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# BACKGROUND

INTERNATIONAL POLICY

## Trend Spotting: NAFTA Disputes After Fifteen Years

Lawrence L. Herman



### **In this issue...**

While recent cross-border disputes under NAFTA have been dominated by investor complaints over provincial actions, Ottawa must carry the ball in court. But who is really responsible? Who pays?

## THE STUDY IN BRIEF

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Cross-border Investment disputes have supplanted trade disputes as the main focus of legal actions under the North American Free Trade Agreement (NAFTA). A growing number of these investment disputes entail challenges by American investors against Canada's provincial, as opposed to federal, laws and regulations. As a result, important constitutional issues need clarifying between Ottawa and the provinces.

While the Canadian federal government, as the official signatory of the NAFTA, is the respondent in these cases, it is the provinces whose actions are being challenged for offending NAFTA guarantees. And there is no statutory provision or other law that provides authority for Ottawa to recover from a provincial government any amounts paid out to a successful complainant.

The issue has come to the fore in the recent AbitibiBowater claim against Newfoundland and Labrador, where money is at stake but where St. John's and not Ottawa is the object of the dispute. Yet, it is the federal government that is the respondent in the litigation. Even though it does not call the tune, it is Ottawa that will be forced to pay the piper if AbitibiBowater wins its case. While it remains far from certain that the company will succeed, the case illustrates the significance of the problem for Canada.

Given these unresolved questions, a federal-provincial understanding or protocol settling responsibility for payment of NAFTA awards, concerning provincial measures, seems the best solution. A pragmatic arrangement, in the tradition of Canadian federalism, could help resolve issues in what appears to be an increasing number of potentially costly challenges to provincial and municipal actions.

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There is an interesting trend in the sort of disputes flaring up under the North American Free Trade Agreement, one that in some ways belies predictions when the NAFTA entered into force in 1994.

While it is not certain if it will continue, the trend we are seeing is a significant cooling down of so-called NAFTA “trade remedy” disputes involving anti-dumping and countervailing duties and the emergence of NAFTA investment claims as the focus of the action.

A growing number of these investment disputes entail challenges by American investors against Canada’s provincial, as opposed to federal, laws and regulations. While the federal government is the respondent in these cases since Canada is the treaty Party, it is the provincial governments whose actions are being challenged as offending NAFTA guarantees. How this is to be handled internally by the two levels of government raises important federal-provincial issues.

#### *NAFTA Architecture*

Differing chapters of the NAFTA cover differing types of disputes. Trade remedy disputes are covered by NAFTA Chapter 19 and involve the use of bi-national panels to settle disagreements over the outcome of national anti-dumping and countervailing duty investigations, giving private parties the right to have these decisions reviewed by bi-national panels. A similar process for government-to-government disputes is covered by Chapter 20 of the treaty.

Investment disputes, on the other hand, are handled differently and involve separate procedures under Chapter 11 of the NAFTA. Following the approach in hundreds of bilateral investment treaties (often called “BITs”) and foreign investment

protection agreements (“FIPAs”), Chapter 11 gives private investors from one NAFTA country the right to bring binding arbitration against the government of another for failing to meet treaty obligations owed to that investor and its investment.<sup>1</sup>

During negotiations for the original 1987 Free Trade Agreement (FTA) and then the NAFTA, the belief was that trade remedies under Chapter 19 would be the focus of Canada-US dispute settlement. The investment provisions in NAFTA were largely designed to deal with Mexico, where Americans had sizeable interests and were concerned about the transparency and fairness of Mexican laws. Instead, Canada has increasingly become the target of US investor claims. While several involve challenges to federal actions, a growing number involve provincial laws and regulations. There is a likelihood that the focus on provincial measures will continue, which raises some interesting constitutional and political issues for Canada, such as which level of government should be responsible for litigating and – more critically – for paying for any damages that might be awarded to these claimants by a NAFTA arbitration panel.

