No. 274, September 2008

C.D. Howe Institute
COMMENTARY

THE BORDER PAPERS

Still Amigos:
A Fresh Canada–US Approach to Reviving NAFTA

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In this issue...

To update NAFTA, the authors propose a distinct Canada–US collaborative strategy, which builds on mutual incentives in the areas of energy security and environmental sustainability.

The Study in Brief

Mending the much-maligned North American Free Trade Agreement (NAFTA), which recently came under attack on the United States presidential campaign trail as a source of American economic woes, should be a central trade policy goal for Canada and the United States.

Job losses in American, or indeed Canadian, manufacturing cannot be traced back to NAFTA. In fact NAFTA has been a source of productivity increases and is one of the anchors of the continental economy.

This *Commentary* proposes a distinct Canada-US collaborative strategy for updating NAFTA, which builds on mutual incentives in the areas of energy security and environmental sustainability. There are four areas where greater Canada-US cooperation is desirable and progressive and where the authors believe the incentives favour updating: energy, water, climate change, and the environment and labour agreements. Both countries have strong incentives to cooperate - for this reason, revisiting sensitive issues will not kill the agreement. Rather, it will create a new framework for moving the NAFTA agenda forward and deepening integration.

Additionally, this *Commentary* offers positive changes to the NAFTA treatment of investor rights and dispute settlement provisions. Whether current politics in Canada and the US favour such changes is the outstanding question.

If NAFTA is re-examined in 2009 or 2010, it may not be a bad thing, so long as goodwill fosters cooperation and deeper integration. The *Commentary* concludes that NAFTA should evolve, but without the threat of abrogation. A fresh approach to dealing with bilateral trade issues, and a new vision of shared North American interests based on cooperation, offer a happy route forward to a more secure relationship.

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$12.00; ISBN 0-88806-764-X
ISSN 0824-8001 (print);
ISSN 1703-0765 (online)

The North American Free Trade Agreement (NAFTA) remains highly contentious in all three NAFTA countries. In Mexico, farm groups have demonstrated over the final elimination of tariffs on corn, sugar, beans, and powdered milk. In the United States, labour unions in manufacturing states such as Ohio and Pennsylvania blame the trade agreement for job losses and shuttered factories. In Canada, critics voice concerns over existing energy provisions and worry openly about possible bulk water exports.

During the Democratic primaries, Senators Hillary Clinton and Barack Obama, both vowed to renegotiate the environmental and labour side agreements and to make tough changes to the provisions under which foreign investors can initiate an international arbitration tribunal. This is not a first for political tough talk. When soon-to-be Canadian Prime Minister Jean Chrétien was running for the post in 1993, he insisted that if the Liberals were elected, his government would seek provisions on labour and the environment, in addition to improvements on energy, antidumping, and subsidies. The Liberals also sought the same energy provisions as Mexico – exemptions from supply and price guarantees on oil and petrochemicals – though Canada never achieved its wish list before the pact entered into force in January 1994.

To a large extent, Senator Obama's recent tough talk on NAFTA can be attributed to a hard-fought primary campaign, but it seems highly likely that an Obama presidency would bring a fresh look at NAFTA. A John McCain presidency would face a US populace harbouring protectionist attitudes toward trade and investment, a sentiment unlikely to dissipate soon.

Yet NAFTA remains vital to maintaining trade and investment in the three countries and helps anchor the economic health of the North American marketplace. We reject any strategy that would threaten to abrogate the trade pact. Instead, NAFTA needs to be reviewed – rather than 'end it,' policymakers on both sides of the border should strive to 'mend it.'

But how can this be done? How do we update NAFTA and improve its provisions, without endangering these same provisions that have become part of the fabric of cross-border trade, investment and economic prosperity?

Several approaches have been advocated in the last few years. Some have suggested deeper integration including a 'big bang' approach that combines greater security – a US imperative – with improved trade and investment provisions that are principally a Canadian goal.[1] Others have recommended a common external tariff as a first step to deeper integration.[2] These approaches never gained political traction.[3] Rather, an incremental 'below the radar' approach could update and improve NAFTA. The Security and Prosperity Partnership of North America (SPP)[4] was born in 2005 but in our view, its modest agenda has had few results.[5] Issues like regulatory harmonization and simplification of rules

The views expressed are those of the authors and do not reflect the views of the Institute, its staff, or directors. Many people provided helpful comments, including Sidney Weintraub, Robert Pastor, Michael Hart, Dan Ciuriak, Jon R. Johnson, Wendy Dobson, Claude Barfield, John Curtis, and Gary Horlick.

1 See Dobson (2002), Gotlieb (2002, 2003), Pastor (2002), Dymond and Hart (2003).

2 See Hufbauer and Schott (2004), Goldfarb (2003).

3 Conference Board of Canada (2003).

4 The SPP was launched in March of 2005 as a trilateral effort to increase security and enhance prosperity among the NAFTA countries. Its aim was to deepen the trade and economic relationships and increase cooperation in areas of the environment, food supply and public health. However, in our view, it has yet to deliver on its promises. See www.spp.gov.

5 Robert Pastor (2008) agrees: "If you measure progress by examining the growth in trade, the reduction in wait times at the borders, and the public's support for integration, all of these initiatives have failed miserably. The growth in trade in the Bush years has been less than one-third of what it was in the previous seven years -- three percent versus 9.8 percent. The wait times have lengthened, and public opinion toward the rest of North America in all three countries has deteriorated, in part because the United States failed to comply with NAFTA on issues (for example, trucking and softwood lumber) of great importance to Canada and Mexico."

of origin, though critical to cross-border trade, largely escape the interest of political leaders.

Though a trilateral approach is preferable, we believe that the nature of policy frictions today between the US and Canada on the one hand, and the US and Mexico on the other, differs dramatically. No serious trilateral negotiation is possible without forward movement on the immigration issue, which is so significant in the US-Mexican relationship. However, implementation of some of the policy recommendations in this paper will require trilateral agreement.

We see a need for an integrated Canada-US approach on environmental and economic issues that straddle political boundaries. In the face of zero progress through a big bang approach, and minimal success through an incremental policy process, Canada and the United States need to initiate a distinct, primarily bilateral approach to updating NAFTA. There are strong incentives for both countries to move the dialogue forward in the areas of energy security and environmental sustainability. First, there is political will in both countries to advance the agenda. Second, the effects of pollutants are cross-border so any solution needs to be collaborative; the same rationale applies for our integrated energy markets. Last, collaboration will reduce transaction costs and ensure that new policy measures do not act as disguised restrictions to trade. In turn, niggling barriers will be reduced as policymakers work to ensure energy security, environmental sustainability, and the development of alternative fuels. A new collaborative strategy can build results and benefits that could not be achieved through national policymaking alone.[6]

This analysis will proceed as follows. Part I examines the claim that NAFTA is responsible for manufacturing job losses and illuminates the host of other factors at play. This is aimed at challenging the campaign claim that reopening NAFTA will bring back jobs lost in manufacturing states. Part II supports continuing work on issues that are part of the SPP agenda and provides new ways of approaching old issues. Part III proposes a new collaborative strategy for updating NAFTA that builds on mutual incentives in the areas of energy security and environmental sustainability. Part IV identifies NAFTA chapters 11 and 19 as areas where we believe changes would be mutually beneficial but may not be politically feasible. Part V proposes a joint framework for working on key NAFTA issues.

Part I: Accounting for Manufacturing Job Losses

As the US economy falters, Americans are increasingly concerned about the trade deficit, manufacturing job losses, offshoring, and whether the playing field is tilted with respect to labour and environmental laws. Add to this the bleak picture of soaring energy costs and rising food prices and the outcome is populist US disapproval of global trade and investment.

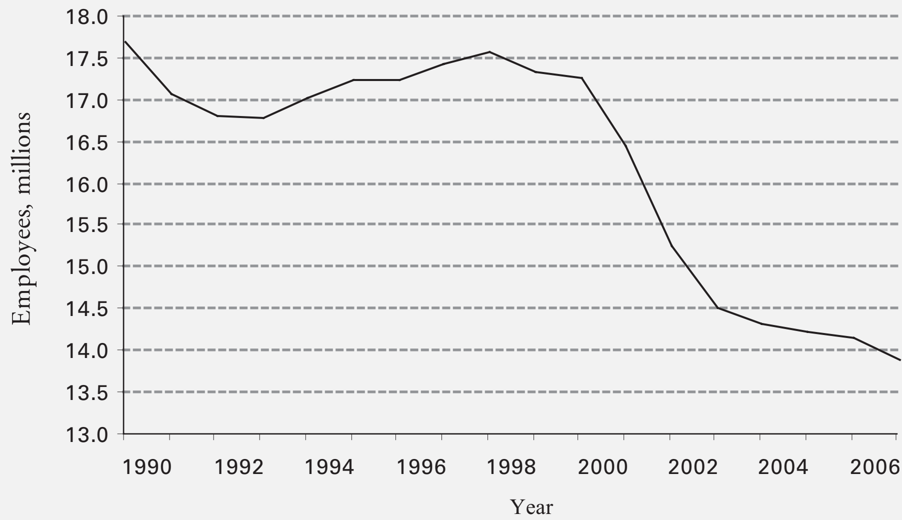
In Canada, the domestic sentiment on trade is less clear-cut because there are regional winners and losers despite overall aggregate benefits. While Canadians hear about layoffs in Ontario auto plants, soaring prices have enriched resource-based industries such as metals and petroleum products, particularly in Alberta and Saskatchewan.[7] But according to recent polls, Canadians realize that it is in their national interest to defend NAFTA.[8]

6 We are aware of the necessity of US legislative passage for these NAFTA updates. Though Fast Track or, as it is called today, Trade Promotion Authority (TPA), is not available currently, we believe the choice of provisions and issues provides the context for legislative passage. We expect close Executive-Congressional collaboration since the incentives for updating the NAFTA provisions should be as apparent to Congressional leaders as they would be to the Administration. Without that Congressional assent, it is unlikely that the Executive would risk re-opening the agreement.

