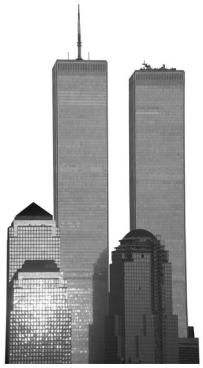
AFTER SEPT. 11: A CANADA-U.S. CUSTOMS UNION



Rolf Mirus

The events of Sept. 11 have increased U.S. interest in a common North American security perimeter. Whether Mexico wishes to come along or not, Canada should take advantage of this interest by proposing a customs union, in which the two countries would establish a common external tariff. This would involve a loss of Canadian sovereignty, since Canada likely would adopt the U.S. tariff code, but it would eliminate the trade distortions inherent in the existing Free Trade Agreement and, by freeing importers from the current requirement of proving compliance with "rules of origin" on goods traded between the two countries, it would help offset the costs imposed by the recent tightening of the U.S. border.

Les événements du 11 septembre ont accru l'intérêt des États-Unis pour un périmètre de sécurité commun à toute l'Amérique du Nord. Que le Mexique désire s'y joindre ou non, le Canada devrait profiter de l'occasion pour proposer une union douanière prévoyant un tarif douanier commun. Il y perdrait un peu de sa souveraineté, puisque nous adopterions vraisemblablement le code tarifaire américain, mais y gagnerait en matière d'échanges commerciaux l'élimination des distorsions inhérentes au présent Accord de libre-échange. En libérant les importateurs de l'obligation de se conformer aux « règles d'origine » sur les biens échangés, ce tarif commun favoriserait de surcroît la compensation des coûts liés au resserrement récent de la frontière américaine.

The reaction to the terrorist attacks of Sept. 11 has shown that Canada's special relationship with the U.S. is fragile. Calls for a "common perimeter" or the harmonization of border-crossing procedures reflect Canadians' serious concern about maintaining access to the U.S. market. With so much of our prosperity depending on exports to and imports from the US, delays of goods and people at the border impose significant economic costs and threaten some of our hard-won gains in that market. Herein lies a key challenge for Canadian policy-makers as a result of Sept. 11.

At the same time, the fight against terrorism is a common interest of our two countries. We should explore ways of cooperating more effectively on a number of fronts. Heightened security concerns may actually represent an opportunity to improve trade relations with the U.S. in ways that benefit both countries. I believe Canada should explore the formation of a customs union (CU) with the U.S. as a means of reducing "border costs." A harmonized tariff schedule, the key characteristic of a customs union, would make customs inspection of goods shipments unnecessary, as in the European Union. At the very least, a CU would offset some of the additional costs of tighter security inspections of travelers.

The present NAFTA represents the least integrative form of economic association found in the textbooks. Its distinguishing feature is that members retain their respective external tariffs and quantitative restrictions on imports. While the WTO is gradually lowering national tariffs, Canada's tariffs against non-NAFTA countries are still on average almost twice as high as U.S. tariffs. This higher tariff schedule is, if you will, a reflection of Canada's sovereignty.

With separate external tariffs, members of an FTA have to address the issue of trans-shipment. When imports from outside the FTA can be brought into the member country with the lowest duty and then trans-shipped duty-free to a higher-duty member country, the national tariff of the higher-duty country is effectively circumvented. To avoid such "trade-deflection" and the resulting tariff revenue loss, FTAs apply "rules of origin" (ROO) that specify the percentage of a prod-

uct that has to be of intra-FTA origin to qualify it for duty-free treatment. For example, 62.5 per cent of an automobile has to be of NAFTA origin to allow duty free access to the U.S. from Canada.

The literature on economic integration reveals a number of adverse effects from the application of ROO. To begin with, such rules provide an incentive to purchase higher-cost inputs from a member country supplier in order to fulfill the origin requirement. The result is trade diversion and lagging future competitiveness. ROO therefore lend themselves to lobbying by interest groups seeking protection from foreign competitors. By demanding a high percentage of North American content, member-country suppliers seek to obtain an advantage over competitors from third countries.

An example is the so-called "thread-forward" rule for textile and apparel imports under NAFTA. Beyond a certain quota of duty-free imports that do not need to fulfill the ROO, garment imports must be made from North American thread in order to qualify for duty-free access. Such a requirement obviously increases the demand for North American thread and cloth, creating cascading distortions with effects on costs and prices that are not readily transparent.

Strict ROO may even have the perverse effect of encouraging more imports. In a 1993 book, Peter Morici presents the following situation: NAFTA's 50 per cent net-cost rule could induce Mexican producers of, say, baby carriages to purchase mostly Asian parts and absorb the (at the time) 4.4 per cent U.S. and 12.5 per cent Canadian duty rate because the additional cost of using North American parts exceeds the cost of the tariff. With tariffs falling further since the Uruguay Round of the WTO, this has become more likely!

Administratively, ROO tend to be complex, and their language is very "legal." An annex of NAFTA devotes approximately 200 pages to ROO. In practice, the NAFTA "certificate of origin" consists of only one page that accompanies exports across the border. But there are five categories for each good shipped, and even the simplified instructions for filling out the form (including NAFTA definitions and certificate of origin instructions provided by customs brokers to exporters) run to 11 pages. Moreover, the exporter assumes legal liability for accuracy and must keep records and documentation for presentation on request.

Such is the administrative burden of ROO that in the European Free Trade Association (EFTA) producers reported costs of 3-5 per cent of the delivered goods solely for providing ROO documentation. These costs have resulted in the growth of a specialized intermediary industry—customs-broking—that helps make the provisions less onerous for businesses, albeit at a price.

