Executive Summary

The Path to Customs Union:
The European Experience and North American Integration

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The economic downturn following the 2008 financial crisis provided the United States, Canada, and Mexico with a unique opportunity to think creatively and act boldly. Yet in the face of crisis and opportunity, all three countries reacted as if they were unaware of the significant trade and investment relationship that they share. Each country created its own stimulus package and adopted policies that hindered continental integration and the development of a long-term recovery solution. Moving forward to the next stage of economic integration, that is, the formation of a customs union, would not only reinvigorate the North American economies, but also increase the region's competitiveness with the rest of the world. Furthermore, because Canada and Mexico are the largest markets for U.S. exports, reducing barriers to trade to the contiguous neighbors creates lower transportation and transaction costs, the possibility for economies of scale, as well as more consumer choice.

The three economies are inextricably linked with roughly 75% of both Canadian and Mexican exports going to the U.S. market and 50% of all North American exports destined for North America. Furthermore, few Americans are aware that 6 million U.S. jobs are dependent on trade with Mexico.[1] This level of intra-regional trade is a sign of strong economic integration, however, it has not been matched by a parallel transformation of the structures and vision that could guide this process. The framework that the North American Free Trade Agreement (NAFTA) created is insufficient, and the leadership of Canada, Mexico and the U.S. has not ventured to think beyond NAFTA and ask what else can be done to enhance the economic clout of the region.

This paper seeks to explore the possibility for the formation of a customs union between Canada, Mexico and the United States to enhance the economic recovery, increase the region's competitiveness and pave the way for a new chapter in U.S. foreign relations. The analysis is developed through a comparative regional study, which examines the European effort that culminated in the Treaty of Rome in 1957 and the completion of a customs union among the Six founding members in 1968. The purpose is not to replicate the European model, but rather to draw the most important themes and lessons from the European experience to help guide and inform North American integration.

Europe and the Customs Union Issue

The study begins by tracing the origins of the customs union idea in Europe to understand the motivation for the project, how the idea was realized, and how the six founding members of the European Economic Community (EEC), Belgium, France, Germany, Italy, Luxembourg, and the Netherlands subsequently adopted it. It becomes quite clear that multiple factors shaped the

Community's development, with individual actors, interest groups, and governments each playing a key role. Though the idea of a customs union in Europe can be traced as far back as the late 18th and 19th century, it was not until the 20th, in the inter-war period, that this idea became more solidified. The Belgium-Luxembourg Economic Union, created in 1921 and the Benelux Economic Union, formed shortly after the Second World War, were the first successful experiments with customs unions that would influence the formation of the EEC.

Though there were several ideas on the table, including a free trade area, Dutch Foreign Minister Johan Willem Beyen strongly championed the customs union as a way to accelerate export-led growth and reinvigorate the devastated European economies. From 1955 to the signing of the Treaty of Rome in 1957, the Six deliberated, bargained, and compromised to set the foundation for what would eventually become the European Union (EU). This was not a simple task, but it was underscored by a strong sense of political will and consensus around a continental solution to Europe's economic woes. It is clear that in the mid to late 1950s there was a strong impetus for cooperation, innovative thinking and inspired leadership to pull Europe out of its slump and create a region that could compete and thrive in the 20th century and beyond.

The next section of the paper looks in more detail at the customs union, examining its formation, obstacles to implementation, and ultimately, its performance. The completion of the customs union requires the achievement of two separate but related tasks; first, the removal of all internal customs duties and quantitative restrictions, and second, the harmonization of tariffs to third countries to create a common external tariff (CET) towards non-member states. The EEC declared the customs union complete on July 1, 1968—eighteen months ahead of schedule. Though internal customs duties were relatively simple to abolish, establishing the CET was a far more difficult task, as there were clear structural differences in the separate tariff systems that had to be reconciled.

Creating the customs union thus required a level of legislative cooperation, which, at the outset, was a little unclear. In fact, the Treaty goes into a great deal of depth in defining the make-up and function of the customs union, but it says little about Member State legislation in relation to it. This is exactly why, at the end of the transitional period, the customs union was incomplete. The Member States had harmonized their national tariffs, but that was just one part of what a fully functioning customs union would entail. The implementation of the customs union requires harmonized legislation on customs matters, otherwise, trade distortion, deflections, and overall discord within the Community could result. The discussion on the formation of the customs union highlights that progress was evolutionary, and that each member state varied in its implementation of the Treaty provisions. However, this did not impede the EEC's performance.

