

THE CANADA INSTITUTE

One Issue, Two Voices

Free Trade in Free Fall? Canada–U.S. Nontariff Barriers

Drawing on expertise from both sides of the Canada–U.S. border, the *One Issue, Two Voices* series is designed to stimulate dialogue on policy issues that have a significant impact on the bilateral relationship. This eighth issue examines the extent to which the smooth flow of goods and people across the border is being eroded by mounting restrictions. Authors Gary Hufbauer and Claire Brunel of the Peterson Institute for International Economics and Michael Hart of Carleton University's Norman Paterson School of International Affairs are leading international trade experts. Here they assess the cost of U.S.–Canada nontariff barriers in terms of economic prosperity and global competitiveness.

In theory, the Canada–U.S. Free Trade Agreement and NAFTA reduced the red tape involved in crossing the border, but, in practice, regulations have multiplied. Even before 9/11, the border had become a dysfunctional place in dire need of an overhaul to accommodate the tripling of trade volume over the past 20 years. Although both the United States and Canada stand to gain economically from minimizing impediments to the movement of merchandise and people between them, the asymmetry in their relationship means that it falls to Canada, the smaller economy, to initiate action.

Our authors flag the key nontariff barriers undercutting trade and prescribe ways to tackle them. Hufbauer describes the border as an obstacle that reduces trade by about 50 percent. He cites separate U.S.–Canada currencies as a major hindrance and says a common currency might boost cross-border trade by as much as 70 percent. Similarly, he suggests that Canada could provide a quick solution to eliminating regulatory trade barriers simply by adopting large swaths of U.S. standards. He recognizes, however, that although these measures would benefit Canada economically, Canadians would view them as a mass surrender of sovereignty. Hart also targets regulatory differences as blocking trade between the United States and Canada, but he differs from Hufbauer in his solution. Both countries, he says, should agree that all new or amended regulatory requirements be convergent, unless there is a compelling reason to regulate differently.

Both authors express concern that increased security measures and reduced trust threaten to choke cross-border trade. Hart maintains that the border protects Canadians and Americans from each other, but not from global security threats, and that failure to rebuild trust will doom prospects for North American economic integration.

The Canada Institute thanks the authors for their contributions to our understanding of a complex topic in the ongoing bilateral dialogue. We are grateful to the Canada Institute on North American Issues for its support.

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Economic Integration in North America

Although North American economic cooperation stretches back to the early decades of the 20th century, the Canada-U.S. Free Trade Agreement (CUSFTA) of 1989 gave a real kick-start to economic integration between the two countries. By the end of 2006, the combined U.S. and Canadian economies produced a gross domestic product of more than US\$14 trillion and contained a population of 335 million. U.S.-Canada bilateral trade reached US\$550 billion (up from just US\$163 billion in 1989), the two-way foreign direct investment stock totaled US\$497 billion (compared to US\$104 billion), and more than 30 million Americans and Canadians crossed the border to the other country.

Yet, for all the traffic in merchandise, investment, and people, the two economies are still far from integrated. Perhaps the most important consequences of this gap are productivity differentials and salary disparities—both to the disadvantage of Canada, the smaller economy by far. For brevity, we focus on two direct indicators of separation: low trade densities and large price divergences. These factors are important not only in their own right but because they foster underperformance in the Canadian economy.

The national border reduces the volume of trade in merchandise by about half. In other words, after taking account of city size and distance, U.S. and Canadian cities would trade twice as much with each other were it not for the border between them.¹ To be sure, 20 years ago the effect of the border was much stronger, and CUSFTA has made a lasting difference in reducing barriers.² But the border still poses a huge obstacle. After allowing for distance and income, trade between the states south of the border is more than twice as robust as trade between the states and the provinces across the border. The border effect is especially costly for Canada because it is more dependent on foreign commerce.

Large price divergences are the companion to low trade densities between U.S. and Canadian cities.³ Although United States-Canada divergences are smaller than those observed between countries in other regions of the world, it is worrying that, in the years since CUSFTA was implemented, little progress has been made in compressing price differentials between U.S. and Canadian cities.⁴

Three key factors account for these limits on economic integration in North America: different currencies, the rising security tax, and regulatory barriers.

Different Currencies

Separate U.S. and Canadian dollars, mediated by a floating exchange rate, have performed well in absorbing the macroeconomic forces that differentially shape the U.S. and Canadian economies. Canada is far more affected than the United States by the natural resource cycle. Without separate currencies and a floating exchange rate, Canada would experience sharp inflation during resource booms, and sharp deflation during resource busts. Moreover, the United States often attracts huge inflows of foreign capital which, on occasion, leads to a super-strong U.S. dollar against world currencies. Without a floating exchange rate, the Canadian dollar would also appreciate during these episodes, perhaps to the detriment of Canadian economic activity.

Reflecting the resource cycle and other forces, the Canadian dollar has moved from US\$0.84 in December 1989 to a low of US\$0.63 in January 2002 and a robust US\$1.03 in November 2007. The Canadian pay packet now buys almost 50 percent more in U.S.

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dollar terms than it did in 2002. But these exchange-rate swings show up only slowly in price changes. A weaker Canadian dollar does not automatically raise prices at the checkout counter, just as a stronger Canadian dollar does not necessarily mean that Canadian consumers pay fewer Canadian dollars for imported goods or their locally made counterparts.

Certainly, a stronger Canadian dollar makes the U.S. market less attractive for Canadian exporters. Firms have a choice: raise their export prices in U.S. dollar terms or trim their profit margins. “Sticky” prices, in the wake of exchange-rate changes, are the rule—indicating that firms typically adjust their profit margins, rather than their prices, for a period of time thereafter.⁵ Because retail prices also reflect the costs of rental space, clerical wages, and other non-tradable inputs, the effect of an exchange rate is further diluted in the final consumer price of imported goods.

