

# **ECONOMIC INTEGRATION: FREE TRADE AREAS VS. CUSTOMS UNIONS**

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## I. INTRODUCTION\*

The Canada-US Free Trade Agreement has anchored our trading relationship on a stronger, more open and rule-based approach. The conclusion of the North American Free Trade Agreement (NAFTA) represented an opportunity to include Mexico in the relationship, to resolve specific irritants between Canada and the US, and to ensure that Canada remained an attractive location for foreign direct investment (FDI). The formation of NAFTA, then, illustrates the motivation for forming preferential trade agreements (PTAs): to ensure market access, to attract FDI, to improve efficiency through competition and specialization, and to apply a co-operative approach to commercial policy

At the same time, NAFTA and other PTAs, like the EU, CARICOM, MERCOSUR, CETA, ASEAN and GCC, reflect the difficulty of moving trade liberalization forward at the multilateral level. Some liberalization among a few partners becomes preferable to the agonizingly slow progress at the level of the World Trade Organization (WTO). By improving growth prospects for their members, PTAs also bring the benefits of increased exports for non-member countries, and that is why the WTO sanctions their formation. The drawback is that PTAs tend to divert trade from more efficient outside sources of supply to the now favored member country producers.

The question arises whether PTAs should be seen as welcome *building blocks* toward an improvement of the multilateral trading system, or whether they constitute *stumbling blocks* for WTO-sponsored efforts towards this end. It is too early to judge which of these views will turn out to be more correct. Nevertheless, because the issue of increasing economic integration is likely to occupy significant space in policy debates in many countries, a better understanding of some key distinctions between different forms of PTAs is clearly needed.

This paper reviews the various forms of economic integration, in particular the distinctions between a Free Trade Agreement (FTA) like the North American Free Trade Agreement, and a Customs Union (CU) like the one that preceded the present European Union. Based on the economics literature we show the benefits that can be expected to derive from a PTA, highlighting the key differences in this regard between FTAs and CUs. We conclude that the economic benefits of a CU outweigh those of an FTA and discuss the implications of moving from the latter to the former.

While faster multilateral trade liberalization would be the best economic outcome, progress at the WTO-level appears stalled. We argue that establishment of a North American Customs Union

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\* Please see Appendix II for a glossary of acronyms.

(NACU) may be a desirable next (and possibly final) step in the evolution of the continent's economic integration.

## II. ECONOMIC INTEGRATION

Economic theory shows free trade on a worldwide basis as the first best outcome, in as much as it allows specialization and exchange to take place globally, thus leading to greater world output and welfare. PTAs among a subset of countries are therefore a second best solution. They create trade among their members as trade barriers fall, and they divert trade from efficient non-member producers to members because of their privileged market access. It should be noted that PTAs can take a variety of forms. These range from low-level integration by means of FTAs or CUs to higher levels of integration, such as a common market, economic (and monetary) union, or even economic and political union. A PTA also refers to two or more countries forming a union with lower tariffs (and other trade barriers) for goods and services from member countries. FTAs eliminate tariffs on goods from members entirely, and CUs are FTAs with a common external tariff.

More specifically, economic integration proceeds by agreements to:

- abolish tariffs and import quotas among members (FTAs and sectoral FTAs).
- establish common external tariffs and quotas (CUs).
- allow free movement of goods, services and workers (Common Market).
- harmonize competition, structural, fiscal, monetary and social policies (Economic Union).
- unify economic policies and establish supra-national institutions (Economic and Political Union).

Thus three progressively higher levels of integration can be distinguished. The first level entails modest integration by means of an agreement to apply symmetric preferential treatment of imports and assign supporting functions and instruments to jointly operated institutions. Examples would be NAFTA's commitment to eliminate tariffs among its members, its dispute settlement provisions, and the various working groups and committees that serve to facilitate trade and investment among the three partners. In the case of a CU, the agreement would additionally involve a common external tariff applicable to non-members, which, in turn, requires an understanding on how to apportion among the partners the tariff revenue collected.

