POLICY ESSAY

Joseph Blomeley

Making choices: Prospects for a Canada-EU Free Trade Agreement

With a population of over 500 million, the European Union (EU) is Canada's second-largest trading partner. In 2006, two-way merchandise trade between Canada and the EU was approximately $78 billion and two-way investment reached $263 billion. While these figures are far from marginal, they pale in comparison to the $626 billion in two-way merchandise trade and $497 billion in two-way investment with the United States. In light of these numbers, analysts have argued that there is room for improvement in the economic relationship between Canada and the EU. They believe that the relationship has been significantly under-traded and under-valued. In an attempt to bolster this claim, a Canada-EU Joint Trade Study commissioned by the European Commission and the Government of Canada (GoC) recently noted that Canada is the EU's 11th-largest merchandise trading partner, with only 1.8 percent of external EU trade in this category (GoC, 2008). In light of the financial crisis in the United States, discussions to revive talks of a Canada-EU Free Trade Agreement (FTA) have begun to garner attention.

Although discussions of a Canada-EU economic partnership are not new – going back to Pierre Trudeau's failed "Third Option" in the mid-1970s – the current reincarnation seems radically different from the failures of the past. With a unanimity uncommon to most of its foreign policy issues, Canada is politically unified behind the idea of a transatlantic FTA, with the governing Conservative Party, the Liberal opposition, the provinces, and Canadian business leaders all indicating their support. In an even more surprising turn of events, the EU has also indicated its interest in pursuing a Canada-EU FTA. On October 23, 2008 the European Commission welcomed the formal adoption by European member states of

Joe Blomeley is a Graduate Student at the Norman Paterson School of International Affairs, at Carleton University. *He would like to thank everyone at the Centre for Trade Policy and Law at Carleton, for their expertise and support over the past two years.*

the negotiating mandate for an FTA with Canada. This is a sharp reversal from the EU's past disinterest and ambivalence in this respect.

Accordingly, it seems that there is significant momentum towards the signing of a comprehensive Canada-EU FTA. Yet, is this the right move for the Canadian economy? Have Canadian officials properly analyzed the consequences of such an agreement, particularly the effect that it may have on Canada's economic relationship with the United States? It does not appear so. At this point in time, it does not make sense to pursue an agreement, particularly in its proposed form.

This policy essay will evaluate the costs and benefits of the proposed Canada-EU FTA. The first section will briefly describe the form that a Canada-EU FTA will likely take, using the economic predictions made by the previously mentioned Canada-EU Joint Study Report as a guide. Through an analysis of the arguments put forward by advocates of an agreement, the second section will attempt to encapsulate the reasoning behind why a deep FTA could be beneficial to Canada, the European Union, North America and the transatlantic partnership as a whole. The third section will examine the case against a Canada-EU FTA, particularly the detrimental effects that it may have on Canada's economic relationship with the United States. The fourth and final section will include policy recommendations, which will advocate further integration with the United States, and will introduce politically feasible proposals on how Canada can successfully further the Canada-U.S. integration process.

What would a Canada-EU FTA look like?

According to the Canada-EU Joint Study, the EU-Canada trading relationship appears to be significantly under-traded. The report noted that the "total trade between the EU and Canada is about the same size as the EU's total trade with India, even though the Canadian economy is one-and-a-half times larger than India's" (GoC 2008, 164). While the report did not provide policy recommendations, it did offer insight into the potential costs and benefits of a closer economic partnership, along with possible areas where the EU and Canada could continue to enhance their bilateral cooperation.

The main finding of the Joint Study Report was that "the overall results indicate that liberalization of trade in goods and services will bring significant benefits to the EU and Canada" (GoC 2008, vi). If a Canada-EU FTA was formulated, it is predicted that the annual real income gain by the year 2014 would be approximately $18 billion for the EU and approximately $13 billion for Canada.

More specifically, the report predicted gains from the elimination of tariffs on bilaterally traded goods, suggesting 25 percent of the total gains for the EU and 33.3 percent of the total gains for Canada. The liberalization of services was also indicated as an extremely important element of a Canada-EU agreement. Currently, barriers to trade in services between Canada and the EU are estimated to represent around 18-42 percent of additional trade costs into the EU, and 24-52 percent of additional trade costs into Canada. These barriers are significantly higher than those hindering the trade of goods. If reductions of 2-10 percent are made, the liberalization of services will offer the most significant gains (GoC 2008, vi).

