

Indecent Proposal: The Case against a Canada-US Customs Union

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1. Introduction: From NAFTA to CUCU?

The call for a Canada-United States Customs Union could just be the next fad to sweep through the Ottawa establishment. The next big thing is being promoted, with a ring of inevitability, as a new step forward—a “big idea” or “strategic bargain” with the United States, in the view of the CD Howe Institute—to the senior echelons of government and the bureaucracy.

Those in favour of a customs union generally also tend to embrace the whole package of deeper economic integration with the US. A customs union might be sold as the next step beyond the NAFTA—in light of post-9/11 developments, it is seen as a solution to potential challenges impeding Canada’s access to the US market—but it would not likely to be the final step.

Among the idea’s supporters is David Dodge, the Governor of the Bank of Canada and former Finance department Deputy Minister. In his remarks to the Couchiching Institute on Public Affairs, an elite gathering held annually outside of Ottawa, Dodge outlined an extensive economic integration agenda that only starts with a customs union then goes much further (Dodge 2003). Canada’s Trade Minister Pierre Pettigrew recently came out in support of deeper integration with the US (fittingly, at the Empire Club), and went as far as suggesting this to US Trade Representative Robert Zoellick during the Cancun WTO Ministerial (Pettigrew 2003). Prime Minister-in-waiting Paul Martin is also favourable to closer economic ties with the US, though he has not publicly committed to any specifics.

A customs union could form the new front line in the battle for Canadians’ minds over Canada-US economic integration. As an idea, it is still below the radar of public opinion, the subject of internal debate not uttered to the general public because, as the *Globe and Mail* pointed out: “it encapsulates, in one neat package, all the risks, opportunities and contradictions of the emerging North American economic space. As such any discussion of it is guaranteed to inflame Canadians’ passions like nothing else since the war in Iraq, or the free-trade debate of 1988.”(Globe and Mail 2003)

The divisions among Canada’s elite were evident in the hearings of two parliamentary committees over the past year. The House of Commons Standing Committee on Foreign Affairs and International Trade released its report in December 2002, noting the differences of opinion on a customs union, then recommending the Government undertake “a detailed review of the advantages and disadvantages of the concept in the North American context” (Canada 2002: 194).

The second report, from the Standing Senate Committee on Foreign Affairs, chose not to punt the issue and recommended Canada not enter into discussions with the US on customs union. In their report, the Senate committee states: “After

seriously examining both sides of the issue, the Committee has concluded that upgrading NAFTA to a customs union would not be in Canada's best interests. We are not prepared to make the sacrifices in Canadian sovereignty that would be required to realize the economic benefits of a customs union" (Canada 2003:69).

So what exactly is the nature of this potentially explosive debate on the future of Canada-US economic relations? This paper aims to fill the gap by setting out the arguments made in favour of a customs union and subjecting those arguments to some scrutiny. It moves ahead on the presumption that there are both costs and benefits associated with a customs union. We need to carefully assess whether the benefits outweigh the costs, as well as who the winners and losers would be.

I will argue that, in fact, the likely benefits of a customs union are quite small, and frequently overstated by promoters of the idea. But there are also some non-trivial economic and political costs that come with a customs union, plus risks entailed in an actual negotiation. Expanding the scope of a negotiation could offer greater gains—such as exemption from US trade remedy laws—but would entail higher costs and bigger risks that Canadians are unlikely to support.

What precisely is being proposed under the banner "customs union" is not necessarily clear and consistent—it typically includes more economic integration than the traditional economic definition. The next section pins down the debate by looking in more detail at the differing degrees of economic integration, from free trade areas to customs unions to single markets—and how these relate to the proposals seen to date. Section 3 looks at the case for a customs union—namely, the elimination of rules of origin—and critically assesses its potential benefits. Section 4 considers the implications for Canada of having a common trade policy with the US. Section 5 looks at the issue of trade remedy measures, a major irritant for Canada with regard to US trade. Section 6 brings costs and benefits together with an overall assessment of political feasibility and negotiation *realpolitik* to assess whether a strategic bargain would be in Canada's interest.

2. Customs Unions and Economic Integration

Terminology is important to this debate. There are some fairly clear economic meanings to terms like "customs union" that differ from the specific proposals being made under the banner "customs union." This section looks first at traditional economic definitions of customs union and other economic integration arrangements, then turns to proposals in favour of a customs union.

Conceptually, it is best to think of integration as a process that occurs in, and is formalized in, stages. The 1989 Canada-US Free Trade Agreement (CUFTA) was such a stage, as was the move to the 1994 North American Free Trade

Agreement (NAFTA). The NAFTA not only extended the trade bloc to Mexico, it deepened the liberalization of the CUFTA. Hence, the question is not so much whether we want a customs union to clean up the “unfinished business arising out of NAFTA”, as former Trade Minister Michael Wilson put it (Wilson 2003), but whether we want a customs union as another step towards ever-increasing integration.

Defining Terms

At the outset, it is worth distinguishing among types of economic integration arrangements, in increasing order of integration: free trade area; customs union; common market; and, single market (or economic union).¹ All of these arrangements are considered preferential agreements that exist within the bounds of the multilateral trading system of the World Trade Organization. The WTO allows preferential trading agreements as set out in Article XXIV of the GATT 1947 so long as they do not raise barriers to trade with other parties.