To summarize, large price divergences, like low trade densities, are an inevitable corollary of separate currencies. According to one model, a common currency might boost U.S.–Canada trade by 50 to 70 percent; other estimates suggest that separate currencies dampen commerce to the same extent as a 26 percent tariff.⁶ In other words, Canada’s monetary independence acts as a major barrier to economic integration—but a barrier that, in Canadian eyes, is well worth the price.

Until Canada decides to adopt the U.S. dollar, formally or informally, and hitch its business cycle more closely to the American rhythm, further integration will confront natural limits. As with everything else in economic life, Canadians have a choice: deeper integration or monetary independence. For the foreseeable future, they will continue to choose monetary independence.

The Rising Security Tax

Since September 11, 2001, a heavy emphasis on security has “thickened” the border. The United States, preoccupied with its efforts to deter terrorists, munitions, and weapons of mass destruction from entering the homeland, has focused on controls at sea ports, airports, and the land borders. Inevitably these controls at the northern border, rather than at the North American perimeter, hamper commerce between the United States and Canada. Moreover, illegal immigration and drug trafficking across the Mexican border have merged in the American public mind with the terrorist threat as a reason for ever stricter controls.

Thus, in October 2007, the U.S. Senate enacted border security measures costing US\$3 billion almost unanimously (95 votes to 1). To be sure, there is a huge difference between spending rates, per mile of border, on the northern and the southern borders. Illegal immigration and drug trafficking are obviously concentrated in the south; in fact, illegal penetrations at the Canadian border are less than 1 percent of those along the Mexican border. Most of the new money will pay for vehicles, observation towers, fencing, and Border Patrol agents along the Mexican border. To cite just one statistic, about 12,000 U.S. Border Patrol agents are deployed along the Mexican border (1,933 miles), compared with only 1,000 along the much more extensive Canadian border (5,525 miles).

Lighter protection of the northern border makes eminent sense from a risk standpoint but causes a lot of worry among armchair generals. These folks often indulge in wild “what if” stories, as they point to small ports of entry left unattended overnight and unmonitored state roads located near the Canadian border. The sheer length of the border, especially during episodes of severe weather, adds further grist for scare stories.

General Accountability Office investigators were able to successfully simulate the smuggling of contraband between Canada and the United States without being detected.⁷ In

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one simulation, the investigator crossed into Canada by foot, stood on the other side of the border for about 15 minutes, and then returned to his vehicle in the United States without attracting attention. Such episodes obviously ramp up fears in the halls of Congress, but comparable simulations, involving home-grown U.S. terrorists bent on destroying metro systems, reservoirs, and power grids, are not disclosed, even if they are conducted. The American public receives a highly slanted appraisal of security risks—a bias that stresses external threats rather than internal vulnerabilities.

Cargo Troubles

Many ports of entry were built decades ago to accommodate much smaller flows of people and merchandise. Even before September 11, 2001, land borders, sea ports, and airports were already struggling to accommodate growing traffic loads. Stringent security regulations now require state-of-the-art scanning equipment and highly trained operators. Superimposed on pre-existing congestion, these new procedures can only result in higher costs for moving cargo, longer crossing times, and missed business opportunities.

Mindful of these problems, Canadian and U.S. officials have tried to ease border frictions through the Smart Border Accord of 2001 and the Security and Prosperity Partnership of 2005. The North American Competitiveness Council has offered its own recommendations, including a new crossing between Detroit and Windsor to alleviate traffic. In principle, Canadian exporters can resort to self-help via certification in the Customs-Trade Partnership Against Terrorism (C-TPAT) program. The costs are high, but this agreement is one of the better methods for locating security checks away from the congested border.

Even with these patches, however, the security tax is rising. One response among affected firms is simply to dismiss low-friction border crossings as an unattainable dream. Some Canadian companies are reverting to pre-FTA methods for exporting to the United States: they pre-ship goods and keep inventories on both sides of the border to ensure on-time delivery.⁸ Another response is to instruct trucking firms to drop goods on their side of the border for pick up by a domestic trucking company on the other side, thereby reducing the costs of security clearance. Such responses may be practical, but they clearly erode the benefits of CUSFTA and the North American Free Trade Agreement.

The next ratchet on the security wheel promises to impose additional costs. U.S. legislation now requires all containers entering the United States to be scanned; this mandate will be implemented over the next five years. Fortunately, in 2005, the United States and Canada signed a Container Security Initiative Partnership Agreement, with the goal of pre-screening imported goods destined

for North America. More than 50 ports around the world currently participate in the program, but so far only shipments identified as potential risks are scanned in foreign ports.

Generalizing container scanning to all shipments entering the United States or Canada will pose serious practical problems. To ease the task of security monitoring, the Bush administration expects the law to decrease the number of ports shipping to the United States from 700 to just 100 in total.⁹ But congestion costs will rise as freight is consolidated in a handful of large, well-equipped ports for scanning and ultimate shipment to Canada and the United States. In fact, port operators predict that the waiting time for loaded containers will increase from five to seven days. One study estimated that 100-percent container scanning could slow each 20-foot equivalent unit by as much as 5.5 hours, depending



A U.S. Customs and Border Protection officer in Buffalo, New York, checks a tractor-trailer for clearance after crossing from Canada in a special truck clearing lane with Free and Secure Trade (FAST). Started in 2002, FAST permits an expedited customs clearance for cargo if all paperwork is submitted in advance to the border crossing point.

on the scanning method used.¹⁰ The global shipping industry has voiced its concerns, but complaints are unlikely to postpone the new requirements.

Owing to the Container Security Initiative, however, sealed cargo arriving in Canadian ports for onward shipment to the United States should not have to be scanned a second time at the U.S.–Canada border. But until some sort of joint inspection force is agreed upon between Canada and the United States, other containers arriving from Canada loaded with Canadian merchandise will have to be scanned at the border—invariably leading to higher costs and longer shipment times.

