

Commonwealth Trade Case Studies: Canada

(David Hearne, Centre for Brexit Studies, BCU)

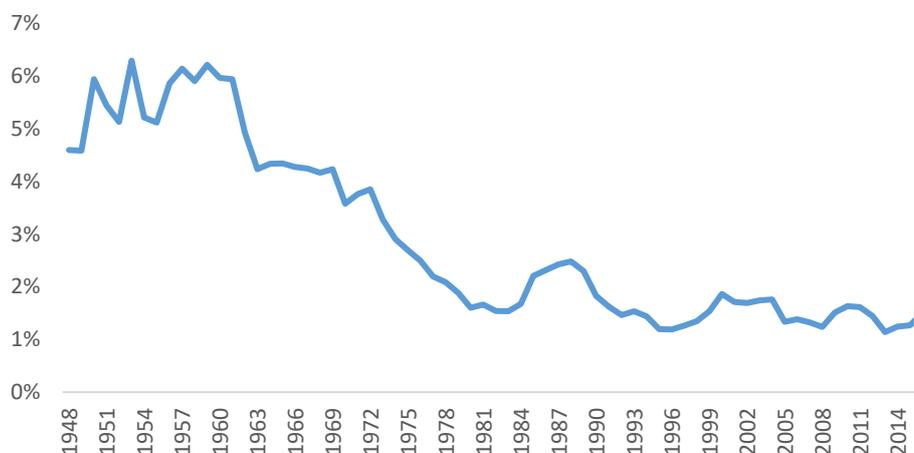
Overview

Canada is one of the world's most advanced economy with a GDP of \$1.64tn in 2017 in spite of its modest population (International Monetary Fund, 2017b). It is affluent with a GDP per capita roughly 10% above that of the UK in purchasing power parity (PPP) terms (International Monetary Fund, 2017b). Business practices in both countries are similar and the legal environment is familiar to a Briton. In addition, Canada has a small but non-trivial British diaspora representing around 1.5% of the total population (Statistics Canada, 2017a). Additionally, some one-third of the total Canadian population have some heritage from the British Isles (Statistics Canada, 2017b).

Nevertheless, today Canada is a relatively small trading partner for the UK representing around 1.5% of exports and 1.2% of imports (Office for National Statistics, 2017). This has declined from around 6% of total UK exports in the late 1950s (International Monetary Fund, 2017a).

UK Exports to Canada as % of Total

Source: IMF DOTS Database

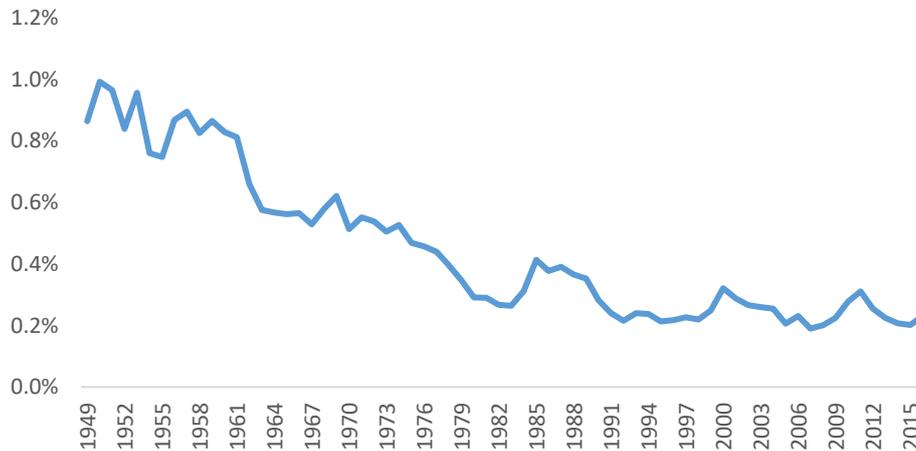


Whilst one might initially hypothesise that the precipitous decline that occurred in the mid-1970s was related to EU membership and the gradual alignment of tariffs that took place between 1973 and 1978, evidence does not show this to be the case. Although trade with Canada shrunk *as a proportion* of total trade, it has continued to grow in absolute terms. One way of getting around this is to assess exports as a proportion of GDP (the latter being largely unaffected by total trade volumes). The chart below shows that exports to Canada fell as a proportion of total GDP until the early 1980s when they stabilised.



