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Last month marked a positive breakthrough in Canada-US relations when the two countries reached a deal that gives Canadian companies an exemption from the protectionist “Buy American” clause in the US government’s \$787 billion economic stimulus package. The new agreement ends a dispute that has raged since Congress passed the American Recovery and Reinvestment Act in February 2009. As Alexander Moens notes in this issue of *Fraser Forum*, the deal is not perfect but it is a step in the right direction (“Canada-US relations in 2010,” pg. 14).

Small successes like this deal may not be earth-shattering, but they are encouraging signs that Canada-US relations may be improving. Such successes are particularly welcome because, as Moens notes, the American attitude toward the Canada-US border has deteriorated since 9/11, and cross-border trade has suffered as a result. Trade trends for the last 10 years show that the rapid growth in trade that took place during the 1990s is weakening (“Canada-US relations in 2010”). While trade in the energy sector is growing, trade in manufacturing has stagnated, and the ongoing softwood lumber war continues to be a source of frustration for many Canadians in the forestry sector (“The Canada-US softwood lumber dispute,” pg. 29).

Adding to these troubles is the high Canadian dollar, which often leads to a decline in Canada’s exports to the United States. This situation is unlikely to change soon; with huge deficits expected in the United States for years to come (“Deficits and debts,” pg. 24), the Canadian dollar is expected to remain high.

Canada faces many challenges ahead. The recent recession has stirred up a strong protectionist sentiment in the United States. Our growing energy trade may be threatened by the Obama administration’s plans to create a “green energy economy” and reduce carbon dioxide emissions. Already, several US states are considering imposing a levy on oil extracted from Canada’s oil sands (“Canada-US relations in 2010”). A slowdown or retraction in oil sands production because of US carbon measures would have a negative impact on Canada’s exports.

Given that the United States is, by far, Canada’s largest trading partner, Canada cannot afford to neglect its relationship with its southern neighbour. As Moens argues, unimpeded access to the US market remains Canada’s top economic interest (“Canada-US relations in 2010”). It’s time for Canadians and Americans to move beyond their disputes and focus on policies that will improve the fortunes of both countries: open trade, regulatory harmonization, and cooperation at the border.

KRISTIN FRYER (kristin.fryer@fraserinstitute.org)

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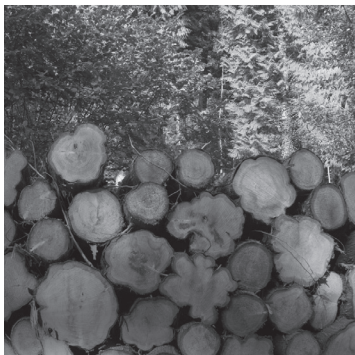
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HST will help, not hinder, Manitobans

NIELS VELDHIJS AND CHARLES LAMMAM

Manitoba's Finance Minister Rosann Wowchuk recently kiboshed the possibility of a harmonized sales tax (HST) in Manitoba. Her reasoning: "We don't think it makes sense to impose \$405 million in new sales taxes" (Manitoba, Department of Finance, 2009a: 1). While such rhetoric might be good politics, it is terrible economics, and worse, it actually misrepresents the facts.

The reality is that introducing an HST in Manitoba would have little or no effect on the total amount of sales taxes paid by Manitobans. It would, however, make Manitoba a more attractive province for business investment. If Minister Wowchuk and her colleagues are truly interested in improving the performance of Manitoba's economy, they would reconsider their decision on the HST.

First, let's dispel the notion that the HST would impose \$405 million in new sales taxes on families.

Currently, Manitoba maintains a 7% provincial sales tax (PST). One of the key problems with the PST is that it applies to both business inputs and the final consumption of goods and services. This means that businesses pay PST on the inputs used in producing goods and services and these costs are passed on to consumers in the form of higher prices (this is referred to as an "embedded sales tax"). Consumers then pay PST on the final goods and services they buy. In the end, Manitobans pay significantly more PST than the 7% they are charged at the till.

An HST would replace Manitoba's current 7% provincial sales tax with a single harmonized sales tax of 12%—a combination of the current 7% PST and 5% federal GST. The HST would be a "value-added" tax, meaning that it would only apply to the final consumption of goods and services; businesses would receive a refund for the sales taxes they paid on inputs.

Past experience with sales tax harmonization in Canada provides evidence that the savings for businesses that no longer pay sales tax on inputs would be passed on to consumers in the form of lower prices. In 1997, three

Atlantic provinces (Newfoundland and Labrador, New Brunswick, and Nova Scotia) harmonized their previously independent provincial sales taxes with the federal GST. Professor Michael Smart of the University of Toronto examined the effects of the harmonization in Atlantic Canada and found that consumer prices in the harmonizing provinces fell after the 1997 reforms (Smart, 2007).

How would the province recoup the lost revenue (about \$510 million) from refunding sales taxes on business inputs, while keeping the provincial portion of the HST at 7%? The group of goods and services (the tax base) upon which the HST would be applied would be larger than the group covered by the current provincial sales tax. Expanding the tax base to include goods and services that are currently exempt from the sales tax (such as gasoline, books, hair cuts, manicures, pedicures, and new homes) would bring an additional \$405 million into the provincial government's coffers (Manitoba, Department of Finance, 2009b).

Minister Wowchuk wants Manitobans to believe that this \$405 million is an additional amount that Manitobans would pay in "new sales taxes." However, she does not account for the savings consumers would receive due to lower prices. After all, while more goods and services would be taxed after harmonization, the embedded sales tax (on business inputs) would be removed.

Even more importantly, Wowchuk does not factor in the damaging impact the current PST has on Manitoba workers. Because the current provincial sales tax applies to business inputs, it increases the cost of capital investment. As a result, businesses in Manitoba invest less than they otherwise would in the machinery, equipment, and new technology that make workers more productive. Higher worker productivity drives up wages, and thus a lower level of investment in productivity-enhancing machinery and equipment ultimately means lower wages for workers.

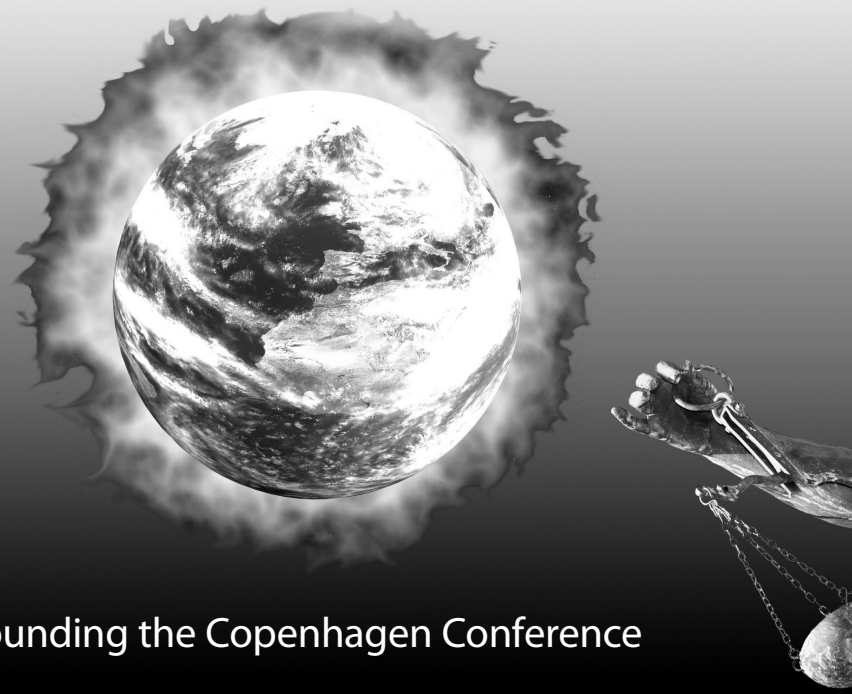
Since under an HST businesses could claim a refund on the sales taxes they pay on business inputs, the tax penalty on new business investment would be reduced, improving incentives to invest.¹ In fact, after the 1997 reforms in the Atlantic provinces, per capita investment rose by more than 11% in the harmonized provinces compared to the non-harmonized provinces (Smart, 2007).

Harmonization would also reduce unproductive tax compliance costs for businesses. Currently, the tax base upon which Manitoba's PST is applied differs from the tax base used for the GST. Differing tax bases, along with a host of different rules, force businesses that collect sales taxes to operate with two sets of sales records and two sets of compliance and reporting requirements. By simplifying the recording and reporting processes, harmonization

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Global warming on trial

The science and politics surrounding the Copenhagen Conference



DIANE KATZ

The politics and science of global warming have been thrown into disarray by the failure of the recent Copenhagen Conference to yield a meaningful accord, and by a series of revelations exposing deception and fraud in the research widely cited as proof of anthropogenic climate change.¹ From a practical standpoint, the resulting uncertainty about the future course of public policy carries significant costs for the private sector (Wagner, 2007). But that's a small price to pay compared to the cost of tolerating the corruption of science and the imposition of misguided, unwarranted regulations.

Organizers² wanted the Copenhagen “Conference of the Parties”³ in December to yield a binding international agreement on reductions of CO₂ emissions; pledges of massive aid to developing nations to mitigate global warming and adapt to its supposed effects; and a blueprint for a global “market” in emissions credits (UNFCCC, 2009a). Full implementation was to succeed the first phase of the Kyoto Protocol, which expires in 2012.⁴

What actually emerged from “Hopenhagen”⁵ didn't come close. The frustration of activists was plainly expressed by John Sauven of Greenpeace UK, who characterized the conference as “a crime scene” (*BBC News*, 2009, Dec. 19).

Technically speaking, no accord was actually adopted or endorsed by the parties. In the words of UN officials, the conferees “merely took note of [the accord] . . . its provisions do not have any legal standing” (UNFCCC, 2010). Moreover, no specific emissions reduction targets were set, nor did countries commit to contributions for the “Copenhagen Green Climate Fund.”⁶ Instead, an “ultimate objective” was identified—that is, emission reductions that supposedly would hold the increase in global temperature to less than 2 degrees Celsius (UNFCCC, 2009b).

Developed countries agreed to submit voluntary emissions reduction targets to the United Nations by January 31; developing nations were to submit mitigation plans by the same date. But less than a week after the conference ended, India and China both reversed their positions, and UN officials subsequently postponed the deadline indefinitely (*China Daily*, 2010, Jan. 23).

Optimists have declared as progress the conferees' general pledge to hold emissions below the threshold that would otherwise increase global temperatures by more than 2 degrees Celsius (Tankersley, 2009, Dec. 19). And President Barack Obama characterized the supposed acquiescence of China and India to UN verification of their mitigation actions as “unprecedented” (Tankersley, 2009, Dec. 19). But from a scientific standpoint, the emissions objective is ambiguous, at best, and meaningless, at worst. Simply put, there is no proof of a direct link between human-caused emissions of CO₂ and global warming (McKittrick, 2007). Consequently, there is no way to calculate the volume of emissions reductions that would be necessary to influence global temperatures.

Based on hypothetical climate models, the United Nations declared that developing countries would have to reduce CO₂ emissions by a whopping 40% below 1990 levels by 2020 to prevent global temperature from rising 2 degrees Celsius or more (NEAA, 2009). A “comparable level of effort” from developing countries, including China and India, would require reductions of CO₂ emissions of 15% to 30% in the same period (NEAA, 2009).

But so radical and potentially disruptive to the global economy are such targets that negotiators failed to make any movement toward them. No major country, in fact, was prepared to sacrifice the basic living standards of its citizens to solve a speculative problem.



Prime Minister Stephen Harper has repeatedly expressed his intention to “harmonize” Canadian policy with that of the United States. But emissions reduction targets well below those pushed by the UN have stalled in Congress, and the Republican win in the recent Massachusetts Senate election sent an unmistakable message to the Obama administration that Americans are in no mood for costly, job-killing government programs.

Xie Zhenhua, who led China’s delegation to the conference, summed up the outcome thusly: “Everyone should be happy. After negotiations, both sides have managed to preserve their bottom line. For the Chinese, this was our sovereignty and our national interest” (*BBC News*, 2009, Dec. 19).

Prospects for a “consensus” turned particularly grim about a month before the conference was even called to order. Thousands of e-mails from the University of East Anglia’s Climatic Research Unit (CRU) in England—a major source of UN global warming data—were posted online by an anonymous whistle-blower. The e-mails contained numerous references to statistical tricks and data manipulations used by researchers to support the core tenets of global warming theory.

This was not the first time such deception had been exposed. Between 2003 and 2005, Canadians Stephen McIntyre and Ross McKittrick published a series of papers showing that the infamous “hockey stick” graph, used widely as evidence of human-caused climate change, was based on faulty data and statistical techniques, and could not be replicated using the methods described in the original papers.