The ultimate goal should be inspection of all North American containers at their points of origin, followed by sophisticated tracking as trucks, railcars, cargo planes, and ships haul merchandise across land, air, and sea borders. Even when this goal is achieved, goods originating in Ontario and shipped to Illinois, for example, will bear a higher security tax than goods originating in Ohio and shipped to Illinois. With more efficient technology, and with inspections calibrated to risk, the security tax on Canadian merchandise can be reduced. But until that distant day when Americans living in Illinois feel equally secure about goods originating in Ontario and goods originating in Ohio, the security tax will continue to impede economic integration.

Travel Woes

As travelers know too well, restrictions escalated sharply after the 9/11 terrorist attacks. Since January 2007, the Western Hemisphere Travel Initiative has required citizens of the United States, Canada, Mexico, Bermuda, and the Caribbean who are traveling by air through the region to hold a passport. The same requirements will apply to land and sea travelers in the summer of 2009. This rule will hamper cross-border traffic between the United States and Canada because many citizens lack passports, the cost of getting one is high (about \$100 in the United States), and the processing backlog is a month or longer.

The U.S. government is developing a new form of identification—the PASS card—to provide travel credentials that cost less than a passport. However, these cards will be available only to U.S. citizens and will be valid only for land and sea travel, not air. To facilitate border crossing by frequent travelers, other official measures are being designed to move the security process away from the border (SENTRI, NEXUS, FAST). So far, however, these mechanisms have worked better on paper than in practice. One 2005 survey by the Conference Board of Canada suggests that U.S. residents would make 12.3 percent fewer visits to Canada in 2008 because of the new passport requirements.¹¹

In addition to their immediate disruptive effect, security issues feed American political opposition to freer trade. At the Montebello summit in August 2007, the three North American political leaders attempted to meet this challenge. They instructed their ministers to develop common inspection protocols to avoid duplication and to explore new ways of moving inspection and screening away from the border. Judging from past initiatives, however, this latest thrust will make little difference to either travelers or merchandise. Until the United States and Canada reach the same degree of trust and cooperation that the Schengen countries of Europe have achieved,¹² crossing the border will be cumbersome for both people and goods.

Regulatory Barriers

Regulatory barriers are rightly blamed as a key factor in separating the U.S. and Canadian economies. But attempts either to harmonize North American standards or to embrace

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the European concept of mutual recognition run into three obstacles: first, even small steps require huge amounts of effort, and the political payoff to national leaders often seems negligible; second, many firms are happy to be protected by their own local standards against foreign competition; and third, national regulatory agencies prize their missions and their jobs, and are loath to surrender bureaucratic turf.

Recognizing the cost that regulatory barriers impose, U.S., Canadian, and Mexican leaders have launched the Regulatory Cooperation Framework as part of a wider Security and Prosperity Partnership. Its announced goal is to streamline regulatory processes so as to avoid redundancies and to promote transparency in both rule-making and information sharing. For example, in one initiative the three North American countries are exploring a common scientific foundation to evaluate labeling and health claims; in another, financial regulators are working to eliminate the withholding tax on cross-border interest payments. The goals are lofty and desirable, yet at the Montebello summit, the leaders spent time harmonizing food safety rules for a trivial item—jelly beans.¹³

Multiple regulatory systems take resources away from both productive investment and research and development, and so undermine the incentives to innovate.¹⁴ Obviously, the payoff from serious regulatory convergence would be substantial. The North American market space would be less fragmented and the number of entrants in any given market would rise, increasing the scope for knowledge spillovers. Small and medium-sized firms, as well as giants, could then sell across the border without changing their product specifications. Production runs could be longer, and fixed costs per unit could be lower.

That said, the obstacles to any quick removal of regulatory barriers are very real. From an economic standpoint, Canada would benefit from simply adopting large swaths of U.S. regulatory standards, particularly those that are newly issued. From a political standpoint, however, any acceptance of U.S. standards would be caricatured in Canada as a mass surrender of sovereignty. The most we can realistically envisage is a modest and cooperative attack on a few high-profile regulatory barriers. And, for this assault, we suggest three targets: rules of origin, food safety, and CO₂ emissions.

When NAFTA was implemented in 1994, complex rules of origin were built into the pact to satisfy special interests. Three rounds of reforms have since liberalized some of the rules, but those remaining still impose large compliance costs—especially on Mexican and Canadian producers who use more third-country inputs than U.S. producers do. Various approaches have been suggested for simplifying the rules, ranging from a common external tariff to value-added rather than change-of-tariff-heading rules.¹⁵ With consistent goading from top leaders, drastic reforms should be possible over the next four years.

Food safety is an area where common Canadian and American standards should cover at least 90 percent of the trade. After all, 30 million Canadians and Americans eat in the other country during their annual travels. High-risk products, such as meats and leafy greens, rightly undergo systematic inspections—but there is no reason why these inspections cannot be performed according to the same standard in both countries.

A third area where cooperation is overdue is CO₂ emissions. The United States is the second largest emitter of CO₂ in the world. Without constraints, Canada will have the highest energy-related carbon dioxide intensity among the OECD countries by 2030.¹⁶ Both countries have room for improvement, but conflicting CO₂ emission standards could potentially disrupt trade. Controlling CO₂ has gathered considerable political appeal thanks to Al Gore, melting glaciers, and drought. Currently six major bills in the U.S. Congress aim to limit carbon dioxide and greenhouse gas emissions by as much as 80 percent below 1990

levels over the next 30 years. If any regulatory subject cries out for cooperation between Washington and Ottawa, this is it.