The second level of economic integration would be the harmonization of instruments over which the parties retain control, and through which, due to different national approaches, obstacles to a common market exist. This could be the case in the area of migration of workers, competition policy, and production standards. One example of such harmonization is the European Single Act. Among other provisions this act applied the "principle of mutual recognition" to product standards. More co-operation and supranational institutions, such as a joint tribunal on competition policy, are also characteristic of this second level.

The third and highest level of economic integration adds coordination of national policies and the creation of further supranational bodies which entail not only economic but increasingly political

integration. Examples here are the creation of a common currency and central bank, and even a supranational parliament as in the case of the EU.

### FREE TRADE AREA

This is the preferred option for countries embarking on economic integration and for those unwilling or unable to engage in higher levels of integration. An FTA can be limited to particular sectors, thus retaining a high level of control at the national level and preventing exposure to competition for the other sectors. The authority to decide how third countries are to be treated remains unaffected (independent trade policy) in an FTA. However, rules of origin (ROO) have to be agreed upon among members so as to determine which products can be transferred duty-free. In the case of NAFTA a product has to have been substantially transformed so that a change in tariff classification has occurred, or it must have 50% (62.5% for cars) member-country content<sup>1</sup> to qualify for duty-free treatment. There are extensive and complex provisions on how such content is arrived at and what documentation is necessary at the border. If there were no such ROO third country, products could be landed in the lower duty jurisdiction and then transferred duty-free to the higher tariff member thereby circumvent its tariff. As a result, in an FTA border controls are necessary for commerce among members, and arguments over interpretation of ROO can lead to delays and disputes. These restrictive effects of ROO have led one eminent economist to observe: “It is reported that Canadian producers have on occasion chosen to pay the relevant duties rather than incur costs of proving origin.” (Krueger, 1995)

### CUSTOMS UNION

When two or more countries agree to remove (essentially) all restrictions on mutual trade and set up a common system of tariffs and import quotas vis-à-vis non-members, the result is referred to as a CU. The adoption of a common external tariff (CET) and joint quotas necessitates closer co-operation with respect to the sharing of customs revenues collected on non-member imports. Rules of origin are no longer necessary: when a common external tariff exists, imports into the CU-area face the same tariff in each CU-member country, hence there is no incentive for trans-shipment of imports between members. The CET effectively creates “destination-neutrality” for imports into the CU.

Both FTAs and CUs imply that the member countries remain nation states, yet when viewed in the historical context there are some subtle differences between the agreements.

The German Zollverein and the European Community for Coal and Steel are examples of successful CUs. The Zollverein preceded the formation of Germany in 1870 and thus holds fewer lessons for today. The European Community for Coal and Steel, a sectoral CU created in 1951, was not expected to be a precursor to eventual European political union. Nevertheless, it was recognized at the time that free trade and the consequent rationalization and specialization of production in coal and steel products would require a supranational body to regulate pricing practices and commercial policies. This historical precedent therefore suggests that a successful CU implies a common competition policy. Subsequently the European Common Market naturally adopted and extended this competition policy.

A common competition policy would replace the need for, and the application of, trade remedy laws among the CU-members. Predatory pricing (dumping) would be dealt with by the common competition watchdog, and Article 19 of the GATT/WTO could be relied upon to obtain temporary relief from import surges that threaten an industry's survival.

That said, the key feature of a CU remains the CET. Derivative issues are a matter of negotiation and will determine how successful the CU is.

### COMMON MARKET

A common market (CM) can be considered the first stage of deep economic integration. Free mobility of the key participants in the process of production is its characteristic. In addition to goods and services, capital and people move freely inside a common market. The benefits expected consist of further gains in efficiency through a more appropriate allocation of resources: capital moves to where skills are and people move to where opportunities beckon.

In addition to the common external tariff that defines a CU and to ensure the viability of a common market, uniform regulations have to be worked out among the members regarding the movement of people and capital. This is a major task that requires, at least over time, agreement on qualifications and certifications of workers from different member countries.

For a common market to become effective, therefore, co-operation in decision-making is required in yet more areas. Non-tariff barriers have to be dismantled, structural adjustment policies have to be jointly reassessed, distribution policies will face harmonization pressures, and fiscal and monetary policies, as a dynamic consequence or by design, will show greater convergence. This convergence results from the increased economic interdependence among the members and necessitates that greater consideration be given to the effects of national policies on the welfare of CM partners.

