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FTA at 15, NAFTA at 10: a Canadian perspective on North American integration☆

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Abstract

NAFTA has facilitated a dramatic increase in North American trade and integration. Indeed, the degree of integration is now running ahead of NAFTA's institutional capacity to sustain it. Accordingly, the analysis focuses on a range of proposals designed to broaden and deepen NAFTA. The analysis concludes with an assessment of these proposals and with a set of conjectures in terms of the likely role and scope of NAFTA at 20.

JEL classification: F02; F13; F15

Keywords: NAFTA; Integration; Customs union; Common market

1. Introduction

NAFTA and its Canada–US precursor, the FTA, have been astoundingly successful. In the 1993–2000 period alone, Canada–US trade has doubled, while Mexico–US and Mexico–Canada trade have both tripled (Hufbauer & Vega-Cánavas, 2003, Table 1). More impressive still, over the full free-trade period (1989–2001) Canada's exports to the US doubled as a percent of GDP, from 18.6% in 1989 to 37.6% in 2002 (Table 1). Indeed, the very success of the FTA and NAFTA has led to a concern on the part of many Canadians that the trading relationship with the Americans needs institutional deepening: "We have reached a level of integration closer to that of a customs union or a common market, but without the institutions and rules to make sure that we are getting the full benefits of this level of bilateral integration" (Hart, 2001, p. 2).

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Then came 9/11, and the possibility that failure on the part of Canada to successfully engage the Americans in their pursuit of "homeland security" might lead to a dramatic "thickening" of the border and perhaps even to an unwinding of the existing degree of Canada–US integration and trade. There can be little doubt that for NAFTA to move forward, it will have to take account of this new reality. As Richard Haass (2002), Director of the Policy Planning Staff at the Department of State, has noted: "In the twenty-first century, the principal aim of American foreign policy is to integrate other countries and organizations into arrangements that will sustain a world consistent with US interests and values, and thereby promote peace, prosperity, and justice as widely as possible." These developments have provided Canada with "an extraordinary window of opportunity to pursue common security and economic concerns within the framework of a well-crafted initiative focused on the need to address border security" (Hart & Dymond, 2001, p. 3).

In recognition of NAFTA's 10th anniversary and the FTA's 15th,[1] my remarks will cast both a retrospective and a prospective eye on the evolution of economic integration in North America, but from a Canadian perspective. Section 2 reviews selected indicators of Canada's performance under FTA/NAFTA, while Section 3 focuses on the FTA and NAFTA as the catalysts, if not the drivers, of the dramatic expansion in trade and the associated transformation of the Canadian economy from its historical east–west trading axis to a north–south trading axis. Attention centers on the evolution of Canadian provinces/regions into what might be termed "North American economic region states," i.e. sub-national jurisdictions whose focus under NAFTA is increasingly to privilege themselves and their citizens in North American economic space. Section 4 then addresses the set of issues related to broadening and deepening NAFTA, beginning with the factors motivating reform, and what a NAFTA reform "wish-list" might look like from a Canadian perspective. This is followed by a focus on strategic bargains—linking Canada's interests in economic security and the American interest in homeland security—as a vehicle for broadening and deepening NAFTA. The section ends with proposals espousing a pluralist and bottom-up approach to the evolution of North American integration. In the conclusion, I offer some conjectures on the likely nature and scope of NAFTA at 20.

2. Canada under FTA/NAFTA: some relevant facts

In order to more fully appreciate the impacts the FTA and NAFTA have had on Canada's political economy, this section provides an economic and statistical "report card" on selected indicators of Canada's performance (relative to the US) since the advent of the FTA in 1989. As the first row of Table 1 indicates, Canada's exports of goods and services in 1989 represented 25% of GDP. By 2001, this percentage had soared to 43%, with the already-very-high US share of Canadian exports rising from 73 to 87%. Expressed as a percent of GDP, Canada's exports to the US doubled over 1989–2001 from 18.6 to 37.6%. This heightened north–south integration stands in stark relief to the pattern of east–west

[1] NAFTA was signed by Prime Minister Mulroney, President George H. Bush and President Carlos Salinas de Gortari in 1992. It was ratified in 1993 and it took effect on January 1, 1994. The FTA was signed in 1988 and took effect on January 1, 1989.

Table 1
International and interprovincial trade 1989–2001

	1989: exports as % of GDP				2001: exports as % of GDP			
	International			Interprovincial (4)	International			Interprovincial (8)
	% of GDP (1)	US share of (1), (2)	US as of % of GDP (3)		% of GDP (5)	US share of (5), (6)	US as of % of GDP (7)	
Canada	25.4	73.2	18.6	22.5	43.1	87.3	37.6	19.7
NFLD	31.0	68.4	21.2	11.9	37.1	65.6	24.3	20.3
PEI	14.7	60.2	8.8	30.6	31.8	89.9	28.5	27.7
NS	15.8	66.0	10.4	21.0	29.0	82.7	23.7	21.1
NB	26.2	66.5	17.4	30.0	45.7	89.1	42.3	31.2
Que.	21.2	75.7	16.0	22.9	39.6	84.8	33.6	19.4
Ont.	28.6	85.9	24.6	22.6	51.5	93.3	48.0	18.7
Man.	18.5	62.6	11.6	28.0	30.7	80.0	24.6	29.7
Sask.	22.7	45.0	10.2	25.6	44.2	59.0	26.1	25.4
Alta.	24.5	75.7	18.5	28.5	41.3	88.8	36.7	22.1
BC	28.7	83.4	12.5	13.5	31.3	70.9	22.2	14.1

Source: Canada Department of Foreign Affairs and International Trade (2002), Tables 1A and 9E.
Notes: NFLD, Newfoundland; PEI, Prince Edward Island; NS, Nova Scotia; NB, New Brunswick; Que., Quebec; Ont., Ontario; Man., Manitoba; Sask., Saskatchewan; Alta., Alberta; BC, British Columbia. Provincial exports relate to provincial GDP.