In fact, analyzing the impact of the customs union by focusing on its trade creating or trade diverting effects shows that the EEC's performance was quite extraordinary. Bela Balassa centered his analysis on the percentage change in imports to the Gross National Product (from 1953-1959 to the 1959-1970), under the assumption that income elasticity of import demand would have remained unchanged without integration, and that the rise of income elasticity of demand for intra-area imports would thus indicate gross trade creation. What he found was that

in the early stages of economic integration, particularly the introduction of the customs union, trade creation had not only been significant, but it also exceeded trade diversion in absolute terms. This trade creation was in part a result of intra-industry specialization in manufacturing and economies of scale. His model showed that every 1% increase in GNP resulted in a 2.7% increase in intra-area imports in the period 1959-1970, and 10% trade creation proper.[2]

Wilfried Prewo also conducted analysis on the effects of the customs union on trade flows by examining its effect on the EEC's export performance. Prewo observed that from 1959-1970 the share of intra-EEC exports rose by 50%, and the total share of EEC-exports to third countries declined by 24%. Though there was a redirection of exports from extra to intra-EEC countries, this occurred in specific sectors, while others, such as manufactures, benefitted from increased extra-EEC exports, outweighing the total decreases in other areas.[3] Though the the Benelux countries showed positive signs of export growth from 1965-1970, the early years were slow; as a result, Germany, Italy and France benefitted the most from the customs union during the initial stages of implementation. If one were to look at the figures in absolute terms, Germany comes out on top in terms of total exports, mostly due to the vast size of its market.[4] The states with the highest pre-union tariff rates (France and Italy) benefitted the most in percentage terms because their markets opened up substantially from previous levels, fostering a boom in both imports and exports. As Table 1 shows, it is quite apparent that the EEC became a formidable trading bloc.

Table 1. Extra-EEC Trade with the World, Exports & Imports (in billions of ECU*)

Year	Total Exports	Total Imports
1958	64.2	68.6
1960	78.5	82.1
1970	200.8	210.9

Source: *Eurostat, External and intra-EU trade Statistical Yearbook, Data 1958-2009* (Luxembourg: Publications Office of the European Union, 2010), 14-16.
*1 ECU= 1 USD

Given the analysis of the EEC's creation, formation and performance, the following observations are noted as the key lessons from the European experience:

- Economic integration is a very technical process that often takes place at very high levels of government, but also involves various actors from the private sector, such as industry, business, and civil society;
- Integration is a dynamic and evolutionary process, and must adapt as circumstances change;
- Clear and achievable benchmarks must be set to motivate member states to meet their long-term goals;
- Strong leadership and effective institutions to oversee the process are necessary to overcome obstacles that arise;
- The impact on national legislation must be considered early on;
- Member countries have to be willing to compromise and maintain a sense of common purpose that can foster the political will necessary for such a project.

By identifying the key themes and lessons that the Six learned on their path to customs union, one can begin to understand the complexity of the process, while shedding light on those mechanisms that lead to success. In fashioning a model that could apply to North America, these items must be kept in mind and serve as guiding principles, and in some cases, warnings, of what can be expected.

Prospects and Challenges for North American Integration

The final section of the paper turns to the prospects and challenges for North American integration. It begins by first laying out the origins of integration in North America; responding to economic downturn and a change in the organization of production, Canada, Mexico and the United States had formalized their interaction through NAFTA and set out on a new stage in their relationship. However, each country's primary concern was, for different reasons, to maintain their sovereignty. This is precisely why a customs union was not considered during the NAFTA negotiations; first, neither country wanted to give up independence in setting its MFN rates, and second, the Canada-U.S. Free Trade Agreement already provided a working template for the region.[5] This resulted in a limited agreement that did not look beyond basic trade liberalization, and subsequently failed to include provisions that would lead to deep integration.

Though NAFTA succeeded in accomplishing what it set out to do, the items left out of the integration process served as the greatest disappointments. Issues of labor mobility, border security, trade remedies, and regulatory convergence, are but a few items that never made it to the agenda. As a result, the problem of illegal migrant workers from Mexico to the U.S. market has not been addressed, a uniform strategy for securing our borders was never developed (the Smart Borders initiative went the old route of dual-bilateralism), and the North American market is limited in its potential due to the slew of non-tariff barriers (labeling, product certification, etc.) that prevent a truly free market of goods and services from becoming a reality. Therefore, the anger at NAFTA is largely misplaced—we should not be upset at what NAFTA achieved, but rather at what it failed to imagine.

