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Policy Implications of a Canada-US Customs Union

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Policy Implications of a Canada-US Customs Union

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Executive Summary

This paper analyzes a range of policy implications that would arise from establishing a Canada-US customs union. The negotiation of such a customs union would occur in the context of:

- a high degree of economic integration and policy convergence between Canada and the United States;
- a complex bilateral and multilateral network of rights and obligations that already severely constrain the policy autonomy of both countries; and
- a common approach to regional and multilateral negotiations that finds both countries negotiating from the same or similar points of departure.

The principal elements of a customs union would include:

- a single customs territory, allowing for the free circulation of all goods within the customs union;
- a common external tariff (CET) created from the merging of the two tariffs and harmonizing on the lowest current rate of either country, with flexibility to maintain separate external rates over a transition period for a small list of products;
- provisions for sensitive sectors such as clothing (likely transition periods), agriculture (leaving the hardest issues to World Trade Organization resolution), culture (similarly leaving aside the principal issues not already covered by the World Trade Organization), and recognition of the importance of the energy sector;
- reconciling the differences in the two countries' current free trade and preferential trade arrangements with other countries respecting product coverage, rules of origin, and possible future free trade partners;
- a common approach to trade remedy laws that would imply a single regime for third countries, and recognizing that Canada-US cases are rare, concern largely resource products, notably softwood lumber, and point to the need to pay attention to resource management issues;
- a common external trade policy with respect to multilateral and regional negotiations (which, given the degree of policy convergence, should not prove difficult) and more generally for the conduct of trade relations with third countries (with respect to trade sanctions for foreign policy reasons,

it should be possible to maintain policy flexibility and devise practical instruments for this purpose without compromising the integrity of the union);

- dispute settlement within the customs union based on the current NAFTA provisions with, however, some major updating; and

- institutions for administering the union, resolving disputes, and facilitating dynamic, joint policy development to govern accelerating economic integration, drawing on existing models, such as the International Joint Commission.

Each of these would pose technically complex challenges but none would raise insurmountable barriers. The major policy issues inherent in implementing a customs union have essentially been resolved by a process of policy convergence and multilateral and bilateral trade agreements. A more complex customs union could contain a series of additional elements, each of which would add incrementally to its economic benefits. These include border administration, regulatory convergence, provinces and states, government procurement, investment, services, intellectual property, competition policy, and the cross-border movement of people. The inclusion of one or more of these elements would add to the complexity of the negotiating agenda and the political challenge in both countries of concluding a customs union. The risk premium inherent in any negotiation would increase significantly and could imperil the chances of success for relatively modest gain. It is for consideration, therefore, whether initially to pursue a more prudent course, confining the negotiating agenda to the essentials and creating a mechanism within the institutional structure of the customs union to address these issues as economic imperatives and evolving political appetites justify.

Although the North American Free Trade Agreement (NAFTA) made a major contribution to policy convergence, it should not be assumed that a Canada-US customs union must include Mexico. Mexico is now just one of a number of free trade partners shared by Canada and the United States. Mexico has, moreover, its own network of free trade agreements. Even if Mexico were interested in joining negotiations for a customs union, the political economy of the negotiating issues in the United States is not the same for Canada and Mexico. The question of Mexican participation in a customs union is not one Canada needs to or should resolve.

A decision to enter in the negotiation of a customs union would give rise to a debate about the implications for Canadian sovereignty. As in the past, this debate would be erected on false or outdated premises. For example, tariff sovereignty on trade with third countries will be evoked, although Canada, by virtue of current agreements, has virtually none left. The eggs in one basket argument will be heard, although the reality is that it is economic geography and the economic

choices of Canadians, not government policy, that fuels economic integration. Canada's alleged devotion to multilateralism will be held to be an insurmountable obstacle to a customs union, notwithstanding Canada's historical record of employing multilateral, regional, and bilateral agreements as useful tools to fit circumstances, rather than goals in themselves. Finally, the race-to-the-bottom criticisms in matters of labour and environmental protection will clash with mountains of evidence to the contrary.

The decision to negotiate a customs union will provoke, as it should, a searching examination of the policy implications of such a step. This paper argues that the optics of such issues are greater than their substance. Canada could enter a customs union with a modest increase in the level of obligations already inherent in current agreements and in the level of co-operation and co-ordination that already occurs between the two governments to govern their common economic space and interests. The ensuing public debate would doubtless be loud, generating more heat than light. If the government decides to proceed in this direction, it can have confidence that arguments are at hand that convincingly make the case for a customs union.

Policy Implications of a Canada-US Customs Union

Centre for Trade Policy and Law[1]

Introduction

This paper analyzes a range of policy implications that would arise from establishing a Canada-US customs union. The analysis proceeds on the basis of a number of assumptions.

- The economic benefits of a bilateral customs union flow principally from the elimination of the rules of origin of the North American Free Trade Agreement (NAFTA) on Canada-US trade in goods, and are substantial (Ghosh and Rao, 2004).[2]

- The existing provisions of NAFTA and the World Trade Organization (WTO) would remain in force between Canada and the United States in respect of any goods not covered by the customs union, as well as investment protection and related issues, trade in services, and the protection of intellectual property.

- Trade relations, including with Mexico and other free trade partners, would continue to be governed by the relevant bilateral and multilateral arrangements including the WTO.

- The customs union would cover trade in civil goods and not extend generally to goods purchased for the use of Canadian or US defence and security agencies.

- A simple customs union, while useful and beneficial, could be considerably enriched by addressing a series of "additional" elements.

The calculus for Canada is the exchange of incremental elements of policy sovereignty for higher economic growth. As scholar Wendy Dobson (2002: 3) observed, "sovereignty is not just about what a country gives up but also about what it gains in more efficient production, larger markets, freer flow of investment…to name a few of the benefits."

Background

The primary point of departure for assessing the policy implications of a customs union should be an analysis of the existing network of rights and obligations governing cross-border trade in goods. Following 70 years of trade policies harmful to each other, Canada and the United States finally concluded agreements in 1935 and 1938 providing for the reduction of customs duties on a range of

goods. These agreements were effectively subsumed in 1948 into the General Agreement on Tariffs and Trade (GATT) comprising originally 23 countries. The Agreement consisted of a series of commitments to regulate border barriers to trade in goods between participating countries on a most-favoured-nation (MFN) basis and to provide for non-discrimination in the internal regulation of trade as between domestic and imported goods. As the governing trade agreement between Canada and the United States, GATT was largely supplanted by the Canada-US Free Trade Agreement (FTA) in 1989 which was, in turn, subsumed into NAFTA in 1994. The successor to GATT, the WTO, added a layer of multilateral obligations but did not materially change the arrangements between Canada and the United States except with respect to telecommunications and financial services. Like the FTA, NAFTA provides that in the event of conflict between it and any other agreements to which Canada, the United States, and Mexico are party, it will prevail except as specified.[3]

These agreements have had three significant impacts on Canada-US relations. First, the agreements have fostered the accelerating integration of the Canadian economy into the US economy. The effect is most pronounced in manufacturing industries where cross-border exchange of goods between autonomous firms has yielded to complex patterns of exchange within supply chains. Today, more than two thirds of cross-border trade is between related parties, taking place either wholly within the confines of a single firm or among parties to an integrated network of firms. A third of the value of Canada's total exports today is made up of previously imported inputs (Cross, 2002).[4] The typical automobile, for example, assembled in Canada and exported to the United States, is made up of inputs that may already have crossed the border up to five times as they wended their way up the value chain. Just-in-time production strategies involve an intricate pattern of parts and components flowing from one plant to another; freer trade has made it possible for firms to locate such plants strategically throughout North America, with less and less regard for borders. While the automotive sector has moved furthest along the integration spectrum, other sectors are not far behind, including machinery and equipment, electronics, plastics, and textiles. Even resource industries, including metals and minerals and forest products, exhibit a growing level of import content in their exports.[5]

Second, the agreements have stripped the Canadian and US governments of most of their trade policy autonomy. Prior to the 1935 and 1938 agreements and the formation of GATT, the two governments enjoyed substantial autonomy to deploy a range of instruments to control trade. These included the level of customs duties on exports and imports, the classification of goods and their valuation for calculating duties, the application of quotas on imports and exports, the resort to antidumping and countervailing duties on imports, and the scope for requiring licences for exports and imports. The two governments were also at liberty to apply internal regulations of trade, for example, sales and excise taxes, to discriminate in favour of domestic goods at the expense of imported goods.[6] In the evolution of the multilateral rules in GATT, the two governments accepted an

increasingly stringent set of disciplines on their policy autonomy. Examples include binding customs duties at agreed levels, forswearing the use of quotas except in strictly limited circumstances, disciplines on the use of subsidies, and the application of antidumping and countervailing duties only in accordance with the relevant GATT articles and their implementing agreements.[7] The Free Trade Agreement (FTA) further reduced policy autonomy in cross-border trade in goods, inter alia, by binding all customs duties at zero (except for some agriculture products), by imposing binding dispute resolution in antidumping and countervailing cases which yields results directly applicable in law, and by developing obligations respecting trade in energy goods going well beyond GATT provisions. The FTA also limited policy autonomy in the regulation of certain service sectors, eliminated the scope for the discriminatory treatment of US investment in most sectors, and provided for procedures to foster the temporary movement of personnel. The result is that there are few implements left in the traditional trade policy toolbox available to either Canada or the United States to impede accelerating economic integration. As discussed below, moving to the next stage of formal integration – a customs union – would amount to a marginal increase in the level of obligations the two governments already owe to each other and a correspondingly slight further reduction in policy sovereignty.

The third impact has been the convergence of Canadian and US trade policy strategies. As a result of seven decades of bilateral and multilateral trade negotiations, Canada and the United States have essentially abandoned protectionism and embraced free trade in industrial goods. This was not always the case. In the early years of the multilateral system, the United States used the system as one part of the arsenal of geopolitical tools in the Cold War.[8] Canada, by contrast, looked at the system exclusively as a tool to enhance economic performance. In the 1964-67 Kennedy Round of GATT multilateral trade negotiations, the United States led the way in negotiating broad-based and significant reductions in tariffs on industrial goods. Canada sought to open world markets for primary industrial and agriculture goods while protecting the manufacturing sector by effectively exempting that sector from major reductions in tariffs. In the 1973-79 Tokyo Round, Canada participated for the first time in major tariff reductions and completed the process bilaterally with the Free Trade Agreement. If free trade is a shared goal for industrial products, both countries remain committed to the protection of uncompetitive agriculture sectors: supply-managed dairy and poultry products in Canada, and peanuts, sugar, tobacco, cotton, and wool in the United States. Both countries have dispensed with the multilateral trade system embodied in the WTO as a goal of foreign policy and now view it as a tool, among others, to achieve trade objectives.[9]

Similarly, in the treatment of foreign investment, throughout the postwar period, the United States embarked on an aggressive program to obtain protection from expropriation and discriminatory treatment through bilateral investment agreements and initiatives in the OECD. Until the FTA and NAFTA, Canada refused to undertake any commitments on the treatment of US and other foreign

investments (Dymond and Hart, 2004). In intellectual property protection, first NAFTA and subsequently the Trade Related Intellectual Property Rights Agreement (TRIPS) of the WTO eliminated any major differences between Canadian and US policies in this area. It is fair to conclude that, in the context of a customs union, devising a common commercial policy as discussed below would involve no significant departure from the trade policy objectives pursued by both Canada and the United States over the past 25 or more years.