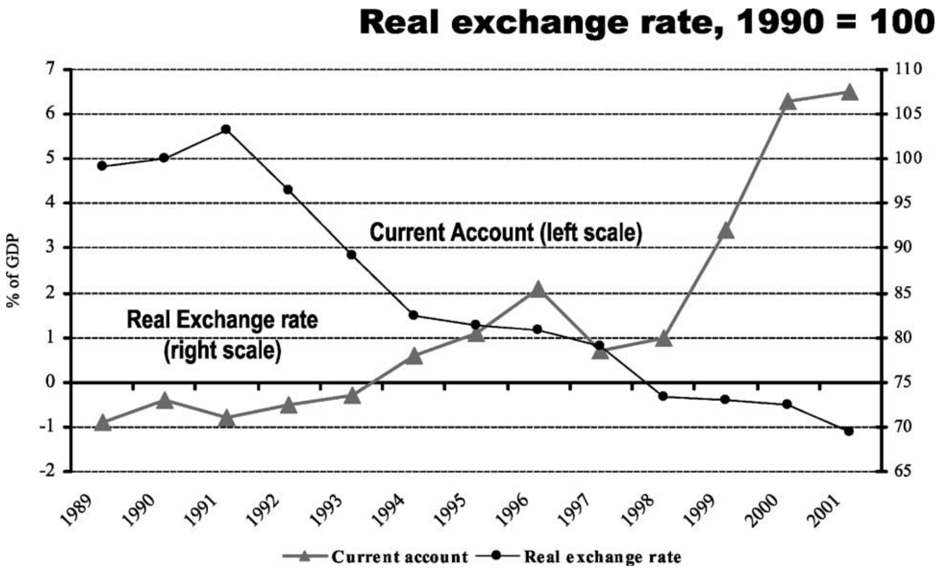

Fig. 1. Canada's real exchange rate vis-à-vis US dollar and current account balance with the US, 1989–2001. Source: Canada (2002), Fig. 12.

or interprovincial exports. From columns 4 and 8 of the Canada row of Table 1, interprovincial exports have fallen from 22.5% of GDP in 1989 to 19.7% in 2001, which leaves interprovincial exports running at only half of the 37.6% of Canada's exports destined for the US.

It is appropriate to note that inflows of foreign goods and services into Canada as a percent of GDP increased from 25.8 to 38.1%. The US share of these imports rose only slightly—from 68.3% in 1989 to 71.0% in 2001. Hence, Canada is running a significant merchandise surplus with the United States. Just how significant is evident from Fig. 1. Canada's current account balance with the US soared from a deficit of 1% of GDP in 1989 to a surplus of over 6% in 2000 and 2001. In dollar terms, this totaled C$67 billion in 2001, with the goods surplus of C$95 billion partially offset by deficits in other components of the current account (Canada, 2002, Table 2B). While factors such as tariff reductions under FTA/NAFTA, within-firm cross-border rationalization of production along product mandate lines in key sectors like autos, the advent of cross-border just-in-time supplier–manufacturer/assembly relationships (again in autos), as well as the shift in Canada toward an export mentality have all contributed to the dramatic surge in exports as recorded in Table 1, a further major reason was the significant depreciation of the Canadian dollar (relative to the US dollar) from 1991 onward. This downward trend is also charted in Fig. 1, where the exchange rate is defined as US cents per Canadian dollar, corrected for relative consumer prices and expressed as an index equaling 100 for 1990. By 2001, the real value of the Canadian dollar had fallen to 70% of its 1990 value.

Fig. 2 presents a longer-term overview of the behavior of the Canada–US nominal exchange rate (expressed as the number of US cents for one Canadian dollar). From a premium

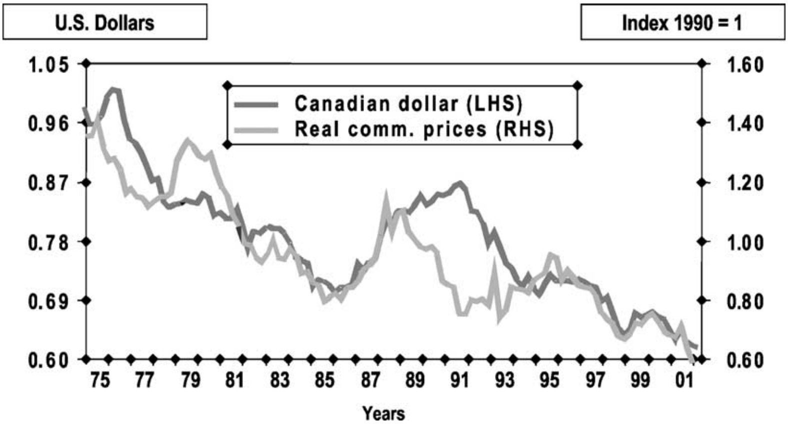

Fig. 2. Canadian dollar and real commodity prices. Source: Bank of Canada, Statistics Canada.

(i.e. above $1.00 US) in the mid-1970s, the Canadian dollar fell sharply to the low 70 US cent range in the mid-1980s, then rebounded to the 89-cent level in 1991, depreciated sharply during Canada's early 1990s recession, fell further to roughly 68 cents in the aftermath of the Asian currency crisis, and then tumbled further still to the low 60-cent range at the turn of the century. At the time of writing, the Canadian dollar has rebounded considerably to trade in the 68-cent range.

The Bank of Canada's principal rationale for the falling dollar is that it is tracking (and "buffering") the fall in world real commodity prices. Fig. 2 charts the behavior of these relative commodity prices, defined as the price of (non-energy) commodities relative to the price of manufactured goods, converted to an index with 1990 equal to unity. The only major post-FTA deviation of the pattern of exchange rates tracking commodity prices occurs during 1988–1991, when the Bank of Canada sharply hiked interest rates (and triggered currency appreciation) as part of the transition mechanism toward its price-stability goal (enunciated in 1988).

3. FTA/NAFTA and the transformation of Canadian economic space

As already noted, the FTA and NAFTA have transformed Canadian geo-economic space from the traditional east–west trading axis to a north–south trading axis. Understanding the full ramifications of this reconfigured trade requires resort to the provincial data in the body of Table 1. In 2001, 9 of the 10 provinces exported more to the US than they did to their sister provinces (compare columns 7 and 8). The sole outlier here is Manitoba, even though its US export share more than doubled over this period—from 11.6% of GDP in 1989 to 24.6% in 2001 (rows 3 and 7). In sharp contrast, only 2 of the 10 provinces (Newfoundland and Ontario) had US exports in excess of interprovincial exports in 1989 (compare rows 3 and 4).

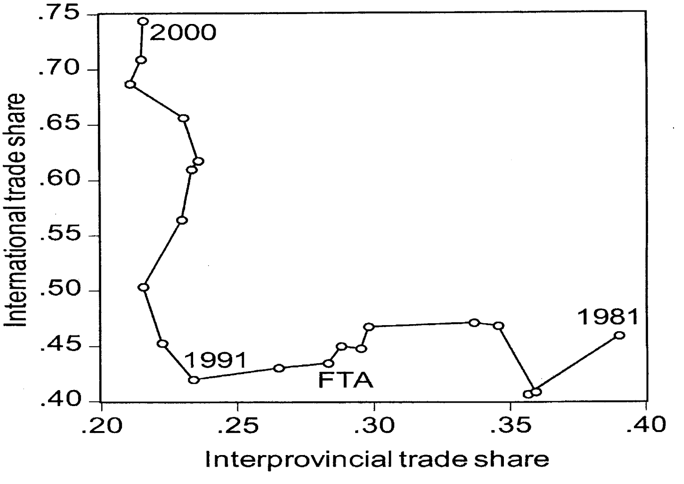

Fig. 3. The Canadian international and interprovincial trade shares. Note: The trade share is defined as the sum of imports and exports as a percent of GDP. Years increase monotonically along the line segment 1981–2000. Source: Coulombe (2002).

