Chapter 2

Towards a More Productive and United Canada: The Case for Liberalizing Interprovincial Trade

By Trevor Tombe

Canada may be one country, but it is not one economy. Thousands of individually modest but collectively significant barriers to investment, trade, and migration create artificial walls between our 13 provincial and territorial economies. And this comes at great cost to our productivity and to our living standards.

Of course, all federations struggle to balance regional autonomy with national unity. And some degree of interprovincial political and economic friction is unavoidable. But in Canada—one of the world's most decentralized countries spanning vast geographic distances—these challenges are particularly acute.

This has always been so. At Confederation, lack of infrastructure initially kept buyers and sellers apart. Trade between provinces at the time barely exceeded 2 percent of GDP, I estimate, compared to over 25 percent for trade between Canada and the world. But as railways were completed and our expansive geography settled, policy barriers to trade became much more relevant. Sometimes such artificial barriers were explicitly protectionist.

"The growing demand for provincial protectionism must not be under-rated," warned the Royal Commission on Dominion-Provincial Relations in 1940, adding, "it is beyond dispute that… local protectionism does tend to hamper national economic life" (Canada, 1940: 63-64).

Nearly 80 years later, their words remain relevant.

Even when not explicitly protectionist, provincial policy can inhibit the free flow of goods, services, and labour. Examples abound. In agriculture, there are inspection and labelling requirements to ship certain food products between provinces, and provincial marketing boards for certain products (i.e., supply management) prevent free trade between provinces. For beer and wine, the provincial monopolies over the wholesale distribution of alcohol means biased procurement, pricing, and marketing decisions by these agencies often favour local breweries and wineries. More generally, biased government procurement means local construction firms and suppliers may be favoured on infrastructure projects, even if they are higher cost than out-of-province firms.

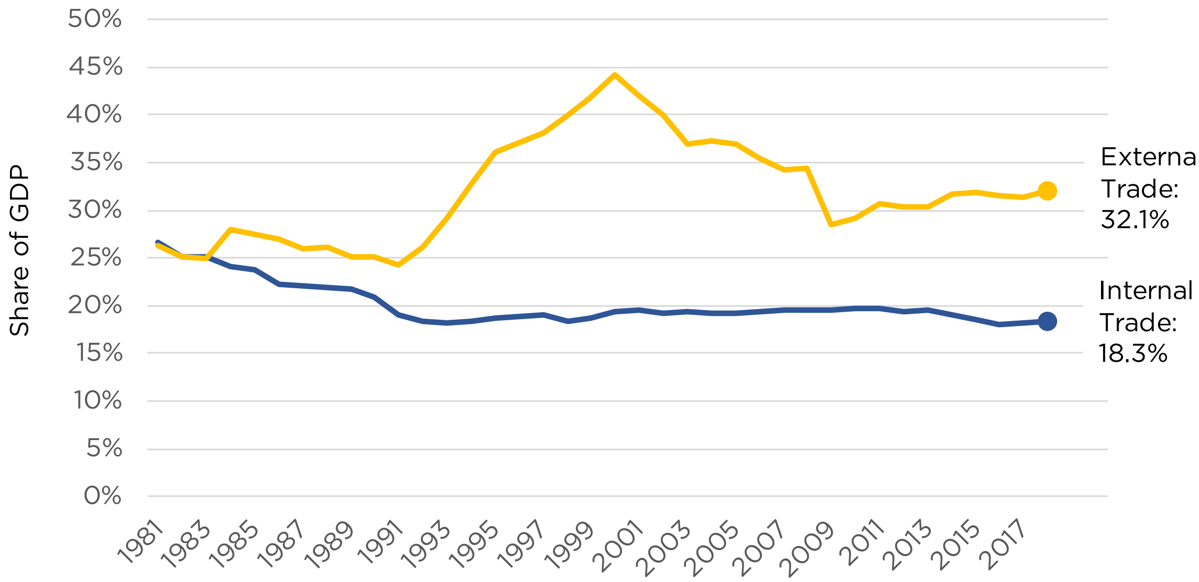
And some trade barriers cascade throughout nearly all sectors of economic life. For trade in goods, differences in trucking regulations across provinces makes shipping across Canada costly. Differences in what tires can and cannot be used, what axle weight limits are, and so on, all add to costs. This results in fewer shipments and higher prices for almost all goods we buy. And for trade in services, provincial standards and certification of professions and skilled trades can also inhibit trade. In Manitoba, to highlight a particularly stark example, one cannot offer legal services without maintaining a physical office in the province. Hiring an out-of-province lawyer—even if they are better suited, higher quality, or lower cost—is therefore made more difficult. Financial and securities rules also vary across provinces. Even French language laws represent a barrier.

Making matters worse, such restrictions can also hinder worker mobility. If credentials from one region are not recognized by another, then Canadians will face costs of retraining or recertifying if they move from one province to another. Denturists are not free to move into Quebec without recertifying, for example, nor are podiatrists into Alberta, dental hygienists into Newfoundland & Labrador, social workers to Ontario, and so on. Fewer people will therefore relocate, even if expected wages are higher.