### ECONOMIC UNION

The next step in deep economic integration, economic union, adds to the common market harmonized fiscal, monetary and labor market policies. Tax and monetary policies affect where a business locates, and because labor market policies affect migration patterns and production costs, these will have to be streamlined among members. There will be no room for different national transportation, regional or industrial policies, as these distort competition among firms from different member countries.

To achieve such a union, it is necessary to form supranational institutions that legislate the rules of commerce for the entire area, leaving the administration to national bodies, but with recourse to supranational administrative tribunals to ensure uniform application of these rules. In an economic union supranational commercial law replaces national law.

For example, the European Union's (EU) regional adjustment policy provides infrastructure funds to regions within the EU that have 75% or less of the average EU-income level, with a

budget of 0.45% of the EU's GDP. This illustrates the degree of co-operation necessitated by an economic union.

An economic union is made more effective, furthermore, by a common currency. When there is no uncertainty about exchange rates among members, location decisions and trade patterns will follow efficiency considerations, and borrowing costs will not be affected by an exchange risk premium on a particular member country's currency.

At this level of integration pressures for uniform taxation policies will increase even if agreement on such may prove elusive as shown in the case of Europe. The final outcome of economic union may well be a political confederation with unified economic policies. Economic union will stop short of political union if no supra-national bodies regarding defense and foreign policy are created.

### SHADES OF GRAY

In practice we observe FTAs and CUs with varying degrees of supranational co-operation or sovereignty abdication. A case in point is the issue of contingent protection, specifically the imposition of anti-dumping or countervailing duties and safeguard provisions in case of an import surge.

Obviously, the mere existence of such provisions represents a barrier to trade, but producer lobbies tend to be strongly opposed to withdrawing such protection when an FTA is formed. This is the likely reason for most FTAs to be characterized by the continued application of trade remedy provisions among partners.

This need not be so. Partners in an FTA and a CU could agree to exempt each others' firms from the application of contingent protection. The Canada-Chile FTA is an example of such co-operation, showing that the distinction between FTAs and CUs cannot be drawn neatly when it comes to competition policy. It is conceivable for both NAFTA and a North-American CU (NACU) to agree to subject member-country firms to each others' antitrust bodies. That would mean Canadian exporters would be scrutinized for anti-competitive practices like dumping by the FTC rather than the Department of Commerce (ITA) and the International Trade Commission (ITC).<sup>2</sup>

### **III. CUSTOMS UNION VS. FTA**

Each of these two forms of economic integration has a distinguishing characteristic that has significant implications. For an FTA, with each country having its own external tariff, the ROO is the distinctive feature. For a CU the distinctive characteristic is the common external tariff (CET) applicable to third countries.

### ECONOMIC EFFECTS OF RULES OF ORIGIN (ROO)

As already discussed, ROO have the purpose of preventing trade deflection, i.e. goods or services entering the member country with the lowest tariff for the purpose of trans-shipment.

A number of negative effects are ascribed to ROO in the literature on economic integration.

1. ROO create incentives for producers to purchase higher cost inputs from member countries to satisfy the origin requirements, thus adding to trade diversion.
2. ROO lend themselves to lobbying by interest groups seeking protection from foreign competitors by demanding stringent ROO that favor component suppliers from member countries over competing firms from third countries.
3. With different input prices in different member countries due to different tariff schedules, producers face different input costs, thus distorting production.
4. ROO tend to be complex. Thus their application results in additional costs and bureaucratic surveillance.

Different criteria, like “substantial transformation,” “change in tariff heading” (CTH), “value-added” or “specified process,” are possible, each bringing its own set of complexities.

The criterion of substantial transformation of a product is rooted in common law and is decided by the courts in the case of a challenge. The CTH criterion is on the surface more objective, “...but in fact requires specification of what level of tariff headings to be updated with changes in technology” (Krueger, 1997, p.15) The value-added criterion poses difficulties as it requires agreement on accounting methods and audits. Finally, process-criteria must be specified for each individual product. As a result, interpretation is subjective and substantial room exists for discretion in implementation. The NAFTA contains 200 pages of fine print regarding the ROO!

