

ENGAGE THE UNITED STATES, FORGET THE REST?

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There are certain things that even peripheral figures in Canadian policy circles know about international trade.¹ First of all, everyone knows that Canada is too dependent on the US as a trade partner. This certainty is customarily expressed with the cliché “We shouldn’t put all our eggs in one basket.” Everyone also knows that Canada is “missing the boat” by failing to expand its business presence in the fast-growing markets of Asia. Furthermore, it is a matter of national pride to Canadians that we play a central role in pushing forward multilateral approaches to policy formulation; in particular, we ought to be performing life support on the “moribund” Doha Round of the World Trade Organization (WTO) negotiations. Finally, it ought to go without saying that we would contemplate no changes in trade policy that would undermine Canadian sovereignty.

In the midst of all this trade policy consensus, Michael Hart has contributed a refreshingly contrarian chapter to this volume. He decisively dismisses all of the foregoing conventional wisdom. He then boldly announces a policy agenda that is likely to be anathema to mainstream Canadian policy-makers. The points Hart makes are best seen as the starting point for a vigorous debate. While I am somewhat sympathetic to the positions he is pushing, I believe that he overstates his case.

Hart considers two big questions: With whom should we engage? And how should we do so? The answers are nested, but, for ease of exposition, let’s call the first question strategic and the second one tactical. Here I provide an outline of the answers to these two questions, as Hart considers them in his chapter.

1. We should engage more broadly with the rest of the world through:
 - a) global trade negotiations (Doha Round);
 - b) free trade agreements (with, for example, South Korea); and
 - c) ad hoc bilateral trade promotion (Team Canada missions).
2. We should pursue deeper integration with the US by:
 - a) reducing the burden of the border;
 - b) harmonizing regulation; and
 - c) establishing new bilateral institutions to facilitate integration.

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With regard to the strategic question, Hart unequivocally advocates a focus on the US: “The simple fact is that Canada’s most basic economic interests have become inextricably bound up with those of the United States...The area of greatest potential is the United States. Engagement with our southern neighbour is the indispensable foundation of any Canadian policy to maximize benefits from international trade and investment.” To these statements about the total effect of Canada-US integration, I cannot think of any plausible counterarguments. Over 80 percent of our exports go to the US, and the US typically provides two-thirds of our imports. We also conduct two-thirds of our service trade and foreign direct investment with the US. Economic life without the US is hard to imagine. But the issue on the table is about our efforts on the margin. Would the allocation of more resources to deeper integration with the US generate larger marginal net benefits than a similar resource allocation directed at broader integration with the rest of the world?

THE CASE AGAINST THE REST OF THE WORLD

Hart begins his argument for deeper integration with the US by demolishing the three policies that Canada would be expected to use to foster engagement with other countries: continued WTO-sponsored liberalization, proliferating free trade agreements (FTAs) and trade missions. While recognizing the value of what the WTO/GATT (General Agreement on Tariffs and Trade) accomplished in the past, Hart argues that a Canadian effort toward completing the Doha Round would have only very small marginal benefits. One reason is that, with their new assertiveness, Brazil and India seem to have pushed Canada to the periphery of the negotiation process. Hart thinks Canadian policy-makers aren’t willing to put agricultural policies on the table, and he is skeptical of the agenda he sees developing countries pursuing. He also argues that the returns to FTAs with small markets are insufficient to cover the fixed costs of negotiating them. Finally, Hart dismisses Team Canada trade missions as “hoopla” and “photo ops.” The conclusion we may draw from these three critiques is that the tactics Canada might use to engage with countries other than the US do not pass a cost-benefit test. I tentatively agree with Hart about Team Canada, partially agree about the new FTAs and disagree about the Doha Round.

