THE FUTURE OF NORTH AMERICAN INTEGRATION

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Relations among the United States, Canada and Mexico face a major challenge. The free trade agreements negotiated in the past 15 years did much to reduce the economic effects of national borders. The September 11 attacks changed all that as national borders came under unprecedented scrutiny for security reasons. Future attacks, especially if they were to originate in Canada or Mexico, could cause prolonged border closures with serious, even catastrophic, consequences for the North American economy.

A promising beginning has been made to address these concerns, but more is required. Canadian and American bureaucracies are engaged in unprecedented cooperation to produce and implement the Smart Border Declaration of December 2001. This cooperative "platform" has been broadened to Mexico as the Border Partnership Action Plan. It should be built upon further. Leaders of the three countries should agree a pragmatic vision of the North American economic space that focuses on the long-term common interest of economic security and catalyzes deeper cooperation on both economic and security issues.

US preoccupations have shifted from the promise of globalization to the vulnerability of openness. Homeland security is now the top priority. To Americans, deeper economic integration in North America is part of the larger trend towards world economic integration. They see greater regional interdependence as an increasing share of total trade and investment that is accounted for by Canada and Mexico.

The two neighbors see things somewhat differently. For them, American primacy has long been a fact of life. Deeper integration is marked by dramatic asymmetry; both countries now rely on the U.S. market for nearly 90 percent of their exports. After the post- September 11 border closing, Canadians vowed that such a disruption should never again be allowed to happen. Indeed, the current challenge is to erase the border to reduce the transactions costs of low-risk cross-border factor flows by moving security operations away from the border itself.

For them, the rapid economic change of the 1990's that increased US global economic dominance has added to the challenges they face. The fall of the Berlin Wall brought forth hungry new competitors; the information and communications technology revolution made possible global production and marketing networks that locate where economic conditions are the most attractive. NAFTA accelerated these changes already underway in North America. Increasingly, locations for high value-added knowledge based goods and services industries are characterized by agglomerations -- critical masses of economic activity built up over time to which new investment is attracted. Many of the North American agglomerations are located in the United States. Creating new ones is difficult; thus small economies and latecomers face risks of peripheralization.

These changes mean that, at least for Canadians, the provisions of NAFTA are now outdated. NAFTA needs to be deepened to remove the obstacles to people, investment, technology and knowledge that matter to the knowledge economy and for the interconnectedness of cross-border value chains. The challenge is to *exercise,* rather than guard, sovereignty which means anticipating change and preparing options that promote US interests in ways that serve Canadians' and Mexicans' national interests. For them, a "smart" future lies, not in imitating what Americans do, but in astutely leveraging the advantages of proximity to the world's leading and largest economy.

Routes to deeper economic integration

There are three main routes to deeper economic integration. One is to deepen NAFTA into a customs union. Another is to create a common market as Mexican President Vicente Fox has proposed. A third option is a pragmatic North American route to integration that meshes US interests in homeland security with Canadian and Mexican interests in economic security.

A *customs union* is the next formal step in economic integration beyond a free trade agreement. NAFTA allows members to remove trade barriers but to retain their respective national trade barriers against the rest of the world. Customs inspectors still police the borders to tax or prevent trade. Rules of origin are negotiated to ensure that trade from third countries does not disadvantage NAFTA members. A customs union is like a free trade area, but members adopt common trade barriers against the rest of the world. Goods and services flow freely across borders. Customs inspection at internal borders is eliminated. Troublesome rules of origin are eliminated. Customs union-like arrangements are also possible in sectors. Indeed, a common external tariff for computers and related products was negotiated in the NAFTA.

Several variants of a customs union can be envisaged:

- Do away with all bilateral tariffs and negotiate a common external tariff, leaving the rest of each country's external policies intact.
- Negotiate a common commercial policy, with each country replacing its own trade remedy laws with a common set.
- Allow a customs union to evolve as sectoral tariffs decline. Common external tariffs could be negotiated sector-by-sector, following the precedent in computers and related products. Sectors could become candidates for the customs union as sectoral tariffs converge across the countries. Gradually more and more cross-border trade would be freed from border procedures.

The US congress has been unwilling in the past to give up trade remedy law and there is no reason to believe it would be willing to do so now. The other two variants might be more acceptable, but administrative considerations abound. For example, Canada and Mexico would have to adjust their external policies with other countries, such as FTAs (Mexico's with the European Union, for example). Canada and Mexico have different external tariffs and non-tariff barriers with the United States that would have to be hammered out. Industries in each country would have to adjust to the common tariff, with Mexico facing the largest adjustment burden.