Christopher Booker notes that the content of the East Anglia e-mails reflects an unparalleled level of deceit:

[T]he authors are not just any old bunch of academics. Their importance cannot be overestimated. What we are looking at here is the small group of scientists who have for years been more influential in driving the worldwide alarm over global warming than any others, not least through the role they play at the heart of the UN’s Intergovernmental Panel on Climate Change. (Booker, 2009, Nov. 28)

Among the most noted of the e-mails was a message dated November 16, 1999, from Phil Jones,⁷ head of the CRU, in which he boasted of using a “trick” to “hide the decline” in key temperature data, thereby covering up evidence that would challenge popular notions of global warming (*Opinion Times*, 2009). Other e-mails provided damning evidence that researchers intent on promoting the global warming theory withheld data and other key information to thwart peer reviews and actively sought to prevent the publication of contrary findings in scientific journals (*Opinion Times*, 2009).

In a BBC interview on February 13, 2010, Jones admitted that there has been no global warming for the past 15 years, and acknowledged that there is no consensus about global warming among the “vast majority of climate scientists” (*BBC News*, 2010, Feb. 13).

The validity of alarmist claims was again challenged in mid-January when the UN’s Intergovernmental Panel on Climate Change (IPCC)—co-recipient, with Al Gore, of the 2007 Nobel Peace Prize—was forced to retract a portion of its most recent assessment of global warming (Walsh, 2010, Jan. 21). The assessment’s assertion that the “Himalayan glaciers would melt by 2035” lacks any factual basis, and was merely the speculation of a scientist who said he sought to provoke government officials into taking action (Walsh, 2010, Jan. 21).

The source of the claim, Dr. Syed Hasnain, was an employee of a Delhi-based institute run by Rajendra Pachauri, the chairman of the IPCC (Leake, 2010, Jan. 24a). Pachauri obtained substantial funding after provoking fears with his bogus claim, including sizable shares of a \$500,000 grant from the Carnegie Corporation of New York and \$3 million from taxpayers in the European Union (Leake, 2010, Jan. 24a).

The UN assessment also claimed that global warming was responsible for “rapidly rising costs due to extreme weather-related events since the 1970s.” But an investigation by the *Sunday Times* revealed that the research paper spawning the claim had not undergone peer review (Leake, 2010, Jan. 24b). It had not even been published.

Long after the UN released its assessment, the paper was published with a caveat acknowledging that there was “insufficient evidence to claim a statistical relationship between global temperature increase and catastrophic losses” (Leake, 2010, Jan. 24b). But UN officials

were already aware of this problem; at least two scientists who reviewed drafts of the assessment had questioned the claim that global warming was to blame for greater losses from natural disasters (Leake, 2010, Jan. 24b).

UN officials and their alarmist allies continue to insist that gaffes in the assessment are minor exceptions to an otherwise airtight case for anthropogenic climate change. However, the UN's top climate official, Yvo de Boer, announced his resignation on February 18, as evidence mounted that the IPCC report sorely lacked scientific credibility (Max, 2010, Feb. 18).

Indeed, the assessment is littered with claims of impending doom that lack a credible reference. For example, James Delingpole of *The Telegraph* revealed that the UN climate change panel relied on the World Wildlife Fund, an alarmist advocacy group, for its untested assertion that "Up to 40% of the Amazonian forests could react drastically to even a slight reduction in precipitation due to global warming" (Delingpole, 2010, Jan. 25). The IPCC's assertion that global warming could cut rain-fed North African crop production by up to 50%—a claim widely repeated among alarmists—is wholly unsubstantiated (Booker, 2010, Feb. 13).

The unfounded claims in the UN assessment, coupled with the CRU e-mails, reveal a concerted effort to masquerade propaganda as scientific fact in order to convince the world of a scientific "consensus" regarding the threat of catastrophic global warming. Indeed, even the US Environmental Protection Agency has used the UN assessment to designate CO₂ as a dangerous pollutant and, as a result, is preparing to regulate virtually the entire US economy (US EPA, 2009).

The alarmist lobby is not about to abandon their cause, nor will regulators and bureaucrats simply cease their efforts to vastly expand their powers. But the Copenhagen fiasco and the revelations of fraud and deceit do portend uncertainty about global warming policy.

Analysts with the environmental law group of Blake, Cassels and Graydon LLP forecast "a continuing patchwork of regulatory initiatives at the provincial and regional levels, resulting in the need for companies to comply with competing regulatory requirements" (Blake, Cassels and Graydon LLP, 2010).

The regulatory competition was evident in Copenhagen, with the premiers of Quebec, British Columbia, Manitoba, and Nova Scotia in attendance, along with Ontario's Minister of the Environment and the mayors of Toronto, Vancouver, and Calgary.

Among the "sub-national" initiatives noted by the Blake analysts was the Western Climate Initiative, which four Canadian provinces (BC, Ontario, Manitoba, and Quebec) and seven US states⁸ have joined to reduce greenhouse gas emissions (Blake, Cassels and Graydon LLP, 2010). There is also the Regional Greenhouse Gas

Initiative, involving 10 Northeastern and Mid-Atlantic states bent on capping CO₂ emissions. California Governor Arnold Schwarzenegger has even called on the United Nations to convene a climate conference for cities, states, and provinces.

The lack of regulatory certainty has hurt the nascent "market" in emissions credits. The price of credits is driven solely by supply, which is dictated by the emissions caps imposed by governments. Absent certainty about the regulatory limits on emissions, there is a void of information by which to calculate the value of the credits. Indeed, the prices of carbon "allowances" in Europe plunged to a six-month low on the first trading day after the close of the Copenhagen summit (*BBC News*, 2009, Dec. 21).

Work is underway on an updated edition of the UN assessment. Ironically, it is China that has issued a call for research transparency and scientific objectivity. As Xie Zhenhua, vice-chair of China's National Development and Reform Commission, has said, "We need to adopt an open attitude to scientific research and incorporate all views" (Walsh, 2010, Jan. 28).

Government officials across North America would do well to heed Zhenhua's advice. There is simply no basis on which to erect a radical regulatory regime to eliminate fossil fuels. When cause and effect cease to matter, irrationality will reign.

Notes

1 Anthropogenic climate change is the term given to the hypothesis that emissions of carbon dioxide and other "greenhouse gases" resulting from human activities are causing Earth's temperatures to rise unnaturally.

2 The conference falls under the United Nations Framework Convention on Climate Change, which meets annually to review treaty provisions and the implementation of the Kyoto Protocol.

3 Conferees included delegations from 194 countries. Also in attendance were representatives of 21,000 nongovernmental organizations and 5,000 media.

4 The Kyoto Protocol of 1997 committed signatories to a reduction in CO₂ emissions of 5% below 1990 levels.

5 The term "Hopenhagen" was widely adopted as an expression of activists' yearning for aggressive action on global warming. In fact, the term was the brainchild of the International Advertising Association, which represents the global advertising industry. See <<http://www.hopenhagen.org/mis-sion>> for more information.

6 The accord does call for collective efforts to secure \$100 billion annually by 2020 to address the climate change needs of developing countries.

7 Jones stepped down on December 1, 2009, while the University of East Anglia conducts a review of the e-mail scandal (Eilperin, 2009, Dec. 1).

8 In February, the governor of Arizona issued an executive order barring the state from adopting the emissions control scheme proposed by the Western Climate Initiative.

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Quarterly Research Alert

Fiscal policy

Alberto Alesina and Silvia Ardagna (2009). *Large Changes in Fiscal Policy: Taxes Versus Spending*. NBER Working Paper No. 15438. National Bureau of Economic Research.

This paper looks at the effects of large changes in fiscal policy in Canada and 20 other industrialized countries from 1970 to 2007. Specifically, the authors examine the impact that large increases and decreases in government budget deficits have had on both the economy and the national debt. They found that fiscal stimulus initiatives (i.e., large increases in the budget deficit) based on tax cuts are more likely to increase economic growth than those based on government spending increases. The authors also found that contractionary fiscal policy (i.e., large reductions in the budget deficit) based on spending cuts is much more effective than tax hikes for reducing government debt and avoiding economic downturns. In fact, they found several instances where spending cuts used to reduce budget deficits were associated with economic expansions.

—Charles Lammam

Andrew Mountford and Harald Uhlig (2008). *What Are the Effects of Fiscal Policy Shocks?* NBER Working Paper No. 14551. National Bureau of Economic Research.

The authors assess and compare the economic impact of various cases of deficit-financed spending, deficit-financed tax cuts, and tax-financed spending in the United States using data from 1955 to 2000. This paper has three major findings. First, deficit-financed tax cuts are the best form of fiscal policy to stimulate the economy. The authors found that a tax cut of one dollar increases GDP by up to five dollars. Second, both deficit-financed and tax-financed spending do not stimulate the economy. Instead, government spending (tax- and deficit-financed) actually discourages private investment, hindering the private sector and the economy generally.

—Alex Gainer and Niels Veldhuis

Christina D. Romer and David H. Romer (2009). *The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks*. University of California, Berkeley. <<http://emlab.berkeley.edu/users/dromer/papers/RomerandRomer.pdf>>.

This paper examines the impact of tax changes on economic growth in the United States from 1945 to 2007. The authors use narrative records, such as congressional reports and presidential speeches, to identify the timing, motivation, and size of the tax cuts or increases. This method allows the authors to separate and discard tax policy changes made in response to contemporary economic conditions. These policies are removed because the factors affecting this kind of tax change are also related to other developments in the economy. This makes isolating the effects of tax policy difficult. By eliminating



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New studies, new ideas

tax changes made in response to current economic conditions, the authors were able to focus only on tax increases that addressed inherited budget deficits and on tax policies intended to achieve some long-term goal (e.g., a smaller role for government, higher economic growth, or increased fairness). The authors found that each dollar of tax cuts increased GDP by approximately three dollars. The reverse was also true: a dollar of tax increases decreased GDP by approximately three dollars.

—Alex Gainer and Niels Veldhuis

Gregory Mankiw, Matthew Weinzierl, and Danny Yagan (2009). *Optimal Taxation in Theory and Practice*. *Journal of Economic Perspectives* 23, 4: 147–74.

This paper analyzes the relationship between economic tax theory and tax policy. The authors identified eight lessons from tax theory and compared them to actual tax policy in several industrialized countries. While there has been considerable change in both the theory and practice of taxation over the past few decades, the authors found that tax policy has generally moved in the direction suggested by theory in a few areas. For instance, top marginal tax rates—rates on the last dollar of income earned—have fallen, income tax schedules have flattened (i.e., moved toward fewer tax brackets), and taxes on consumption goods and services have become more uniform and are levied on final goods as opposed to intermediate ones. However, capital income continues to be taxed, which is contrary to what theory recommends.

—Milagros Palacios and Charles Lammam

Entrepreneurship

Silvia Ardagna and Annamaria Lusardi (2009). *Where Does Regulation Hurt? Evidence from New Businesses Across Countries*. NBER Working Paper No. 14747. National Bureau of Economic Research.

Using international data on the individual characteristics of entrepreneurs, the authors investigated the impact of three types of regulation—entry regulation, regulation of contract enforcement, and labour market regulation—on entrepreneurs' decisions to start a new business. They

distinguished between two types of entrepreneurs: those who wanted to pursue a business opportunity (opportunity entrepreneurs) and those who could not find better economic work (necessity entrepreneurs). The authors found that all types of regulation are detrimental to entrepreneurial activity, especially for opportunity entrepreneurs. In fact, entrepreneurs with superior business skills and social networks in heavily regulated countries are less likely to engage in entrepreneurship than those in less regulated countries. The authors found that increased regulation also exacerbates fear of failure, which discourages business start-ups, and that it harms vulnerable groups such as women and the unemployed by pulling them into necessity entrepreneurship. Given these findings, the authors noted that countries can foster entrepreneurship by relaxing regulation.

—Milagros Palacios and Charles Lammam

Poverty and inequality

Maxim Pinkovskiy and Xavier Sala-i-Martin (2009). *Parametric Estimations of the World Distribution of Income*. NBER Working Paper No. 15433. National Bureau of Economic Research.

In this paper, the authors estimate poverty rates and measure income inequality, among other things, for 191 countries for the years 1970 to 2006. They found that global poverty has decreased in the last 36 years for all poverty lines ranging from \$1 per day to \$10 per day. Specifically, at the \$1-per-day line, the poverty rate—that is, the proportion of the population earning \$1 per day or less—declined by 80% from 26.8% to 5.4%. At the \$2-per-day line, the poverty rate declined by over 70%. In fact, poverty rates (at the \$1-per-day and \$2-per-day poverty lines) decreased in all regions of the world including Sub-Saharan Africa. The number of individuals living below a poverty line also decreased for most poverty lines considered. For instance, the number of individuals living below the \$1-per-day line declined from 403 million in 1970 to 152 million in 2006. The authors also found that global inequality decreased (regardless of the measure used) and that most global inequality is due to between-country, as opposed to within-country, inequality.