In a *free trade area*, strictly defined, tariffs are eliminated on imports of goods and services among the nations, although each country may maintain differing external tariffs that apply to other countries. In practice, free trade agreements can go far beyond this definition. The NAFTA, for example, encompass investment, intellectual property rights, government procurement, standards and competition policy.

A *customs union* is the next step past a free trade area towards deeper economic integration. The key features of a customs union are the creation of a *common external tariff* that applies to all nations not part of the free trade area, and the elimination of *rules of origin*. Rules of origin appear in free trade agreements to ensure that exports from country A to country B originate in A, or at least have substantial value added to them in A. This is to ensure that country C, who is not party to the FTA, does not export only to the country with the lowest tariffs on its product as a means of serving the entire trade bloc. (More on the pros and cons of rules of origin in the next section.)

In the NAFTA, for example, rules of origin stipulate that exported goods have at least 60% North American content (62.5% for automobiles). The NAFTA also sets up a process to determine that exported goods containing non-North American content are substantially transformed. The rules vary slightly from sector to sector, although for autos and textiles there are some additional specific requirements.

A stage beyond customs union is the establishment of a *common market*. At a simple level, this means allowing the free movement of all factors of production — capital, labour and technology — across borders. In practice, it includes

¹ I follow the taxonomy used by Krueger (1995).

harmonization of regulations, standards and other economic and social policies across the area. A common market would eliminate trade actions against partners, and could subsume trade remedy measures (such as antidumping and countervailing duties) to a common competition policy.² New supra-national institutions would need to be created to oversee the common market.

The end-point of economic integration is a *single market* or *economic union*, within which producers and consumers are governed by the same overarching rules, with highly harmonized fiscal and monetary policies. The European Union is the most significant modern example of a single market, where a common currency has been established and rules govern the ability of individual countries to run deficits (though currently being broken by Germany and France). The EU has also evolved joint supranational political institutions and has eliminated border checkpoints. The EU is now expanding its membership and contemplating full political union as expressed in a draft EU constitution—another illustration of the dynamic process of deepening integration.³

Back in North America, a key consideration is whether a new economic integration arrangement, whatever its specific form, would include Mexico or not. That is, would the proposed customs union become a tri-partite extension of the NAFTA, or would it include only Canada and the US? It appears that at this point Canada's customs union proponents, while paying some lip service to Mexico, are focused narrowly on a new Canada-US bilateral agreement. Such a negotiation would already be quite complex, and adding Mexico would overly compound the complexities involved in obtaining an agreement. For this reason, in the remainder of the paper, Mexico as a potential third party to the customs union is left out of the analysis (although it could be argued that the inclusion of Mexico would strengthen the ability of Canada to extract concessions of interest from the US).

What does Canada want?

² International trade rules permit the application of antidumping duties in cases of dumping, when a good is sold for export at a price lower than cost of production or sometimes the price of sale in the domestic market. When a good is deemed to be subsidized by a foreign government, a country is allowed to impose countervailing duties to offset the impact of the subsidy. Trade rules also permit temporary tariffs to be put in place as safeguards against import surges or for balance of trade purposes. In practice, rich countries often use these trade remedy measures to protect domestic industries. The US is considered to be one of the worst offenders. The Canada-US dispute over softwood lumber is a case in point.

³ A "layer" down, the 19th Century German Zollverein began as a customs union (like the EU) and evolved a few decades later into the German nation-state.

Just as the NAFTA should be viewed as an economic integration agreement that goes beyond a free trade deal, so should the customs union proposals. Recent discourse on establishing closer economic ties with the United States sometimes uses the term “customs union” in a broad sense that includes some of the policy terrain of a common market. Ultimately, any negotiation between Canada and the US for deeper integration will be driven by perceived problems and issues in relation to the border and Canada-US relations, not by theoretical stages of integration. The issue is whether Canada enters into another round of negotiations with the US, regardless of what it is called.

Bank of Canada Governor David Dodge views a common external tariff (a traditional customs union) as part of an extensive economic integration agenda that then moves on to harmonization of commercial policies and regulation, ending trade remedies within North America, and uniform rules on subsidies (elements of a single market but sometimes considered as a “deep” variant of customs union). Dodge also advocated labour market integration, and even delicately supported the idea of a currency union if “we were well on the way to achieving a true single market for goods and services, labour and capital.”⁴

Former Canadian trade officials and pro-integration boosters, Michael Hart and William Dymond argue that “if the bilateral CUFTA and trilateral NAFTA have benefited both Canada and the United States, more effort along the same lines should be even better.” (2001:6) They call for an initiative that is broad in scope leading to a formal agreement. This includes custom union proposals, plus a new deal on trade remedies, national treatment for government procurement, elimination of other border restrictions, cooperative enforcement of competition policy, and harmonized standards and regulations.

In a series called the Border Papers, the CD Howe Institute is championing more economic integration with the US. Dobson (2002) calls for a “strategic bargain” that would trade be a “pragmatic mix of customs union-like and common market-like proposals plus Canadian initiatives in areas of strength that are of particular interest to the Americans” (p. 20) in exchange for market access guarantees to the US market. This would include greater cross-border labour mobility, harmonization of corporate income tax bases, and dispute settlement procedures around the application of trade remedy laws.