#### *Declining Use of Trade Dispute Proceedings*

Trade remedy cases under Chapter 19 of the NAFTA have been tapering off for several years. There was a flurry of activity under the Free Trade Agreement and in first five years of the NAFTA. However, leaving aside the unique situation of the softwood lumber dispute, there have been only six completed Canadian cases against the US under Chapter 19 since 2000. The last Canadian Chapter 19 challenge was filed in 2006.<sup>2</sup>

With the signing of the Canada-US Softwood Lumber Agreement (SLA) in 2006, settling this long-standing dispute, all remaining Canadian softwood lumber challenges under the NAFTA were terminated. As noted, no other Chapter 19 cases have been initiated by Canadian exporters against US

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- 1 These obligations are, in general terms, to not discriminate against another country’s investor in favour of local investors (Article 1102), to provide foreign investors with “fair and equitable treatment” and “full protection and security” in accordance with international law norms (Article 1105) and, in cases of expropriation, to provide expeditious compensation based on the “fair market value” of the expropriated property (Article 1110).
- 2 The case involved an administrative review of an anti-dumping and countervailing duty order by the Commerce Department against Canadian carbon and alloy steel wire rod exports, the original Commerce decision having been made back in 2002: File No. USA-CDA-2006-1904-09.

trade agencies since 2006<sup>3</sup> and only a handful have been brought against Canada by Americans in the last 10 years.<sup>4</sup>

Not only has there been a tapering off of Chapter 19 cases, but there has been a falling away of state-to-state trade disputes under NAFTA Chapter 20 as well. In fact, there has only been one Chapter 20 case between Canada and the US under the NAFTA, a US complaint over Canadian agricultural tariffs brought in 1995.

It is interesting to compare this situation with that under the former Free Trade Agreement. In the short five-year period between 1989 and 1994, when the FTA was supplanted by the NAFTA, the Chapter 19 docket was extremely heavy. There were 23 completed panel proceedings brought by Canadian exporters against the US and 38 completed cases brought against Canada by American exporters during that short time span.<sup>5</sup>

#### *Global Supply Chains and the Relevance of the Border*

The decline in trade disputes may be due, in part, to increased integration of the two economies and to the rise of global supply chains, making the Canada-US border – in this sense – less significant to business dealings and less a factor for the application of extraordinary antidumping and countervailing duties. As noted by Michael Hart and William Dymond, the FTA and the NAFTA have deepened Canada-US economic integration and Canada's participation in global (US-led) value chains:

“High levels of both two-way intra-industry trade and foreign direct investment indicate continued cross-border integration and rationalization of production between Canada and the United States, as well as a deepening interdependence of manufacturing industries . . . Proximity of the US and Canadian industrial heartlands, well-developed infrastructures, and transparent legal systems all contribute to the highly integrated nature of the two economies.” (2008, 17.)<sup>6</sup>

All of this seems to explain why traditional trade remedy cases (anti-dumping and subsidization complaints) have receded in Canada-US trade. Indeed, some of these same factors may be at work globally. The World Trade Organization (WTO) has reported a general decline in the worldwide number of dumping investigations over the last decade. In the period between 1995 and 2000, the number of new investigations averaged 255 such per year. In the eight years following (2001-2008), the number declined to an annual average of 237 new investigations.<sup>7</sup> In fact, the average is skewed by the fact that 2001 investigations reached a high water mark of 366, while in the last few years they were well below that number: 232 new cases in 2003, 214 in 2004, 200 in 2005, 202 in 2006, 163 in 2007 and 208 in 2008.

Whether due to bilateral Canada-US factors or as part of a more global phenomenon, this decline in anti-dumping and countervailing duty actions and Chapter 19 reviews is one of the most notable parts in the NAFTA dispute settlement story. As these kinds of disputes have tapered off, however, there has been a corresponding increase in NAFTA investment

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3 To be accurate, the above numbers concern cases initiated where final panel decisions have been rendered under Chapter 19. A number of other cases were launched up to 2007 but withdrawn by the complainants before going very far. The result is that, over the last three years, there have been no new Canadian Chapter 19 cases filed against the United States.

