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Toward a North American customs union: Rules of origin liberalization matters more than a common external tariff for Canada

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ABSTRACT

This paper shows that the general equilibrium impacts on Canadian GDP and welfare, of liberalizing NAFTA Rules of Origin (ROO), largely dominate the small effects of adopting a Common North American External Tariff (CET). Therefore, proposals for a North American CU should not be dismissed solely on the basis that a CET would marginally affect Canada while the negotiation process with the U.S. would be long and difficult—ROO liberalization matters more than a CET for Canada.

1. Introduction

In Canada, more than 15 years of increased market integration through the (1989) Canada-US Free trade agreement (CUSFTA) and the (1994) North American Free Trade Agreement (NAFTA) has led Canada's economy to be more closely integrated with the USA than at any time in history. The 10-year

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anniversary of NAFTA gave the occasion to take stock of its *ex post* impact, and Harris (2006) provides a review of the generally positive evidence given in a large number of empirical studies.

Notwithstanding Canada's strong official commitment to multilateralism and to the WTO and the strongly held view by some that Canada's economic dependence upon the United States is a serious weakness and that trade and investment diversification should be a high priority of Canadian policy, many suggestions exist to broaden and deepen NAFTA, including harmonization of border measures and regulatory procedures, common external tariff (CET), customs union (CU), liberalization of NAFTA rules of origin (ROO), liberalization of the remaining restrictions on U.S. direct investment in Canada, free movement of labor, and negotiations to curb U.S. trade remedy laws [*e.g.*, Dobson, 2002; Goldfarb, 2003; Harris, 2003; Mandel-Campbell, 2008]. The objective of this paper is to examine the *ex-ante* economic effects of adopting a North American CU—establishing a CET *and* concomitantly liberalizing NAFTA ROO. The paper fills a gap in the literature because the economic effects of a CU that also liberalizes preferential ROO are not well understood.

In economic literature, a CU is the second level of regional integration following a Free Trade agreement (FTA) and involves (as in a FTA) the eventual elimination of all tariffs between member countries, but unlike a FTA, also establishes a common external trade policy, in particular by adjusting all tariffs external to the customs union to a common level. In an FTA, however, the members maintain their individual most favored nation (MFN) tariffs that they impose on countries outside the agreement.

As a result, a CU requires members to negotiate a common trade policy and a CET with respect to non-member countries, while a FTA requires negotiating measures such as preferential ROO, to avoid trade deflection. Trade deflection – a modification of trade flows between the rest of the world and the members of the FTA – occurs when a non-member agent transits goods through the FTA member-country with the lower-external tariff and then transships duty-free (or with preferential treatment) to the final destination. To eliminate the incentive for trade deflection, preferential ROO are negotiated among members of the FTA. These rules determine which goods have "origin" in member countries and thus are eligible for duty-free (or preferential) treatment when crossing partners' borders, and which goods are not as they are simply being transshipped through, or undergoing only minor transformations in a member country.[1]

Theoretically, Kemp and Wan (1976) have proved that a CU can benefit its members and do no harm to the rest of the world under some conditions. In particular, they prove that there exists a CET that can be chosen so that exports from the rest of the world to the union are *globally* unaffected and world price (terms of trade) are unchanged. They then show that there exists a pattern of self-financing lump-sum transfer across countries within the union that leaves no individual country worse off. Panagariya and Krishna (2002) have developed a proof which shows that the Kemp-Wan theorem can be extended to cover FTAs if *every* country in the FTA has exactly the same trade with the rest of the world, as it did in the pre-FTA benchmark. Therefore, by preventing trade deflection as defined above, ROO take steps towards fulfilling this condition so that the Panagariya–Krishna requirement rationalizes the existence of ROO within a FTA.

However, ROO also generate distortionary effects (discussed further in Section 2) that lead FTA countries to purchase less from the rest of the world and more from other members (Krishna & Krueger, 1995), so that the Panagariya–Krishna requirement is unlikely to hold. Thus, as suggested long ago by Krueger (1995), CUs are Pareto superior to FTA *because* the establishment of a CET in a CU (under the conditions of Kemp and Wan) would also remove the incentives for trade deflection and therefore eliminates both the need for preferential ROO and their distortionary impact on the economy and competitiveness of firms.[2] Thus, preferential ROO are typically absent from a CU arrangement and movements of goods within a CU are not based on their "originating status" but on the principle of "free circulation".

[1] For a recent collection of papers analysing different aspects of ROO, see Cadot, Estevadeordal, Suwa-Eisenmann, and Verdier (2006).

[2] Starting at any FTA, the theorem of Kemp and Wan ensures that there is a CU that is Pareto superior (to the FTA) if ROO are eliminated, but this requires to chose a CET that does not affect the terms of trade of the union with respect to outside countries and that member countries implement lump-sum transfers so that no individual member is worse off.