Economics

IN FOCUS

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A modest pot of gold at the end of the interprovincial trade-deal rainbow

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With Canada facing a growing threat of US tariffs, attention is turning to opportunities in our own backyard. We'll no doubt see an increase in trade across the country, as consumers and businesses seek out domestic products out of patriotism and to avoid import tariffs. But the federal government and the provinces are also aggressively aiming to reduce internal trade barriers, because if trade with other countries is an economic plus, that must be true for flows across provinces.

We applaud those efforts, but at the same time, we all need to be clear-eyed about just how much the benefits of reduced internal trade barriers could offset the hit from a potential trade war with the US. After looking at the touted benefits, and the research that estimates them, we find reasons to be skeptical over claims about the size of the pot of gold waiting to be found at the end of the interprovincial trade rainbow.

Much of GDP is in unaffected sectors

When the issue comes up for discussion, one hears the same handful of problems and sectors at the top of the list. Why can't I get B.C. wine in my province? Why can't a contractor in Ottawa bid on a construction project in Hull? That might be a hint that the list of material barriers to trade isn't that long.

Looking at the composition of Canada's GDP, it appears that the affected slice is relatively narrow. Some services are, by their nature, always going to be untraded across provinces. That would include, rental housing, live entertainment, hair salons, fruit and vegetable stores, and so on. At the other extreme, in many goods sectors, there are national brands sourced from centralized facilities with dominant market shares, suggesting that interprovincial barriers must be relatively small. Think, for example, of auto assembly, defense equipment, tissue paper, or frozen French fries.

In some services, trade across boundaries is possible, either by travelling to deliver them or online. These are often cited as having barriers tied to licensing requirements, which are indeed an issue. But even when that's the case, there are sometimes workarounds. Employees at large engineering firms, for example, can hold licenses in more than one province.

Measuring the barriers: Does anyone even read past the abstract on page 1?

That said, even if a lot of the economy is unaffected, there might be big enough wins from interprovincial trade liberalization to add up to a material gain by eliminating or reducing the existing barriers. Various studies have claimed that non-geographic barriers are the equivalent of having tariffs at anywhere from 7% to 20% across provincial boundaries, and that removing all trade barriers could boost GDP by an impressive 4% to 7% in the long-run. For context, our recent study of the impact of 25% US tariffs on the Canadian economy put the hit to GDP at 4-5%, which is also about how much GDP was lost in the 2008-09 financial crisis.

But estimating those impacts is indeed challenging. There's no comprehensive listing of all barriers, and even if there were, the implications of each barrier would, in effect, be a separate study.

As a result, economists generally use roundabout methods to estimate the magnitude of all such barriers in one fell swoop. The most cited reports on Canadian interprovincial barriers have been done by Trevor Tombe and various co-authors (See Manucha and Tombe 2022; and Alvarez, Krznar and Tombe 2019). These studies are centred around what economists call the gravity model of trade. That approach attempts to explain trade flows using the economic size of trade partners and their distance. The authors try to account for a few other forces, and the part left unexplained by the model is ascribed to policy-related barriers.

Sounds good in theory, but in practice, that method has its challenges, and the results don't look intuitive. The biggest trade barriers are found in services like hotels and restaurants, utilities, and education and health. That reflects the problematic nature of having local and often non-tradeable businesses showing up in these models. Even in 2015, the last year of the data in one of the studies, it seemed easy enough to book a hotel room in another province online or over the phone.

The result is that service sector barriers are being significantly overstated, with estimates of the tariff equivalent rates at 30-50% in some of these studies. Unsurprisingly, the tariff rates on the goods sector are found to be significantly smaller, ranging from 10-20%, likely because conventional gravity models do a better job of explaining that type of trade.

But even in the goods sector there are issues with the methodology. In some studies, businesses in a given sector are assumed to be similar other than their location. So, an equipment factory in Ontario is making the same sort of product as one in PEI. In these models, "equipment" is "equipment". Gravel from Ontario and diamonds from the Territories are both products of "mining", but one clearly is easier to move than another. It seems suspect that three of Canada's four largest and most urbanized provinces are found to be those facing the fewest barriers, while smaller and less urban provinces are deemed to be most held back by barriers.

There are also major issues with the measure of "population-weighted distance" to capture geographic barriers. In one of the studies that includes international trade, the US is a single dot on the map at its population centre point (Missouri), making it a long way from B.C., despite that province being closer to California's massive populace than it is to Ontario. A footnote acknowledges this point, but there are no caveats on page one for the less discerning reader.

