



Understanding CETA: An Upgrade for Canada's Global Connections

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History has delicious ironies.

The first attempt by Canada and the European Community to strike a trade agreement was in the early 1970s. Ottawa called it the “Third Option.” Canada’s first trade option was hit when, in 1971, Republican President Richard Nixon imposed tariff surcharges on Canada (and everyone else) – the so-called Nixon measures. Canada’s second trade option was hit when, in 1972, the United Kingdom joined the European Community, eroding Canada’s position under the system of British Imperial preferences. So Canada approached the European Community, its third option, and struck a trade deal (though not a strong one) under Prime Minister (Pierre Elliott) Trudeau.

Fast forward four decades, another Republican president is threatening to impose tariff measures on Canada (and everyone else), the UK is leaving the European Union (thereby hurting Canada’s negotiated preferences to that market), and Canada and the European Union have struck a trade deal under Prime Minister (Justin) Trudeau.

Thankfully for Canada, this deal, the Comprehensive Economic and Trade Agreement (CETA), is much stronger than the Framework Agreement for Commercial and Economic Cooperation that was achieved in the 1970s. And it could not come at a better time for both Canada and our European partners.

CETA is a very important statement for the international community at the present time. It affirms a commitment to rules-based trade, to open economies, and importantly to multilateralism. CETA not only lowers actual barriers to market access, but also improves on both Canada’s and the EU’s previous binding commitments under the World Trade Organization’s (WTO) rules, both in regards to tariffs and to non-tariff barriers (NTBs) that control market access to services, investment, and government procurement. These

binding commitments create greater certainty of market access for the parties to the agreement, in addition to the improved market access on an applied basis.

This is a striking contrast to the direction being taken in the United States, where the Trump Administration has created uncertainty about its commitment to a rules-based system in numerous ways and done this repeatedly in a number of contexts. These include the US Trade Representative's statement of the President's 2017 Trade Policy; a speech by Peter Navarro, head of the White House Trade Policy Council to the National Association of Business Economists (Lopez 2017); and the US position at the G20 (RTE 2017). These positions include resisting the routine reaffirmation of support for the multilateral system and pointed emphasis on the primacy of Congressional authority in connection with WTO rulings; rejecting binational panels to adjudicate disputes under the North American Free Trade Agreement (NAFTA); and rejecting regional trade agreements, as evidenced by the US withdrawal from the Trans-Pacific Partnership (TPP) and threatened withdrawal from NAFTA, in favour of bilateral negotiations in which the United States would typically have a stronger hand vis-a-vis its negotiating partner.

In this context of sharply heightened uncertainty, the entry into force of CETA is even more important for what it signals than for its economic impact – but its economic impact is also not insignificant.

1. The Economics of the CETA

With the benefits of trade and free trade agreements (FTAs) very much in question today, it is useful to step back and consider why it is that countries trade. This can be hard to visualize when dealing with large economies like Canada and the EU, which produce a wide range of goods and services, but it is very easy to understand if one thinks in terms of a smaller economy, like Iceland. Without trade, Iceland's 330,000 people would live off fish and seasonal vegetables – a very poor lifestyle indeed. With trade, Iceland has the per capita gross domestic product (GDP) of an advanced country and enjoys the myriad products the entire world has to offer, from tropical spices to Caribbean vacations. Thus, the benefits of trade are essentially the benefits of imports.

Notwithstanding this, governments typically put the emphasis on exports in selling FTAs, which is sometimes decried as mercantilist. In reality, it is not mercantilist, but quite sensible. It is easy to go shopping in the global mall if one has an income – getting the job that generates the income is the hard part of the equation. A country's exports represent its job in the global economy. These exports generate the income that provides the foreign exchange needed to buy the world's products. Trade liberalization generates both imports and exports – it's the imports that generate the economic welfare gains, but the exports that get the good press.

Conventionally, the impact of an FTA is assessed using a computable general equilibrium (CGE) model. This model creates a type of fiction or counter-factual by comparing the economy as it actually was at a point in time without the CETA and how it would have been if, at some point in the past, the CETA had been put in place. In modern practice, this comparison is made by projecting the current economic structure into the future and then seeing how the CETA would alter it. This is not a forecast of the future under CETA; rather it is a statement regarding whether the European and Canadian economies are more efficient with the deal, whether the people are wealthier, etc., all else being equal. Typically, when tariffs and NTBs are removed, imports increase and thus welfare increases – and, of course, exports go up to finance the additional imports. Overall, better economic outcomes are reached.

Models put numbers around this broad-brushstroke understanding of trade and help to calibrate expectations about how much trade a given agreement can deliver. Neither Canada nor the European Commission has yet released a formal study on the CETA's likely economic impact based on the negotiated outcome. However, there are some available estimates that provide quantitative perspective.

The two governments' 2008 joint study was based on optimistic premises. It assessed the deal's potential if both economies liberalized as much as possible, including moving Canada-EU services trade to a level of openness seen within the EU. It found an increase of a tenth of a point of GDP for the EU, a 0.77% increase for Canada, and a 20% increase in bilateral trade, which is a reasonable number for such a relationship that features two already highly open economies.