—Amela Karabegović

Aerospace subsidies

The latest “distortion of competition”



MARK MILKE

Early in 2010, the European aerospace giant, Airbus, and the world’s largest manufacturer of aircraft, Boeing, combined lobbying efforts to convince the Organisation for Economic Co-operation and Development (OECD) that Canada’s government was skirting international trade rules on export credits—government-backed financing that many countries, including Canada, offer to foreign buyers of their products or services. Essentially, these credits create a situation in which taxpayers are involuntary enlisted by businesses and governments to fight corporate battles, instead of one in which corporations are forced to hash it out in a competitive market without subsidies and loan guarantees backed by public treasuries. These credits turn a private battle into a public one.

Airbus and Boeing’s complaint concerns Bombardier aircraft and the Export Development Canada (EDC) agency. In this case, the EDC acts as a guarantor for loans

made to those who wish to purchase Bombardier planes as a way to help “grease” sales for Bombardier and enable purchases that might otherwise be seen by a bank as too risky to finance. With the EDC guarantee in place, banks and other lenders feel free to lend potential purchasers money for the aircraft; after all, if the buyer defaults on payments, it’s Canadian taxpayers and not the financial institution’s shareholders who will be left with the unpaid loan and will be forced to pursue the debtor, incurring even more expenses in the process.

In the *Wall Street Journal* article where the ad hoc lobbying partnership between Airbus and Boeing was first reported, a Boeing spokesperson argued that “Bombardier’s position clearly would be a distortion of competition” (Michaels, 2010, Jan. 24).

The spokesperson was referring to Bombardier’s attempt to stretch the OECD rules, which allow countries to finance or guarantee the sales of smaller regional jets, the type of jet Bombardier specializes in. A 2007 agreement between countries

with aerospace industries, the Aircraft Sector Understanding on Export Credits for Civil Aircraft, sets out the terms under which a country is allowed to finance aircraft (OECD, 2007). Makers of smaller regional jets are given more leeway than manufacturers of larger jets—the type for which Airbus and Boeing are best known.

The agreement’s terms include a limit on government loan guarantees to no more than 85% of the aircraft purchase price and set repayment terms at between 10 and 15 years, depending on the type of aircraft. The agreement also sets out the maximum age of the aircraft to be financed, minimum interest rates to be charged, and four extensive categories that specify which company’s plane fits under which restriction insofar as government-backed financing and guarantees are concerned (OECD, 2007).

As Bombardier began to market its newer and larger (but not yet built) CSeries jet as an alternative to Boeing and Airbus aircraft, and as the Canadian government began to try to re-classify the significantly larger plane as a “regional” jet,¹ Bombardier’s competitors cried foul, leading Boeing to accuse Bombardier of a “distortion of competition.”

Boeing may or may not be right under the Aircraft Sector Understanding agreement, but the accusations and counter-claims over the agreement obscure the larger

point: various countries have long distorted competition through loan guarantees and subsidies.

In the case of the Canadian aerospace industry, lavish subsidies and loan guarantees have been popular with governments for many years.

Two of the highest-profile recipients of subsidies and guarantees are Pratt & Whitney and Bombardier. Bombardier has never publicly disclosed its repayment record, but recent Access to Information requests (Industry Canada, 2009) obtained by the author reveal that authorized assistance to Bombardier from April 1, 1982, to May 12, 2009, amounted to \$750.2 million; it is not clear how much of that had been repaid as of the latter date. The author's 2007 study on corporate welfare found, through an Access to Information request, that Bombardier had repaid just \$188 million of the assistance as of 2005 (Milke, 2007).

Canada's other major aerospace manufacturer, Pratt & Whitney, has been more open. The company told the Fraser Institute in October 2009 that it had received \$1.4 billion from various Industry Canada programs since 1982 and that \$325 million in royalties had been paid to the federal government (Pratt & Whitney Canada, 2009).

Though the EDC and its loan guarantees are the main focus of the recent international dispute, it is important to note that the EDC is not the only provider of loan guarantees for Canada's aerospace sector. As EDC president and CEO Eric Siegel (2009) told an audience last fall, the Canada Account also plays a significant role:

The Canada Account is separate from EDC's corporate account, and the decision to use these funds rests with the federal Cabinet, but the funds are administered by EDC. This model is unique to Canada, and allows the government to take on certain transactions where the amount or the risk is higher than what EDC would normally take on its own books. The Canada Account has played a strategic role in the development of Canada's aerospace industry.

How much have the EDC and the Canada Account lent and guaranteed to Canada's aerospace industry? According to the EDC, it and the Canada Account had together either loaned or guaranteed \$2.23 billion to the aerospace industry as of December 31, 2009. Detailed breakdowns on exposure by company for EDC guarantees were not provided, nor were start dates (Taylor, 2010).²

In its January article, the *Wall Street Journal* quoted a US Treasury spokeswoman who said that the goal of the upcoming talks between signatories to the Aircraft Sector Understanding to change the 2007 pact is to get to "a single set of financial rules for all aircraft models" (Michaels, 2010, Jan. 24).

The simplest set of rules would be one that puts an end to subsidies and renews the signatories' commitment

to open, free competitive markets. This has been the goal of free trade negotiations since World War II, from the General Agreement on Tariffs and Trade (GATT) to various World Trade Organization negotiations and bilateral and trilateral agreements such as the Canada-US Free Trade Agreement and the North American Free Trade Agreement.

If the OECD countries want to be an example of free trade in action and reinvigorate the drive for open markets around the world, ending loan guarantees and subsidies for the world's largest airplane manufacturers would be an excellent place to start.

Notes

1 The CSeries will have between 100 and 149 seats (Bombardier, 2010); most jets that are considered "regional" have 90 seats (Michaels, 2010, Jan. 24).

2 The EDC did not provide a breakdown of this figure by loan or loan guarantee, by separate EDC or Canada Account liabilities, or by company, as requested by the author.

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Canada-US relations in 2010

Canada's top economic interest is still unimpeded access to the US market

ALEXANDER MOENS



Since 9/11, the American attitude towards the Canada-US border has changed dramatically and cross-border trade has suffered as a result. Although we share intelligence and use biometrics and electronic customs reports, we are like nineteenth century nation-states: two separately sealed jurisdictions, each with multiple checklists on our side of the border. This presents a serious long-term challenge to the integration of our economies. The resulting discouragement, irritation, just-in-case deliveries, and towering paperwork will eventually frustrate the entrepreneurial spirit, and investment and trade will decline.

In October 2008, 19% of Canadian respondents to a national poll felt that "it was a lot more difficult for Canadian exporters" to cross the border. In September 2009, 26% of respondents shared that sentiment (Bouzane, 2009, Sep. 20). Border restrictions and waiting costs in particular threaten the integrated supply chain in manufacturing (Sands, 2009, Jan. 17). The border is now a de facto barrier to trade, even for shippers who are enrolled in secure and trusted cargo and driver programs such as the Customs-Trade Partnership Against Terrorism (C-TPAT) and Free and Secure Trade (FAST). In these programs, businesses and individual employees (e.g., truck

drivers) submit to a background security check and set up a secure process for moving goods from the manufacturing plant to their destination. Nevertheless, truckers enrolled in these programs find themselves in long lines to get to their expedited lanes and are frequently pulled over for inspection, despite their "secure" status.

Because Canada, the United States, and their many sub-federal jurisdictions keep a plethora of different regulations and product standards, the two federal governments spend a lot of time on the borders enforcing small differences (NACTS, 2009). For example, Canada and the United States have different standards for the amount of cheese allowed in cheese-flavoured popcorn and whether fortified orange juice should be a drug (Canada) or a food (United States). Multiple product standards, overlapping testing, and duplicative certification all lead to unnecessary costs (Hart, 2006). If the associated border costs continue, integrated supply chains in manufacturing may begin to decline as investment in Canada is diverted to the United States or to other jurisdictions outside North America. Nearly 50% of business respondents in a 2004 survey confirmed that border costs affect their investment strategy (Manley, 2005).

A new wave of protectionism

The financial crisis and economic recession that started in 2008 has sparked a new wave of protectionist measures in the United States, creating further challenges for the Canada-US relationship. The United States' \$787 billion stimulus program, approved in early 2009, included a "Buy American" provision for iron, steel, and manufactured products that severely limits Canadian companies' involvement in up to \$260 billion worth of projects at the state and municipal levels (Austen, 2009, Aug. 7).

The talks for obtaining a Canadian exemption in return for American access to Canadian projects began in August 2009 and bore fruit in February 2010. In the Canada-US deal, Canadian firms are exempted from most of the Buy American provisions at the state and municipal level. In return, Canadian provinces and territories have agreed to sign on to the World Trade Organization's Agreement on Government Procurement, just as 37 US states did years ago. The deal is not perfect as most US contracts have already been awarded and both countries continue to have exceptions—health care and social services in Canada and mass transit and highways in the United States (Iverson, 2010, Feb. 6). Canada should use this opportunity to negotiate a full reciprocity agreement on public procurement.

However, the Buy American provision is not the only new protectionist measure. The implementation of Country of Origin Labeling (COOL) on some food products was sped up by Congress and Obama's Secretary of Agriculture, Tom Vilsack, contributing to a decline in Canadian pork exports in 2009 and pushing down Canadian beef prices (Krauss, 2009, Oct. 12). The new COOL labels show whether a product is homegrown and thus allows consumers to "buy American" if they wish. Many American food companies consider the paperwork involved in meeting the COOL requirement to be so burdensome that they simply do not bother to buy Canadian products (Vieira, 2009, Apr. 9). Shortly after the Canadian government filed for a WTO review of the COOL regulation, the Obama administration moved to block the request.

A third area of protectionism that could prove very significant concerns carbon dioxide emissions and low-carbon fuel standards. The Obama administration's controversial plan to create a "green energy economy" includes a cap-and-trade system to reduce carbon dioxide emissions. The current House (Waxman-Markey) and

Senate (Kerry-Boxer) bills aim to reduce greenhouse gas (GHG) emissions by 17% and 20% below 2005 levels, respectively, by 2020. If these bills become law, Congress will also impose tariffs or levies at the border to protect "trade-exposed industry" from jurisdictions with lower GHG emissions standards (Rennie, 2009, Dec. 15). Needless to say, Canada's manufacturing and energy sectors would be hit hard by such a levy.

While the Waxman-Markey bill will likely not pass in 2010 due to the victory of Republican Scott Brown in the US Senate, the Obama administration remains adamant about its goal to reduce GHG levels. With good sense and prudence, the Canadian government is trying to make sure that our rules will be as similar as possible to those in the US. Even though punishing carbon is bad public policy based on shaky science, Canada would stand to lose greatly by being outside the American regime.

However, even if Canadian carbon measures were at par with American emission cuts, small regulatory differences would still expose Canadian industry to American trade action. Given the history of Canada-US trade, this is no idle threat. While the Canadian government wants to harmonize and align CO₂ reductions with those in the United States, it also wants to be able to set internal regulations according to Canadian parameters. However, a "separate but equal" system would considerably increase the chance of trade action from the United States (Prentice, 2009). This tension between wanting to retain control over Canadian adjustments while harmonizing with the American system creates a difficult situation for Canadian policy makers.

Western Canada's oil sands industry has been singled out as a source of CO₂ emissions, especially by environmental groups who argue that per barrel emissions are three times as high as emissions from conventional oil. However, when emissions are calculated in terms of the entire life cycle of a barrel of oil (i.e., "from wells to wheels"), the extraction of oil from oil sands does not result in significantly more carbon dioxide emissions than the extraction of conventional oil (PBS Newshour, 2009). Furthermore, GHG emissions per barrel of oil extracted from the oil sands have fallen 33% since 1990. Nevertheless, several US states are considering a levy on this "dirty" oil because of its higher carbon footprint (McCarthy, 2010, Jan. 6), and the Waxman-Markey bill contains a provision that would prohibit the US federal government from using fuel extracted from the Canadian oil sands.

Table 1: Total crude oil and petroleum products trade for Canada and the United States, 1998 to 2008 (in billions of 2002 Canadian dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total exports	12.5	14.5	26.2	23.3	25.2	27.8	32.2	38.4	45.5	48.7	71.9
Total imports	2.1	1.4	1.7	1.7	1.4	1.5	2.1	3.1	3.5	4.2	7.6
Net trade balance	10.4	13.1	24.5	21.6	23.7	26.3	30.2	35.3	42	44.5	64.3

Source: Industry Canada, 2010.

Oil products like gas and electricity form an integrated market between Canada and the United States in which investment flows, equipment supplies, pipelines, and refineries reveal as much of an American stake as a Canadian one. A slowdown or retraction in oil sands production due to US carbon measures would have a significant impact on Canada’s export earnings (table 1). In 2008, total proceeds from crude oil products exports to the United States amounted to half of Canada’s total export earnings. In 2008, Canada’s total trade surplus for energy products was \$80.6 billion (FAIT, 2009).