Like a customs union, a *common market* is also a formally negotiated step toward a single market within the common economic space. Not only are internal trade and services freed up, even greater efficiency gains are achieved by allowing people and technology to circulate freely as well (capital already flows quite freely in North America). The benefits of liberalization are measured by the extent to which a single price for a good, service, or factor of production exists throughout the market. These benefits can be realized by harmonizing existing domestic standards, regulations, and policies to a common norm that applies throughout the economic space. The European experience has also shown that countries can achieve these benefits by mutual recognition of each other's standards and allowing competitive forces to bring about adjustment to the most efficient one.

Creating a common market is much more difficult than it looks on paper since it involves creating common rules that each member is committed to respect, and common institutions to administer their application. Each NAFTA member is a federal state with fragmented decision making processes that make it difficult to negotiate and implement common rules. Appropriate policies would also be required to facilitate adjustment and compensate losers from economic change. Thus, strong political leadership and public support is required for the sustained effort. Europe's long-term political vision was essential to provide the political will necessary to inter-governmental bargaining and compromise; and common institutions were essential to its progress.

Political interests in deeper economic integration

The immediate question is whether any of the three countries would be interested in such ideas. They are European constructs, developed in a very different political environment. When the great European project began 50 years ago, the security issue was to end all wars through eventual political union. The long-term goal in North America, which is more highly integrated now than was Europe in the early years, is quite a different one. It is to create a common economic space but to *preserve* political independence and distinctiveness.

A Canadian or Mexican initiative on either of these options would have significant implications for US sovereignty and for this reason alone, such proposals could not be ignored. But each alternative implies harmonization of trade remedy laws, and there are no signs of political willingness to consider such an idea. From the US perspective, the smaller partners would have less to lose yet they would share in the benefits. For their parts the smaller partners would have to weigh the potential benefits of deeper integration against the risks of losing sovereignty and being forced in asymmetric negotiations toward harmonization with the laws, standards and policies of the United States.

Economic security as the common interest in a four-pillar strategy

A common vision that might attract all three countries is to promote *a secure North American economy* based on mutual confidence and commitments by each partner. To make this vision a reality much would have to change over time. Thus a broad framework is needed that links security and defense goals with economic integration goals. Such a framework can be envisaged with four main pillars: security, natural resources, economic efficiency and defense.

A pragmatic route that pursues economic security while preserving political independence and distinctive institutions can be envisaged as a four-part package:

- Secure borders that enhance the mobility of low-risk cross-border flows while tightening the obstacles for high risk cargo and people;
- A North American natural resources area;
- Common approaches to promoting greater economic efficiency in North American economies; and
- A North American defense partnership.

1. Security

The first pillar addresses common objectives to secure borders and to separate low risk movement of people and cargo from high risk flows.

Much has already been done to secure the Canada- US border for flows of goods. The Smart Border Declaration of December 2001 promises to break some longstanding infrastructure bottlenecks. But significant issues remain. First, the goal of a *seamless* border is to move security measures for low-risk products and people, particularly those originating within the NAFTA area, *away* from the border through electronic measures that allow registration and inspection at points of origin rather than at road crossings, bridges, tunnels and airports.

Second, substantial infrastructure investment was identified even before September 11 to handle increasing volumes of cargo and people crossing the border. Third, bureaucracies need to coordinate within an agreed framework. One example of the need for coordination of bureaucratic initiatives is the INS proposal to require visitors to the United States to sign in and sign out. Without an appropriate modification for NAFTA visitors, this potential barrier to the movement of low risk people could raise transactions costs out of proportion to the stated objective. Higher costs of moving people, goods and services will undermine Canada's productivity performance. It will cause international investors headed for North American to bypass Canada as a location, heading into the United States to serve Canada from there.

With respect to third countries, further work is needed on inspection of maritime and air traffic. Progress is being made on third country migration. The two countries have pledged a number of joint reviews, intelligence sharing and cooperation and synchronization of procedures. Permanent resident cards are contemplated, including a biometric identifier; a Canadian presence is contemplated on the US Foreign Terrorist Tracking Task Force, among others. The numbers differ with respect both to annual immigration targets and numbers of illegal migrants. The two countries have quite different profiles for selecting permanent residents, with Canada more focused on a demographically inspired, well-educated highly skilled immigrant, and the United States focused on family reunification.