7 In March 2008, Canada's trade surplus widened to $5.53 billion as energy exports jumped and imports of automotive products fell. Energy exports advanced 6.6 percent; however, industries tied closely to slumping US demand for automobiles and lumber are suffering. Automotive products posted a 4.9 percent drop in exports during the month, while the forestry sector recorded a 7.7 percent decline. See Egan (2008).

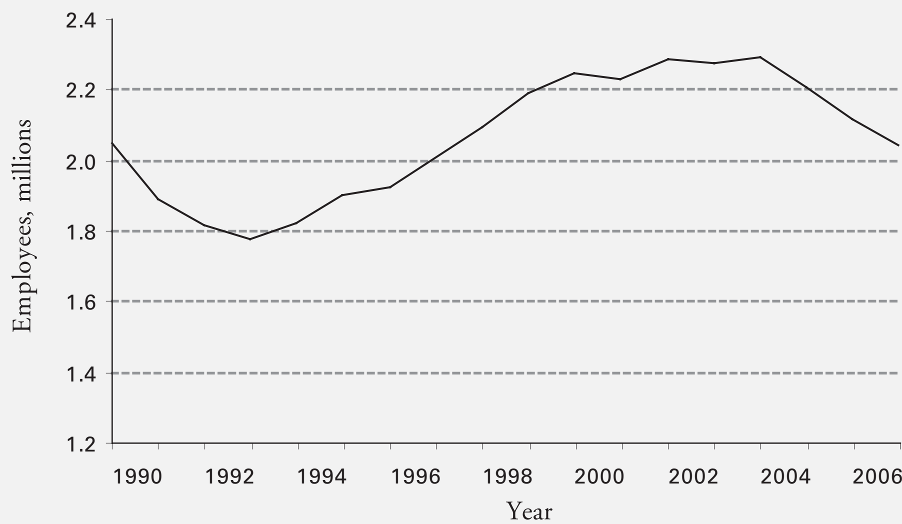
8 According to Harris/Decima, a public opinion and market research company in Canada, 49 percent of Canadians feel NAFTA has been good (39 percent) or very good (10 percent) for the Canadian economy. Nineteen percent feel it has been bad or very bad (8 percent). In every region, a plurality of respondents believes that NAFTA has been a good thing. Canadians tend to think that any effort by a Democratic President to reopen NAFTA would have a negative (38 percent) rather than a positive impact (21 percent) on Canada. Data were gathered between February 28 and March 3, 2008. http://www.decima.com/en/pdf/ news_releases/080310E.pdf

Figure 1: US Manufacturing Employment, 1990-2007



Source: US Department of Labour, Bureau of Labour Statistics, Series CEU3000000001.

Figure 2: Canadian Manufacturing Employment, 1990-2007



Source: Statistics Canada, Table 282-0094.

Sparking the current NAFTA debate in the United States is the dramatic fall in the share of US employment in the manufacturing sector – from 16 percent in 1990 to 10 percent in 2000.[9] However, the level of manufacturing employment has been declining for decades. In the early 1940s, manufacturing employment peaked at 32 percent of the labour force, but dropped below 13 percent in 2000.[10] Figure 1 traces the decline in US manufacturing employment since 1990: a steep recession from 2000 to 2003 ended the surge that took place during the 1990s, as nearly three million jobs were lost after 2000. The automobile sector was hardest hit. Since then, the rate of job attrition has slowed.

Canadian manufacturing firms – benefiting from rapid growth in the US, increased investment following NAFTA, and a cheap Canadian dollar – saw the number of jobs grow by 25 percent between 1992 and 2000. Canadian industry weathered the 2000-2003 recessions better than its US counterpart, although Canadian manufacturing employment registered a 10 percent decline over the past three years (Figure 2).[11]

To put the blame for recent US adversity on NAFTA would be to ignore underlying economic forces in both economies – notably fast productivity growth in manufacturing, slow demand growth, rising energy costs, and competition from large developing countries. The following section makes no attempt to assess the relationship between trade, wages, and employment; excellent literature surveys exist.[12] Rather, the section will outline forces that shape the current economic climate and suggest that long-term trends in Canada and the United States will not be reversed by renegotiating NAFTA chapters. While improving the agreement through revisiting certain chapters and adopting a joint approach to trade, energy, and the environment is central to this paper, it should not be driven by unattainable outcomes.

Increased Efficiency and Labour Productivity in the Manufacturing Sector

During the last 15 years, US manufacturing output has increased dramatically, particularly in the 1990s. Taking a longer view, output grew more than elevenfold between 1940 and 2000.[13] After 1990, US manufacturing capacity[14] expanded even more rapidly than output (Figure 3), so that today there is a fair amount of unused capacity.

Higher growth in labour productivity – output per hour – in both the United States and Canada since the mid-1990s, reflects capital investment and new technology.[15] Despite cyclical dips, US labour productivity growth has averaged over 4 percent since 1997.[16]

Improvements in productivity lead to higher real wages, lower prices, and greater profits. However, though prices of manufactured goods have fallen relative to services, the share of GDP accounted for by manufacturing output has been relatively constant for 50 years. In other words, lower relative prices have not led to increased sales. Instead, higher productivity has led to a decline in manufacturing's share of total employment. Here is the paradox: while North American factories have become far more efficient, and while manufacturing output has been growing, communities that rely on manufacturing industries have been hit by job losses.

Shifts in Consumer Demand – The Automotive Industry

The automotive industry has been hard hit both in Canada and the United States, especially the big

9 US Bureau of Labor Statistics. www.bls.gov.

10 Ibid.

11 Statistics Canada. www.statscan.com. Table 282-0094.

12 See, for example, Baldwin (1995), Slaughter (1998), Johnson and Stafford (1999), Gaston and Nelson (2000), Feenstra and Hanson (2004), Goldberg and Pavcnik (2004). Hoekman and Winters (2005) provides some stylized facts based on broad themes covered in the literature.

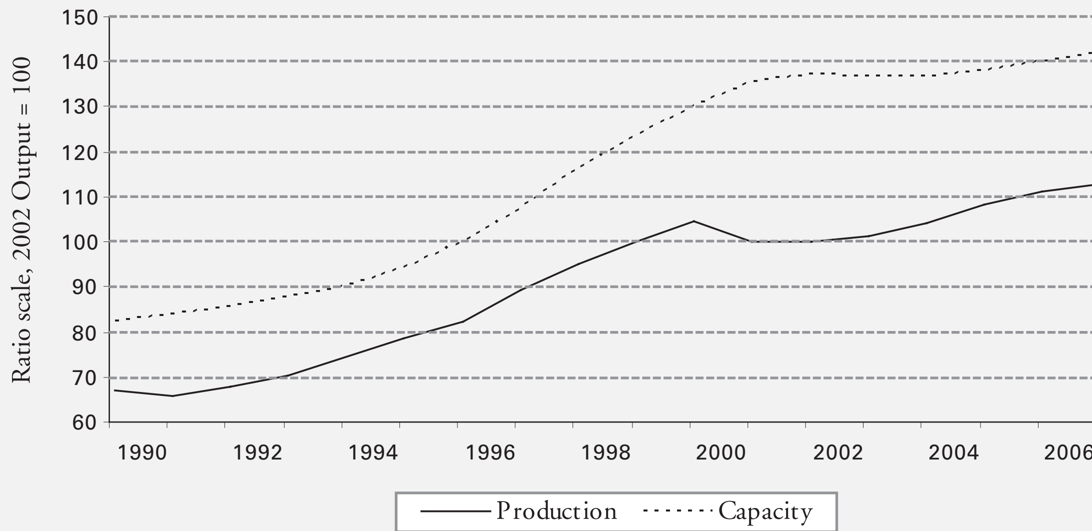
13 Federal Reserve, www.federalreserve.gov.

14 Capacity is an index of the maximum sustainable output of an industry. Capacity utilization is the ratio of output to capacity and represents a good barometer for the economy. If market demand grows, capacity utilization will rise. If demand weakens, capacity utilization will slacken.

15 As well, labour productivity is affected by the level of output; capacity utilization; the use of purchased inputs, including contract employment services; the organization of production; managerial skill; and the characteristics of the workforce. Statistics Canada, www.statscan.ca.

16 See US BLS Series PRS300006091.

Figure 3: US Manufacturing Production and Capacity, 1990-2007



Source: Federal Reserve Annual Revision 2008.

Table 1: Value of Canadian Automotive Trade Balance*, selected years ($millions)

Sector	Sub-Sector	1998	2000	2002	2004	2006
Total Motor Vehicle		29,530	37,481	28,974	27,462	18,925
	Light Vehicles	27,870	36,126	28,758	27,920	18,832
	Medium & Heavy-Duty Trucks	1,660	1,355	216	-458	93
Total Parts		-20,935	- 22,751	- 20,745	- 17,817	- 16,435

*Trade balance = total exports (including re-exports) – imports.