The process of economic integration and policy convergence between Canada and the United States presents a remarkable contrast to European integration. The establishment of the European Coal and Steel Community in 1952 and then the Common Market in 1958 revolved around efforts to create a firmer economic base for promoting peace and security, particularly between France and Germany (Thody, 1997; Monnet, 1978).[10] It took more than 30 years and a high level of will, co-operation, and institution building to create what has become known as the *acquis communautaire*, the detailed construction of rules that now govern the conduct of affairs within the Union. This experience is wholly different from that in North America. Rather than the push of government action, integration has been largely driven by the pull of market forces: proximity, consumer choice, investment preference, and firm behaviour. Government policy has been largely responsive, motivated by efforts to resolve problems generated by market-driven integration. Rather than seeking deeper integration, governments have only gradually accepted the need to facilitate it by addressing problems experienced by private traders and investors. The result is a much more piecemeal and less deliberate approach to rule making and institution building (Dymond and Hart, 2003).[11]

These impacts have occurred in the historical absence of an institutional infrastructure for managing this complex, multifaceted relationship. Unlike other bilateral relationships enjoyed by both Canada and the United States, there is no body to provide political or policy oversight of the relationship, no regular meetings between heads of government or foreign or trade ministers, no formal structure of committees looking at the relationship in a coherent and co-ordinated manner.[12] In the 1950s and 1960s, the Canada-US Ministerial Committee with a variable collection of Canadian ministers and US cabinet secretaries met annually to review issues in the relationship. It gradually fell into disuse and was abandoned by Prime Minister Trudeau. At the level of foreign ministers, there were quarterly meetings during much of the 1980s devoted to the whole of the bilateral agenda, but these fell into disuse at the end of the Reagan administration in 1988. The FTA provided for a ministerial commission, subsequently subsumed into the three-member NAFTA Commission, meeting annually to supervise implementation, resolve disputes, and oversee the Agreement's further elaboration.[13] Despite a grand title evoking the European Commission – a body with independent executive powers – both the FTA and NAFTA commissions basically confine themselves to technical issues and abstain from any effort to chart a course for the evolution of the relationship.[14] Prime Minister Paul Martin

has now established the Cabinet Committee on Canada-US Relations to provide co-ordination on the Canadian side of the border, but has, to date, taken no steps to chart a new institutional course at the bilateral level.

The absence of formal structure results from a determined and largely successful effort to treat issues in the relationship vertically, rather than horizontally, and to build firewalls to prevent cross linkages. In part, this method of management derives from Canadian fears that as the smaller partner, Canadian interests would be overwhelmed in any more formal relationship. In part, it originates in the US system of governance that makes coherence and co-ordination in both foreign and domestic policies extraordinarily difficult to achieve on a sustained basis (Gotlieb, 2003).[15]

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

In the aftermath of September 11, which caused major if short-term border disruptions, Canada and the United States agreed on a 30-point program of action, embodied in the Smart Border Declaration, to address the issues thrown into stark relief by the tragedy of that day.[16] For this analysis, the Declaration is interesting from two perspectives. First, it covers four separate areas of border management in an integrated fashion: the movement of people and goods, infrastructure, enforcement, and acknowledging that Canada and the United States face a complex of challenges that need to be addressed in an integrated way. The aim is to "create a unique opportunity to build…a border that securely facilitates the free flow of people and commerce." Second, in the movement of goods, the Declaration is silent on issues left over from NAFTA and multilateral negotiations that would have featured prominently on trade agendas. Instead, it

focuses on border management issues, such as the processing of goods, behind-the-border clearance, and intensified sharing of customs data. The concept underlying this part of the Declaration is that the growth of Canada-US trade and investment depends on the efficiency with which the border is managed rather than the removal of classical trade barriers.

The FTA/NAFTA and the WTO represent the culmination of the postwar trade agenda between Canada and the United States consisting of tariff and non-tariff barriers to trade in goods and the new issues of services, investment, intellectual property, and temporary movement of skilled personnel. They are essentially liberalization agreements erected on static rule making (Dymond and Hart, 2000). Each has left unresolved a long list of issues that appear on various bilateral and multilateral agendas. Included are rules of origin, which restrict the full potential of NAFTA trade, antidumping and countervailing duty regimes, and government procurement restrictions, to name a few. In neither Canada nor the United States, however, is there any sense of enthusiasm or urgency to devoting the political resources necessary to undertake negotiations to deal with such leftovers. Nor is there any pressure from the broad business community on governments to move in this direction. The reason is that the benefits of classic trade liberalization have now been largely realized between Canada and the United States. The next stage of negotiations will be bilateral and needs to address the governance of deepening economic integration and accelerating policy convergence.

Finally, initial discussions about the implications of deepening integration with the United States assumed that Mexico, by virtue of NAFTA, would necessarily be part of any negotiation between Canada and the United States to craft a new agreement. This assumption does not stand scrutiny. There is no automatic link between membership in a free trade agreement and the move to the next stage. Mexico is one of a number of free trade partners shared by Canada and the United States. Mexico is no more a natural member of a Canada-US customs union than Chile, the Central American countries, or Singapore. Mexico has, moreover, its own network of free trade agreements, including the European Union and Japan. Despite rather grand ambitions 10 years ago that NAFTA would give rise to a three-country North American economy, the reality is quite different. Instead, NAFTA governs two robust bilateral trade and investment relationships; Canada-Mexico trade and investment remains at miniscule levels. Even if Mexico were interested in joining negotiations for a customs union, the political economy of the negotiating issues in the United States is not the same for Canada and Mexico. Both relationships have long histories and have economic and political importance for the United States, but they have followed divergent paths and responded to different imperatives. In sum, the question of Mexican participation is not one Canada needs to or should resolve and, in any case, is not pertinent to the analysis of the customs union issues discussed below.

Components of a Bilateral Customs Union

A customs union constitutes a stage of economic integration along a continuum of agreement types that progressively eliminate political borders among the members as a determining factor in the exchange of goods, services, and other economic factors originating in their territories (Cable and Henderson, 1994).[17] The first stage is typically an agreement between one country and one or more other countries to reduce customs tariffs, quotas, and other barriers to trade administered at the border. The second stage of integration is a free trade agreement, by which members eliminate barriers to trade among themselves while maintaining national regimes respecting trade with third countries. The third stage is a customs union, which replaces national regimes respecting third country trade with a common regime. The fourth stage is a common market, which provides additionally for the free circulation of capital, labour, and services. The fifth stage is an economic union, which adds a common currency and common macro-economic policies.[18] There is more art than science in these terms. As noted above, an increasing number of sectors in Canada and the United States capture the result of a fully functioning customs union and even elements of a common market. Moreover, unlike the European experience, which has been top-down, politically driven, North American integration is the product of the natural flows of economic geography and business dynamics. Concluding a formal customs union would make the process of economic integration more efficient, but would not change the basic direction.

The WTO provides for free trade agreements and customs unions respecting goods in GATT article XXIV and services in the General Agreement on Trade in Services (GATS) article 5. A customs union, under GATT, is defined as the substitution of a single customs territory for two or more customs territories, so duties and other restrictive regulations of commerce with certain specified exceptions are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories, and substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union. With GATS, economic integration agreements are based on essentially the same principles.

In the first 50 years of the multilateral trade system, 124 free trade agreements and customs unions, or about three and one half a year, came into force among members of the system.[19] Since the birth of the WTO, the average has grown to 15 a year amounting to 149 new regional trade agreements. Currently, only Mongolia among WTO members is not party to one or more regional trade agreements. The WTO Secretariat estimates that if the agreements planned or under negotiation are concluded, the total number in force might well approach 300 by 2007 (Boonekamp, nd).[20] No separate GATS agreements have been ratified.

Canada and the United States have already implemented three WTO-consistent free trade agreements.[21] Any impediments to deepening their commitments in a

customs union or other deep integration arrangement raised by WTO rules are minimal to non-existent. The two countries could, for example, craft aspects of a customs union on a sector-by-sector basis without ever making a formal declaration or notification to the WTO that they have decided to create a customs union. Neither GATT article XXIV nor GATS article V contain specific provisions governing the transition from a free trade agreement to a customs union, except the requirement that any common customs rules cannot impose, on average, higher barriers to third-market imports, than existed previously on an individual country basis. In short, the WTO provides a guide, not a straitjacket, to the negotiation of a customs union.

To create a simple customs union, Canada and the United States would need to address the following elements:

- a single customs territory, allowing for the free circulation of all goods within the customs union;
- a CET including the harmonization of customs policies and the sharing of customs revenue;
- sensitive sectors, such as clothing, agriculture, culture, and energy;
- current free trade and preferential trade arrangements with other countries;
- a common approach to trade remedy laws;
- a common external trade policy with respect to multilateral and regional negotiations and, more generally, for the conduct of trade relations with third countries;
- dispute settlement within the customs union; and
- institutions for the administration of the union and the resolution of disputes.

The sections below examine the policy dimensions and implications of each of these elements of a bilateral customs union (Hart, 2004a).

