



**AgEcon** SEARCH  
RESEARCH IN AGRICULTURAL & APPLIED ECONOMICS

*The World's Largest Open Access Agricultural & Applied Economics Digital Library*

**This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.**

**Help ensure our sustainability.**

Give to AgEcon Search

AgEcon Search

<http://ageconsearch.umn.edu>

[aesearch@umn.edu](mailto:aesearch@umn.edu)

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

GIANNINI FOUNDATION OF  
AGRICULTURAL ECONOMICS  
LIBRARY

AUG 25 1981

A NORTH AMERICAN COMMON MARKET:  
Lessons from Previous Experiences with Common Markets\*

By

Vernon L. Sorenson\*\*

Economic integration among nations has become a major thrust of international commercial policy during the post World War II period. The most significant of these developments occurred in Europe through the formation of the European Economic Community, the European Free Trade Association, and the Council of Mutual Economic Assistance in Eastern Europe. Numerous efforts also have been made in less developed countries. In Latin America this has given rise to the Central American Common Market, the Latin American Free Trade Association, and the Andian group. A number of initiatives have also been taken in Africa, led by the East African Common Market, consisting of Kenya, Uganda, and Tanzania. In West Africa efforts have included the West African Customs Union, the Economic Community of West Africa. Several other efforts have been made in central and equatorial Africa. Only Asia of the major regions of the world seems to have spurned efforts to achieve formal economic integration among nations, though some cooperation is achieved through the ASEAN group. These efforts have taken various forms ranging from a complete customs union, as in the case of the European community, to free trade associations, to more loosely defined economic cooperation sometimes limited to provision of basic

---

\*Comments at a seminar on "Agricultural Trade Implications of EC Enlargement," Roseville, Minnesota, June 30 - July 2, 1980.

\*\*Professor in Agricultural Economics, Michigan State University.

services such as transportation and communications. They have met with varying degrees of apparent success, though none seem to have functioned without a considerable degree of economic and political conflict.

I will make no attempt to empirically evaluate any of these efforts nor seek to draw from them conclusions or lessons related to the feasibility of establishing a North American Common Market. Rather, what I propose to do is look briefly at some of the conceptual propositions that have evolved from the theory of customs unions with a view toward generating questions concerning the potential gains that could be achieved from North American integration and second, to comment briefly on a few economic and political conditions that will influence the possibilities of achieving workable integration of Canada, the United States and Mexico.

#### Customs Union Theory

Economic integration implies that barriers among the participant countries will be reduced to permit an increased flow of goods, and in some cases resources among the member countries, and that the rest of the world will be discriminated against. The incentive for integration is the anticipated economic benefits that will flow from the arrangement. In principle these benefits can be derived from a number of sources, including: "1) the specialization of production according to comparative advantage; 2) economies of scale; 3) changes in the terms of trade; 4) forced changes in efficiency due to increased competition; and 5) a change in the rate of economic growth."<sup>1</sup> These sources of gains suggest evaluating two kinds of impacts from integration. One is whether formation of a customs union on balance is trade creating or trade

---

<sup>1</sup>R.G. Lipsey, "The Theory of Customs Unions: A General Survey," in R.E. Caves and H.G. Johnson, eds., A.E.A. Readings in International Economics, Richard D. Irwin, Inc., 1968, pp. 261-278.

diverting. Trade creation refers to the increase in trade that will occur among the members of the union and trade diversion is that which is a reduction of trade with the rest of the world. The static theory of the customs union concludes that if trade creation exceeds trade diversion then a net gain has been achieved through the formation of the union.

A second focus suggested by the above criteria is that a custom union needs to be evaluated in terms of its dynamic effects in stimulating economic growth, creating a benefit through improved competition and efficiency, permitting the exploitation of economies of scale, and in general stimulating desirable structural and economic change that might not otherwise have occurred.

To provide a basis for assessing the trade creating and trade diverting effects of a North American Common Market let me briefly recite some essential points of customs union theory. The theory leads to the following possibilities that can arise from a customs union between two countries.<sup>2</sup>

1. Neither country A nor country B may be producing a given commodity. In this case, they will both be importing this commodity from a third country and removal of tariffs on trade can cause no change in the pattern of trade.

