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COMMENTARY

THE BORDER PAPERS

Potholes and Paperwork: Improving Cross-Border Integration and Regulation of the Automotive Industry

Michael Hart



In this issue...

Divergent regulations and border regimes in Canada and the US are threatening the integrated, cross-border structure of the Canadian auto industry. It is time for common regulations governing safety, fuel consumption and environmental protection, and faster, more efficient border clearances.

THE STUDY IN BRIEF

THE AUTHOR OF THIS ISSUE

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\$12.00; ISBN 0-88806-753-4
ISSN 0824-8001 (print); ISSN
1703-0765 (online)

The automotive industry has benefitted enormously from the 1964 Canada-US decision to pursue trade and industrial policies that gave it the incentive to integrate. Integration, in turn, has allowed suppliers, workers and customers alike to reap the benefits of specialization and economies of scale. Regulatory developments in the two countries, on the other hand, while generally consistent in philosophy and approach, have not kept up with the reality of integrated production. When combined with the thickening of the border after 9/11, the result has been to reintroduce barriers to full Canadian participation in the industry. The situation is not sustainable.

The author examines a critical aspect of government policy that requires greater Canada-US cooperation: the need for common regulations governing safety, fuel consumption and environmental protection. More broadly, he assesses how today's differences in regulatory and border administration regimes undermine the ability of Canadian autoworkers and suppliers to remain part of a fully integrated North American manufacturing base. He offers potential solutions to reverse the two governments' divergent approaches, including greater investment in infrastructure and technology, more reliance on risk assessments and random inspections, and better pre-clearance programs for goods, vehicles and people.

The automotive industry in North America faces tough challenges, from product development to financial woes. Both the US and Canadian governments have responded to the pleas from the industry to help it through its current difficulties. One way to do that is to reduce the cost of regulatory divergence, a reform that will impose no burden on taxpayers.

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INDEPENDENT • REASONED • RELEVANT

In 1964, Prime Minister Lester Pearson and President Lyndon Johnson authorized negotiation of the Canada-US Automotive Products Agreement – the Auto Pact. They agreed that it made little sense for their two governments to fight a trade war over automotive policy and stand in the way of the integration of the North American automotive industry.¹ It turned out to have been a remarkably prescient decision.

Over the subsequent four decades, integrated production has proven a boon to industry, workers and consumers alike on both sides of the border.

Today, the industry again faces major challenges, from product development and new environmental requirements to changing demand and increasing overseas competition, including the prospect of new rivals from India and China. Governments are providing major infusions of cash to help the industry face a barrage of economic problems. In these circumstances, there is concern that the industry is in danger of fragmenting once again, this time because the two governments are insufficiently sensitive to its integrated, cross-border structure.

This *Commentary*² focuses on one critical aspect of government policy that requires greater Canada-US cooperation: the need for common regulations governing safety, fuel consumption and environmental protection. It examines how today's differences in regulatory and border administration regimes undermine the ability of Canadian

autoworkers and suppliers to remain part of a fully integrated North American manufacturing base. And it offers potential solutions to reverse the two governments' divergent approaches, especially since 9/11.

Enhanced regulatory convergence and a more open Canada-US border are objectives widely shared among all North American industries. The auto industry, however, provides an excellent test case to demonstrate the feasibility of efforts to meet these goals. It is the most integrated cross-border industry, with a record of nearly five decades of working with the two governments to meet shared public policy objectives.

Modern, just-in-time production techniques pioneered by the industry are critically dependent on efficient transportation and communications infrastructure and a well-functioning border regime. Reducing government-mandated barriers to the further integration of the industry should also pay tangible dividends in strengthening the industry to meet global competition and in meeting shared safety, environmental and fuel-economy goals.

The *Commentary* begins with an assessment of the Auto Pact and its impact on the evolution of the industry. It next describes the development of the principal regulatory regimes in the United States and Canada and the reasons for the differences that have emerged between the two countries. It then considers the limits of global coordination mechanisms, the basis that already exists for cross-border cooperation and the extent to which Canadian and US approaches to safety, fuel economy and pollution abatement are similar in objectives and desired outcomes, but slightly different in detail.