Single Customs Territory

A customs union would create a single customs territory applicable to the customs territories of Canada and the United States. The customs territory of Canada is defined in NAFTA as the territory to which its customs laws apply, including any areas beyond the territorial seas of Canada within which, in accordance with international law and its domestic law, Canada may exercise rights with respect to the seabed and subsoil and their natural resources. The

customs territory of the United States includes the 50 states, the District of Columbia, and Puerto Rico, the foreign trade zones located in the United States and Puerto Rico, and any areas beyond the territorial seas of the United States within which, in accordance with international law and its domestic law, the United States may exercise rights with respect to the seabed and subsoil and their natural resources.[22] A single schedule of customs duties and common customs procedures, that is a common external tariff, would be applied at all points of entry from third countries into Canada and the United States. Once goods from third counties had entered into the customs territory, they would be entitled to free circulation within the two countries. The rules of origin of NAFTA would be abolished for the cross-border movement of goods, which would no longer be subject to revenue-related customs inspection (Mirus, 2001).[23]

It is important to note that the creation of a single customs territory does not, ipso facto, mean the abolition of border inspection for a variety of other purposes as provided in Canadian and US law. In the European Union, border inspection remained a feature of intra-Union trade and the movement of people until the creation of the single market with respect to goods and the Schengen Accord providing for the free movement of people (in which not all members of the Union participate). The Canadian Border Services Agency is directly responsible for the administration of 30 separate statutes, and administers a further 64 other statutes and regulations on behalf of 14 other government departments and agencies. The US Customs Service enforces its own statutes and, additionally, enforces over 400 legal provisions on behalf of 40 other federal agencies. Obvious examples include immigration, the inspection of vehicles, food safety regulations, and the control of firearms and illegal drugs. To reduce the impediments to the free circulation of goods arising from such laws would require measures to address border administration and regulatory divergence, the results of which could be incorporated into the customs union.[24]

Common External Tariff

The CET would be created by merging the Canadian and US tariff schedules. Canada's customs tariff has approximately 8,445 lines, while that of the United States exceeds 10,000. On approximately 3,000 tariff items, the two countries already impose a zero MFN rate. On about 40 percent of the products where duties are assessed, the difference between Canadian and US rates is less than two percentage points. The simple average of all applied MFN tariff rates for Canada was 5.1 percent, while that for the United States was 3.6 percent (Goldfarb, 2003).[25] Accordingly, the scope for harmonizing to the lowest rate applied by either country should not impose a major hurdle. The issues here are technical and administrative, not political. The offers which Canada and the United States have made to reduce their tariffs on industrial products in the current Doha Round of multilateral trade negotiations are a strong indication that the scope for tariff harmonization at the lower level applied by either country is quite large (Goodrich and Hufbauer, 2003).[26] In Canada, tariff changes can be effected by order-in-council while US tariff changes require legislative action.

Administration of the CET would present few issues. Since 1984, both countries have applied the GATT system of customs valuation and, since 1988, the Harmonized System of Tariff Nomenclature (HS). There remain, however, some differences that would need to be addressed. Some effort would need to be devoted, for example, to harmonizing beyond the six-digit level, as required by the HS, to the eight-digit level used by both countries, as permitted under the HS.[27] Under the terms of the FTA and NAFTA, Canada and the United States agreed to phase out a number of tariff-related programs on bilateral trade, including duty remissions, drawbacks, free trade zones, and similar tariff reduction programs. Establishing a CET would require any remnants of these formerly important programs to be addressed.[28] Options include eliminating them altogether or reaching agreement on how to administer them within the customs union.

The practical administration of the CET during and after any transition period would probably require recourse to end user certificates for a variety of purposes. These certificates are the vehicle by which the exporter or importer makes commitments on the ultimate use of traded items; they make trade possible, which might otherwise not occur.[29] On the export side, they are quite common in respect of shipments of military or security related goods. On the import side, wheat and certain auto parts are examples of products whose importation requires the provision of certificates.[30] Such certificates are enforceable and their misuse creates liability to a range of sanctions. In the context of a customs union, as discussed below, end user certificates would ease the transition to a common trade remedy regime as well as make possible the maintenance of varying regimes for trade in military or security goods or with selected countries. In the latter case, the regime is well understood and should result in no additional costs. In the former case, the additional costs would be modest and far less than the costs of inclusion in a trade remedy measure taken by the United States.

Procedures would be required for sharing revenue from the collection of customs duties. In the European Union, customs revenue is part of the general revenues of the Union and used to finance common programs, for example, the common agriculture policy and general administration expenses. In the South African Customs Union, the revenue sharing formula is based on each country's portion of total intra-union trade including re-exports; a percentage of the total excise pool is allocated to all members based on the inverse of each country's per capita gross domestic product. Devising a formula on this or any other basis is a technically interesting task, but it would not appear to raise substantive policy implications. In any case, tariff revenue accounts for only a small part of total government revenues in both countries (Goldfarb, 2003: 16).

The development of negotiating positions on the CET in multilateral or regional negotiations is considered below.

Treatment of Sensitive Sectors

There are a relatively small number of industrial sectors for which one or both of the two countries maintain high levels of tariff protection (Goldfarb, 2003: 19-23). These reflect sensitivities to import competition which are not the same in each country. For example, on most ships, the Canadian MFN tariff is 25 percent, that of the United States is 0.5 percent. On trucks, the Canadian tariff is 6.1 percent while the US tariff (arising from a retaliatory measure taken against the Europeans in the 1960s) is 25 percent. Textiles and clothing are examples where both countries maintain high MFN tariff rates but they vary considerably across product groups. In the United States, 33 percent of textile fabric categories and 44 percent of clothing categories have tariff rates of 10 percent or more. In Canada, close to 100 percent of clothing imports face tariffs of 15 to 20 percent (Cline, 2004).[31] These are large differences, but they affect products that account for only a small percentage of bilateral trade. A useful point of departure here would be to harmonize those tariffs to the level of the lowest partner. Where harmonization is not politically feasible, separate rates might need to be maintained over transition periods tailored to specific needs. The goal would be to reduce this group to as small a list as possible.[32]

Agriculture

Cross-border agriculture trade is robust. The United States remains Canada's largest trading partner for agricultural products while Canada is the United States' second largest market for food and agricultural exports. Although trade in many agriculture sectors is largely free of impediments, there are some technical issues unique to agriculture that would also need to be addressed, such as food safety issues (on which there is already a high level of co-operation) and rules governing consignment shipping and similar details of the distribution systems.[33] None of these problems, however, poses insuperable obstacles, and solutions to them all would bring significant benefits from higher levels of convergence and co-operation.

There are, however, three significant problem areas.

- Direct agricultural subsidy programs are higher in the United States than in Canada, structured differently, and apply to a different range of products (Cline, 2004: 119).[34] Given the global character of agriculture markets, a bilateral agreement on subsidy levels would leave producers in both countries vulnerable to the subsidy practices of other countries.

- Canada's poultry and dairy products enjoy astronomical levels of tariff protection to preserve the integrity of supply management regimes. Creating an open border for trade in these sectors would effectively end supply management, lead to a major reduction in the number of Canadian producers, and impose significant financial hardship for some farmers since the value of their production quotas would be reduced to zero. By contrast, an open border would not expose US sensitive sectors (peanuts,

tobacco, cotton, wool, and sugar) to serious competition from Canadian producers.

- The Canadian Wheat Board's (CWB) state-trading practices in third markets remain a perennial, if minor, irritant in cross-border trade relations. However, unlike the virtually unanimous support the dairy and poultry sectors enjoy among producers, a number of grain producers would support the abolition of the CWB or at least an end to its monopoly buying and selling power (Penner, 2004).

Economic logic suggests a common Canada-US agriculture policy should be an essential component of the customs union. However, the negotiation of such a policy coincident with the negotiation of a customs union is, in all probability, beyond the political reach or appetite of Canada and the United States. It would, inter alia, require a massive restructuring of the two countries' domestic agriculture policies and the creation of a central body to decide on the amount and distribution of subsidy programs. Complex and lengthy adjustment periods would be inevitable. Since a common agricultural policy is, at best, incidental to the overall purpose of a customs union, the pragmatic decision may well be to leave the governance of outstanding bilateral market access, subsidy, and Wheat Board issues to the rules of the WTO and the outcome of the current Doha Round before deciding whether and in what manner these results should be brought within its scope. [35]

Culture

Imports of cultural products and services from the United States and US investment in the Canadian cultural sector have been highly sensitive issues in Canada for decades. The FTA provided an exemption for cultural industries except with respect to tariffs on cultural goods, and retransmission rights on the now repealed print in Canada requirements. However, it also allowed the United States to take measures of equivalent effect if Canada takes a measure under the exemption that is inconsistent with the Agreement.[36] These provisions were incorporated into NAFTA by reference and thus remain in effect. The negotiation of a customs union would bring renewed prominence to this issue and would require sensitive handling.

In trade policy terms, the objective of the cultural exemption is to establish a special regime for trade and investment in cultural goods and services. The exemption does this, however, in a highly inefficient manner. For example, it is not comprehensive, as the FTA eliminates customs tariffs for goods used in cultural productions.[37] Furthermore, the capacity to take equivalent measures to respond to actions covered by the exemption is tantamount to a right of automatic retaliation for a breach of obligations. Under normal trade rules, retaliation rights are only available after a process of dispute settlement and the opportunity to remedy the offending action or to offer compensation. It is not, therefore, surprising that in defending the exemption in the approval phase of the FTA,

Canada and the United States offered radically different explanations of the meaning of the exemption. Canada contended that the FTA and NAFTA left untouched Canada's unique cultural identity and ability to pursue cultural objectives, and that the US right to retaliate was limited to measures inconsistent with the Agreement. The US Administration assured Congress that it would discourage Canadian action under the exemption; in the case of NAFTA, the Administration indicated it would monitor Canadian treatment of the cultural industries, particularly in respect of measures which, in the US view, unfairly discriminate against US exports.

Since the FTA entered into effect, the exemption has never been tested. In 1994, the United States protested the cancellation of the licence held by Country Music Television, a US-based company, to sell programming on Canadian cable systems, as unreasonable and discriminatory, but not contrary to any specific obligation. It threatened retaliation against Canadian telecommunication and cultural enterprises operating in the United States. The dispute was resolved when a partnership was formed between the US company and its Canadian competitor. In 1997-98, Canadian measures amounting to an import prohibition on magazines were successfully challenged by the US government under the WTO, rather than NAFTA, and led to a threat of retaliation. In neither case did Canada invoke the exemption. These cases suggest that the terms and conditions under which the exemption may be invoked, and any limitations that may exist on the US right to retaliate, remain essentially unknown and probably unknowable (Dymond and Hart, 2002b).

The Canadian industry recognizes that the traditional tools of protection are less and less useful. It is prepared to abandon the exemption and examine the elaboration of a set of rights and obligations in this sector (*Report of the Cultural Industries Sectoral Advisory Group*, DFAIT, nd).[38] It remains, however, fearful of open markets and supports the proposal for an international cultural diversity instrument, which it believes would provide scope for special measures to mitigate US competition (Canadian Heritage, 2003). Since the United States seems prepared to consider the dimensions of such an instrument, Canada could argue that cultural goods and services should be left out of the negotiation of a customs union until the results of these efforts are known. However, the United States could view the negotiation of a customs union as an opportunity to eliminate Canadian restrictions on access to the Canadian market for US cultural goods, services, and investment.