Krueger (1997) relates that even where the intent of ROO is not protectionist, they have a significant cost for producers and administrators. In Europe, EFTA producers reported costs of three to five percent of the delivered cost of goods solely for providing ROO documentation, though this estimate dates back to the mid-eighties when tariffs were higher.

#### ECONOMIC EFFECTS OF THE COMMON EXTERNAL TARIFF (CET)

The effects of the negotiated CET can be summarized as follows:

1. As the negotiations are carried out at the government to government level this reduces incentives for individual lobbies. Once established, a CET remains non-negotiable. On the other hand, internal pressures, like in the well-known prisoners’ dilemma, could result in a higher CET.
2. In light of the inability to influence the (re)negotiation of the CET, efforts to increase non-tariff barriers may be observed. Common commercial and trade policies would limit such efforts.

3. There is administrative simplicity in a CET that makes it easy to implement, and it creates predictability.
4. Input costs will not differ among members solely as a result of tariffs, promoting efficiency and competition.

Based on these differences, Krueger (1995) has shown that an FTA does not lead to more net trade creation than a CU for the same partners, provided the CU takes into account the levels of higher and lower tariff countries and settles on an average CET for each commodity.

An FTA also will not be more welfare-enhancing than a CU for the same members, if the CET is set below the level of the high cost country. In that case, trade is created when the high cost country cuts production in the wake of tariff cuts, whereas an FTA would retain the tariff and create less trade.

Together with the trade-diversion (protectionist) effect of ROO this implies more trade creation and less trade diversion for a CU, hence the conclusion that the potential welfare effects of a CU outweigh those of an FTA.<sup>3</sup>

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

As well, a large enough CU will have an influence on 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 to the CU. This effect is much less clear for an FTA of similar composition. Therefore, on balance, the economic benefits of a CU outweigh those of an FTA.

### POLITICAL IMPLICATIONS

FTAs are a limited form of integration and by design little sovereignty is compromised, both in economic and political terms. The institutional agreements for an FTA are not extensive: a secretariat as a monitoring device and a forum for ongoing dialogue among members are all that are necessary.

The existence of ROO mitigate against expansion of an FTA inasmuch as new members need to negotiate new ROO. Each new application for entry provides an opportunity for lobbyists to renegotiate existing ROO, slowing down the process of enlargement in comparison with the given CET of a CU.

In addition, if a country has membership in two or more FTAs (e.g. NAFTA and the emerging FTA of APEC), different ROO for different FTAs create administrative complexity and customs disputes. It is difficult to envision the emergence of a single market in the face of such complicated access conditions. By contrast, a CU represents tariff-unification by definition. While FTAs mean a continuing administrative presence at internal borders for the purpose of documentation monitoring, CUs foster the borderless movement of goods among members.

As a result the political economy of FTAs is less conducive to further trade liberalization than that of CUs, and the ROO of the former create opacity, complexity and lobbying room for protection. A CU, in turn, requires co-operation in arriving at a CET and agreement on a sharing rule for the customs revenue that is actually raised. For future trade negotiations a CU necessitates a harmonized trade policy, and that means an additional loss of sovereignty. The question then arises as to how much more sovereignty will have to be ceded to arrive at a CU compared to an FTA?

The initial negotiations for either an FTA or a CU are not that different in substance: agreement has to be reached on the schedule of implementing free trade among the partners. Adding on the negotiation to unify tariffs towards outsiders is the extra complication for a CU. The number of partners and the differences of national tariff codes will determine the complexity of these discussions. At present WTO obligations dictate that existing schedules are not raised to facilitate a compromise with respect to the CET. For this reason the deliberations for a CU will be more complex. Just as revenue sharing agreements exist within countries, we observe formula-based voting and international reserve allocation at the supranational level, e.g. at the IMF. It is therefore not inconceivable that an allocation of tariff revenue can be found that mimics international practice elsewhere.<sup>4</sup> Whether or not such an agreement represents a significant loss of sovereignty is a matter for debate.