Key themes that have characterized the integration process in North America are as follows:

- A commitment to trade liberalization—integration has been focused on achieving this specific goal, on which the three countries share a broad consensus;

- Short-term vision—the NAFTA had a specific set of goals it set out to accomplish. The *ex ante* nature of the agreement highlights the fact that the negotiators were not looking for a long term, evolutionary integration process, but a solution for the moment;

- Dual-bilateralism—though NAFTA was a trilateral agreement, common issues continue to be tackled on a dual-bilateral basis, which leads to a lack of continental vision and sense of community. Canada and Mexico compete for U.S. attention while largely ignoring the benefits of approaching the U.S. on an issue together;

- Asymmetry—in terms of economic and military power, Canada and Mexico are severely disadvantaged by the U.S., and thus often hostage to U.S. will and the priorities of whatever administration is in power;

- Weak institutions and ad hoc structure—due to U.S. concerns over sovereignty, no strong institutions were created to implement, monitor or continue the dialogue of the integration process. As well, the NAFTA committees and working groups have proven largely ineffective;

- Lack of political will—with the exception of the meeting of the minds between Mulroney, Reagan/Bush, and Salinas, the North American leadership since then has given the region a low priority, and has not implemented any new and innovative ideas to improve the economic relationship;

- The influence of civil society, business, and industry—the people of North America seem to be operating as if the region truly does exist, often partaking in transnational lobbying, and pushing their national governments to address the concerns NAFTA did not deal with. Business and industry were also heavily involved in supporting NAFTA, and due to increasing economic interdependence, built epistemic communities that transcend national borders.

With these factors in mind the analysis turns to an examination of the possibility for a customs union in North America. The distinguishing feature of a customs union from a free trade area is that a customs union creates a common external tariff to third countries. This would be especially beneficial to the North American market, since current rules of origin (ROO) requirements, which require goods to have 60% North American content to qualify for the NAFTA preferential tariff, are extremely restrictive; ROO compliance costs amount to 2-3% of the NAFTA GDP. Table 2 shows the impact of customs unions on the economy. A customs union eliminates ROO by creating a CET and preventing the problem of transshipment, but it does more than eliminate these cumbersome requirements; it can also increase predictability for investors, expand output and trade, possibly increase employment, and increase choice and provide lower prices for consumers.[6] Harmonizing the MFN tariffs between the three countries is the most important factor in creating a CET. To decide where to begin, Canada, Mexico and the U.S. should look at tariff lines that have differences of less than 10% and organize these into a list to begin negotiations. Working through the lowest tariffs first will build confidence in dealing with more difficult ones down the line. About 40% of U.S. and Canadian MFN tariffs are within 1-2% of each other, and will be easy to adjust.[7] For other tariff lines, it is possible to agree on an arithmetic average, so long as the tariff is not substantially increased.

The greatest challenge to a common commercial policy and creation of full-fledged customs union are the existing number of FTAs that Canada and Mexico have concluded with other countries, which are incompatible with U.S. FTAs.[8] This is problematic because the FTAs would have to be renegotiated to include all members in the customs union. ROO requirements in each FTA would thus be reconciled, eliminating conflicting ROO provisions.[9] Though there is a significant amount of overlap, there are also major disparities; particularly the FTAs Mexico has

with Japan and the EU, as well as Canada's FTA with the EU, which is currently under negotiation. However, even in cases where there is overlap, the substance of the agreements may differ, and thus each FTA would have to be examined on a case-by-case basis.

Though this ultimately implies that a full-fledged customs union like the EU's is not possible in the near future for North America, it does suggest that movement towards a customs union that is specifically tailored to address the needs of this continent is a plausible goal. The EU customs union took over twelve years to implement—undertaking a similar process would undoubtedly be a long-term project.