Notes

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3. Price differentials have been examined by many scholars. One recent contribution is Michael A. Anderson and Stephen L.S. Smith, “Borders and Price Dispersion: New Evidence on Persistent Arbitrage Failures,” paper prepared for the Mid–West Economics Meetings, Indiana University–Purdue University Indianapolis, April 30–May 2, 2004.
4. Steven Golberman and Paul Storer, “Canada–US Free Trade and Price Convergence in North America,” *American Review of Canadian Studies* 35(3) (September 2005): 423–52.
5. For a discussion of the effect of demand conditions on prices and profit margins, see Carolyn Evans, “The Economic Significance of National Border Effects,” *American Economic Review* 93(4) (September 2003): 1291–1312. For certain industries, such as the automobile industry, a high level of intra–industry trade provides a large element of “natural hedging” against exchange–rate fluctuations. See Maurice Obstfeld and Kenneth Rogoff, “Perspectives on OECD Economic Integration: Implications for US Current Account Adjustment,” Federal Reserve Bank of Kansas City Symposium Proceedings, 2000.
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7. U.S. General Accountability Office, *Border Security: Security Vulnerabilities at Unmanned and Unmonitored US Border Locations*, September 27, 2007 (Publication No. GAO–07–844T), retrieved October 21, 2007, from GAO reports, via GPO Access: <http://www.gao.gov/new.items/d07884t.pdf>. The simulated smuggling episodes were launched from four states.
8. “Is Just-in-Case Replacing Just-in-Time? How Cross-Border Trading Behavior has Changed since 9/11,” Conference Board of Canada International Trade and Investment Center and Center for National Security, June 2007.
9. John W. Miller, “US Laws to Alter Tack of Global Shipping,” *Washington Post*, October 25, 2007, p. D5.
10. Susan E. Martonosi, David S. Ortiz, and Henry H. Willis, “Evaluating the Viability of 100 Percent Container Inspection at America’s Ports,” *Rand Corporation*, June 2006. Also see Christopher Koch, Testimony Regarding H.R. 4954, “The Safe Port Act,” before the House Committee on Homeland Security, April 4, 2006.
11. “The Potential Impact of a Western Hemisphere Travel Initiative Requirement on Canada’s Tourism Industry,” report prepared by the Conference Board of Canada for the Canada Tourism Commission, July 2005.
12. The Schengen Agreement, which established the Schengen visa and the Schengen Information System, removes border controls at the internal borders of the Schengen member states, establishes common rules on checks at the external frontiers, provides for a common visa policy, and introduces new measures in police and judicial cooperation for criminal cases. The current Schengen area consists of 21 EU members—Austria, Belgium, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Italy, Greece, Hungary, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Slovakia, Spain, and Sweden—plus Norway and Iceland.
13. “Diverted by Jelly-Beans,” *The Economist*, August 25, 2007, p. 36.
14. Stefano Scarpetta and Thierry Tresselt, “Productivity and Convergence in a Panel of OECD Industries: Do Regulations and Institutions Matter?” OECD Economics Working Paper No. 342, September 25, 2002.
15. For the CET approach, see Gary Clyde Hufbauer and Jeffrey J. Schott, *NAFTA Revisited: Achievements and Challenges* (Washington, D.C.: Peterson Institute for International Economics, 2005). For the value-added approach, see Michael Gasiorek, Patricia Augier, and Charles Lai-Tong, “Multilateralising Regionalism: Relaxing Rules of Origin or Can Those PECS Be Flexed?” Paper prepared for the WTO–HEI conference “Multilateralising Regionalism,” Geneva, September 10–12, 2007.
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Michael Hart

What About the Border?

For more than 150 years, Canadians and Americans have been negotiating agreements to reduce the impact of the border between them. For most of the second half of the 20th century, they enjoyed steady success in several areas: in trade in goods; in tourism and business travel; and, aided by military, intelligence, and police cooperation, in ensuring the safety and security of citizens in both countries.

To be sure, progress has not been universal or even steady. At one time, Canadians pursued misguided efforts to control and deter American investment in Canada. Even today, some Canadians and Americans are wary of benefiting from each other's comparative advantage. And there is always a political market in Canada for bouts of anti-Americanism, just as there is one in the United States for paranoia about socialist ideas seeping into the republic from Canada. Asymmetry in size leads to inequality in attitudes: Canadians are much more aware of matters American than the other way around—sometimes malevolently so.

Since the 1930s, however, the two governments have worked consistently to find ways to work together and to develop rules and procedures that will ease social and economic interactions among their citizens. Most Americans and Canadians have supported these initiatives.

The last few years have seen a steady erosion of this progress, in both attitudes and effort. The long shadow cast by the tragic events of September 11, 2001, brought home to both Canadians and Americans the radically different security context of the new century. Rather than a nuclear confrontation between two superpowers and their allies, today's threats come from a wide range of groups capable of wreaking quick havoc and withdrawing into the shadows. The U.S. response has been to intensify domestic security efforts and to harden external borders. As the American analyst Peter Andreas points out: "The politicization of the border has unsettled the traditional special US-Canada relationship and brought to an end what had been a mutually convenient low-maintenance approach to border control matters ... [Canada is] far more economically tied to and dependent on the United States than the other way around, and thus [is] much more vulnerable to security-related disruptions in cross-border flows."¹

Trade and investment numbers are still impressive, but worrying signs are emerging in cross-border travel statistics, anecdotes about investment intentions, and discussions of border-related costs to industry and government alike. The reason is easy to find—increased anxiety about security and reduced trust—a trend that is obviously not good for either country.

Managing Our Common Border

There are two ways to proceed: incrementally, building on the step-by-step progress made to date in reducing impediments to the cross-border movement of people and goods; or, boldly negotiating new instruments to equip the two countries with the rules and institutions they need now and in the future to manage threats to their mutual security and prosperity. Five issues are critical to meeting this bolder approach: a renewed security partnership, better border management, greater regulatory cooperation, infrastructure integrity, and institutional capacity.

A Renewed Security Partnership

As the country closest to the United States, both physically and temperamentally, Canadians are well placed to work with Americans in advancing common security interests. While our interests may not always be identical, they are sufficiently similar to make cooperation and joint efforts mutually beneficial. Even in areas where the two governments might have different appreciations and priorities, Canada is more likely to satisfy its own requirements by cooperating with the United States than by working at cross-purposes.