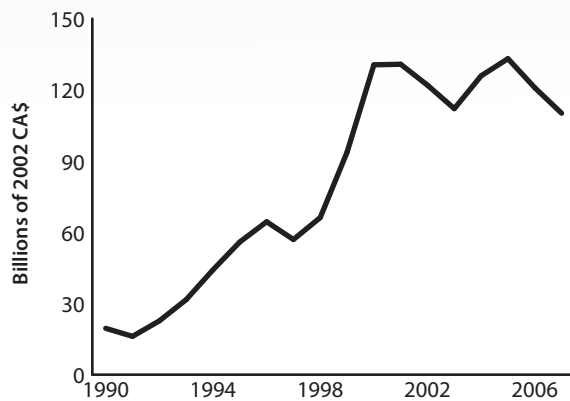
The best Canadian policy on carbon emissions is caution and delay. Caution because the public policy solutions are not as simple as many global warming activists would have us believe; delay because the American political agenda remains in flux. The election of Republican Scott Brown to the US Senate in January 2010 likely means that the Waxman-Markey bill will not make much progress before the November 2010 Congressional elections. Significant gains by the Republicans in the 2010 Congressional elections would give US politicians a second chance to consider what, if anything, should be done.

Trade trends

Canada-US trade trends for the last 10 years show that the rapid growth in trade that took place during the 1990s is weakening (figures 1 and 2).

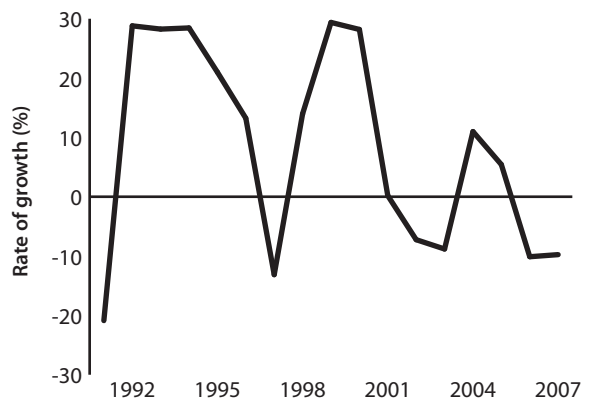
While trade in the energy sector has been growing, the once dynamic integrated supply chain in manufacturing, including automotive, appears to be stagnating (figures 3, 4, 5, and 6). Trade in manufactured goods, including transportation, chemicals, and equipment, has been declining since 2005; of the 21 manufacturing

Figure 1: Canada-US net trade balance, 1990 to 2007 (in billions of 2002 CA\$)



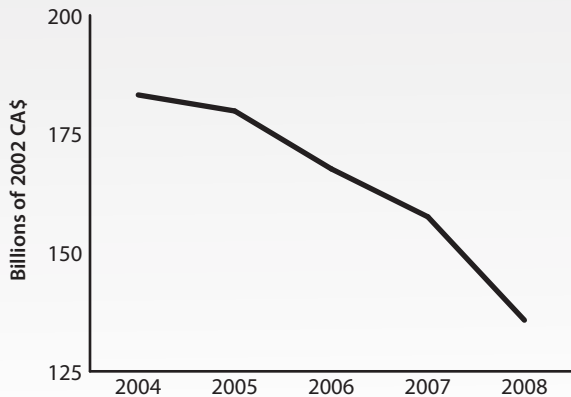
Sources: Industry Canada, 2010; Statistics Canada, 2010.

Figure 2: Growth rate of Canada-US net trade balance, 1990 to 2007



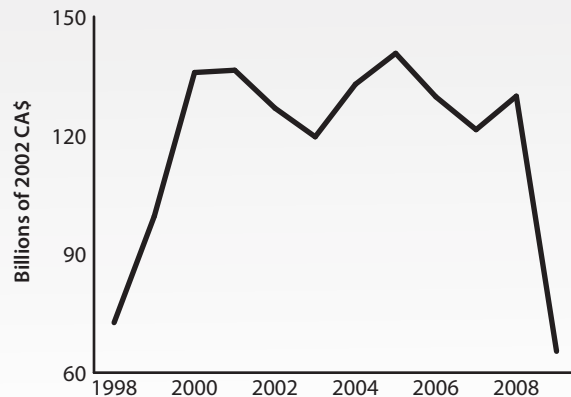
Sources: Industry Canada, 2010; Statistics Canada, 2010.

Figure 3: Value of Canadian manufactured products exports, 2004 to 2008 (in billions of 2002 CA\$)



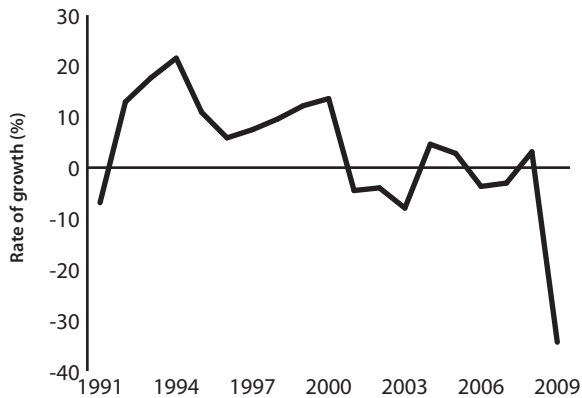
Source: Industry Canada, 2010.

Figure 4: Canada-US net merchandise trade, 1998 to 2009 (in billions of 2002 CA\$)



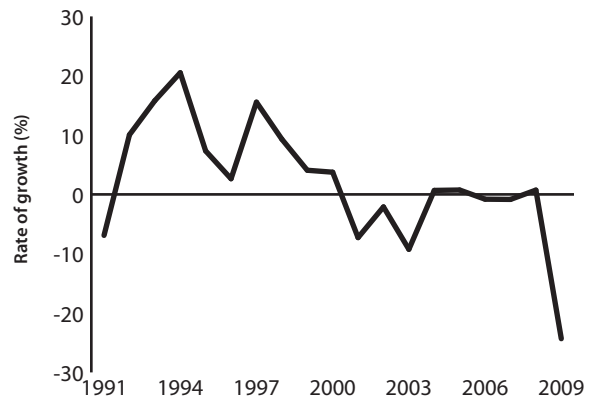
Source: Industry Canada, 2010.

Figure 5: Growth rate of Canada-US merchandise exports, 1990 to 2009



Source: Industry Canada, 2010.

Figure 6: Growth rate of Canada-US merchandise imports, 1990 to 2009



Source: Industry Canada, 2010.

sectors in Canada, only four have shown tiny increases (FAIT, 2009).

Canadian exports have declined slightly more than Canadian imports. Overall, the share of the United States in Canada's trade fell by 5.3 percentage points between 2004 and 2008 to 67.8% of total trade, the lowest share in 15 years (FAIT, 2009).

While there appear to be new opportunities for Canadian businesses, for example, in the banking sector,

several current trends do not bode well for Canada-US trade growth. The most important of these challenges for future Canadian exports to the United States is the relatively high value of the Canadian dollar.

The Canadian dollar is likely to remain high relative to the American greenback, putting downward pressure on Canadian exports (Scotia Bank Group, 2009; Tal, 2009). As Clemens and Kaszton explain in this issue of *Fraser Forum* (pg. 24), America's budget deficit problems are

serious enough to put downward pressure on the US dollar. America's national budget deficit for 2009 was 11.9% of its GDP and its current debt is equivalent to 60% of its economy. Huge debt projections for years to come, compounded by unfunded liabilities for Medicare/Medicaid and Social Security, will keep deficits high and the American dollar low. The risk of higher interest rates is not far behind.

At the same time, strong prices projected for raw materials and oil will keep upward pressure on the Canadian dollar. Most analysts expect the Canadian dollar to go slightly over par with the American dollar by 2011 (Scotia Bank Group, 2009; Tal, 2009).

Compounding the high dollar challenge is the expectation of a relatively weak recovery of demand for Canadian products in the United States, due to slow growth in US real disposable income (which was only half of Canadian growth in real disposable income in the last five years) and persisting high unemployment rates projected to last until at least 2011. In addition, the financial and housing crises have caused a 20% drop in US household net worth since 2007 (Scotia Bank Group, 2009; Tal, 2009).

An unproductive relationship

Twenty years ago, the two nations enjoyed one of the most successful periods in their bilateral relationship as Brian Mulroney and Ronald Reagan negotiated a successful free trade deal, solved a variety of bilateral problems (such as the Acid Rain Accord), and deflected major collisions on East-West relations. No major advancements were made in the bilateral relationship in the 1990s, and the 2001 to 2006 period was plagued by lingering disputes over trade (e.g., softwood lumber and BSE) and international security (e.g., Iraq and missile defence).

Our failure to pursue deeper trade integration between Canada and the United States in such areas as regulatory harmonization or mutual recognition, common external tariffs on manufactured products, free trade in agricultural products, government procurement, and an overall energy and environmental accord in the 15 years following NAFTA has left Canada's future economic relationship with the United States dangling.

The public denigrating of the NAFTA accord in the 2008 Democratic primaries further rattled Canadian confidence. Neither the NAFTA nor the WTO process can be relied upon to protect Canada's interests if its energy

or manufacturing sectors are discriminated against by American green energy legislation.

Canada cannot assume that Congress will deal strategically with foreign interests. American stakeholders in industries integrated with Canadian oil exports (such as



refineries, oil drilling equipment, and investment firms) will have to carry the ball. Concentrated Canadian lobbying and diplomatic efforts to rally this interest are of key value in the next two years.

Many in Canada assume that the so-called BRIC countries (Brazil, Russia, India, and China) will pick up the slack in Canada-US trade, but our history shows that diversification is difficult. It is more likely that Canada's long-term prosperity will depend, to a large extent, on renewed American prosperity. Of course, Canada does not have to choose between diversification to other markets and trade with the United States. Canada's strong growth in trade with the United States after the Canada-United States Free Trade Agreement did not come at the expense of trade with other areas of the world (Andresen, 2006).

Canada's top economic security interest remains unimpeded access to the US market. Canadian businesspeople still see opportunities in the United States, though the number of obstacles is increasing.

Marrying America's security concern with Canada's need for a single economic market should have been Canada's top goal on September 12, 2001. Since then, reaching such a deal has only become increasingly difficult, especially as most American politicians are not focused on this problem. Still, it remains Canada's most important foreign policy goal.

Canada's government must show Canadians what is at stake in terms of developing deeper economic integration with the United States. Canada's goal should be twofold: to remove all remaining non-tariff barriers to trade and achieve regulatory harmonization and product standards compatibility, and to render the border as invisible and unobtrusive as possible.

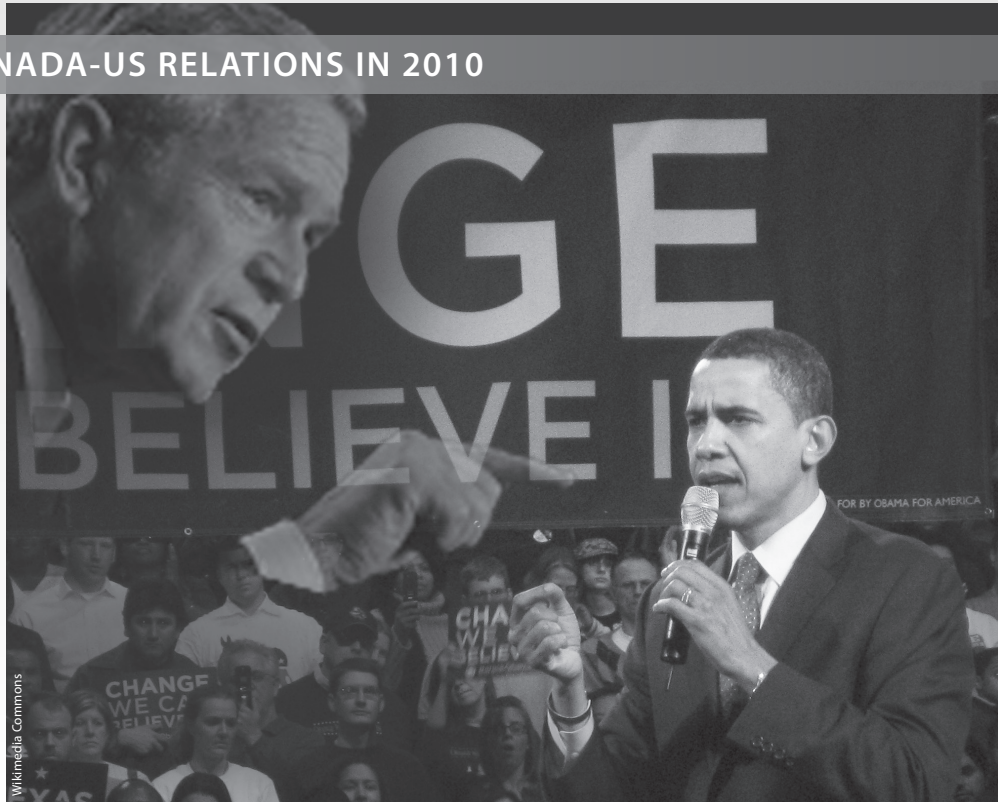
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Change, continuity, or both?