Table 2. The Impact of Customs Unions

Action	**Impact**
Removal of tariffs between member countries	• Free movement of goods • Increased competition, specialization • Economies of scale, lower unit costs • Increased consumer choice, lower prices • Attract foreign direct investment • Expanding production, technical efficiency • Low cost suppliers can increase exports to member countries, but in the short term, their consumers will face higher prices since supply is imperfectly elastic. Will either change as a result of industry expansion along its domestic supply curve, or the creation of a common price on products • Geographically limiting
Establishment of a common external tariff to the outside world	• Elimination of rules of origin between member countries • Reduction of transportation and transaction costs • Bargaining power in international trade negotiations, improved terms of trade • Trade creation • The higher the external tariff rates, the more adverse its impact on third countries, possibly leading to trade diversion if the lowest-cost producer is not within the customs union for a product adversely affected by the increased tariff • Member countries give up independence in setting tariff rates • Possibility for a common commercial policy

In his study on the effects of a customs union in North America, Appiah showed that the gains from a customs union would be significant.[10] The European case supports this evidence, as countries with the highest pre-union tariffs experienced large percentage increases in intra-union trade. The reduction of both internal and external tariff barriers in the EEC caused previous high tariff states to shift from inward-looking trade policies to an export-oriented strategy, causing significant increases in export levels. Due to the asymmetric size of its market, Germany benefitted the most in real terms from the customs union, and it would be reasonable to assume that a similar trend would emerge here with the U.S. market. As well, since the U.S. is a globally oriented trader, the effect of this market opening could possibly be even greater than the expansion of the German market after the implementation of the customs union, since Germany was far more dependent on intra-community trade. Since Canada's market size is considerably smaller than the U.S., and also because its MFN tariffs are not very restrictive, Canada would

most likely make more modest gains from a customs union. However, because a customs union could eventually lead to the formation of a joint commercial policy, it would effectively eliminate U.S. trade remedy penalties that Canada greatly dislikes.[11]

Mexico has the potential to reap great benefits from a customs union because its MFN tariffs are quite high. If done right, it could experience the tremendous increase in trade felt by Italy and France as barriers to trade were reduced. However, the important element that cannot be ignored is the development gap between Mexico and its two neighbors. Increased trade for Mexico will not be enough, and it will need to continue to modernize and expand its economy. If Mexico is to be an equal partner in this customs union, Canada and the U.S. must be committed to closing the income inequality gap. This requires a commitment to ideas like the North American Investment Fund, and trilateral solutions for Mexico's key challenges.

Given the complexity of the integration process, and the less than impressive performance of the NAFTA committee structure, it is difficult to imagine how this process can be completed without creating new institutions or by improving the old ones. To foster continuity in the policy process and to ensure that issues brought to attention are not forgotten, the three countries would be better served by a revamped Free Trade Commission that includes deputy cabinet-level officials as well as expert bureaucrats from the trade and commerce departments of each country to assist in monitoring progress and setting the agenda for future FTC meetings, which need to occur on a far more regular basis. Furthermore, it is imperative that in any integration scheme all sectors of civil society are included in the process. The European trade unions secured the European Economic and Social Committee (EESC) in their lobbying efforts, which allow civil society actors to have permanent representation and access to the Community structure. North America would benefit from a similar structure that offered various groups of society the opportunity to put forth ideas, comment on legislation, and provide real insights on what is actually happening on the ground, without getting lost in disconnected political debates. Such a forum could also provide guidance as to where to begin the integration process, and where to be more careful in the application of new projects.

Institutions are also important because the distribution of customs revenues will have to be enforced on an agreed upon formula. Some authors have suggested using the model of the South African Customs Union (SACU), which calculates the amount of revenue allocated to each country by its portion of total intra-union trade and its GDP.[12] The EU has employed a system in which the territory of point of origin keeps 25% of the duty for its administrative costs, while the rest of the duty goes towards the community's central budget. Since the U.S. collects the most revenue in import duties overall, the most likely revenue sharing agreement to be saleable in North America would have to be more similar to the SACU model than the EU. However, the EU model has a particular benefit, in that a set amount of tariff revenue becomes part of the Commission's 'own resources' that make up the EU budget. This revenue helps to fund operations of the community, including a large number of programs that help with member states' economic development. A portion of revenue collected from import duties could be reserved for a common body, such as a North American Investment Fund, which would assist with infrastructure and development projects to further improve the trading relationship.[13] This would be particularly helpful to Mexico in closing the development gap, but it would also be

tremendously beneficial for critical infrastructure improvements, as 80% of North American trade is done by road.

