CANADA AND THE NEW AMERICAN EMPIRE

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CANADA-U.S. CUSTOMS UNION: A CRITICAL ASSESSMENT

Subject: *Benefits and Costs of a Canada-U.S. Customs Union*

Background/Introduction:

Since the September 11, 2001 terror attacks, pressure has been mounting for a new deal between Canada and the United States to ensure unimpeded flows of trade and investment in the future. A new wave of pro-integration literature has emerged with hypothetical proposals for a "strategic bargain" (in the words of the C.D. Howe Institute) with the U.S. across a number of policy areas, including border security, defence policy, and immigration. Among the deep integration proposals is a call for a Canada-U.S. Customs Union (CUCU).

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 establishment of a common trade policy. It also involves 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 free trade agreement, does not export only to the country with the lowest tariffs on its product as a means of serving the entire trade bloc.

In the North American Free Trade Agreement, rules of origin stipulate that exported goods within the free trade area should have at least 60% North American content (62.5% for automobiles) to benefit from tariff-free access. The NAFTA also sets up a process to determine that exported goods within the NAFTA region containing non-North American content are substantially transformed in order to qualify for tariff-free status. The rules vary slightly from sector to sector, although for autos and textiles there are some additional specific requirements.

The term “customs union” is occasionally used in a broad sense to include some of the policy terrain of a common market, a deeper stage of integration that includes harmonization of regulations, standards and other economic and social policies across the area. Most advocates of a Canada-U.S. customs union are in fact seeking an integration package that goes beyond the economic definition of a customs union above.

Key Issues:

There are both benefits and costs associated with a move to a customs union. Canadians need to carefully assess whether the benefits outweigh the costs, as well as who the winners and losers would be. Canadians also need to assess whether we can reasonably achieve our objectives in a new negotiaion with the U.S., and what we might be asked to give up.

The principal source of benefit accruing to a customs union would be the elimination of rules of origin that, it is argued, pose administrative costs to exporters and distort trade patterns. It is worth taking such arguments with a healthy dose of skepticism. These are largely theorized costs and benefits in the economics literature. They do not seem to be a major irritant to exporters.

One oft-cited estimate is that rules of origin cost about 2-3% of NAFTA GDP. The source of this is a PhD thesis that uses computable general equilibrium (CGE) model — a quasi-empirical approach with a number of shortcomings that tend to bias results in favour of free trade. This is in part due to its grounding in the assumptions of neoclassical economics, and in part due to data and modeling issues. It essentially models rules of origin as if they are huge costs to exporters that undercut the gains from tariff reductions. Moreover, the thesis produces a range of results, of which only the top end has been cited.

There is no reason to expect major economic benefits from the elimination of rules of origin because they are not really that costly. 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, as some have argued. Indeed, the rules of origin process as applied at the border is extremely straightforward — a one page certificate of origin document — whereas the concerns of U.S. authorities about immigration, drugs, arms, security and smuggling that consume most border resources would not go away if rules of origin were eliminated.

Because they create an incentive to source inputs domestically or within the NAFTA area, 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 the NAFTA to a 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 from a CUCU. A crucial downside of a CUCU would be the need for a common trade policy with the U.S. vis-à-vis the rest of the world. In practical terms, this would mean surrendering Canada’s trade policy to the U.S. Trade Representative. Such a move would have sweeping implications for Canadian institutions and how we manage our place in the world.

In both countries there are politically sensitive sectors that have been protected from the full force of international trade agreements. In Canada, these include public services, Crown corporations, agricultural marketing board, the Canadian Wheat Board, cultural industries, telecommunications and banking. Many of these have been targeted for dismantling by Washington, and would be put on the table should Canada seek to negotiate greater economic integration.

On its side, the U.S. 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. Given the U.S. Congress's tendency to protect these areas in the first place, Canada could be placed in the ironic position of needing to raise its tariffs to U.S. levels to meet the common external tariff.

In certain areas, the United States 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 United States via Canada to end-run the VER, something Washington would not be happy about.

Over the course of history, Canada and the United States have also developed different trade ties and political relationships with other countries. Reconciling these within the context of a customs union could prove to be difficult. The U.S. has embargoed trade relations with some countries — such as Cuba and Iran — while Canada continues to maintain trade relations (often in spite of U.S. pressures to follow its lead).

Even when embargoes are not involved, Canada and the United States have differing relationships with other countries. Canada has a different set of international trade agreements than the U.S., and different trade preferences granted to developing countries. Reconciling these differences would be complicated and difficult.

A common trade policy with Washington would foreclose on all kinds of independent policy initiatives for Canada. For example, 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 United States it would likely never happen, due to the powerful influence of brand-name pharmaceutical companies in that country.

