What will it take to build a North American Community?

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Introduction

Why is it important to assess North America's integration potential? Regional integration is one method countries use to solve commonly held problems, such as migration, security, and development. Migration, security, and development can be viewed as inter-related problems because they have in common the quest for a stable environment where individuals' and states' objectives can be realized. Individuals will choose to exit when they perceive the lack of economic opportunities and/or physical security in their home countries and believe that there are ample quantities of these two items in a neighboring country (Chang 1998). States seek to control immigration in order to maximize security and development in their countries (Rudolph 2003). Political development also helps in the area of security by reducing the likelihood of civil conflict (Collier and Hoeffler 2002) and external threats (Kugler et al. 1997). Economic development reduces the likelihood that individuals will seek the exit strategy. It also increases the likelihood that states will experience domestic stability and favorable relations with neighboring states. Economic development, therefore, becomes the linchpin in solving the associated problems of migration and security.

The solution to the migration-security-development issue can therefore be conceptualized as a collective good because benefits are spread to all those involved, although not necessarily equally. However, collective goods are achieved through collective action, which is often difficult to carry out (Olson 1965). What are the main problems for achieving collective action and what form would this action take? Although there are many views associated with the collective action problem (Olson 1965; see also Ostrom 1990), I will focus on transaction costs with attention on how homogenous institutions lower such costs. Transaction costs are costs borne by firms when they operate in a foreign political and economic environment. Differences between the home and foreign environment increase costs due to the need for firms to adjust. Also, with increased transaction costs comes uncertainty of success since they will be departing from what is known to what is unknown. These extra costs can discourage firms from requesting that politicians deepen integration, thereby leading

to little or no action. In assessing North America's current and future state of integration, it is important to examine the compatibility of the three partners in light of transaction costs.

Collective action can take the form of regional integration. Regional integration is the establishment of collective decision making among states for the intention of establishing and regulating market flows (Haas 1958; Lindberg 1970). Market flows are the entries and exits of the factors of production (except land), as well as goods and services. The degree of integration refers to the degree of collective decision making. At one end is an intergovernmental arrangement in which states make common decisions but are autonomous in regulating those decisions. If a regional authority does exist, it serves at the pleasure of the individual states. On the opposite end is the supranational arrangement, in which regional institutions do exist and make decisions alongside intergovernmental arrangements or supersede member-states' authority.

Conditions of Regional Integration

The literature provides several important variables for explaining the levels of integration. The power theories indicate that the asymmetric distribution of power is a more favorable condition for integration than a grouping of similarly powerful actors (Krasner 1976; Mattli 1999; Gilpin 1987 & 2001; Efird and Genna 2002; Genna and Hiroi 2004, 2005 & 2007). This is due to the ability of the preponderant power to coordinate efforts and distribute incentives to other members. In other words, the region must include a capable leader.

Next is the compatibility of actors. Having a powerful regional neighbor alone cannot help the development of integration if there is wide preference disagreement (Efird and Genna 2002). Although the powerful country could force preferences on others in the region, the outcome would resemble an empire rather than a voluntary association of countries. In order to form a cohesive unit, political and economic environments must be similar in order to reduce transaction costs (Feng and Genna 2003). Without compatibility, firms will assume a cost of having to adjust to foreign environments. Therefore, firms would prefer that regional integration develop between compatible actors so that the costs are low. The inclusion of firms in this explanation follows theories involving interactions between domestic groups and the interests represented in government policies (Genna and Hiroi 2004).

Institutional homogeneity can deepen integration for two reasons. One is the perceived reduction of the costs due to the effects that identity politics has on cooperation. Prior research has demonstrated that states that have a similar political identity also have similar policy preferences (Souva 2004). Institutions can be defined as the set of rules and procedures that are deemed appropriate by the political leaders (March and Olsen 1984). Given this definition, individuals are assumed to make decisions based on institutional values (Peters 1999). Similar institutions breed ideological similarities since they share a "co-evolutionary process" (Denzau and North 1994). Norms and institutions reinforce one another, and therefore a country's institutions are viewed as the expected expression of their norms (Maoz and Russett 1993). Similar institutions, therefore, will correlate with similar preferences.

The identity factor also provides a decision-making short cut that would facilitate cooperation because it greatly simplifies a rather complex set of cognitive processes. Research into the dynamics of in-group and out-group behavior has shown that cooperation is easier among those that share an identity than those that do not (Tajfel 1978). Simply being viewed as "one of us" will elicit the type of cooperation that would also include resource allocations (Tajfel 1978). This not only holds for individuals, but states as well. For example, Werner and Lemke (1997) demonstrate that alliances are more likely among similar states. With a similar identity, actors believe that cooperation is easier due to lower transaction costs.