As mentioned above, one consequence of a CU is that future trade liberalization at the WTO-level will force member countries to coordinate their negotiating position closely with each other: a common stance is necessary for a CU, and this need for a coordinated approach represents an additional loss of sovereignty compared to an FTA.

The foregoing explains why it is politically easier to arrive at an FTA than a CU. Trade creation, an economic gain, is viewed as a loss by domestic industry and by other lobbying groups. Hence they oppose it. Trade diversion is at the expense of external producers, hence does not elicit a negative response. And since free movement of workers is an extremely sensitive issue anywhere, higher degree integration tends to prompt stronger political resistance.

Political feasibility favors an FTA over a CU. The fact that FTAs have a higher potential for trade diversion and no greater potential for trade creation than CUs implies that FTAs are less likely to encounter political resistance. A CET is difficult to arrive at: it took the EU thirty years to overcome national quotas on clothing, footwear and steel imports. Substantial political will and preparation have to be nurtured for a CU formation. This is made more important by the fact that the economic gains from any PTA tend to be longer run, whereas the adjustment costs tend to occur right away. Not surprisingly, we rarely observe successful economic integration at a

higher level than the FTA. By May 1998, 162 PTAs had been notified to the WTO. Of these only 19 were CUs (World Bank, 2000).

### OTHER IMPLICATIONS

#### a) Environmental and Labor Standards

There appear to be no differences between FTAs and CUs regarding environmental and labor standards. Both FTAs and CUs can have subcommittees that work towards mutually acceptable standards. NAFTA explicitly recognizes that certain of its provisions are overruled by obligations members may have from international agreements such as the Convention on International Trade in Endangered Species (1973), the Montreal Protocol (1987, 1990) on Ozone Layer Depletion, and the Basel Convention (1989) on transborder movement of hazardous wastes. A CU could have similar clauses.

Neither an FTA nor a CU would force harmonization of national environmental standards towards a “more lax” common level. In either form of PTA, arguments arising from standards issues can be handled by the joint dispute settlements mechanism. Environmental and labor standards are therefore a matter of negotiations for a CU just as for an FTA. For example, NAFTA led to a side agreement on work place conditions and safety because of concerns about enforcement of existing rules in Mexico. This is also conceivable for a CU of members at different stages of economic development. As nations tend to resist giving up sovereignty in these areas, commissions with supranational power have not emerged in NAFTA. In this respect a CU would not be different.

#### b) Other PTA-Commitments

An interesting complexity arises when a country is a party to several FTAs, which is the case for Canada (NAFTA, FTA with Chile), Mexico (NAFTA, FTA with the EU), and the US (NAFTA, FTA with Israel). Can a CU be formed out of NAFTA under such circumstances?

The existence of overlapping FTAs has indeed led to what Bhagwati (1995) calls a “spaghetti bowl” of tariff rates, with countries levying different rates of duty on a product depending solely on its origin. Even abstracting from the varying tariff levels during the transition to free trade, a world with several overlapping FTAs has become a reality, moving us away from the ideal of the (one) MFN-tariff. This development creates a significant practical obstacle to moving from an FTA to a CU: it makes it necessary to agree to a new set of ROO while doing away with an old set.

Concretely, in the case of NAFTA the establishment of a CU for North America would require:

- i) negotiation of a CET for the NAFTA-members which applies to all non-members except imports from the EU into Mexico.
- ii) dissolution of existing NAFTA-ROO.

- iii) acceptance by the US and Canada of the ROO applicable to trade between the European Union and Mexico; similarly for the ROO between Canada and Chile, and between the US and Israel.

#### IV. FROM NAFTA TO NACU?

It therefore emerges that a CU brings more economic benefits and political costs than an FTA for the same partner grouping. The economic benefits are:

- more positive scale and competition effects.
- increased market and negotiation power vis à vis outsiders.
- diminished role for lobbyists (protection seekers).
- simplified transborder trade among members.
- simplified accession for new members due to the CET.

The political costs are:

- more complex negotiations (CET, tariff revenue allocation).
- deeper integration, hence more harmonization pressure (e.g. need for a common external trade policy stance).