Both countries accept an internationally agreed definition of a refugee and both take small portions of their refugee intake from camps abroad. Both have similar appeal processes for "inland" claimants. A safe third-country agreement will enhance the management of refugee claims. But processes are slow and cumbersome, and enforcement systems are sufficiently weak that authorities lose track of many applicants. While Canada's practice of releasing potential security risks while in the refugee or general enforcement process has received criticism, the area that may be most in need of rethinking is US Visitor Visa policy.

The three countries should focus first on their common interests. Topping the list should be an efficient system for low risk NAFTA travelers along the lines already being implemented on the US-Canadian border. NAFTA-wide visas could also be adopted for retirees. Beyond this, harmonization of immigration policy can have significant labor market implications. Europeans would consider these issues in the context of a common market. The North American alternative should be to facilitate movement and agree common procedures that also preserve political independence and distinctive national institutions, particularly in labor markets. Mutual recognition may be a more sensible way to address these issues. Building on this base, the most difficult issue of illegal migration between Mexico and the United States can be addressed.

2. A North American natural resources area

The second pillar reflects the central role of natural resources endowments and trade in North America including oil and gas, agricultural products, forestry products and services, and primary metals. As political uncertainties increase in the Middle East, so do the uncertainties about crude oil supplies from the area. One way to reduce these uncertainties is to increase supplies from within North America. The concept of North American resource security is a concept that could also be applied more broadly to include forestry products and agriculture. Energy and forestry products are introduced here for illustrative purposes.

Energy: The United States depends on imported crude oil for 60 percent of its requirements. Canada supplied 15 percent of these in 2001, just ahead of Saudi Arabia (14.7 percent), followed by Mexico (13.7 percent) and Venezuela (11.3 percent). By statute, the United States is prohibited from exporting crude petroleum, although the Canada-U.S. FTA made Canada an exception (that was not extended to Mexico under NAFTA). The United States is also a major net exporter of natural gas to Mexico. It is a net importer of electricity from both Canada and Mexico.

Under NAFTA, US-Canadian energy trade is largely driven by market forces, but Mexico's energy sector has remained immune to free trade. The respective energy sectors are still encumbered by domestic regulatory barriers, but much of Canada’s energy infrastructure is already linked with US markets.

NAFTA’s energy provisions cover trade in petroleum, natural gas, electricity and the associated fuels for power generation, including coal, uranium and other nuclear fuels. Canada and the US have broad-based commitments to limit government interference in energy trade except in extraordinary circumstances; minimum export price requirements as well as export taxes are prohibited in Canada and the US unless the taxes are also levied on sales for the domestic market. These prohibitions limit the tools traditionally used to implement government-enforced price discrimination in favor of domestic energy users. Narrowly defined exceptions to the prohibitions on trade restrictions are limited to situations involving national security. Either country may also restrict exports for three specific "economic" reasons: to relieve supply shortages, to maintain a domestic price stabilization program, or to prevent exhaustion of a non-renewable resource.

US energy policy aims to secure adequate energy supplies since it consumes more than it produces. Since the early 1980’s U.S. presidents have called for continental energy plans that coordinate with Mexico and Canada to ensure access to their exportable resources. These issues have always been difficult to deal with because of complicated and decentralized regulatory policies and Mexico’s constitutional constraints. The US presidential task force on energy which reported in 2001 recommended a three-way discussion through the North American Energy Working Group to pursue "closer energy integration" among the three countries, to identify areas of cooperation consistent with national sovereignties, and to expedite the delivery of northern natural gas.

Forest products are a major Canadian export to the United States. In 2000, the United States was customer for 64 percent of Canadian exports of forest products and 97 percent of its forest services exports. The softwood lumber dispute is the latest round in an ongoing dispute in which the underlying issue is differing regulatory and legal systems and the use of different mixes of subsidies and regulation. For example, most logging in the United States is on private land. In Canada it is on publicly owned land; companies are charged “stumpage fees” for access to this land. American producers complain that these fees are too low and constitute a subsidy. Canadian provincial governments argue that such fees do a reasonably good job of reflecting long-term market forces. Canadian producers see their US counterparts as less efficient and resorting to protectionist practices.