- 1 In 1964, following Canada's decision to introduce an enhanced duty remission scheme to promote more export-oriented production, the US Treasury Department was considering a request from Modine Industries in Racine, Wisconsin for countervailing duties on any exports benefiting from this program. The odds indicated that the request would be granted and would lead to other industry complaints.
- 2 The *Commentary* builds on an earlier C.D. Howe Institute *Commentary*, Hart (2006). It focuses on the bilateral dimensions of the issues. The increasing role of Mexico in the assembly of cars and the production of parts that form part of North American supply chains suggests that some of the recommended bilateral reforms here will need eventually to include Mexico as well. Experience since the negotiation of the NAFTA, however, argues for a two-speed approach. Addressing regulatory differences and border administration issues with Mexico will prove much more productive once Canada and the United States have resolved the issues identified in this *Commentary*. Pursuing such issues on a trilateral basis from the outset is likely to be much slower and less productive than first pursuing them bilaterally. Finally, as topical as discussion of the industry's financial woes may be, this paper addresses a longer standing problem that illustrates the extent to which ministers, legislators and officials on both sides of the border fail to take sufficient account of the industry's cross-border, integrated structure in considering regulatory and other matters, including financial assistance. I leave to others the discussion of the pros and cons of bailouts, new regulatory demands and their impact on the industry's future.

In conclusion, this *Commentary* recommends that Ottawa and Washington eliminate remaining regulatory differences and introduce mandatory coordination mechanisms to ensure that new differences are not introduced into the system. The objective should be to implement a coherent regulatory regime that allows manufacturers to produce and certify vehicles to a single North American standard. It further proposes that the two governments complement their regulatory convergence efforts by pursuing an ambitious joint program aimed at making the border both less intrusive and more secure.

The Lessons of the Auto Pact

Prior to the negotiation of the Auto Pact, the Canadian and US auto industries developed in parallel, producing largely similar products for domestic consumption in each market. The consolidation of the industry in the 1920s and 1930s resulted in the same companies dominating vehicle assembly and parts production in both countries. Even the principal union – the United Auto Workers – represented workers on both sides of the border.³ In effect, Canadian production developed as a branch-plant of its US owners, but without the benefit of operating as part of an integrated industry.

The small size of the Canadian market and the increasing capital intensity of the industry, however, exposed Canadians to three inevitable results: less choice, higher prices and lower wages. Tariffs of 25 percent on cars and 17.5 percent on parts reserved the Canadian market for Canadian workers and producers, but at a high cost. The much larger US market allowed assemblers, parts manufacturers, workers and consumers to gain the full benefits of specialization and economies of scale. By the mid-1960s, on the other hand, Canadians were paying up to twice as much for similar cars, while Canadian auto workers' wages were as much as 30 percent lower than their US counterparts (Hart 2002, 240-247; and Anastakis 2005).

From the late 1950s through the early 1960s, Canadian officials tried to find solutions to this

conundrum, largely by focusing on export incentives to increase the size of the market. None succeeded, but some raised the ire of US government and industry officials, thereby exposing the Canadian industry to potential retaliation under American trade rules.

The key to resolving this dilemma was to recognize market and industrial reality and allow the Canadian and US industries to become fully integrated in a single North American industry. To that end, the Auto Pact allowed qualified firms producing vehicles and parts in Canada to freely import parts and vehicles from anywhere in the world. It also allowed such firms to export parts and vehicles produced in Canada to the United States without facing tariff or other protective measures. Canadian plants could thus become much more specialized and gain the same economies of scale as their US counterparts.

In less than a decade, choice expanded, the wage gap narrowed and prices converged. It is difficult to point to any other Canadian or US trade or industrial policy decision that had such immediate and long-term positive results for all involved. As an integrated industry, the North American industry, now including Mexico, produces about 15.9 million motor vehicles annually for a market that absorbs about 19.9 million vehicles. Canadian plants assembled 2.6 million vehicles in 2006, while the Canadian market added up to 1.7 million vehicles (Industry Canada 2007b).

Economies of scale have had an enormous positive economic impact in Canada, providing consumers with access to a high-quality, competitive and diverse automobile product lineup and employing upwards of 150,000 people in their manufacture.