⁴ The theoretical anchor for Dodge’s expansive agenda is the theory of comparative advantage of David Ricardo in the 19th century. This is bizarre for a number of reasons. Ricardo was trying to explain trade in a completely different era, at the height of the British Empire. This was a time where labour was more mobile than capital, and many of the institutions of the modern nation-state did not exist (such as central banking, corporate governance laws, etc.). Dodge’s program goes way beyond what Ricardo was talking about with comparative advantage. And interestingly, empirical work has found that international trade is not actually explained by comparative advantage (see Helliwell 2003b).

A more recent CD Howe study by Goldfarb (2003) on customs unions suggests that the question is not whether we move ahead with a customs union but what type of customs union, how deep should it be. Goldfarb (2003) distinguishes between a “basic” customs union consisting of a common external tariff on all goods, and a “deep” customs union that includes a common external tariff plus common trade and commercial policies. (p. 3)

Another key contributor to the proponents’ side is the Canadian Council of Chief Executives (the lobby group formerly known as the Business Council on National Issues). CCCE President Tom d’Aquino (2003) argues for “a *customs initiative* designed to reduce differences in Canadian and United States treatment of third country trade and eliminate the need for rules of origin and other burdensome customs requirements on most goods.” However, this is but one small point in an expansive “new partnership” agenda that includes: harmonization of standards, regulations, inspection and certification procedures (“tested once” principle); more integrated resource sectors; and common security measures for the external border. He does not call for new supranational institutions, and thus argues CCCE is not seeking a common market.

The call for greater integration with the US has been heard loud and clear by Canada’s Trade Minister, Pierre Pettigrew. In a major speech to business leaders in September, he outlined a plan on Canada-US trade relations that includes broader and deeper regulatory cooperation, addressing trade remedy measures, reviewing rules of origin, facilitating the travel of business professionals and new security measures (Pettigrew 2003).

Hence, it is not always obvious precisely what is on the table when the term “customs union” is invoked. Much has to do with the perceived issues on the part of Canada, and thus which Canadians are the *demandeurs*. Most are seeking an integration package that goes further than customs union. However, the *idea* of a common market probably goes much deeper than most policy analysts, much less Canadians in general, are prepared to accept, whereas the bland-sounding term “customs union” could have greater sale-ability to a skeptical public.

3. Customs Unions and Rules of Origin

The principal source of benefit accruing to a customs union would be the elimination of rules of origin. Goldfarb (2003) comments that “the greatest economic gains from a common external tariff are those associated with eliminating rules of origin” (p. 25) and makes a claim that rules of origin cost 2-3% of NAFTA GDP. This is an implausibly large number to expect of any major policy change, let alone elimination of rules of origin. As we will see below, it does not hold up to serious scrutiny.

The case against rules of origin is threefold: first, rules of origin pose administrative costs to exporters; second, rules of origin distort trade patterns as companies source materials and intermediate inputs from higher cost North American sources to meet content requirements; and third, rules of origin can be used as protectionist barriers (and protection is “bad”). Hence, eliminating rules of origin, the theory goes, would lead to economic benefits, including increased efficiency, administrative savings, fewer delays at the border, and larger economies of scale.

It is worth noting upfront that these are largely theorized costs and benefits in the economics literature. They do not seem to be a major irritant to exporters. This begs the question: If rules of origin are such a massive burden, why are we only hearing about this now? In the fourteen years since the 1989 Canada-US FTA we heard not a peep about the allegedly large costs attributable to rules of origin, only breathless praise about how wonderful the CUFTA was. Nor did the proponents of the CUFTA consider these allegedly huge costs to business when making their case, even though now they are considered to be significant. Were these costs so large, Canada and the US had an opportunity to set things right a few years later when the NAFTA was being negotiated (in fact, rules of origin were made more stringent).

Costs of Rules of Origin

Rules of origin do pose costs to businesses. There are administrative and legal requirements that must be accounted for by exporters. As a result, there are benefits for exporters in eliminating rules of origin. But it is not obvious that these costs really are that large, especially relative to the other legal and administrative costs faced by businesses, and are much smaller than their predecessor: the tariffs existing before the CUFTA.

Much has been made of the alleged complexity of rules of origin—several commentators note that some 200 pages of NAFTA text are devoted to spelling out rules of origin—and the administrative burden this poses. While this may sound terrifying, it misrepresents rules of origin in practice. The vast bulk of these 200 pages is an annex containing a long list of the specific rules on a product-by-product basis. Not every exporter must understand every rule for every product, only the product they are producing for export.

The specific legal text on rules of origin in the NAFTA (Chapter 4) is 26 pages in length—six of these are devoted to definitions, and another three specifically refer only to the auto industry. Thus, the legal aspect of rules of origin is no greater than anywhere else in the NAFTA. Even counting the entire 26 pages, this is shorter than the chapters on Investment (Chapter 11) and Intellectual Property Rights (Chapter 17), neither of which seems to be under attack for being overly complex, despite being quite prescriptive.