The shift of trade is evident in Fig. 3, adopted from Coulombe (2002), where the trade share is defined as (X + M)/GDP for both interprovincial and international trade.[2] What this "L-curve" reveals is that Canada's international trade share remained roughly constant from 1981 to 1991, whereas interprovincial trade fell from nearly 40% to just under 25% over this same period. From 1991 onward, the opposite occurred—the interprovincial trade share remained roughly constant, while the international share ballooned from about 42 to 75% of GDP. Note that the inflection point corresponds with the sharp depreciation of the Canadian dollar around 1991 (see Figs. 1 and 2).

The province of Ontario, with over one-third of Canada's population and two-fifths of its GDP, merits highlight. Fig. 4 charts Ontario's interprovincial exports, its US exports and its total international exports over the 1989–2001 period. Prior to the FTA (i.e. in the early 1980s), Ontario's total international exports, let alone its exports to the US, were running below its interprovincial exports. As Fig. 4 reveals, by the time the FTA was signed, Ontario's exports to the US had surpassed exports to its sister provinces—roughly 25% versus 23%. By 2001, Ontario's interprovincial exports had fallen nearly 4 percentage points from 1989, whereas exports to the US had soared to nearly 50% of provincial GDP (18.7% versus 48.0% from rows 7 and 8 in Table 1). This reality suggests that Ontario's economic future now lies in NAFTA economic space and that Ontario, long the economic heartland of Canada,

[2] The dots represent successive years beginning with 1981. For example, the FTA is located at the 1989 dot. The data in Fig. 3 relate to trade in goods. Services trade has a different pattern, although the aggregate results (for goods and services) also generate an L curve. See Coulombe (2002). Finally, the ratio of exports to GDP can exceed 100%, since exports are valued in terms of the full cost of the product, independent of the value-added in Canada, whereas GDP measures value-added.

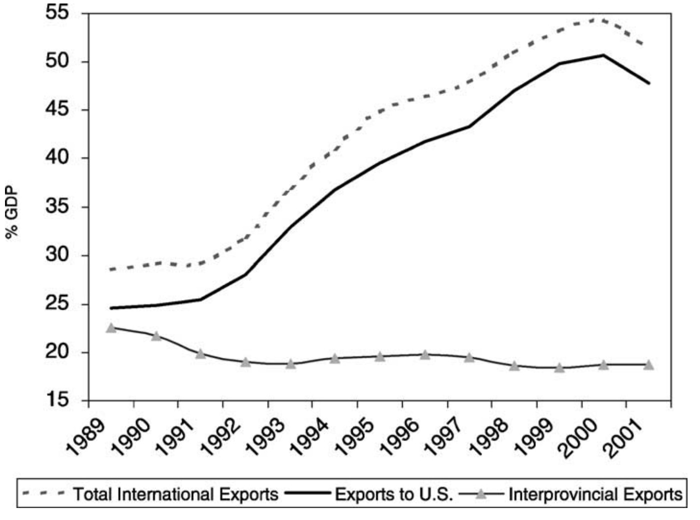

Fig. 4. Ontario's interprovincial and international exports. Source: Canada (2002), Table 9E and F.

is becoming what Telmer and I (1998) labeled a North American economic region state, or more simply a North American region state.[3]

However, in order to merit fully the economic-region-state label, Ontario must be more than highly trade-linked with the US: it must also utilize its policy levers to privilege Ontario and Ontarians in North American economic space. Phrased differently, it must embrace a sub-national/international orientation, which in turn means that it must legislate to create attractive locational externalities. And Ontario certainly has done this, initially with its 1995 *Common Sense Revolution* in pursuit of fiscal integrity and tax cuts and, later, with its institutional/municipal revolution which reformed virtually every facet of the Ontario public sector in quest of operational efficiency (Courchene & Telmer, 1998, chapters 8–10). By way of an obvious example, the tax rates that concern Ontario are those in Michigan, Ohio, New York, etc., rather than those in Newfoundland or British Columbia. Accordingly, when Ontario recently cut its corporate income tax rates in half, the Ontario Finance Minister noted: "When our tax cut is fully in place, the [combined] Ontario and federal corporate income tax will be more than 10 percentage points lower than the average of that of the US Great Lakes states, our biggest competitors for businesses and jobs" (Eves, 2000, p. 26).

3.1. Canada as a series of north–south economies

While Ontario may be leading the way in pursuing a north–south economic future, other provinces/regions are not far behind. British Columbia is closely tied economically with

[3] In *From Heartland to North American Region State . . .* (1998) we defined region-state in terms of three characteristics: it must be a political sub-region, i.e. a province or a state; it must have an economic hinterland/trading area that is cross-border; it must use its legislative powers to advance its economic fortunes in this cross-border economic space.

Washington, Oregon and parts of California. Energy-rich Alberta's policies keep a close eye on those of the Texas Gulf. The breadbaskets of Saskatchewan and Manitoba compete with the grain states south of the border. Quebec, an industrial province like Ontario, also vies for markets along the New York–Chicago corridor. And the four Atlantic provinces, which still maintain an Atlantic Rim interest, are progressively turning their attention to Boston, and New England generally. This means that one of the world's most decentralized federations is becoming not only more decentralized, but more policy-asymmetric. Canada is thus progressively less and less a single national economy and more and more a series of regional cross-border economies.

While the Canadian domestic or east–west economy is still more integrated than the cross-border regional economies, it is nonetheless the case that, in terms of gross flows and dynamism, NAFTA economic space is where Canada's economic future will unfold. The Canadian response to this new economic climate has been to preserve and promote selected socio-economic and political achievements of the former east–west paradigm, on the one hand, and to combine them with creative measures and instrumentalities designed to capitalize on the opportunities arising from NAFTA, on the other. For example, the governments of Canada and the provinces embarked on a series of agreements designed to secure the east–west or internal economic and social unions—the 1995 *Agreement on Internal Trade* for goods and services; the 1999 *Social Union Framework Agreement* for securing the internal social union; and the mutual recognition proposals/commitments designed to ensure that training, licenses, credentials and certification are portable across the Canadian provinces.

3.2. Mexico and north–south integration

The foregoing considerations are also relevant to Mexico. Indeed, Mexico's northern tier of states (the maquiladora states as well as the more fully integrated border pairings such as Nuevo Leon and Texas) would surely qualify as North American economic region states. Not surprisingly, these NAFTA-integrating northern states want much more in the way of fiscal autonomy, in terms both of taxation and expenditure powers, in order to enhance their opportunities and competitive position in NAFTA economic space. Some of these states are already highly dollarized and are developing governmental capacity and expertise to take on more policy responsibilities. In contrast, many of the southern states have much weaker tax bases and administrative capacities, and would prefer to continue to rely on cash transfers from the center rather than opt for greater tax autonomy. This NAFTA-triggered challenge to the operations of Mexican federalism is every bit as daunting as is the corresponding centrifugal challenge to Canadian federalism.[4]

[4] One potentially promising approach to accommodating these diverging state preferences arising from North American integration would be to decentralize taxation and expenditure responsibilities, but then to embed this tax decentralization within a Canadian-style equalization program so that benefits of economic progress, wherever they arise, are equitably shared across all states and citizens. See Courchene, Diaz-Cayeros, and Webb (2002) for elaboration.