Canada could play a significant role in promoting North American energy security by offering the United States a long-term energy supply arrangement that reflects Canadian capabilities. Capability will be constrained by existing infrastructure. Much investment will be required needed to increase production and powering up the alternatives could take a decade or more. Canada’s initiative will also require a comprehensive strategy that takes account of the diverse supply capabilities in different parts of the country. These include natural gas from the McKenzie River Delta in the North West Territories, oil sands in Alberta, oil and gas in the Atlantic provinces and electric power supplies from several provinces.

Implementing the concept of a secure North American resources area would require changing some of the current rules of the game. At a minimum, it would require mutual recognition of federal and state or provincial regulation in the three countries — in energy, forestry and agriculture as appropriate. Environmental and constitutional differences would also have to addressed.

3. Promoting economic efficiency

The third pillar is promoting greater efficiency in North American markets, through facilitating labor mobility and addressing regulatory obstacles that protect vested interests from competition.

Rising trade and FDI flows increasingly require that people move more freely as well. Yet cross border labor mobility is still restricted, despite NAFTA provisions that facilitate movement of business persons and professionals. The North American Agreement on Labor Cooperation, a side agreement, ensures that each country enforces its own labor standards. The European Common Market has progressed much further, removing most barriers to the free flow of people to jobs anywhere in the European Union.

Increased labor mobility is desirable because the growth of cross-border production networks in both goods and services requires people to move to be near their customers. The prominence of American (and other U.S. based) multinationals requires that people move frequently and fairly freely across national borders. Existing restrictions may be one factor that attracts FDI to bypass Canada for the United States.

Consistent with the increasingly networked nature of North American markets, common economic interests will be served by doing away with differing standards and regulations that protect inefficiencies and thwart progress towards higher living standards. For example, Canadian and US competition policies are broadly similar, so cooperation in antitrust administration and enforcement exists. But with rising cross border transactions following the deregulation of key industries such as telecommunications, transportation and financial services, merger control is more complicated than it needs to be. All three countries have stated their intentions to develop a common regime with an appropriate legal framework and enforcement, but progress has been modest because of national interests wishing to preserve domestic markets.

4. North American defense

The fourth pillar, defense policy, has been pushed far back up the North American agenda by September 11. Military security expenditures should be one price Canadians are willing to pay for the openness on which they depend for their economic success.

A public debate about the choices is required, however, since the fiscal implications are significant after decades of declining defense expenditures. Some call for the renewal of Canada□sNorth American Air Defense assets. Others call for a re-examination of Canada□s maritime capacity to monitor its extensive ocean boundaries; the requirement for highly mobile land force units, equipped and trained to play a range of roles from response to natural disasters, to peace keeping; and moving Canadian Forces to international combat roles. Still others argue for the status quo whereby Canadians free ride on US military capability, since any security threat to Canada will also be a threat to Americans; thus US forces will be activated regardless of what Canada is prepared and able to do.

Supporting the economic security goal

Pursuit of economic security and deeper integration will require political and institutional support. There is little doubt that, in the long term, North American institutions are possible to facilitate the development of a North American community.

At present, however, the priority is to secure the North American economic space. Recent public opinion surveys indicate that Canadians, more confident of their identity than a decade ago, prefer the Canadian health care system and Canadian gun laws, but would also like to have the strength of the US dollar, US innovative zeal and prosperity. As the economy becomes more deeply integrated, attachment to a national identity is increasing.

Institutional changes should therefore focus on changing the rules of the game to fit the new realities. Mutual recognition of each other's rules, standards and policies will work in some cases; harmonization to common norms will be necessary in others. For the latter, institutions may need to be altered (for example, in areas where Canada and the United States already have a fair amount of convergence) or new institutions may need to be created. Building on the common "platforms" created for the Smart Border plans could contribute to significant progress. Ad hoc working groups can speed up the flows of low risk cargo and people; share and gather intelligence; share defense; and work on the mutual recognition of national economic standards, policies and rules. Different priorities in the two bilateral relationships will initially require different speeds, particularly when it comes to such issues as the mobility of people. As well, different speeds may require decentralized institutions.

Conclusion

Initiatives to deepen North American economic integration should address the new security imperative. A common goal of economic security could be achieved in pragmatic ways proposed in this four-pillar approach and, in turn, support a future that is secure, stable and prosperous for all three partners.