The report also indicated benefits that could be accrued from cooperation in the complex area of regulatory convergence. By embarking upon a regulatory partnership, Canada and the EU would seek greater convergence on standards and regulations in both goods and services, beginning with a commitment to action in priority sectors (GoC 2008,5). This type of collaboration, which would include convergence in areas such as certification and health standards, would be binding and supported by a dispute settlement mechanism. The proposed integration in a Canada-EU FTA, along with the other areas of expected co-operation such as government procurement, would be significantly deeper than the integration that has already taken place under the North American Free Trade Agreement, as Canada and the U.S. have yet to align their regulatory policies in such a comprehensive manner (WSJ Online, 2008).

The Argument for a Canada-EU FTA

The Ties that Bind

Advocates of any transatlantic agreement between Canada and the EU often rightly assert that the historical ties between Canada and Europe are strong and deep. The two societies are bound together by history as well as by common values, including respect for the rule of law and a commitment to market-based economies. Additionally, Canada is home to millions of people of European descent. Both Canada and the EU are reliable and trusted partners in the North Atlantic Treaty Organization and both societies share an important relationship with the United States. According to Thomas d'Aquino, "these are powerful imperatives which, coupled with the certainty of more vigorous economic growth and cooperation, create an irresistible case for Canada and the European Union to move forward [on an agreement] without delay" (CCCE, 2008). D'Aquino argues that the Canada-EU economic relationship has suffered from political neglect for far too long, thus political leaders must ensure that all future opportunities are firmly seized.

Furthermore, from an economic standpoint, the EU is Canada's second largest commercial partner and Canada is among Europe's ten largest partners. It is not a marginal economic relationship. Investment has grown rapidly between the two economies, as the EU is now the second-largest foreign investor in Canada, with Canada being the fourth-largest investor in the EU. In addition, sales in each other's market by wholly owned affiliates are now four times the value of exports, with sales by Canadian affiliates within Europe growing especially rapidly (GoC 2008, vi).

Diversification

In the past, Canada had to rely solely on the U.S. economy as a place for export. The reasoning behind this theory is that if the U.S. economy went into recession, the rest of the world was likely to follow. Therefore, "it did not matter where Canadians invested, because if the U.S. market weakened, Canadian investors were likely to lose no matter where their investments were" (Guerin and Napoli 2008, 22). Advocates for a Canada-EU FTA argue that this assertion is no longer viable - the world today is a very different place. The "increased 'dynamism' of the global economy offers a case for Canada to diversify, as diversification could make Canadian firms more resilient as the global economy becomes less subject to economic cycles in the United States" (Guerin and Napoli 2008, 22). They argue that Canada must take advantage of other stable options, particularly the EU, in order to weather future economic storms.

A Harbinger to an EU-NAFTA FTA

Finally, according to Roy MacLaren, former Canadian International Trade Minister, the United States and Europe are losing their economic lead over their Asian rivals and were accordingly unable to engineer an acceptable outcome for the Doha Round discussions. As a result, they are now at risk of finding themselves on the outside looking in, as China, India, and other Asian countries orchestrate various large-scale, potentially profitable regional free trade arrangements (MacLaren 2008, 5). A transatlantic FTA, for which the Canada-EU FTA is a precursor, would change this.

From a Canadian perspective, "a bilateral deal with Europe would give Canadian companies a competitive advantage over U.S. and Asian rivals in the burgeoning European market" (MacLaren 2008, 6). According to MacLaren, "it would sharpen Canada's competitive edge vis-à-vis the United States" and "strengthen Canada's hand in negotiating bilaterally with the United States, as U.S. companies would be concerned about the dilution of their access to the Canadian market," especially if a Canada-EU agreement was based on the deep integration described in the previous section (2008, 5).

The Argument against a Canada-EU FTA

Threatening Canada's Position with the United States

The argument against a Canada-EU FTA, particularly one that focuses on deep regulatory integration, generally begins with the assertion that such an agreement will have extensive implications for Canada's commercial relationship with the United States. According to William A. Dymond and Michael Hart, "given the EU's economic and political weight and its complex and frequently contentious economic relationship with the United States, free-trade negotiations with Europe would carry major strategic implications going well beyond the possibility of enhanced commercial opportunities for Canadian exporters (Dymond and Hart 2002, 30). In their view, "no Canada-EU agreement should undermine the continued high levels of profitable trade and investment between Canada and the United States" (Dymond and Hart 2002, 29).