Taking stock of Obama's first-year foreign policy

ALAN W. DOWD



After campaigning on promises to withdraw from Iraq, “finish the fight against al Qaeda and the Taliban in Afghanistan,” build a diplomatic coalition against nuclear proliferation, “curb Russian aggression,” and stand up for “the blogger in Iran,” President Barack Obama has learned that conducting US foreign policy is more difficult than simply critiquing it (Obama, 2008, August 28; Obama, 2008, July 24).

Has his on-the-job training yielded a year of change or continuity—or a little of both?

Continuity

There is a surprising amount of continuity between Obama and his predecessor in several key foreign-policy areas. This is partly the result of major adjustments after George W. Bush's first term which led to mild successes at the end of Bush's second term.

For example, the Bush administration's revamped counterinsurgency strategy in Iraq brought about a more stable security environment¹ and enabled Bush to begin the drawdown that Obama promised.

Stability in Iraq (i.e., reductions in civilian casualties and attacks on coalition forces) also allowed Washington to refocus on the growing problems in Afghanistan and Pakistan (commonly referred to as “AfPak”). The drone strikes in the AfPak theatre, for example, began under

Bush and have intensified under Obama. In addition, we now know that the AfPak plan announced by the Obama administration in March 2009, which featured more troops and a sharper focus on counterinsurgency, was largely developed in the final months of the Bush administration and handed off to Obama's national security team (Cheney, 2009, Oct. 21). Even after months of deliberation last autumn, Obama's re-review of that plan did not change much about the policy.

Moreover, the insurgency in Iraq and the Taliban resurgence in Afghanistan had a constraining effect on the Bush administration's capacity to apply its post-9/11 doctrine of regime change and preventive war in other problem states, such as Syria, Iran, and North Korea. As a result, the Bush administration relied on diplomatic avenues² in its second term, which is what Obama promised to do as president (see, for example, Saine, 2008, Nov. 14).

Another important reason for continuity in the related areas of foreign policy and defence policy flows from the simple fact that Obama hired Bush's defence secretary, Robert Gates, who carried out the surge strategy in Iraq and helped plan the revised mission for AfPak. Defence spending has continued apace. The Bush administration's last defence budget was \$578 billion. The Obama administration's first defence budget was \$636 billion (Boles, 2009, Dec. 16).

In addition, Obama chose a relatively hawkish secretary of state, Hillary Clinton, who supported the Iraq

war as a senator and talked tough on Iran as a presidential candidate.

Continuity was also forced upon the Obama administration by the behaviour of certain regimes.

North Korea, for instance, tested a nuclear weapon and long-range missiles during Obama's first year in office, just as it had during the Bush administration. As a result, the new administration could not easily engage in the promised one-on-one talks with no preconditions.

Likewise, Iran remained defiant, flouting appeals from the International Atomic Energy Agency to verify that its nuclear program is not being used to develop nuclear weapons. When evidence of a secret Iranian nuclear-fuel manufacturing plant came to light in September 2009, French president Nicolas Sarkozy challenged Obama to get serious. Obliquely dismissing the young president's "dream of a world without nuclear weapons," Sarkozy reminded Obama that "we live in a real world, not a virtual world" (Sarkozy, 2009). He then detailed the growing dangers in the real world:

Since 2005, Iran has violated five Security Council resolutions ... An offer of dialogue was made in 2005, an offer of dialogue was made in 2006, an offer of dialogue was made in 2007, an offer of dialogue was made in 2008, and another one was made in 2009 ... What did the international community gain from these offers of dialogue? Nothing. More enriched uranium, more centrifuges ... There comes a time when facts are stubborn and decisions must be made.

In short, it appears that Sarkozy's tough talk on Tehran, Iran's brutal response to the so-called "Twitter Revolution" that shook the Islamic Republic in 2009, and the regime's defiance on the nuclear issue may have forced Obama to deviate from his plan of diplomatic engagement without any preconditions. Indeed, Obama himself conceded during his 2010 State of the Union address that "the Islamic Republic of Iran is more isolated" (Obama, 2010).

Change

To the extent that there has been change in US foreign policy, it has largely been rhetorical and stylistic, which is not insignificant. How a president says something can be as important as what he says.

During his inauguration, Obama vowed to embrace "the tempering qualities of humility and restraint"

(Obama, 2009a), and he has conveyed this in his use of the spoken word.

Where Bush sought to isolate and in some cases punish rogue regimes, Obama promises engagement. "Condemnation without discussion," he says, "can carry forward only a crippling status quo. No repressive regime can move down a new path unless it has the choice of an open door" (Obama, 2009d). To be sure, events have largely forced Obama to keep engagement in the realm of rhetoric for now, as noted above, but Obama wants to offer the "open door" to regimes that have been shut out.

Where Bush used the phrase "war on terror" routinely, the Obama administration has made a concerted effort to expunge the "war on terror" phraseology from official pronouncements. Federal agencies are using the banal "overseas contingency operations" instead (Wilson and Kamen, 2009, Mar. 25).

Where Bush was caricatured as waging a war against Islam, Obama has gone to great lengths to promise "a new beginning between the United States and Muslims around the world" (Obama, 2009c).

Whether or not this change in style and tone will yield tangible policy benefits remains to be seen, but it appears to have contributed to a change in global attitudes towards America, which can have a salutary effect. Opinion of the United States has gone up around the world: in Canada from 55% favourable in 2007 to 68% in 2009; in Britain from 51% to 69%; in France from 39% to 75%; in China from 34% to 47%; and in India from 59% to 76% (Pew Research Center, 2009).

To be sure, there have been some genuine changes on the foreign policy front, the most significant of which have affected America and its allies.

For instance, Obama does not seem to share the pro-trade predisposition of the Bush administration.

The president's stimulus package—the American Recovery and Reinvestment Act (ARRA)—included "Buy American" provisions that raised concerns in Canada, Europe, and Japan. Although fears of a full-blown trade war were initially tempered by a compromise that kept the "Buy American" language but added an important caveat requiring that the measures be "applied in a manner consistent with US obligations under international agreements" (Reuters, 2009, Feb. 12), problems persist.

As the *Washington Post* reports, one provision requiring the use of US steel and iron in ARRA projects has negatively impacted Canadian companies (Shin, 2009, Aug. 11). When an Ontario-based water-treatment

company was blocked from bidding on an ARRA project, cities in the province passed measures promising to block US-based companies from bidding on projects north of the border (Shin, 2009, Aug. 11).

In addition, US trade agreements with South Korea, Panama, and Colombia have stalled. Obama reportedly told South Korean officials that “we have a lot of work to do” before the languishing free trade deal can move forward (Glionna and Nicholas, 2009, Nov. 19). And Commerce Secretary Gary Locke bluntly noted last November that “trade agreements are going to have to wait,” conceding that “the administration is focused on a very aggressive and very tight legislative agenda” (Kennedy, 2009, Nov. 13).

In Europe, Obama has tried to “reset” the US-Russia relationship. Not coincidentally, he scrapped Bush-era plans for a permanent ground-based defence against missile threats—plans that had been endorsed by NATO and host governments in Poland and the Czech Republic.

Of course, those plans angered the Russian government. Hence, when Obama announced his scaled-back approach to missile defence, the expectation was that Moscow would respond with a concession of its own. Instead, Dmitry Rogozin, the Russian ambassador to NATO, declared, “The Americans have simply corrected their own mistake. And we are not duty-bound to pay someone for putting their own mistakes right” (Pan, 2009, Sep. 18).

Both continuity and change

Finally, at the intersection of foreign policy, national security, and domestic policy, Obama ordered the closure of the detention facility at Guantanamo Bay (commonly known as “Gitmo”). Yet even this policy change highlights the continuity between Bush and Obama, albeit in an unintended way.

Obama’s decision was welcomed overseas, but those being held at Gitmo were not. Although the European Parliament passed a measure calling on EU members “to be prepared to accept Guantanamo inmates,” individual European countries are not jumping at the chance to open their borders to Gitmo’s residents (European Parliament, 2009).

The Dutch government refuses to accept any Gitmo inmates, while a Czech official argues that the Gitmo headache “is primarily a US responsibility” (Donahue and Neuger, 2009, Jan. 26; European Parliament, 2009). The British foreign secretary says his country has “already

made a significant contribution to the closure of Guantanamo” (Donahue and Neuger, 2009, Jan. 26).

The American people oppose the plan to shut down Gitmo and move the detainees into the United States by a two-to-one margin (Jones, 2009)—and understandably so. Of the 198 detainees at the facility, the Pentagon says dozens should not be released due to the danger they pose to US interests (Morgan, 2009, Jan. 13).

Moreover, of the approximately 800 detainees that have cycled through Gitmo since 2002, at least 61 have returned to their jihad (Morgan, 2009, Jan. 13). In fact, one former Gitmo inmate is now second in command of al Qaeda in Yemen (Worth, 2009, Jan. 22). That branch of al Qaeda has been very active recently—the failed Nigerian airline bomber was trained by Yemini—so active that Obama recently suspended the transfer of Gitmo detainees to Yemen.

It was on January 22, 2009, two days into his presidency, that Obama issued his directive to close the Gitmo detention facility “no later than one year from the date of this order” (Obama, 2009b). However, Gitmo is still holding dozens of suspected terrorists, just as it was during the Bush administration—yet another indication that there has been more continuity with the previous administration’s foreign policy than Obama’s supporters expected and less change than his opponents feared.

Notes

1 Increasing levels of stability in Iraq are documented in the Brookings Institution’s Iraq Index. See <<http://www.brookings.edu/saban/iraq-index.aspx>>.

2 The clearest example of this is the Bush administration’s approach to Iran during its second term, which was characterized by its allowing the Europeans to pursue the so-called “diplomatic track” rather than confronting Iran in a manner similar to the way Iraq was confronted in 2003.

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Deficits and debts

The fiscal state of the US government

JASON CLEMENS AND JULIE KASZTON

Any assessment of the Canada-US relationship that does not include an examination of fiscal policy is incomplete. After all, the US federal budget exceeded \$3 trillion for the first time in 2009—more than double Canada's *total* GDP—and is expected to reach \$4 trillion by 2014 (CBO, 2009d).

This analysis of US fiscal policy relies on expectations as they stood at the end of 2009. There will no doubt be additional developments between the completion of our analysis and the publication of this article, particularly with respect to the resolution of President Obama's signature legislation: health care reform. However, there is little chance that such developments will constitute a fundamental change in the direction of and concerns regarding US fiscal policy.

Huge deficits

Deficits occur when a government borrows money because the revenues it collects are insufficient to finance spending. This is different from the debt of a country, which is basically the accumulation of deficits over time.

Figure 1 illustrates the surpluses and deficits of the US federal



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government as a share of the economy (GDP) between 1970 and 2009,¹ along with projections for the next 10 years as calculated by the Congressional Budget Office (CBO). Both the original CBO estimates (March) and the August 2009 updates have been included in the analysis in order to illustrate the deterioration in expectations that occurred over the course of 2009.

As figure 1 shows, deficits have been the norm in the United States

since 1970 (and indeed before). The only respite from deficits occurred between 1998 and 2001 under the Clinton administration. Deficits as a share of the economy began to shrink in 1993 (Clinton's first year in office) and turned into surpluses in 1998.

As in many countries, including Canada, the US fiscal position deteriorated rapidly with the onset of the financial crisis of 2008-2009, the ensuing recession, and the government's response of increasing spending. The US federal deficit increased from 3.2% of GDP in 2008 to almost 12% of GDP in 2009 (CBO, 2009d). While the CBO expects some decline in the size of the deficit relative to GDP over the next three years, it does not project a return to surpluses over the next 10 years; deficits are expected to average about 3.2% of the economy (GDP) from 2013 to 2019.

However, both the March 2009 and August 2009 projections were made before the resolution of the government's health care reform initiative, the Affordable Health Care for America Act (the AHCAA), which, depending on the final details, could add significantly to the long-term deficit of the US federal government.

Sustained deficits in excess of 3.0% of GDP are a cause for concern. Indeed, the non-partisan Tax

Foundation estimates that personal income tax rates would have to triple in 2010 to balance the federal budget, given current spending levels (Ahern, 2009).