A material mechanism is another reason for why similar institutions can improve the deepening of integration. Entrepreneurs are faced with two realities; parts of their business enterprises are controllable and others are not. The controllable parts are those within their firms and operations. They include personnel, marketing, physical operations, etc. Those that they cannot control are found outside the firm. These factors are the political, economic, and social factors of a country. For example, a firm cannot control the economic climate at any given time. Also, they cannot control the institutional arrangement of a foreign country. There have been examples of large firms influencing regulations especially in small countries, but firms in general can at best lobby for their preferences at the margin. They are not believed to have the ability to produce revolutionary institutional change in a given country. Given this, firms are less likely to demand regional integration with neighbors that do not share similar

institutions because needing to adapt to new environments introduces greater costs and uncertainty.

In sum, power preponderance and compatibility are the main conditions associated with the deepening of regional integration. A regional leader is needed for guiding the processes using available capabilities. Compatibility promotes the idea that states are similar enough in either perceived or material terms not to add additional transaction costs.

Hypothesis Testing

I test the hypotheses using a panel time series linear regression technique that assumes correlated panels. Since such data properties produce inaccurate standard errors, a correction method is used (Beck and Katz 1995). AR(1) autocorrelation is assumed and the unit of analysis are the regional integration organizations from 1975-2004. The timeframe is bounded by data availability. The variables measuring regional integration, power preponderance, and institutional homogeneity are lagged by five years given the hypothesized direction of association.[1] Five year lags were chosen in order to reduce endogeneity problems, to work with some data issues (see below), and to focus on a long-term examination. Control variables (see below) are lagged by one year while the regional dummy variables are not lagged. The remainder of this section describes the variables used in the model with the following specifications:

$$Integration_t = \alpha_1 + \gamma_1 Power\ Preponderance_{t-5} + \gamma_2 Institutional$$
$$Homogeneity_{t-5} + \gamma_n Controls_{t-1} + \varepsilon_t$$

The operationalization of regional integration is a systematic coding so that the analysis can distinguish varying levels while still comparing similar attributes. This is done by using a multidimensional measurement referred to as the integration achievement score (IAS), which was first developed by Hufbauer and Schott (1994) and later refined and applied in Efird and Genna 2002 (see also Efird, Genna, and Kugler 2003; Feng and Genna 2003; and Genna and Hiroi 2004). It gauges the level of

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[1] Lagged dependent variables were not used because as Achen (2001) points out, lagged dependent variables will dominate the results thereby destroying the effect of other variables when included with heavily trending exogenous variables and disturbances, regardless if the lagged dependent variable has any true causal power or not. In addition, the interest in this study is not in the change or growth in the level of integration, but the level of integration at a given time period. The lagged independent variables were included to better account for causality.

regional integration by looking at six categories commonly attributable to regionalism: (1) trade in goods and services, (2) degree of capital mobility, (3) degree of labor mobility, (4) level of supranational institution importance, (5) degree of monetary policy coordination, and (6) degree of fiscal policy coordination. Each of the six categories is also broken down into five levels along a Guttman scale. The measure is an equal weighted average of the six categories. The potential range of the score is from zero to five. Zero represents no formal regional integration in place and five represents a complete merger of markets, including all economic factors, and political decision-making.

Power preponderance is relatively simple to operationalize using GDP data (in constant US dollars) from the World Development Indicators (2005). I calculate the variable by dividing the GDP of the largest economy by the sum of the GDPs of all remaining members.

I operationalize institutional homogeneity using World Bank's *Database of Political Institutions* (Beck et al. 2001) An index was created using three variables: "Legislative Indices of Electoral Competitiveness," "Executive Indices of Electoral Competitiveness," and "Checks and Balances." A confirmatory factor analysis of the three variables indicated a strong association with a single latent variable (alpha=0.83). The values for each country were summed and a standard deviation was taken for each regional integration organization.

The data analysis also includes the following control variables. The first is the presence of an ongoing crisis between members of the regional integration association. Intuitively, one would suspect that integration would not deepen under such circumstances. The data come from the International Crisis Behavior dataset (Brecher and Wilkenfeld 2000). The variable has a value of zero for the absence of an ongoing crisis and one otherwise. The second control, which is also found in the International Crisis Behavior dataset, is the presence of a new crisis during the year. Like ongoing crisis, a new crisis may threaten current or future integration efforts. The variable has a value of zero for no new crisis and one otherwise. The age of regional integration organization was also included because older organizations are more likely to have deeper integration. Integration may deepen due to the political will or persistent effort. The number of members was also included. Larger memberships may encounter greater collective action problems, which makes coordination among member states challenging.