By agreeing to the Canada-United States FTA, and subsequently to NAFTA, the Canadian government made a strategic decision to accept the American model in the governance of bilateral trade and related domestic economic regulation. In doing so, Canadian commercial policies, practices, and procedures in areas such as tariffs, product standards, trade remedies, and intellectual property rights are now largely aligned with those of the United States, with room for improvement (Dymond and Hart, 2002, 31).

An agreement on a Canada-EU FTA would theoretically run counter this strategic decision to accept an American "acquis communautaire." For several years, the EU has required that countries entering into European Economic Agreements accept a European regulatory model. There has been little leeway on this front, and the requirement is expected to be a part of a Canada-EU FTA, as European officials have yet to indicate any favorable treatment for Canada (Dymond and Hart 2002, 29-32).

This dichotomy could prove problematic, as the regulatory model of the

United States is considerably different than that of Europe. An example of this is the approval process used to determine the safety of new products entering the market. In both Canada and the United States, common practice has been to approve all new products entering the market unless there is compelling evidence of risk to public safety and health. In contrast, the EU has moved towards a precautionary principle, "which requires compelling proof of an absence of risk before approval" (Dymond and Hart 2002, 30). According to experts, these two sets of product-safety regulations are completely incompatible. Consequently, they would also be nearly impossible to harmonize.

Therefore, the existence of two very different regulatory regimes creates a dilemma for Canadian officials. If officials refuse to align with the European model, Canada would see fewer commercial benefits resulting from an agreement. On the other hand, if Canada accepts the European model, it would lead to an increase in the differences between Canadian and American policies, practices, and procedures, which, according to Dymond and Hart, would "bring severe consequences for Canadian access to the U.S. market" (Dymond and Hart 2002, 31).

With the above point noted, some critics have pointed out that other countries have agreements with both the EU and the U.S., particularly Mexico, and asked why these countries have yet to see this clash of regulatory models. With regard to Mexico, it is a civil law country, with a regulatory regime that is more in line with the European model, than the American. As such, Mexico faces a large hurdle in trying to integrate with the U.S. within a civil law system. Most major investments in Mexico are wholly export oriented or manufactured to U.S. standards, as Mexican compliance and verification leaves a lot to be desired. Moreover, most Mexican products sent to the United States only see U.S. soil in their final form, passing the border once. Conversely, Canada and the United States "build things together using value chains and other modern production techniques" (Hodgson 2008, 11). The Canada-U.S. auto industry, integrated through the Canada-U.S. Auto Pact, offers the best example of this reality. In building an automobile, the two economies are highly integrated, with several companies maintaining plants on both sides of the border, with materials being sourced between each country on multiple occasions before the final product sees the show floor.

Policy Recommendations

Canadian media coverage of this issue in recent months certainly suggests that advocates of a Canada-EU FTA are bullish in their support for an agreement. It also appears that they largely outnumber their opponents. But Canadians must look at the bigger picture before getting swept up in negotiating such a consequential agreement. While a simple trade, services, and investment enhancement agreement may be acceptable and worthy of discussion, in its current proposed form, a Canada-EU FTA must be rejected. In particular, the altruistic belief that a Canada-EU FTA will one day eventually lead to an EU-NAFTA FTA is not a strong enough reason to jeopardize Canada's economic relationship with the United States, especially when an EU-NAFTA FTA may never happen.

Regarding potential considerations moving forward, with President Barack Obama's popularity amongst the Canadian population, politically, the time is ripe for the Canadian government to devote itself to further integration with its biggest trading partner. In 2007, Canadians exported $356 billion in goods to the United States and imported roughly $269 billion; fully 78 percent of Canadian goods exports go to or through the U.S., representing a significant portion of the Canadian GDP (Statistics Canada, 2008). The relationship with the United States is vital to Canadian interests.

Furthermore, in light of an increasingly protectionist American Congress, Canada's first priority must be to remove the various barriers to the movement of goods and people between Canada and the U.S.; "a two-way flow that will continue to dominate Canadian economic activity for the foreseeable future" (Goldfarb 2003, 3). The best strategy to do so is through the reduction of border impediments to trade and the acceleration of regulatory convergence. Reducing these barriers will facilitate deeper integration, and thus strengthen the competitiveness and efficiency of Canadian firms.