Deficits = more debt

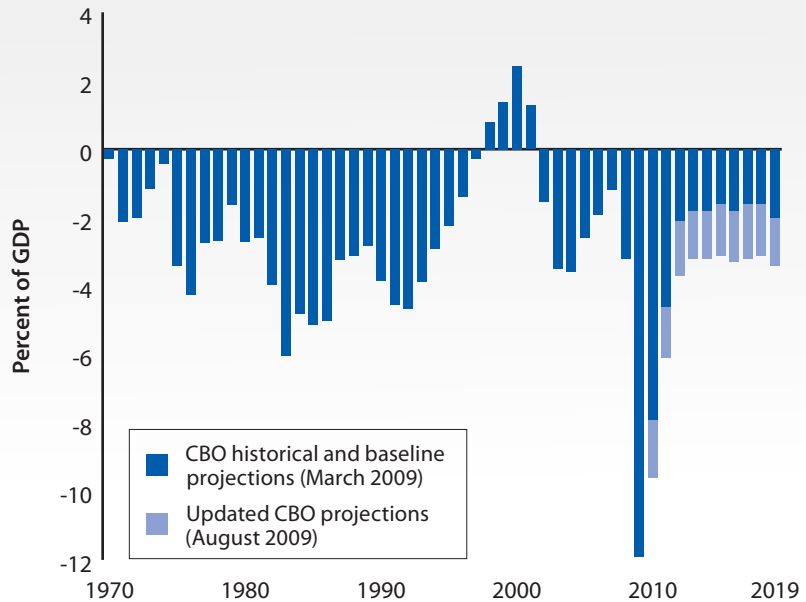
It's not difficult to recognize that deficits mean more debt. Figure 2 illustrates the US federal government's debt held by the public² as a share of GDP from 1970 to 2009, along with projections for the next 10 years. US federal debt as a share of the economy increased from 21.7% of GDP in 1970 to 40.8% of GDP in 2008. In dollar terms, the US federal debt reached an estimated \$7.6 trillion in 2009 (CBO, 2009d).

The CBO's original projections expected US federal debt held by the public to reach \$11.8 trillion in 2019, representing 56.1% of GDP. Its updated projections (August 2009) show US federal debt reaching \$14.3 trillion in 2019, representing 67.8% of expected GDP (CBO, 2009d).³ Critically, the revised CBO projections for US federal debt as a share of GDP no longer show any decline over the next 10 years, showing instead a consistent increase. The increase in national debt now expected over the next decade is, however, less severe than was proposed by the Obama administration, whose budget propositions would have seen US federal debt reach 82.4% of GDP by 2019 (CBO, 2009b) (figure 2).

More debt = more interest

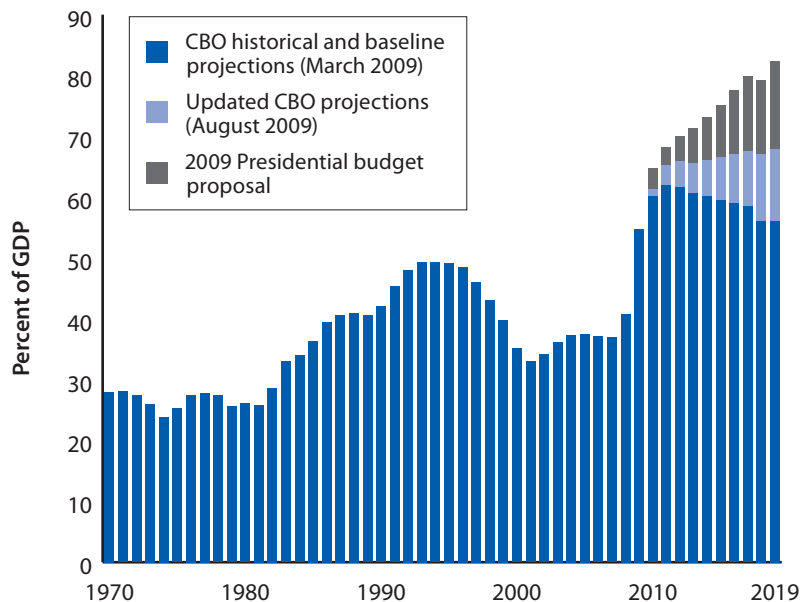
There are a number of ways to examine the effects of increasing debt

Figure 1: US federal deficits as a share of GDP, 1970 to 2019



Sources: CBO, 2009b, 2009d, 2009e.

Figure 2: US public debt as a share of GDP, 1970 to 2019



Sources: CBO, 2009b, 2009d, 2009e; OMB, 2009b.

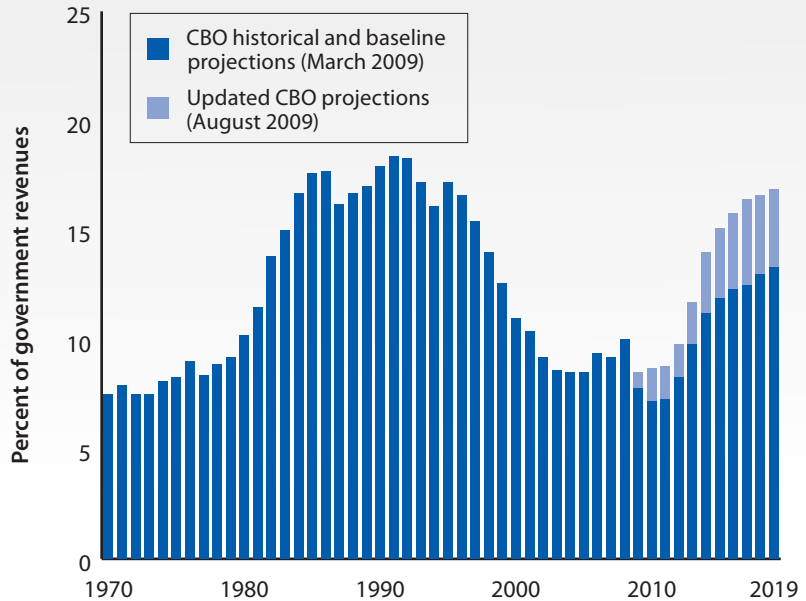
on interest costs. The most obvious is that the dollar cost of interest expenses will likely increase as debt increases.⁴ In nominal terms, that is certainly what the CBO is projecting: net interest costs⁵ are expected to increase from \$177 billion in 2009 to \$722 billion in 2019 (CBO, 2009d).

Another way to examine interest costs is to look at the portion of revenues they absorb. This approach measures the portion of taxes and other revenues that are actually available to the government for program spending and income transfers after the interest costs on outstanding debt have been paid. Figure 3 illustrates the percentage of federal revenues allocated to net interest costs each year beginning in 1970. The US federal government clearly enjoyed a period from 1991 to 2005 when interest costs as a percentage of revenues were declining. However, the opposite trend is now expected to dominate federal finances for the next decade. The CBO estimates that net interest costs will consume almost 17% of revenues by 2019, more than double the portion recorded in 1970 when interest costs represented 7.5% of revenues (CBO, 2009d). This means that the US federal government expects to spend one out of every six dollars of revenue collected by 2019 on simply servicing the national debt held by the public.

Understanding why

There is no doubt that federal revenues declined during the recession of 2009. In nominal terms, total federal revenues dropped from \$2.5 trillion in 2008 to \$2.3 trillion in 2009 (CBO, 2009d). However, the CBO expects revenues to rebound

Figure 3: Net interest costs as a percentage of government revenues, 1970 to 2019



Sources: CBO, 2009b, 2009d, 2009e.

fairly quickly, exceeding their pre-recession level by next year (2011).

Spending is the driver of federal deficits in the United States. In nominal terms, US federal spending grew from \$3.0 trillion in 2008 to \$3.7 trillion in 2009 (CBO, 2009d). These levels are expected to be maintained even as the so-called “stimulus” spending winds down in 2011.

Figure 4 shows federal government spending from 1970 to 2019 (expected) as a share of GDP (note that these numbers were calculated before the resolution of the AHCAA). The CBO expects federal government spending as a share of GDP to decline from the recession peak of a little over 26% in 2009 to a resting point of roughly 22% over the next decade (CBO, 2009d). This is markedly higher than previous levels (figure 4) and well above levels during the Clinton

years, which were quite successful economically. Indeed, the decline of government spending as a share of the economy under President Clinton—from 22.1% in 1992 to 18.4% in 2000—was accompanied by strong economic growth, low unemployment, and high levels of investment.

Entitlements: making a bad situation worse

As if the fiscal position of the United States were not disconcerting enough, there is also the issue of unfunded liabilities—benefits promised to future Americans for which no resources are available—and in particular the country’s public retirement program (Social Security) and public health care programs (Medicare and Medicaid).

Social Security

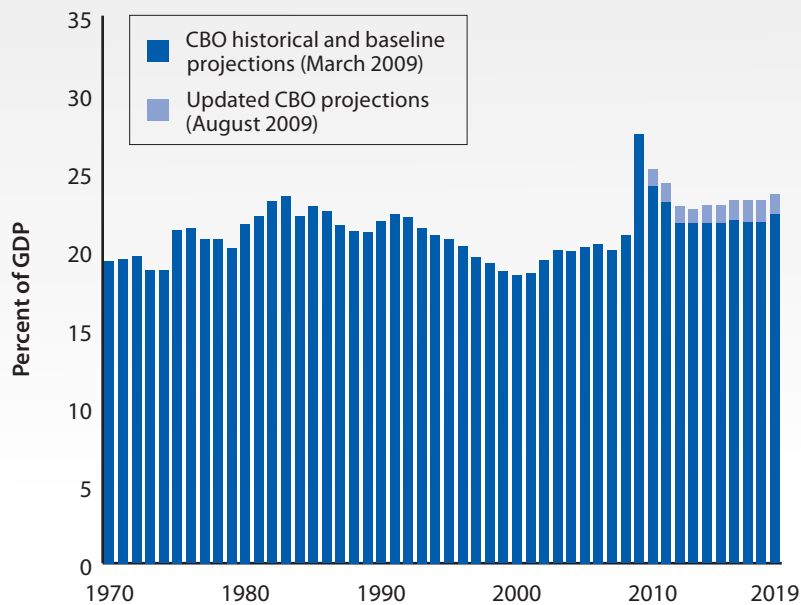
Each year the trustees of Social Security and Medicare release analyses examining the programs and their prospects for the future. According to the 2009 report, the annual cost of Social Security will exceed revenues (payroll taxes) in 2016. At this point, the notional assets held by the Trust will start to be drawn down until they are fully exhausted in 2037. The report estimates that a 16% increase in the payroll tax, an immediate reduction in benefits of 13%, or some combination of the two would be necessary to solve the problem as it stands today, although these estimates may be overly optimistic (Trustees of Social Security and Medicare, 2009). It is fairly clear that spending on Social Security will further constrain US federal finances in the near future, making a difficult situation even worse.

Medicare

A number of government agencies including the Government Accountability Office (GAO, 2008) and the Congressional Budget Office (2009c) have examined Medicare and concluded that it is financially “unsustainable” and jeopardizes the fiscal position of the US federal government. Indeed, there is wide agreement that the problems with Medicare dwarf those of Social Security (see Graham, 2008).

The conclusions of the 2009 annual report for Medicare are even more startling than those for Social Security. Spending on hospital insurance, for instance, already exceeds revenues, and the notional trust fund is expected to be exhausted by 2017 (Trustees of Social Security and Medicare, 2009). According

Figure 4: US federal spending as a share of GDP, 1970 to 2019



Sources: CBO, 2009b, 2009d, 2009e.

to the report, immediate solutions include a 134% increase in the payroll tax that funds the program, a 53% reduction in spending, or some combination of the two.

While the report concluded that financial concerns were less critical for other parts of Medicare, such as the Supplementary Medical Insurance portion (Part B) and the Prescription Drug Coverage program (Part D), it ignored the reason. These programs have an automatic funding mechanism wherein as costs increase other existing federal revenues are diverted to these programs. Such diversions to Medicare from other programs such as transportation, education, and other discretionary spending will place increasing pressure on the government to provide alternative financing for those programs.

Warnings

One useful way to conclude this analysis is to present the conclusions of Dr. Peter Orszag, a former director of the Congressional Budget Office who is now Obama’s “point-man” on the budget in his role as director of the Office of Management and Budget. During his time at the CBO, Orszag submitted warnings to Congress on the economic effects of increasing and persistent budget deficits. For example, in a 2008 report, Orszag stated that rising and persistent deficits would have a number of costly and damaging effects on the economy, including lower private investment, lower wages, and higher real interest rates (CBO, 2008). Similar warnings have been reiterated by Orszag’s successor (CBO, 2009d).

Conclusion

The fiscal policy being pursued by the US federal government is characterized by sizable deficits, increasing debt, and higher interest costs driven by large increases in federal spending for the foreseeable future. These fiscal challenges are made worse by future pressures from Social Security and Medicare. It is clear that at some point in the near future, substantial fiscal reforms will have to be made in order to achieve some level of fiscal sustainability. What these reforms look like—namely, whether they will rely on spending reductions or tax increases—is yet to be determined, but they will inevitably have profound effects on the nation.