Without doubt, rules of origin mean additional paperwork for exporters. But much of this is a one-time cost in terms of getting the paperwork right and ensuring that the product supply conforms to specifications. And in practice, the NAFTA certificate of origin that accompanies exports across the border is a one-page document (Mirus 2003).

There may be some legal and accounting cost that goes along with this, but it is unlikely that it is any greater than any of the other legal and accounting work that companies must comply with as part of doing business. Compared to the resource requirements dedicated to payroll, general administration, tax filing, applying for permits, and so on, the costs of rules of origin are a drop in the bucket.

Certainly, the costs of rules of origin are nowhere near the 2-3% of GDP—or \$20-30 billion—suggested by Goldfarb. This can only be a massive over-estimate. I will get into the specifics of the 2-3% range below. For the moment, it is worth analyzing another line of argument put forth by Goldfarb in relation to the costs attributable to rules of origin.

Goldfarb uses a “revealed-preference mechanism” that looks at the percentage of Canadian exported goods being admitted to the US under the NAFTA zero tariff (i.e. with rules of origin), rather than under the MFN tariff, for different sectors. If a substantial amount of exports enter under the MFN tariff, it is reasoned, there must be large enough costs to rules of origin for companies to avoid the zero-tariff NAFTA route. Goldfarb finds that overall only 55% of Canadian exports entered the US under NAFTA, but notes that one-third of US MFN tariffs are zero, so there is no incentive for these to enter under NAFTA. And many industries have utilization rates well below 100%. Goldfarb argues that this is indicative of the *administrative* costs of rules of origin.

However, a more plausible explanation is that exporters may be paying the tariff because they do not actually qualify for tariff-free treatment, i.e. the exports in question have not been sufficiently transformed, perhaps because they do not have readily available North American input substitutes at a cost less than paying the tariff. But when all other factors are considered, there is still a business case for going ahead and paying the MFN tariff.

We need to think through what the utilization numbers really mean. The theoretical argument is that rules of origin create an incentive for producers in one country to source higher-cost materials from inside the free trade area rather than via cheaper rest-of-the-world sources, so that the finished product can be exported to the partner country tariff-free.

In practice, the fact that utilization numbers are generally less than 100% is evidence of the opposite. Clearly, there are lots of exports to the US from Canada that do not meet the standards for NAFTA treatment, not because of

administrative costs, but because there are lots of materials, components and supplies imported from non-NAFTA countries, presumably at costs low enough to justify paying the MFN tariff on the way into Canada and the outgoing MFN tariff to the US market. One factor is that both Canadian and US MFN rates, for the vast majority of goods, are already quite low (i.e. less than 10%). There are many other factors—such as labour costs or access to skilled labour—that play into the game as well. Ultimately, there is a case to be made for going the MFN route: costs of production in Canada are sufficiently low and prices received in the US sufficiently high to give them decent profit margins.⁵

The implication of this analysis is that under a customs union, companies now paying the MFN tariff instead of entering under NAFTA would save the cost of the MFN tariff when exporting. However, some caution is required here. A common external tariff could increase or decrease effective levels of protection, depending on industrial sector and which tariff becomes the standard (likely the US tariffs). The actual cost savings would also depend on what levels the common external tariff was set at for the customs union—if harmonized upwards, this could increase exporters' costs via higher input costs that would erode or even outweigh the savings of not paying the MFN tariff when re-exporting.

Moreover, the rules of origin were put in place for a reason as part of the negotiation of CUFTA and NAFTA. Presumably, this situation is better for exporters than what prevailed before the CUFTA. But there is no reason to expect that the US will agree to eliminate rules of origin in a subsequent negotiation without some other concession being made.

This is related to the argument made by Krueger (1995) that there is an incentive for domestic producers to lobby for sufficiently restrictive rules of origin as a protectionist measure. This likely has some truth to it, though we should not presume that this is a negative. To the extent that this is the case, it supports economic activity in North America, even if deemed inefficient by some economists. Eliminating rules of origin would have to consider the cost of potential economic losses in these areas.

Given the above figures, it does not seem very likely that rules of origin are engendering protectionism anyway. Such a scenario only makes sense if MFN tariffs were relatively high, which they are not for Canada and the US. There are a few sectors that have quite restrictive rules of origin, such as textiles and autos.

⁵ This fact also undermines the case made by supporters of the CUFTA/NAFTA that trade creation effects were large. One study from Industry Canada, Archarya et al (2001) found that only 9% of the increase in trade came from CUFTA/NAFTA. Most of the increase was due to the expansion of the US economy and the decline in the Canadian dollar.

But consider that auto exports boomed in the years following CUFTA/NAFTA, as much as any sector.⁶

The bottom line is that businesses would save some money by not having rules of origin in place, but this would do little to ease congestion and delays at the border. Indeed, the rules of origin process as applied at the border is extremely straightforward, whereas the concerns of US authorities about immigration, drugs, arms, security and smuggling that consume most border resources would not go away if rules of origin were eliminated.