3.3. US and NAFTA

Although the trade impacts of NAFTA for the US are identical in absolute value, they are *relatively* much less important to the US economy than they are to Mexico and Canada. Nonetheless, and perhaps surprisingly, the FTA and NAFTA are gradually reworking US economic geography in very significant ways. For example, as Sands (2002) and Haynal (2002) note, Canada is now the number one export market for 38 US states. At least six of the remaining states have Mexico as their top trading partner, and roughly a score of states have Mexico as number two. US exports to Canada account for 22.4% of overall US exports, which is above the 21.8% destined for the European Union. In tandem with Mexico's 13.9% share of the US export market, NAFTA now accounts for over a third of US exports, and it is not difficult to foresee a day when this percentage will approach 50%, in part because Mexico will likely replace Canada as the largest export market for the US.

This completes the brief NAFTA retrospective as it relates to the implications for North American integration. Arguably, and drawing from Blank (1992), in the pre-FTA era for Canada and the pre-NAFTA era for Mexico, trade flows were running behind the existing degree of infrastructure and economic integration. The FTA and NAFTA addressed this by decreasing tariffs, by enhancing access, by broadening free trade to include services, and the like. One result was the mushrooming of trade. Another was the further transformation of North American infrastructure (rail, roads, gas, electricity, pipelines, airline routes, telecommunications, standards and regulations) from three national systems into a single continental system (Blank, 2002, p. 2). In tandem, these two factors have created an environment where both trade flows and the underlying cross-border infrastructure and economic integration are, as noted, proceeding at levels more appropriate to a customs union or a common market than a free trade agreement. As a consequence, and in spite of the daunting challenges alluded to above, pressures are mounting in Canada to take steps to shrink this growing gap between the extent of cross-border integration, on the one hand, and the rules and institutions needed to govern it, on the other (Hart, 2001, p. 2).

4. Broadening and deepening NAFTA

4.1. Motivating reform

NAFTA is a remarkable milestone in the annals of international trade and economic integration. For the first time ever a comprehensive free trade agreement brought together both developed and developing countries. Moreover, it not only broadened the scope of traditional free trade agreements by embracing services, foreign investment and property rights, but as well it recognized the importance of workers' and environmental rights and issues (although it settled for having countries enforce their existing laws in these two areas rather than advancing some common principles and enforceable practices). Since it envisages no political evolution, the operative principle is "national treatment," which is sovereignty-preserving, if not sovereignty-enhancing, in contrast to the EU drive toward harmonization and a single market via hundreds of directives adjudicated via administrative law.[5] And, of course, NAFTA has been spectacularly successful in enhancing North American trade and integration.

While these are indeed signal achievements, there is nonetheless a groundswell of interest among governments, think tanks and the academy in all three countries directed toward rethinking and reworking aspects of NAFTA. At the most general level, potential reforms tend to focus on one or all of broadening, deepening and updating NAFTA. *Broadening* is straightforward—extending NAFTA to new areas (e.g. trucking) or to potentially new members (e.g. the FTAA membership). *Deepening* is much more complex since it could imply (a) institutional deepening such as converting the free trade agreement into a customs union (CU) or a common market (CM); (b) integrating the US and Mexican states and the Canadian provinces more fully and more formally into NAFTA; and (c) embedding internal governance structures into NAFTA so that it has the ability to adjust from within to new challenges. *Updating* NAFTA involves, among other things, addressing what Hart and Dymond (2001) refer to in the Canada–US trade context as "the tyranny of small differences." In their words:

> The response of the two economies to the challenges posed by freer bilateral trade and investment has been both remarkable and positive. Nevertheless, the results have created new bilateral tensions, challenges, and opportunities. The growing web of economic linkages joining the two countries, the result of the cumulative impact of billions of discrete daily decisions by consumers and producers alike, point to the need for policy responses on both sides of the border that will have an important bearing on the quality and pace of further integration. Deepening interaction is exposing policies and practices that stand in the way of more beneficial trade and investment. Cumbersome rules of origin, discriminatory government procurement restrictions, complex antidumping procedures, intrusive countervailing duty investigations, burdensome regulatory requirements, vexatious security considerations, onerous immigration procedures, and other restrictive measures remain in place, discouraging rational investment decisions and deterring wealth-creating trade flows. The key to resolving many of these issues can be found in better ways and means to *manage the border*. (Hart & Dymond, 2001, p. 3, emphasis added)

4.2. A Canadian "wish list"

Table 2, reproduced from Hart and Dymond (2001, pp. 12–13), presents what could pass for a rather comprehensive "wish list" in terms of broadening (nos. 4, 5, 7, and 8), deepening (nos. 2, 3, 5, 6, 7, 8, and 9), and updating (nos. 1, 3, and 4) NAFTA.

By way of elaboration, some of the items in Table 2 (e.g. no. 2 relating to rules of origin) could be addressed by moving toward a CU, since a common external tariff would obviate the need for complex rules of origin.[6] Intriguingly, however, many of the items in the table

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[5] National treatment means that an American firm can do in Canada exactly what a Canadian firm can do. In contrast, and in the limit, the EU single-market principle (sometimes referred to as home-country rule) implies that a German firm can do in France exactly what the German firm can do in Germany. Apart from exemptions relating to health and safety, the application of home country rules drives the EU toward uniform regulations.

[6] It is not evident that NAFTA members would be willing to embrace a formal CU since, among other things, this would require altering bilateral free-trade agreements with third nations.

Table 2
An agenda for opening the Canada–US border further

1.	For customs and border administration, more progress needs to be made on various initiatives to facilitate, streamline, and even eliminate the need for routine customs clearance of both people and goods
2.	For tariffs and related programs, such as rules of origin, industry on both sides of the border would benefit from the reduction and harmonization of MFN tariff levels, obviating the need for many of these programs
3.	For product and process standards and regulations, much more progress can be made in developing either common standards or greater acceptance of equivalence, mutual recognition, common testing protocols, and similar provisions
4.	For services, there is room to move beyond commitments on market access to greater reliance on common standards and mutual recognition; sectoral discussions related to financial, transportation, telecommunications, and professional services would also provide further scope for reducing discrimination and enhancing trade and investment opportunities, and increasing healthy competition on a broader basis
5.	For government procurement, the rules could advance from the limited entities method pursued in the GATT/WTO Procurement Agreement and expanded in the CUFTA/NAFTA to a full national-treatment approach, mandating that governments throughout the region purchase goods and services for their own use on a non-discriminatory, fully competitive basis, at least insofar as North American Suppliers are concerned
6.	For trade remedies—antidumping and countervailing duties—the rules should evolve beyond WTO-like procedural safeguards to common rules about competition and subsidies, reducing the scope for anti-competitive harassment and procedures
7.	For competition policy, more effort could be devoted to setting out common goals and providing a basis for cooperative enforcement procedures
8.	For investment, provisions should move further down the track of enforcement by the domestic courts of jointly agreed rules of behavior, and
9.	Institutionally, the two governments may need to move beyond the ad hoc inter-governmental arrangements of the CUFTA and NAFTA toward more permanent supranational institutions

