The Growing Imperative to Create a More Integrated Internal Economy in Canada

FRASER INSTITUTE

2024

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TRADE

November 2024 • Fraser Institute

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FRASER INSTITUTE 50 YEARS

Contents

Executive Summary

- Regardless of the outcome of the 2024 US presidential election, it is likely that protectionist pressures will intensify in that country, thereby further threatening Canada's exports to its largest trading partner. The imperative to create a truly integrated internal market will therefore be even more pressing.

- There are relatively large economic benefits to Canadians from eliminating or even reducing interprovincial barriers to trade, capital flows, and labour mobility.

- There are two main legal instruments to reduce existing interprovincial barriers to trade and labour mobility. One is the Canadian Free Trade Agreement (CFTA) which currently includes all 13 provinces and territories. A second is the New West Partnership Trade Agreement (NWPTA) to which the provinces of British Columbia, Alberta, Saskatchewan and Manitoba are signatories.

- The main advantage of using the CFTA is that it mitigates the risk of trade and investment diversion. The disadvantage is that it is more difficult to negotiate trade agreements encompassing a larger number of trade partners than it is to add individual partners to a regional trade agreement.

- Whether barriers are reduced by deepening the existing CFTA or expanding and deepening the NWTPA, a major step to a more integrated domestic economy would be for members of both trade agreements to implement a policy of "mutual recognition." This would mean that an item of commerce (either a good or a service) that meets the regulatory requirements of a member province or territory is deemed to automatically satisfy the regulatory requirements of other member provinces or territories.

Introduction

The 2024 US Presidential election outcome promises to pose new challenges to the Canada-US trade relationship. Republican candidate Donald Trump imposed tariffs on Canadian steel and aluminum exports to the US during his administration. More recently, Trump has indicated in his campaign that he continues to favour protectionist policies. Indeed, he has threatened to impose an across-the-board 10 percent tariff (or larger) on manufactured imports if he is elected.[1] In principle, any such across-the-board new tariffs levied against Canadian exports would violate US commitments under the Canada-United States-Mexico Free Trade Agreement. However, a review of the Agreement is scheduled for July 2026. If one of the parties does not agree to extend the life of the Agreement at the time of the review, the Agreement would automatically expire after an additional 10 years.[2] Given Trump's threats to abandon NAFTA when he was president, it is certainly plausible that a new Trump administration would refuse to extend the life of the current Agreement.

The Democratic candidate and current vice-president, Kamala Harris, along with President Joe Biden have been less protectionist than their predecessor, although the Biden administration has been, and a Harris administration likely would be a major supporter of US trade unions and environmental interests. A Harris presidency would therefore also pose significant risks to Canadian manufactured and energy exports to the US. Indeed, one of the Biden/Harris administration's first acts after taking office was to revoke the permit needed to build the Keystone XL oil pipeline that would have brought Canadian crude to the US (Ljunggren, 2021). Biden and Harris's initiatives to promote domestic investments in electronic vehicles and semiconductor chips, as well as in telecommunications and transportation infrastructure have strong "Buy American" features, although Biden did announce in March 2023 that Canadian-assembled EVs would be eligible for US tax credits given that they met North American content requirements.[3] This concession was made after vigorous lobbying by Canadian trade authorities and amidst real uncertainty about whether the integrated North American transportation equipment supply chain would become fragmented with a shift to EV production.

1 See York (2023) for a discussion of Trump's proposed across-the-board tariff threat.

2 During that ten-year period, the parties could agree to renew the trade agreement which would then be in place for an additional 16 years. While the scheduled review does not contemplate a significant renegotiation of the Agreement, the parties might choose to renegotiate rather than have the Agreement expire. For a discussion of the upcoming review, see Maria de la Mora (2024).