A mutually beneficial security relationship is critically dependent on trust, which in turn takes time to build. Past experience has demonstrated that bilateral institutions, when they work well, can be a vehicle for building trust, leveling the playing field, and exposing Americans to Canadian concerns and interests—and vice versa.

Institutions are also instruments for managing expectations through the advancement of shared norms, rules, and standards of behavior and action. Progress has been made over the last few years, but the new challenges that have emerged in the Canada–U.S. security relationship suggest that traditional policy frameworks and assumptions will have to be carefully re-examined. Failing to rebuild trust will doom any progress on the remaining issues.

Border Management

The second challenge is to address the increasingly dysfunctional impact of conventional border administration. The intensity of the cross-border relationship is apparent from the 36,000 trucks and the nearly 400,000 people who cross the border every day. Nevertheless, even after two decades of “free” trade, the bilateral border continues to bristle with uniformed and armed officers determined to ensure that commerce and interaction between Canadians and Americans comply with an astonishing array of prohibitions, restrictions, and regulations. The list of rules and regulations for which the border remains a convenient, and even primary, enforcement vehicle has grown, rather than diminished, since the implementation of free trade, particularly in response to the new security realities created by 9/11.

Administering the physical border imposes high costs on the two governments, on firms and individuals who use the border frequently to conduct their affairs in the integrated North American economy, and on the two economies—especially in terms of opportunities missed in reaping the full benefits of deep integration. The result is not an integrated, single North American market, but two markets with many cross-border ties that remain hostage to the efficiency and reliability of customs clearance.

In addition to routine customs and immigration activities, both governments use border controls to interdict illegal immigration, drugs, terrorism, and other criminal activities. Experience suggests, however, that the cost of border administration to pursue these goals is out of proportion to the results. The border is simply too long and too porous to prevent determined cross-border criminal activity. It is highly unlikely that border checkpoints will achieve any significant improvements in results without extraordinary investments in human and physical infrastructure. The screening process for illegal activity can simply be handled more effectively and efficiently through other initiatives.

The two governments need to find better ways to address border enforcement—by strengthening institutional contacts, enhancing cooperation, and sharing information on matters small and large. They must explore further investments in intelligence gathering and focus more on initial entry points into North America. They should also make

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greater investments in infrastructure and in technology, both at ports of entry and at the corridors leading to such ports. Rather than following current inspection methods, they should rely more on risk assessments and random inspections. Finally, they should expedite negotiations to achieve convergence in U.S. and Canadian policies in matters such as pre-clearance programs for cargo and passengers, all types of border-related law enforcement, and decision-making procedures for immigration and refugee status.

In contrast to the passage of people and merchandise, the cross-border exchange of services takes place without much government notice. Some of these services are exchanged electronically, some are eventually embedded in goods, and the overall extent of this trade is difficult to measure. Nevertheless, certain parts of this trade in services, particularly professional and entertainment services and economic transactions that require the movement of people across the border, are subject to border administration. Both the Canada-U.S. Free Trade Agreement and the North American Free Trade Agreement include provisions to facilitate the temporary movement of business people across the border, though, unlike the Schengen Agreement in Europe, they in no way allow for the free movement of labor between the two countries.

Given the extent of cross-border integration, the two governments have taken steps to address border congestion, but with limited results. Efforts to make the border less intrusive and more efficient were integral to the 1996 Shared Border Accord, the 1999 Canada-United States Partnership Forum, the 2001 Smart Border Accord, and the 2005 Security and Prosperity Partnership. These initiatives, however, have been limited by the decision to work within the confines of existing legislative mandates; they are aimed less at eliminating or limiting the impact of the border than at making that impact more efficient. Rather than these minor steps, the objective for politicians and officials working on this file should be to create a border that is considerably more open and less bureaucratic, within a North America that is more secure.

Regulatory Cooperation

If cross-border markets are to work more effectively, it is essential to reduce the regulatory differences between Canada and the United States. Both governments need to ask whether they are ready to proceed to a more formal, treaty-based process of regulatory cooperation aimed at eliminating the tyranny of small differences. If they agree on this point, much of the rationale for customs administration at the border will disappear.

Regulatory divergence with the United States undermines Canadian competitiveness and results in lost investment. A coherent program of cross-border cooperation is likely to strengthen Canadian regulatory outcomes, even one that requires Canada to do much of the adjustment. More to the point, bilateral regulatory convergence will promote the adoption of best practices rather than reliance on the lowest common denominator.

Compliance with different national rules, together with redundant testing and the certification of products and providers for different markets, raises costs for manufacturers operating in the North American economy. Complex and lengthy product- or provider-approval procedures slow down innovation, frustrate new product launches, and protect domestic producers and providers from foreign competitors. For smaller firms, the cost of acquiring knowledge of and access to another country's regulatory regime inhibits attempts to develop markets in those regions.

For consumers, regulatory divergence is tantamount to a concealed “inefficiency tax” that citizens pay on virtually everything they purchase. This tax is the sum of the costs

of duplicate regulations, border administration delays, and other regulatory impediments. For businesses, higher costs of compliance hinder their international competitiveness and complicate the most efficient deployment of scarce resources. For governments, regulatory divergence increases risk, reduces efficiency, and leads to less than optimum outcomes in achieving regulatory goals.

Infrastructure Integrity

The extensive flow of two-way trade between Canada and the United States is critically dependent on the sophisticated infrastructure developed by both the public and the private sectors. The Canadian Border Services Agency and the U.S. Customs and Border Protection bureau maintain 135 land border crossing facilities along the 5,525-mile border, some of them jointly. The most important of these facilities link major Canadian and U.S. highways, including bridges jointly maintained or supervised by the two countries. As a result, major Canadian roads now connect to the U.S. interstate highway system, facilitating the burgeoning trade carried by a growing fleet of trucks owned by entrepreneurs on either side of the border. Trucks now carry about 63 percent of the value of bilateral trade in goods.