Energy

The cross-border energy market is already substantially integrated with cross-border flows of energy in both directions. Canada is the leading foreign supplier of oil and gas to the US market, an important source of uranium, and an integral part of various electricity grids. Some regulatory hurdles remain, particularly in electricity, but are not substantial impediments to cross-border trade. In the case of petroleum, NAFTA imposes rigorous disciplines on the right of either country

to interfere with trade, in part, by interpreting GATT rules and, in part, by creating new obligations. For example, export taxes may not be imposed unless the same tax is levied on products destined for domestic consumption. Export restrictions may only be imposed so long as the restriction does not reduce the proportion of the total export shipments made available relative to the total supply of that good of the party maintaining the restriction as compared to the proportion prevailing in the most recent 36-month period. Neither country can impose a higher export price or disrupt normal channels of supply and distribution.[39] While there is little scope left for a customs union to add to the level of rights and obligations of either country in this sector, energy supply and Canada's energy supply potential resonate as strategic issues in the United States. Notwithstanding the modest scope for addressing the security of supply issues, Canada's readiness to entertain a separate energy agreement addressing issues, such as infrastructure development and regulatory convergence, might well have a constructive impact on the readiness of the United States to contemplate a customs union meeting Canada's needs.

Reconciliation of Current Preferential Trade Arrangements

Both countries apply broadly two types of preferential trade arrangements in trade with third countries. The first consists of preferential tariff rates under general or regional schemes applied to certain imports from developing countries. The most comprehensive of these is the General System of Preferences adopted pursuant to a 1971 GATT decision. Canada also has preferential rates in effect for Australia and New Zealand (the last remnants of the old British preferential tariff), for Commonwealth Caribbean countries, and for least developed countries, which benefit from duty and quota elimination on most products. The United States has special tariff rates for the Caribbean Basin countries (except Cuba) and those benefiting from the *African Growth and Opportunity Act* and the *Andean Preference Act*.[40] In a few instances, Canada and the United States apply tariff rates higher than MFN levels to imports from countries which are not WTO members or with which they do not have MFN agreements, such as North Korea, Serbia, and Laos.

The second category consists of the duty-free treatment extended to bilateral and regional free trade agreement partners. Both countries have used the NAFTA template in the overall structure and content of these agreements. Canada has free trade agreements with Israel, the United States, Mexico, Chile, and Costa Rica, and is negotiating such arrangements with the remaining European Free Trade Agreement countries, Singapore, and Central America (El Salvador, Guatemala, Honduras, and Nicaragua). The government is holding public consultations on negotiating free trade agreements with the Andean Group (Bolivia, Colombia, Ecuador, Peru, and Venezuela), the Commonwealth Caribbean, and the Dominican Republic.[41] The United States has free trade agreements in force with Israel, Canada, Mexico, Jordan, Chile, and Singapore and has completed negotiations with nine countries: Australia, Bahrain, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Morocco, and

Nicaragua. Negotiations are under way with 10 countries: Colombia, Ecuador, Peru, Panama, Thailand, and the five nations of the Southern African Customs Union (SACU). Both Canada and the United States are politically committed to the negotiation of free trade agreements in the Asia-Pacific region and in the Americas, although the prospects that such agreements will materialize in the foreseeable future are remote.[42] None of these is economically significant for either country. Such agreements are political manifestations of a relationship and are essentially versions of the trade and economic consultation arrangements popular in the 1970s, which fell into disuse as free trade agreements became politically fashionable. They do require a political and bureaucratic resource commitment wholly out of proportion to the economic gain from success or loss in the event of failure.

A customs union would have important consequences for these arrangements. Products imported into Canada or the United States under a preferential tariff rate or a zero rate would enjoy free access to the other country. There are significant differences between the various Canada and US schemes in terms of product scope, preference rates applied, the conditions for granting the preferences, as well as the rules of origin. For example, Canada grants duty and quota-free access to all products, except certain agricultural products, to 44 least developed countries while the United States does not. The US *African Growth and Opportunity Act* conditions the granting of preferential access to indicators of democratic progress and the rule of law in beneficiary countries. There are also differences in the rules of origin, especially in the clothing sector, where cotton products benefiting from preferences have to be made of yarn originating in the United States. Achieving a workable reconciliation would be technically demanding and doubtless generate adjustment problems in sectors, such as clothing, where the sensitivity to low-cost competition from developing countries varies. However, the relatively low levels of trade involved – actual and potential – suggests the task of finding solutions, which might include creative transition arrangements, should not be insurmountable.[43]

In the two years since the Administration gained negotiating authority from Congress, the United States has surpassed Canada in the number of bilateral agreements it has concluded. This gap is certain to grow since the United States, because of the size of its market, is a far more attractive free trade partner than Canada. While Canada could intensify its efforts to conclude such agreements in advance of implementation of a customs union, this would yield little advantage. The more practical course is to operate on the assumption that there would be a common list of free trade partners from the date of implementation of the union and devote the necessary resources to resolving the differences in rules of origin and other issues.

Trade Remedies

A long-cherished myth among Canadians is that the United States is a serial abuser of antidumping and countervailing measures while Canada largely abstains

from such disruptive protectionism.[44] The reality is quite different. Both countries are enthusiastic users of such measures. Since the FTA came into force in 1989, globally the United States has issued 291 antidumping and countervailing duty orders. Canada has issued 135 orders, a higher level on a percentage of trade basis than the United States.[45] There is another reality that merits close attention. In both countries, more than 80 percent of trade remedy cases involve steel products from third countries. Of the 232 steel orders since 1989, only five have affected Canadian steel exports to the United States. Similarly, only six Canadian orders have affected US steel. Both countries are effectively operating a highly protective trade remedy scheme for steel products while the use of trade remedies for other products is sporadic and marginal. It should be noted, however, that the extent of WTO challenges to US trade remedy measures (see below) suggests the US system may be much more prone than the Canadian system to exploring the outer reaches of the rules and accepting the consequences.

On cross-border trade, new antidumping and countervailing duty investigations have become increasingly rare. Since the full implementation of the FTA tariff cuts at the end of 1997, only six new US orders on imports from Canada have been issued.[46] Canada, for its part, has issued four new antidumping orders against US products and no countervailing duty orders in this period.[47] The extent of intra-corporate trade and other structural forms of commercial integration, and no doubt the disciplines imposed by NAFTA review, have virtually eliminated resorting to trade remedies by firms in the manufacturing and industrial sectors. In cross-border terms, the principal trade remedy problem remaining is the role of government in resource management, including pricing.

The logic of a customs union has two implications for trade remedies. First, it would mean the unified application of trade remedy measures to imports from third countries so imports subject to such measures in one country would be automatically subject to the same measures in the other. Given the preponderance of the steel cases, such integration would be welcomed by the steel industry in both countries. There would, however, be instances where the application of an antidumping or countervailing duty by one country would raise costs for users and consumers in the other with no corresponding gain for domestic industry.[48] To achieve a unified system, Canada and the United States would need to create an integrated trade remedy regime to address third-country trade. Again, this would be a technically challenging task but one made manageable by the broad compatibility between the two regimes, including the method of investigations and the administrative infrastructure.[49] If there is a transition period for the integration of the trade remedy regimes, the two countries would need to deploy techniques to ensure that trade remedy orders that apply to imports from one country are not evaded by importing through the other market. End-user certificates, for example, can be required on imports of goods entering the open market at a time that a trade remedy order is in place in the other.[50] Again, the availability of sophisticated information processing technologies makes such a strategy realistic today.[51]

Second, it would mean the elimination of such measures on cross-border trade or, more realistically, a solution adapted to the political and economic context of trade remedy issues in the two countries. Total elimination is probably beyond reach at this time and its benefits would be wholly disproportionate to the cost, including the risk of failure of the negotiations for a customs union. During the 1986-87 free trade negotiations, Canadian attempts to achieve a separate status under US trade remedy law, amounting to all intents and purposes to an exemption, and US refusal to entertain such a step almost resulted in the failure of the negotiations as a whole (Dymond et al., 1994). These risks should be avoided in the negotiation of a customs union by virtue of the emerging reality of few cases and exploring two strategies to further reduce the impact of trade remedies on cross-border trade. First, the two governments could agree to eliminate trade remedy measures in sectors that have had no new cases and where the preponderance of industry on both sides of the border agrees.[52] Second, they could negotiate rules about resource pricing, including in agriculture, that will reduce the friction that has given rise to the most persistent and difficult cases. Given the increasing depth and extent of cross-border integration, making the transition from two separate regimes to a single trade remedy regime makes commercial sense. Doing so on a gradual, sector-by-sector basis makes political sense.[53]

The softwood lumber case has attained iconic status in the management of Canada-US trade relations. Moreover, the enduring political weight of US industry creates a reasonable presumption that even if there is an accommodation on resource pricing, the United States would find ways to limit Canadian exports whenever these exports achieved a politically uncomfortable market share. Further periodic initiatives in the US congress to water down the disciplines of NAFTA generate considerable uneasiness and could imperil the political viability of a customs union on either side of the border or both.

Common External Trade Policy

The development of a common external trade policy to manage trade relations with third countries would need to address the conduct of multilateral and bilateral free trade negotiations with third countries, dispute resolution, and the use of trade sanctions for foreign policy reasons. It would need to provide for a decision-making process and the appointment of single delegations in the case of negotiations and dispute settlement in the WTO and free trade agreements. Although Canada would need to accept that, in many cases, US preferences would prevail, the convergence of trade policy over many years reduces the likelihood that sharp differences will emerge between the two countries. Indeed, the prospects of achieving Canadian trade policy objectives would be considerably enhanced to the extent that they can be pursued in the context of a common negotiating position with the United States.

Multilaterally, Canada and the United States have usually pursued broadly compatible goals and strategies. The implementation of a customs union would present few problems of finding agreement on a common negotiating position. In each of the GATT rounds prior to the conclusion of the FTA, since the largest bilateral relationship within GATT was the Canada-US relationship, it was the size of the tariff liberalization package between the two countries that determined the scope of the final agreement. On non-tariff issues, the most important difference between the two countries has been trade remedies. Canadian ambitions typically allied with other countries to limit the scope of US application of US measures, a position that clashed with the US objective of making GATT rules compatible with the US system. Subsequent to the FTA, bilateral tariff issues have disappeared (except for a small number of agriculture products) and the elaboration of a CET would resolve any remaining differences in the treatment of third-country imports. A customs union would transfer trade remedy issues out of the WTO for the two countries and bring them within the ambit of the union. On issues left outside the scope of a customs union, for example sensitive agriculture sectors and cultural goods and services, the two countries would retain a small multilateral agenda between them.