Today, the industry faces new, but equally challenging issues. The solution, however, remains the same: the two federal governments need to work together to facilitate further and deeper cross-border integration. The barriers to that integration today are not tariffs, subsidies and other industrial policy measures, but regulatory differences and border administration.

Fifty years ago, economic goals and regulations prevented the two industries from reaping the full

3 Canadian autoworkers proved less enthusiastic about integration and formed their own union, the Canadian Auto Workers, in 1984.

benefits of specialization and scale. Today, small differences in regulations and programs to ensure border security, vehicle safety, energy efficiency and environmental stewardship are again carving the North American industry into two. They are threatening the ability of firms operating on the Canadian side of the border to remain part of cross-border supply and distribution chains.

Evolution of the Industry Subsequent to the Auto Pact

Looking back half a century, the North American automotive sector consisted of the major US-based assemblers and a range of in-house, affiliated and independent parts suppliers. All of the major firms produced passenger vehicles and light trucks designed specifically for the Canadian and US markets. Their customers beyond North America were typically served from overseas operations, while foreign car producers, at best, served niche markets in North America.

Today, North American consumers are served by a much wider range of firms – foreign and domestic – relying on both Canadian and US assembly facilities as well as imports. The Big Three US-based firms – GM, Ford and Chrysler – rely on their Canadian and US assembly facilities to meet most domestic demand. They import both parts and vehicles from overseas suppliers and facilities to fill out their lines and meet competition. Both US-based and foreign-based firms increasingly source parts from independent and affiliated suppliers on both sides of the border. Cross-ownership and joint research and production arrangements add to the complexity of the industry's structure.

Five major brands assemble cars in Canada: the Big Three plus Toyota and Honda. As well, GM and Suzuki operate a joint facility in Ingersoll, Ontario. The same five companies, together with Nissan, Mitsubishi, Subaru, Mazda (joint venture with Ford), BMW, Mercedes-Benz, Hyundai/Kia and Volkswagen, maintain facilities in the United States. These major assemblers, joined by a dozen or so others, also maintain factories throughout

Europe, Asia and Latin America and have integrated their global operations in order to serve customers around the world as efficiently as possible.

These large multinational firms are the public face of the industry. In addition, more than 100,000 firms – about 4,000 located in Canada, including major operations such as Magna – supply the assemblers with parts and components. These suppliers, in turn, are essential customers of steel, aluminum, glass, rubber, plastic and other purveyors of the raw materials needed to manufacture parts and components.

The major name-brand automotive firms are contributing a decreasing share of the value of finished vehicles. Many of them have spun off former in-house suppliers and rely on competition among independent suppliers for the approximately 8,000 parts, components and sub-assemblies that go into a finished vehicle. While long-term relationships remain a feature of the industry, particularly for Asian-based firms, competitive pressures ensure that parts suppliers keep a close eye on costs.

Downstream from the producers of finished vehicles, a vast network of dealerships, fuel refiners and distributors, service and repair facilities, specialty modifiers along with after-market parts makers and distributors all depend on a well-functioning and regulated automotive industry. It is not a stretch to conclude that the automotive industry produces one of the most technologically sophisticated products of the 21st century. Its products are the result of a highly complex research, development, design, engineering, manufacturing, distribution and services process. It is also one of the most regulated industries in the world. Innovation in design and performance – and awareness of increasingly demanding regulatory requirements – permeates all levels of the industry.

Global automotive capacity currently outstrips global demand, leading to fierce competition in all sectors and at all price points. Mature markets in Europe, North America and Japan offer limited prospects for growth, but emerging markets, particularly in Asia, have spurred major increases

in capacity geared to serving these markets.⁴ Total global auto production in 2006 reached 68.5 million passenger vehicles, an increase of 18.5 million from a decade earlier. While the absolute numbers of finished vehicles produced in Canada that year increased to 2,571,000 from 2,397,000 a decade earlier, Canada's share of global production has nevertheless declined from 4.8 percent to 3.7 percent over the past decade (Industry Canada 2007b).