Notes

1 The fiscal year for the US federal government runs from October 1 to September 30.

2 The Congressional Budget Office, along with most other US authorities, collects and analyzes US federal debt data using “debt held by the public.” This is a narrower measure than gross federal debt, which stood at a little over \$900 billion in 1980 compared to \$711.9 billion in debt held by the public. The difference between the two measures is the debt held in federal government accounts, principally the Social Security trust fund and several other trust funds.

3 Several liberal political commentators have begun to raise concerns about the size and persistence of budget deficits and the country’s rising debt. For example, see Broder (2009, Dec. 18).

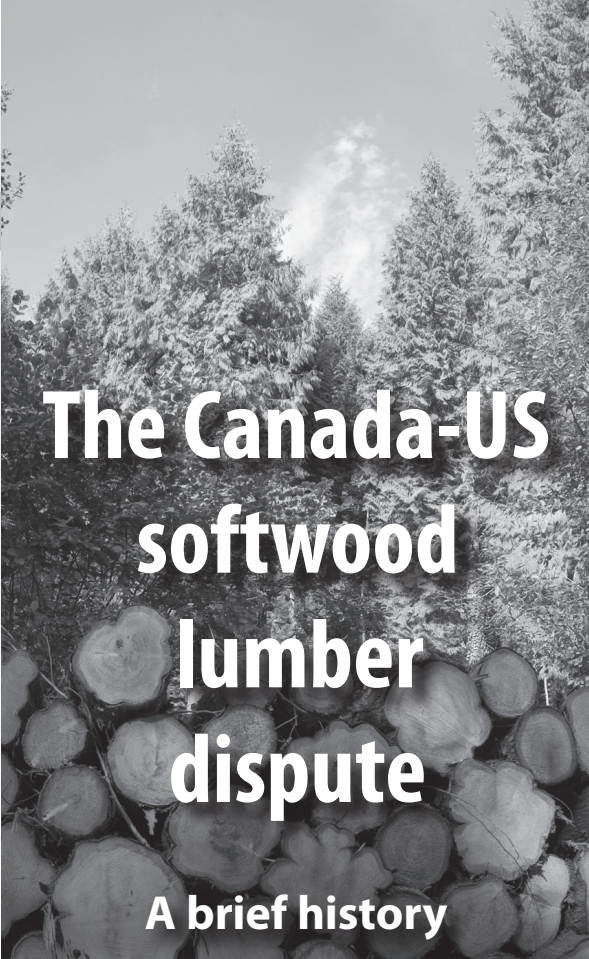
4 This can be mitigated when interest rates are falling. Specifically, the nomi-

nal cost of servicing debt can decline even when overall debt is increasing if the reduction in interest rates is sufficient to offset the increase in the stock of debt.

5 The United States uses “net interest costs,” which account for the borrowing costs incurred by the federal government and the interest earned on Social Security and other trust assets. The “net” cost quoted is meant to reflect the actual or net cost of borrowing.

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The Canada-US softwood lumber dispute

A brief history

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CSABA HAJDU

The moribund state of the North American forestry sector¹ is forcing significant changes to the structure of the industry in both Canada and the United States. World demand for forest products declined during the recent economic recession, especially in North America. Around the world, there has been a growing perception that the forest is more of an ecological preserve than an extractive renewable natural resource for forest products. This is particularly true in North America where the existence of “old-growth” forests has led environmental groups to push for preservation. There has also been a worldwide shift of production capacity to Asia, parts of Europe, and South America.

Many forestry companies in the United States and Canada continue to lose money. They have been reorganizing for survival, merging with other companies, investing in the most productive equipment, and, in cases where their borrowing capability has been damaged by losses, they have closed down mills. Some companies are pulling their timber resources out of timber production and preserving them as long-term investment trusts or as land for development. For example, TimberWest, the largest owner of private forest lands in Western Canada, has stopped producing lumber and has become, essentially, a land development company.

In both countries, the interdependent wood products and pulp and paper products manufacturing

enterprises are struggling to find politically stable and economically viable combinations of a good regulatory environment, guaranteed timber availability, a stable supply of energy, a competent labour force, good transportation, and favourable corporate taxation. Unfortunately, the recurring problems with Canada-US trade relations in the forestry sector—principally with regard to softwood lumber—have added to the lack of stability and certainty. This article examines the recent history of the softwood lumber trade war between the two countries.

The softwood lumber conflict

The United States produces less lumber than it needs. It imports about one-third of its lumber from Canada.² Canada produces more lumber than it needs. It exports two-thirds of its lumber to the United States and the rest of the world.³ This should be a happy coincidence, but it isn't. The two countries have different timber ownership systems that have left their respective lumber producers in continuous conflict. US producers feel that Canadians have access to cheaper timber that is not available to them. Canadians feel that a protectionist US lobby has the upper hand, imposing unfair levies on Canadians.

The last two decades of the softwood lumber trade war between the United States and Canada have simmered down to a continuous flow of complaining and periodic initiatives for arbitration. The relationship is popularly referred to as “Lumber V”—that is, the fifth period of lumber disputes in modern times.

The current softwood lumber agreement (SLA) was signed in September 2006. The SLA is a seven-year agreement, extendable to nine years. It put an end to the costly litigation that followed the expiration of the previous SLA in March 2001. The Canadian view is that the SLA has created some winners on the US side and many losers on the Canadian side.

To appreciate “Lumber V,” it is useful to review briefly the recent history of this trade dispute, ignoring the early friction between the two countries that goes back 200 years (Reed, 2001).

“Lumber I” started in 1982 with a petition from a group of US lumber producers for a countervailing duty (CVD). Countervailing duties are a type of trade penalty that can be imposed on a foreign exporter under WTO rules in order to neutralize the effects of foreign export

subsidies that harm domestic producers in an importing country. That duty was eventually rebated to Canada.

“Lumber II” followed in 1986 when the US Department of Commerce issued new CVD guidelines and the US Coalition for Lumber Imports (CFLI) petitioned the US International Trade Commission (ITC) for a 15% CVD. They claimed that the Canadian stumpage rate was lower than market value. Stumpage rates are the prices that logging companies pay to individual landowners or state land administrators for the right to harvest timber. The stumpage rate is usually calculated on a cubic metre basis. In 1986, a settlement was reached through a Memorandum of Understanding (MOU), under which Canada imposed a 15% export tax on lumber shipped to the United States. Provinces that increased their stumpage rates or imposed other taxes could reduce the export tax. In response, provincial charges were increased in British Columbia and Quebec, resulting in a complete elimination of the export tax in BC in 1987 and partial elimination in Quebec in 1988.

However, industry in Canada lobbied against excessive provincial tax increases and Canada withdrew from the MOU in 1991. The United States immediately imposed a cash deposit levy equal to the 15% tax that the MOU would have required, and the Department of Commerce initiated a new CVD investigation, which concluded that a 6.5% subsidy existed in Canada. Further, the ITC determined that lumber shipments represented a “threat of injury” to the US industry (Stanbury et al., 1999).

“Lumber III” followed. Canada renewed its challenge to the current CVD by appealing to both the dispute settlement panel of the General Agreement on Tariffs and Trade (GATT) and to the binational panel of the US-Canada Free Trade Agreement (FTA). Complex and expensive legal investigations and arguments ensued, at the end of which the US Department of Commerce recalculated the CVD rate at 11.54%. However, the FTA panel ordered that the CVD be revoked and the FTA extraordinary challenge committee affirmed the panel’s decision since the Department of Commerce’s order could not demonstrate the trade effects of the CVD. The US Congress affirmed both FTA panel decisions. Consequently, the CVD was revoked but the funds that had already been collected were not refunded until the two governments reached the five-year SLA in April 1996.

Under the 1996 SLA, quarterly tariff-free quotas were negotiated. Taxes were to be paid to the Canadian government for shipments above the quotas, though

additional tariff-free quotas could be granted when lumber prices were high. However, problems emerged with the complicated agreement, which was difficult to oversee and enforce, as did court challenges regarding the nature and classification of lumber products with “added value.” The result was that Canada chose to not renew the SLA upon expiry in March 2001.

At this point, the CFLI took the opportunity to file claims for both a CVD and an anti-dumping duty (ADD)⁴ against Canada and “Lumber IV” followed. The Department of Commerce determined that a 18.8% CVD and an average 8.4% ADD applied. The ITC concluded in 2002 that “threat of injury” also applied. Canada challenged all three US charges before the NAFTA and World Trade Organization (WTO) dispute determination panels. Claims, counter-claims, appellate decisions, administrative reviews, and extraordinary challenges led to the current SLA and “Lumber V.”

In the late stages of the protracted dispute process leading up to the 2006 SLA, the binational panel of judges of the North American Free Trade Agreement dismissed the ITC’s claim that Canadian lumber exports posed a “threat of injury” to the US softwood lumber industry. However, the WTO sided with the US claim that a CVD and an ADD were legally enacted by the US against Canada (WTO, 2006).

Once all the extraordinary challenges within NAFTA were exhausted, the US Supreme Court was approached to determine whether NAFTA judges had the right to order US government departments to cease collecting lumber duties at the border. The desire to prevent an embarrassing Supreme Court decision gave urgency to the creation of a new softwood lumber agreement, a political settlement.

One can see the logic in the United States rushing to sign the SLA as it is putatively slanted in favour of the US. The Coalition for Fair Lumber Imports (CFLI, 2005), the group of US lumber producers that opposed Canada, feared that the Supreme Court may issue an unfavourable verdict and was already agitating for a review of the validity of NAFTA itself. Such a review would have locked the two countries in a much broader legal fight. That may be the strongest reason why Canada signed the SLA. Any possibility of the United States pulling out of NAFTA would have caused serious economic hardship, particularly among the manufacturing industries in Ontario and Quebec.

In the end, Canada withdrew its appeal to the US Supreme Court to eliminate the CVD and refund the

monies, and the United States withdrew its claim that any basis existed for a CVD and an ADD.

The 2006 SLA

At the time the agreement was signed, most Canadian forestry companies were mired in such dire financial circumstances that they supported the 2006 SLA just to get a share of the duty refund. Canadian exporters' paid duties, which were held in escrow pending the outcome of the litigation. In the end, US\$4 billion were refunded. US\$1 billion was retained and divided equally between the US federal government (for various worthy forest development projects) and the US companies that originated the dispute.⁵ Canadian companies view this outcome as unjust.

In a recession, lumber demand drops and lumber prices decline. The SLA aims to reduce the volume of Canadian lumber entering the United States so as to protect US producers, reduce Canada's share of a shrinking economic pie, and thus shift more of the pain onto Canadians.

Canadians, in the view of their US competitors, receive government subsidies since they pay lower than market-determined prices for purchasing Crown (i.e., government) timber. This claim is the basis of decades of litigation. The agreed upon fact is that the two systems of timber pricing are different. Canadians feel that the Crown has been extracting maximum benefit in stumpage charges, taxes, regulated obligations, and the like, leaving less than competitive returns in the hands of investors (Stanbury, et al., 1999; Apsey, 1997). They point to the exodus of disenchanted US investors as poignant validation of their position.

Nevertheless, the aim of the SLA has been manifestly achieved: it has reduced Canada's share of the US market

(Dufour, 2007). The result has been devastating to the Canadian industry, which has virtually collapsed. According to the Canadian Forest Service, between 2006 and 2009, 25,000 direct sawmill jobs and 23,000 pulp and paper jobs were lost permanently in Canada (NRC, 2010a).

The industry's financial results are similarly negative. PricewaterhouseCoopers (PWC) compares the financial performance of the 100 largest forest, paper, and packaging corporations in the world (PWC, 2008). According to the last PWC comparison, Canadians lost US\$4 billion in 2008, in addition to a large loss in 2007. Canada suffered half of the US\$8 billion in global losses. It is anticipated that the 2009 figures, when they become available, will also show massive losses.

The SLA provides two options for Canadian lumber exporting provinces. British Columbia and Alberta selected "Option A," which involves a lumber price trigger, while Eastern Canada selected "Option B," which involves a lumber price trigger and a quota (table 1).⁶ Canadian lumber exporters earn a bonus export quota when the average price of softwood lumber is above a designated "trigger price." The SLA export charges are levied by the Canadian federal government and transferred to the provinces; the funds remain in Canada. This means there is less incentive for the government to negotiate support for Canadian companies.

The most important additional provision—which caused the most significant dispute since 2006—is called the "surge mechanism." This mechanism triggers a large penalty if any region's monthly shipment exceeds 110% of its export quota.⁷ For this provision, the London Court of International Arbitration (LCIA) was chosen as the independent body for industrial dispute settlement.