The choice of free trade partners following implementation of a customs union requires attention; however, its importance should not be exaggerated. In the case of both countries, the pursuit of bilateral and regional free trade agreements has a far larger foreign policy than trade policy content. Such agreements have replaced the old trade and economic consultation arrangements commonly employed by countries to demonstrate a foreign policy, if not a business interest, in the development of trade and economic relations. Canada has been eagerly seeking regional and bilateral free trade partners since the implementation of NAFTA in 1994. With each of these partners, trade is small and the corresponding impact on the Canadian economy infinitesimal. The US program is more recent and is largely motivated by the same interests but in some cases with a geopolitical overlay, as with the proposal for free trade agreements with Middle East countries that the United States believes would contribute to economic reform and democratic development. The economic impact of these arrangements is even more marginal than in the Canadian case, given the smaller percentage of the US economy engaged in international trade. While it is theoretically possible that sharp divergence between the two countries on a free trade partner might emerge, its likelihood seems extremely low and the practical implications modest.[54]

Dispute management in the WTO would present a series of risks endemic to a customs union since both countries would be joint plaintiffs or respondents in each case. The risks are higher on the Canadian side, because the United States has a higher propensity to be involved in dispute settlement as either plaintiff or respondent. Leaving aside Canada-US cases, since 2000, the United States has been the respondent in 35 cases, of which 25 have challenged US trade remedy law or its application, primarily in steel cases. The United States has been the plaintiff in 15 cases. Over the same period, Canada has been the respondent in one

case and the plaintiff in another.[55] The two countries in this period have contested 11 bilateral cases, six of which involve softwood lumber and two wheat. In a customs union, both countries would be required to pursue cases jointly as plaintiffs or as respondents. If a case resulted in trade retaliation or trade compensation, the impact could fall on both countries. While these are serious risks, they are not substantially different from the risks inherent from deep economic integration where barriers to exports arising from retaliation or any other factor automatically affect all the participants in the cross-border supply chain.[56]

The decision-making process (considered below under institutions) for the conduct of trade negotiations and dispute management, will need to accommodate the differences between Canadian and US practices. In Canada, the decision to enter into negotiations and the determination of negotiating mandates for Canadian delegations are federal Crown prerogatives. Further, the federal Crown retains the prerogative to enter into agreements and to implement them without parliamentary approval. In the United States, the Constitution conveys exclusive responsibility for external trade relations, including trade agreements, to the Congress. While Congress has delegated some of this authority to the Administration, it retains ultimate control over the choice of partners, the content of negotiations, and the implementation of results. With respect to dispute settlement, the Administration may implement panel findings if consistent with US law, but it runs the risk of provoking congressional initiatives to change the law. In certain cases where US law is disputed, Congress has proved highly resistant to changing its laws to conform to dispute settlement findings.[57]

Finally, as is typical in a customs union, each country will wish to retain the flexibility to control or prohibit the export and imports of certain products in trade with third countries. Both countries also apply trade restrictions for foreign policy reasons.[58] While Canadians often obsess about the risk of having trade relations with countries, such as Cuba, affected by unilateral US foreign policy measures, the reality is subtler. The United States resorts to unilateral sanctions less than is often realized. If Canada, on the other hand, has traditionally been less willing to use trade sanctions as a tool for achieving non-trade objectives, it is not immune from pressures to take such measures.[59] Beyond measures taken for foreign policy reasons, both countries have long lists of prohibited and restricted goods, many of them similar in intent but different in detail. Many are used to administer a wide range of domestic policy measures relating to consumer safety or national security.[60] Thus, while there may be added pressure on Canada from the United States to join it in applying unilateral sanctions and rare instances where Canada takes sanctions without US support, it should be possible to find pragmatic solutions that would limit sanctions to commercial shipments to the United States or Canada. Modern information sharing and reporting technologies make it possible to design ways and means, for example, end-user certificates, to limit the commercial application of a trade sanction to the market of one of the partners.[61]

Dispute Settlement within the Customs Union

A customs union could build on the three types of dispute settlement procedures of NAFTA. Chapter 20 provides for arbitration of issues flowing from the interpretation and implementation of the Agreement and is based on the traditional dispute settlement procedures of GATT. The decisions of Chapter 20 arbitral panels are binding on governments but not directly applicable in domestic law. Implementing such decisions, providing compensation, or accepting retaliation remains within the discretion of the offending party (Hart, 2000). Chapter 19 provides for panel review of decisions under antidumping and countervailing procedures, and its results are directly applicable in domestic law (Macrory, 2002). Chapter 11 establishes the right of private parties to seek remedies for the breach of investment obligations and, if such remedies are granted, they are enforceable in the domestic courts of the offending party (Ritchie Dawson, 2002; Soloway and Tollefson, 2003). The negotiation of a customs union would provide the opportunity to adapt these procedures to the requirements of a customs union in the following ways.

First, if a chapter 20 dispute concerns a matter covered under both NAFTA and the WTO, the parties may choose arbitration in either forum. Historically, the NAFTA forum (and the FTA option before it) has been used only occasionally as both countries have preferred the WTO route.[62] While providing this option may have made sense when the FTA was first negotiated, issues that arise within a customs union should be litigated and resolved within that framework and not be decided in a forum dominated by other concerns and participants. While there is a case for providing that the decisions of arbitral panels should be directly applicable in law, as is the case for chapter 19 and chapter 11 procedures, this would require Parliament and Congress to cede control over their legislative prerogatives in cases that involve challenges to legislation rather than the administration of legislation. Although it would be useful to explore the scope for this approach in such cases, there are so few instances of disputes that do not involve trade remedy legislation or measures, the effort expended to achieve this result would probably exceed the benefits.

Second, all three procedures currently rely on ad hoc panels or tribunals, which weaken the precedential value of earlier decisions. Finding competent panellists willing to serve has also become increasingly difficult. There needs to be a permanent tribunal, staffed by individuals with broad experience, from which individual panels would be drawn, and assisted by an expert staff. It would also be useful to make a number of procedural reforms for each of the three sets of procedures that recognize their adjudicatory, rather than diplomatic, function, including such matters as transparency, rules of evidence, standing for private parties, discipline in frivolous complaints by private parties, the role of amicus briefs, and similar matters.

Third, the NAFTA Secretariat consists of three small national sections limited to administrative functions. One consequence is that ad hoc staff hired for each case

serve the analytical needs of the panels. To meet the needs of dispute settlement in a customs union, there needs to be, either separately or as part of the larger secretariat discussed under institutions, a better-resourced secretariat to assist in dispute settlement cases, with a broader mandate, and the ability to provide independent legal advice as well as administrative services to panels.[63]

Institutions

The Europeans vested their customs union from the outset with a vast administrative infrastructure whose principal features are an executive secretariat independent of the member governments and exercising autonomous powers, a complex structure of ministerial councils and committees, a parliament, and a court. None of that is either necessary or indeed feasible in a North American context. Rather than seeking to create structures where none is needed, the two governments should focus on the functions that need to be performed for the efficient implementation of the customs union and create new institutions only where current arrangements are unsuitable.

Given the intensity and intimacy of cross-border co-ordination and co-operation on all the matters which would fall within the scope of a customs union, the administrative requirements arising out of a customs union suggest that these are only incrementally more demanding than for NAFTA. In many cases, these could be met by making use of existing Canada-US co-operative arrangements and by investing officials in agencies on both sides of the border with new responsibilities. There is no reason, for example, why a customs union could not require the Canadian Border Services Agency and the US Customs Service to co-ordinate their efforts to ensure efficient administration of third-country imports. A good basis for this kind of co-operation already exists in both the informal networks among officials, and in the relatively minor differences in regulatory approach. What is missing is an agreed mandate to resolve differences and a more formal institutional framework with authority to ensure mutually beneficial outcomes. Establishing a joint Canada-US commission to supervise efforts to establish a more co-ordinated and convergent set of regulations governing all customs matters could prove critical to providing the necessary momentum and political will.

Food safety is one area already invested with a high degree of co-operation. The Canadian Food Inspection Agency (CFIA) and Health Canada, and the US Animal and Plant Health Inspection Service (APHIS), Food Safety Inspection Service (FSIS), and Food and Drug Administration (FDA) work closely together on the basis of hundreds of agreed protocols and understandings. Much of this, however, lacks the status of domestic law or international treaties, and any problems need to be resolved at the level of the Minister and Secretary of Agriculture. Enshrining current levels of co-operation into a bilateral treaty and assigning supervisory responsibility for the continued adaptation of its implementation to a joint commission would greatly enhance both consumer and producer confidence in

the two governments' commitment to governing what is, de facto, an integrated market.

In some areas, for example, a common external trade policy or the administration of a unified trade remedy regime vis-à-vis third countries, more formal and independent co-ordination mechanisms and permanent secretariats might be required. Establishment of such joint commissions could be phased in over time as progress is made in implementing the new commitments, and as confidence develops in the efficacy of such joint decision-making. As with the existing International Joint Commission, ultimate political authority would continue to rest with the two governments, but by appointing high-quality commissioners and pledging to maintain an arm's-length relationship with each commission, the two governments would seek to foster a similar, respected status for the new commissions (Legault, 2002).[64]

Additional Elements

A more complex customs union could contain a series of additional elements, each of which would add incrementally to its economic benefits. The inclusion of one or more of these elements would add to the complexity of the negotiating agenda and the political challenge in both countries of concluding a customs union. The risk premium inherent in any negotiation would increase as well and could imperil the chances of success for relatively modest gain. It is for consideration, therefore, whether to pursue a more prudent course initially, confining the negotiating agenda to the essentials and creating a mechanism within the institutional structure of the customs union to address these issues as economic imperatives and evolving political appetites justify.

Border Administration

One of the most pressing issues facing the two governments is the high cost of administering the physical border, both for the two governments as well as for firms and individuals that use the border frequently to conduct their affairs in the integrated North American economy. The intensity of the cross-border relationship is apparent from the 16 million trucks crossing the border annually, the 100,000 passengers crossing daily, and the 200 million annual individual crossings. On average, 15 million Canadians travel annually to the United States for visits of more than one day. Efforts to make the border more effective and efficient are integral to the current Smart Border Accord. These discussions are proceeding at a snail's pace, because they are both limited by the decision to work within the confines of existing legislative mandates and by the lack of a strategic framework. Creating such a framework, investing in infrastructure and in technology (both at ports-of-entry and the corridors leading to such ports) and targeting resources toward pre-clearance programs for goods, vehicles, and people are critical components of any comprehensive effort at improving the management of the border and reducing its commercial impact. Finally, the two governments could increase the level of convergence in US and Canadian policies governing such matters as cargo and passenger pre-clearance programs, law

enforcement programs of all types, and immigration and refugee determination procedures. The objective should be to create a border that is considerably more open and less bureaucratic, within a North America that is more secure. If Canadians and Americans want a smarter and less intrusive border between them, they will need to co-operate to create a more secure perimeter. The result should be a more open, more prosperous, and more secure continent.