Source: Statistics Canada, available through Industry Canada, Table 25.

three North American firms – Ford, General Motors, and Chrysler. The recent US financial turmoil coupled with dramatically higher oil prices has triggered a sharp decline in demand for automobiles. The larger energy-consuming models, predominantly manufactured in Canada, are becoming unpopular.[17] In addition, many consumers are considering buying hybrid cars despite their higher cost.[18]

Table 1 shows the value of the Canadian automotive trade balance. The year-to-year change for medium- and heavy-duty trucks has been steadily decreasing since 1998 – the recent sharp fall in demand has led to a narrower trade balance with the US as the big three struggle to remain competitive. In

17 In April 2008, General Motors announced it would lay off 3,500 workers in their pickup and SUV factories in Michigan and Ontario. Sales of large SUVs were down 26 percent in March. Yahoo News, April 28, 2008 (article no longer available online).

18 *US News & World Report* (2008).

Table 2: Annual Average Growth Rates of Merchandise Exports, 1995-2005 (percent)

Mexico	Brazil	China	India	Canada	United States
9.17	8.51	17.48	11.35	5.52	3.24

Source: UNCTAD Handbook of Statistics 2007.

order to cut costs, all three firms have slashed jobs and are quickly moving to smarter, more fuel-efficient models. In absolute terms, there is less cross-border trade both in parts and in final goods.

These figures point to the fact that deep forces changing consumer preferences have had a profound impact on the automotive industry in both Canada and the United States.

Energy Costs

The rising cost of energy also has an adverse impact on manufacturing activity. High-energy consuming industries, such as pulp and paper, have adjusted to some extent by switching to cheaper fuel sources, but they still have been hard hit. The consequences are not limited to a narrow range of industries. For example, over 55 percent of US manufacturers are dependent on the chemical industry for basic chemicals, synthetics, paints, and coatings that are used in everything from auto parts to pharmaceuticals, to diapers.[19] All these items become more expensive as energy prices escalate.

The rising price of natural gas, which has increased 60 percent since January 2000,[20] has led chemical and fertilizer manufacturers to locate offshore where natural gas (not easily transported) is cheaper. Dow Chemical has joint ventures in the Middle East, Kuwait, and Oman, where natural gas prices are lower and there are opportunities for export. In fact, of the 80 plants being built by Dow, none are scheduled for construction in the United States, due to both the high cost of natural gas and US policies that limit drilling.[21]

Unless the economic environment changes dramatically, it is unlikely that departing chemical plants will come back anytime soon. The same is true of other manufacturing firms that locate plants abroad to take advantage of low-cost energy, either directly or by way of purchased inputs that are costly to transport. Further detail on rising energy costs and policy prescriptions are provided in Part III.

Rise of the BRICs

During the past 10 years, strong competition has arisen from several emerging economies, often stylized as the BRICs – Brazil, Russia, India, and China.

In comparison to China and India, Mexican and Brazilian growth rates are moderate, and Canadian and US growth rates are downright sluggish (Table 2). The shift in production from high labour-cost locations to China, India and other developing countries has reduced the volume of manufacturing production in Canada and the United States. The US trade deficit with China has surged in recent years as imports from China have grown much faster than US exports to China (see Table 3). The bilateral deficit rose from $30 billion in 1994 to $256 billion in 2007 and represents 32.4 percent of the total US trade deficit.[22]

These figures do not imply that a negative trade balance reduces the overall number of US jobs, but rather that it quickens the pace at which production shifts from one sector to another. To be sure, the

19 Friscia and O'Marah (2007).

20 Energy Information Administration. www.eia.doe.gov

21 Friscia and O'Marah (2007).

22 Trade deficits are not determined by the microeconomics of trade policy or industrial competitiveness but rather reflect underlying macroeconomic factors, specifically investment flows and, ultimately, the national rates of savings and investment that determine those flows. See Griswold (1998).

Table 3: US Merchandise Trade Balances with Major Trading Partners, 2007

Country or Trading Group	US Trade Balance ($billions)
World	-791.0
China	-256.3
European Union (EU27)	-107.4
Organization of Petroleum Exporting Countries (OPEC)	-127.4
Japan	-82.8
Canada	-64.7
Mexico	-74.3
Association of Southeast Asian Nations (ASEAN)	- 50.6

Source: USITC DataWeb

advanced nations still have a strong advantage in producing sophisticated manufactures, such as aircraft, power plants and medical equipment, while less complex products, such as textiles and electronic components, are increasingly the province of developing nations. But NAFTA helps ensure that the North American economy remains competitive, by giving producers access to a wide range of high-quality inputs at low prices.[23]

What does this recital of broad economic forces tell us? Manufacturing employment in Canada and the United States has declined for reasons unrelated to NAFTA.[24] International trade creates both winners and losers – but, in our view, the effects of NAFTA on trade and investment, employment and wages, dispute settlement, labour and the environment, and hemispheric cooperation and integration, have been welfare enhancing.[25] Yet evidence points to distributional effects related to the short-run transaction costs versus the long-run gains.[26] In addition, at the same time that manufacturing employment is falling, OECD countries are shifting towards service-based economies – both in terms of production for the home market and exports to global markets. NAFTA has created opportunities for services sectors. Reflecting the shifting patterns of comparative advantage, in 2007, the US manufacturing trade deficit was $679 billion while the services trade surplus was $104 billion.[27]

The solution for losers is not to support the abrogation of a free trade agreement that is tangentially related to their plight, especially since that agreement provides economic gains to the whole of North America.[28] Workers are understandably anxious about job losses and the costs they face in moving from the manufacturing sector to growing sectors of the economy. Social safety nets – job search assistance, portable pensions, continuing health insurance, and wage insurance[29] – better address the negative externalities of globalization.

23 See Trefler (2004) for labour productivity gains.

24 Leamer (2007) argues that the decline is due to a larger story of strong domestic demand growth offset by strong productivity growth.

25 See Hufbauer and Schott (2005), Weintraub (2004), Lederman, Maloney, and Serven (2005), and Romalis (2007).

26 Trefler (2004) finds that for those industries that experienced the deepest Canadian tariff cuts, employment fell by 12 percent and labour productivity rose by 15 percent as low-productivity plants contracted. For industries that received the largest US tariff cuts, there were no employment gains, but plant-level labour productivity soared by 14 percent. Simple welfare analysis provides evidence of aggregate long-run welfare gains.

27 Federal Reserve. www.federalreserve.gov.

28 See Hufbauer and Schott (2005) for a synthesis of the evidence on NAFTA's effects.

29 Wage insurance is a program of financial assistance upon reemployment, for workers who lose jobs, for any reason, through no fault of their own. The goal is to get workers back to work as soon as possible, while minimizing longer-term earnings losses. A key aspect of the program, and the difference between it and other adjustment assistance programs, is the employment incentive created by making benefits conditional on reemployment. See Kletzer and Litan (2001).

In what follows, we present an agenda for mutually beneficial reforms that can serve to deepen North American integration – some which require changes to NAFTA and others that do not. The next section addresses issues that do not require changes in the NAFTA text, though they do require changes in national laws and regulations.

Part II: Revisiting the Security and Prosperity Partnership (SPP)

Over the years, there has been much research on how to improve the flow of trade between Canada and the United States. Many of the ideas were adopted in the SPP initiative, though in our view, very little progress has been made in that forum. In this section we will identify key areas covered by the SPP where the costs of trade are increasing and propose coordinated efforts at the federal and the provincial/state levels.

Rising Security Concerns

Since September 11, 2001, heavy emphasis on security has 'thickened' the border. The United States, preoccupied with its efforts to thwart entry of terrorists and weapons, has focused on seaports, airports, and land borders. Inevitably, controls placed at the northern border, rather than at the North American perimeter, hamper commerce between the United States and Canada. Moreover, illegal immigration and drug trafficking across the Mexican border have merged in the US public mind with the terrorist threat. Thus, in October 2007, with little debate, the US Senate almost unanimously enacted border security measures, costing $3 billion.[30]

Even before 9/11, US ports of entry were struggling to accommodate rapidly growing traffic. For entering cargo, stringent security regulations now require state-of-the-art scanning equipment and highly trained operators. Superimposed on pre-existing congestion, the outcome is longer and more variable crossing times, and missed business opportunities.

Econometric studies have shown mixed outcomes from the imposition of these security measures. Globerman and Store (2006) find that while the effect of increased security measures on US exports to Canada disappeared by 2005, there has been a lasting negative impact on Canadian exports to the United States.[31] By contrast, Burt (2007) finds little evidence that tighter border security has reduced export volumes. Instead, industry-specific factors, such as the tech bust in 2000, and the softwood lumber dispute, were more important in explaining reduced trade flows.

In our view, whatever the residual impact of 9/11, increased security measures promise to impose additional costs and curtail cross-border trade. In 2007, US legislation – designed to implement many of the remaining recommendations of the 9/11 Commission – was adopted which mandates foreign ports to scan 100 percent of US-bound containers by 2012.[32] Fortunately, in 2005, the United States and Canada signed a Container Security Initiative Partnership Agreement with the goal of pre-screening imported goods destined for North America. Owing to this initiative, sealed cargo arriving in Canadian ports for onward shipment to the US need not be scanned a second time at the Canada-US border. Ideally, a joint inspection force between Canada and the United States would ensure that all containers arriving at the US border from Canada – whether loaded with Canadian or foreign merchandise – would pass. Scanning at congested borders inevitably leads to higher costs and less reliable shipment times.[33]

The goal, however, should be inspection of all North American containers at their points of origin,

30 Reuters (2007).

31 In Grady (draft 2008), the author finds that Canadian exports of goods to the United States, excluding energy and forestry products, are around 12 percent lower than they would have been otherwise. Similar results are found for the export of services, a decline of 8 percent.