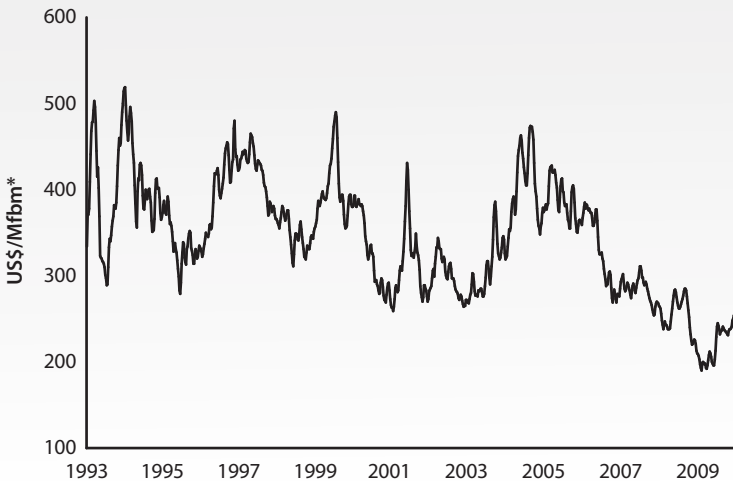
In August 2007, the US government, following a petition from the Coalition for Lumber Imports (CFLI),

Table 1: Softwood lumber export options under the 2006 Canada-US Softwood Lumber Agreement

US\$/Mfbm*	OPTION A: Export charge (%)	OPTION B: Export charge and volume limit on regional share of US consumption
Over \$355	0	0
\$336-355	5	2.5% + 34% share
\$316-335	10	3% + 32% share
\$315 or under	15	5% + 30% share

* Random Lengths' Framing Lumber Composite price per thousand board feet in US dollars

Figure 1: Lumber price according to Random Lengths' Framing Lumber Composite, 1993 to 2010



* Price per thousand board feet in US dollars
Source: Random Lengths, 2010.

requested LCIA arbitration in order to resolve the dispute, claiming that there had been shipments in excess of quotas and improper quota calculations. The LCIA found that quotas were incorrectly calculated for the first half of 2007, but that the complaint did not apply to BC and Alberta. On February 26, 2009, the LCIA ordered Canada to collect from eastern Canadian exporters an additional 10% compensatory charge for this breach and use the monies to pay the US government CA\$68.26 million (Cherniak, 2008). Canada delayed instituting the charge and instead offered to pay the US government CA\$46.7 million while maintaining the collection of a 5% export charge in those regions. The United States rejected the Canadian offer and started levying a 10% duty as ordered by the LCIA for the collection of the judgment amount (USTR, 2009).

In British Columbia and Alberta, exporters are penalized more now than they were before the SLA. Under "Option A," they pay a 15% export charge to the Canadian government instead of a 11.54% CVD to the US government. That punitive 11.54% CVD was declared illegal by the NAFTA panel and was supposed to be repaid in full; however, it was only partially refunded as part of the SLA deal. The jump to 15% happened because of the low market price of lumber at the time and the low lumber prices since then.

Conclusion and recommendations

Will the softwood lumber war ever come to an end? In 200 years, the documented differences between the two countries' legal and taxation structures have not been given sufficient recognition to dismiss the US lobby's claim that Canada's industry is subsidized. Canada should look at what can and needs to be done at home. First, Canada should seek to emulate the mostly privately owned resource forest industry in the United States and elsewhere in the world (see Berry and Fretwell, 2007; Chittick, 2003). Canadians should establish private-like area-based long-term tenures of forest land as a second-best solution since outright privatization is legally and politically impractical in Canada.

Second, the Canadian taxation system should be reformed to ensure that it is competitive with that of the United States. That means local and municipal governments should be less dependent on the forest industry for revenues, recognizing that the industry can no longer be viewed as a "cash cow."

Notes

- 1 The "forestry sector" includes logging, hauling, wood products manufacturing, and pulp and paper manufacturing.
- 2 Canada had 33% of the US lumber market in 2006 and 28% in 2008, according to the US Census Bureau (2010).
- 3 Canada exported 66% of its lumber in 2006 and 59% in 2008, according to Natural Resources Canada (2010b).
- 4 Anti-dumping duties usually entail charging an extra import duty on a product from a particular exporting country in order to bring the product's price closer to a prevailing market value or to remove the detrimental impact on domestic producers in an importing country.
- 5 Annex 2C(5) to the 2006 SLA states: "Canada or its agents shall distribute \$US 1 billion pursuant to the irrevocable Directions to Pay to the accounts referred to in paragraph 4 in

the following amounts: \$US 500 million to the members of the Coalition for Fair Lumber Imports, \$US 50 million to the binational industry council, and \$US450 million for meritorious initiatives.”

6 Lumber made from logs harvested in the Atlantic provinces and the three territories, as well as certain companies exporting non-competing products, were exempted from the SLA and afforded free trade. The SLA also provides for a potential refund based on the possibility of third countries increasing their share of the US market by 20% in a given quarter.

7 The penalty is 150% of the “normal” export charge for that period. A region’s US market share is its portion of total Canadian lumber exports to the United States during 2004 and 2005, applied against the 34% US market share for Canada as a whole.

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“Stay the course”? Let’s hope not

NIELS VELDHIJS AND CHARLES LAMMAM



With Parliament shut down until March 3, the federal government appears to be taking the opportunity to “recalibrate” its economic agenda (Beltrame, 2010, Jan. 11). What can Canadians expect from this exercise? Not much based on Finance Minister Jim Flaherty’s recent comments.

While the government has made some overtures about the need to eventually focus on the deficit (and possibly cut spending), it is clear that the government plans to “stay the course” and roll out more of its stimulus plan “into early 2011” (Vieira, 2010, Jan. 2; Puxley, 2010, Jan. 11; Geddes, 2010, Jan. 14).

Meanwhile, the finance minister is going through the motions of holding pre-budget consultations, both online and in cities across the country, asking Canadians for their views on how best to fully reinvigorate the economy.

Specifically, the government is asking four questions (see Canada, Department of Finance, 2010), almost all of which seem intended to generate answers in support of putting more tax dollars into a variety of projects in the name of economic “stimulus.” Here is our response to the government’s questions.

To what extent has Canada’s Economic Action Plan been effective in stimulating activity?

Very little. As the encouraging signs of economic recovery are now appearing, the answer the government is obviously hoping for is that the Economic Action Plan (EAP) has been effective. That’s certainly the answer you would get from many Canadian politicians and followers of John M. Keynes, the intellectual architect of economic stimulus.

The reality, however, is different. The private sector, encouraged by low interest rates and not government “stimulus” spending, is behind the positive signs in the economy thus far.¹

Canadian GDP estimates for 2009 by Statistics Canada suggest that government spending at all levels of government (federal, provincial, and local) increased by 2.2% compared to 3.7% in 2008 (Statistics Canada, 2009; calculations by authors). Government capital investments are estimated to have increased by 10.1% in 2009 compared to 12.2% in 2008 (Statistics Canada, 2009; calculations by authors). In other words, preliminary estimates show that Canadian governments actually slowed spending increases in 2009; their actions can hardly be called stimulus spending.

With more than a third of the total federal stimulus package devoted to infrastructure projects, most of this money will not be spent until well into this year (Canada, 2009; PBO, 2009). The risk for 2010 is that a large portion of the government stimulus spending—particularly infrastructure spending—will hit the economy as it naturally moves out of recession. The government will end up competing with the private sector for scarce resources, resulting in increased costs and fewer private sector projects than would otherwise be the case.

The government will, of course, point to sector specific spending (e.g., auto bailouts) and tax breaks (e.g., the home renovation tax credit), claiming that these had an impact in the targeted areas of the economy. But increased activity in these sectors will come at the expense of decreased activity in others as spending is substituted. The end result: increased redistribution rather than increased economic activity.

What suggestions do you have for improving the effectiveness of the Government’s stimulus measures or the speed of their delivery?

If the government wants to improve the effectiveness of stimulus measures, it should examine the economic

evidence regarding stimulus packages, which clearly shows stimulus spending fails while tax relief works.

A recent study by economists Andrew Mountford and Harald Uhlig assessed and compared the economic impact of various cases of deficit-financed spending, deficit-financed tax cuts, and tax-financed spending in the United States from 1955 to 2000 (Mountford and Uhlig, 2008). They found that deficit-financed tax cuts are the best form of fiscal policy for stimulating the economy. And perhaps more importantly for the Canadian government, Mountford and Uhlig found that both deficit-financed and tax-financed spending do not stimulate the economy; instead, they actually discourage private investment.

In addition, a recent analysis by Harvard economists Alberto Alesina and Silvia Ardagna of stimulus initiatives in Canada and 20 other industrialized countries from 1970 to 2007 found that successful stimulus initiatives—those that increased economic growth—focused on tax cuts while unsuccessful ones relied on government spending (Alesina and Ardagna, 2009). One of the major problems with the federal government's \$47.2 billion EAP is that only 13% was dedicated to tax relief (Canada, 2009).

What steps should the Government take to improve the competitiveness of the Canadian economy and ensure that Canada continues to attract investment and create jobs once the recovery is achieved and the Economic Action Plan is wound down?

The current Economic Action Plan needs to be wound down immediately in order to create the fiscal room needed to refocus on improving Canada's ability to attract investment and create jobs.

The key to improving Canada's competitiveness is to focus on tax relief that improves the incentives for Canadians to work, save, invest, and be entrepreneurial. Of particular concern are Canada's high marginal personal income tax rates on middle and upper income Canadians that apply at relatively low levels of income. For instance, Canada maintains among the highest marginal personal income tax rates on middle and upper income earners among the G7 countries (Canada, Department of Finance, 2006, 2007).

The government would also do well to deliver on one of its prominent 2005 election commitments and eliminate the capital gains tax for individuals on the sale of assets when the proceeds are reinvested. The capital gains tax is one of the most damaging taxes in Canada because it encourages the owners of capital to hold on to their investments, and it has a detrimental effect on entrepreneurship (Veldhuis et al., 2007). Eliminating the tax completely would result in a much more innovative, dynamic, and prosperous economy (Veldhuis et al., 2007).

Over what time period should the Government bring the budget back into balance?

The faster, the better. Once the government gets its fiscal house back in order, it can implement a multi-year plan for tax relief. A prudent and realistic plan would eliminate the deficit by 2011/2012.

Fortunately, the current government has precedent to follow in its efforts to eliminate the deficit. The austerity reforms initiated by former Prime Minister Jean Chrétien and then Finance Minister Paul Martin during the 1990s balanced the budget within three years—and the deficit they faced (4.8% of GDP) was larger than the current deficit (3.7% of GDP) (Canada, Department of Finance, 2009a, 2009b).

While Finance Minister Flaherty has hinted about the possibility of austere measures, he has also said that some areas of spending, including federal transfers to individuals (i.e., the elderly and disabled) and other levels of government, will be protected from cuts (Puxley, 2010, Jan. 11). Thankfully, however, tax increases are apparently “off the table” (Beltrame, 2010, Jan. 13).

Even if federal transfers are left untouched and taxes are not increased, there is still approximately \$117.2 billion in direct program spending per year that could be pared back (Canada, Department of Finance, 2009b). Eliminating the scheduled \$11.4 billion in EAP spending in 2010/2011 and 2011/2012 and reducing direct program spending by 8% in each of these years would result in a balanced budget by 2011/2012 (Canada, Department of Finance, 2009b; calculations by authors).

The Conservative government claims that it is committed to “staying the course” and sticking to its original plan. Let's hope it reconsiders.

Note

1 Lower interest rates reduce the cost of borrowing for all types of investments, making long-term investing more desirable and potentially increasing short-term economic activity. For instance, lower interest rates correspond with lower mortgage rates, which lower the cost of purchasing a home. Lower interest rates also decrease the cost of borrowing (through loans and lines of credit) for businesses wanting to invest in machines and equipment. These lower borrowing costs ultimately increase the number and value of investments made by private individuals and businesses.

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HST will help, not hinder, Manitobans

Continued from page 5

would save Manitoba businesses \$40 million annually in tax compliance costs (Manitoba, Department of Finance, 2009b). Administrative savings for the Manitoba government would total approximately \$12 million (Manitoba, Department of Finance, 2009b).

Manitobans would do well to ignore the rhetoric of Minister Wowchuk and consider the facts. Introducing an HST in Manitoba would improve the province's investment climate and increase the competitiveness of its businesses, while having little or no effect on the total sales taxes paid by Manitobans. Simply put, the HST is an excellent economic deal that would provide significant and lasting benefits for the province.

Note

1 Recent estimates by the federal Department of Finance suggest that harmonization would reduce the marginal effective tax rate on investment in Manitoba by more than one-third (see Canada, Department of Finance, 2008: Chart 3.10; calculations by authors). Given the mountain of evidence showing that individuals and businesses alter their behaviour and investment decisions according to changes in tax rates (Palacios and Harischandra, 2008), this would undoubtedly improve the incentives for people to invest in Manitoba. Higher marginal tax rates (tax rates on the last dollar of income earned) have been shown to lead to reduced work effort, savings, investment, and entrepreneurial activity.

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