Canada's two major railroads have made substantial investments over the past 20 years to integrate their Canadian operations more fully into a North American rail freight system. They operate 32,000 miles of track in both countries and earn more than half of their annual revenue from U.S. and cross-border operations. Partnership and interlining arrangements allow both railways to serve customers seamlessly throughout Canada and the United States. About 17 percent by value of bilateral trade in goods is moved by rail.

Along the St. Lawrence Seaway, Canadian and American ships carry bulk materials from deep inside the continent at Thunder Bay, Duluth, and Chicago to Montreal, Halifax, New York, Philadelphia, and overseas. Ocean-going ships bring in goods from all over the world to Montreal, Toronto, Erie, Cleveland, Detroit, and Chicago. Package freight services maintain a presence in most Canadian and U.S. cities and make it possible for shippers and consumers alike to ensure delivery of time-sensitive material within 24 hours anywhere in North America.

More than 10 percent by value of bilateral trade moves quietly across the border through pipelines and along transmission grids to power offices and factories, heat homes, and fuel cars. Canadian and American electric power companies have built extensive cross-border transmission lines to integrate regional electricity grids. Canada is a net exporter of electricity, as excess capacity in Quebec, New Brunswick, Manitoba, and British Columbia is sold to power hungry consumers across the United States. Gas pipelines similarly deliver Alberta natural gas to consumers across North America. Finally, more than 1.9 million barrels of oil per day are exported from Alberta and Saskatchewan through a second grid of pipelines.

Today, any airline in either country can serve any cross-border route it considers profitable. As a result, six Canadian cities—Halifax, Montreal, Toronto, Winnipeg, Calgary, and Vancouver—have become hubs for service into the United States, and other cities are served on a point-to-point basis to one or more U.S. cities. On any given day, hundreds of flights by both Canadian and U.S. airlines cross the border, serving travelers between the two countries as well as a growing number of passengers using Canadian and U.S. gateways to fly to other parts of the world.

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Maintaining the integrity and security of this complex of cross-border infrastructure has become a matter of growing concern. Similar to the steps taken to ensure that airline passengers are screened for lethal tubes of toothpaste and deadly fingernail clippers, the security of North America's ports, airports, and border crossings involves symbolic rather than effective steps. Although some matters can be addressed by either country on its own, it is essential for both of them to address the integrity of this infrastructure as a shared concern requiring joint solutions. More will be gained, for example, from joint intelligence gathering and police cooperation than from the kind of screening mechanisms now in place.

Institutional Capacity

Finally, Canadians and Americans will need to develop the institutional capacity required to address the much more complex relationship that is emerging on both the security and economic fronts. Unlike other bilateral relationships enjoyed by Canada and the United States, there is no institution to provide political oversight of the relationship, nor are there regular meetings between heads of government, foreign ministers, or trade ministers, and no formal structure of committees looking at the relationship in a coherent and coordinated manner. The absence of formal structure results from a determined and largely successful effort to treat issues in the relationship vertically rather than horizontally and to build firewalls to prevent cross linkages. This method of management derives, in part, from Canadian fears that, as the smaller partner, its own particular interests would be overwhelmed in any more formal relationship, and also from the U.S. system of governance that makes coherence and coordination in both foreign and domestic policies extraordinarily difficult to achieve on a sustained basis.

The institutional gap is filled by inspired *ad hocery*. The interconnected natures of the two economies require Canadian and U.S. officials to work closely together to manage and implement a vast array of similar but not identical regulatory regimes—from food safety to refugee determinations. Political leaders and officials have developed a dense network of informal cooperative arrangements to share information, experience, data, and expertise with a view to improving regulatory outcomes, reducing costs, solving cross-border problems, implementing mutual recognition arrangements, and establishing joint testing protocols. On any given day, dozens of U.S. and Canadian officials at federal, provincial, and state levels are working together, though most of this activity takes place below the political radar screen. Little of it is coordinated or subject to a coherent overall view of priorities or strategic goals.

Much can be achieved on the basis of existing networks of cooperation, but more can be done if the two governments commit to the establishment of a limited number of bilateral institutions with a mandate to provide them with the necessary advice and information to bring about a less-intrusive border and a more secure North America. An independent Canada-U.S. Secretariat with a mandate to drive the agenda and report annually to the president and prime minister on progress could, for example, prove critical to overcoming bureaucratic inertia. Similarly, a Joint Advisory Board could contribute some creative drive to the development of new bilateral initiatives.

Conclusions

The Canadian and U.S. economies have become intertwined in response to demands by Canadians and Americans alike for each other's products, services, capital, and ideas, creating jobs and wealth across many sectors and accelerating the forces of mutually beneficial

cross-border integration. The border as presently constituted protects Canadians and Americans from each other; it does not protect Canadians and Americans from global security threats. It also presents a risk to the wealth-creating flow of people, goods, services, and capital between the two countries. In order to address global security concerns and expand cross-border economic opportunities, Canadians and Americans need to develop greater confidence in each other and initiate cooperative solutions to common problems—from threats to their security to building a competitive platform from which to tackle global markets.

Notes

1. Peter Andreas, “The Mexicanization of the US-Canada Border,” *International Journal* 60(2) (spring 2005): 449–50.



A U.S. Customs agent stands guard at the inauguration of the Customs Trade Partnership Against Terrorism (C-TPAT) program at the U.S.–Canadian border in Detroit, Michigan. C-TPAT, a joint government-business initiative, seeks to provide the highest level of international commerce security while at the same time expediting processing at the U.S. border.