The first component of Hart’s anti-Doha argument — that Canada has become a bystander in the current negotiations — finds support in comments WTO director-general Pascal Lamy made recently in the Philippines. Announcing that “after

a period of suspension, the negotiating engines are buzzing again,” Lamy went on to describe who was doing the negotiating: “We don’t work with the QUAD anymore. We have a new G-4 : US, EC, India, and Brazil, and G-6 with Australia and Japan” (2007). “The QUAD” is GATT-speak for the US, the European Union, Japan and Canada. Note that Canada is out of the inner quartet and not even playing in the sextet. The question I would ask is whether Canada could resume a vital role in the negotiations if our government made it a priority. If that were possible, I could see Canada helping the deal go through by setting an example on lowering agricultural subsidies and tariffs. I would also like to see Canada push for more WTO discipline on the growing use of antidumping duties (ADDs). Popular support for ADDs rests on the misconception that they are necessary to prevent predatory actions by foreign firms. The reality — as I read the evidence — is that ADDs have become a tool that legally sophisticated industries utilize to exclude foreign competitors from the market. Canadian firms have been both victims and perpetrators of ADDs. Indeed, WTO data show that Canada imposed ADDs 84 times from 1995 to 2006, but other countries imposed ADDs on Canada just 12 times. In the last decade, countries like India and Argentina have become major initiators of antidumping cases (mounting 323 and 149 cases, respectively). The proliferation of ADDs as a form of trade harassment is likely to continue, and if it does it will undermine efforts to open markets via reductions in standard duties. I would also like to see Canada push for a change in the WTO rules to compel complainants to present evidence of predatory intent by foreign firms. I predict that such evidence would not exist in most cases, and ADDs would therefore rapidly fall into disuse. While I recognize that this proposal is very unlikely to survive an attack by organized industry interests, it is important to focus attention now on ADD abuse, as neglect will almost certainly allow the problem to spread.

On the issue of FTAs, Hart is right that agreements with countries like Israel, Costa Rica and Chile are unlikely to yield high-magnitude benefits. Devoting major resources to an agreement with small countries in Central America also seems of dubious value. I draw a distinction with regard to South Korea, which should not be dismissed as a minor market. South Korea’s population is 50 percent larger than that of Canada, and its economy is growing faster. While South Korea’s lower average income and its remoteness from Canada decrease bilateral trade potential, I am reasonably confident that the discounted present value of future gains from trade with South Korea outweighs the opportunity cost of Foreign Affairs negotiators. As the US is also negotiating with South Korea, there is probably some additional benefit to maintaining relative parity in tariff levels.

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The use of trade missions as a tool for diversifying Canadian trade probably deserves the scorn Hart heaps on it. John Ries and I (2007) recently assessed the impact of Team Canada trade missions on Canadian trade. We find that, after taking into account the pre-existing degree of trade integration, Canada's trade missions have no significant effect on bilateral trade with the visited country. Although millions of dollars in deals are announced, it seems likely that much of the trade would have happened in the absence of the mission.

In response to the recommendation that Canada pursue deeper integration with the US to the exclusion of engagement with other countries, three additional points are worth noting: first, the US is a member of the WTO, and thus one way to influence US behaviour toward Canadian goods is to pursue reforms as part of the Doha Round; second, Canada already has remarkably good access to the US market, so there may not be much low-hanging fruit to be had there; and third, about three-quarters of the world economy exists outside the US, so Canada may find that there are substantial gains to be realized from trade with other countries.

THE CASE FOR DEEPER INTEGRATION WITH THE UNITED STATES

Hart envisions three related initiatives for closer engagement with the US: "the two governments must do more to address the dated, dysfunctional and intrusive nature of border administration, the haphazard process leading to deepening regulatory convergence and the frail institutional capacity to govern accelerating integration" (406). I will now consider the pros and cons of each of these tactical proposals.