32 Implementing Recommendations of the 9/11 Commission Act of 2007.

33 According to a recent study initiated by the World Customs Organization and undertaken by Professor Frederic Carluer of Le Havre University, besides burdening several ports with large investments, the new law would hamper world trade by creating severe logistical problems at ports. Carluer argues that even the leading ports in the world are unlikely to meet the 2012 deadline of 100 percent scanning and that consumers would eventually bear the increased cost of imported goods, estimated at $100 per container. See Carluer (2008).

whether in North America or abroad, followed by sophisticated tracking as trucks, railcars, cargo planes, and ships haul merchandise across land, air, and sea borders. This would require technical and personnel cooperation between Canada and the United States and could be extended to Mexico once capacity has improved. But the payoff of reduced congestion costs and border waiting times will be significant.

In addition to delays for trade in goods, restrictions on travelers escalated after the September 11, 2001 terrorist attacks. Since January 2008, the Western Hemisphere Travel Initiative has required citizens of the United States, Canada, Mexico, Bermuda, and the Caribbean who are traveling through the region to hold a passport. This rule hampers cross-border traffic between the United States and Canada because many citizens lack passports and the cost of getting one is high ($100 in the United States for 10 years; $87 in Canada for 5 years). Alternatives to a passport are stop-gap measures. The PASS card, SENTRI, NEXUS and FAST are designed to move the security process away from the border, but they have worked better on paper than in practice, and they cost money. As a constructive interim step, both countries could waive fees for these programs between 2008 and 2012. Like the defence budget, these security measures should be financed by general revenues, not by specific charges on affected travelers and cargo. These charges neither target directly the problem they are meant to address, nor do they provide a stable source of revenues.

Regulatory Harmonization

Regulatory barriers are a key factor in separating the US and Canadian economies. But attempts to harmonize North American standards or to embrace the European concept of mutual recognition run into three obstacles. First, even small steps require huge effort, and the political payoff often seems negligible. Second, many firms are happy to be protected by local standards against foreign competition. Third, national regulatory agencies prize their missions and their jobs, and are loathe to surrender bureaucratic turf.

Nevertheless, recognizing the burden of regulatory barriers, US, Canadian, and Mexican leaders launched the Regulatory Cooperation Framework as part of the wider SPP.[34] The announced goal is to streamline regulatory processes so as to avoid redundancies and to promote transparency in both rule-making and information sharing. Very little progress has been made to harmonize food safety rules.

When markets are fragmented by regulatory barriers, resources are taken from productive investment and from research and development, thereby eroding incentives to innovate.[35] Hence, the payoff from regulatory convergence would be substantial. The North American market would be less fragmented and the number of potential entrants in any market would rise, increasing the scope for knowledge spillovers. Small and medium-sized firms, as well as giants, could then sell across the border without changing their product specifications. Production runs could be longer, and fixed costs per unit could be lower.

In the realm of regulatory conflict, the Bovine Spongiform Encephalopathy (BSE) dispute between the United States and Canada was a model of poor consultation and cooperation. A two-year ban followed by burdensome requirements, and a border still not fully open, stand as a blot on the concept of an integrated market. Further, the Canadian cattlemen found no recourse for the damages they suffered from regulatory delays apparently designed to benefit US cattle interests.

Positive lessons, however, can be drawn from the US-Mexico avocado case. Due to a risk of avocado-specific pests, US phytosanitary rules – pertaining to the health of plants – blocked the entry of Mexican avocados into the United States until 1993. Agricultural authorities in Mexico recognized the risks but argued that they could be controlled. US growers resisted the opening, fearing pest infestations, while enjoying high prices in the US market. Negotiations leading to annual surveys of pest incidence and quantitative risk assessments

34 See Hart (2006) for a longer discussion of the merits of a joint approach to regulatory convergence.

35 Scarpetta and Tressel (2002).

were performed over four years starting in 1990. Risk mitigation proved successful, and the US market was progressively opened between 1997 and 2007.[36] This case is an example of how the United States and a partner can work together to resolve regulatory issues, even in areas as sensitive as agriculture.

As the successful avocado episode illustrates, the obstacles to quick removal of regulatory barriers are real. From an economic standpoint, however, Canada would benefit from progressively adopting US regulatory standards, particularly when they are newly issued. From a political standpoint, acceptance of US standards might be caricatured in Canada as a surrender of sovereignty despite the fact that US standards are arguably as high or higher in quality. The political challenge is to find a path to sensible economic solutions, perhaps starting with less sensitive sectors. Some areas where Canadian adoption of new US regulations can be envisaged, at least as a default option, include pharmaceutical testing, food labelling, electrical equipment, and electronic gear. There would be no impediment to Mexico doing the same.

NAFTA Tariffs and Rules of Origin

Bilateral tariffs have been eliminated on most goods, but not all of the commerce between Canada and the United States benefits from the agreed NAFTA tariff preferences. In some cases, the administrative cost of complying with NAFTA regulations to qualify for duty-free treatment is not worth the tariff savings; in other cases, exported products do not qualify for the zero-tariff treatment because they do not meet the content requirements.[37] In either case, business firms complain that these costs need to be reduced to promote competitiveness.

The most straightforward solution is to eliminate the source of the discrimination: tariff preferences. In other words, the NAFTA countries should gradually reduce their most-favoured-nation (MFN) tariffs so that over time the MFN rate and the NAFTA rate converge at zero.[38] In fact, the United States initially proposed the elimination of all developed country tariffs on non-agricultural products at the start of the WTO Doha Round, but few countries were willing to accept the challenge, and US officials subsequently shied away from their own offer.

Tariff-free trade is an ambitious goal that politicians may find hard to accept – yet our view is they should take a deep breath and plunge ahead. Hufbauer and Schott (2005) and Goldfarb (2003) suggest that NAFTA members should deepen their trade bargain by negotiating a common external tariff. This idea never resonated with officials. Attempts to harmonize the tariff schedules of the three countries made sense to economists but scared politicians, especially those representing farmers and Mexican firms facing competition from China in light manufactures.

With these political constraints in mind, joint steps by all three partners could be taken towards a common tariff by forming a compact to reduce – with limited exceptions – industrial input tariffs to zero by 2015. These tariffs are generally low for Canada and the US, especially compared to those applied by Mexico.[39] The combination of limited product exceptions and a longer transition period to zero tariffs should calm fears in Mexico about a surge of Asian imports. Of course, countries would still have recourse to safeguard measures that permit temporary restrictions to protect against sharp increases in imports. Some of the limited exceptions might include textiles, though these should be reduced with a longer transition period. Agricultural

36 Orden and Peterson (2008).

37 Head (2007) cites a good example of the complex rules that make it difficult for goods to qualify unless all of their principal parts are sourced within North America. NAFTA rules do not deem a television to be North American unless its chief component, the cathode ray tube, is made in North America; this means that the tube's chief components, the cone and the glass panel, must also be North American.

38 MFN tariff rates are those applied to all WTO member countries that are not members of a free trade agreement with Canada or the United States, or do not enjoy a special preference. Under the MFN principle, every country gets the lowest tariff that any country gets, and reductions in tariffs to one country are provided also to others.

39 Mexico offers tariff preferences for most of its trade covered under FTAs in place with more than 30 countries; its MFN tariffs primarily target goods from China, India, and South Korea. However, Mexico and South Korea launched negotiations on an FTA in August 2007.

products should be on the agenda for future discussion despite their political sensitivities.

As a half-way measure to the desirable outcome of zero duties on industrial inputs, the North American partners could begin by harmonizing over a short period of time the tariffs that each member applies to third countries on an MFN basis. The key to this approach, however, is that the standard of convergence should be the lowest rate applied by any NAFTA member. For example, if the US levies a 5 percent tariff on thread but Canada and Mexico levy 7 percent tariffs, the latter two countries would reduce their tariffs to the US level. The convergence calculations would be based on applied tariff levels – the actual tariffs – rather than the WTO bound rates that might be higher.[40]

Movement toward this implicit common tariff for industrial inputs need not be bound in WTO schedules – though this could be done in the context of a reciprocal tariff deal among WTO members. To encourage other countries to participate in a multilateral tariff reform, the NAFTA countries could include a provision that would allow them to restore their tariffs on specific products to WTO bound rates.

There have been marginal results in simplifying rules of origin: since the initiation of the SPP, rules of origin provisions have been removed on $30 billion of goods. However, in reality, this amount is less than the growth of annual trade in North America.[41] The lack of progress in the SPP signals that an incremental approach is not working. In the next section, we will propose a new cooperative framework on trade, energy and the environment. If this framework is put in place, serious impediments to trade can be addressed.

Part III: New Directions for NAFTA Cooperation

Both Canada and the United States should renegotiate specific aspects of NAFTA. Unlike some, we do not believe the agreement is fragile. There are four areas where greater Canada-US cooperation[42] is desirable and progressive and where we believe the incentives favor updating: energy, water, climate change, and the environment and labour agreements.

Both countries have strong incentives to cooperate – for this reason, revisiting sensitive issues will not kill the agreement. Rather, it will create a new framework for moving the NAFTA agenda forward and deepening integration.