Economic Benefits from Eliminating Rules of Origin

There are no real economic benefits to having a common external tariff *per se*. In fact, Canadian and US tariff structures are already quite close a high percentage of goods, as Goldfarb (2003) points out. The benefit stems from eliminating rules of origin. But given the above analysis that the costs associated with rules of origin are in fact quite modest, where does the 2-3% of GDP cost of rules of origin cited by Goldfarb come from?

The source of Goldfarb's 2-3% estimate is an unpublished PhD thesis by Appiah (1999) at Simon Fraser University under the supervision of Richard Harris, the professor who produced massive estimates of the gains from the CUFTA fifteen years before. Most estimates of economic gains from the original FTA as a whole were much less than the 2-3% now attributed to rules of origin (and these CUFTA estimates did not consider rules of origin as offsetting costs, a point made by Appiah in the thesis). The one outlier was Harris and Cox (1984), which produced the astounding prediction that the gains would be 8-10% of GDP.⁷

Appiah uses a computable general equilibrium (CGE) model to generate his results. This approach solves a complex system of equations that purports to represent 26 sectors of the economy. The model is then "calibrated" to reproduce the macroeconomic outcomes of the pre-free trade North American economy. Changes in the equations are then made to simulate the move to free trade. This becomes the base for comparing additional simulations that include free trade with rules of origin (in several different formulations) and a customs union (no rules of origin and common external tariff).

⁶ Though this was really due to the 1965 Auto Pact and a falling dollar rather than the CUFTA/NAFTA. Still, rules of origin do not seem to have made a difference.

⁷ See Hazledine (1990) for a review of the alternative specifications used by modelers that come to such a wide range of forecasts about the impact of Canada-US free trade, and a methodological critique of Harris and Cox (1984). He finds that "only a model with an extreme combination of non-competitive product market and free entry (as well as unexploited scale economies) can generate substantial gains from free trade." Other forecasts ranged from net losses to gains of 0.7% and 1.2% of GDP.

There are some major problems with Appiah's approach that suggest his numbers should not be taken too seriously. First, CGE modeling for trade policy analysis has a number of shortcomings as a methodological approach.⁸ Second, Appiah uses a particular methodology that is prone to producing unrealistically large estimates. Appiah follows his supervisor, Rick Harris, in using a model that assumes large unexploited economies of scale and a form of imperfect competition that generate large gains from small cost savings to exporters, which are then magnified by general equilibrium "virtuous circles."⁹ Third, Appiah produces a range of estimates under different scenarios. Goldfarb chose the largest estimates in the thesis without qualifying them as such. These numbers have subsequently been tossed around as plausible estimates of eliminating ROO without reference to the nuanced findings in the thesis.¹⁰ Finally, it is worth noting that benefits in this model accrue to one representative consumer—thus there is no analysis of distributional effects, split between capital and labour, or foreign ownership that would transfer increased profits out of the country.

Appiah essentially models rules of origin as if they are huge costs to exporters that undercut the gains from tariff reductions. The assumption is that eliminating these costs would induce structural change in the Canadian economy similar to that predicted for the CUFTA—it would increase productivity, enable exporters to

⁸ The CGE approach is grounded in neoclassical economics—a world where wages and prices always adjust to clear markets so that supply always equals demand (i.e. there is no unemployment or underutilized resources). Making a GE model computable involves a number of specific problems including data limitations, issues around modeling the structure of the economy and specific industries, the "calibration" of the model to one point in time as a reference case, and rules around closure of the model. Hazledine (1992) provides an overview of these problems.

⁹ Recent evidence suggests that the Harris and Cox assumption about unexploited economies of scale was wrong—that productivity increases from the CUFTA came not from economies of scale but from weaker companies going out of business. See Gu et al (2003) and Trefler (1999). General equilibrium modeling then exaggerates these gains. According to Hazledine (1990), "general equilibrium brings into play a 'virtuous circle' of events: the initial cost reduction reduces the supply price of domestic exports, resulting in an appreciation of the exchange rate to maintain external balance, which reduces further the domestic market price of imports, forcing additional domestic output price and cost reductions, and so on."(p. 795)

¹⁰ Comparing different scenarios of rules of origin with a base case of "pure" free trade, Appiah finds welfare costs that range from 0.3 to 2.8 percentage points off the estimated gain of up to 6% from moving to a free trade area. In a second section that estimates the difference between NAFTA with rules of origin and a customs union, he estimates the largest gain to Canada from a customs union of 1.1% increase in aggregate welfare.

capture previously unexploited economies of scale, boost foreign investment, and so forth.

While it is fair to say that the CUFTA did structurally change the Canadian economy, for better or for worse (the record of the CUFTA and NAFTA is assessed elsewhere in this volume), the major structural changes have already happened. Eliminating rules of origin is not likely to spark another round of major structural changes. And if they did, we would have to consider the costs associated with these changes.

In sum, there is no reason to expect major economic benefits from the elimination of rules of origin because they are not really that costly. Rules of origin may actually have benefits to the Canadian economy that are not being considered, and eliminating them would be a cost. As a result, any incremental gains fashioned from the move from FTA to customs union are likely to be extremely small, if there are positive gains at all. There are likely to be costs as well as benefits, as we will see in the next section, and to the extent that we desire to eliminate rules of origin, there will be negotiating trade-offs that will have to occur for the US to accept such a change.