A final adverse effect of an FTA, though not one directly attributable to ROO, is that different tariff schedules lead to different input prices in the various member countries, with the result that producers face different input costs, a fact that tends to distort production.

When two or more countries want to remove essentially all restrictions on their bilateral trade, they can do that by agreeing to a common external tariff and joint imposition of all other trade restrictions—such as import quotas—on non-members. The result is called a customs union.

The adoption of a common external tariff (CET) and joint quotas necessitates additional negotiations and cooperation in sharing customs revenues collected on imports from non-member countries. ROO are no longer necessary: when a common external tariff exists, there is no incentive for trans-shipment and ROO therefore lose their entire *raison d'être*. The CET effectively creates "destination-neutrality" for imports into the CU.

There are at least three effects of a negotiated CET. First, once established, the CET is not easily renegotiated, except for liberalization led by the WTO. While this creates predictability and administrative simplicity, industries that have lost tariff protection presumably will lobby for non-tariff barriers. Second, with a CET, input costs will not differ among members solely as a result of tariffs, and this will promote efficiency and competition. Finally, the literature also suggests that a customs union that sets the CET at the level of the lower tariff partner would create more trade than, and at least as many economic benefits as, an FTA consisting of the same set of partners.

While borders and separate customs procedures continue under an FTA, a CU approximates a larger single market. In negotiations with third countries this lessens the power of interest groups and makes for more pronounced scale economies and pro-competitive effects. Non-members will behave in a more conciliatory fashion vis-à-vis an emerging CU than an emerging FTA, since the risks of confrontation with a larger economic unit may act as a strong deterrent.

A large enough CU will also affect the prices of internationally traded goods, forcing outside countries to accept the prices prevailing inside the CU. Thus the outside countries will export to the CU at prices that include the CET and transport costs, bestowing an element of monopsony power

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on the CU. This effect is much less clear for an FTA of similar composition. It can therefore be argued that on balance the economic benefits of a CU on outweigh those of an FTA.

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Rapid progress at WTO-sponsored multilateral trade liberalization would gradually transform existing FTAs into CUs with zero as the CET rate. But since a successful next round of WTO talks is far from assured, Canada should consider the option of turning NAFTA into a customs union, whether as a fallback position or as an historic opportunity that has suddenly presented itself.

Supposing both that a CU brings more economic benefits than an FTA for the same partner grouping and that Mexico at present is not ready to commit to a CU, what steps could Canada and the U.S. take to move to a CU within NAFTA?

Given the U.S. interest in more secure North American borders, Canada could begin by committing additional resources and agreeing on joint external border administration. Agreement on a common external tariff with attendant phase-out of existing ROO could form the basis of cooperation that would result in more uniform border procedures with the outside world, allow freer trade without the encumbrance of ROO, and provide incremental security that maintained access for individual travel among the CU partners.

Despite what seems to be a common assumption post-Sept. 11, such changes would not require that Canada's immigration and refugee policy be fully harmonized with the US. Information exchanges among security agencies and additional resources for the enforcement of existing policies may satisfy the security needs of the partners.

As a step up from the present FTA, a Canada-US CU would involve special working groups in each member country to implement the CET. Realistically, and to make for easier negotiations, Canada could simply adopt the U.S. customs schedule, which generally provides for lower tariffs and therefore would encourage trade with non-NAFTA countries. For sensitive sectors—for example, agriculture—transition periods would have to be negotiated. In addition to a uniform customs code, administrative procedures and information systems would have to be agreed upon. As already mentioned, a revenue-sharing rule would also become necessary. Clearly, these steps would require considerable political will. As regards Mexico, present NAFTA rules would continue to apply, though Mexico presumably would be given the option of joining the CET.

A move to a CU would not bring new challenges for the application of trade remedy law in case of dumping and/or subsidy. The challenges in this respect already exist. It would be desirable, however, to review whether a more integrated North American economy would benefit from a rationalized competition policy. One way to achieve a more rational competition policy in an integrated market would be to reallocate administrative responsibility for intra-NAFTA dumping and subsidy determinations to the countries' respective competition watchdogs. In a single market with a common external tariff the U.S. Federal Trade Commission might be best placed to assess whether the pricing practice of a Canadian supplier into the U.S. market was anti-competitive and harmful. Similarly, Canada's Competition Bureau might well be best equipped to assess whether or not a U.S. supplier into the Canadian market was employing anti-competitive pricing policies.

To sum up, a CU means deeper economic and political integration. On economic grounds deeper is better: simplified and more harmonized border procedures facilitate trade; common product standards enable longer production runs; and a more rational competition policy better serves the integrated market. The price to be paid for these benefits is reduced national autonomy, the cost of which is more difficult to assess. Some harmonization has already occurred without causing much anguish. For example, in 1992 Canada adopted U.S. auto-emission standards, thus avoiding separate production lines for cars intended for export vs. those destined to be purchased domestically.

In light of its significant dependence on the U.S. market, Canada cannot have trade policies that diverge substantially from those of the US. Self-interest therefore suggests that we at least explore the possibility of a common position for future trade negotiations. The European Union, which resulted from a common commitment, not just to further the economic interests of member countries but to avoid war, aims at eventual federation as a political union. For Canada the goal is to secure market access without political absorption, and a CU would serve this purpose well.

In light of recent geopolitical events and the *de facto* integration of Canada in NAFTA, a Canada-US CU is now within reach. We should try for it.

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