Chapter 6 – Energy

During the 'Three Amigos' summit in April 2008, Prime Minister Stephen Harper took the opportunity to issue a veiled threat to the United States regarding NAFTA renegotiation. Canada is the largest and most secure supplier of oil and natural gas to the United States but, according to the Prime Minister, "[i]f we have to look at this kind of an option [a renegotiation], I say quite frankly, you know, we would be in an even stronger position now than we were 20 years ago. And we will be in a stronger position in the future."[43] Though the warning is political rhetoric, Harper's statement is also a response to critics who have long felt that, under NAFTA, Canada can do little to curtail oil exports to the US, even during times of shortages at home.[44] These criticisms have jeopardized an honest discussion of the future of Canada-US energy trade

40 Bound tariff rates are those negotiated and incorporated in a country's schedule of WTO concessions. Raising a tariff above the bound rate invites retaliation by other WTO members.

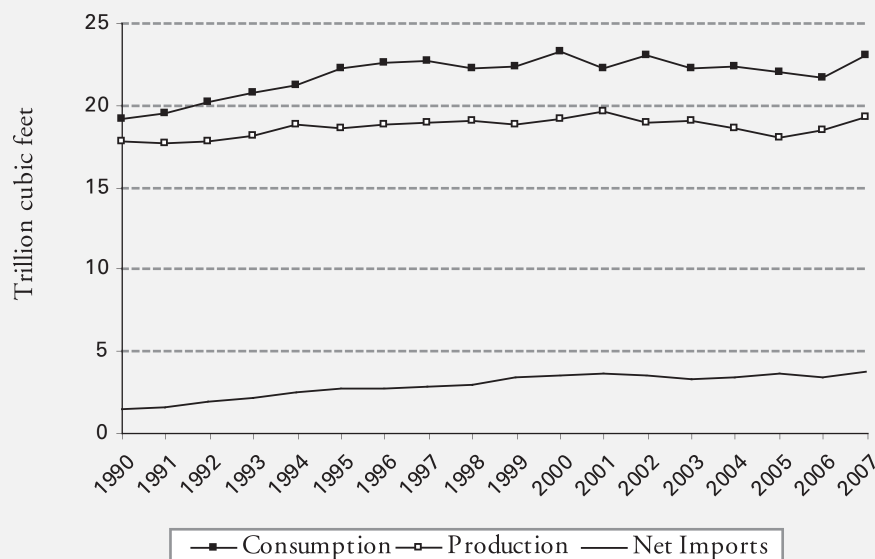
41 Pastor (2008).

42 We will identify where Mexico's participation is essential for proposed changes but we will not discuss the economic or political motivations or incentives behind it.

43 Greenaway (2008).

44 According to a Harris/Decima poll, most Canadians (61 percent) would endorse the idea of using energy exports as a bargaining chip in any NAFTA renegotiation; only 24 percent oppose the idea. This idea was popular across all demographic groups. http://www.decima.com/en/pdf/news_releases/080310E.pdf

Figure 4: Production, Consumption, and Net Imports of Natural Gas in the United States, 1990-2007



Source: EIA Natural Gas Monthly, May 2008.

Table 4: US-Canada Electricity Trade 1995 to 2006

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
US Imports	40.6	42.2	43.0	39.5	42.9	48.5	38.4	36.5	29.3	33.0	42.9	41.5
US Exports	2.7	2.0	7.5	11.7	12.9	12.6	16.1	15.2	23.6	22.5	19.3	23.4

Source: Electric Power Annual 2006 Table 6.3.

and have led to calls in Canada to husband its own resources.[45]

CRUDE OIL: With 179 billion barrels of proven oil reserves (95 percent are oil sand deposits in Alberta), Canada is second in supply only to Saudi Arabia and provides 17 percent of US oil imports.[46] In 2007, Canada exported nearly 2.5 million barrels per day of crude oil and refined products to the United States.[47] Most of the Canadian exports go to Western areas of the United States, as they are well connected to Alberta by oil pipelines. In 2007, Canada imported roughly 1.2 million barrels per day of crude oil and refined products for the Eastern provinces, mainly from Algeria, Norway, and the United States.[48]

NATURAL GAS: With the largest reserves in the world, the United States is virtually self-sufficient in natural gas but imports roughly 10 percent of con-

45 Practically speaking, the oil price is set on international markets and in the event of emergency, oil prices will be high in Canada so there is an incentive to sell to Canadians. Should this crisis be of mythical proportions, Canada could abrogate from the NAFTA.

46 US Department of State, Background Note: Canada, May 2008. http://www.state.gov/r/pa/ei/bgn/2089.htm

47 By comparison, the United States imported 1.5 Million barrels per day (Mbpd) from both Mexico and Saudi Arabia, slightly less from Venezuela and Nigeria (1.3 and 1.1Mbpd) and 5 Mbpd from other sources. EIA International Petroleum Monthly, April 2008, Table 4.10.

48 International Energy Agency. http://www.iea.org/Textbase/stats/index.asp

sumption to meet residual domestic demand. In 2006, Canada exported 3.6 trillion cubic feet of natural gas to the United States, or over 86 percent of total US imports. Imports of natural gas by the United States have risen substantially since the mid-1980s, when pipeline imports from Canada began to meet increased consumption needs while US domestic production remained stable (Figure 4).[49] This also coincided with the deregulation of the Canadian industry in 1986 and the requirement that Canada hold 30 years of proven supplies in reserves.[50] This ratio is fairly constant as potential or probable resources are converted to proven reserves.

ELECTRICITY: The electricity networks of Canada and the United States are heavily integrated:[51] the grids represent more than $1 trillion in asset value, cover more than 320,000 km of transmission lines operating at 230,000 volts for more than 950,000 megawatts of generating capability. They provide business for nearly 3,500 utility organizations serving well over 100 million customers and 283 million people.[52]

Table 4 shows that, while US imports of electricity have remained fairly constant, exports have increased tenfold. Open trade in electricity is of rising importance to Canada, and in particular the province of Ontario, which has not invested in developing greater electricity supply. This was acutely evident during the 2003 Northeast Blackout, which crippled Ontario while the affected US states recovered far more quickly. As a result of the blackout, the North American Electric Reliability Organization was established in 2007 to improve the reliability and security of the bulk power system in North America. It is overseen by provincial authorities and the US Federal Energy Regulatory Commission. This intergovernmental organization is a good example of how cooperation between Canada and the United States on energy matters can lead to more predictable supply and avoid service disruptions.

NAFTA LAW: Trade in energy products is governed by the rules in Chapter 6, "Energy and Basic Petrochemicals," and applies to measures relating to energy and basic petrochemical goods. These rules were carried forward from the Canada-United States Free Trade Agreement (CUSFTA) but were not extended to Mexico, which insisted on an exemption. NAFTA strictly interprets the rules of the General Agreement on Tariffs and Trade (GATT) and attempts to broaden them, particularly in the area of export taxes and other restrictions.[53] The aim and effect of this approach is to limit the ability of NAFTA parties to use dual pricing – supplying local firms with energy below international prices – to protect or encourage downstream industries. The interventionist energy policies prevalent in Canada during the 1970s and 1980s created strong opposition from oil-producing provinces, notably Alberta, which challenged the constitutionality of the federal export tax that was entrenched in the federal government's National Energy Program in the 1980s.[54] The United States also opposed government intervention – thus a market-driven approach to energy trade was imperative during NAFTA negotiations.

NAFTA removes all tariffs and quantitative restrictions on energy products but stops short of

49 Energy Information Administration/Annual Energy Review 2006, Table 6.3

50 Gordon Laxer and John Dillon (2008) of the Parkland Institute and CCPA recently claimed that Canada's natural gas reserves are dwindling and that there are only 9.3 years of proven supplies left. However, this ratio (of proven reserves to production) has been constant for nearly 20 years and is in line with the reserves held in the US. In addition, it ignores the vast potential resources that could be and are being converted to proven resources. Prior to this, Canadian law required 30 years of proven reserves – therefore, the sharp decline in reserves is the adjustment to US levels and monetization of artificially inflated stocks of supplies.

51 It would be difficult to apply the proportionality requirement to electricity because these are regional and not national. Export decisions are made on a grid-by-grid basis.

52 Government of Canada, Natural Resources Canada (2004).

53 UNCTAD (2000).

54 Though disputed, according to Helliwell and McCrae (1981), the residents of Alberta lost roughly $46,000 per capita and Canadians outside Alberta gained $7,500 per capita as a result of the NEP. See also Mansell and Schlenker (1995).

writing rules that ensure an integrated market. The concerns regarding NAFTA's competency in energy matters are largely Canadian and stem from fears of scarcity. There are four provisions in Chapter 6 that directly or indirectly affect Canada's ability to restrict exports: Article 603(2), which prohibits the use of minimum or maximum export-price requirements; Article 604, which prohibits the use of export taxes or duties; Article 605, which enumerates the conditions under which Canada can restrict energy exports; and Article 607, which provides exemptions for national security scenarios.

The most contentious provision for Canadians is Article 605, the 'proportionality' obligation, which allows governments to impose export restrictions on NAFTA parties on the grounds of conservation of exhaustible resources, supply shortages, price stabilization, and national security – but the restrictions must be 'proportional' to the prior ratio of exports to total energy supplies. This obligation arose both out of US concerns of a return to Canadian export restrictions and out of Alberta's insistence, as an emerging energy superpower, that the federal government should have little say in provincial energy matters. In return – and this is particularly important since 9/11 – the United States agreed to a narrow interpretation of national security to assuage Canadian apprehensions about the unwarranted invocation of disguised restrictions to trade.