Source: Hart and Dymond (2001, pp. 10–11).

would require a degree of institutional or policy deepening that is typically associated more with a CM than with a CU—for example, nos. 8 and 9. Overall, however, the provisions in Table 2 would fall way short of an EU-type single market, since principles such as national treatment and mutual recognition (evident in nos. 3 and 4 but implicit throughout the table) would be operative, thus preventing the degree of harmonization and uniformity found in the EU. The larger point here is that none of the NAFTA signatories would embrace the EU model either in its elimination of the border for non-trade purposes or in its implications for national sovereignty.

Trade in services is another problem area. With trade in services expected to increase substantially, and with employee mobility an essential part of services trade, failure to expand the Trade-NAFTA Visas (T-N Visas) beyond professional workers will surely tempt Canadian-based firms to relocate in the US. More generally, the “thicker” the border, the greater is the incentive to locate state-side for those firms intent on serving the North American market.

Overall and apart from removing the economic border, what Canadians want from any reworking of NAFTA is first, to level the playing field for Canadian-based firms and second, to permit further policy coordination in sensitive areas only to the extent that Canada maintains appropriate policy flexibility. Among other things, the former requires that the national treatment provision of the FTA and NAFTA be interpreted very expansively. For example, Canada-based firms operating in the US should be accorded privileges and responsibilities identical to those of US firms. With respect to policy coordination, Canadians will accept that there need to be minimum standards in various areas (e.g. labor market, environment) as well as some agreed-upon principles relating, for example, to competition policy and regulation generally. After setting these minimum standards and principles and non-discrimination provisions, however, NAFTA should allow the signatories to implement these standards and principles in *equivalent* rather than *uniform* ways.

4.3. An analytic detour: deepening NAFTA and rational choice

That NAFTA lacks institutional infrastructure or institutional depth is fully recognized. Pastor (2001, pp. 73–74) for example, reflects as follows:

> The signatories of NAFTA deliberately wanted to avoid establishing any bureaucratic or supranational institutions. The core of the agreement was therefore self-executing or designed to be implemented by *each* government. Still, the dispute-settlement mechanism obviously needed some structure. The modus operandi was to create a "NAFTA Free Trade Commission," which was a "virtual" structure; that is, it was simply a phrase to describe periodic meetings among the trade ministers of the three countries, "with no permanent location or staff."

Hence the preponderance of numbers in Table 2 that relate to deepening NAFTA. But why was NAFTA so institutionally shallow in the first place?

Toward this end, Bélanger (2002, p. 4) notes that international agreements/treaties such as NAFTA have to strike a balance between comprehensive and internal precision, on the one hand, and delegation and internal governance structures, on the other, or, more simply, between completeness and self-governance. NAFTA fares incredibly well on the completeness dimension:

> NAFTA is among the most highly detailed international trade agreements ever negotiated between governments. It comprises twenty-two chapters setting forth specific obligations on trade in goods, services, financial services, investment, intellectual property rights, technical barriers to trade, sanitary and phytosanitary measures, safeguards measures, and dispute settlement. It incorporates a panoply of annexes that elaborate the extent (and limits) or obligations by reference, among other things, to the internal legislation of its parties. NAFTA is broader in scope of coverage ... than the WTO agreement, and it is comparable in the level of detail to the WTO agreement. NAFTA was drafted at a level of detail substantially higher than the EC treaty ... (Abbott, 2000, p. 542)

Bélanger goes on to note that with this high degree of completeness one might have expected NAFTA to also have a correspondingly well-developed process of institutionalized delegation or internal governance, e.g. a permanent court on trade and investment. But this is precisely what NAFTA does not have. Rather, as noted above, it has institutionally shallow dispute–resolution mechanisms that have neither the power of a tribunal nor the ability to internally update NAFTA to accommodate new challenges. This is in sharp contrast to the EU, which has a "relatively imprecise charter coupled with a high degree of delegation that may promulgate secondary legislation with more precise content" (Abbott, 2000, p. 521). Thus, the European Court of Justice, for example, can trump national courts.

Given the long-standing US concern about yielding sovereignty to international bodies, and the overwhelming power imbalance between the US and Canada (and Mexico), it should come as no surprise that the FTA/NAFTA has effectively no ability to adapt and adjust from within:

> Powerful states are most concerned with delegation, the major source of unanticipated sovereignty costs. As a result, forms of legalization that involve limited delegation ... provide the crucial basis for cooperation between the weak and the strong. Lower levels of delegation prevent unexpected intrusions into the sovereign preserves of powerful countries while allowing them significant influence over decision making. (Abbott & Snidal, 2000, p. 449)

In his overall assessment of the interaction between the structure of NAFTA and rational choice theory, Bélanger (2002, p. 11) suggests that powerful states like the US will not only prefer agreements that favor completeness relative to meaningful delegation and especially to discretionary internal governance structures, but they will go further and will favor completeness as an *alternative* to internal governance.[7] While both Canada and the US have benefited initially from the specificity and amplitude of NAFTA, over the longer term the US, because of its sheer size and power, can bear more easily than can Canada the costs/frustrations of the progressively increasing trade problems and irritants which arise in part because NAFTA itself cannot resolve them.

The important message here is that NAFTA is institutionally shallow by design, not by happenstance. The obvious corollary is that proposals for deepening NAFTA are not likely to be successful unless US self-interest changes significantly. Enter 9/11 and homeland security.

4.4. Strategic bargains: linking trade and security

The American reality is characterized by a new single-mindedness—"homeland security" will henceforth be uppermost, and if the movement of persons, vehicles, and goods across the border compromises US security, then the border arrangements will be altered in ways that will serve to guarantee homeland security. While Canadians also remain vitally concerned on the security front, 9/11 brought home the dual reality of just how economically dependent Canada is on the seamless border with the US and just how vulnerable Canada is when the border becomes dysfunctional. Border security measures after September 11 triggered shutdowns for the just-in-time automobile manufacturers that cost them up to US$ 25,000 per minute (Hart & Dymond, 2001, p. 7). Clearly a border subject to unpredictable

[7] It is admittedly the case that Canada also feared that deepening NAFTA along selected lines could lead to Washington-based institutions modeled along US policy lines (Wolfe, 2003). However, in important areas like dispute resolution, approaches to countervail, subsidy codes and the like, Canada would have preferred institutionalized governance structures embedded within NAFTA.

slowdowns and closures will wreak havoc with much of Canada's manufacturing and export sector. Existing Canadian firms in the just-in-time manufacturing mode will consider relocating to the US and incoming North American foreign direct investment will discount Canadian locations.