The globalization of the industry is more than a matter of ownership and a much wider customer base. Just-in-time production techniques and sophisticated supply chains have resulted in the development of intricate production patterns and inter- and intra-firm relationships.⁵ Crucial to this development has been the ability to move parts and finished products across borders unimpeded by the trade barriers of the past.

Customs unions and free-trade agreements have eliminated traditional customs barriers among many geographically proximate producers. Even the remaining most-favoured-nation tariffs on parts and vehicles are now low enough in OECD countries – e.g., 6.1 percent to 8.5 percent in Canada, 2.5 percent in the United States, free in Japan and 10 percent in the EU – that they are now less critical to location decisions and less likely to act as barriers to the integration of production.

The Canadian industry – both assemblers and parts manufacturers – represents a subset of this global industry and, like other smaller national industries, is vulnerable to global competitive pressures. Canada is a significant importer and exporter of parts and vehicles. Most of that trade is between the United States and Canada as a result of the industry's post-Auto Pact integration, adding up to \$134 billion in two-way trade in 2006, nearly a quarter of the value of total two-way merchandise trade between the two nations.

In the same year, Canadian manufacturers exported about \$2 billion a year in automotive

products beyond the United States, and Canadian firms and distributors imported \$21 billion in parts and finished vehicles from non-US suppliers (Industry Canada 2007b). The ability of the major firms to maintain assembly facilities in Canada, and thus maintain the viability of the many parts suppliers that feed their operations, is vitally dependent on the regulatory and policy framework within which the industry operates.

Regulation of the Automotive Sector

Increased automotive mobility has sparked various social concerns ranging from land use for transportation infrastructure and depletion of finite energy resources to environmental and safety impacts. Governments have responded to these concerns in different ways: limiting roadway construction, investing in public transport systems, implementing vehicle inspection and maintenance programs and introducing fuel taxes and toll roads. These differences can have important impacts on how industry responds. Most of these developments, however, are relatively recent. Few existed at the time the Auto Pact was negotiated.

The 1964 negotiation of the Auto Pact fitted in well with prevailing regulatory philosophy: the state should use its power to effect socially and/or politically desirable economic outcomes. The negotiation of international trade agreements, however, steadily whittled away at the trade and industrial policy instruments available to governments to direct or even influence economic outcomes.

While not often considered as such, trade agreements operate similarly to disarmament agreements: governments enter into commitments to reduce and eliminate barriers to international trade, such as tariffs and quotas, and to circumscribe the use of others such as subsidies, government procurement preferences and product standards.

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- 4 According to Fine et al., p. 74: "A massive increase in automobile usage is also occurring in developing countries, where mobility is absolutely essential to the development process. ... Developed countries typically have 300 to 600 cars per 1,000 population, but many large developing countries have fewer than 10 cars per 1,000 population. While the market for automobiles in the developed countries will continue, the major growth will occur in the developing countries."
- 5 See Hart and Dymond (2008) and Hodgson (2008) for more complete discussions of these new production patterns and their implications for the design and implementation of trade and industrial policies as well as administration of the border.

Trade agreements thus seek to reduce government ability to use micro-economic instruments that discriminate in favour of local producers and influence the operation of markets.

Trade agreements have made steady progress in eliminating or minimizing many of the tools in the government economic toolbox to the point that it is now virtually impossible for most governments to shape the structures of their economies. Markets have become the principal determinants of who makes what, for whom and where (Hart and Dymond 2008, Hodgson 2008).

Some analysts have wrongly characterized this process as deregulation. What has changed is the focus of government intervention. Indeed, the past 50 years of OECD government regulatory activity has seen a major shift away from a focus on economic outcomes to a preoccupation with quality-of-life issues. The result has been a significant increase in the regulatory reach of government. As American public policy expert James Q. Wilson points out: “When Dwight Eisenhower [1953-1961] was president, hardly anybody thought that Washington should make policies about crime, guns, education, abortion, medical care (except for veterans), the environment, automobile safety, local advertising, the economically disadvantaged or minorities’ access to jobs and schooling. Today, people assume that Washington will have policies on all these matters and more” (Wilson 2003, 528).