Regulatory Divergence

The benefits of a customs union would be considerably enhanced by deepening regulatory convergence and eliminating minor regulatory differences that, as a matter of convenience, are often administered at the border. Within the Canada-US context, there already exists a high level of regulatory convergence, at least as far as goals and objectives are concerned.[65] The Centre for Trade Policy and Law has developed an extensive database detailing co-operation in 10 sectors, including customs administration, energy, agriculture, surface transportation, immigration, drug approval, medical devices, chemicals and petrochemicals, environment, and financial services. The differences that do exist are more matters of detail and implementation, rather than of fundamental design. Nevertheless, these differences impose costs and affect investment decisions. Much, therefore, can be gained, by exploring ways and means in which such differences can be bridged or their impact ameliorated. The higher level of co-operation signalled by a deep integration arrangement provides an enhanced basis for pursuing various convergence strategies, including mutual recognition, co-operative enforcement, uniform product and process standards, the "tested-once" principle, and even harmonization. The extent of regulations in both countries at all levels of jurisdiction suggests that this task would need to be broken down along sectoral and functional lines and include procedural and institutional capacity to address the dynamic character of most regulatory regimes.[66]

Provinces and States

The two federal governments share governance of their common economic space with 50 state governments and 10 provinces, including in important areas related to the regulation of economic and commercial matters. The constitutional and political realities that govern the division of powers in the two countries are not the same. The highly fragmented American decision-making process makes it difficult for the federal government to supervise the rule-making activities of the states and even of some of the quasi-independent commissions established by Congress. Further, even on matters where the US federal government could exercise the trade and commerce power of the Constitution, it has proved reluctant to do so. Similarly, the Canadian federal government cannot direct the provinces in areas of provincial jurisdiction. While it would be possible to conceive of a customs union that would subject all regulatory decision making by provinces and states to its rules, procedures, and institutions, such an agreement would be difficult to negotiate and even more difficult to implement and manage. Canada and the United States have the advantage, as a result of the impact of silent integration and nearly 70 years of bilateral and multilateral negotiations, of

close equivalence in external tariff levels, of a deeply embedded commitment to national treatment, and of extensive convergence in regulatory purpose and design. The provincial and state governments share in this process of convergence and are likely to continue along this path. Including the provincial and state governments in formal arrangements to further facilitate and govern integration and convergence, while desirable, may also prove problematic and raise more problems than it solves. At least for the foreseeable future, a pragmatic approach of passive co-operation would be appropriate.

Government Procurement

Both NAFTA (Chapter 10) and the WTO Agreement on Government Procurement open significant amounts of Canadian and US federal government procurement of civilian goods to cross-border trade. There remain, however, important barriers to a fully open market. Exclusions include defence goods, provincial and state procurements, and a significant amount of US federal procurements that are "set aside" for small and minority-owned businesses. State and municipal access to US federal funding of infrastructure investment is conditioned by Buy America restrictions. Both countries would benefit from more open and fully competitive government procurement markets at federal and state/provincial levels. The increasingly integrated nature of production in North America, makes the distinction between a Canadian and a US product more and more artificial and, probably, difficult to prove. It is for consideration whether customs union negotiations offer a further opportunity to open procurement markets. More practically, given the politics of rewarding constituents with government contracts, even when they are not the most competitive, the two governments may wish to pursue a strategy that gradually opens government markets to full North American competition on a sectoral basis, reflecting the support of the preponderance of industry on both sides of the border.

Investment, Services, and Intellectual Property

Cross-border direct investment remains restricted in a limited number of sectors, including national security, culture, telecommunications, transportation, energy, and financial services. The scope for addressing these remaining restrictions depends on either or both governments foregoing these objectives or accepting that the objectives served by these restrictions could be served by other means, often to greater effect. Further co-operative efforts along these lines would yield additional beneficial results, particularly if they form part of a larger strategy (Dymond and Hart, 2002a). Trade in services is largely unencumbered by restrictions, either because such restrictions were never introduced or have been addressed in NAFTA or the WTO. Those that remain fall largely into four categories: professional certification requirements, restrictions on foreign direct investment, for example in the financial services and cultural industry sector, restrictions affecting cross-border movement of personnel, and limitations on government-provided services. Restrictions on the cross-border exchange of technology have been reduced to a small number of national security-related

objectives, most of which are governed by a range of mutually satisfactory bilateral arrangements.

Differences in the two countries' intellectual property regimes have, as a result of both NAFTA and the WTO TRIPS Agreement, been reduced to a minimum, and pose, at most, a minor obstacle to deepening bilateral integration. Remaining restrictions would appear to be amenable to relatively straightforward arrangements based on mutual recognition and similar approaches.

Competition Policy

In the Treaty of Rome, members of the European common market agreed to subject intra-European commerce to market-wide competition disciplines. The scope for such disciplines has gradually expanded and now includes all commerce that may affect the operation of the economic union. This European experience, which is not shared by many other regional integration agreements, has disposed some in Canada to suggest that a Canada-US customs union would require the two governments to negotiate a common competition policy. Neither the WTO rules nor economic literature indicate that a customs union requires a common competition policy. Nevertheless, there are benefits that would flow from such an approach, as well as costs. The real issue, therefore, is whether there is a need for common competition and related policies.

Given similarities in values and goals, Canadian and US competition and similar commercial policies, including securities law, company law, and consumer protection law, already demonstrate a high level of convergence and a high level of information sharing and co-operative enforcement based on a network of formal and informal understandings. It is for consideration, therefore, whether much would be gained by including such laws and policies within the framework of a customs union on any other basis than as part of a broad agenda of addressing regulatory differences. Initial Canadian enthusiasm for competition provisions in the FTA/NAFTA was predicated on such provisions acting as a replacement regime for antidumping law. Now that it is clear that there is no US appetite for treating dumping as a competition issue, Canadian enthusiasm has waned. Additionally, there have been significant advances in anti-trust law co-operation since the mid-1980s, further reducing the need for requiring that this dimension of commercial policy fall within the purview of customs union disciplines.

On balance, therefore, the best approach to this aspect of governing deepening integration appears to be to take a pragmatic and flexible approach. There seems to be no pressing need to push this issue to the top of the agenda, nor is there either a political or public policy benefit in rejecting out of hand enhanced levels of co-operation in the future. Any well-crafted customs union agreement, therefore, could provide scope for addressing this nexus of issues as the need arises.

The Cross-Border Movement of People

Customs unions do not normally extend to the free movement of people (Hart, 2004b: Young, 2004). Indeed, the European goal of free movement of all the factors of production, enshrined in the Treaty of Rome, did not become fully operational until the 1990s, and even then remains subject to some limitations for those countries not participating in the Schengen Accord. At the same time, in negotiating the FTA, Canada and the United States recognized that easing restrictions on the temporary entry of business travellers was critical to the success of the agreement. Not surprisingly, the chapters on temporary entry in both the FTA and NAFTA have proven of immense value. It is for consideration, therefore, whether in negotiating a customs union, the two governments would want to include the cross-border movement of people.

From an economic efficiency perspective, there is much to be gained from further steps to ease the cross-border movement of people. As technology has become more sophisticated and integration has deepened, the scope for delivering services on a cross-border basis has increased, and the key to service delivery is people. Similarly, as goods production has become more integrated along north-south lines, the need to deploy key personnel where they are most needed has increased. Thus, as helpful as the temporary entry provisions of the FTA/NAFTA have proven, there is scope to do more. Doing more, however, engages security considerations, particularly in the aftermath of September 11. Security threats are now much more varied and sophisticated than in the past and entry controls are critical to reducing risk.

Within the context of a customs union negotiation, therefore, there are good reasons to explore the prospect for further easing restrictions affecting the entry of Canadians and Americans to each other's economies, either as visitors or as temporary workers. Addressing this as part of a broader effort at co-operation in the treatment of people from third countries would significantly enhance the prospect of success and, concurrently, build confidence in the commitment of the two governments to the security of North America.

A Common Currency

Much heat has been generated over the past few years by discussion of the need to move toward a common currency. The precipitous decline in the value of the Canadian dollar relative to that of the US dollar in the 1990s convinced some analysts that the time had come to peg the Canadian dollar's value to that of the US dollar (Courchene and Harris, 1999; Laidler and Robson, 2002). At a practical level, many firms and even individuals have addressed the currency issue by denominating many of their cross-border dealings in US dollars and maintaining US dollar accounts for that purpose, suggesting to some that a more formal and permanent solution would be desirable. The policy question for this discussion, however, is whether adopting one of a number of formal approaches to currency co-operation would advance the objectives of a customs union.

Neither customs unions nor common markets normally extend to currency issues and other macro-economic matters, in large part, because the issues raised by moving toward a common currency are at best only marginally related to the issues addressed by either a customs union or a common market. The European common market functioned well for 40 years without a common currency; the adoption of a common currency in 2002 created growing pains, none of which, however, brought into question the fundamentals of the common market. Given the difficult issues that would need to be addressed to effect a common Canada-US currency and the impact such a move would have on Canadian policy flexibility in managing macro-economic performance, we believe the issues of a deep integration agreement and of currency co-operation should be addressed separately and on their own merits, rather than as part of a single strategy.

The Sovereignty Dimension

Canadian trade policy debates are virtually unique in their elevation of sovereignty as a critical issue of public policy.[67] In the great debates of the past over free trade, notably the elections of 1891, 1911, and 1988, supporters of free trade with the United States found themselves under sustained attack on the grounds that the sacrifice of Canadian sovereignty was too heavy a price to pay. Any negotiation of a customs union with the United States is certain to revive this old, if increasingly quaint, discussion along a number of fronts.

One argument, advanced by the Senate Foreign Affairs Committee, is that a customs union would rob Canada of the capacity for setting tariffs on trade with third countries (Senate, 2003). The reality is that Canada has given up tariff autonomy through the progressive binding of its tariff in the GATT and WTO negotiations as well as the declining utility of the tariff as a policy instrument. A variant on this theme is the claim that a customs union would prevent the pursuit of distinct industrial, energy, immigration, and environmental policies (Jackson, 2003: Clarkson, 2002: Newman, 2002).[68] This point also lacks substance. The scope for industrial and energy initiatives is already severely constrained by WTO rules on subsidies in the former and by NAFTA rules in the latter. As regards issues such as immigration and environment, which would not fall within a simple customs union, it is far from clear how creating an agreement to capture the dynamics of economic integration would limit Canadian policy.