3 See Globerman (2023).

The potential for US protectionist measures has long been a stimulus for calls to diversify Canadian trade patterns away from this bilateral relationship, including the Indo-Pacific Trade Strategy.[4] Notwithstanding numerous regional and bilateral trade agreements involving other countries, Canada's geographical trade patterns have remained primarily US-focused. By way of illustration, over the period 2017–2022, approximately 75 percent of Canada's merchandise exports went to the US, while about two-thirds of Canada's merchandise imports came from the US. These shares are almost identical to the respective shares in 1990 which was one year after the US-Canada Free Trade Agreement came into effect. The United States is also Canada's dominant trade partner for services. Between 2017 and 2021, service exports to the US were almost 53 percent of Canada's total service exports.

The US trade dominance reflects the influence of both physical and cultural distance. The so-called gravity model of international trade documents the importance of physical distance as a prominent cost of doing international business. The proximity of major Canadian manufacturing and population centres to large US metropolitan areas is an enduring advantage to doing business with US suppliers and customers. Physical distance is a particularly significant cost driver for exporting and importing manufactured goods. In the case of services, cultural distance is arguably an even more significant contributor to the cost of doing business internationally. Cultural distance reflects differences in factors such as language, laws and regulations, norms and values and the like.[5] In this regard, the cultural distance between Canada and the US is arguably smaller than the cost Canadian businesses would face doing business in other countries, other things being constant.

Against the background of physical distance and cultural differences, it might be argued that increasing trade liberalization across provinces within Canada is an especially attractive policy initiative. This is especially the case for interprovincial regional trade liberalization for which the disadvantages of physical distance are attenuated. Tombe (2020) notes that trade among provinces and territories in Canada has stagnated at around 18 percent of Gross Domestic Product (GDP) in recent years, which is nearly 10 percentage points below its 27 percent share in 1981. He further notes that interprovincial trade barriers add between eight and 14.5 percent to the prices of goods and services in Canada,

4 Globerman (2023) discusses and assesses the Indo-Pacific Trade Strategy initiative.
5 For an extensive discussion of the determinants of the costs of cultural distance, see Shenkar (2012).

which implies direct economic costs of around CAN $32 billion per year. Interprovincial trade barriers also contribute to reduced productivity improvements from foregone economies of scale and scope that roughly double the overall costs of the barriers.[6]

The economic benefits of interprovincial free trade have been known for some time. As noted earlier, emerging political developments in the US elevate the imperative for Canadian politicians to reinvigorate efforts to reduce interprovincial trade barriers. In the remainder of this essay, we will identify the currents status of interprovincial trade arrangements and then consider new initiatives to move Canada closer to an integrated market for internal trade in goods and services.

6 As a point of reference, Tombe (2020) estimated that the direct and indirect costs of interprovincial trade barriers would equal approximately four percent of Canada's GDP in 2020.

Current Trade Arrangements

There are currently several intergovernmental agreements that condition interprovincial trade arrangements. The geographically broadest is the Canadian Free Trade Agreement (CFTA), which was signed by Canadian ministers representing the federal government and all 13 provinces and territories.[7] The stated objective of the CFTA is to reduce and eliminate to the extent possible, barriers to the free movement of persons, goods, services, and investments within Canada. However, there is an important caveat. Namely, the CFTA preserves the ability of federal, provincial, and territorial governments to adopt and apply their own laws and regulations related to economic activities to achieve public policy objectives including the protection of public health, social services, public safety, consumer protection, the promotion of cultural diversity and workers' rights. CFTA rules apply automatically to all areas of economic activity with exceptions being explicitly identified. The Regulatory Reconciliation and Cooperation Table (RCT) was established to align regulatory frameworks to reduce barriers to interprovincial trade, investment and labour mobility.

An updated version of the CFTA was published in 2023. The update combined the text of the original CFTA with all Protocols of Amendment that were adopted post-2017.[8] Changes to the CFTA procurement framework limit the ability of government entities and public entities to buy local when procuring goods and services that surpass certain values. However, federal, provincial and territorial governments can maintain a list of exceptions. In particular, the CFTA specifically excludes the procurement of health services from falling under its purview.