The same holds true for Canada. Today, both the Canadian and US federal governments promulgate more than 4,000 new or amended regulations every year, most of them focused on risk and quality-of-life issues from the environment to food safety (Jones and Graf 2001; Crews 2004).

The automotive industry provides a perfect illustration of this change in focus. At the time of the Auto Pact, Canadian and US federal, state and provincial governments regulated neither the vehicles produced nor the manner in which they were produced.⁶ European governments began

regulating automotive products in 1958, but US and Canadian governments did not follow suit until a decade later.

The European approach was geared from the outset to the establishment of internationally recognized regulatory norms. Neither Canada nor the United States, however, adopted that approach. Today, both governments maintain extensive industry-specific regulatory regimes governing safety, fuel consumption and environmental impacts.

Unfortunately, despite the determination to create an integrated industry in 1964, Ottawa and Washington have seen limited utility in integrating their regulatory approaches with each other or more broadly. While regulatory regimes in both countries have evolved to meet virtually identical goals, their approaches have diverged.

The steady expansion of risk-oriented regulations has been a principal catalyst in the increasing sophistication of modern passenger vehicles. In addition, greater consumer awareness of, and demand for, safer, more fuel-efficient and less-polluting cars has spurred the industry to offer vehicles that go beyond government-mandated requirements. As a result, cars built today are significantly safer, more fuel-efficient and less polluting than those of earlier years.

Additionally, consumers have been prepared to pay a premium for an increasing range of amenities and performance characteristics, from air conditioning and all-wheel drives to high-end audio equipment and GPS navigation systems. Competition, including from off-shore, has ensured that the cost of building these more complex, higher-performing, longer-lasting and more satisfying vehicles has remained at competitive levels.

Differences in regulatory approaches challenge manufacturers to design vehicles that satisfy both regulatory requirements and consumer preferences in different markets. Regulatory divergence discourages global approaches and inhibits the use

6 The only extant regulation was a US rule dating back to 1940 requiring use of sealed-beam headlights in automobiles. Ralph Nader's 1965 *Unsafe at Any Speed: The Designed-In Dangers of the American Automobile* is widely recognized as the principal catalyst to Congressional hearings in 1965/1966 and the subsequent adoption of safety legislation, laying the foundation for today's extensive regulatory regimes in both countries.

of cost-effective, interchangeable parts and designs. As in other industries with high levels of regulation, the dividing line between social objectives and protectionism in pursuing regulatory goals can be a thin one. Convergence in national regulatory approaches, on the other hand, can facilitate adjustment to more globalized markets. Broader acceptance of best practices in both manufacturing and regulation can contribute to the development of better vehicles and reduce socially undesirable impacts.

Three principal, industry-specific regulatory regimes are now critical to the design and production of passenger vehicles and light trucks in Canada and the United States: safety regulations, fuel consumption targets and pollution abatement goals. Growing public concern with anthropogenic climate change has added greenhouse-gas-emission targets to public demands to improve fuel consumption and reduce engine emissions.

None of these regimes existed in 1965. Each was introduced in response to emerging societal interest in health and safety risks as well as quality-of-life concerns. For each regime, the US Congress was, and remains, instrumental in establishing benchmarks, and American regulatory officials are critical to translating them into specific rules and standards. Today, the US federal government maintains extensive rules governing safety, fuel consumption and engine-emission standards that must be met by all US-based manufacturers and, to a lesser extent, all imported vehicles. The Canadian regime generally tracks, but is not wholly compatible with, the US system.

The US Regime

Congress set up the National Highway Traffic Safety Administration (NHTSA) in the Department of Transportation (DOT) in 1967 to establish and monitor “motor vehicle safety standards and regulations” to which manufacturers of motor vehicles and equipment must certify compliance. NHTSA standards target minimum performance

requirements for motor vehicles and equipment with a view to reducing risks arising from defects in the design, construction or performance of motor vehicles.