Ultimately, regulatory cooperation and the reduction of border formalities are quite similar. First and foremost, the federal government must find politically and administratively feasible methods to improve Canada-U.S. border administration and infrastructure. Currently, border delays, many of which are caused by regulatory friction, represent between $7 and $13 billion per year in direct costs for businesses and consumers (Taylor & Robideaux, 2003). To alleviate this problem, more innovation will be required to facilitate the movement of low-risk cargo and people, and large investments in border crossings are also needed (Hart 2007, 424-425). Doing so will result in a large reduction of business costs derived from unnecessary border measures.

Similarly, the federal government must work with the U.S. to achieve compatible standards and regulations in sectors that would improve the efficiency of the Canadian economy. Canada and the United States have remarkably similar regulatory objectives and approaches. As has been noted, "it makes no sense to run what are essentially parallel regimes when our two economies are so highly intertwined and when the majority of regulatory differences that do exist are inconsequential" (Macmillan, 2008, 4).

The benefits of increased regulatory convergence with the United States lie in the reduction of costs and duplication. Compliance with different standards and rules, along with redundant certification and testing of products, providers and processes, raises costs for manufacturers operating in an integrated market. The compliance costs are staggering, as 2.6 percent of the Canadian GDP, or $33 billion, is spent annually by businesses complying with cross border regulations (CFIB, 2005). Even a 10 percent reduction in duplication would make an important contribution to reducing administration and compliance costs (Dobson, 2007, 460-461).

There is also a strong link between Canadian and American regulatory differences and productivity performance. In particular, it has been noted that Canadian productivity would rise considerably if Canadian and American regulations governing the non-manufacturing sectors were aligned to the regulations of the least restrictive country. If this were to take place, Canada would see an increase in annual productivity of roughly 1 percent, which would imply a substantial gain over the long term (Conway et al, 2006).

If the time is right and the political capital is available, Canadian officials should also attempt to promote the accession of NAFTA into a customs union. While this proposal seems improbable at the moment, the potential payoff of such an idea is substantially higher than the returns Canada would see from a Canada-EU FTA. According to Danielle Goldfarb, "the major benefit of a Canada-U.S. common tariff against third countries is that it would eliminate costly rules of origin requirements between Canada and the U.S., reducing border costs and bolstering investor confidence" (Goldfarb, 2003, 5). A customs union alone would save Canadian businesses up to $18 billion annually (Goldfarb, 2003, 5-6). A common trade-remedy regime would also eliminate trade-remedy penalties, reducing trade irritants, while common non-tariff barriers would further reduce border frictions. This would undoubtedly lead to the generation of wealth and higher incomes for Canadians.

If the suggested customs union is not politically palatable, Canada and the United States could always look towards developing sectoral agreements on tariff levels (Lofthouse, 2004, 823). One possibility that has been suggested is a common framework for the North American auto industry. The reason for this suggestion is that the auto industry is highly integrated, and, as mentioned previously, several companies have plants on both sides of the border, with materials being sourced between each country. Such a trial run could be a good way for Canada and the United States not only to improve the efficiency of the current industry, but also to assess the real impact of a move to a more common external tariff. Given its precarious state, the auto industry would also be a natural partner in any sectoral initiative to reduce non-tariff barriers (Hodgson 2008, 1-15).

Conclusion

A Canada-EU FTA is a politically-driven attempt to diversify trade which will produce marginal results. Canada should not follow this misguided route. In the near term, the Government of Canada must make a strategic decision on where to best put its time, effort and resources for the maximum economic long-term benefit of Canadians. Strengthening Canada's economic relationship with the United States offers the most lucrative policy option.

Canada's economic relationship with the United States has been extremely fruitful, but there still is room for improvement. Several minor issues continually hamper cross-border business, costing Canadians billions of dollars every year. Unfortunately, most Canadian politicians have lacked the fortitude to correct these persistent problems. This must change. A new and popular American administration has taken office, giving Canadian policymakers the unprecedented opportunity to build on this important relationship. It must be Canada's first priority. Therefore, while the Canada-EU economic relationship must remain strong and nurtured, it cannot take priority over Canada's economic relationship with the United States.

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