The proportionality obligation states that, if supplies are restricted on the grounds of conservation of exhaustible resources, supply shortages, or price stabilization, then the share of total supply available for export purchase may not fall below the average level in the previous 36 months. For example, if the ratio of total export shipments to total supply was 1:3 for the previous 36 months, the requirement would be breached if an export restriction were imposed by government (as opposed to the operation of markets) in such a way that exports were less than one-third of total supply. Thus, the proportionality requirement does not guarantee *a level of supply* to the United States but rather *a level of access*. Note that the proportionality provision aims to prevent government actions, not market forces, from restricting exports. However, it does preclude a 'Canada-first' policy since it ensures a market-oriented approach to energy trade – an approach most developed countries have already taken on other basic goods.

However, many Canadian citizens, research institutes, and non-governmental organizations have called for a trans-Canada energy pipeline.[55] Under current arrangements, Canada exports energy from the West but it imports in the East. This is viewed as according higher priority to US energy needs than to Canadian uses. The capital costs of building a trans-Canada pipeline are roughly $4 million per kilometre, for a total capital cost of $12 billion, and operating costs of $1 billion per year. This works out to an additional 7.5 percent annually of transportation costs at current prices.[56] This figure assumes everything works well – but of course several risk factors could raise costs, including the environmental impact of new infrastructure, payment for indigenous land rights, construction delays, and provincial or municipal resistance to the project. Further, Canada currently does not have sufficient refining capacities to meet the East's needs, so new refineries would need to be built; where this would happen is unclear given their unpopularity. In our view, this is not the way forward.

55 See work by the Parkland Institute and the Council of Canadians. Laxer (2008) argues that we export two-thirds of our oil to the United States but import oil to meet 90 percent of Atlantic Canadians' and Quebeckers' needs from politically volatile countries. The problem according to Laxer is not only the proportionality clause but the fact that we cannot divert exported oil during emergencies to Eastern Canadians because there is insufficient pipeline capacity between West and East.

56 This estimate is calculated by inference. The Alberta Clipper pipe from Hardisty, Alberta to Gretna, Manitoba cost $2.2 million per kilometre in 2007. Triple the distance, account for higher costs of running through the Great Lakes states and central Canada, add inflation, and the figure gets closer to $4 million per kilometre. Given a distance of approximately 3,000 km from Alberta to Ontario or Quebec, capital costs are roughly $12 billon. Capital cost is amortized at roughly 10 percent a year so the annual cost is $1.2 billion of capital costs plus $1 billion of operating costs. If these costs are divided by the annual barrels – say 600,000/day over 365 days – then the total amount works out to around $10 per barrel. At current prices ($135 per barrel), the total transportation cost would be ($10 / $135 barrel) = 7.5 percent annually for the first 10 years. Special thanks to Roy MacMullin for the intuition.

Canada would be unwise to bow to nationalistic demands and push to repeal the proportionality obligation in any potential negotiation. But the United States should take this threat seriously – repealing the obligation would mean an end to proportionality and the ban on export taxes in a period of rising energy costs and unstable supply. Keeping the status quo with Chapter 6 serves both countries well. In the case of Canada, it would be political suicide for the Canadian federal government to restrict energy exports flowing from three provinces: Alberta, Saskatchewan, and Newfoundland. Doing so would ignite a full-blown political war where tensions already exist – not just between the federal government and the oil-producing provinces but between East and West. Second, while Canadian critics argue that the proportionality clause prevents Canada from developing its own energy policy and that the obligation protects supply to the United States to the detriment of Canadian consumers (particularly those on the eastern coast),[57] the fact is that cross-border regional supply chains provide far more security in terms of delivery and price. Third, trade and regional supply chains have created an integrated energy market: the two countries are now linked by 22 petroleum pipelines, 34 natural gas pipelines, and 91 electric transmission lines.[58] Both economies would suffer an economic and political crisis if there were an attempt to alter energy-trading patterns. This is lose-lose for both Canada and the United States.

An integrated continental strategy (implicit in the NAFTA chapter), which includes sustainability and reduced energy dependence, offers a far more palatable direction for Canada and for the United States. The realistic approach is to seek sustainability and energy security on a cooperative basis. A Working Group should be established to focus on the economic and environmental aspects of growing bilateral energy trade (as proposed by the Energy Consultative Mechanism in July 2008). A joint effort would cover consultations on risk mitigation and cooperative emergency arrangements. In addition, cooperation should be the route for increasing spare electric capacity, possibly through publicly guaranteed 'take or pay' contracts for new power plants and transmission lines.[59] A cooperative approach would also help deal with market failure obstacles that retard the development of alternative energy supplies – wind, solar, nuclear.

Whither Water?

Bulk water exports have been a contentious issue for some time – politicians have on numerous occasions stressed that bulk water exports are neither part of NAFTA nor a commercial good available for exchange. Bulk water removal refers to large-scale shipments of water by man-made diversion, such as tanker ships or trucks, canals, or pipelines.

There is little political appetite in Canada for permitting bulk water exports to the United States. Canada has sought assurances from the United States and Mexico by issuing a joint statement in 1993 declaring that NAFTA creates no rights to the natural water resources of any of the countries. Canada has also enacted domestic legislation.

The potential for Canada's fresh water to be exported to the United States is an important public concern, one worth clarifying legally.[60] As it stands, the 1909 Boundary Waters Treaty (BWT) is the main legal instrument regulating the use of the Great Lakes waters, while the GATT and NAFTA regulate water exports more generally. The consensus among legal scholars seems to be that, under NAFTA and WTO rules, controls on the

57 Watkins, G. C. (1993).

58 US Department of Energy (2006).

59 Classically, under a take or pay contract, a buyer is obliged either: (a) to take delivery of and pay for an agreed minimum quantity of gas in the course of a year; or (b) in the event that the buyer does not take that quantity, to pay for the difference between the agreed quantity of gas and that actually taken. See Hardaker (2000).

60 According to an IPSOS-Reid poll released April 15, 2008, only 6 percent of Canadians think that consumers represent the biggest threat to Canada's freshwater supply. Instead, Canadians are likely to blame mass removal of water to the United States (28 percent) and run-off of pollutants from land to water (19 percent). http://www.ipsos-na.com/news/pressrelease.cfm?id=3887

export of bulk water are prohibited.[61] A measure to ban exports would likely fall foul of Canada's obligations at the WTO. Under GATT Article XI, the use of quantitative export controls is prohibited; thus, to deter exports, the Canadian government would have to impose an export duty or tax (exempting NAFTA partners). Article XI would only apply if water were defined as a good – which, at the moment, is not explicitly done either in the GATT or in NAFTA. According to a study done by the Canadian government, the fact that a provincial or municipal government in Canada has allowed the extraction and transformation of some water into a good (including for export) does not mean it has a set a precedent for other governments.[62] This view is reinforced by the International Joint Commission, which concluded that NAFTA and WTO agreements do not constrain decisionmaking on whether to allow exports or not; nor do they force governments to undertake new sales or diversions even if these have been done in the past.[63]

A second legal issue arises from Canada's obligations under Chapter 11 of NAFTA, which provides extensive rights and privileges for foreign investors who, in turn, can enforce these rights privately by collecting compensation from governments when a violation of NAFTA privileges is demonstrated. Private investor-state arbitral tribunals decide the cases.

The question remains whether Canada should be concerned about legal challenges and murky language. Some have argued that there is no business case for bulk water exports so concerns regarding water are moot.[64] However, others have argued that there is a real and significant risk that US firms may explore the provisions under NAFTA and seek to import bulk water and, thus, Canada needs to be proactive.[65]

The topic of bulk water exports has arisen in three main areas: 1) large-scale export for irrigation; 2) small-scale export for municipal use; and 3) as an input for energy, in particular electricity and unconventional hydrocarbons (e.g., shale oil and gas, gas hydrates). According to a report produced by the Policy Research Initiative,[66] bulk water exports for irrigation are neither economically nor politically viable since Canadians would oppose any large-scale diversion schemes necessary to transport the water south. The report does, however, suggest that small-scale movement of water between border communities would be efficient and the business case could change. As an input for electricity generation and producing unconventional hydrocarbons, the demand for water is great.

It is likely that the NAFTA would be given precedence over domestic legislation; if contested, domestic legislation would not be binding on NAFTA panels.[67] Given this state of affairs, and for environmental sustainability reasons and not for trade protection, Canada should seek to ensure that bulk water exports to the US or elsewhere are prohibited. However, climate change and technology might lead to environmental conditions that could bring about political reconsideration. Canada should leave open the possibility of revisiting the arrangement after a given time period, say 10 years. Water management should be part of a bilateral agenda, trilateral if necessary.

61 A good overview of the legal background can be found in Nikiforuk (2007) and Johansen (2001).

62 See Johansen (2001).

63 See International Joint Commission (2000). Pages 32-34 of the report deal with trade issues.

64 Policy Research Initiative (2006).

65 See Boyd (2003), Nikiforuk (2007), Quinn (2007), and www.patcarney.ca/priorities.html# on Bill S-217.

66 Policy Research Initiative (2006).

67 Current domestic legislation includes a private member's bill, S-217, to amend the *International Boundary Waters Treaty Act* by prohibiting bulk water exports (http://www2.parl.gc.ca/content/Senate /Bills/392/public/S-217/S-217_1/S-217_text-e.htm). The Munk Centre for International Studies (MCIS) has gone further and drafted "A Model Act for Preserving Canada's Waters" (2008) which uses a water basin approach – the view that inter-basin transfers of water would violate ecosystem integrity -- instead of a political approach (e.g., outright ban) which would likely run foul of Canada's trade obligations. Rather than focus on the legality or illegality of a political approach, the Model Act focuses on the irreversible environmental effects as justification.