Since 1967, the NHTSA has issued dozens of required standards in response to expanding public concerns about automotive safety. Standards are performance-based and rely on self-certification by the manufacturer, supplemented by compliance investigations and court orders flowing from litigation by both individuals and interest groups.⁷

In response to the quadrupling of oil prices in 1973, the NHTSA established “fuel economy” standards in 1977 in an effort to increase the performance of passenger vehicles and light trucks. Over the years, the NHTSA has set progressively more stringent minimum average fuel economy levels. Corporate Average Fuel Economy (CAFE) standards require vehicle manufacturers to comply with the gas mileage standards set by the DOT. Under current rules, US manufacturers must reach a fleet average of 35 miles per US gallon by the 2020 model year. CAFE values are obtained using city and highway fuel economy test results and a weighted average of vehicle sales.

In 1990, Congress amended the *Clean Air Act* to define federal “emissions standards” that took full effect for the 1996 model year. Congress subsequently tightened the standards to take effect over a phase-in period covering model years 2004 to 2007 for cars and light-duty trucks. In every successive model year within this period, an additional 25 percent of an automaker’s fleet had to comply with the new standard.

Every passenger car and light-duty truck sold in the United States must also comply with emissions regulations established by the EPA under the *Clean Air Act*. In addition to the federal standards enforced by the EPA, the *Clean Air Act* provides that California can implement its own, more stringent emissions standards and that other states may adopt California’s standards at their discretion. By the beginning of 2009, up to 11 states were considering adopting this option.

⁷ See the NHTSA website for more detail at <http://www.nhtsa.dot.gov>. The agency became an independent organization in 1975.

The Canadian Regime

Canadian officials have generally followed the trend line for regulations set in the United States, but have adapted them to Canadian circumstances. Canadian legislative and regulatory approaches, for example, tend to be more flexible than those in the United States. The separation of powers in the United States, with Congress establishing broad legislative standards, the executive branch translating these into very specific rules and regulations and the courts enforcing the results, leads to greater rigidity and specificity than is the case in Canada.⁸

In Canada, “product standards” are defined by the federal government and in-use requirements by the provinces. Transport Canada is the principal regulator of automobile safety issues under the 1970 *Motor Vehicle Safety Act* (MVSA). As in the United States, Canada relies on a self-certification system, requiring vehicle and parts manufacturers to certify that their products comply with all applicable requirements.

Transport Canada officials, however, are more prone to conduct compliance investigations and to second guess the engineering judgment of the manufacturers, a bone of contention within the industry (CAPC 2005). National trademarks and labels are used to indicate that a vehicle complies with the MVSA.

Today, no one can ship a vehicle from one province to another or import vehicles or equipment into Canada without certifying that it conforms to the standards prescribed for its class. Vehicles may be imported into Canada from: 1) anywhere by manufacturers or dealers who are able to certify that they comply with all applicable regulations, or 2) the United States by individuals or dealers who must then seek proof of compliance from a competent agent before registering the vehicle in the relevant province.⁹

Transport Canada also sets “fuel economy standards” under the voluntary federal Motor Vehicle Fuel Consumption Standards (MVFCs) program inaugurated in 1978. It provides information on fuel consumption rates to prospective vehicle buyers. Under the program, manufacturers commit to meet a progressively more stringent annual Company Average Fuel Consumption (CAFC) standard for new automobiles sold in Canada.

The CAFC standards in Canada are modelled on the mandatory US CAFE regulations, but remain voluntary at this time. The government believes that approximately 98 percent of all vehicles sold in Canada meet these standards; the remaining 2 percent are built by limited-line manufacturers of luxury, high-performance or special-use vehicles. At the beginning of 2008, however, then-transport minister Lawrence Cannon announced that the government would develop mandatory standards for the 2011 model year, with a view to achieving the US target of 35 miles per US gallon as the new fleet goal by 2020. In a burst of national pride, the minister welcomed the US goal, but insisted that Canada is “committed to developing made-in-Canada standards that achieve – at minimum – that same target in Canada (Transport Canada 2008).”

Canada introduced “national emissions regulations” to provide health and environmental protection in 1971. These standards cover crankcase emissions, exhaust emissions of carbon monoxide, hydrocarbons, oxides of nitrogen, diesel particulate matters, evaporative hydrocarbon emissions and smoke opacity.

