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# A Canada–U.S. customs union: Potential economic impacts in NAFTA countries☆

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**Abstract**

Using a multi-sector and multi-region dynamic CGE model, the paper estimates the potential economic impacts of a possible Canada–U.S. customs union in the three NAFTA countries. Our scenario for the customs union assumes common Canadian and U.S. tariffs against the non-NAFTA countries as well as the elimination of the *Rules of origin* provisions of NAFTA. Our simulation results suggest that all three NAFTA countries would benefit from such an arrangement. However, the biggest beneficiary would be Mexico, followed by Canada and the U.S. Mexico's real GDP could increase by as much as 5%, compared to over 1% for Canada and 0.2% for the U.S. Canada's total trade could expand by almost 20%. American trade would also increase significantly, but the increase will be much smaller than that of Canada. Most of the increase in trade flows and real GDP are the result of the elimination of the *Rules of origin* provisions. On the other hand, economic benefits from common external tariffs (CET) are quite modest. All Canadian industries, except food and beverages, would gain from a Canada–U.S. customs union. Nevertheless, the big beneficiaries are going to be transportation equipment, electronics, and machinery and equipment industries. On the other hand, the gains in service and resource-base industries will be quite modest.


*JEL classification:* C61; C68

*Keywords:* Customs union; Dynamic general equilibrium; Rules of origin

☆ Views expressed in this paper are those of the authors and do not reflect those of Industry Canada or the Government of Canada.

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## 1. Introduction

Almost all world economies are increasingly integrating with one another. Dramatic reductions in transportation and communication costs, rapid technological changes in production processes, fierce international competition for markets and factors of production, bilateral, regional and multilateral trade agreements have all contributed to the increased economic interdependence among the national economies.

Canada too is actively participating in the globalization process. Canada is one of the most open economies in OECD countries. At present, exports account for more than 40% of Canada's real GDP. Similarly, imports represent about 40% of GDP. Furthermore, since 1990 Canada's export intensity and import penetration have increased considerably. Inward and outward direct investment orientation has also increased significantly. Canada is a net exporter of capital, and the gap is widening, a dramatic reversal of the situation 20 years ago, when Canada used to be a large net importer of capital.

The increased outward orientation of the Canadian economy is largely the result of increased economic linkages with the U.S. Currently, more than 85% of Canada's merchandise exports are destined to the U.S., compared to about 70% in 1990. However, the U.S. share in our imports increased only marginally. The booming U.S. economy, the depreciation of the Canadian dollar vis-à-vis the American dollar and the two free trade agreements (FTA and NAFTA) contributed to the increased economic integration between the two economies in the 1990s (Acharya, Sharma, & Rao, 2003). Canada is also an important trading partner for the U.S. Canada accounts for about 20% of U.S. exports and imports. Canada is the largest trading partner of 39 U.S. states. In addition, Canada is the largest supplier of U.S. energy requirements.

The increased economic linkages between Canada and the U.S. have been beneficial to Canada. For instance, close to 80% of the growth in Canadian manufacturing shipments in the 1990s was driven by the growth in exports to the U.S. Research done for Industry Canada strongly suggests that FTA and NAFTA have also contributed positively to Canada's productivity performance. The available research also show that both inward and outward direct investment exerted a significant positive impact on the Canadian economy.

Despite a high degree of interdependence between the two economies, there is a great deal of uncertainty about future of Canada–U.S. economic relations because of a number of factors: U.S. concerns about future terrorist threats and the security at the Canada–U.S. border; softwood lumber dispute and other trade irritants; trade frictions associated with the mad cow disease and the growing protectionism in the U.S., partly due to a huge and growing U.S. trade deficit.

There has been a great deal of public discussion and debate in Canada about future Canada–U.S. economic relations. A number of researchers and policy analysts have proposed various initiatives to broaden and deepen the NAFTA.[1] These include: harmonization of border measures and procedures with regard to customs, refugees and immigration; increased investments in transportation and border infrastructure; increased

[1] See Harris (2003) and Goldfarb (2003), for example. See also C.D. Howe Institute Border papers commentary series.