If a CU brings more economic benefits than an FTA for the same partner-grouping, what are the steps that can or must be taken to move from a FTA to a CU? Are these steps worth their political costs? No steps would obviously be necessary if multilateral liberalization occurred at a reasonable and predictable pace. In that event, an FTA would gradually become a CU with zero tariffs as the CET. Our first choice therefore would be rapid progress at the multilateral trade liberalization. As the next round of WTO-sponsored negotiations does not look promising at present, it is worth considering the CU option.

Given the current North-American context, a CU would not be intended as a stepping stone to a higher order integration, such as a common market or economic and or political union. In our view there is no consensus for that much integration. Rather, a more modest objective would be to further reduce trade barriers, while maintaining independent commercial, taxation, foreign and monetary policies. In order to achieve a CU along these lines, an agreement would be required to phase out ROO while phasing in a Common External Tariff and attendant uniform customs administration.

As for expanding NAFTA or NACU, this could occur under one of two principles, open regionalism or unanimous regionalism. In the former, membership would be open to all applicants willing to abide by the rules of the group, while in the latter new entrants would require the unanimous consent of existing members. Current discussions of a Free Trade Area of the Americas (FTAA) and the expansion of the European Union are grappling with these principles. The CET of a CU would make accession easier inasmuch as negotiations over ROO would be unnecessary.

A CU as a step up from an FTA would involve special working groups in each member state to implement the CET. Common administrative authorities would be necessary to monitor the compliance to timelines and schedules agreed upon by the members. Additionally, procedures for exceptions from agreed rules, for other special authorities, and for financing would be essential.

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. There is also the complication of Mexico's FTA with the EU which requires acceptance by Canada and the US of the ROO in that agreement. To date, little is known about these ROO.

These steps would require considerable political will but should face less opposition than the original FTA for the simple reason that most of the adjustment costs have already been incurred when the FTA was formed. Similarly, the previous FTA will have already brought harmonization pressures regarding sectoral, regional and labor market policies. The experience with the FTA dispute settlement and other joint institutions should prove beneficial.

As regards fair trade rules (AD, CVD) and competition policy, a move from an FTA to a CU would not bring new challenges. With experience accumulating, moving to a CU may or may not lead to a common market or monetary union, depending on the post CU integration dynamics. Our reading of the current North-American situation is that integration beyond a basic CU is politically not feasible.

## **CONCLUSION**

To sum up, a CU means deeper economic and political integration. On economic grounds deeper is better, as simplified and more harmonized border procedures facilitate trade, common product standards enable longer production runs, and a common competition policy serves to unify the 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 US auto-emission standards, thus avoiding separate production lines for cars to be exported. In light of the significant dependence on the US market, Canada's self interest suggests that closer economic integration be explored to safeguard and enhance market access.

Still, the relatively modest step from an FTA to a CU is more readily urged than undertaken: it requires substantial political leadership. In comparison, however, to the political courage that was necessary to implement the EU-CU, MERCOSUR, or the EU-Turkey-CU, the commitment required for NACU does not appear that great. Of course, these CUs resulted from a strong common purpose, based on geopolitical events (wars, rivalry, threat of isolation), as well as common economic interests. Yet even these CUs emerged on the basis of an evolutionary process that started with much less ambitious sectoral agreements such as the European Community for Coal and Steel.

Seen in this light, a North American evolution from Auto-Pact FTA/NAFTA to NACU seems plausible. However, trade negotiations can take governments away from other pressing problems, and trade professionals are in short supply. Should the multilateral negotiations become stalled, it appears realistic and worthwhile to pursue NACU. What is needed now is a thorough analysis of the economic impact that ROO entail and the political decisions necessary to move to a common external tariff for NACU, as well as the scrutiny of Mexico's ROO vis à vis the EU.

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## APPENDIX I

### A Primer on ROO

In “NAFTA Rules of Origin and Automotive Content Requirements,” Peter Morici explains the essential role of ROO for an arrangement that extends preferential tariff treatment. This primer pulls together a few of the key points that have relevance in the current context.