Making Good on Commitments to Reduce CO_2 Emissions

The United States is the second largest emitter of carbon dioxide (CO_2) in the world after China. By 2030, Canada could have the highest energy-related CO_2 intensity (relative to GDP) within the OECD.[68] Both countries have room for improvement, but conflicting emission standards could potentially disrupt trade. Six major bills in the US Congress aim to limit GHG emissions by as much as 80 percent below 1990 levels over the next 30 years. In Canada, opposition Liberal leader Stéphane Dion has proposed a broad-based carbon tax while British Columbia introduced a new carbon tax in July 2008, starting at a rate that will have drivers paying about an extra 2.4 cents per litre at the gas pump. Ontario and Quebec are talking enthusiastically about a cap and trade program as is the federal Conservative government.

On the question of climate cooperation, NAFTA leaders 'talk the talk,' but they have yet to 'walk the walk.' The North American Commission for Environmental Cooperation has long advocated renewable energy production, green supply chains and green building projects but few have heard of them. The United States and Canada established a Bilateral Working Group on Climate Change, but its last session was held in 2005. This working group needs to be reactivated and expanded. In August 2007, the three NAFTA leaders, meeting in New Orleans, promised clean and sustainable energy. So far these pronouncements have done nothing to arrest the trajectory of GHG emissions from North America, but they have set the stage for measures that could well interrupt the free flow of commerce.

In fact, US efforts to promote alternative fuels and to reduce greenhouse gas emissions have already distorted regional trade and raised food prices. Ethanol from corn is a culprit, but sugar trade between Mexico and the United States has triggered its own ethanol battle. Bills now on the congressional docket would endorse additional subsidies for biofuels and border taxes against carbon-intensive imports, presaging new barriers to North American trade. A climate change bill with some of these provisions is very likely to pass in Congress in 2009, though it recently faltered in its first attempt.[69] Similar legislation will certainly be vetted in Canada if a carbon tax or a greenhouse gas emissions permit system is enacted by Congress.

Given this context, NAFTA leaders should work hard and fast, beginning in January 2009, to forge common industrial standards and competitiveness provisions that will apply to regional trade. A cooperative effort is essential for monitoring GHG emissions and creating an efficient trading market for North American emission permits. If the United States and Canada develop a joint approach to climate policy by adopting carbon taxes for example – at this writing, against long odds – they should make every effort to agree on the same base and rates, so that border adjustments are unnecessary in North America.

Future negotiations on climate change are likely to bring about stricter climate reduction goals than Kyoto. Regional cooperation can ease these burdens, for example by investing in emission reduction projects across the Western Hemisphere, and by developing clean technologies that will be licensed for free or at affordable rates across the globe.[70] Equally important, with meaningful regional cooperation, Canada and the United States can avoid placing new impediments on North American trade, even as they adopt stern measures to reduce their own emissions.

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68 EIA (2007).

69 "The Lieberman-Warner Climate Security Act of 2007" (S. 2191) http://lieberman.senate.gov/ documents/lwcsa.pdf; "The Lieberman-Warner Climate Security Act of 2008" (S. 3036) http://thomas.loc.gov/cgi-bin/query/z?c110:S.3036::.

70 One possibility would be that suggested by Diane Francis, Editor-at-Large of the *National Post*, in her blog dated June 14, 2008: "The three countries should finance a Manhattan Project to come up with environmentally benign alternatives, conservation methods and technologies to better utilize oil and gas." The Manhattan Project refers to the joint cooperation of the United States, the United Kingdom, and Canada to develop the atomic bomb during World War II.

The Side Accords on Labour and Environment

In 1993, President Clinton insisted on negotiating side accords on labour and on the environment before submitting NAFTA to Congress. While they contributed to NAFTA's ratification by a narrow margin that December,[71] the side accords never satisfied US labour unions and quickly disappointed most environmental NGOs.

Union officials charged that the North American Agreement on Labour Cooperation had no teeth: the new obligations were inadequate to address their concerns about low-wage competition from Mexico. Moreover, the enforcement procedures – which excluded labour issues from NAFTA's basic dispute mechanisms – seemed too weak. At the insistence of Canada and Mexico, the agreement was written to include special dispute resolution processes long on consultation, with very limited recourse to litigation. Environmental NGOs highlighted a more specific complaint: they attacked the pact's investor-state dispute provisions for opening a new legal channel for investors to contest environmental policies (see the section below on Chapter 11). Even groups supporting NAFTA were lukewarm about the side accords. Business lobbies grudgingly accepted the inevitable, but vigorously opposed subsequent proposals to strengthen the accords for fear that current US policies could be challenged in trade cases and result in costly new regulations.

In practice, the two side agreements actually make modest improvements in labour and environmental policies in the three countries.[72] Perhaps the most noteworthy aspect has been their spotlight effect – that is, creating public platforms where private groups can name and shame abusive practices. Labour issues, however, represent a real challenge for Canada, and specifically, its constitution. Labour questions fall under both provincial and federal jurisdiction. As a result, the current labour agreement requires ratification by the provinces in Canada. The Canadian Intergovernmental Agreement regarding the agreement provides a mechanism for provincial participation, but so far this has been signed by only four of Canada's 10 provinces – Alberta, Manitoba, Quebec and Prince Edward Island. This agreement gives the provinces a means to participate in managing Canada's involvement in the labour cooperation agreement. But with the combined participation of these provinces and the federal government, the agreement now covers less than 50 percent of the Canadian workforce. Thus it is unclear how changing the agreement will impact Canada.

While the side accords broke new ground when introduced in 1993, their core rights and obligations could never be considered the 'gold standard,' and within a decade, NAFTA provisions in these areas had been eclipsed by new arrangements. Negotiators learn by doing, and subsequent free trade agreements (FTAs) have improved upon NAFTA's skeletal regime on labour and the environment. Recent FTAs embrace more comprehensive rights and obligations in the main treaty text, and have been supplemented by bilateral cooperation accords that seek to develop joint responses to labour and environmental problems in the partner countries.

In May 2007, the Bush administration agreed to revise US trade pacts awaiting congressional ratification to accommodate expanded labour and environmental obligations demanded by the new Democratic majority in Congress. Peru, Colombia, Panama, and South Korea readily incorporated these additional provisions into their FTAs with the United States. New demands to strengthen the FTA provisions on labour and the environment did not encounter significant resistance from US trading partners because the obligations reflect principles those countries had already adopted in the International Labour Organization and largely incorporated in their own laws and regulations.[73]

71 The NAFTA passed the House by a vote of 234 to 200 and the Senate by a 61 to 38 margin.

72 See Hufbauer and Schott (2005), chapters 2 and 3.

73 In large measure, Canada's negotiations with Latin American countries follow the precedents established by the May 10 accord between Congress and the Bush administration. See, for example, the text of the Canada-Peru Labour Cooperation Agreement signed May 29, 2008.

Including similar provisions in NAFTA should be part of the regular updating of the pact that trade Ministers undertake during the annual meeting of the NAFTA Free Trade Commission. We believe that adopting the standards on labour and environment set out in the Peru FTA is desirable on the merits; in addition, it should mitigate the specific political concerns about NAFTA raised by Senators Obama and Clinton during the Democratic primary. Indeed, Senator Obama cited the new provisions on labour and the environment as the reason he voted in favour of the Peru-US FTA.[74] To complement these textual reforms, we recommend increased funding for specific projects undertaken by the North American Development Bank[75] to redress infrastructure problems and environmental abuses. The Bank has been under-funded from the start, and its capital base needs to be doubled in the near term with more resources over a 10-year horizon. While these improvements are valuable they are not vital bilateral issues. Our discussion reflects in part the insistence of US politicians to answer the quest for NAFTA revisions.

Part IV. The Highly Contentious Issues

Chapter 11 governing investor-state relations and Chapter 19 covering dispute settlement have created concern and even acrimony between Canada and the United States. We have some suggestions on improving these provisions however, the political realities may not warrant trying to make changes to the current text.

Investor-State Dispute Provisions

NAFTA broke new ground with Chapter 11 by incorporating provisions to resolve investor-state disputes. Instead of relying on Mexican courts, with their chequered history of adjudicating expropriation and other investment cases, NAFTA established an international arbitration channel for resolving investment disputes. Under Chapter 11, disputes between private NAFTA investors and the member states can be heard by international arbitration tribunals. For Mexico, the establishment of investor-state provisions, drawing on international standards and superseding Mexican reliance on the Calvo Doctrine,[76] represented a major revision of Mexican legal culture. Negotiators thought they had found a pragmatic solution to business concerns about protections afforded under the Mexican court system. Mexican officials accepted this intrusion because they thought that increased juridical security would improve the climate for US and Canadian investment in Mexico. Some investment experts hailed these provisions as "a most innovative and favourable element of the accord."[77] And foreign direct investment poured into Mexico.

Officials from the NAFTA parties thought that investor-state disputes would primarily involve Mexican laws and regulations. But the subsequent caseload has had a broader geographic reach. Investors utilized the investor-state provisions to bring claims against all three NAFTA parties. Indeed, over the period 1994-2007, nine claims were filed against Canada, 18 against Mexico, and 15 against the United States.[78] Several of the cases drew headlines with exorbitant claims for injury and redress, including the Methanex Corporation dispute over California's environmental regulations

74 See text of Obama's speech on US policy toward the Americas on May 23, 2008 in Miami. www.miamiherald.com/1060/v-print/story/544657.html.