Originally administered by Transport Canada under the auspices of the MVSA, emission standards have since 1999 been the responsibility of Environment Canada under the terms of the *Canadian Environmental Protection Act* (CEPA) and the On-Road Vehicle and Engine Emission

8 Parliament, for example, passed legislation in 1981 – the *Motor Vehicle Fuel Consumption Standards Act* – providing the government with the authority to establish fuel-consumption standards. For the next 26 years, however, no government saw a need to proclaim this legislation and follow up with more detailed regulations, relying on voluntary compliance and free riding on the US standards. That changed on November 2, 2007, when the Harper government, as part of its climate change strategy, decided to proclaim the *Act* and begin the process of developing mandatory regulations (Transport Canada 2008).

9 Individual consumers importing cars from the United States in late 2007 and early 2008 to take advantage of the strong Canadian dollar and Canada/US price differentials experienced some of these problems, particularly as regards the Canadian requirement to add theft immobilizers to some US models (Chase and Keenan 2007).

Regulations promulgated in 2002. These regulations apply to new vehicles imported into Canada or shipped from one province or territory to another, as well as to used vehicles imported into Canada. Since 1997, Canadian emissions standards track those established by the EPA in the United States.

Regulatory Cooperation

In order for manufacturers to build a vehicle for more than one market, it must be tested to multiple standards. This increases vehicle development cost and, in some cases, can and does result in limiting the choice of vehicles for consumers, particularly when projected sales volumes do not justify the additional engineering and testing resources to satisfy the unique requirements of a smaller market like Canada.

Differences in philosophy can further complicate efforts to reduce the negative economic effects of regulatory divergence. Canada and the United States, for example, have developed unique performance-based standards while the rest of the world relies on type-approval rules pioneered in Europe and codified by the UN's Economic Commission for Europe (ECE).

Despite the close ties and common automotive interests between Canada and the United States, there is no formal program to ensure that regulatory developments in either country are pursued on a cooperative or coordinated basis with a view to minimizing or eliminating minor differences. Officials in both countries remain free to regulate without reference to the rules in place or contemplated in the other. Nevertheless, they do

work together as a matter of habit and common interest. A NAFTA automotive committee, for example, provides a basis for exchanging information and discussing regulatory developments. The UN's World Forum on Vehicle Regulation¹⁰ and the APEC Automotive Dialogue¹¹ both provide further opportunities for consultation between industry and government officials, suggesting that there is an appetite among governments to reduce regulatory differences where possible.¹²

Canada and the United States are also both signatories to the 1998 Parallel Global Agreement developed by the ECE. This agreement promotes the development of global technical regulations addressing safety, energy efficiency and environmental protection (Industry Canada 2007a). While the long-term goal of global regulatory convergence may be desirable, the more immediate challenge is to address the Canada-US divergence.

Experience outside of North America suggests that coordinated approaches to regulation pose no serious obstacle to stated public policy goals. Prior to 1965, highway death and injury levels were sufficiently high to warrant government intervention in all jurisdictions. Canada and the United States took one direction and gradually developed very stringent performance-based requirements. Europe and the rest of the world relied on the already established ECE type-approval regime. Looking back over 40 years, it is not possible to conclude that one approach or the other has led to superior results.¹³

There is no evidence that cooperation and harmonization have compromised effective regulation in Europe. However, evidence on the

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- 10 The World Forum for the Harmonization of Vehicle Regulations is a Working Party of the UN's Economic Commission for Europe (ECE). Its mandate flows from a 1958 "Agreement concerning the adoption of uniform technical prescriptions for wheeled vehicles, equipment and parts which can be fitted and/or be used on wheeled vehicles and the conditions for reciprocal recognition of approvals granted on the basis of these prescriptions." Participating countries agree to a common set of ECE Regulations for type approval of vehicles and components. When an item is type-approved for a regulation by one participating country, then the approval is accepted by all other participating countries. Some 52 countries adhere to the ECE's regulatory framework. Canada and the United States do not.
- 11 The APEC Automotive Dialogue was set up in 1999 to provide a public-private forum devoted to trade facilitation, standards and regulatory harmonization, as well as economic and technical cooperation in the industry. Nine meetings have been held to date, the latest in Melbourne, Australia (April 17-20, 2007). More at http://www.apec.org/apec/apec_groups/committee_on_trade/automotive_dialogue.html.
- 12 In their overview of the extensive informal networks among Canadian and US officials, Mouafo, Morales and Heynen devote 10 pages (145-154) to the extensive links between US and Canadian officials in the transportation area.
- 13 Traffic safety expert Leonard Evans reports, for example, that in 2001 fatalities per 1,000 vehicles ranged from a low of 0.102 in Norway to a high of 0.235 in France among OECD countries, with the United States at 0.190 and Canada at 0.153. Fatality and injury rates in OECD countries have greatly declined over the past 40 years, but more rapidly in Europe than in North America, albeit from a higher base (Evans 2004, 43).

