



Michael Mendelson
Caledon Institute of Social Policy

BRIEFING NOTE: CANADA-UNITED STATES CUSTOMS UNION AND ‘SOCIAL CANADA’

Issue:

Is it likely that a customs union between Canada and the US would have an effect upon Canada’s social programs? If so, what effect?

Background:

While the term ‘customs union’ can be used to describe a number of different arrangements between countries, the customary meaning of the term has these four elements:

1. An agreement to common tariff and non-tariff barriers to apply to countries external to the customs union area.
2. An institutional arrangement to decide upon what tariff and non-tariff barriers to impose upon countries external to the customs union area, and to resolve any disputes that might arise.
3. Agreement on how to divide tariff revenue among the countries in the customs union area.
4. The elimination of any ‘rules of origin’ between countries within the customs union area.

While non-tariff barriers are not always explicitly mentioned in the context of a customs union, obviously these too must be the same between countries in a customs union area, or it will not be possible to eliminate fully rules of origin. For example, say country A and country B are in a customs union. If country A embargoes goods from country X but country B does not embargo goods from country X, it would be simple enough for country X to circumvent the embargo by shipping goods through country B to country A. This applies similarly for almost all other non-tariff trade restrictions. For this reason the implication of the four elements of a customs union is that countries within a customs union must share a common trade policy and, in essence, negotiate as one with the rest of the world with regard to matters of trade. Of course, it is

possible to exempt certain sectors, but to this extent the customs union is less than one hundred percent and some rules of origin would have to remain in force.

The usual reasons for supporting a customs union are:

- If there is already a free trade agreement between the countries in a proposed customs union area, then adding on a customs union will encourage even freer flows across borders by eliminating administratively cumbersome rules of origin.
- A small open economy such as Canada's will be able to attract more foreign direct investment due to firm's locating in Canada to take advantage of the US market, which, with a customs union, would be fully open to exports from Canada.
- The existence of rules of origin distorts trade patterns by encouraging a country to source production within the customs union area, thus foregoing efficiencies and savings that may be obtained from sourcing in countries outside of the customs union.

These factors, it is argued will increase a country's GDP by increasing trade and investment and allowing it to pursue its comparative advantages.

The usual reason for opposing a customs union is the inability of a country to maintain an independent trade policy in its own national interests. There is a sacrifice of sovereignty which may, or may not, entail a transfer of sovereignty to a multi-country political institution established by the countries in the customs area – depending upon the rules for the new multi-country institution.

Implications beyond these are not often much raised in the Canadian literature. However, this briefing note discusses whether there are implications for Canada's social programs should Canada enter into a customs union with the US.

Discussion:

There is no realistic possibility of a customs union between Canada and the US, with or without Mexico included. The US has no interest in a customs union and Canada would have no bargaining power if it attempted to negotiate a customs union with the US. The US would not agree to give up its capacity to make trade policy and hand over its policy-making regarding trade to a multi-national institution, unless the multi-national institution was *de facto* controlled by the US. The US would not forego its ability unilaterally to impose embargoes on countries such as Cuba and Iran. (Canada has substantial trade with both these countries.) The only way that Canada could enter a customs union with the US would be if Canada agreed to become subject to US trade practices without significant capacity to control these practices. In short, Canada would neither be a sovereign country able to control its own trade policy, nor a part of a democratic customs area in which Canada's interests were reflected. Canada should not accept such an arrangement, and it is extremely unlikely that such an arrangement could ever be sold politically.

Canada is not in Europe. A Canada-US agreement (with or without Mexico) is not the same as an EU agreement. A one-sided customs union agreement would essentially turn Canada back into a colony of a foreign country, much as we were when Britain still controlled our foreign and trade policy.

Nor do the possible economic gains, which are highly hypothetical and likely small in any case, seem to be worth giving up Canada's sovereignty. While it would undoubtedly be nice to fill out fewer forms at Customs, the elimination of rules of origin would have only a small impact on border hassles, which are much more about security, drugs and immigration than about tariffs. The promise of increased foreign direct investment was also made when the original free trade agreement was being negotiated with the US: but the result has been Canada receiving a decreasing proportion of foreign direct investment in North America. It turns out that what is sauce for the goose is also sauce for the gander: if the border is permeable why not invest in the US where you can be closer to markets and suppliers, and ship to Canada?

Notwithstanding its impossibility and its questionable desirability, this briefing note is about what such a customs union, which might or might not include Mexico, would mean for social programs in Canada. Simply put, on the face of it, a customs union would have *no* implications for Canada's social programs, because for the most part these are not tradable goods and services – and in any case there is no non-US country from which anything is being imported. A customs union has little or no direct effects on Canada's social programs. However there a number of avenues through which there may be *indirect* effects:

- **Harmonization pressures**

With a customs union it is argued that there would be increased economic integration with the US. Actually the effect on economic integration would likely be small, since the elimination of rules of origin is not especially significant to start with – but if there were a substantial increase in economic integration with the US, would this have an impact on Canada's choices with regard to its social programs?