Exports to Canada as a Percentage of UK GDP

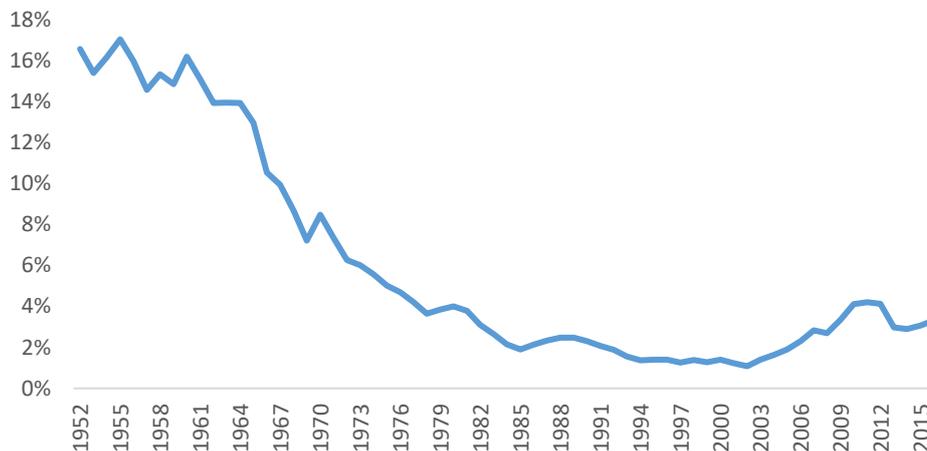
Source: Author's Calculations



As shown below, the same pattern is visible in Canadian exports to the UK, although these appear to have rebounded from their nadir in the early 1990s. On balance, the UK is a more important trade partner to Canada than the converse. In any event, Canadian trade is dominated by trade with the USA, which accounts for around ¾ of total trade.

Canadian Exports to the UK as a % of Total Exports

Source: IMF DOTS Database



The Present Tariff Regime

The Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU has been approved by the European Parliament and is now subject to ratification by national legislatures in the EU. Nevertheless, as of 21st September 2017, parts of the agreement have begun to be applied on a provisional basis (European Commission, 2017a). As a result, the present regime is in transition. At the time of writing, final trade data refers to the pre-CETA period.

Tariffs covering some 98% of trade will be eliminated. However, this will be done in a phased manner, with some tariffs taking up to 8 years to be completely removed ("Comprehensive Economic and Free Trade Agreement," 2017). CETA additionally covers a wide variety of non-tariff barriers. Quotas for a number of food and drink products (e.g. Cheese) will be increased and the requirement for blending imported bulk spirits with domestic spirits will be eliminated for EU countries. Similarly, changes to "cost-of-service" fees by Canadian "liquor boards" mean that exports of European alcohol will be treated in the same manner as their Canadian counterparts (specifically charging will take place by volume rather than by value). This should particularly benefit British Whisky exporters.

CETA also has a number of provisions that will further benefit service-sector businesses. In particular, certain exceptions notwithstanding (e.g. "cultural" services, financial services or air services), both the EU and Canada have agreed to "treatment no less favourable than that it accords, in like situations, to its own service suppliers and services" ("Comprehensive Economic and Free Trade Agreement," 2017, Article 9.3). In practical terms, however, most services remain non-tradable and even amongst those which are, a number of restrictions remain and so it is unclear how much easier trade in services will actually become in practice. These include licensing requirements, the requirement to maintain a local address, professional membership requirements and participation in collective compensation funds ("Comprehensive Economic and Free Trade Agreement," 2017, Article 9.4).

One area in which concrete progress has been made is in the ability to transfer staff between the EU and Canada. Graduate trainees will be permitted to stay for up to a year, whilst specialists may stay for up to three, with the possibility of an 18 month extension ("Comprehensive Economic and Free Trade Agreement," 2017, Article 10.7). As this is one of the major benefits of CETA, it is unclear how the UK will reconcile this with a post-Brexit desire to reduce migration.

Progress has been made in liberalising barriers to the provision of financial services in each other's markets. Nevertheless, whilst the agreement precludes the imposition of arbitrary measures, it continues to permit divergent prudential and regulatory standards. In practice, these protections form a greater part of barriers to trade, in addition to the requirement to maintain local offices. A number of areas (e.g. pensions and social security) are excluded entirely and only a limited number of cross-border services can be offered at all ("Comprehensive Economic and Free Trade Agreement," 2017, Chapter 13).

Government procurement will also be substantially liberalised, potentially benefitting British businesses (Department for International Trade, 2017). Pharmaceutical companies may also benefit from the supplementary patent protection period (Department for International Trade, 2017). Much of the remainder of the document commits both parties to eliminate overtly discriminatory practice and specifies investor protections, whilst also attempting to maintain labour rights, environmental standards and a variety of initiatives pertaining to energy efficiency, corporate responsibility and similar issues.

In practice, overtly discriminatory practices in both Canada and the EU have become increasingly uncommon as emphasis has been put on promoting competition, maximising consumer surplus and efficient markets. As a result, the document codifies and guarantees these rights. What remains to

be addressed are today's more important practical barriers, including regulatory alignment, technical testing and restrictions on the provision of services.

Professional membership requirements or accreditation (e.g. for lawyers or accountants) are often crucially important in order to maintain standards. Nevertheless, whilst a framework has been established that would allow mutual recognition, negotiations will need to take place between the appropriate bodies. Furthermore, recognition of full regulatory equivalence appears to be off the agenda for the time being.

Technical testing is also left as an area for further voluntary cooperation ("Comprehensive Economic and Free Trade Agreement," 2017, Chapter 4). In practical terms, it is difficult to see how the two can ever agree to agree mutual standards for testing and certification of products because of Canada's close integration with the US economy. For post-Brexit Britain looking to "improve" upon CETA, this will be a major issue: one is left with a binary choice – either attempt to maintain equivalence with the EU or move into the American regulatory orbit. In practice, reducing trade frictions with Canada will increase them with the EEA (50% of UK exports and deeply embedded into supply chains).