Reduce the burden of the border

Hart advocates improving management of the border so that it becomes less of an impediment to cross-border business. This may involve new infrastructure, new technology and new procedures for reducing bureaucratic hassles. Two questions need to be answered affirmatively to justify aggressive pursuit of this policy. First, does the border currently impose an undue burden? Second, is it politically feasible to materially reduce the burden? In relation to the first issue, Hart reports that nontariff border costs add 5 to 13 percent to the cost of trade. While these numbers first struck me as implausibly high, they are consistent with the well-established statistical result that provinces trade on a greater order of magnitude with other provinces than with states of similar size and proximity. With respect to the second issue, there is a large

constituency of traders and travellers who would welcome a facilitation of north-south flows of goods and people. The question is which border impediments could be eliminated without setting off alarm bells over Canadian sovereignty and US security.

One clear target would be rules of origin. At present, those transporting goods across the Canada-US border must prove that the goods originated in North America before they can qualify for duty-free treatment. The NAFTA rules of origin take up 243 pages of annex 401. The rules are complex and often make it very hard for goods to qualify unless all their main parts are sourced within North America. For example, NAFTA rules do not deem a television to be North American unless its chief component, the cathode ray tube, is made in North America; this means that the tube's chief components, the cone and the glass panel, must also be North American. These rules impose a burden at the border. And more importantly perhaps, they frustrate the operation of modern trade, in which production processes are fragmented and each component is sourced from the nation with the greatest comparative advantage.

If rules of origin are so bad, why do we have them? There is an economic answer and a political answer. The economic answer is that they prevent backdoor entry into a free trade area. Suppose Canada had a most-favoured-nation (MFN) duty (the standard duty charged in the absence of an FTA) on TVs of 8 percent, but the US duty was 3 percent. An importer in Canada would be tempted to route Asia-origin TVs via US ports in order to save 5 percent on duties. This would amount to a backdoor entry, and it would incur unnecessary transport costs and transfer duty revenue away from the country that was entitled to that revenue (being the location of use). The requirement of NAFTA certificates of origin eliminates the incentive for backdoor entry. It also induces large-scale region-oriented factories to rely more on North American parts than is efficient. The North American firms that supply these inputs presumably lobbied hard to have NAFTA rules of origin be as stringent as possible. Such political pressure tactics will need to be reckoned with. However, the economic motivation for rules of origin is easily addressed: with a common external tariff (CET), backdoor entry is pointless. One might argue that it would be politically infeasible for Americans and Canadians to agree on CETs, and yet, across the Atlantic, the 25 diverse members of the European Union have agreed to CETs as part of their customs union.

Canadian and US external tariffs are, for the most part, fairly similar. They both tend to be low on most manufactured goods — except footwear, apparel and a handful of food products. In the TV example, it turns out (according to the APEC *Tariff Database* [2007]) that Canada and the US impose exactly the same 5 percent MFN duty on standard TVs. More study is needed, but it seems likely that a move to a common

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Canada-US external tariff could be made with very little disruption. Mexican MFN duties tend to be considerably higher; for example, the rate on TVs is 20 percent. However, this means that Mexico would have to worry about backdoor entry via the US, not vice versa. With a Canada-US CET, we might consider limiting the NAFTA certificate-of-origin requirement to Mexico-bound goods.

I dwell on the rules-of-origin issue here — even though Hart mentions it only in passing — because I think that by addressing it we can take a concrete step toward reducing administrative hassles at the Canada-US border. Hart envisions that the next steps would involve addressing noncustoms regulations that impose a burden at the border.

Harmonize regulation

Hart writes that “regulatory divergence is tantamount to a concealed ‘inefficiency tax’ that citizens pay on virtually everything they purchase” (426). What is the basis for such a provocative claim? Hart points to the costs of duplicate regulations. In many cases, I believe this critique is essentially correct. For example, the CBC recently reported on a call for new safety standards for the helmets used by skiers and snowboarders. Since Canadian and American snowboarders take similar risks and their skulls respond to impacts in the same manner, I cannot think of any reason why Canada would need helmet standards distinct from those of the US. I was reassured to discover online that the Government of British Columbia accepts certification by Canadian and American standards associations for bicycle helmets. This kind of mutual recognition is the approach the EU has taken.