Finally, regions could possess specific attributes that may influence the level of integration. I include regional dummy variables for Europe, Latin America, [2] the Middle East, and Africa. Asia is the baseline region.

Results

The regression model estimates the relationship of regional integration around the world with power asymmetry and institutional homogeneity while controlling for other factors. Overall the results support the hypothesis.

Table 1. OLS (AR1) Regression with Correlated Panels Corrected Standard Errors

	IAS	Standard Error
Power Preponderance (t-5)	0.022**	0.011
Institutional Variables		
DPI Index, standard deviation (t-5)	0.017**	0.007
Controls		
ICB On Going Crisis (t-1)	-0.010	0.028
ICB New Crisis (t-1)	-0.001	0.018
Regional Organization Age (t-1)	0.015***	0.002
Regional Organization Membership Size (t-1)	-0.007***	0.002
Europe	1.42***	0.086
Latin America	0.635***	0.088
Middle East	0.428***	0.140
Africa	0.183**	0.089
Constant	0.437***	0.073
Observations	534	
R^2	0.346	

Standard errors in parentheses; *** p<0.01, ** p<0.05, * p<0.1 (one-tailed tests; except regional dummies which are two-tailed); the standard deviation variables were transformed (the negative of the standard deviation) so that the indices now measure institutional homogeneity.

Table one presents the estimation results. The model one supports the hypothesis that a regional leader and homogeneous institutions among member-states are positively associated with the level of integration. The power preponderance variable is significant at the 95% confidence level (one-tail test). If the regional leader is *as large as* all other member-states combined (a ratio equal to one) then the level of integration is small.

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[2] I code NAFTA in the Latin America regional dummy.

At the maximum value of the power preponderance variable found in the data (~11), the effect would be 0.24 or a ten-fold increase from the value of parity. At the smallest value of preponderance found in the data (~0.17) the effect would be 0.0037 or an 83% decrease from parity. Institutional homogeneity is significant at the 95% confidence level. From the variable's lowest value to its highest value, the level of integration increases by 100%. The next column displays the results with the EFW measure for institutional homogeneity as the dependent variable. The integration score does help explain the level of homogeneity, but power preponderance does not. This finding, in association with the first model, points to power preponderance affecting the level of homogeneity indirectly, i.e. through its effect on the level of integration.

Implications for North American Integration

This analysis indicates that the optimal conditions for regional integration to develop are the presence of a preponderant power and compatibility among the member states. The condition of power asymmetry was demonstrated with the finding that the larger the GDP ratios (between the regional leader and the sum of all other members), the greater the regional integration score. The necessary condition of institutional compatibility was also demonstrated by the findings. Recall that these tests demonstrate a *general relationship* and not one that is exclusive to North America. Assuming that North American integration is not unique and is therefore comparable to all other cases, the general results give us an opportunity to see how North America compares with all other cases of regional integration. From this comparison, it becomes possible to make recommendations for deepening integration. The next step is to examine the estimated models in the North American case.

One of the key variables, power asymmetry, is clearly present in the region. The GDP ratio between the US and Canada during 1989-1993 was between 9.8-10.8. After the implementation of NAFTA, the ratio between the US and the other two partners varies between from 6.8 – 8.4. The data indicates a fairly wide variation in the homogeneity variables. The standard deviation of NAFTA's DPI values ranges from 2.08-0.58. This section will examine the effect of this variable has on North American cooperation.

Table two displays calculated North American integration scenarios using varying values of power preponderance and institutional homogeneity indicators. We begin with a baseline