4 The last completed Chapter 19 case against Canada was in 2003, involving exports of X-ray contrast media from the United States: CDA-USA-2000-1904-02. The detailed legal arguments and panel decisions in these cases can be found on the NAFTA Secretariat web-site at: <http://www.nafta-sec-alena.org>.

5 The reference to “completed” cases excludes cases that were filed but later terminated by the complainants. The FTA record of cases is available under the NAFTA Secretariat's website, *supra*.

6 The authors go on to point out that, “The continued legitimacy and application of trade remedy measures is wholly at odds with the efficient operation of global value chains.” *Ibid.*, p. 20.

7 WTO Secretariat Press Release, No. 556, 7 May 2009.

disputes, in particular challenges by American investors against Canada involving federal and, notably, provincial measures of one sort or another.

This acceleration of NAFTA investment disputes seems to reflect a global phenomenon. The United Nations Conference on Trade and Development (UNCTAD), which provides ongoing monitoring of investment arbitrations, recently reported that as of the end of 2009, there were 357 treaty-based investment disputes in various international forums, with 202, or 57 percent, involving cases initiated since 2005. This contrasts with a mere handful of these cases in the decade from 1990 to the end of the century.<sup>8</sup> The growth of NAFTA Chapter 11 disputes is consistent with this global trend.

Judging from the current roster under Chapter 11, it seems that provincial measures – as opposed to federal laws and regulations -- may well be the largest source of future NAFTA investment disputes. An illustration of this is the \$500 million claim by AbitibiBowater Inc. concerning the expropriation of timber and water rights by the Government of Newfoundland and Labrador in December 2008.<sup>9</sup> While this trend is in the early stages, given their Constitutional competence over property and resources within provincial boundaries, it is not unreasonable to predict that increasingly more challenges to provincial measures will emerge as US (and Mexican) investors are affected by provincial actions of one sort or another.

#### *International Law and NAFTA Obligations*

Under international law, the NAFTA is a treaty that binds Canada as a state vis-à-vis the US and Mexico. The provinces are not NAFTA Parties and have no direct treaty obligations: nor do sub-federal units of the United States or Mexico. The most that NAFTA provides is the requirement, under Article 105, that all three Parties “shall ensure that all necessary

measures are taken in order to give effect to the provisions of this Agreement, including their observance . . . by state and provincial governments.” But that is an obligation placed on the federal levels of government, not on the sub-federal units.

It follows, nonetheless, that actions by the provinces can result in Canada, as a treaty Party, being in breach of NAFTA obligations. Because Canada is bound to comply with these obligations, it is the federal government, not the provinces, that is the defendant in NAFTA investment disputes and it is Ottawa that is on the hook even where a dispute involves actions by one or more of those provincial governments.

The unresolved issue, explored below, is whether and how Ottawa could enforce a NAFTA Chapter 11 award that involves provincial action. If a tribunal awarded damages to an investor involving such provincial measures, for example, Ottawa would have to pay up. Could the federal government then recover those damages from the offending province? If the province refuses to pay, what then?

#### *Investment Arbitration Scorecard*

To date, a total of 59 investment claims have been filed against the United States, Canada and Mexico since NAFTA's inception in 1994: 17 against the US, 15 against Mexico and, somewhat surprisingly, a total of 28 against Canada, putting Canada in the lead as a Chapter 11 respondent.<sup>10</sup> Why this is so is not entirely clear, particularly since, as already noted, there were expectations that the Chapter 11 dispute regime would be primarily directed against Mexico where there were substantial American investments.

Of the 28 claims initiated against Canada, eight have been withdrawn or are inactive, one case has been settled and four have been concluded by final awards. Fifteen cases remain on the active list, in varying stages of readiness. Of the four cases that

8 *Latest Developments in Investor-State Dispute Settlement*, IIA Issues Note No. 1 (2010), UNCTAD/WEB/DIAE/IA/2010/3, UNCTAD, New York and Geneva, 2010.