It seems worth noting that not all divergent regulations constitute inefficient duplication. In some cases, regulations diverge in response to divergent preferences or constraints in the two countries. For example, to comply with its Kyoto obligations, Canada might choose to impose more regulatory restrictions on emissions of greenhouse gases. Or, in deciding which drugs to approve, Canada’s drug regulators might assign less importance to the interests of US-based pharmaceutical companies than the US Food and Drug Administration would. When two countries impose the same standard despite differing circumstances, it may result in a reduction in efficiency.

Hart appears to advocate for Canada to adopt US regulations unless it can justify a difference. I have a feeling this proposal would meet with considerable public opposition. The fact that many Canadians routinely travel to the US is not a direct expression of approval for US regulations any more than their penchant for holidaying in Mexico is an expression of confidence in Mexican tap water. Canadians are ultimately pragmatic, as seen, for example, in Canada’s recent shift in daylight saving time dates in response to the

change initiated by the US. However, they will need to be persuaded that regulatory harmonization is not just a scheme to exchange Canada's more interventionist regulatory climate for what many perceive to be a lax, probusiness regulatory climate in the US.

The case for harmonizing regulation depends in large part on establishing that regulatory divergence truly imposes significant costs on exporters. Thierry Mayer and I have addressed this indirectly by examining trade within the European Union before and after the Single Market Program (SMP) implemented from 1988 to 1992 (2000). We found that the border's negative impact on trade was slightly lower in industries characterized by standards conflict, although differences were not statistically significant. Moreover, while all border effects continued a long-standing downward trend in Europe, the border effects in industries where standards conflict was thought to be more important did not decline more quickly during the SMP. Johannes Moenius provides more direct empirical evidence on the effects of divergence in standards on trade. Using a diverse sample of 14 countries, he found that two countries that share a higher number of common standards tend to trade more. Although effects differ across industries, on average a 10 percent increase in common standards leads to about a 3 percent increase in bilateral exports. This effect supports the idea that harmonizing regulation would generate a non-negligible reduction in costs for exporters. Moenius also finds that for a given number of shared standards, use of more country-specific standards seems positively associated with manufacturing imports (2004).

The mixed evidence on how standards affect trade leaves me unsure as to how much benefit could be obtained from Canada-US standards harmonization. As neither of the two cited studies involves Canadian data, I would like to see some direct evidence of the impact of Canada-US regulatory divergence on trade between the two countries.

Establish new bilateral institutions to facilitate integration

I have little to say about Hart's last policy proposal. Presumably, in order to reduce border costs and harmonize regulations, some new bilateral commissions would be needed. The commissions would, of course, require a commitment of government resources, and the question we ought to consider is whether these resources would be better directed at promoting Canadian interests in the Doha Round or enacting a Canada-South Korea FTA. One of the less-emphasized elements of the Doha agenda is trade facilitation. A multilateral initiative to reduce nontariff costs of crossing borders might ultimately yield greater dividends for Canada, if I am correct in believing that border services in the rest of the world generally operate much more slowly and are more corrupt than those of the US-Canada border.

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CONCLUSION

While I have raised a range of potential criticisms of the proposals contained in Hart's chapter, I would also like to outline our main areas of agreement. First, a small reduction in the cost of trading with the US is worth much, much more than an equivalent reduction in the cost of trading with any other partner (because of the size and proximity of the US economy). Second, increasing speed and decreasing paperwork at the border should yield significant gains; one policy that Hart and I agree on is a common external tariff with the US, which would eliminate the need for cumbersome rules of origin. Third, we ought to follow the European Union's lead in trying to find ways to achieve standards harmonization where divergent regulations lack an underlying justification.

My major disagreement with Hart is that I do not believe Canada can maximize its benefits from international trade by disengaging from the three-quarters of the global economy that resides outside the US. In particular, I would like to see Canada resume its role as an active promoter of WTO-sponsored multilateral trade liberalization.

NOTES

- 1 Thanks go to John Ries for offering helpful comments and furnishing some of the data reported. He bears no responsibility for any dubious assertions or unreasonable arguments expressed herein.

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