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KYOTO—AN UNLEVEL PLAYING FIELD?

Against a backdrop of increasing economic ties, the Kyoto Protocol emerges as a potential source of differences across the NAFTA partners. Were Canada to ratify the Protocol—the oft-repeated objective of the Canadian government—then its coming into effect would have different implications for each of these countries. By ratifying, Canada would signal its agreement to meet the targeted reductions in greenhouse gas (GHG) emissions negotiated in Kyoto. Mexico would also be a party to the Protocol, but would not face any limit on GHG emissions, consistent with the treatment extended to all developing countries. Finally, as President Bush has made very clear, the United States will not proceed with ratification and will not be bound by the provisions of the Kyoto Protocol.

Given the evolving economic structure of North America, is this a case of too much climate-policy diversity? This is simply a more specific version of the concern as to the cost of maintaining, in highly integrated economies, differences in environmental standards, social programs or tax policy. As in all of these cases, key considerations relate to the competitiveness effects that such cross-jurisdiction policy differences would create. All else being equal, the larger the policy-induced cost differences, the larger the competitiveness effects, and the more likely are production-related activities to migrate toward the lower-cost jurisdictions. One would also expect that in highly integrated economies the cost differences necessary to bring about the relocation of production activities would be smaller than in situations where significant barriers to cross-border flows of goods and services were in place.

So where does this leave us? As far as access to the US marketplace is concerned, an examination of the top 20 Canadian and Mexican exports (which account for at least 65 percent of the total value of these two countries' exports to the United States) indicates that the main competing industries are motor vehicles and parts, telecommunications equipment, and furniture. Since none of these industries is particularly GHG-intensive, Kyoto-induced cost differences are, at least potentially, not very large. In that case, we could expect the competitiveness effects to be relatively muted. For other top 20 Canadian exports, such as natural gas, electricity, paper and paperboard, competition from Mexican firms is relatively weak, so that the main concern is with Kyoto-induced cost differences with US producers.

There are reasons to think that US policy developments are likely to reduce any cost differences due to Canadian ratification since announcements by the Bush administration and by several state governments have made it clear that initiatives aimed at reducing GHG emissions will be implemented in the United States. While it would be reasonable to assume that these measures will not bring about the kinds of reductions envisaged at the time of the Kyoto negotiations, these do suggest that the negative competitiveness effects of ratification on Canadian firms are not likely to be as large as might be expected if one were to equate the US decision not to ratify with a complete lack of action on reducing GHG emissions in the United States.

There is also one source of benefits from climate policy that would be available to Canadian firms—and not to their US counterparts—as a result of ratification by Canada. The Kyoto Protocol provides for a number of mechanisms allowing countries that have agreed to emissions reduction targets to increase their allowed emissions through activities involving other Kyoto signatories. Of particular relevance to the North American context is the so-called clean development mechanism. Basically, this would allow Canadian firms to partner with Mexican firms and undertake emissions reductions projects in Mexico, and then share the resulting emissions credits.

A Canadian decision to ratify the Kyoto Protocol would most likely lead to a situation where Canadian firms have to incur higher climate-policy costs than will their counterparts in Mexico and the United States. Existing North American trade patterns suggest that the resulting effect on the competitiveness of Canadian exports vis-à-vis Mexican exports is unlikely to be severe since many of the competing products are not very GHG-intensive. Of perhaps more concern is the resulting higher costs compared to US firms. Here it is important to note that initiatives to reduce GHG emissions will be undertaken in the United States even in the absence of ratification, and that Canadian firms would be able to use the Protocol's clean development mechanism as a source of competitive advantage over US-based firms.

When all is said and done, climate-policy diversity does have a cost—one that is undoubtedly higher in highly integrated economies. However, provisions of the Kyoto Protocol and characteristics of North American policy and trade patterns act to reduce this cost across jurisdictions. The economic ties that bind the NAFTA partners do highlight the importance for Canada of the competitiveness effects of climate-policy diversity. A sure way of reducing any negative effects on Canadian firms of ratification is for governments to pursue the least expensive ways of living up to Canada's commitments under the Kyoto Protocol.

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