75 The North American Development Bank (NADB) and its sister institution, the Border Environment Cooperation Commission (BECC), were created under the auspices of the North American Free Trade Agreement (NAFTA) to address environmental issues in the U.S.-Mexico border region.

76 Under the Calvo Doctrine (which originated in Argentina), the claims of foreign investors could be adjudicated only by the courts of the host country.

77 Graham and Wilkie (1994). p.19.

78 These are instances where the case actually went to arbitration. See US Department of State website for a list of cases. http://www.state.gov/s/l/c3439.htm.

that banned the use or sale of the gasoline additive, MTBE. In the end, the Methanex claims were dismissed after lengthy arbitration.

Chapter 11 has solicited outsized reactions by various interest groups, most notably environmental NGOs. Concerns have been raised over the size of claims and possible undermining of environmental regulations. Moreover, environmental advocates have argued that the threat alone of investor-state claims has a chilling effect on regulatory rulemaking. Environmentalists are concerned that possible big-ticket cases could erupt, linked to a new wave of environmental controls seeking to curb GHG emissions.

The politics of Chapter 11 have become evident. While it is true that the threat of action exists, in practice the number of claims raised is insignificant: in the first 10 years of operation, only 42 cases have been initiated pursuant to Chapter 11 and only six resulted in the investor successfully winning damages. Moreover, the amounts awarded were minimal in comparison to original investor claims.[79] Finally, it is worth remembering that any claims by investors are restricted only to money damages; no other relief is available to claimants. Chapter 11 provides no provisions that alter or change national laws or regulations and thus, many of the concerns raised over public policy seem misplaced.

Notwithstanding the limited exercise by investors of these investor protections against all three governments and their even less successful results, interest groups and some politicians in the United States and Canada have urged the elimination or significant revision of investor-state provisions in the NAFTA context. During the 2008 presidential primaries, for example, Senator Barack Obama argued that the investor-state dispute provisions need to be recast to "fully exempt any law or regulation written to protect public safety or promote the public interest."[80] Irrespective of who becomes the next US president, the Democratic Congress will likely press for these and other NAFTA reforms.

Again some politicians have urged that national courts alone, and not international tribunals, should deal with regulatory takings and that the NAFTA process should be restricted to outright cases of expropriation. Yet such an approach would leave government in the position of determining the reasonableness of its own laws and regulations. That approach seems unlikely to ferret out policies that are discriminatory.

What is the purpose of providing investor-state protections and are the NAFTA provisions unreasonable? A look at global investment makes clear that almost all countries today enter into kindred provisions. There are now more than 2,000 Bilateral Investment Treaties which are either stand alone instruments or, as in recent US practice, are embedded in FTAs. Such agreements extend globally to include countries such as Russia, Singapore and South Korea. As Thomas Walde, an international advocate in investment and energy law has argued, "[i]nvestment arbitration can best be seen as one of several instruments which can be employed to encourage economic reform policies and to anchor them in external disciplines and procedures which are less subject to domestic political volatility."[81] Advocates for a return to national court oversight in the United States, Canada and Mexico fail to understand that the international standard is widely recognized and accepted globally. Beyond that, if the international standard were to be removed in North America it would lead to the anomalous prospect of investors based in many other countries having rights that are denied to US, Canadian and Mexican investors in North America.

It may be that a new tripartite commission should screen claims for their relevance to the intent of Chapter 11 before a full-blown arbitration can be launched (in other words, a preliminary determination of legal standing). Thereafter, it seems

79 Alexandroff (2006).

80 Obama letter to the Wisconsin Fair Trade Campaign, February 18, 2008.

81 Walde (2004).

reasonable, in the limited number of genuine investment cases that arise, to allow the international process to run its course. Chapter 11, in its current form, should be protected.

Chapter 19: Dispute Resolution

For Canada, the elimination or amelioration of US anti-dumping (AD) and countervailing duties (CVD) was a critical objective of Canadian negotiators in the CUSFTA negotiations.[82] Indeed Canada's hope was the complete elimination of the application of AD/CVD laws as between the two trading partners, or at least a common code to define permissible and impermissible subsidies. The failure to achieve much progress in the CUSFTA toward that end caused the Canadians to suspend the talks and threatened the complete collapse of free trade negotiations. Only last minute and high-level intervention by officials from both countries saved the negotiations. They agreed on an appeal process from national agency determinations and the review of AD and CVD decisions by a special binational panel, in lieu of recourse to the domestic appeals court.

This dispute resolution process was adopted in NAFTA. Practitioners have generally applauded the review process set out Chapter 19. In the early days of NAFTA, a 1995 report by the US General Accounting Office found that a number of practitioners believed that panels dealt more thoroughly with the facts than the US Court of International Trade.[83] By 1997, officials from all three countries and private sector representatives thought the system was working well. Notwithstanding a number of US court challenges to binational panel awards – arguing among other things that panels had gone beyond their appropriate reviewing function – the awards to this point have been upheld.

This was the state of affairs until the conflict over softwood lumber led to a heated "trade war." Canada and the United States fought over a series of CVD petitions from the US industry. These petitions included an appeal to a binational panel and peace was only established in 1996 with an agreement between the two countries, appropriately called the Softwood Lumber Agreement. The agreement required that Canadian officials levy fees on exports of softwood lumber that exceed specified levels. In response, the US industry agreed not to file any further CVD petitions. The agreement had a five-year term and in 2001 the Canadian government decided not to renew the agreement when the termination date arrived. Two days after the agreement expired, the US industry filed a new CVD petition and for good measure, and for the first time, added an AD petition.

The terms of the 1996 agreement, which included export taxes, suggested that the two countries treat the lumber industry as being outside the traditional free trade framework. Nevertheless, Canada sought to use both the dispute resolution mechanisms both under NAFTA Chapter 19 and under the WTO. The US courts were drawn into the fracas as well. The result of this complex litigation was a series of decisions from both systems, often difficult if not impossible to square. Further stirring the pot, the binational panel under Chapter 19 remanded back to the national regulator – the US International Trade Commission – a decision arguing that the Commission had arrived at a decision without substantial evidence. The Commission, in turn, issued a remand determination that affirmed its original finding, leading to so-called ping-pong decisions. This charade, plus the confusing resort to multiple forums, led the US and Canadian governments to finally negotiate an agreement that provided a special dispute settlement mechanism for Canadian softwood lumber exports.

82 Antidumping duties can be imposed on goods that are deemed to be dumped – when goods are exported at a price less than their normal value or at less than production cost – and causing injury to producers of competing products in the importing country. These duties are equal to the difference between the goods' export price and their normal value, if dumping causes injury. Countervailing duties reflect action taken by the importing country, usually in the form of increased duties to offset subsidies given to producers or exporters in the exporting country. www.wto.org/glossary.

83 United States General Accounting Office (1995).

The new Softwood Lumber Agreement 2006 added a specific arbitration mechanism, separate from Chapter 19, to resolve future softwood lumber disputes. US reluctance to utilize Chapter 19 since the resolution of softwood lumber, and the US resort to various procedural means to delay the establishment and operation of new binational panels, suggests continued US dissatisfaction with Chapter 19 panels. It is not too strong to suggest that Chapter 19 is now broken.

What then should be done in the face of US reluctance to employ Chapter 19? When Chapter 19 was created, the WTO Code on Subsidies and Countervailing Measures had not been written, and the WTO Dispute Resolution Understanding was not in place. Unlike the weak GATT system, the WTO mechanism is a strong rule-based system with a well-defined process to implement its rulings. With these new rules and mechanisms in place, NAFTA Chapter 19 is now largely duplicative. To avoid forum shopping, it is our recommendation that the NAFTA members now agree that appeals from national AD and CVD determinations should be taken to the WTO dispute settlement body.

Part V. Next Steps

NAFTA should be re-examined in 2009 and 2010. This may not be a bad thing as long as there is genuine goodwill to cooperate further and deepen integration. We believe that some or all of the issues identified in Parts II and III could form the basis of a new US -Canada collaborative strategy and launch a significant updating of NAFTA. Resolving Part IV issues would be a significant bonus. However, unless there is a baseline of understanding between the two parties, we would not recommend proceeding. Instead, trade negotiators should focus on issues where collaboration is mutually beneficial.

NAFTA is not responsible for the loss of manufacturing jobs in the United States and Canada over the past 14 years. A host of other economic forces are changing the face of the North American economy, and renegotiation of the NAFTA will not revive manufacturing employment in the American heartland. The exchange rate of the US dollar against Asian currencies is far more important to the short-term future of US manufacturing firms than renegotiation of NAFTA. However, Canada and the United States can certainly improve the quality of liberalization afforded by NAFTA and make North America a more competitive place to do business.

NAFTA should evolve, but without the constant threat of abrogation. What is needed is a fresh approach to dealing with bilateral trade issues and a new vision of shared North American interests. Given the interconnected nature of trade liberalization, energy security, and environmental sustainability, we recommend the creation of a framework for fruitful cooperation. As we have suggested here, the new framework would advance a joint approach to reducing greenhouse gas emissions, developing new measures to advance energy security and alternative fuels, and promoting policies to protect natural resources. These should be drivers for a new and improved NAFTA.

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