4. Common Trade Policy and Customs Union

Another aspect of a customs union and the implementation of a common external tariff is the need for a common trade policy with the rest of the world. In practical terms, this would mean surrendering Canada's trade policy to the US Trade Representative. Such a move would have sweeping implications for Canadian institutions and how we manage our place in the world.

Consider even the most basic implications of having a common external tariff with the US. Canada and the US would need to set common tariffs by harmonizing tariff schedules, establishing uniform customs procedures, and determining how to share tariff revenues. It is hard to imagine that the US would enter into a negotiation with Canada to jointly set common tariffs; rather, given the highly asymmetric differences in economic size and power, Canada would adopt US tariff rates, convert to US customs procedures, and take whatever share of tariff revenues the US deems appropriate.

The history of the South African Customs Union (SACU) gives pause for thought. Founded in 1910, the SACU is the longest standing customs union in the world, consisting of South Africa, Botswana, Lesotho and Swaziland. It is one of highly asymmetric economic and political power—perhaps as asymmetric as Canada and the US—dominated by South Africa. The result, according to McDonald and Walmsley (2001), is that: “Historically the RSA [Republic of South Africa] enjoyed *carte blanche* over the setting of tariff and excise duty rates for SACU, and used implicit threats, not least over transit rights, to reinforce its control. Consequently

the development of trade policies within the SACU was determined by the ‘development’ agenda of the RSA.”

In many areas, where Canadian and US MFN tariffs are very close (less than two percentage points apart), a move to a customs union would not be too difficult. However, in both Canada and the US, there are politically sensitive sectors that have been protected from the full force of international trade agreements. These include agricultural marketing boards in eggs and dairy (protected by 200-300% tariffs), the Canadian Wheat Board, cultural industries, telecommunications and banking. Many of these have been targeted for dismantling by the US, so it is hard to believe that if these sectors survived a customs union negotiation that they would be given preferential treatment by a US-set trade policy in the future.

On its side, the US also has key sectors that have been protected. These include tobacco, peanuts and peanut butter, footwear, porcelain and glassware, tuna, brooms, dates, sugar, bovine meat cuts and carcasses, trucks, sweet corn and dried onions (Goldfarb 2003). Given the nature of US Congress in protecting these areas in the first place, Canada would have to substantially raise its tariffs to US levels to meet the common external tariff. Moreover, in certain areas, the US has pressured trading partners like Japan to accept voluntary export restraints (VERs), effectively quotas, for its domestic market. Would these VERs be extended to Canada under a customs union? If not, Japan could route its exports to the US via Canada to end-run the VER, something the US would not be happy about.

It is also unclear how far such arrangements would go in terms of the vast scope of modern trade policy. The concept of a customs union leading to a joint trade policy was obvious when most trade discussions focused on goods sectors and the principal barriers to trade were border measures like tariffs. This alone—the loss of capacity to set external tariffs or at least to negotiate their levels in international negotiations—is a huge loss of autonomy in trade policy

But the scope of “trade” policy in modern times includes a wide variety of measures taken by governments inside the border. Services negotiations are explicitly about removing perceived barriers in the form of domestic regulations and standards, temporary work arrangements, access to network infrastructure, public services and so on. Trade agreements also cover investment, competition policy and intellectual property rights, and food safety standards.

Some proponents of a customs union have argued for greater harmonization between US and Canadian regulations and standards as part of deeper integration. A customs union could force those changes onto the agenda due to the need to harmonize trade policy in services industries. Again, this would likely mean Canadian adoption of US standards and regulations. In some areas this could actually increase the level of Canadian regulations (certain environmental regulations, for example). But adopting US standards and

regulations would mean accepting that Canadian standards and regulations could never exceed those in the US in the future. What would this mean, for example, in the case of the Kyoto Protocol, which Canada has ratified but the US has not? Under a common regulatory regime, Canada would not be able to use regulatory powers to meet its targets.

Full integration of regulations may not be possible, much less desirable. Even within Canada, there are differences among provinces in terms of regulations for environmental measures, workplace standards and consumer safety. Indeed, these differences are attacked from time to time by corporate Canada as allegedly massive interprovincial “barriers to trade.”¹¹

The question remains: how far does a common trade policy reach inside Canada’s borders? Ultimately, there is much more to this than setting a common external tariff.

Then consider that over the course of history, Canada and the US have developed different trade ties and political relationships with other countries. Reconciling these within the context of a customs union could prove to be difficult. US trade policy is closely tied to its foreign policy objectives in a manner much more focused than Canada. The US has embargoed trade relations with some countries while Canada continues to maintain trade relations (often in spite of US pressures to follow its lead). The US also restricts the trade of certain products (defense industries, satellite, nuclear, encryption technology) in general and in particular with specific countries. Canada may not be willing to sign on to such restrictions on our trade.¹²

Cuba stands out as an example in the Americas. In the years following the Cuban revolution, the US restricted trade with Cuba, and over the 1960s tightened its embargo on trade with Cuba. The US does not permit US citizens to travel to Cuba, and has sought to rope in other countries in support of its embargo through extraterritorial means, such as the Helms-Burton Act of 1996 and its predecessors. The US has also balked at the inclusion of Cuba in the negotiations towards a FTAA.