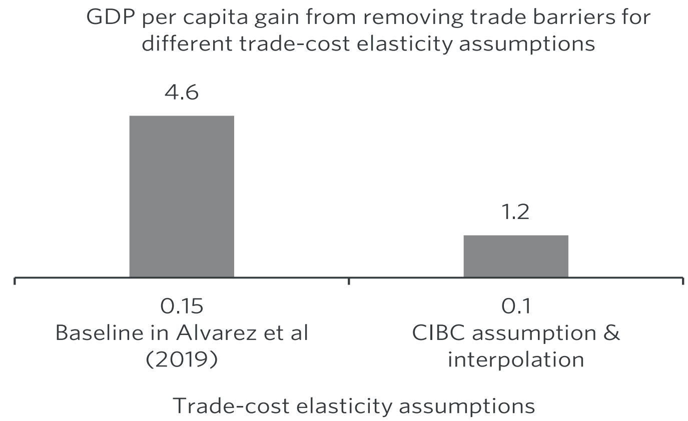
How big is the GDP pot of gold?

If measuring the size of the barriers, as a tariff equivalent, seems fraught with difficulties, then taking these results as a starting point for assessing the gains from relaxing them is even more troubled.

That massive 4-7% GDP boost in these studies reflects not only an overstated translation of internal trade barriers into their tariff equivalent, but also suspect assumptions about the elasticity of trade barriers — that is, how much a given change in trade barriers translates into changes in GDP. For the goods sector, the elasticity is taken from another paper studying the effects of NAFTA and reflects how combined trade patterns of the US, Mexico and Canada change as their import and export prices change (Caliendo and Parro, 2015). And for services, when you follow the rabbit hole of citations, it's clear the elasticity of 5 is just basically a wild guess with no Canadian data behind it (Costinot and Rodriguez-Clare, 2014; Caliendo and Parro, 2010). So, none of these trade barrier elasticities actually reflect the Canadian context, where natural resources dominate and distance and transportation costs are very high. And they actually capture how changes in prices impact GDP, rather than changes in rules.

Assuming a moderately lower elasticity — which survey evidence discussed below suggests — would result in dramatically smaller gains, cutting the benefit of internal trade liberalization down to a 1% long-run boost to GDP as opposed to a 4% gain the authors like to cite (Chart 1). That's still helpful and very much worth pursuing, but far from the solution to all our trade problems.

Chart 1: GDP gains from removing trade barriers could be a lot lower using more realistic trade elasticity assumptions



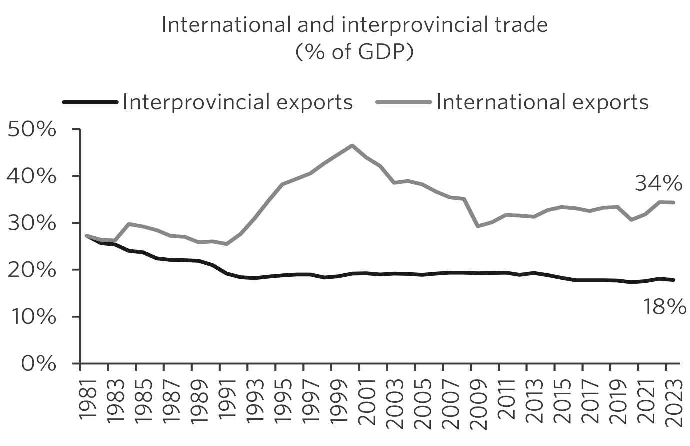
Source: Alvarez, Krznar and Tombe (2019); CIBC calculations

Note: The trade-cost elasticities in this chart are expressed as 1/θ, θ being the trade-cost parameter used in Alvarez et al (2019).