2. One of the countries may be producing the commodity inefficiently under tariff protection, while the second country is a nonproducer. If country A is producing commodity X under tariff protection this means that her tariff is sufficient to eliminate competition from the cheapest possible source. In this case, the combined market of the union is secured for A's inefficient industry and welfare reducing trade diversion occurs.

3. Both countries may be producing the commodity inefficiently under tariff protection. In this case, the customs union removes tariffs between

---

<sup>2</sup>Ibid.

countries A and B and insures that the most efficient of the two will capture the union market. In this case, trade creation occurs.

Thus, it is necessary to predict the relative strengths of trade creating and trade diverting forces in order to predict the welfare effects. As pointed out by Lipsey, this leads to the conclusion that, if the commodities produced by each country overlap to a large extent, then the most efficient of the two countries will capture the union market and there will be a reallocation of resources in a more efficient direction. On the other hand, if the commodities do not overlap and tariff protection exists there likely will be a reallocation of resources in a less efficient direction.

Further, if substantial overlap exists the gains will be larger the more dissimilar the cost ratios in the two countries. The basic thrust of this analysis is complicated when the possibilities of substitution, both in resource use for production and in consumption, are considered. Nonetheless, the essence of the idea remains that a reduction in trade barriers among member countries of the union that stimulates readjustment of production within the union in line with comparative advantage will result in welfare gains and in improvement in conditions within the union. Change that perpetuates inefficient production but expands its market to cover the total of the union rather than just the domestic economy leads to loss.

A number of additional propositions can be appended to this analysis that will further clarify the potential for gains from the formation of a union. One of these is that the more elastic are the demand functions for the product of the other partners relative to demand functions for products from third country sources, the higher will be the gain derived from trade creation and the smaller the losses from trade diversion. This simply says that if the price elasticity of demand is higher, the increase in quantities traded will

be larger in response to a given reduction in trade barriers among members of the union. The decrease in purchases from third countries will at the same time be smaller if we are dealing with more inelastic demand.

Viewed in the context of differences between developing countries and industrial countries it is roughly appropriate to say that industrial countries offer better prospects for increasing internal trade, where a larger proportion of interregional trade consists of manufactured products. Developing countries, on the other hand, if they seek largely to expand exports of agricultural products and raw materials, will tend to gain less from economic integration.

A second proposition is that the greater the initial height of tariffs on trade among the countries forming the union, the greater will be the potential economic efficiency and welfare gains to be accomplished by their elimination. This simply means that with any given set of demand and supply relationships, the larger the reduction in tariffs that occur, the more impact it will have in terms of redirecting resource use and increasing trade among partners of the union. The importance of this factor has been reduced among industrial countries through several recent rounds of trade negotiations, but these negotiations in general have touched less developed countries very little. In comparing Canada, Mexico, and the United States, Mexico's import regime remains highly protectionist relative to those in Canada and the United States, hence this factor would suggest a greater impact in Mexico and between Mexico and the other two countries than between Canada and the United States.

A third proposition is that the lower the economic distance between the member countries of the union, the larger will be the scope for adjustments to comparative advantage resulting from integration. Economic distance consists not only of geographical distance and transport costs but also includes differences in business techniques and methods, cultural habits, and other

factors that tend to inhibit economic intercourse. The shorter this economic distance between countries the higher the possibility of taking advantage of favorable production effects that potentially can take place due to integration. The European community, for example, seems to have offered better prospects for gains at the moment of creation than the Latin American Free Trade Association. Within the North American area relationships between Canada and the United States are less distant and hence should provide a better basis for gain than between Mexico and either the United States or Canada.

Viewed in a more dynamic context, issues of the extent to which formation of a customs union will stimulate increased competitiveness and, hence, improved economic efficiency and the extent to which economies of scale can be exploited are crucial questions.

In the case of economies of size, two points should be noted: 1) economic area must at least be of sufficient size to permit exploitation of economies of scale and 2) that the smaller the countries involved in the customs union the higher the potential gain to be derived from enlargement of the market. It is on this ground that the hopes of the Latin American integration has been placed. Latin American countries had pursued policies of import substitution that led to the existence of compartmentalized industries.

When integration takes place in these circumstances the market becomes wider and the scope for splitting functions and generating scale economies is larger. Therefore, the increase in the size of market is likely to create growth points which will have multiplicative effects with respect to the introduction of advanced technology in the supplier and buyer industries. An increase in the size of the market and the consequent regional specialization can make possible the establishment of larger plants and also horizontal and vertical specialization that permits greater efficiency and reduces the degree of overlap.

