columns by David Crane in the *Toronto Star*, August 9, 13, and 16, 2003. Support among Canadians for such a defensive attitude toward the United States, however, has steadily declined.

⁷⁶ Canadians have demonstrated that they have become increasingly comfortable with their proximity to the United States and with the pragmatic pursuit of better ways to manage deepening integration. See the discussion of

A third criticism is that a customs union would further erode Canada's historical multilateral vocation and undermine Canada's ability to participate in multilateral negotiations.⁷⁷ This argument reflects the continuing allure of multilateralism as the central organizing principle of Canadian trade and foreign policy. In fact, an objection to new bilateral arrangements on the grounds of protecting Canada's multilateral heritage is not only historical revisionism, it confuses ends with means⁷⁸. Multilateral rule making and institution building have proven effective means for Canada to pursue its trade objectives but have never impeded the pursuit of trade or foreign policy objectives by other means. Canada has been prepared to look to bilateral rules and institutions when these are available and better suited to achieve the policy objective sought. Both bilateral and multilateral strategies need to be judged on their ability to satisfy Canadian needs and interests. To forego benefits available in a bilateral arrangement in order to uphold the multilateral ideal would make a nullity of coherent policy making.

A fourth criticism is that a deep integration agreement would ignite a "race to the bottom," i.e., to a relentless effort by governments to attract foreign investors and retain domestic investors by reducing regulatory norms and expectations. There is little evidence to support this charge. Indeed, there is a preponderance of evidence pointing in exactly the opposite direction. As societies become more prosperous—one of the most important impacts of globalization and of deepening integration—the demand for regulations to enhance the quality of life increases. The explosion of government regulatory activity to address environmental, human rights, safety, and other issues provides com-

recent polling in Hart, "A New Accommodation with the United State: The Trade and Economic Dimension."

⁷⁷ See, for example, Robert Wolfe, "See You in Washington? A Pluralist Perspective on North American Institutions," *IRPP Choices*, 9:4, at irpp.org.

⁷⁸ Brian Tomlin and Bruce Doern, *Faith and Fear: The Free Trade Story* (Toronto: Stoddart, 1991), debunk this cherished myth of Canadian foreign policy elites.

elling evidence of the gap between rhetoric and reality. In the other direction, the impact of regulatory convergence and regulatory cooperation has been repeatedly to raise the bar by establishing international benchmarks of minimal performance and best international practice. As argued above, bilateral regulatory convergence is more likely to involve adoption of best practices than a lowering of standards to the lowest common denominator.

Conclusions

The Canadian and US economies have become intertwined in response to demands by Canadians and Americans alike for each other's products, services, capital, and ideas, creating jobs and wealth across many sectors and accelerating the forces of mutually beneficial integration. The strategic challenge facing Canadians today is whether they want their government to help or hinder accelerating cross-border economic integration and social and political interaction. Whatever the homilies about the value of independence, there is no sentiment that the government should interfere in private business and investment decisions to change the logic of resources, geography, and private choice that underpin economic integration.

The trade policy of the post-war years, grounded in the theories of well-established international trade theory and pursued on the basis of the politically pragmatic strategy of mercantilist bargaining, proved critical to underwriting the first stages of cross-border integration. The framework of rules and institutions developed over the past seventy years have worked well to facilitate and govern a process of "silent," market-led integration. Both the theory and the practice responded well to the issues that concerned the dominant economic players: large, vertically integrated, multinational companies with operations on both sides of the border focused on the production and exchange of physical goods. While such companies remain important players in North America, the development of much more fragmented production strategies, the ability to disperse production much more widely around the world, the emergence of new security threats, and the reality of a much wider range of cross-

border transactions, all point to the need to look at a new set of policy issues that threaten to disrupt the mutually beneficial process of cross-border integration.

The continued presence of a heavily administered border, of similar but differentiated regulatory regimes, and inadequate institutional capacity to solve problems, now undermines the ability of firms and individuals alike to reap the full benefits of deepening cross-border integration. New developments in trade and industrial organization theory help us to understand the nature of new production and exchange patterns and underline the extent to which subtle differences in regulatory regimes and undesirable border complications can frustrate corporate efforts to organize production and exchange as efficiently as possible. In a world where firms have many more choices about what to produce and where, the smaller partner in a deeply integrationist relationship is particularly vulnerable to the impact of border delays and regulatory differences. In these circumstances, the Canadian government is well-advised to invest in efforts that will bring the framework of rules governing cross-border exchange into line with commercial and economic reality.

The Consequent Policy and Research Agenda

Pursuing the policy issues outlined above would be facilitated if analysts, both inside and outside government, developed further some of the ideas set out in this paper and the data and analysis upon which it is based. To that end, we believe further work along the following lines would make a material contribution to informed policy discussion:

- More detailed assessments of the extent of fragmentation and integration involving firms and facilities with cross-border interests in Canada and the United States.
- The extent of investment and other corporate ties linking production in the two countries.
- An inventory of the issues critical to business and investment in making cross-border trade and investment function to its full potential.

- An inventory of the customs and related functions performed at the border that can be performed behind the border, facilitating pre-clearance and similar strategies.
- The relationship of formal border clearance procedures to the interdiction of criminal, terrorist, and other unlawful cross-border activities.
- An inventory of Canadian and US regulatory regimes with serious implications for cross-border trade and investment, and the extent of differences in each of these regimes.
- An inventory of the extent and nature of cross-border networks of decision-makers and an assessment of their effectiveness in addressing cross-border problems.
- An assessment of the European experience in governing deepening integration and the extent of its applicability to North American experience.

We list these as indicative of the range of interesting issues that warrant timely investigation and consideration in building the necessary intellectual capital to address the issues raised in this paper. Other may have additional ideas. What's important is that the analytical and policy communities devote the necessary intellectual resources to thinking through what would be involved in making the North American economy function even better in meeting the needs of Canadians and Americans alike.