Similar complications will arise for post-Brexit attempts to facilitate trade in services with Canada. Given cultural, linguistic and legal similarities, it may prove easier for bodies in the UK and to agree on mutual recognition than would be the case in the EU as a whole. Nevertheless, in general there will remain differences that make recognition of legal equivalence challenging or impossible. On the accounting side, Canadian adoption of International Financial Reporting Standards (IFRS) for publicly listed companies simplifies things (*vis-à-vis* the situation that appertained previously). Nevertheless, Canadian "accounting standards for private enterprises" can differ from IFRS in important ways (BDO Canada, 2016).

Challenges thus remain in terms of standardising interpretation and legal differences even for those areas where international agreements are already in place. Financial services will remain sensitive for all parties. Given London's pre-eminence as the EU's financial centre, greater harmonisation and wider access than has been achieved with CETA appears unlikely.

More broadly, the agreement sets out a number of areas where voluntary cooperation is strongly encouraged (including over important areas such as customs checks). Information sharing is rendered more likely as a result of the agreement. Nevertheless, much cooperation remains voluntary and is therefore not legally enforceable. Goodwill between the two sides (and all various sub-agencies) will therefore be important.

Future Prospects

The initial challenge for Britain outside the EU will lie in "grandfathering" the existing CETA arrangements. It is not clear that existing free trade agreements will automatically apply during any transition period. The UK argues that it should continue to benefit from such agreements as it will continue to be legally bound to honour them and is likely to ask the EU to support this position. At present, the EU guidelines state that the UK can continue to benefit from such agreements but the EU cannot guarantee that it will as this also depends upon the agreement of other signatories.

With the wholehearted support of the EU, the UK is likely to be able to roll over most existing agreements but it is not unlikely that some partners may seek to take advantage of the country's lack of leverage in the absence of complete support from the EU. Moreover, it is unclear why such support would necessarily be in the EU's interests unless accompanied by UK concessions in another area. In any event, some legal finesse is likely to be necessary in order to avoid additional non-tariff barriers related to rules of origin etc.

After the end of the proposed transition period, even in the event the UK is able to "grandfather" CETA, there are likely to be a number of challenges around "rules of origin". In particular, at present a car is certified as originating from the EU (and thus is eligible to enter Canada tariff free) if "not more than 50% of the value of the materials has been imported [...] to manufacture it" (European Commission, 2017b, p. 15). At present, any vehicle manufactured in the UK will be covered by the agreement as over 50% of the value of its components are from Europe. If CETA is replicated simply by replacing the term "EU" with "UK" then that will no longer be the case *even though both the UK and EU will be covered by identical agreements*.

As it stands, CETA contains only limited provisions for so-called "diagonal cumulation" (where a UK company using EU components would be tariff exempt because both the EU and UK have an equivalent FTA with Canada). As such, both agreements (CETA and the "grandfathered" CETA that the UK wants) would need to be renegotiated in order for this to apply.

Moreover, if the UK signs an FTA with the EU, the same issue will present itself for those goods (admittedly a small minority) produced in the UK using Canadian components for export to the EU¹. Of course, this problem affects the EU as well as the UK, but to a much lesser degree because of its size – the UK represents around 7% of most EU countries' imports whilst the EU accounts for over 50% of the UK's. Additionally, the paperwork associated with proving rules of origin is onerous, particularly for small exporters.

Nevertheless, there are likely to be areas where the UK could go beyond CETA in the event that it chooses to leave the EEA (as the Government, at present, appears to want to do). Agricultural tariffs and non-tariff barriers are one obvious candidate. Even after CETA, the EU maintains some significant tariffs on certain Canadian agricultural produce. The UK is likely to be far more amenable to removing many of these, perhaps in exchange for greater access for certain service industries.

Alongside this, the EU maintains extremely high (some would argue onerously high) phytosanitary standards and large agricultural subsidies (primarily through the Common Agricultural Policy). The UK has already argued that these should be targeted towards environmental protection rather than farming, theoretically giving the UK additional room to negotiate. Moreover, reducing agricultural tariffs and non-tariff costs will prove of direct benefit to UK consumers.

In practice, given the overwhelming dominance of the US in Canadian trade, removal of non-tariff barriers in services trade is likely to prove challenging. There may be certain minor changes that the UK can make outside of the EEA, particularly if done in conjunction with the relevant Canadian

¹ Imagine a good, 45% of whose inputs come from the UK and a further 10% of which come from Canada. Unless diagonal cumulation is agreed, those goods will be subject to WTO tariffs *even if both the UK and Canada have an FTA with the EU*.

authorities. More broadly, however, if the UK wants to further reduce frictions with the Canadian market it would need to consider moving towards the regulatory orbit of the USA. Business and consumers may prove reticent to do so given different consumer standards in addition to how embedded British businesses are in European supply chains.

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