The European Commission's Trade Sustainability Impact Assessment (SIA) (2011) provides an assessment based on the actual negotiating mandate. For the EU, this study found a 0.02% increase of GDP; for Canada, the GDP gain was estimated to be in the range of 0.2%-0.4%.

Unpublished estimates in a Ciuriak Consulting study based on an analysis of the October 2013 general agreement on the deal, which it undertook for the Government of Nova Scotia, found very similar figures to those in European Commission (2011): welfare and real GDP gains of 0.02% for the EU and 0.24% for Canada.

And finally, a gravity model estimate of the likely impact of an FTA between the EU28 and Canada based on the Baier et al. (2015) model suggests similar levels of welfare gains: 0.02 for the EU and 0.22 for Canada.¹

These gains are not transformative, but are tidy at a time when economic gains have been hard to come by. For companies that are already engaged in Canada-EU trade and still face tariffs or actioned NTBs, CETA will have immediate effects in lowering the costs of market access. For companies not yet engaged in Canada-EU trade, but looking for new and steadier opportunities in an uncertain international trade context, CETA will likely induce new entry into international trade.

This latter effect of FTAs is important, as it drives a lot of interesting developments. When companies enter into trade, they tend to raise the overall level of their game, including by investing more in human capital development and in new physical capital. Access to larger markets also helps them to expand their scale and this drives improvements in their competitiveness. As market share in any given sector shifts towards more efficient companies, the overall productivity of the economy rises. Since this market share composition effect is not explicitly captured in the CGE model results reported above, the CETA might well exceed the expectations that these modelling results show.

2. CETA Features

Tariffs and Tariff Bindings

While modern FTAs like the CETA involve extensive treatment of non-tariff issues, tariff reduction still accounts for an important share of the overall benefits that can be captured in quantitative terms. For example, the EU's 2011 SIA study of the CETA found that about half the gains came from tariff reduction.

However, conventional approaches to quantifying the benefits of tariff liberalization overlook a major source of benefits, namely from binding the tariffs at their new lower values (for the most part zero under the CETA). Binding under the CETA improves upon both parties' commitments on tariff bindings under the WTO Agreement. For example, Canada unilaterally lowered tariffs on a variety of industrial inputs in Budget 2010, but it did not bind them, meaning that it reserved the right to raise them back to WTO bound levels. And, indeed, recently, Canada graduated several countries to which it had granted general preferential tariff status back to most-favoured nation (MFN) tariff levels, raising the tariffs faced by those countries in trading with Canada. Similarly, the EU has suspended many tariffs (e.g., on blueberries), but is free to re-impose them without incurring WTO penalties. CETA prevents such retrograde actions.

CGE modelling shows zero trade gains from binding tariffs that are already at zero on an applied basis; yet, for businesses, the increased certainty that these tariffs will indeed remain zero in bilateral EU-Canada trade can induce investment in production capacity and indeed entry into exporting by creating stability and predictability. The models thus quantify tariff elimination, but fall short on describing the impact of tariff binding and thus underestimate the impact.

Goods Trade Facilitation

In terms of facilitating trade in goods, CETA features state-of-the-art commitments on customs procedures and other

1 Private communication with Jeffrey Bergstrand.

measures affecting border transit. However, both Canada and the EU had previously signed and ratified the WTO's Trade Facilitation Agreement (TFA), which set a new high bar for disciplines on border measures. Though CETA reaffirms these standards, it does not materially improve upon them and thus cannot be given credit for any improvements.

The CETA does make some sector-specific NTB reductions, but these are quite modest. A company must spend a significant amount in both money and time/hassle costs to have its products certified for foreign markets. The CETA gives mutual recognition to conformity assessment bodies (CABs). Being able to use domestic CABs to certify one's products for international markets facilitates the process and reduces the cost to individual traders. The overall scale of savings at the economy-wide level is, however, likely to be relatively small. CABs' revenue appears to be on the order of about 0.2%-0.3% of the annual sales of goods, including both certifications for domestic markets (which are not facilitated by CETA) and for export markets (which are, but only on a bilateral EU-Canada basis).

Services Trade Facilitation

The CETA's main liberalization of cross-border measures in services trade comes in respect of improving conditions for the movement of persons, which is important for companies that invest and sell abroad, specifically those that provide after-market service. Unfortunately, any increased ease of movement of persons across borders generated by the agreement cannot be readily quantified, as this feature is not integrated into mainstream CGE models. This omission, yet again, contributes to understating the CETA's impacts.

Otherwise, CETA does not materially impact on Canada's or the EU's scores on indexes of cross-border services restrictiveness; however, it does improve on both parties' bindings under the WTO General Agreement on Trade in Services (GATS). This squeezes "water" out of the GATS bindings and, in so doing, reduces uncertainty about future market access for services firms.