Gary Hufbauer and Claire Brunel's Response

We find much agreement with Michael Hart. Regulatory convergence, better infrastructure, and stronger institutional bodies are all essential to further the economic integration of North America. Canadian provinces and U.S. states are making progress, and so are the federal governments, but the pace is too slow. Meanwhile, transatlantic cooperation seems to be moving at a faster clip. The United States and the European Union are taking concrete measures to cooperate on regulatory standards and import safety. In fact, to reduce the costs of transatlantic shipping, the United States plans in 2009 to recognize the EU's Authorized Economic Operator program (dealing with port and container safety) on par with U.S. measures.

That leaves North American security as the central issue on which we appear to differ with Michael Hart. Let's start with obstacles to the free circulation of merchandise originating in the United States and Canada, and the free movement of citizens between the two countries. To get rid of border restrictions on these categories of goods and people, the United States first needs to accept the proposition that Canadian merchandise poses no greater threat to the Empire State Building than Texan merchandise, and that Canadians are not more prone to terrorism than Californians. Canadians need to accept reciprocal propositions about U.S. merchandise and Americans. Alas, the requisite level of trust that must precede popular acceptance of these propositions is not in sight—at least not in the United States.

If Canada wishes to accelerate the trust-building process, it could, on a unilateral basis, open its borders without any security checks to U.S. merchandise and American citizens. We doubt that the Canadian government is prepared to make a non-reciprocal concession of that magnitude. If it is, then Hart's security agenda would take a great leap forward.

As a more timid step, Canada and the United States might agree that citizens with high-tech passports could enter through rapid travel lanes, simply by placing their passports on a scanner—akin to those at use in metro stations but linked to a large flat-panel split-screen display of both the person's face and the passport photo. This suggestion should not be controversial, and, if adopted, it would ease the cross-border flow of citizens in airports and on major highways. However, while 40 percent of Canadians have passports, the figure stands at a low 25 percent in the United States. On both sides of the border, 100-percent passport usage is still some ways off. As a constructive interim step, both countries should waive all fees for passport applications submitted between 2008 and 2010.

The burden of the border could also be alleviated for U.S. and Canadian merchandise traveling between the two countries. Goods made in Canada, whether from Canadian or foreign components, could be examined and certified at the originating factory according to rules and personnel agreed on by both countries. If the merchandise was then sealed and tracked all the way to the border using high-tech equipment, it could travel through to the United States with no further inspection. Such security checks at originating factories, however, could prove to be costly and cumbersome. In a way similar to the 100-percent scanning measure in ports, they could lead to severe cargo congestion at some Canadian factories.

Security for goods coming from outside the North American perimeter is another matter. Hart correctly points out that relocating security checks for merchandise away

from the border would make the frontiers more efficient and erase a great source of border friction. In August 2007, President Bush signed into law a bill implementing the recommendations of the 9/11 Commission Act of 2007, which represents a step in that direction, since it requires that all ship containers destined for the United States be scanned before their arrival at U.S. ports of entry. Because the United States and Canada had previously signed the Container Security Initiative Partnership Agreement, the latest bill effectively relocates security checks to ports outside the North American perimeter, whether containers destined for U.S. soil enter through Seattle or Vancouver. This kind of security agreement for containers arriving by ship is perhaps the most prominent way in which the United States and Canada are working together to facilitate the flows of merchandise. However, to complete the relocation of security checks away from the border, a similar arrangement will have to be agreed on for merchandise arriving in Canada from overseas by air and destined for U.S. soil.

To make all of this possible, Canada might have to accept the presence of U.S. Customs and Border Protection officers at all Canadian airports of entry. This step, although it might yield immediate relief, seems so intrusive that it becomes highly improbable.

As we argue in our essay, the best approach for relocating security checks to the North American perimeter is to create a joint inspection force for all merchandise imports entering the United States or Canada and destined for the other country. Once certified, and put in sealed and tracked containers, the cargo would not have to go through security checks when reaching the Canada–U.S. border. The main obstacle to this sensible idea is the difficulty of creating a joint institution, especially in the sensitive security arena. To be sure, Canadian officers have long been stationed at the North American Aerospace Defense Command (NORAD), located in Colorado Springs. Unfortunately, this fact is so unknown to most Americans that it belongs among the great secrets of modern times. Unfortunately, too, the inertia of established customs bureaucracies and the strong connection in the popular mind between sovereignty and border control militate in the short term against a joint inspection force at the North American perimeter. To get things moving, Prime Minister Harper and President Bush should take the initiative in creating a bilateral commission to examine the perimeter question and report back to national leaders with a menu of options by the end of 2009.

Regulatory convergence, better infrastructure, and stronger institutional bodies are all essential to further the economic integration of North America. Canadian provinces and U.S. states are making progress, and so are the federal governments, but the pace is too slow.

Michael Hart's Response

In their essay, Gary Hufbauer and Claire Brunel add significant fuel to the fire I would like to light under Canadian and U.S. policymakers. The business case for tackling the dysfunctional nature of border administration is strong, as are the economic benefits of addressing such issues as mutual security confidence, regulatory cooperation, cross-border infrastructure integrity, and institutional capacity. Some of their practical suggestions for moving the file forward also make sense, although I would focus my initial efforts elsewhere.

I disagree with the suggestion that Canada move toward monetary integration. Such an initiative would undoubtedly promote price convergence, but at a cost few Canadians would be prepared to accept—including problems in addressing Canada's different terms of trade, its diverse inflation and unemployment performance, and the symbolic importance of currency independence. There are better ways to tackle price divergence and its negative impact on Canadian economic performance—namely, regulatory convergence and a more open border.

On the issue of regulatory convergence, in addition to the sectoral suggestions advanced by Hufbauer and Brunel, Canada and the United States could begin with one simple political commitment: all new or amended federal regulations must meet a convergence test. Rather than the default position of convergence, if desirable and politically acceptable, they should adopt a rule that all new or amended regulatory requirements must be convergent unless there is a compelling public policy reason to regulate differentially. Positive experience with this approach would build a basis for tackling the broader agenda.