Small wonder, then, that there has been a groundswell of interest and activity in Canada directed toward rethinking NAFTA in the larger context of an overall security perimeter encompassing homeland security as well as economic security. What is emerging are proposals for a "grand bargain" (Gotlieb, 2003) or a "Big Idea" (Dobson, 2002) that link common security and economic concerns. If there is a consensus among those Canadians desirous of broadening and deepening NAFTA, it is to see 9/11 as creating a window of opportunity for pursuing common security and economic interests. As the CCCE (Canadian Council of Chief Executives) notes, "The events of September 11 provided a powerful catalyst ... Homeland security and economic security quickly became cross-border rallying cries" (d'Aquino, 2003, p. 1). The two principles that underpin this new strategy are that North American economic integration is *irreversible* and that North American economic and physical security is *indivisible*.

Beyond the security-trade linkage, there are at least two other common features of these strategic proposals. The first is that they tend to be *bilateral*, or Canada–US proposals. As a signatory of NAFTA, Canada has a moral commitment, as well as a material interest, to advance common tripartite goals in North America. Yet, in the post 9/11 environment, the Canada–US relationship is characterized by a set of opportunities, challenges and priorities that are quite distinct from those that characterize the Mexico–US relationship. The further reality is that despite President Vicente Fox's earlier proposals for deepening NAFTA, Mexico appears recently to have dedicated itself to a series of important domestic reforms as prelude to any further negotiations related to deepening NAFTA (Ramirez De la O, 2002). Lest one view this Canada–US bilateral option as abandoning the tripartite character of NAFTA, it is instructive to recall that it was the bilateral (Canada–US) FTA that prepared the way for trilateral NAFTA. Indeed, Sands (2002a) suggests that the so-called "variable geometry" of European integration may well be appropriate as an approach to deepening NAFTA. And by way of underscoring this point, Sands notes that North American integration is already proceeding on a de facto "two-speed" basis, inasmuch as Canada and the US have already substantially deepened their security/border relationships.[8]

The second common feature is that, as is the case of the FTA, it is up to Canada to take the initiative in generating proposals linking economic and security issues. Moreover, since past experience shows how difficult it is for Canada to engage US officials on an issue-by-issue

[8] From Sands (2002a, p. 2): The action plan set out in the 30-point Smart Border Declaration signed by both countries in December 2001 is mostly complete, with officials in the two countries now sharing an unprecedented amount of information (including intelligence on potential immigrants and refugees) in real time. Under the Container Security Initiative, US and Canadian inspectors have formed joint teams in the ports of Halifax, Montreal, Vancouver, Seattle, and New York to ensure that shipping containers do not conceal weapons of mass destruction. The FBI and RCMP (Royal Canadian Mounted Police) cooperate in joint investigations, including counterterrorism and old-fashioned criminal cases. Interoperability with the US military is the declared goal of Canada's military planners, and Canada is seeking to develop a close relationship with the new US Northern Command, including NORAD (North American Air and Aerospace Defense Command), which first integrated Canadian and US air defenses in the 1950s.

basis, any Canadian initiative must be sufficiently bold, broad and creative to capture the imagination of leading US political figures (Hart & Dymond, 2001, p. 18). Dobson (2002, p. 19) argues along similar lines: "Close observers of the US political system argue that Canada can achieve nothing of significance by pursuing deeper integration in a piecemeal manner." Rather, "only a Big Idea will succeed, one that addresses US objectives while creating new economic opportunities for Canada" (Dobson, 2002, p. 1).

One such Big Idea is a customs union, another is a common market. Still another is Dobson's proposal of a pragmatic *strategic bargain* (Dobson, 2002, p. 1):

> Canadian initiatives would be required in areas of interest to the United States, specifically border security, immigration, and defense. Energy security is another key area where Canada should build on its existing strengths. In exchange for these initiatives, Canada should seek customs-union- and common-market-like arrangements that achieve deeper integration but recognize deep attachments to political independence and distinctive national institutions.

The CCCE position paper "Security and Prosperity: The Dynamics of a New Canada–US Partnership in North America" (d'Aquino, 2003) embeds Dobson's energy security proposal within a broader "North American resource security pact," encompassing oil, gas, electricity, coal, uranium, metals, forest products and agriculture. What the CCCE hopes to accomplish is to trade off resource security for resolution of long-standing issues and irritants relating to pricing, subsidies and regulatory practices in selected resource products (e.g. lumber).

Not surprisingly perhaps, a focus on re-inventing the border also looms large in these position papers. For example, the CCCE proposals include shifting key aspects of security enforcement away from the internal border to the North American perimeter and then streamlining the internal border by (a) creating shared identity documents for frequent border users, (b) moving commercial clearing away from the border, and (c) sharing border infrastructure and policing. The proposal also includes the creation of a Canada–US Joint Commission on border management, replicating the highly successful International Joint Commission, the oldest Canada–US intergovernmental organization, established in 1912 (under the Boundary Water Treaty of 1901) to deal with the development and conservation of water resources along the international boundary.

It is instructive to note that this security-economic linkage is finding voice elsewhere in NAFTA. In "Whither NAFTA: A Common Frontier," Hufbauer and Vega-Cánavas (2003) advance the concept of a "common frontier" with a three-pronged agenda focusing on border management, defense alliances and immigration. They envisage benefits in energy cooperation (including pipeline construction), services trade (finance, transportation, tourism, broadcasting, entertainment, health, education), agriculture, and a common external tariff. Indeed, they go further than most Canadian proposals by contemplating some version of North American monetary cooperation which, in the shorter term, could be advanced by non-voting Mexican and Canadian central bank representatives on the Federal Reserve Board.

Not surprisingly, the strategic-bargain approach to reforming NAFTA also has its detractors, even among those who are in favor of deepening North American integration. One alternative proposal (Golden, 2003), probably best described as "aggressive incrementalism," would eschew any overarching homeland-security/economic-security deal or bargain in favor of engaging the Americans in a pragmatic manner across a variety of areas, such as those outlined in Table 2 above. A more challenging alternative (Wolfe, 2003) insists that meaningful deepening of North American integration requires much more than reworking NAFTA. What NAFTA needs are healthy doses of decentralization, pluralism and subsidiarity.

4.5. Pluralism, subsidiarity, mutual recognition and NAFTA

Wolfe (2003) takes a dim view of any grand or strategic bargain since the result will, he suggests, lead to Washington-based institutions designed, in all likelihood, in line with Washington's policy priorities. Hence, "if we don't want to see the Americans in Washington, we have to talk to them everywhere" (ibid). To Wolfe that is precisely what North American integration is all about. In 2002, there were nearly 300 treaties, agreements and understandings in force between Canada and the US. This is but the tip of the iceberg of the thousands of arrangements—some formal and some informal, some written and some tacit or in the form of conventions, some public and some private—that effectively serve as a living and growing "constitution" of North America.