9 The Notice of Arbitration was served on Canada by the complaint investor on 25 February 2010. The legal documents in the case and all of the other cases referred to below can be accessed through the Foreign Affairs and International Trade (DFAIT) website under NAFTA Chapter 11 Investment Disputes at: <http://www.international.gc.ca/trade-agreements-accords-commerciaux>.

10 The 28th case was filed against Canada as this article was being prepared and involves a US company's claim for breach of Chapter 11 obligations in relation to the Canadian efforts to construct, with the US, a second bridge at the Detroit-Windsor border crossing: *Detroit International Bridge Company v Government of Canada*, Notice of Intent filed, 25 January 2010. <http://www.international.gc.ca/trade-agreements-accords-commerciaux>, under NAFTA Chapter 11 Investment Disputes, *supra*.

have resulted in final awards, two were successful against Canada (*Pope & Talbot v Canada* and *S.D. Myers v Canada*)<sup>11</sup> and two were dismissed outright – a claim by UPS involving the operations of Canada Post<sup>12</sup> and a claim involving Canada's restrictions of exports of raw logs from British Columbia.<sup>13</sup>

The amounts paid out by Canada under the two successful awards total approximately US\$10.0 million, including costs and interest, in contrast to the US\$18.0 billion originally claimed. Canada also paid out \$13.0 million in settlement of the earlier *Ethyl Corporation v Canada* case, which challenged the Canadian government's import ban of a gasoline additive. Including the Ethyl settlement, the total paid out by Canada so far under Chapter 11, including costs and interest, is in the range of US\$24 million.<sup>14</sup> These figures show that awards have totalled far less than the billions of dollars originally claimed by American investors, but don't necessarily point the way to the future.

An interesting side-note is that Canadian investors have not fared particularly well in their own NAFTA claims against the US over the years, with several high-profile Chapter 11 arbitrations involving both federal and state measures having been dismissed by the arbitration panels.<sup>15</sup>

### *Cases on the Horizon that Bear Watching*

Cases on the active list of NAFTA investment claims against Canada are all brought by Americans. Oral hearings have been completed in one, *Crompton (Chemtura) Corp. v Canada*, and the tribunal's decision is pending (the case having been commenced in 2001). The case involves the banning

by the federal government of the sale, distribution and use of a pest-control chemical called lindane in canola production and is important from the perspective of environmental and human health-related issues. The company argues, among other things, that the banning of lindane was discriminatory, biased and arbitrary and lacked a credible scientific basis.

Turning to NAFTA claims against provincial measures, an important case is *Dow AgroSciences LLC v Canada*, where the investor is claiming compensation for losses allegedly caused by a Québec ban on the sale, distribution and use of lawn pesticides containing the active ingredient 2,4-D. The arbitration notice was only served on March 31, 2009. No detailed legal arguments have yet been filed. The case has a long way to go but is significant because of the nature of the provincial health and environmental measures under attack.

A second case targeting provincial environmental regulation is *Bilcon of Delaware v Canada*, in which the US investor claims compensation for discriminatory treatment in an environmental assessment by both the federal and Nova Scotia governments over a basalt quarry and a marine terminal project. While pleadings have been exchanged, the case has yet to proceed to discovery and it may be some months before hearings are convened. As in the Dow AgroSciences case, this case raises important issues about provincial environmental regulation in the context of Canada's NAFTA obligations. A more advanced Chapter 11 claim involving a provincial environmental regulations and where panel hearings may be convened within the next 18 months or so is *Gallo v Canada*, which targets the closing down of a landfill

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11 Awards dated 26 June 2000 and 21 October 2002, respectively. The Pope and Talbot case concerned defects in the issuing of lumber export quotas to a US investor under the previous softwood lumber agreement with the United States. The S.D. Myers case concerned deficiencies in Canada's ban of PCB exports. The legal archives in each of these cases, including the full text of the awards, can be accessed at the DFAIT website, *supra*.

12 *United Parcel Service of America, Inc. (UPS) v Canada*, Award, 24 May 2007: legal documents are also available on the DFAIT website, *supra*.