Some proponents of a customs union have argued for greater harmonization between U.S. and Canadian regulations and standards as part of deeper integration. A customs union could force those changes onto the agenda due to the desire to harmonize trade policy in services industries. This would likely mean Canadian adoption of U.S. standards and regulations. In some areas this could actually increase the level of Canadian regulations (certain environmental regulations, for example). But adopting U.S. standards and regulations would mean accepting that Canadian standards and regulations could never exceed those in the United States in the future. What would this mean, for example, in the case of the Kyoto Protocol, which Canada has ratified but the U.S. 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 protection, labour and employment standards, and consumer safety. Indeed, these differences are attacked from time to time by corporate Canada as allegedly massive "inter-provincial barriers to trade." 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.

There could be benefits for Canada in achieving some sort of agreement on trade remedy measures (such as antidumping and countervailing duties) — though these are not considered part of a customs union. The failure of Canada to secure exemptions from U.S. trade remedy laws has proved to be a major weakness of the original Canada-U.S. Free Trade Agreement, and the subsequent NAFTA, from Canada's point of view. However, given prevailing attitudes in the U.S. Congress, changing trade remedy laws or even negotiating an exemption is a non-starter. That is, this source of gain for Canada is, for all intents and purposes, off-limits.

Ultimately, what is politically feasible would determine the outcome of a new round of negotiations with the United States. Canada would be seeking particular gains from Washington, and in turn would 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, Canadians would 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 the NAFTA) might be in store.

Choices for Canadians:

The expansion of Canada-U.S. trade to a customs union is a major proposition in terms of Canadian trade and foreign policy. If anything Canada needs a more multilateral trade policy — the gains from more trade are not with the U.S. but with the rest of the world. Yet, a customs union would not only be a shift away from multilateralism – at the same time as Canada fails to diversify multilaterally, the very tools needed to pursue a multilateral trade diversification strategy would be given away.

What might Canada give up in order to seal a new deal with the U.S.? Washington would be focused on the following list of issues were it to enter into a new negotiation with Ottawa: 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; and, foreign investment and ownership restrictions (in particular, in banking and telecommunications industries). Canada would be required to make serious commitments in these areas — commitments that many Canadians would find unacceptable.

Canada's energy resources are also cited as something that Canada could bring to the table as part of a "strategic bargain." While critics of CUFTA and NAFTA rightly point out that Canada has already given up a lot in the energy sector, the U.S. obsession with acquiring cheap energy to power its economy means that Canada could offer a deal that included greater energy integration.

Potential Flash-Points:

Proposals for a CUCU could form a new front line in the battle for Canadians' minds over Canada-U.S. integration. For supporters of free trade, customs union is a natural extension of the same liberalization logic. As a result, there are many prominent supporters of the customs union concept among Canada's business elite, politicians and bureaucrats. But there are many dissenters as well.

Outside elite policy circles, the idea of a CUCU is still below the radar of public opinion, the subject of internal debate not uttered to the general public because of its potential to polarize (as in the case of the last great debate on the Canada-U.S. Free Trade Agreement).

Much depends on perceptions of how necessary is securing a new economic framework agreement with the United States. Canada and the U.S. already have a complex bilateral relationship across numerous policy areas. It is likely that priorities for both sides can be addressed as needed without negotiating a sweeping new agreement.

Options/Recommendations:

Canada should reject entering into a new negotiation with the United States over a customs union, or a broader negotiation that would include as one component a customs union. As this briefing paper has noted, the potential gains from a customs union are rather small, and nowhere near some of the incredible numbers being cited in favour of a customs union. And to bring about a customs union, Canada would have to forgo its independent trade policy, and potentially sovereignty in a variety of other areas.

Canada should consider pragmatic initiatives on a case-by-case basis. Under the NAFTA, for example, there is already an agreement to waive rules of origin for most computers and parts. 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 most-favoured nation tariff rates are already identical or close enough that they could be harmonized on a sectoral basis. Autos and steel, for example, represent sectors where Canada and the U.S. could gain from a common trade policy. As long as costs to Canadian industry and workers are taken into account, such an approach could harvest the "low-hanging fruit," reaping most of the benefits, but without a dramatic loss of sovereignty.

The gains from trade for Canada are more likely to be found in enhancing trade with Europe or the Global South, which suggests a multilateral approach to trade policy rather than a narrow bilateral one. Canada's concerns would also be better addressed via multilateral institutions and international cooperation with other countries that share those concerns. This is the only way to get the leverage necessary with Washington to make changes on issues of real substance, like its punishing trade remedy laws.