The real barriers are distance and market size

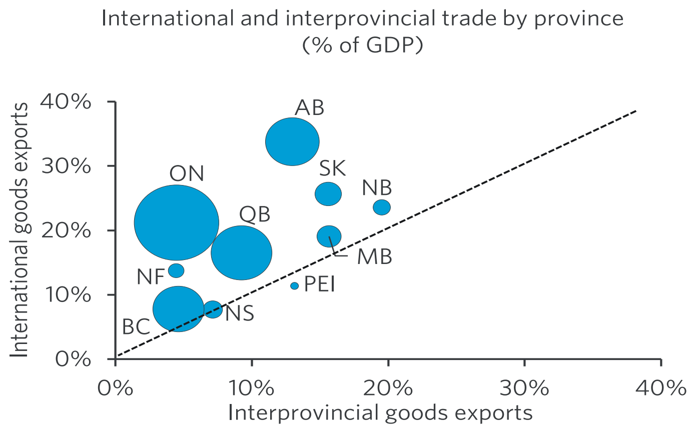
Interprovincial exports have been fairly steady for most of the past 30 years, hovering around 20% of GDP while international exports have followed a boom-and-bust pattern due to NAFTA, the emergence of China, and other global shocks (Chart 2). But since the financial crisis the gap between the two has been about 10-15%-points of GDP. Ontario, Quebec and BC have fairly small shares of goods exports within Canada (5-10%) while the prairie provinces, Atlantic Canada and Alberta have a

Chart 2: Interprovincial trade has been steady for the past three decades, close to 20% of GDP



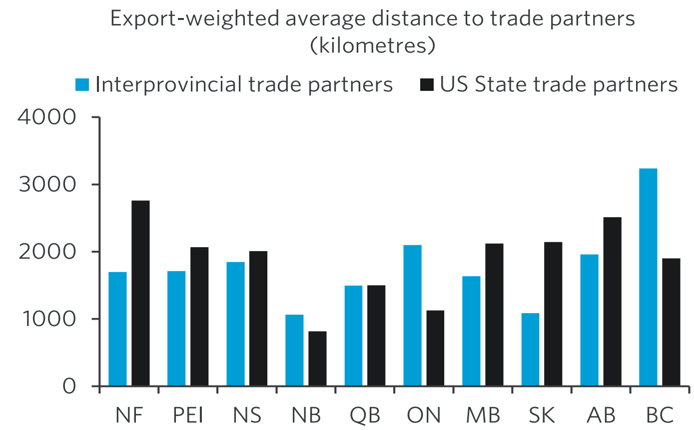
Source: Statistics Canada, CIBC

Chart 3: Larger provinces trade disproportionately more with the US than within Canada



Source: Statistics Canada, CIBC

Chart 5: For most of Canada's largest provinces, US states trade partners are as close or closer than provincial partners



Source: Google Maps, Industry Canada, Statistics Canada, CIBC calculations

higher share of their economies devoted to interprovincial trade (Chart 3).

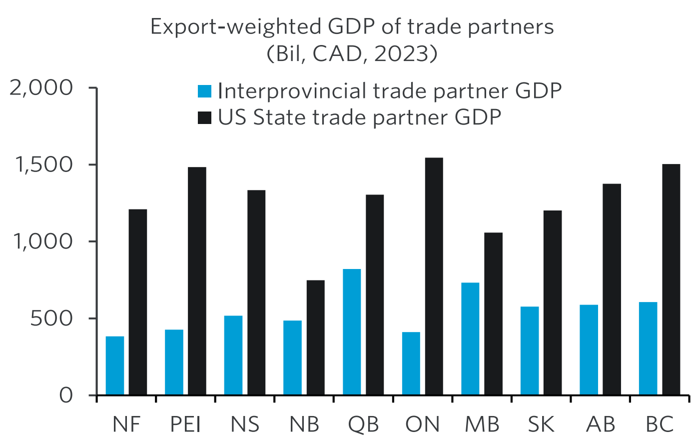
Why is that? Well, for starters, markets south of the border are typically much larger than what's available in the provinces that a given province trades with (Chart 4). On average, provinces' US state trading partners' weighted-average GDP is close to 2.5 times larger than the weighted-average GDP of their interprovincial trade partners, and for Ontario, the gap is close to four times larger.

The other big part of this equation is that the US is closer to the centre of our economies (Chart 5). Unlike some of the existing studies which treat the distance to the US as the distance to Missouri, we measure the distance between each provincial capital and the capitals of their interprovincial and US state trading partners, averaging the distances based on trade shares. For Ontario, BC and Quebec — over 70% of Canada's GDP — their US state trade partners are as close or closer than their interprovincial trade partners. For Ontario, its major US state trade partners are almost 50% or an average 972km closer. Ontario factories ship to Michigan, New York and Ohio, more than to Missouri.