A second line of criticism is that a customs union agreement would tightly tether Canadian foreign policy to that of the United States. During the free trade negotiations, critics charged that the United States would threaten Canadian access to its market provided for under the agreement unless Canada embraced US foreign policy goals (Dymond et al., 1994). Such criticism should be dismissed on a number of grounds. The United States has no modern history of withdrawing from trade agreements or reducing access to its market provided thereunder for foreign policy reasons and is unlikely to invent such a pretext in the case of a customs union.[69] Second, the vulnerability of Canada to such a remote probability arises not from the existence of bilateral agreements, but from the deep

integration of the Canadian economy into the US economy, an integration occurring principally because of the natural dynamics of economic integration, driven by the daily economic choices of individuals and firms and fostered by past multilateral and bilateral trade agreements. The only way to mitigate this vulnerability to the United States is to reverse the course of economic integration and accept the incalculable economic costs of such action as a price of insulation from US influence.[70]

A third criticism is that a customs union would further erode Canada's historical multilateral vocation and undermine Canada's ability to participate in multilateral negotiations (Wolfe, nd). This argument reflects the continuing allure of multilateralism as the central organizing principle of Canadian trade and foreign policy. Nevertheless, an objection to a customs union on the grounds of protecting Canada's multilateral heritage is not only historical revisionism, it confuses ends with means (Doern and Tomlin, 1991). Multilateral rule making and institution building have proven effective means for Canada to pursue its trade objectives but have never impeded the pursuit of trade or foreign policy objectives by other means. Canada has been prepared to look to bilateral rules and institutions when these are available and better suited to achieve the policy objective sought. Both bilateral and multilateral strategies need to be judged on their ability to satisfy Canadian needs and interests. To forego benefits available in a bilateral arrangement in order to uphold the multilateral ideal, would make a nullity of coherent policy making.

A fourth criticism is that a customs union would ignite a "race to the bottom" (i.e., to a relentless effort by governments to attract foreign investors and retain domestic investors by reducing regulatory norms and expectations). There is little evidence to support this charge. Indeed, there is a preponderance of evidence pointing in the opposite direction. As societies become more prosperous – one of the most important impacts of globalization and of deepening integration – the demand for regulations to enhance the quality of life increases. The explosion of government regulatory activity to address environmental, human rights, safety, and other issues provides compelling evidence of the gap between rhetoric and reality. In the other direction, regulatory convergence and co-operation has repeatedly raised the bar by establishing international benchmarks of minimal performance and best international practice. Despite populist notions to the contrary, US regulatory requirements are often more stringent than those in Canada. More to the point, bilateral regulatory convergence is more likely to involve adoption of best practices than reliance on the most common denominator.[71]

Conclusion

The analysis presented in this paper points to the conclusion that pursuing a customs union is a viable policy choice for Canada and would make a major contribution to deriving maximum economic benefits from the realities of deepening and accelerating cross-border economic integration. The negotiation of

a Canada-US customs union would add incrementally to the existing complex web of rights and obligations exchanged by the two countries in three quarters of a century of bilateral and multilateral treaty making. Substantial economic benefits would flow from the creation of a single market and the adoption of common external trade policies with third countries. To create the customs union, the two governments would need to resolve a series of technically challenging issues but none requiring serious departures from existing trade policies or the yielding of policy sovereignty in areas where such sovereignty has not already been substantially abandoned.

There would be any number of issues for which US preferences would tend to dominate, such as setting the common external tariff on sensitive goods, for example clothing, and the use of trade remedy measures on third country trade. In circumstances in which tariff differences cannot immediately be bridged, transition periods or exceptions can be deployed. As regards trade remedies, the differences between Canadian and US policies are small, as demonstrated by the predominance of steel products in both Canada and US trade remedy cases. In the implementation of the customs union, the two countries would field single delegations to organizations, such as the WTO, and it would be normal to expect that the US representatives would lead in most cases. As in other customs unions, sufficient flexibility can be maintained to deploy separate trade measures for foreign policy reasons.

The negotiators would need to be alert to the dangers of hostage taking by important but outdated issues, such as the application of US antidumping and countervailing duties on Canadian exports. As the evidence amply demonstrates, these cases have declined rapidly in number and economic importance and, indeed, beyond perennial disputes on softwood lumber and wheat, trade remedies have virtually disappeared in cross-border trade. Whatever the importance of finding lasting solutions to these issues, the economic potential of Canada is many-fold greater than that which can be assured by the softwood lumber and wheat industries; the value of any customs union should not be judged on the basis of its relevance to those sectors but on its impact on Canadian economic well-being as a whole.

The creation of a customs union would constitute a further stage in formalizing the process of economic Canada-US integration but would not change its fundamental character, nor would it provide a comprehensive solution to the barriers that prevent Canada from capturing the full benefits of this integration. Addressing these barriers would require a broader initiative focused additionally on reducing the costs of border administration and regulatory divergence and a range of other issues. Adding to the negotiating agenda of a customs union, however, would increase the risk premium inherent in any negotiation. As discussions progress, the two governments might well decide to limit the negotiating agenda to the essentials and create a mechanism within the

institutional structure of the customs union to address these issues as economic imperatives and evolving political appetites justify.

A vigorous debate on the implications for Canadian sovereignty is an inevitable component of any discussion of Canada's trade and economic relationship with the United States. This debate is more about optics than substance since the essential components of a customs union are largely to be found in the commitments already undertaken by the two countries and in the long practice of collaboration and common approaches to these issues. In such a debate, it will be important to discard myth from reality and ensure that a serious calculation of benefits and costs occurs.

Notes

[1] This paper was prepared by Bill Dymond and Michael Hart, respectively Senior Executive Fellow, Centre for Trade Policy and Law, Carleton University/University of Ottawa, and Simon Reisman Chair in Trade Policy, Norman Paterson School of International Affairs, Carleton University, and Distinguished Fellow of the Centre.

[2] Someswar Rao and Madanmohan Ghosh found that the implementation of a common external tariff and the elimination of the rules of origin would generate a permanent gain of 1.1 percent of gross domestic product.

[3] Articles 103 and 104 of NAFTA provide that the provisions of certain multilateral environment agreements such as the *Convention on International Trade in Endangered Species of Wild Fauna and Flora* will prevail in the event of conflict with NAFTA.

[4] Cross emphasizes how industry has reorganized production to take advantage of a more open border.

[5] The BSE problem demonstrates how economic integration has spread beyond sophisticated manufacturing and high tech industries to one of the most ancient economic activities of settled societies: cattle herding. Japanese demands that US beef exporters segregate US and Canadian origin beef to keep the latter out of shipments to Japan were declared impossible to meet by the US beef industry.

[6] Until the advent of the Goods and Services Tax, Canada engaged in reverse discrimination by effectively applying higher internal taxes on manufactured goods (the manufacturers' sales tax – MST) than on imports. Had the MST had the opposite effect, Canada would have been in violation of its GATT obligations.

[7] For example, until the antidumping agreement embodied in the results of the Kennedy Round in 1967, Canada did not need to find that dumped goods were causing material injury to domestic producers before applying antidumping duties. The United States was similarly free respecting the application of countervailing duties until the conclusion of the Tokyo Round in 1979. See below for discussion on energy.

[8] In the 1962 *Trade Expansion Act* that gave the Administration negotiating authority for the Kennedy Round, Congress declared that one of its purposes was to fight communism.

[9] With the passage of the *Trade Promotion Act* in 2002, the United States joined Canada and many other countries in breaking out of the confines of the multilateral system, aggressively seeking negotiating partners for bilateral and regional free trade agreements.

[10] Jean Monnet, the father of European integration, noted in one of the most-quoted passages from his *Memoirs*: "There will be no peace in Europe if States reconstitute themselves on a basis of national sovereignty. … European States should form themselves into a federation or a 'European entity' which would make them a joint economic unit."

[11] There are options to economic integration. Canada could impose significant barriers to the forces of silent integration and seek to create economic distance from the United States. Such a policy would mark a major departure from nearly 70 years of efforts to smooth the process of Canada-US silent integration and would mean a poorer Canada.

[12] This paucity of institutions stands in stark contrast with a veritable cornucopia of institutional relationships with the European Union including biannual meetings of the Prime

Minister, the President of the European Commission and President (in office) of the Council as well as a host of ministerial committees, official working groups, etc.

13 FTA article 1802 and NAFTA article 2001.

14 The most recent Commission meeting dealt with certain aspects of rules of origin, transparency and other technical issues. See NAFTA Free Trade Commission Joint Statement, San Antonio, July 16, 2004 <www.itcan-cican.gc.ca>.

15 As former Canadian ambassador to the United States, Allan Gotlieb (2003) observed: "[T]he world's largest bilateral economic relationship [is] managed without the assistance of bilateral institutions and procedures."

16 See press release #78 at <www.fac-aec.gc.ca>.

17 British economist David Henderson (1994: 179-180) defines integration "as a tendency for the economic significance of political boundaries to diminish."

18 See Dobson (2002) for a discussion of the possible evolution of the three latter stages as between Canada and the United States.

19 The most important of these, such as the European Union and the FTA, effectively removed intraregional trade from direct coverage by the multilateral system, underlining the point that substantially less than half of world trade is now directly governed by the multilateral trade system.

20 For a discussion of such agreements from the perspective of the WTO Secretariat, See Boonekamp (nd).

21 The 1965 Autopact, the FTA, and NAFTA. The Autopact required a waiver for the United States, while Canada successfully claimed that its administration of the agreement met the MFN requirements of GATT.

22 NAFTA Annex 201.

23 Rolf Mirus (2001) noted the administrative burden of the rules of origin in the European Free Trade Agreement (EFTA) was such that producers reported costs of three to five percent of the delivered goods solely for providing rules of origin documentation.

24 See below for further discussion.

25 There is a wide variation of rates within these averages, including astronomical rates for selected agricultural products, such as 350 percent for tobacco in the United States and 245.7 percent for cheese in Canada. In her analysis of a customs union, Danielle Goldfarb (2003) provided various tables that set out comparative rates for various sectors and groups of products and identified where some of the more sensitive tariff peaks can be found (e.g., ships and supply-managed agricultural products for Canada, tobacco, peanuts, footwear, and textiles and clothing for the United States).

26 For the Canadian position, see <www.itcan-cican.gc.ca>.

27 Both countries are parties to the 1973 International Convention on the Simplification and Harmonization of Customs Procedures (Kyoto Convention), administered by the World Customs Organization (WCO) in Brussels. The HS is also administered by the WCO and is subject to frequent revisions. Like the GATT/WTO, the WCO has contributed to convergence between Canada and the United States in the administration of border procedures.

28 One potentially troublesome policy is the US outward processing program, which under certain conditions assesses the duty on imports of products originating in the United States that are further processed off shore. Customs duties on such products are assessed on the basis of value added off shore rather than the full value of the reimported product. Canada does not have a similar program except with stringent conditions in respect of goods repaired abroad.

29 The Canadian tariff schedule in the past had a large number of end use items employed as a device to convey protection to the production of goods for certain purposes while creating access to processors to lower cost imports. One classic example was the 17 end use items in the Canadian tariff for olive oil.

30 For wheat, see the *Canadian Wheat Board Act*, R.S.C. 1985, c. C-24; *The Canada Grain Act*, R.S.C. 1985, c. G-10; *The Seeds Act*, R.S.C. 1985, c. S-8; *The Customs Act*, R.S.C. 1985, c. C-52.6; and regulations made pursuant to these acts. For autos, see memorandum D10-16-1 at <www.cbsa-asfc.gc.ca/E/pub/cm/d10-16-1/d10-16-1-e.html>. For an export example, see SOR/2002/153 Order Amending Export Control List.