Conclusion

Overall, a customs union would be the logical next step to deeper integration in North America, but it is up to its leaders and its people to decide what path they wish to take. As this discussion has shown, Canada and Mexico are key trading partners of the U.S., but the U.S. attitude towards its two neighbors has been more characterized by disinterest than true friendship. The sheer volume of trade that crosses the southern and northern borders is simply astonishing. In 2011, U.S. exports to Canada totaled $281 billion, and to Mexico, $198 billion; U.S. imports from Canada amounted to $317 billion, and from Mexico, $263 billion.[14] The trade relationship is significant, but since the U.S. remains committed to a multilateral agenda, and is consistently distracted by security concerns, it has not given the region the attention it deserves. But Canada and Mexico have an important role to play too. Canada must start treating Mexico as an equal partner, and Mexico must reach out to Canada as it did during the NAFTA negotiations, to build consensus on priorities for the continent.

Thinking trilaterally will be a major challenge to policy makers that have continually tackled the agenda in the traditional bilateral way. But this is not impossible. What this paper hoped to achieve was to inspire a different way of thinking about the relationship between Canada, Mexico and the United States, and engage the reader in an intellectual exercise to question whether as a country, as a region and as a people, we have truly examined each and every option on the table before brushing it aside as impossible. When Europe began its integration project fifty-five years ago, many questioned its merits. Even today, facing economic crisis, criticism is strong. Yet the European Union has undergone numerous crises throughout its history, and survived all of them. Its reaction to crisis has also always been the same—more, not less integration, as evidenced by the recent signing of the fiscal pact. The region has adapted and remained influential in the world; its soft power, despite crisis, has also not declined, as states still seek to join the union. On March 9th 2012, all 136 members of the Croatian parliament voted in favor of accession to the EU; Iceland, Macedonia, Montenegro, Serbia and Turkey remain candidate countries.

Regional integration offers a possible solution to North America's economic, social and political problems, and a customs union is a viable next step in this process. Maintaining the status quo limits the region's growth and prevents the realization of the economic reality of our continent. Jean Monnet once wrote "people only accept change when they are faced with necessity, and only recognize necessity when crisis is upon them."[15] North America has just faced a crisis, and is still dealing with the recovery; but its policy makers remain prisoner to a way of thinking that limit the potential of a diverse, innovative and inspiring people, who should demand more of their leaders.

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[2] Bela Balassa, "Trade Creation and Diversion in the European Common Market: An Appraisal of the Evidence," in *European Economic Integration*, ed. Bela Balassa (Amsterdam: North Holland Publishing Co., 1975), 117.
[3] Wilfried Prewo, "Integration and Export Performance in the European Economic Community," *Weltwirtschaftliches Archiv* 110 (1974): 14. http://www.jstor.org/stable/40438741 (accessed December 15, 2011).
[4] Ibid., 23.
[5] Jaime Serra Puche, e-mail message to author, March 13, 2012.
[6] Danielle Goldfarb, "The Road to a Canada-U.S. Customs Union: Step-by-Step or in a Single Bound?" *The Border Papers,* C.D. Howe Institute Commentary, no. 194 (June 2003) http://www.cdhowe.org/the-road-to-a-canada-u-s-customs-union-step-by-step-or-in-a-single-bound/9794 (accessed February 2, 2012), 2.
[7] Ibid., 18.
[8] Jaime Serra Puche, e-mail message to author, March 13, 2012.
[9] Karl Meilke et. al.,"Is 'NAFTA Plus' an Option in the North American Agrifood Sector?" *The World Economy* 31, no. 7 (July 2008): 934.
[10] Alex Jameson Appiah, "Applied General Equilibrium Model of North American Integration with Rules of Origin" (PhD diss., Simon Fraser University,1999), 164.
[11] Alex Huelsemeyer, "Toward Deeper North American Integration: A Customs Union?" *Canadian-American Public Policy*, Occasional Paper no. 59 (October 2004), 17.
[12] Goldfarb, 16.
[13] The idea of a North American Investment Fund can be found in Pastor's *The North American Idea* (New York: Oxford Univeristy Press, 2011), 165, 171. Though he deals with a direct contribution from member states, I am just expanding on the idea by adding a revenue source.
[14] U.S. International Trade Commission. Dataweb. http://dataweb.usitc.gov/scripts/INTRO.asp (accessed February 8, 2012).
[15] Jean Monnet, *Memoirés* (Librarie Arthème Fayard, 1976), 304-305.