Reducing uncertainty in services markets is likely to have a similar trade liberalizing effect to that of reducing uncertainty in goods market access: greater preparedness of firms to

make the commitments to enter into trade (see, e.g., Ciuriak and Lysenko 2016), with consequent improvements in their performance.

Investment Facilitation

Canada and the EU both already have very open foreign direct investment (FDI) regimes and CETA has comparatively little work to do in this area. Notably, the economic literature on FDI concludes that bilateral investment agreements – including investment chapters in FTAs – have no robust impact on FDI inflows, so expectations should be appropriately calibrated.

The major controversy over CETA in the EU was, of course, over the investor-state dispute settlement (ISDS) mechanism and, thus, the investment chapter will not in any event be part of the provisional implementation of the CETA.

Government Procurement

The CETA significantly liberalizes government procurement regulations for European companies in Canada, greatly expanding the range of Canadian procurement that is formally open to EU-based bidders on a non-discriminatory basis.

How much cross-border trade this will generate is an open question. Even within the EU, where there is free and open procurement on a cross-border basis, at least 94% of all procurement is done through local establishments (Kutlinova-Dimitrova and Lakatos 2014). That is, when German companies, for example, seek to apply for government procurement projects in Portugal, they are more likely to operate from subsidiaries in Portugal rather than to provide the goods or services from their domestic establishments. In part, this is likely dictated by the local nature of much procurement – construction, building maintenance, services, etc.

Still, the CETA will improve on the amount of government procurement that can be done across borders and will likely provide a fair increase in business to those companies able to trade on this basis. However, going by past experience, this will not be game changing for the economy as a whole.

Conclusion

The CETA represents a tidy deal for both parties. It will not be economically disruptive and will encourage companies that are not currently trading to do so, which will have a positive economic impact on both sides of the Atlantic.

There are two areas, however, where the CETA could be substantially improved in my view.

First, through adoption of accommodating rules of origin, the CETA would encourage small and medium-sized enterprises (SMEs) to trade. Rules of origin (ROOs) dictate which products qualify for lowered tariffs. Typically, the rules are waived for shipments with a face value of \$1,000 or less. Above that value, products must be shown to “originate” within the free trade area to qualify for lowered tariffs. This involves paperwork and, depending on the specific rules that apply, a company may have to document the product’s entire supply chain and maintain those records in case a country’s customs authority performs a compliance audit. Evidence shows that smaller shipments facing lower tariffs often do not take advantage of preferential market access and instead shippers choose to pay the MFN tariff. This suggests that complying with ROOs is not a negligible task. Additionally, eBay research indicates that there is significantly greater use of e-commerce-based trade within the EU, which does not require ROOs, than when ROOs come into play in extra-EU trade. Thus, a liberal rule for *de minimis* shipments could greatly improve the CETA for SMEs and for e-commerce more generally (e.g., see Ciuriak and Melin 2014).

Ciuriak and Bienen (2014) propose that the *de minimis* waiver for ROOs certificates be based on the face value of duties payable rather than the face value of trade. Firms could then ship more goods of greater value before reaching the threshold that triggers the need for full ROOs documentation. As they note, in the case of a low tariff of say 1%, the duties payable on 100,000 euros worth of goods would amount to only 1,000 euros. In such cases, there would be minimal incentives to cheat. Allowing such shipments to take advantage of preferences without ROOs certificates would enable small businesses to make commercially significant shipments without the hassle and cost of ROOs documentation but also without compromising the enforcement of the overall system

of preferences. Harris (2017) similarly recommends greater flexibilities along these lines.

The CETA text (Article 24 of the ROOs Protocol) provides for a waiver for ROOs certificates for low-value shipments, but only in the same breath as dealing with goods imported as part of the personal luggage of individuals – which implies not at any commercial scale. While the outcome ultimately will turn on implementing regulations, the CETA could give a stronger signal for an accommodating ROOs regime.

Second, the CETA ISDS mechanism, while a substantial improvement upon existing mechanisms in procedural terms, could be further improved. In response to criticisms that ISDS produces a “chilling effect” on public-sector regulation, governments have persistently reiterated that ISDS does not compromise their continued right to regulate – see, for example, the Canada-EU Joint Interpretative Instrument on CETA (CETA 2016). However, such statements fall short of providing substantive guidance to arbitration panels as to exactly when it is that government regulation is “legitimate” – that is, when it is based on justifiable grounds for policy changes – and when it may be deemed to be arbitrary, capricious, or lacking in public purpose.

The foundation for public regulation of private affairs is the presence of externalities – impacts of economic activities that the market does not address and that are therefore left to public policy to regulate. In Ciuriak (2016), I propose the introduction of specific criteria for arbitration awards that balance the expected profits from an investment with the expected costs of negative externalities that regulation addresses. This could be used to further clarify the current stipulation that the award not be greater than the loss suffered by the investor.

To summarize, the CETA is an important agreement for both Canada and the European Union. It is being implemented at a time when uncertainty about international trade relations is rising and, in addition to generating valuable economic benefits to both parties, it sends an important signal about commitment to open borders, support for the multilateral system, and for sustainable economic development.

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