Canada, on the other hand, maintains trade ties with Cuba. Canadian companies invest in Cuba, and thousands of Canadians travel to Cuba each year. Two-way trade (imports and exports) between Canada and Cuba was \$753 million in 2001 (with a peak of \$815 million in 1998) (DFAIT 2003a). Mexico is also a major trading partner with Cuba.

¹¹ See Lee (2000) for an overview.

¹² I am not arguing here that Canada should be an arms dealer of last resort, only that decisions about who we trade with and what we trade should be made by Canadians not Americans.

Another example is Iran. The US does not have trade relations with Iran. Two-way Canada-Iran trade was about \$700 million in 2000, and Iran is one on Canada's major export markets for wheat (DFAIT 2003b).

Given the imperial ambitions of the current US regime, economic sanctions could be imposed on other countries by future US administrations. Canada would have to go along for the ride; even though the common trade policy is ostensibly limited to trade, it would likely creep into foreign policy as a whole. Adding these together, we come up with some relatively large numbers in terms of the impact on Canada's trade relations with other nations.

Canada and the US also have differing existing relationships with other countries even when embargoes are not involved. Canada has a different set of trade agreements than the US, and different preferences granted to developing countries. Reconciling these differences could be quite complicated and difficult.

A common trade policy with the US forecloses on all kinds of policy initiatives for Canada. What if Canada wants to move ahead with the generic production of AIDS medication for poor countries in Africa that do not have domestic manufacturing capacity? After a long fight at the WTO, this could become practice in Canada, but under a common trade policy with the US it would likely never happen, due to the powerful influence of brand-name pharmaceutical companies in Washington. On the same note, what if Canada wanted to introduce tariff-free access to its market for certain developing countries as part of a push for international development? Canada could not do this unilaterally if sharing a common trade policy with the US.

Parties to a customs union must present a united front on trade policy negotiating in fora like the WTO. It is far from clear how this would work in practice, given the asymmetrical balance of power between Canada and the US. But it likely involves the devolution of substantial power at the negotiating table to Washington. This, of course, begs a number of questions: What role would Canada have in setting trade policy and priorities? What capacity would Canada have to defend its significant interests that US negotiators might be indifferent to? Would all final negotiating decisions affecting Canada be made in Washington?

In the past, Canada has often coordinated with the United States in areas of joint interest at the WTO. But the difference is that this was in the perceived interest of Canadian negotiators, was done on a voluntary basis, and could be changed due to a shift in government or policy priorities. Arguably, Canada's trade policy has not been particularly progressive—Canada has championed trade liberalization, investment liberalization and so on—but Canada needs to maintain control over the crucial aspect of how we manage our international trade relations. Were Canada to effectively hand over this role to the US, it would be a substantial loss.

Canada could probably negotiate some form of process by which its views would be heard, but the likely consequence would still be living with whatever US negotiators decided was in their best interests. This could result in all kinds of decisions that Canada would have to adhere to that internally we would disagree with. Remember too that Canada has many disagreements over trade policy with the US.

Thus, the expansion of Canada-US trade to a customs union is a major proposition in terms of Canadian trade policy. If anything Canada needs a more multilateral trade policy—the gains from more trade are not with the US but with the rest of the world (Helliwell 2003a). Yet, a customs union would not only be a shift away from multilateralism – at the same time as we fail to diversify multilaterally, we give away the very tools by which we could pursue a multilateral trade diversification strategy.

5. Trade Remedies

Most proponents of a customs union would like Canada to negotiate some form of exclusion from the application of US trade remedy laws (countervailing duties and antidumping duties), or perhaps even a common competition policy. This goes beyond the definition of a traditional customs union, but it is clearly of policy significance to Canada. The major stumbling block is in the US political arena.

This desire has a long history. It was one of the main objectives of the CUFTA. Canada put trade remedies on the table early on, but the US deferred the issue until the very end of the negotiation, when Canada was already so committed to securing an agreement that the perceived costs of failure were high. The result was an agreement to a binational panel that would assess whether trade remedies were appropriately applied in accordance with the laws in that country (Ritchie 1997).

The failure of Canada to secure exemptions from US trade remedy laws has proved to be a major weakness of the FTA from Canada's point of view. It is most visible in recent trade harassment over softwood lumber, wheat, tomatoes, potatoes and so forth. Often the US Congress will set down sweeping duties that apply to all countries, including Canada, and Canada must grovel for an exemption. This is pretty much the same as before the FTA.

The diffuse nature of power in the United States is at the crux of the problem. As Robert Wolfe notes:

Power is everywhere in the United States, and no central institution can be created to manipulate it on Canada's behalf. The fragmentation in Washington does not apply merely to political control of the levers of power, it is in the nature of the levers

themselves. . . A foreign country is but a minor special interest, because it sends no one to Congress. (pp. 15-16)

Certainly, there is merit for Canada in achieving an agreement on trade remedies. In particular, negotiating clearly defined rules on what constitutes a subsidy (this was supposed to happen in the CUFTA process but was dropped by the US once the deal was in place). This would address the major source of dispute over softwood lumber, for example. Dealing with anti-competitive practices under competition policy rather than antidumping would raise the bar in a way that would likely make most antidumping cases against Canada go away, but it is not clear that Canada would want a common competition policy with the US. Some sort of mutual recognition agreement for each other's competition authorities in these matters could provide satisfactory results without the costs of institutional integration.