Table 2. North American Integration Scenarios

Scenarios	Integration Score
2004	1.34
Low End Values	1.17
High End Values	1.50
Institutional Homogeneity (15 years)	2.32
Institutional Homogeneity (30 years)	2.55

examination before discussing potential scenarios that could deepen North American integration. The 2004 estimated value for NAFTA is 1.34 while the actual value is 1.67. Therefore we will need to keep in mind that the model underestimates the integration score's value when examining future estimated values. The next entry includes North American values at the low end of the range for all the independent variables, while the third entry includes high end values. Note that these entries represent hypothetical scenarios; the actual data do not have these combinations of values. The point is to determine the bounded values of integration given historical precedence before expanding to other scenarios. At the historically lowest values, the predicted integration score is approximately 1.17. Using the European Union as a substantive comparison, the EU scored a value of one just before the implementation of the Treaty of Rome (1957). At this time the EU was a partial free trade area that also allowed foreign capital withdrawal. Regional institutions were limited to information gathering and had advisory roles. At NAFTA's historically highest values, the estimated score is 1.50. This value represents a substantive change in the level of integration because it requires a one point increase in at least three categories of composite index. For example, the score increase could represent a change to a full free trade area, the ability for full access for foreign investment and capital withdrawal (except for national government procurement), and the ability for regional institutions to amend member state proposals.

The next entries in table two provide results given improvements to institutional homogeneity between the three countries at different ages of NAFTA. I keep the power ratio at seven and also hold the membership at three. *If* the three had achieved perfect homogeneity when NAFTA turned 15 years old (in 2009), it is estimated that the value would be 2.32. Recall that the model underestimates the values, so this is a conservative estimate. What could such a value represent? Let's again use the EU as a comparative example. It achieved this value in 1972 as the member-states began their earliest efforts in developing the common currency. The EU was a customs union, provided full access for foreign investment (except for national government

procurement), allowed capital withdrawal from member states, labor mobility among nationals of member states, included regional institutions that had the ability to amend proposals, and required member states to commitment to maintain parity in currency values. Therefore a one point increase in the integration score represents a great deal of change from NAFTA's 2004 score. Thinking into the future, what would NAFTA look like if member states achieve perfect institutional homogeneity when it turns 30 years old (in 2024)? The estimated value is 2.55, which is similar to the value of the EU in 1975.[3] In 1975, the EU improved integration since 1972 by allowing European institutions to veto proposals.

Conclusion

The literature on regional integration has fashioned various theories and empirical findings. The conditions distilled in this paper are power asymmetry and partner compatibility. First, I evaluated the empirical validity of these conditions and then compared the general models with the North American experience. My goal was to assess North America's potential for deepening integration; does it have the "right stuff" to develop agreements that furthers integration? The rationale is that collective action through trilateral agreements would be the most effective way to solve the migration-security-development issue.

The general findings confirm that specific conditions are needed. First is the presence of a regional leader. The statistical results show that greater asymmetry is associated with greater levels of integration in general. The presence of the leader was theorized to be necessary in order to solve some problems of collective action (coordinate efforts and distribute incentives). However valid this variable is in general, it does not extensively help us to explain North American integration since the US has been a regional (and global) preponderant power for some time.

The second condition was compatibility of members. The results indicate that domestic institutional homogeneity is a good predictor for integration. It is in this area that we see a good deal of variation among the North American states. Compatibility is stronger in the northern partnership than the southern partnership, which produced an unbalanced compatibility problem. Therefore the policy recommendations are geared to improving the

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[3] The actual value was 3.167.

compatibility between Mexico and Canada-US if further integration is desired.

One set of recommendations involves homogenizing institutions. There are two points here. The first is the effort to improve democratic institutions in Mexico. Mexico is already on upward trajectory in this area, but still falls short. Given the high levels of corruption, democratic institutions have credibility problems. Also the Mexican president's powers are not as constrained as those of the executives from Canada and the US. The second recommendation is to reduce the differences involving legal structures, the security of property rights, and regulation of labor and business. Regarding the legal structures, the deepening of integration would benefit from the Mexican judiciary becoming more independent, impartial, and increasing its integrity. Also, there will need to be some sort of convergence in the protection of property rights. Regarding the regulation of labor and business, there needs to be a convergence in the regulation of workers' rights regarding hiring and terminating employment. Work also needs to be done in converging business regulations and the reduction of the use of bribes in Mexico.

Overall, North America does not currently have the appropriate conditions that would improve integration at the moment. While a power asymmetry is in place, the compatibility of three partners is unbalanced. But a two-pronged policy of improving homogeneity while increasing integration can very well promote a virtuous cycle that continues to unite the economies and decision making of the three countries. The need to solve problems like the migration-security-development issue requires collective action because unilateral action thus far has proven to be unsuccessful. The limiting factor of the three issues is development, which integration has the potential to solve. By recognizing that the problem is a commonly held one, the three partners can begin to seek out the conditions, and make the appropriate adjustments, for cooperation to develop. Otherwise we will see future elections that mechanically focus on solutions that do not produce results.

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