31 Until 2005, both countries applied quotas to differing categories of textile and clothing products to different lists of countries pursuant to the WTO Agreement on Textiles and Clothing.

[32] World Trade Organization rules require that any averaging exercise result in a CET that is, on average, no more protective than the protective effect of the two separate tariffs. By applying the lower of the two rates for most tariffs, the two governments would leave themselves wide discretion to address the relatively modest list of difficult cases.

[33] Canadian regulations place limitations on the consignment selling of imported horticulture products.

[34] The US "aggregate measure of support" calculated for purposes of implementing the WTO agriculture agreement amounted to 9.8 percent of value added while the equivalent Canadian figure was 2.3 percent. US and Canadian direct support for agriculture is more similar than these numbers suggest; relatively higher numbers for Canada would result from the subsidy equivalent impact of higher consumer prices in supply managed sectors.

[35] Canada and the United States treated agriculture separately in the FTA and NAFTA: Annex 702:1 incorporates the relevant FTA provisions which "incorporates the GATT rights and obligations of Canada and the United States with respect to agricultural, food, beverage and certain related goods."

[36] FTA articles 2005-2007 and NAFTA Annex 2106. Cultural services are not covered under either the FTA or the WTO by virtue of their absence from the schedule of services on which Canada has accepted obligations.

[37] If the exemption were, in fact, comprehensive, pre-FTA tariffs on a vast range of inputs to the industry, for example, sound recording equipment, would have been maintained.

[38] See *Report of the Cultural Industries Sectoral Advisory Group* (DFAIT, nd). See also <www.Hincd.net/incden.htmlH>.

[39] NAFTA articles 603-605.

[40] There is hardly any trade with such countries, and harmonizing Canada's average rate of 35 percent and the US rate of around 40 percent should not present a problem.

[41] The Foreign Affairs/International Trade web sites would have one believe that Canada and the European Union have agreed to negotiate a free trade agreement by including the Canada-EU Trade and Investment Enhancement Agreement (TIEA) signed in March 2004 in the list of regional free trade initiatives. However, the TIEA may evolve, it is decidedly not a free trade agreement.

[42] The Asia-Pacific Economic Co-operation negotiations have been effectively moribund since the Asian financial crisis of the late 1990s. The Free Trade Area of the Americas (FTAA) is in a major stall since the ministerial meeting of November 2003. The United States has, to all appearances, decided to put its negotiating energies into bilateral and sub-regional arrangements; without US leadership, the FTAA negotiations will remain in neutral.

[43] One possibility would be to retain separate tariffs with associated rules of origin for a limited number of sensitive products for, say, a five-year period.

[44] This section discusses antidumping and countervailing duty cases. The third pillar of trade remedies is emergency safeguard action under Article XIX, a measure fallen into disuse except for the US 2001 measures from which Canada and Mexico were excluded on the grounds of the integration of the North American steel industry.

[45] Since US imports are typically three times Canadian totals, it would be normal to expect that over a representative period, the number of US cases would be at least triple the number of Canadian cases. As the numbers indicate, however, Canadian cases number almost half the total of US cases.

[46] Two against softwood lumber, two against carbon steel wire rod, one against stainless steel plate in coils and one against wheat. There are only 12 orders outstanding against seven Canadian products, most of them stemming from old cases which, as a result of sunset requirements, should gradually wither away.

[47] The US data on active cases as of August 9, 2004 are found at <www.usitc.gov> and Canadian data at <www.csba-asfc.gc.ca>, accessed August 30, 2004.

[48] An example would be the US antidumping duty on frozen fish fillets from Vietnam (ITC case #a-552-801).

[49] One difference is that Canadian duties are applied prospectively on the determination of normal value on importation while US duties are applied retrospectively following importation. Although it is beyond the scope of this paper to explore the legal and organizational ramifications of the integration of the two systems, there would not appear to be any policy implications in such a step once the two countries agreed to establish a common trade remedy regime.

[50] End user certificates are used for a variety or purposes, including meeting the conditions to obtain a tariff remission. See <www.cbsa-asfc.gc.ca/E/pub/cm/d10-16-1/d10-16-1-e.html>.

[51] That antidumping or countervailing duties applied by third countries to the imports of Canada or the United States, would be applied to the goods of the other would not occur; the former are firm specific and the latter are subsidy specific.

[52] The steel, automotive, aerospace, and information technology sectors would be obvious candidates.

[53] The argument in some quarters on the importance of removing the threat of US trade remedies from Canadian trade assumes that resource exports are and will remain the key to Canadian prosperity. It also implies that the volumes of ministerial speeches on the knowledge, innovation, high tech economy have missed the mark.

[54] Suppose, for example, that Canada wanted to enter a free trade agreement with post-Castro Cuba and the United States refused. Compared to the economic benefits flowing from a customs union, denying free access to the Canadian market for Cuban products would carry minimal economic consequences.

[55] Data from the WTO. The two Canadian cases are the challenge to the European Union ban on licensing biotech products jointly with the United States and responding to the Brazilian challenge of aircraft export financing programs.

[56] See, for example, the list of US exports on which the European Union threatened to impose retaliatory tariffs unless the US steel safeguard measures were removed. The list is heavy with steel products. Given the cross-border integration of the steel sector, Canadian exports would have been no doubt sideswiped. See proposal for Council Regulation 2002/0095/acc at <www.europa-eu/comm/trade>.

[57] A recent example is the Byrd amendment, which authorizes US Customs to distribute the antidumping and countervailing duties it collects to the companies that petitioned for such measures to be taken. Congress has yet to implement the WTO finding that this practice was contrary to US obligations.

[58] Currently, US trade sanctions generally prohibit trade with Cuba, Iran, Iraq, Libya, North Korea, Serbia, and Sudan. Additionally, persons designated as having promoted the proliferation of weapons of mass destruction, named foreign terrorist organizations, designated terrorists and narcotics traffickers, and the Taliban face restrictions on imports into the United States. Vessels and aircraft under the registry, control, or ownership of sanction targets cannot import merchandise into the United States. Cuban cigars and Iranian carpets can only be imported under certain restrictions. Finally, diamonds from Angola must be accompanied by a certificate verifying that they are not "conflict diamonds." Canada sanctions trade with Myanmar and Angola; controls exports of firearms, weapons, and devices listed in the Export Control List to countries with which Canada has an intergovernmental defence, research, development, and production arrangement; and maintains some controls on exports to Iraq, North Korea, Cuba, Libya, Iran, and Bolivia.

[59] An example is the call by some Commonwealth countries for sanctions against Zimbabwe. Should a consensus for such action emerge, the United States would not consider itself in any way bound. Yet Canada would wish to proceed.

[60] The US Customs and the Canadian Border Services Agency enforce import and export permits on a broad variety of products including alcoholic beverages, agriculture products, certain drugs, firearms, and ammunition. US customs ensures compliance with regulations of other agencies for art materials, cultural property, hazardous/toxic/flammable materials, household appliances, some electronics products, toys and children's articles, various trademarked and copyrighted products, and textiles and clothing.

[61] See, for example, Order in Council Amending the Export Control List P.C. 2002-551 11 April, 2002 at <www.canadagazette.gc.ca>.

[62] There has only been one Canada-US NAFTA Chapter 20 case involving tariffs on certain dairy, and poultry products, barley and margarine, settled in Canada's favour. There were five cases under the similar FTA Chapter 18 procedures.

[63] The prolonged saga of the softwood lumber dispute has prompted Canadian complaints about the efficacy of the dispute settlement system. There can be no doubt that the United States is using every legal instrument in the WTO and NAFTA to maintain the measures imposed for as long as possible, but whether such tactics are unique to the United States or indicate a serious problem with the system is a highly dubious proposition.

[64] Leonard Legault (2002), former Canadian co-chair of the International Joint Commission (IJC), ascribes the success of the IJC to

> its binational but unitary character; its permanence and independence; its impartiality and commitment to solutions that focus on the common interest of both countries; its emphasis on consensus-building; its comprehensive use of joint fact-finding procedures through the establishment of binational advisory boards; and finally, its accessibility to all persons or bodies who wish to put their views before the Commission. Thus, the Commission generally bypasses the disadvantages of government-to-government negotiations and offers certain advantages that go beyond most dispute-settlement mechanisms. As with all institutions, however, the Commission is only as good as its membership. Much depends upon the quality of appointments by the two governments.

[65] For example, the Standards Council of Canada and the US National Institute for Standards Technology (NIST) manage a 1994 agreement for the mutual recognition of the testing laboratory systems they each administer. For the benefit of an industry that exports $1 billion in fasteners annually to the United States, the SCC has concluded an agreement with relevant American agencies so assessments for conformity with US regulations on Canadian-made fasteners can be performed in Canada.

[66] The External Advisory Committee on Smart Regulation, appointed by the Chrétien government in May 2003, has reached similar conclusions. In its September 23, 2004 report to Prime Minister Martin <www.smartregulation.gc.Canada/en>) It observed:

> International cooperation is increasingly necessary to provide high levels of consumer, social and environmental protection. It is no longer possible to protect Canadians' health and safety and provide access to innovative products – and do it all ourselves. From a business perspective, Canada must be more strategic in its regulatory relations with trading partners. A key irritant for industry is the proliferation of minor differences between Canadian and American regulations, given an increasingly integrated North American market. Minimizing these differences would remove wasteful duplication and reduce costs for consumers, industry and government.

To that end, it recommends that the government pursue a strategy of regulatory co-operation with the United States broken down along sectoral lines.

[67] Except for defence policy issues, where public discussion often veers into dead-end tangents divorced from the iron realities of protecting the two countries from external threats.

[68] See also Clarkson (2002) and Newman (2002). A more thoughtful version of this view can be found in a series of columns by David Crane (2003). Support among Canadians for such a defensive attitude toward the United States, however, has steadily declined.

[69] The palpable anger of the US Administration and many in Congress directed at Canada and other opponents during the Iraq war did not lead to such consequences.

[70] Canadians have demonstrated that they have become increasingly comfortable with their proximity to the United States and with the pragmatic pursuit of better ways to manage deepening integration. See the discussion of recent polling in Hart (2004a).

[71] An Industry Canada survey (2002) of Canadian regulators notes: "All of those surveyed indicated that their broad policy objectives were similar to those of their US counterparts. However, many stressed that differences in the respective systems of government and authorizing legislation complicate efforts to cooperate, effectively limiting what can be achieved without significant legislative changes." The External Advisory Committee on Smart Regulation reached similar conclusions. See its report at < www.smartregulation.gc.ca/en>.

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