Tombe (2020) identifies the CFTA as perhaps the most significant development for internal trade in Canadian history, while also highlighting its individual achievements and many shortcomings. The former include a deal to harmonize construction codes by 2025 to make it easier for builders and suppliers to do business across Canada. Energy efficiency standards for various home appliances will be harmonized across provinces

7 The CFTA came into effect in 2017. For a full description of the Agreement, see Government of Canada (2017).

8 For a discussion of updates to the CFTA, see Dentons (2023). The 2023 consolidated CFTA permits a province/territory to remove its specific exceptions to the Agreement without other signatories' consent. As the CFTA now stands, Alberta no longer maintains any province-specific exceptions to the CFTA's procurement framework.

under the CFTA, as will rules for wide-base tires which should lower costs of interprovincial truck transportation. Still, as Manucha and Tombe (2022) note, regulatory divergences across provinces remain substantial impediments to internal free trade notwithstanding the CFTA. Notably, in agriculture, there are inspection and labeling requirements to ship certain food products between provinces, as well as provincial marketing boards that prevent free trade in specific food products. Provincial monopolies at the wholesale level for beer and wine effectively protect local breweries and wineries. Differences in certification standards for various occupations and different financial and securities regulations across provinces negatively affect interprovincial commerce across a range of industries.[9]

Over the past two decades, several provinces have entered into regional trade agreements.[10] For example, in 2008, New Brunswick and Quebec signed an agreement to improve labour mobility and skills recognition. New Brunswick and Nova Scotia signed the Partnership Agreement on Regulation and the Economy in 2009 to streamline, remove duplication, and harmonize regulations. Also in 2009, the Ontario-Quebec Trade and Cooperation Agreement was signed to improve labour mobility between the two provinces and to improve the resolution of disputes related to occupational licensing and standards. In 2015, Nova Scotia and New Brunswick established the Joint Regulatory and Service Effectiveness Office to improve the regulatory environment between the two provinces, while PEI and Newfoundland and Labrador joined shortly after.

The New West Partnership Trade Agreement (NWPTA) was implemented in July 2013 with the first Protocol of Amendment signed in January 2015.[11] Under the NWPTA, British Columbia, Alberta, Saskatchewan and Manitoba committed to:

1. Avoid measures that restrict or impair trade through their territories or investment or labour mobility between them;
2. Treat businesses, investors or workers of the other provinces at least as favourably as they treat their own or those of another jurisdiction;
3. Mutually recognize or otherwise reconcile unnecessary differences in their standards and regulations;

9 Alvarez, Krznar, and Tombe (2019) provide a comprehensive discussion of the main categories of internal trade barriers in Canada.

10 A number of these agreements are discussed in Alvarez, Krznar, and Tombe (2019).

11 The Protocol of Amendment clarified language concerning labour mobility and dispute resolution provisions. See Manucha and Tombe (2022).

4. Be fully transparent and notify each other of any proposed measure that is covered by the Agreement to ensure that the new measure does not create new impediments;
5. Have an enforceable dispute resolution mechanism.[12]

The NWPTA aims to liberalize trade among the four provinces to a larger extent than the CFTA by decreasing the monetary thresholds for government procurements that must follow a non-discriminatory process and by not including any province-specific exceptions. Further, the CFTA procurement thresholds are adjusted every two years to account for inflation, whereas thresholds governing public procurement under the NWPTA do not change with inflation. Nevertheless, the NWPTA contains general exceptions to non-discriminatory government procurement as does the CFTA. Tombe (2020) on balance views the NWPTA as going beyond the CFTA.

In the next section of the essay, we consider possible new initiatives to further liberalize interprovincial trade and promote capital and labour mobility.