13 *Merrill & Ring Forestry v Canada*, Award, 31 March 2010. The final award has recently been posted on the DFAIT website under NAFTA Chapter 11 Investment Disputes, *supra*.

14 These figures were provided to the author by the Trade Remedies Division (TNR) of the Department of Foreign Affairs and International Trade, Ottawa.

15 Some noteworthy cases that have been lost by Canadians include: *Mondev International v United States*, 2002 (court decision that a municipal development agency was immune from tort liability); *Loewen Corporation v United States*, 2003 (punitive damages in a civil jury trial); *ADF v United States*, 2003 (Buy America preferences in a state highway construction project); *Methanex v United States*, 2005 (a ban on the use of a gasoline additive by California); *International Thunderbird Gaming v Mexico*, 2005 (regulation and closure of gaming facilities); *Glamis Gold v United States*, 2009 (regulatory delays and refusal of a mining permit).

site in an abandoned mine by the Ontario government.<sup>16</sup>

A fourth claim where a combination of federal and provincial resource-related measures is at issue will be heard in the next number of months: *Mobil Investments and Murphy Oil v Canada*. The case concerns rules for research and development payments required by the joint Canada-Newfoundland Offshore Petroleum Board and involves amended guidelines to spend these monies within the province, thereby imposing performance requirements on operators allegedly contrary to Article 1106 of the NAFTA. While not exclusively a provincial issue, the dispute largely concerns matters of provincial, as opposed to federal, interests and policies.

Each of these cases is significant for the reasons indicated. Not only do they pinpoint matters of health, environment and related public policy at the provincial level, they also cause the federal government of Canada to be the respondent. This puts Ottawa on the line in defending measures enacted, not by the Parliament of Canada, but by the provincial legislatures.

The un-sought-after obligation by Ottawa to defend actions of the provinces is not entirely new, of course. In the annals of the General Agreement on Tariffs and Trade (GATT), predating the WTO Agreement, are several prominent disputes brought against Canada as a result of one or more provincial measures. Among the most noteworthy are the challenges launched against provincial liquor board practices by the European Union and the United States in the 1980s and early 1990s.<sup>17</sup> Ultimately, Canada as a whole was held to account and, with the possibility that Canada's trading partners would withdraw trade benefits for Canadian exports, provincial liquor board practices were adjusted to remove the offending measures.

These and other cases involving provincial actions made it clear at the time that Canada's GATT obligations were more onerous than initially thought. Similarly, the focus on provincial measures

in the investment dispute realm shows that Canada at large is exposed to legal challenges resulting from provincial (and even municipal) initiatives. This raises important challenges in the management of federal-provincial relations.

The remaining list of Chapter 11 cases involving provincial actions are well away from hearing dates, with written arguments having yet to be filed or, where filed, pre-hearing proceedings are not yet completed. This includes the above-noted claim by AbitibiBowater regarding the Newfoundland and Labrador expropriation measures. This is a critical case to watch as well, not just because of the large amount of compensation being sought (some \$500 million) but because it deals with provinces' rights to expropriate where those actions affect a NAFTA investors' Canadian assets. Again, this is a case where a provincial measure is under attack but where Ottawa has to put up the defense and handle all the case preparations.

#### *The Federal-Provincial Dimension – Who Defends? Who Pays?*

This brief review shows that a growing number Chapter 11 challenges involve provincial measures and, as seen, at least three concern important matters related to protection of health and the environment. A plausible prediction can be made that, to the extent that many aspects of environmental, human health and property regulation fall under provincial constitutional jurisdiction, future disputes will be more focused on these kinds of provincial laws, regulations and policies than on actions by Ottawa at the federal level.

That leads to a consideration of the federal-provincial issues referred to at the outset of this article. If an American or Mexican investor succeeds in its claim, the result will be binding on and enforceable against Canada at large. Even though the measure may be purely a provincial one, it will be Ottawa, and not the offending province, that will be

16 Information and documents on each of these are also found on the DFAIT website under NAFTA Chapter 11 Investment Disputes, *supra*.