Further, it can create certain external economies that will reduce costs in the total production-distribution system that, in turn, can lead to increased specialization and trade creation.

While the question of market size is crucial to gains from association in less developed countries, it is of less consequence in larger economies such as those in Western Europe and North America. An assessment by Harry Johnson, for example, concluded that there would not be noticeable improvement for Great Britain derived from a larger market as a result of its entry into the European Community. In the case of North America, the market size issue probably would be of greatest relevance to Mexico. Certainly there would be little basis for gain to U.S.-based industries with gain to Canadian industry somewhere between Mexico and the U.S.

#### The Economic Setting in North America and Problems of Integration

The basic question to be answered is whether conditions exist in the North American continent for gains to be achieved from integration. Gains can be viewed in a worldwide context and this is the focus that most theoreticians have used. This is of little relevance to the question of whether nations enter into integration. The more relevant question is whether gains can be achieved by the member nations even if this is at the expense of outsiders.

Gains can be assessed only within the framework of the economic and political relations among the countries involved. In North America this can be viewed in the context of relations between the United States and Canada and relations between the United States and Mexico. Of considerably lesser importance are relationships between Canada and Mexico. For Canada and the United States trade relationships center around exports by Canada to the United States of raw materials, oil and natural gas, some industrial commodities, and a limited range of agricultural products with a concentration in livestock products. U.S. exports to Canada include industrial commodities and a number



of agricultural products, particularly fruits and vegetables. A considerable amount of trade exists simply because of the long, unrestricted border between the two countries.

The United States exports a wide range of industrial products and increasingly basic agricultural food items such as grains and oilseeds to Mexico. Exports from Mexico to the United States consist of lighter industrial products, parts and components to complement U.S. industry, coffee, a variety of horticultural products and increasingly petroleum.

As indicated above, the essence of exploiting gains, either static or dynamic, is the effect that economic integration will have on promoting specialization and improvement in efficiency of production that in turn add up to longer term restructuring of the participants' economies. The conceptual conditions as discussed above lead me to the following overall hypotheses.

Economic integration between Canada and the United States would lead to meaningful but not spectacular changes in production patterns and trade. While some conditions such as limited economic distance and the configuration of the two economies provide the basis for gains from integration, it is likely that differences in cost levels are limited and would inhibit change. If in overlapping industries cost levels are the same there would, of course, be no change. Secondary change related to economies of scale and reorganization could occur in some industries, particularly if U.S. capital began moving to Canada at an increasing rate. This, in turn, would depend on its form. Some one way changes could occur such as Canada becoming increasingly inundated by McDonald hamburger outlets, but these would not lead to meaningful specialization in production.

In agriculture some restructuring of trade would occur. Current subsidized shipments of grains from Western Canada to Eastern Canada for livestock feeding

is uneconomical and probably would enter north/south trade between Western United States and Western Canada. The same could occur for some livestock products. Additionally, a few items such as potato production in Eastern Canada could displace potato production in Eastern United States and U.S. tobacco production probably could displace Canadian tobacco production. Despite these changes, overall basic agricultural production patterns in both countries could be expected to remain relatively stable without too much shift in intercountry trading patterns.

Trade barriers between Canada and the United States are limited and have been brought to relatively low levels through recent rounds of trade negotiation. During the Kennedy Round and the MTN industrial tariffs were reduced to low levels and a number of harmonized reductions were made in barriers to agricultural products. Further, nontariff barriers are not a major deterrent to industrial trade between the two countries.

The potential gains in trade between the United States and Mexico would appear to be greater. Economic distance between the two countries is greater but current levels of trade restriction maintained by Mexico are much more severe. Not only are tariffs important, but also quantitative restrictions through licensing exist, and close control of many imports through state trading results in Mexico having a highly managed trading system. Major efforts were made during and following the MTN to encourage Mexico to join the GATT and begin a program of trade liberalization. An accompanying bilateral package of reductions in barriers between the United States and Mexico had been agreed to but was abrogated on Mexico's decision not to join the GATT.

In agriculture the basic trade-off is imports of coffee and horticultural products in return for food and feed grains and oilseeds from the U.S. plus some livestock and products. One would expect that U.S. capital movements into

Mexico for combination with lower cost labor would result in the rapid stimulation of further agricultural development for export and development of a range of industrial products.