impact of differential regulations governing fuel consumption and emissions is more difficult to measure. The European approach of high fuel taxes has conditioned consumers to prefer smaller, more fuel-efficient vehicles, while concerns about pollution are politically potent in all advanced economies. The average fuel economy and environmental impact of passenger vehicles sold in Europe, Japan and Australia are comparable to those sold in North America, indicating that different regulatory approaches can result in similar outcomes.

The differences in approach between North American jurisdictions of Canada and the United States, on the one hand and the rest of the world, on the other, are extensive and make it difficult to move toward global regulatory convergence. But the differences between Canada and the United States, themselves, are marginal and can only be explained on two grounds: the rent-seeking behaviour of officials and the risk-averting concerns of ministers.

Once a regulatory regime is in place, officials will fight hard to maintain or even enlarge it, aware that their jobs and careers depend on it. Ministers, on the other hand are reluctant to reduce, change or eliminate regulations that serve, at best, marginal public policy purposes for fear that they will be criticized for failing to ensure the welfare or safety of their constituents. Both ministers and officials, aided by the media, are quick to point to market failures, but rarely accept the more widespread problem of government failure.

Well documented in the literature, rent-seeking and risk-averting behaviour are notoriously difficult to overcome once regulations are entrenched in law and practice.¹⁴ The task of reducing national differences in regulatory details frequently conforms to this phenomenon. Nevertheless, the task is not impossible: after all, the two countries seek virtually identical goals in their regulatory efforts.

Additionally, as indicated above, the story of the past 70 years of trade negotiations has been one of using international disciplines to overcome exactly

these two obstacles to better public policy. A further incentive to reform is that regulatory convergence and a less obtrusive Canada-US border are inextricably linked.

Eliminating Remaining Cross-Border Regulatory Divergence

Cross-border integration of the auto industry has progressed significantly since 1965. The emergence of inconsistent regulations in the two countries, on the other hand, has led to inefficiencies and increased costs.

The automotive industry, like most other large businesses, conducts its planning and business development in a global environment in order to remain competitive. While efforts are made by Canadian regulatory departments to consider North American market realities, regulatory policy generally continues to be made on the basis of domestic priorities, as opposed to an approach more consistent with today's globalized market realities. In addition to divergence in standards, differences also exist between Canadian and American authorities with respect to how vehicle certification is undertaken to show compliance with those standards.

Cross-Border Regulatory Divergence Matters

The Canadian and US markets for vehicles are, for all practical purposes, a single market, with largely similar driving conditions, a wide range of climatic conditions and broadly shared regulatory goals and approaches. Bilateral coordination of product regulations, therefore, makes business sense and represents good public policy.

Like the industry itself, regulatory regimes on both sides of the border are mature, having developed over four decades. They are also highly technical in nature with Canadian and US officials historically sharing information and experience. As

14 From airport security to pesticide regulations, government officials and their political masters have saddled the world with an increasing array of rules that shield ministers, cabinet secretaries and their officials from criticism by the modern army of "activists." Once in place, such rules are difficult to repeal or reform. The work of analysts influenced by the public-choice theories of Gordon Tullock and the law-and-economics theories of Richard Posner has been particularly important in pointing to the problems of self-serving regulatory behaviour by ministers, cabinet secretaries, their officials, activists and industry clients, each of whom can frustrate reform of over-zealous regulatory regimes.

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Canadian Publication Mail Sales
Product Agreement #40008848