These barriers to trade, investment, and employment are not merely irritants. They decrease trade flows, increase prices, and lower overall productivity. The first effect is clear in the data, which I display in figure 1. While international trade has grown, thanks to a proliferation of free trade agreements, internal trade has stagnated at 18 percent of GDP in recent years and is nearly ten percentage points below its 27 percent share in 1981. Put another way, internal trade is roughly half as important to the overall economy today as international trade is. Four decades ago, the two were similar.

As for prices, recent research by myself and Lucas Albrecht, published in the *Canadian Journal of Economics*, finds that the effect of interprovincial trade barriers adds between 7.8 and 14.5 percent to prices of goods and services that we buy each day (Albrecht and Tombe, 2016). Other research from a team at Statistics Canada finds the price effect on goods alone (that is, excluding services) approaches 7 percent (Bemrose,

Figure 1: Internal and International Trade as a Share of GDP, 1981 - 2018



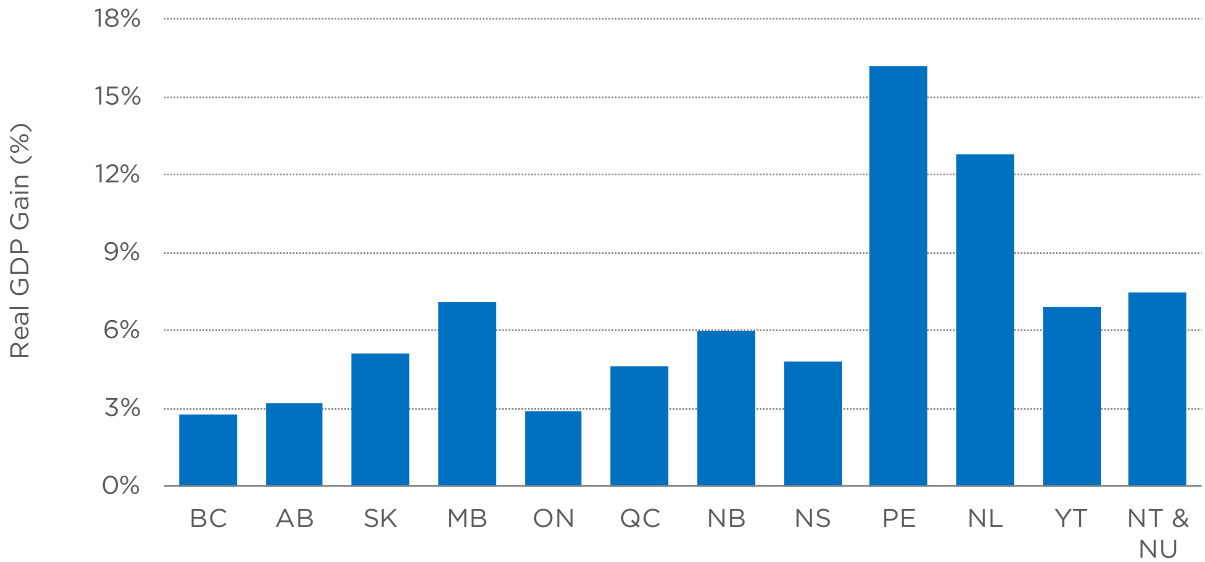
Source: Own calculations from Statistics Canada data table 36-10-0222-01.

Brown, and Tweedle, 2017). For comparison, the same model applied to the US finds internal trade costs there are nil. Costs of living are consequently higher in Canada as a result. Interprovincial trade barriers add, in effect, more than the cost of the GST to cross provincial borders—yet most of us do not realize it because the costs are hidden; consumers are not aware of the lower price they would pay without these barriers.

Finally, Canada's overall productivity is also harmed by interprovincial trade barriers. The reason is straightforward: allowing regions to specialize in what they are relatively good at, and import what they are not, boosts economic productivity. Barriers to trade inhibit this specialization and therefore lower productivity. If such barriers were eliminated, trade flows would increase, productive firms would expand, prices would decline, and real incomes would rise. The cumulative effect on productivity is large.

For a sense of scale, since internal trade accounts for roughly one-fifth of GDP in Canada today, each one percentage point reduction in the cost of engaging in that trade is directly worth 0.2 percent of GDP. Taking the Statistics Canada estimates of trade costs of nearly 7 percent as given, this implies aggregate economic costs of 1.4 percent of GDP, or over $32 billion per year. But the gains do not stop there. What is produced by one

Figure 2: Gains from Eliminating Non-Geographic Internal Trade Barriers for Goods



Source: Alvarez, Krznar, and Tombe, 2019: Table 7.

business is often used by others as inputs into producing yet some other good or service. These input-output connections mean the direct gains from lower trade costs are amplified by indirect gains elsewhere. Canada's economy is a web of interrelated activities and, taking this into account, the gains from lower trade costs are roughly double the direct gains alone. Amplifying the gains further still, lower trade costs expand the volume of trade, increasing its importance for the economy, and reduced regulations facilitate the movement of workers across locations and sectors which allows productive firms to expand.