17 *Canada – Provincial Liquor Boards (EEC)*: Panel Report, *Canada – Import, Distribution and Sale of Alcoholic Drinks by Canadian Provincial Marketing Agencies*, BISD 35S/37 (1989), adopted 22 March 1988; *Canada – Provincial Liquor Boards (US)* Panel Report, *Canada – Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies*, BISD 39S/27 (1993), adopted 18 February 1992.

responsible for paying whatever compensation may be ordered.

Under Canada's constitution framework, the federal government alone possesses the authority to make treaties and to bind Canada internationally. However, according to constitutional orthodoxy, this in itself does not create legal rights or obligations within Canada. That requires implementing legislation at both the federal and provincial levels.

In the case of the NAFTA, nothing in the federal implementation statute binds the provinces. Quite the contrary, the *NAFTA Implementation Act* specifically says that it binds only the federal government.<sup>18</sup> Moreover, while it amends certain pieces of federal legislation and provides for regulation-making authority by the federal cabinet to implement Canada's NAFTA obligations in federal areas of responsibility, such as tariff reduction, rules of origin and a number of border-related measures, the *NAFTA Implementation Act* does not give the NAFTA the force of law in Canada.<sup>19</sup>

As a result of these internal arrangements, there is nothing that would allow Ottawa to recover damages that it may be required to pay to settle an award involving a provincial action or to recover the costs of legal representation from the offending province. At the end of the day, there is no statutory provision or other law that provides authority for Ottawa to recover from a provincial government any amounts paid out to a successful complainant. Even if a claim could theoretically lie against a province – say on the basis of unjust enrichment – there is a legal prohibition against the federal and provincial governments suing each other in damages.

#### *Some Recommendations – A Test of Good Faith*

All of this raises the question as to how the federal-provincial aspects of Chapter 11 reviewed in this article will play out and how the two levels of government will deal with these issues in the months

and years ahead. Admittedly, the problem is moot if none of the NAFTA investors succeed in their claims. But it may not be satisfactory to let these matters drift unresolved. For one thing, it is Ottawa that is required to respond to every claim and to prepare the legal defenses in the dispute. And sooner or later we are bound to be faced with a situation where Ottawa is required to pick up the tab for provincial action.

The issue has come to the fore in the AbitibiBowater claim against Newfoundland and Labrador, where vast amounts of money are at stake but where St. John's and not Ottawa is the object of the dispute. Yet, it is the federal government that is the respondent in the litigation. Even though it does not call the tune, it is Ottawa that will be forced to pay the piper if AbitibiBowater wins its case. While it remains far from certain that the company will succeed, this illustrates the significance of the problem for Canada.

Given these unresolved questions, consideration should be given to a federal-provincial understanding or protocol settling responsibility for payment of NAFTA awards that concern provincial measures. Some sort of pragmatic arrangement, in the best traditions of Canadian federalism, would help resolve issues in what appears to be increasing challenges to provincial, and potentially, municipal actions. Such an agreement need not be black and white and should be flexible enough so avoid the extreme case of a province having to pay an inordinately large sum in settlement of a claim.

An agreement along these lines is preferable to Ottawa simply waiting to send the bill to the province at the end of a lost case and scrambling to find out how to recover payment, inviting images of a collection agency knocking on the doors of the provincial premier's residence with the unpaid bill in hand.

Progress on this front may ultimately lie in maturity and good faith at the highest levels of political leadership in Ottawa and the provinces.

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18 *North American Free Trade Agreement Implementation Act*, S.C. 1993, c. 44, section 5. The legislation specifically limits itself to binding "the Crown in right of Canada."

19 Under section 10 of the statute, the NAFTA is "approved" but nothing in the legislation purports to make the NAFTA legally binding within Canada in a direct sense. There are provisions for extending aspects to the NAFTA's provisions on market access under Chapter 3 thereof to the provinces by regulation but only where the individual province consents. In this sense, Canadian treaty law differs significantly from the US, where legislation passed by Congress to implement treaties makes those treaties the law of the land and binding on the individual states. See Hogg //year tk, // 1: 11-19.



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