Moreover, this network of linkages, formal or otherwise, is expanding rapidly. For example, the number of bilateral arrangements/agreements that will emerge in connection with the reform of corporate governance and accounting/auditing procedures and principles in the wake of the Enron debacle will surely run well into the hundreds as regulatory agencies, stock exchanges, legal firms, accounting firms, civil society associations and governments on both sides of the border harmonize or otherwise reconcile their approaches to this common challenge. Wolfe would argue that it is this complex and comprehensive web of arrangements that needs to be deepened and broadened in order to advance common interests in North America.

While NAFTA is undoubtedly the single most important framework for North American integration, the pluralistic nature of the players and the linkages is such that not all of the negotiation efforts should focus on the Ottawa–Washington axis. Rather, Wolfe (2003) calls for "Swiss-knife diplomacy," modeled after Gotlieb's (1991, pp. 117–118) "multiplicity-of-instruments" doctrine, i.e. "encouraging Canadian officials, legislators, politicians, businessmen, lobbyists, and others from all levels of government to be active in a kaleidoscopic effort to defend Canadian interests in the United States (Wolfe, 2003). Beyond this, Wolfe argues that the multilateralism of the WTO may be a more promising venue to engage the United States in trade disputes than the (highly-power-imbalanced) trilateralism of NAFTA.

Blank (2002), in his "Building the North American Community: Next Steps," approaches deepening North American integration from a somewhat similar perspective. Noting that there is at present no sense of a North American interest, almost no university institutes dedicated to North America, nor any foundation devoted to North American research, Blank wrestles with how to build a North American "community." Responding to Pastor's (2001) suggestion that a reformed NAFTA should create a North American Commission (modeled on the EU counterpart), whose mandate would be to develop a top-down plan for North American development, Blank notes (2003, p. 7):

> Is this the right step at this time? I think not—at least for now—for several reasons. The first is that it is unlikely that Ottawa, Mexico City or Washington would be willing to take this step. Second is that, if the national governments were prepared to take steps to create a North American Commission, its composition would surely be severely politicized . . . Finally, . . . the institutions of North America should not be the creation solely of the three national governments. Their legitimacy must rest on wider and deeper foundations. . . . [They] must represent the reality and complexity of North America—a mosaic of regions.

Like Wolfe, Blank adopts a pluralist view of North American integration by focusing on the myriad of associations/agreements and players/agents. However, he places more emphasis on deepening NAFTA politically (or, perhaps, federally) by proposing to bring in Mexican, US and Canadian state and province legislators and governments more fully and more formally into the institutions of North America. Indeed, in recognition of the fact that the three NAFTA partners are all federations, Blank proposes that mutual recognition and subsidiarity be the appropriate operational instrument since they both serve as counterbalances toward excessive centralization:

> Europeans found that efforts to harmonize regulations at the EU level were inefficient, expensive and exhausting. The innovation was for each government to recognize regulations that had been put in place by the other governments, i.e. mutual recognition. In fact, our federal systems operate this way. We don't need separate licenses for each state we drive in. My New York State license is recognized not only by other US states, but in Canada and Mexico as well. The second policy is "subsidiarity," by which the Europeans mean that decisions should be taken as close as possible to the level of citizens. The aim is to build in from the beginning what the Europeans' learned along the way—that a critical function of the North American community should be to protect and invigorate local and regional identities. (Blank, 2002, pp. 11–12)

My assessment of these "bottom-up" approaches is that Wolfe wants to *democratize North American integration* by relegating NAFTA to the role of one (albeit still the most important) of many frameworks/agreements for conducting relationships on this continent. Blank, on the other hand, wants to *democratize NAFTA*, by arguing that with roughly 100 national and subnational governments (abstracting from the municipalities) in Canada, Mexico and the US, NAFTA should have purchase on more than just three of these. Implicit in both approaches, however, is that some of the trade disputes that currently defy resolution, because they get caught up in the high politics of the Ottawa–Washington–Mexico City power corridor might, in a more pluralistic, decentralized and subsidiarity-driven framework, be more likely to be defused in an out-of-the-limelight manner by the relevant cross-border interests.

4.6. Recapitulation

This completes the brief *tour d'horizon* of alternative blueprints for broadening and deepening NAFTA. The analysis attempted to be indicative rather than exhaustive in terms of the range of proposals and no attempt was made to canvass the views of free-trade opponents. Moreover, these are not mutually exclusive blueprints—adherents of grand or strategic bargains would have no problem at all with bringing sub-national governments more formally under the NAFTA umbrella, and for his part Blank is on record as being in favor of a permanent court on trade and investment. Finally, the emphasis was on airing differing perspectives with respect to reforming NAFTA, without any concerted effort either to assess the merits of particular perspectives or to reconcile them with others. I now turn to a comparative perspective and assessment in the concluding section, by speculating on what NAFTA at 20 might look like.

5. Conclusion

NAFTA and the FTA have been astoundingly successful in generating trade and integration among Canada, Mexico and the US. In the wake of this integration, several challenges have emerged. One is that in the process of reaping these benefits, Canada has undergone a dramatic transformation of its geo-economic space, so much so that for some policy purposes Canada is best viewed as a series of north–south cross-border economies rather than as a single east–west economy. Given that similar trading areas exist along the US–Mexico border, there are now important regional dimensions that have a stake in the future evolution of NAFTA.

A second challenge is that the transformation of the underlying economic infrastructure from three national systems toward one continental system is, if anything, accelerating as the process transcends physical infrastructure (transportation, energy grids, telecommunication systems, etc.) and involves not only electronic infrastructure but increasingly the range of areas coming under the umbrella of what Friedman (1999, p. 20) calls “software” (the regulatory system, competition policy, accounting and legal practices, commercial policy, and the like). This is part and parcel of the claim that North American trade and integration are running well ahead of the institutional capacity to efficiently accommodate these flows.

The third challenge is to reconcile international integration with preservation of national policy flexibility. This trancends NAFTA, as Ostry (1997, pp. 10–11) notes:

> The “shallow integration” of GATT, which centred mainly on the removal of [border] barriers, implied a preservation of national diversity . . . But the [WTO] agenda of deeper integration is . . . more intrusive and erosive of national sovereignty as it involves an intrinsic pressure for harmonization of diverse systems.

Most, if not all, of the above reform proposals wrestle in one way or another with this sovereignty dimension, as reflected in the emphasis on national treatment, mutual recognition, and equivalencies as avenues for reconciling different national policy preferences.

A final challenge or opportunity is the new issue of US homeland security as a domestic/foreign policy priority and the degree to which it might influence the evolution of NAFTA.

With these challenges as backdrop, the remainder of the conclusion draws inferences relating to how NAFTA might look a decade from now. Since this will be an issue-oriented rather than a detail-oriented exercise, let me make a blanket assertion to the effect that most, if not all, of the items in the Table 2 "wish list" will either be part of NAFTA at 20 or substantively addressed in alternative ways.