Taking all this into account to estimate the overall effect of internal trade barriers on productivity does require some sophisticated analysis, but luckily there is a wealth of research that does just that. The most recent estimates from the IMF suggest that Canada's overall productivity could increase by 3.8 percent if internal trade barriers on goods were eliminated (Alvarez, Krznar, and Tombe, 2019). This is large. It represents an aggregate increase in Canada's economy of nearly $90 billion per year—that is over $2,300 per person or over $6,000 per household.

These results also suggest lower income regions would gain more than higher income ones. I illustrate this in figure 2. Among the five provinces with the lowest average household income, for example, gains from lower trade costs average 5.4 percent—significantly higher than the overall average. The territories also gain more. This not only brings equity benefits but dampens the need for fiscal redistribution through federal revenue and spending programs. Recent work by myself and Professor Jennifer Winter suggests federal transfers across provinces are between $1 billion and $4 billion higher due to the disproportionate effect that interprovincial trade costs have on poorer regions (Tombe and Winter, 2020 forthcoming).

These gains are significant and would help meaningfully shrink the productivity gap between Canada and the United States as reflected in differences in per capita income levels. In 2019, for context, US GDP per person was equivalent to $77,740 (in PPP (purchasing power parity)-adjusted Canadian dollars)—over one-quarter higher than Canada's. Worse, US labour productivity is over one-third higher than Canada's, and this has increased from the one-quarter higher level that prevailed in 2000. Internal trade costs in Canada are undoubtedly an important factor behind this large and growing productivity gap.

Of course, liberalizing trade is easier said than done, but governments have many options for reform. Provinces could agree to harmonize their regulatory rules, or a single province could move on its own and recognize out-of-province credentials and standards. There has been some important recent progress, but much work remains.

Consider the Canadian Free Trade Agreement (CFTA) between the federal, provincial, and territorial governments. It came into force in July 2017 and seeks to develop "a comprehensive set of rules that will help achieve a modern and competitive economic union for all Canadians" (Committee on Internal Trade, 2020). It represents a real commitment to improved internal trade. The Canadian Federation of Independent Business rightly recognized Canada's trade ministers with its Golden Scissors award to celebrate the agreement's potential.

At a high level, the agreement is straightforward. It establishes a wide variety of working groups to deal with labour mobility, financial services, government procurement, alcoholic beverages, and more. The hope is that each will help ratchet Canada slowly but steadily towards easier internal trade. So far, it has led to a deal to harmonize construction codes by 2025 to make it easier for builders and suppliers to do business across the country. This alone may yield economic gains of up to $1 billion by 2028. It has also moved towards harmonizing rules for wide-base single tires, which can help lower trucking costs. It has helped eliminate federal grade and quality inspections for apples, potatoes, and blueberries (which can differ from provincial inspections). It guided provinces to adopt common standards within occupational health and safety rules for items like head, foot, and eye protection, first aid kit contents, and life jackets, among others. It moved us towards harmonized corporate registration and reporting requirements. And energy efficiency standards for various home appliances from washing machines and dryers to microwaves and refrigerators will soon be identical across the country.

Such efforts are valuable, and however small the gains from the individual changes, they compound upon one another and gradually move us closer to free internal trade. The CFTA is perhaps the most significant development for internal trade in Canadian history. But it is far from perfect. Its piecemeal approach is *very* slow. And the recent COVID-19 pandemic prompted many governments to return to protectionist instincts—promoting local production of various products, for example. The CTFA should therefore not substitute for other options available to governments.

More limited deals with only certain provinces, for example, can push further and faster than the CFTA. British Columbia and Alberta, later joined by Saskatchewan and Manitoba, formed the New West Partnership Agreement to harmonize regulations, standards, and certifications in many areas. This agreement goes beyond the CFTA in many ways and other provinces could join or reach their own bilateral deals.

But the gold standard to liberalize trade involves provinces moving unilaterally. Alberta, for example, moved in summer of 2019 to drop many of its self-imposed exemptions under the CFTA. It did this in exchange for nothing from any other government. It recognized the need for leadership, but it also recognized that most of the gains from internal trade come from making imports cheaper rather than expanding exports. I estimate that roughly two-thirds of the gains from lower internal trade costs for Alberta can be achieved by unilaterally eliminating barriers. Provinces can go further and recognize all standards, certifications, regulations, and so on, issued by any other province as automatically valid in lieu of its own. This would restrict each government's individual power but ease internal trade substantially (and do so quickly).

There's reason for optimism. Substantial progress in recent years, and growing public appreciation of the challenge, creates momentum governments can build on. Efforts in the CFTA can be enhanced and more unilateral moves encouraged. But as provincial autonomy is closely guarded, and always has been, constant effort and goodwill is required to bring Canada's disparate economies closer together. Though it is hard work, our goal should be nothing less than freedom to trade, to invest, to move, and to work. The resulting benefits for Canada's economy are too great to ignore.

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