1. If the PTA is a CU, no ROO are necessary for intra-CU trade.  
  
A CU has a common external tariff, which means that imports into the CU are ‘destination-neutral’.
2. When the PTA is an FTA in which members maintain different national tariff schedules ROO serve the purpose of preventing:
  - a) trans-shipment of imports from low to high tariff members to circumvent higher duties and
  - b) light processing or assembly (screw-driver plants) by foreign suppliers in the low tariff jurisdiction for sale in the high tariff jurisdiction. ROO ensure that only “genuine” products of countries entitled to preferential treatment receive this benefit.
3. As multilateral trade liberalization progresses the world gradually approaches a CU with a common external tariff of zero - at which point ROO become superfluous.
4. For industrialized countries in the WTO there is no ROO-issue as they grant and receive the MFN-tariff.
5. An FTA on one hand needs ROO in order to ascertain “qualifying” imports. On the other hand, member countries can use ROO as an industrial subsidy by making their details strict and administration onerous.
6. An example of why NAFTA needs ROO is the fact that Canada through its (now discontinued) duty-remission program lowered to zero the tariff on imported engines for Japanese producers building plants in Canada. The duty-remission program therefore encouraged automotive FDI but it also enabled Japanese producers to export cars to the US duty-free, circumventing the US tariff on imported engines.
7. An example of how NAFTA is using the ROO as a subsidy to thread-, fiber- and clothing producers is the so-called “thread-forward” rule for textile and apparel imports. Beyond a certain quota of duty-free imports (that do not 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 transparent. Basically consumers end up subsidizing the industries involved. This effect is also quite pronounced in the processed food industry where ROO prevent the transformation of imported fresh fruit and vegetables into frozen or canned products as a subsidy to domestic farmers.

Similarly, imported sugar, milk or peanuts used in processed foods are denied duty free status by ROO in order to protect North American producers of these commodities.

8. Strict ROO may even have perverse effects. Morici (1993) presents the following situation: the 50 percent net-cost rule of NAFTA could induce Mexican producers of, for example, baby carriages to purchase mostly Asian parts and absorb the (then) 4.4 and 12.5 percent US and Canadian duties because the additional cost of using US or Canadian parts exceeds the cost of the tariff.

As tariffs are coming down in the wake of the WTO's Uruguay Round, this perverse outcome becomes even more likely: lower US and Canadian tariffs provide more incentive for importing Asian components.

## APPENDIX II

### Glossary

AD	Anti-Dumping
AFTA	ASEAN Free Trade Area
ASEAN	Association of South East Asian Nations
CARICOM	Caribbean Common Market (Customs Union of English Speaking Caribbean States)
CEFTA	Central European Free Trade Area
CET	Common External Tariff
CGE	Common General Equilibrium
CM	Common Market
CU	Customs Union
CVD	Countervailing Duty (imposed to offset subsidies to exports)
EFTA	European Free Trade Association (Norway, Iceland, Switzerland)
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATT	General Agreement on Tariffs and Trade (precursor to WTO)
GCC	Gulf Co-operation Council
ITA	International Trade Administration (unit of the US Department of Commerce)
ITC	International Trade Commission (bi-partisan Committee of the US Congress)
MERCOSOR	South American Common Market (southern cone countries)
MFN	Most Favored Nation (WTO-principle)
NACU	North American Customs Union (hypothetical)
NAFTA	North American Free Trade Agreement
PTA	Preferential Trade Arrangement/Agreement
ROO	Rules of Origin
RVC	Regional Value Content
WTO	World Trade Organization

## ENDNOTES

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<sup>1</sup> This content is based on the ‘net-cost’ test. This method is mandatory for automotive products. Usually exporters can choose between ‘net-cost’ and ‘transaction value’ test. For the latter 60% is the threshold level. It refers to the f.o.b. price less the value of non-originating components.

<sup>2</sup> In our view this would be highly desirable. According to Messerlin (1997) and Schöne (1996) more than 90% of AD-cases would not have led to antitrust proceedings on competition grounds, let alone for predation. Whether such a change is achievable is another matter, of course.

<sup>3</sup> This argument assumes that FTA and CUs are welfare-enhancing, for the group and each participating country. Economic theory allows for welfare-reducing CUs and FTA, for the group and individual countries.

<sup>4</sup> In the EU tariff revenue is allocated to the central budget. Value-added tax collections on imports are allocated according to where the goods in question are destined.