This is all in the realm of theory, however, because barring a sea-change in attitude in US Congress, changing trade remedy laws or even negotiating an exemption is essentially a non-starter. That is, this is one potentially huge source of gain for Canada that is, for all intents and purposes, off-limits. Even if political will was there south of the border, Canada would probably have to pay too high a price to get an acceptable deal.

6. Assessing the Bargain

Ultimately, what is politically feasible would determine the outcome of a new negotiation with the US. Canada would be seeking particular gains from the US, and in turn will need to make concessions to seal a deal. The history of such negotiations is cause for concern. There is a great danger that Canada would have to give up a lot to get little in return. In a negotiation that is broad, even if couched as a customs union, we have no real idea where it would lead, what the final package would look like, or what surprises (like the revolutionary investor-state dispute settlement mechanism that came with NAFTA) might be in store.

What might Canada give up in order to seal a new deal with the US? Hart and Dymond (2001) suggest the following list of issues for the United States were it to enter into a new negotiation with Canada: agricultural supply management; Canadian content provisions and other cultural policies; border measures (including refugee policies, entry, and customs procedures); provincial and federal agricultural programs and practices; intellectual property rights issues; telecommunications policies; and foreign investment and ownership restrictions. These are areas in which serious commitments would be required of Canada.

Dobson (2002) suggests a number of things Canada could bring to the table as part of her "strategic bargain." At the top of the list are Canada's energy resources. While critics of CUFTA/NAFTA would rightly point out that Canada

has already given up a lot in the energy sector, the US obsession with acquiring cheap energy to power its economy means that Canada could offer a deal that included greater energy integration. Other initiatives include enhanced border security, harmonization of immigration and refugee policies, and an enhanced defense policy under the US umbrella.

These are some major concessions that intrude greatly into Canadian policy space. And they go much deeper than a customs union. There is little notion among proponents of diminishing returns to further integration. Other chapters of this volume are covering the push to harmonize with the US in these policy areas. Ultimately, given that the original CUFTA negotiations were supposed to guarantee our market access to the US but failed to, will Canada really secure that objective this time around?

This is not to rule out space for some pragmatic initiatives. Under the NAFTA, for example, there is already an agreement to waive rules of origin for most computers and parts.¹³ If it is in the interest of companies on both sides of the border, there seems to be little problem in negotiating sectoral agreements where there is the most to gain. There are a large number of sectors where tariff rates are already identical or close enough that they could be harmonized on a sectoral basis, and agreement made to eliminate rules of origin. Such an approach could easily harvest the “low-hanging fruit,” reaping most of the benefits of eliminating rules of origin, but without the costs of a full customs union.

Ultimately, the issue before Canadians is not whether we must take the next step, but whether this is the correct road to be on in the first place. As UBC economist John Helliwell (2002 and 2003a) argues, there are diminishing returns to further integration with the US and attempts to increase north-south trade flows. The gains from trade are more likely to be found in enhancing trade with Europe or the Third World, which suggests a multilateral approach to trade policy rather than a narrow bilateral one. And Canada’s concerns would be better addressed via multilateral institutions through international cooperation with other countries that share those concerns. This is the only way to get real leverage with the US to make changes on issues of real substance, like its trade remedy laws.

Moreover, improvement in our quality of life is about much more than GDP per capita. Helliwell’s research points out that beyond per capita incomes of about US\$15,000 per year, there is little gain in measures of subjective well-being (how

¹³ NAFTA Annex 308.1 provisions on “certain automatic data processing goods and their parts.” This includes automatic data processing machines, digital processing units; input or output units; computer parts; computer power supplies; storage units; diodes, transistors and similar semiconductor devices; and electronic integrated circuit and microassemblies.

people personally rate their quality of life). Further increases in well-being are more closely linked to levels of health and education, quality of communities, and participation in public life. One of the key reasons why Canada will likely face costs that exceed benefits of further economic integration is that there are a number of institutional differences that underpin higher levels of well-being in Canada, and integration would undermine these institutions.

Conclusion

The next great debate in Canada could be over whether Canada should enter into a customs union with the US. In this paper, I have noted that the potential gains from doing so are rather small, and nowhere near some of the incredible numbers being cited in favour of a customs union. And to get a customs union, Canada would have to forgo its independent trade policy, and potentially sovereignty in a variety of other areas.

The net result is not likely to be more secure access to the US market, in any event, because the US will not give up the ability to use trade remedy measures. Nor would a customs union facilitate border traffic. The certificate of origin accompanying NAFTA goods across the border is perhaps the most straightforward part of crossing. The border will not go away because US authorities will still be concerned about immigration issues, drug trafficking, smuggling and other security matters.

When the facts are laid bare, there is little case for entering into a new negotiation with the US over a customs union. Hopefully, common sense will prevail, and the debate will not be necessary because Canada charts a different course than deeper economic integration with the US.

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