5.1. NAFTA at 20

The underlying force driving the shape of NAFTA at 20 is the force that led to the FTA and NAFTA in the first place—the relentless continentalization of diverse aspects of North American infrastructure. The emerging standards underpinning structural integration, especially in the software areas, tend to be set by international technical committees, international regulatory agencies, trade associations, international businesses, and institutions such as the World Bank, IMF, UN, etc., rather than by individual governments. This move in the direction of generally acceptable standards/principles will serve to level the playing field and facilitate both the broadening and deepening of trade and economic integration. In selected areas, NAFTA at 10 can accommodate this broadening of trade. In important new areas, however, NAFTA will need to be updated in terms of both substance and process to reap the benefits from on-going continental integration.

Deepening NAFTA is at the same time more complex and more difficult. Developing common standards may lead to deepening, but not necessarily always under the NAFTA umbrella. The CCCE recommendation (d'Aquino, 2003, p. 8) that the principle of "tested once" with respect to standards, inspection, and certification procedures could be implemented either as a stand-alone agreement or within a renewed NAFTA, is an example.

Among the forces serving to deepen North American integration by NAFTA's 20th anniversary will be the drive to strengthen economic integration within each of the three federations. Canada has begun the process of removing internal barriers. As Mexico's development proceeds, a free and well-functioning domestic market becomes ever more important. In the US, completing its internal economic union has never been a national priority, and in any event may not have been possible politically. However, the US will be under increased economic pressure to perfect its internal market. Whether this comes about via the harmonization of state regulations, or the adoption of the equivalent of national treatment at the state level, or by the acceptance of the principle of mutual recognition, the stage will then be set for a simultaneous broadening and deepening of NAFTA. States and provinces are already committed to full-blown internal economic integration in key NAFTA problem areas such as trucking regulation and sub-national government procurement. Hence, it will become much easier for US states to extend any reciprocity treatment to Canadian provinces since they would be extending it to their sister states. In a sense this is an extension of the principle of national treatment to the sub-national government level.

Sub-national governments will likely become the new motors for energizing NAFTA reform. Already, the governments of Ontario and Michigan are discussing cross-border trade and how to better manage the Ontario–Michigan border. Similar initiatives are in progress elsewhere along the US–Canadian and US–Mexican borders. Since the needs and interests of Michigan and Ontario are likely to differ from those of BC and Washington or those of Texas and Nuevo–Leon, it may be desirable for NAFTA to allow for sub-national/regional "understandings" that would enhance cross-border trade and access for these clusters (subject, presumably, to some overarching principles). From the US standpoint, it will not go unnoticed that many of the Canada-based firms likely to gain from such measures are in fact US-owned and that there is enormous potential for US export growth as Mexico reaps the benefits from North American integration.

The very definition of policy sovereignty or autonomy is changing rapidly in the information era. Global forces are progressively impinging on the ability of nation-states to control key aspects of policy, even within their own borders. One can view this as the development of a "global policy commons." Castells (1998, p. 330) applies this "global commons" analytical framework to the evolution of the EU when he observes that European integration has succeeded in part because the European Union does not supplant existing nation-states. On the contrary, it enhances their survival in spite of the forfeiture of some sovereignty by ensuring their greater say in region and world affairs in the age of globalization. Phrased differently, "nationalism, not federalism, is the concomitant development of European integration" (ibid, p. 327). Admittedly, what applies to multi-polar Europe may not carry over to US-dominated North America. Nonetheless, proposals for deepening that are unacceptable today may be welcome a decade from now, in the same way that Canadians are probably ready to embrace a CU today, even though this was deemed unacceptable during NAFTA negotiations.

In terms of strategic or grand bargains, it is certain that Canada and the US will undertake further initiatives relating to homeland-security/economic-security. As former Canadian Prime Minister Mulroney (2002, p. 5) noted, "our internal borders will only be smart if our external perimeter is secure." The more interesting question is whether homeland security can be exchanged for a deepening of NAFTA. If something like the CCCE proposal for a resource pact were included, there would be enough on the table to enable Canadians to achieve some of their objectives.

However, deepening in the sense of Gotlieb's (2003) conception of NAFTA as a "community of laws" is a more difficult goal, since it is not evident that the US would relinquish anti-dumping and trade-remedy laws in favor of coordinated competition policy and anti-trust law. Better, perhaps, to apply the rule of law initially to a less high-profile area, where success is more likely and then count on extending this to other areas as Americans become more comfortable with a rules/law-based regime and as the sense of a North American community gains momentum.

Two further policy issues could have important implications for NAFTA at 20. One is Canada's flexible exchange rate regime. Courchene and Harris (1999, 2000) argue that the Canada–US exchange rate has been too volatile, given Canada's degree of integration with the US. They argue that a fixed-exchange-rate regime is preferable and that the optimal fixed rate is North American Monetary Union (NAMU) anchored around the US dollar and modeled along euro and European Central Bank lines. Pastor (2001) is clearly in favor of NAMU, Hufbauer and Vega-Cánavas (2003) appear to be supportive, and Dobson (2002) accepts it as a possibility. In the interval between winning the election and ascending to the Presidency, Vicente Fox was a staunch advocate for deepening NAFTA, including the introduction of a common currency. Even though NAMU could play an important role in deepening North American integration, it appears that it remains an idea whose time is not quite nigh.

Canada's exchange rate regime affects the country's relations with the US in yet another way. Commenting on the dramatic depreciation of the Canadian dollar in the early 1990s (see Figs. 1 and 2), Pastor (2001, p. 110) is candid:

> A significant element of the timber problem—and, for that matter, many other trade problems—is due to foreign exchange rates. As long as the Canadian dollar sells for about two-thirds (65 cents) of the US dollar, Canadian exports will remain cheap, and a surge is likely to have dangerous effects, evoking threats of countervailing duties or antidumping from the United States. If the currencies were in better alignment, protectionist measures would diminish.

It is one thing to ignore this issue, as all Canadian proposals do. It is quite another for Canadians to ask for conversion of countervail and antidumping procedures to rules-based adjudication, without recognizing that the Americans will insist on ensuring that Canada does not use exchange-rate depreciation to undercut any such agreement. This is just one area where Canada can influence the degree to which NAFTA may be deepened.

The second policy issue impinging on NAFTA at 20 is the proposed Free Trade Area of the Americas (FTAA), which would embrace 34 countries, 800 million people and an annual GDP of US$ 12.5 trillion. The FTAA and NAFTA could well get caught up in the "European dilemma"—deepening NAFTA may preclude meaningful broadening to encompass the remaining countries of the FTAA, and broadening may inhibit deepening. None of the Canadian proposals highlighted above devotes any attention to the FTAA.

It is clear that the underlying infrastructure of North America will continue to evolve along continental lines, deepening interdependence and creating common interests and goals among North Americans. NAFTA will continue to be a key vehicle on this journey.

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