12 These commitments are reported in Manucha and Tombe (2022).

Reducing Internal Barriers to Interprovincial Commerce

Conceptually, there are two broad avenues to liberalize internal barriers to trade, investment, and labour mobility. One is to improve the CFTA so that freer trade is undertaken on a national basis. This approach is comparable to multinational trade agreements such as the World Trade Organization (WTO). A second is for individual provinces to form new agreements or expand upon existing trade agreements to create (or expand) what are in effect regional trade agreements. In the international context, the Canada-US-Mexico Free Trade Agreement is an example, while the NWPTA is a domestic example. Indeed, there have been calls for the Atlantic Provinces specifically to join the NWPTA.[13]

To be sure, political jurisdictions can be part of both multilateral and regional free trade agreements, just as Canada is a member of the WTO as well as of numerous regional and bilateral trade agreements. Agreements involving a smaller number of participants are typically easier to negotiate.[14] On the other hand, regional and bilateral trade agreements create the potential for uneconomic trade and investment diversion. Trade and investment diversion refer to situations where it would be more economical for specific economic activities to be carried out in Region A to serve Region B, but are, in fact, carried out in Region C because the latter has a free trade agreement with Region B. As a consequence, exports from Region C are cheaper for buyers in Region B than are exports from Region A because tariffs or other barriers make goods from Region A more expensive in Region B than are goods from Region C. The result is that the aggregate income of the three regions is lower than it would otherwise be if all three regions were part of the same free trade agreement.

Simply put, any given set of trade liberalization measures will likely have greater economic benefits the broader the geographical scope covered by the agreement and the larger the number of participants, other things constant. A greater span of members diminishes the risk of trade diversion. Also, it expands the scope for comparative advantage gains as factors such as natural endowments, skilled labour, and other inputs likely differ more in relative amounts across a larger number of members. These considerations would argue for leveraging the CFTA as the basis for reducing interprovincial barriers to trade. In this regard, Tombe and Manucha (2022) recommend “mutual recognition”

13 See Navarro-Genie (2016) as an example.

14 Tombe (2020) characterizes the CFTA as taking a piecemeal approach to expansion and concludes that it should not substitute for other trade liberalization options.

as perhaps the most significant initiative to strengthen the CFTA. If implemented, it would mean that any item of commerce that meets the regulatory requirements of one provincial or territorial government is deemed to automatically satisfy the requirements of another. province or territory. Mutual recognition therefore obliges a host province/territory to accept the standards set out by the province from which the imported good or service originates.[15]

Mutual recognition is arguably the single most robust trade and mobility liberalization initiative that Canadian provinces and territories can implement. However, the benefits of mutual recognition are circumscribed by key exceptions from the CFTA. In particular, the exception of sectors such as health care, education and financial services limit the gains from mutual recognition.[16] In this regard, some have argued that the NWPTA would be a preferred basis for reducing trade barriers within Canada given shortcomings of the CFTA including the long list of exceptions and the burdensome and protracted negotiation process. For example, Navarro-Genie (2016) argues that individual Atlantic Provinces should become members of the NWPTA rather than negotiate an Atlantic Canadian Free Trade Agreement. He discusses a number of features of the NWPTA that make it a more robust instrument for deepening existing interprovincial trade, investment, and labour mobility integration.[17]

Alvarez, Krznar, and Tombe (2019) estimate the relative gains from reducing barriers to internal trade in the form of increases in real GDP to be higher among smaller provinces and especially among the Atlantic Provinces. Removing all non-geographic internal trade costs would result in real GDP per capita increases as high as 16.2 percent for Prince Edward Island and 12.8 percent for Newfoundland/Labrador. They estimate much smaller gains for Alberta (3.2 percent), Ontario (2.9 percent) and British Columbia (2.8 percent). The smaller anticipated gains for Alberta and British Columbia presumably reflect not only the larger relative sizes of those economies but also the fact that as members of the NWPTA, their economies are already part of a freer trade, investment, and labour mobility environment.

This latter point is underscored by the information summarized in table 1 which reports the estimated number of exceptions to the CFTA. The Atlantic Provinces are

15 Deloitte (2021) also argues for adopting mutual recognition of standards and regulations as a feature of the CFTA.

16 Alvarez, Krznar, and Tombe (2019) estimate that reducing trade costs in finance, computers and business services lead to the largest gains, followed by wholesale and retail activities and transport and warehousing.

17 For provinces and territories that are signatories to both the CFTA and the NWPTA, if conflicts arise, the provisions of the agreement that is more conducive to trade liberalization prevails.

estimated to have a greater number of exceptions than do other provinces other than Quebec.[18] Hence, while adjustment costs from joining the NWPTA will be higher for the Atlantic Provinces than for Ontario, the commensurate gains should more than compensate for those costs.

