Intelligence MEMOS

From: Jean-François Perrault and James A. Haley

To: Internal Trade Watchers

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Re: **Picking up the Twenties: A Simple Proposal for Internal Free Trade**

Internal trade barriers are universally understood to needlessly hobble Canadian prosperity even as a "collective action problem" prevents any serious reform.

Tariffs on interprovincial trade are prohibited under the *Constitution Act*, but a range of non-tariff barriers – such as occupational licensing restrictions – impede the efficient allocation of resources and reduce productivity.

The failure to address this is akin to glancing at a $20 bill on the sidewalk, and just walking on past, in the metaphor from former Bank of Canada Governor Poloz.

Estimates of the cost of internal trade barriers vary. Almost 40 years ago, a royal commission calculated the cost at 1.5 percent of GDP annually. Reforms since then likely reduced some costs, while new barriers increased others. There are large potential gains from reform, according to recent studies with the amount of the gain depending on the extent of reform.

The failure to address these trade barriers can may be explained by a collective action problem that stymies mutually beneficial reforms.

Gains from reducing barriers are uncertain and lie in the future, whereas the costs of reform are upfront and all too certain.

It is magnified by the possibility that others may renege such that a province bears the costs of reform without reaping the expected benefits.

And if provincial and territorial unanimity is required, reforms are deferred, leaving all provinces worse off.

We recently proposed an answer to this problem. The federal government should offer financial inducements conditional on the removal of internal trade barriers.

This approach was used to address regulatory fragmentation across jurisdictions in the Australian federation. The elimination of these barriers would increase GDP and grow Ottawa's tax base. Over time, as the full economic gains are realized, the federal fiscal position would not be affected, as it would, in effect, "pick up the twenties."

Four features should tempt policymakers:

First, voluntary participation helps avoids lengthy and potentially divisive judicial reviews and constitutional changes.

Second, as with international trade deals, compliance monitoring could be "outsourced," with private actors – firms or individuals – permitted to seek damages from provinces violating reform commitments. This would build on proposals to enhance the dispute resolution mechanism under the Canadian Free Trade Agreement.

Third, and crucially, the scheme does not require unanimity, reducing possible disruption from hold-out provinces.

Fourth, the proposal is scalable to the reform effort. The only requirements are that payments be tied to reforms undertaken, and that the impact of those reforms on GDP can be estimated.

There are issues to overcome. Obtaining sufficient provincial participation is largest.

Provinces might also be reluctant to participate if the federal government could balk on promised payments. But since the proposal is based on incipient tax revenues, Ottawa would have no incentive to renege. Careful and transparent analysis of reforms and the use of prudent assumptions that ensure expected increases in federal revenues exceed payments would enhance the scheme's credibility. More fundamentally, payments could be subject to a legally binding agreement.

Table I shows illustrative revenue transfers by province based on population and size of economy. The GDP increase in this hypothetical example corresponds to the mid-point of the 3-7 percent of GDP range (depending on reforms) from Albrecht and Tombe (2016). If realized, this boost to GDP would generate additional federal revenues of roughly $15 billion, assuming Ottawa gets 14 cents for every dollar increase in nominal GDP. With payments totalling this amount, projected 2022 provincial deficits would either be eliminated or significantly reduced, regardless of whether payments are made on the basis of population or size of economy.

We do not know if this figure is attainable or the reforms on which it is based are politically feasible. We use it here simply as a metric of the potential gains.

We also need to acknowledge the challenge of estimating the impact of lowering barriers on GDP, an exercise both difficult and subject to a high degree of uncertainty.

Nonetheless, any fiscal risks could be contained by adopting prudent planning assumptions and providing for the recalibration of federal payments if projected output effects prove too optimistic.

Future Canadians may come to view our collective response to the COVID pandemic as a watershed. Reducing interprovincial trade barriers could strengthen the economic union by raising output and generating the revenues needed to address the challenges facing Canada. Exploiting opportunities to improve the economic union – picking up the twenties – can only benefit all Canadians.

Jean-François Perrault is Senior Vice-President and Chief Economist, Scotiabank where James A. Haley is a special advisor.

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Jurisdiction	Revenue Transfer ($ millions) based on:		Budget Balance, 2022[f]
	Population	*Size of Economy*	*($ millions)*
Newfoundland and Labrador	209	248	-587
PEI	67	48	-46
Nova Scotia	401	304	-218
New Brunswick	319	247	-296
Quebec	3,468	2,944	-5,547
Ontario	5,992	5,871	-19,600
Manitoba	557	498	-374
Saskatchewan	474	636	-1,685
Alberta	1,794	2,531	-3,277
British Columbia	2,109	2,032	-5,484

Table I. Illustrative Revenue Transfers and Provincial Fiscal Indicators

Source: Authors' calculations, Statistics Canada and Scotiabank Economics.
f=Scotiabank Economics forecast