With regard to the border, the two federal governments could make another political commitment: to simplify and then implement the commitments already made on pre-clearance and the related programs for secure, low-risk travelers and cargo. As it is, many low-risk shippers and frequent travelers have dismissed these initiatives as little more than PR exercises. The take-up on these programs is depressingly low, not because they are undesirable, but because the barriers to their full implementation are often higher than the original barriers they seek to get around.

It is clear that neither government stands ready to take on these issues with the vigor, imagination, and determination they demand. The political economy of the emerging Canada-U.S. agenda presents a daunting hurdle, bedeviled as it is by the familiar problem of asymmetry: the issues are perceived to be vastly more important—and beneficial or threatening, depending on one's perspective—to Canadians than to Americans. The inevitable result is a lack of awareness or an indifference on one side of the border, and fear, anxiety, or impatience on the other.

The need for a new approach to the Canada-U.S. border has been apparent for more than a decade as the two economies adapted to the impact of freer trade and the structural and institutional changes of deep integration. The crisis of September 11, 2001, provided a perfect opportunity to seize the moment to re-imagine the border, but Canada blew it. Rather than work with the United States to address real security and related concerns and to use the opportunity to build a much better functioning, more open, and more integrated North America, Canadian authorities reacted defensively and anxiously to American security concerns. More preoccupied with nationalist phobias than enduring interests, the Chrétien government did what it had to do, but grudgingly, and without foresight as to the long-term impact of lost U.S. confidence in Canada as a reliable security and economic

partner. The result was predictable: a border that has become a growing obstacle to Canada–U.S. interaction and integration.

Separate U.S. and Canadian responses to the crisis of 9/11 are now embedded in both law and policy, and everyday practice drives home the reality—and the problems—of the different paths that were taken at the time. Eventually, common sense will prevail. In the absence of another crisis, however, only inspired leadership can overcome the narrow-minded response of special and entrenched interests and the urge for bureaucratic self-preservation. Each group is adept at exploiting the default position of incrementalism, exemplified by such initiatives as the Security and Prosperity Partnership (SPP). Progress will be made under the SPP banner, but at a snail's pace and without the impact needed to make a perceptible difference.

Leadership can come from two sources: a business sector prepared to speak out forcefully and convincingly about the costs and lost opportunities flowing from misdirected and overzealous border administration, and a political leadership prepared to admit that much of what is done at the border in the name of security and other objectives serves more as a symbol of their concerns than as a palpable deterrent to terrorism, crime, and other risks. Much as air travel has been made into an increasingly unpleasant experience by the politics of symbolic gestures, so interaction among Canadians and Americans will become hostage to the politics of the same similar gestures.

The business case for tackling the dysfunctional nature of border administration is strong, as are the economic benefits of addressing such issues as mutual security confidence, regulatory cooperation, cross-border infrastructure integrity, and institutional capacity.

Gary Clyde **Hufbauer**

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Before joining the institute, he was the Marcus Wallenberg Professor of International Financial Diplomacy at Georgetown University. From 1977 to 1980 he served in the Treasury Department as deputy assistant secretary, responsible for trade and investment policy during the Tokyo Round, and as director of the international tax staff. He holds an A.B. from Harvard College, a Ph.D. in economics from King College at Cambridge University, and a J.D. from Georgetown University Law Center.

Hufbauer's publications include *Economic Sanctions Reconsidered*, 3rd edition (co-author, 2007), *US Taxation of Foreign Income* (co-author, 2007), *Toward a US-Indonesia Free Trade Agreement* (co-author 2007), *Sustaining Reform with a US-Pakistan Free Trade Agreement* (co-author, 2006), *The Shape of a Swiss-US Free Trade Agreement* (co-author, 2006), *US-China Trade Disputes: Rising Tide, Rising Stakes* (co-author, 2006), *Reforming the US Corporate Tax* (co-author, 2005), *NAFTA Revisited* (co-author, 2005), *World Capital Markets* (co-author, 2001), *NAFTA and the Environment* (co-author, 2000), *Unfinished Business: Telecommunications after the Uruguay Round* (co-editor, 1997), *Flying High: Liberalizing Civil Aviation in the Asian Pacific* (co-editor, 1996), *Fundamental Tax Reform and Border Tax Adjustments* (1996), *Western Hemisphere Economic Integration* (co-author, 1994), and *NAFTA: An Assessment* (co-author, 1994).

Claire **Brunel**

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Michael **Hart**

Michael Hart holds the Simon Reisman chair in trade policy at the Norman Paterson School of International Affairs at Carleton University in Ottawa, where he teaches courses on the laws and institutions of international trade as well as Canadian foreign policy. He spent the 2004–5 academic year in Washington, D.C., as the Fulbright–Woodrow Wilson Center Visiting Research Chair in Canada–U.S. Relations, working on a book on Canadian foreign policy and the United States. Concurrently, he was also a scholar-in-residence in the School of International Service and a senior fellow at the Center for North American Studies at American University in Washington.

Hart is a former official in Canada's Department of Foreign Affairs and International Trade, where he specialized in trade policy and trade negotiations. He holds an M.A. from the University of Toronto and is the author, editor, or co-editor of more than a dozen books and numerous articles and chapters in books on international trade issues, including *A Trading Nation*, short-listed for the Donner Prize (public policy), the J.W. Dafoe Prize (history), the Donald V. Smiley Prize (political science), and the Purvis Prize (economics) in 2003, and *Decision at Midnight*, short-listed for the Gelber Prize and the Canadian Business Book Award in 1995.

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[The Canada Institute on North American Issues](#), incorporated in 2002 and affiliated with Operation Dialogue, was founded to conduct research on cross-border topics and encourage dialogue among key government, corporate, and academic institutions in Canada, the United States, and Mexico. CINAI, based in Toronto, is chaired by C. Warren Goldring.

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