Clearly, the overall efficiency benefits of deepening interprovincial trade and investment integration through an expanded NWPTA would be substantially enhanced if Ontario joined that agreement. Ontario's real GDP accounts for about 42 percent of total Canadian real GDP, so less costly access to Ontario's provincial market for goods and services represents a substantial increase in market access for the Atlantic Provinces, as well as for the current members of the NWPTA. Perhaps the key reservation on the part of Ontario to joining the NWPTA would be a de facto harmonization of financial services regulations with other NWPTA members. Arguably, Quebec would have substantially greater reservations than Ontario about joining the NWPTA as suggested by its leading position on the list of exceptions to the CFTA as reported in table 1. However, if the Atlantic Provinces and Ontario were to become members of the NWPTA, the pressure of trade and investment diversion might be sufficient incentive for Quebec to join as well.

Table 1: Number of Exceptions to the CFTA by Province/Territory

Quebec	**35**
New Brunswick	**29**
Newfoundland & Labrador	**21**
Nova Scotia	**17**
British Columbia	**13**
Alberta	**6**
Yukon	**33**
Ontario	**21**
Nunavut	**21**
Northwest Territories	**19**
Saskatchewan	**11**
Manitoba	**10**

18 The estimates reported in table 1 are provided in Deloitte (2021), figure 4..

Conclusions

Policy analysts have identified the costs to Canadians of maintaining barriers to interprovincial trade, investment, and labour mobility. Trade and investment integration with the US has mitigated the adverse consequences of those barriers to a significant extent. However, increasing support for trade protectionism and a growing political consensus in the US for an "America-first" international economic and political strategy raise real concerns that the bilateral trade relationship will face serious future challenges regardless of which presidential candidate wins election in 2024. Initiatives to diversify Canada's international trade away from the US such as the Indo-Pacific Trade Strategy are unlikely to achieve their objective in a substantial manner.[19] Hence, the economic imperative to reduce and even eliminate existing barriers to interprovincial trade, investment, and labour mobility will only become more compelling going forward.

In principle, the "first-best" approach to reducing such barriers is an agreement among all provinces and territories to implement appropriate modifications to the CFTA including mutual reciprocity discussed earlier in this essay.[20] Improving the CFTA would address concerns about trade and investment diversion that surround trade agreements involving subsets of provinces and territories. However, the NWPTA provides a framework that is arguably more "liberalized" than the CFTA and might therefore provide a better basis for a comprehensive national agreement than the CFTA.

Currently, a majority of provinces are not signatories to the NWPTA. The most notable non-signatory is Ontario. The economic benefits of any interprovincial free trade agreement that does not include Ontario would be limited. Hence, Ontario joining the NWPTA would substantially enhance the benefits to the Atlantic Provinces from also joining. Even though Quebec arguably has the most provincial protections to trade and labour mobility, the pressure for it to join the NWPTA might be overwhelming were Ontario and the Atlantic Provinces to join first. Ontario's likely reservation would be a reluctance to include financial services in the Agreement and to harmonize or mutually

19 Negotiations for a new U.K.-Canada trade agreement launched in March 2022 were suspended in January 2024 given Canada's commitment to keep its supply management programs in place.

20 Reducing or eliminating exempted sectors and reforming government procurement practices would also represent major initiatives to create an economically integrated domestic economy. Manucha (2020) recommends additional reforms focused on expediting the complaint resolution process under the CFTA, as well as enhancing the financial compensation to private parties who bring forward and win complaints. He also recommends clarifying ambiguous language surrounding the CFTA's Most Favoured Nation Obligation.

recognize financial regulations. Addressing this reservation in a mutually satisfactory manner might be the key to moving the provinces and territories forward to substantially greater internal economic integration.

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Date of issue

November 2024

ISBN

978-0-88975-807-0

Citation

Steven Globerman
The Growing Imperative to Create a More Integrated Internal Economy in Canada
<http://www.fraserinstitute.org>

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