In a recent Statistics Canada survey on interprovincial trade, businesses cite distance and transportation costs as well as a lack of demand as far more important hurdles to interprovincial trade than erected trade barriers (Chart 6). Trade barriers account for about 10% of the reasons why they don't trade in other provinces, compared to distance and transportation at close to 40%, and a lack of demand being about 20% of the reasons cited. That is in stark contrast to the estimates of Alvarez et al (2019) who allocate roughly 40% of the total barriers to trade to non-geographic barriers.

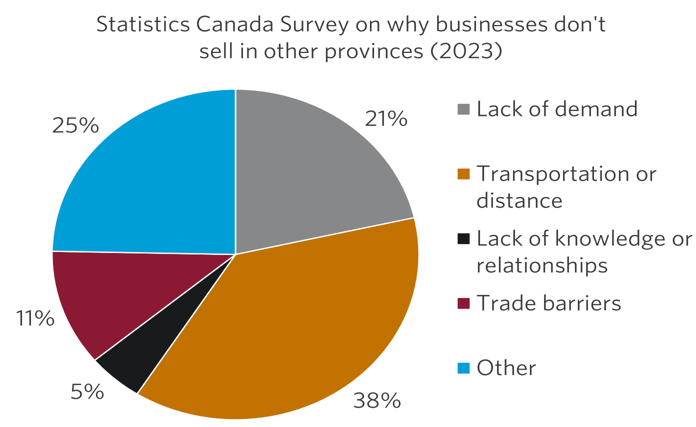
When we put everything together and compare interprovincial goods exports to goods exports to the US as share of their respective market-sizes and average distance — the classic

Chart 4: Size of the US markets provinces trade with is on average close to 2.5 times greater than the interprovincial market



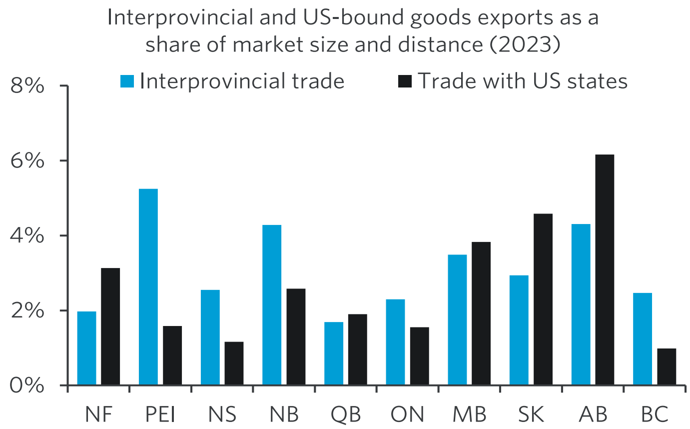
Source: Industry Canada, Bureau of Economic Analysis, Statistics Canada, CIBC calculations

Chart 6: Businesses cite transportation and distance as the biggest hurdle to interprovincial trade, not trade barriers



Source: Statistics Canada, CIBC

Chart 7: Interprovincial trade is as healthy or more than Canada's trade with US states after taking into account market size and distance



Source: Google Maps, Industry Canada, Bureau of Economic Analysis, Statistics Canada, CIBC calculations

Note: This metric is a variation of the classic gravity equation: Exports(i,j) = [GDP(i)^α * GDP(j)^β] / Distance(i,j)^ζ, representing trade between economies i and j. We assume α, β, and ζ are equal to 1 (Chaney, 2011).

gravity equation — the health of interprovincial trade actually doesn't look so bad (Chart 7). Adjusted for distances and market sizes, outside of Newfoundland, Saskatchewan and Alberta where commodity-trade dominates, interprovincial trade looks comparable or better in the remaining provinces than US-bound trade. That doesn't scream out that there is huge ground to make up on the home front if non-geographic barriers are removed.

Worth pursuing internal trade, and an end to the trade war

All that said, removing interprovincial trade barriers is unambiguously a positive step, and the efforts underway deserve to be lauded. But at the same time, we should be cautious in believing these rule changes are going to offset the losses from a protracted conflict with the US. There probably won't be a big pot of gold waiting for us once a new internal trade deal is ratified.

Indeed, the gains that are to be reaped might have more to do with Canada's business sector stepping up efforts to identify markets at home if their exports are disrupted, and by Canadian consumers, business and governments seeking out home grown products due to patriotism, or a desire to avoid retaliatory tariffs on US imports. We'll applaud the efforts underway in that direction. But given the relative market sizes and opportunities, we would also reiterate the need for an all out diplomatic effort to bring a negotiated end to a Canada-US trade war as soon as possible.

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