In general, thus, for both Canada and Mexico the economic basis for gain appears to exist. An inherent problem, however, is the difference in economic size of the United States relative to both economies. A small change in specialization for the U.S. economy could represent massive changes in specialization for either of the other two economies. This means that while the potential gains can be greater to Canada and Mexico, it also means that the potential disruption and costs of integration can also be much greater. The problems of dealing with questions related to the distribution of gains and costs within each country from adjustments to comparative advantage could be proportionately much greater than in the United States.

A second distributional question also exists, namely the distribution of gains and losses among the countries of the union. Although integration may provide potential benefits to the region as a whole, the gains and losses may be unevenly distributed. Conceivably, one or more countries can become net losers. This issue was of crucial concern in creation of the East African Common Market where Kenya had an advantage in stimulating growth points due to pre-existing industry and infrastructure. Though efforts were made, the issue was never fully resolved through special measures and seriously inhibited achievement of a full customs union. Traditional theory of the customs union has little to say about distribution of benefits among countries. This issue probably would become central in North American integration. Each country would be primarily concerned with its own welfare and have varying perceptions of the final outcome.

### Political Factors

While economic conditions may indicate a favorable atmosphere, this probably cannot be said about political conditions. Both Mexico and Canada clearly are concerned about generating closer economic ties to the United States. Aside from this general position, significant institutional changes would be required in order to achieve economic integration. Canadian agricultural policy depends heavily on a system of marketing boards that implement domestic price support policy and programs of production. In some cases, the boards handle all exports. Imports of some products under federal marketing board control face quantitative limitations. This contrasts sharply with the price support mechanism and the general reliance on a private trading system in the U.S. The two probably could not exist together in an integrated economic system.

On the other hand, the general structure of the economy and the political control system existing in Canada probably are compatible with that in the United States.

This is not the case in Mexico. The Mexican economy has developed a dualism with some components of the industrial economy being relatively modern and a substantial class of middle to upper income population in urban centers. On the other hand, much of rural Mexico is very poor and based on small scale agriculture, with the exception of those export industries developed around winter vegetables. The political economy of the country is more centralized, and with the development of oil, Mexico possesses economic power in dealing externally that had not previously existed. Through use of its oil revenues the government is implementing a broadly-based program of economic development and feels that it must have control of international commerce to assure its success. Fear that a more open trading system would result in a strong negative impact, both on the Mexican industrial and agricultural economies, exists.

This fear was an important reason for Mexican refusal to join the GATT and implement a program of trade liberalization.

A further set of questions relates to the potential for harmonizing policies that will be needed to permit maximum exploitation of market integration. One of these is fiscal integration which would be required if the primary gains from market integration are to be achieved. Harmonization of methods and rates of taxation would facilitate integration because differences in taxation may affect the allocation of production and thus prevent specialization and exploitation of scale economies to an optimal degree. For similar reasons there would be a need, if not to create full monetary union, to at least achieve a degree of harmonization in monetary policies before the full benefits of market integration can be obtained. These imply a degree of political interdependence that would be hard to achieve short of some pressing threat felt simultaneously by all governments, which at present is not evident. Further, the one thing that probably can be inferred collectively from experience with economic integration elsewhere is that this extreme form of political and policy integration is difficult to achieve and has been the major stumbling block in developing increased market integration in virtually all customs unions that have been promulgated.

### Conclusion

I would arrive at the conclusion, therefore, that economic conditions are such that gains from trade liberalization, possibly even to the extent of formulation of a customs union, could be achieved on the North American continent. The stumbling blocks or impediments to achieving this integration are largely those related to political dimensions and problems of dealing with the distribution of costs and benefits that would occur both within individual countries and among countries. Since there is no compelling pressure for

formulation of a customs union it is unlikely that this degree of integration will occur. This does not mean that there is no possibility of improvement through seeking specific arrangements on a commodity or subsector basis. An effort to harmonize and liberalize North American trade barriers on cattle was negotiated during the MTN but did not come to pass when Mexico refused to join the GATT and the U.S./Mexican bilateral package was abrogated. Improvement in trading relationships potentially can be achieved in the future through bilateral agreements between pairs of the three countries. Since these in general would be on an MFN basis, all countries would be affected. The possibility of achieving full economic integration, however, is remote.