Experience in the last few decades has demonstrated that it is quite possible to maintain very different tax and spending regimes despite not just free trade and a customs union, but a full monetary union. It is quite possible to maintain independent policies and substantially higher or lower taxes despite significant economic integration. This is likely because there are gains from higher spending as well as from lower taxes. A classic example is the advantage for Canada's auto sector of the socialization and control of medical costs through Canada's medicare program compared to health costs in the US. More 'modern' examples have to do with the existence of vibrant, attractive cultures and the capacity to innovate. Firms make location decisions for a variety of reasons, differing from firm to firm. For some firms low taxes will be extremely important: for others low health costs or the availability of a trained workforce will outweigh a tax advantage.

Despite the lack of evidence that lower taxes and reduced social services result in increased economic growth, there would undoubtedly be an increased chorus of demands for closer emulation of US tax levels should Canada integrate further with the US. This is primarily a *political* phenomenon rather than an economic phenomenon. As a political argument, the call for greater harmonization with the US could have an increasing impact were there more integrated economies. Regardless of their merits, with the greater integration of the Canadian and US economies of the last decade the arguments seem to have convinced many policy makers and large portions of the Canadian public.

Tangentially, it might be noted that the models used to show the supposed advantages of adopting US tax levels usually fail to include the effects of proposed cuts in tax revenue on public spending and instead assume that everything else is equal. Consequently what these models really come down to is the observation that Canada would be better off with lower taxes and the same levels of public spending, and no increase in debt – a conclusion with which everyone can agree but which is regrettably not possible. Furthermore, US total tax revenue is now about 5% less as proportion of GDP than is Canada's tax revenue. This happens to be about equal to the deficit in the US as a proportion of GDP. If the US deficit is accounted for (by adding it in to tax revenue as deferred taxes), Canada and the US at the present time have almost exactly the same levels of tax revenue as a percentage of GDP. Canada and the US have different compositions of tax, with the US relying more heavily on payroll taxes and Canada on income taxes. Many of the so-called comparisons of tax levels in the US and Canada are in fact comparisons of one type of tax – usually income tax – while ignoring all other taxes.

- **Pressure to permit commercialization of public services**

A customs union would not necessarily result in or require the commercialization of public services in Canada. Yet the US relies much more heavily on commercial for-profit firms in health and social services than does Canada, and some of those firms are reportedly eager to enter the Canadian market place. There might be pressure to make concessions on the entry of US for-profit firms into Canada, as part of negotiating a customs union package. Most infamously, the NAFTA made commercialization effectively one-way, by allowing for the compensation of US (but not Canadian) firms who have existing market access limited by new public sector regulations or programs. This means that once a health program is commercialized it is difficult to return it to the public sector because of the danger of having to pay compensation. This NAFTA rule might also make it difficult to introduce a universal disability compensation plan, or even universal coverage for drugs and other health needs through a publicly administered program. Whether a Canada-US customs union agreement would contain such provisions is of course unknown, but as a rule when entering into negotiations with no bargaining power and your negotiating partner has little interest in obtaining a positive outcome – expect a hard bargain.

- **Possible elimination of quasi-social managed trade sectors**

Canada has a number of managed marketing programs meant to stabilize rural incomes and farm marketing. Prime among these is dairy marketing, eggs and chickens, and the Wheat Board. Although these are not social programs *per se*, they do have a significant social component. The US might insist on lowering barriers to the entry of US firms into these sectors or, in the case of the Wheat Board, allowing farmers to market directly wherever they please.

It would be difficult to maintain a barrier to US entry if Canada has to have the same tariff and non-tariff structure with respect to outside goods as the US. For example, if the US wants to eliminate tariff barriers to Mexican dairy products (assuming for the moment that Mexico is not part of the Canada-US customs union), would this mean that Canada would permit Mexican dairy products to enter with little or no restriction while imposing barriers against US products? This does not seem possible.

Of course, it is theoretically possible to exempt certain products from a customs union, and Canada would no doubt attempt to do so with respect to its managed agricultural sector, but how could concessions of this kind be obtained in a one-sided negotiation? Moreover, to the extent that there are exemptions, any possible benefit from a customs union is reduced.

Conclusion:

A Canada-US customs union is extremely unlikely and there are many reasons to suppose that it is not necessarily a good idea anyway. But should a Canada-US customs union be implemented its direct effects on social programs in Canada are likely to be minimal or non-existent. A Canada-US customs agreement could have *indirect* effects by increasing the political demands for Canada to duplicate US patterns of taxing and spending. A Canada-US customs agreement could also require opening Canada's public sector to greater commercialization in a variety of ways. Neither of these effects are a necessary result of a customs union. A customs union would, however, probably require that some quasi-social managed markets in Canada open to competition.

Michael Mendelson
Senior Scholar
Caledon Institute of Social Policy
30 July 2004