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Redesigning Canadian
Trade Policies for
New Global Realities



Edited by Stephen Tapp, Ari Van Assche and Robert Wolfe

About this chapter

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Redesigning Canadian Trade Policies for New Global Realities, edited by Stephen Tapp, Ari Van Assche and Robert Wolfe, will be the sixth volume of *The Art of the State*. Thirty leading academics, government researchers, practitioners and stakeholders, from Canada and abroad, analyze how changes in global commerce, technology, and economic and geopolitical power are affecting Canada and its policy.

The Potential to Enhance Canada's Services Trade in CETA, TPP and TiSA

Erik van der Marel

THE RULES GOVERNING INTERNATIONAL TRADE IN SERVICES INCREASINGLY ARE BEING negotiated through large regional trade agreements. Services feature prominently in Canada's recently concluded Comprehensive Economic and Trade Agreement (CETA) with the 28 members of the European Union and in the 12-country Trans-Pacific Partnership (TPP). Canada is also currently involved in the 50-country Trade in Services Agreement (TiSA). (See the appendix to this chapter for a list of the countries involved in CETA, the TPP and TiSA.) Services are important for Canada's trade for several reasons:

- > Services represent a large part of aggregate economic activity, accounting for over three-quarters of Canada's gross domestic product (GDP) and employment (see Miroudot, in this volume).
- > With more sophisticated measurement techniques, value-added data reveal that services contribute much more to international trade than was previously thought based on conventional gross trade statistics (see De Backer and Miroudot, in this volume). For example, the distribution sector — which includes wholesale and retail trade — and the business services and transportation sectors are responsible for the lion's share of value added embodied in the manufactured goods Canada exports.
- > Over the past decade, Canada's international services trade has grown faster than its goods trade — in addition to being less volatile — with particular strength in key sectors such as finance and insurance, management services and computer and information services (Palladini 2015).
- > Because a local presence is often crucial to deliver and sell services effectively abroad, the role of foreign affiliates in Canada's global commerce has increased. In fact, by 2012, the value of Canada's foreign affiliate

services sales overtook that of foreign affiliate goods production and became about twice as large as Canada's services exports (see Koldyk et al., in this volume).

- > Canada still maintains significant trade restrictions in some important services sectors — even though it ranks near the average in the Services Trade Restrictiveness Index compiled by the Organisation for Economic Co-operation and Development (OECD) (see Miroudot, in this volume).

Despite the growing importance of services in its trade, however, Canada appears to be “undertrading,” relative to economic fundamentals, with certain key trade partners. After examining the likely effect of CETA, the TPP and TiSA on Canada's services trade over the medium term, I conclude that the largest untapped potential for growth is with the United States, followed by several members of the European Union. In terms of trade negotiations to pursue these gains, Canada might benefit from the TPP — most notably with the United States, though likely not as much as was hoped for. Naturally, CETA could improve Canada's services trade with the European Union, even though several sensitive sectors were essentially kept off the negotiating table. Finally, TiSA could expand market access to a broader set of countries, although the ultimate level of ambition in this deal remains to be tested.

At the same time, I argue that Canada does not need to negotiate trade agreements in order to develop a more competitive services sector. Canada has plenty of opportunities to remove domestic restrictions unilaterally or to lock-in existing trade preferences, particularly in services sectors that are important inputs to the rest of the economy but where barriers to foreign entry remain high, such as in transportation, finance and telecommunications. These actions would provide broader economic benefits to Canada's economy over the long run even if outstanding trade agreements are not implemented in a timely fashion.

Canada's Services Trade Performance and Potential

AS A SHARE OF GDP, CANADA'S EXPORTS OF SERVICES ROSE FROM 3.0 PERCENT IN 1981 to a peak of 5.4 percent in 2004 before falling somewhat to 5.0 percent in 2015.¹ Canada has a well-diversified export basket of services, with the most active areas being business services — a key component of Canada's comparative advantage is in accounting, financial services, engineering, architecture, telecom and computer services — followed by travel and transportation.

Canada's most important trading partner for services is the United States, the destination of more than half of its services exports. France, Canada's second-largest services trade partner, in contrast, accounts for only 3.4 percent of services exports. Similarly, more than half of Canada's services imports are from the United States, followed by the United Kingdom with 4.5 percent. Other notable trading partners for Canada's services are China, Hong Kong, Japan, Mexico and Australia, all of which, except China, are involved in ongoing trade negotiations with Canada.

The extent to which Canada stands to gain from trade agreements with various trading partners varies considerably. One way to shed light on the upside of Canada's services trade potential is through gravity analysis. This approach shows how much a country's exports differ from a gravity model's predictions based on factors such as distance, the size of the country's GDP and endowments such as the quality of the labour force, information and communications technology infrastructure and the regulatory environment, all of which also affect trade costs.² If Canada exports more services to a given country than the gravity model predicts, it is said to be "overtrading" with this partner; conversely, Canada is "undertrading" when actual values are below the model's predictions (see table 1) which reports results for the top 10 countries with which Canada is estimated to be under- and over-trading based on the structural factors described above). These results provide useful, if noisy, signals suggesting that Canada could improve its services trade more with particular countries, especially if it implements more supportive services trade policies.

Using such gravity analysis, an important finding — consistent with that of Anderson, Milot and Yotov (2014) — is that, even though the United States is by far Canada's top services export market, Canada is significantly undertrading with that country, as well as with several EU members, including France, the United Kingdom, Belgium, the Netherlands, Italy, Spain, Denmark and Ireland. On the other hand, Canada is overtrading with China and Hong Kong, as well as with certain tax havens such as Barbados and Bermuda — likely related to financial services flows.

Another approach to gaining some insight into Canada's services trade prospects is through a services trade complementarity index, which tries to capture the "goodness of fit" between Canada's services exports and its trading partners' services imports. This approach assumes that each trading partner will

Table 1

Canada's services exports to various countries relative to gravity model predictions

| Top 10 countries with which Canada is undertrading | Top 10 countries with which Canada is overtrading |
|---|--|
| 1. United States | 1. China |
| 2. France | 2. Hong Kong |
| 3. United Kingdom | 3. Barbados |
| 4. Belgium | 4. Sweden |
| 5. Netherlands | 5. Bermuda |
| 6. Italy | 6. Malaysia |
| 7. Spain | 7. Russia |
| 8. Denmark | 8. Indonesia |
| 9. Australia | 9. Saudi Arabia |
| 10. Ireland | 10. Trinidad and Tobago |

Source: Author's calculations based on the World Bank, Trade in Services Database, World Development Indicators and Services Trade Restrictiveness Index.

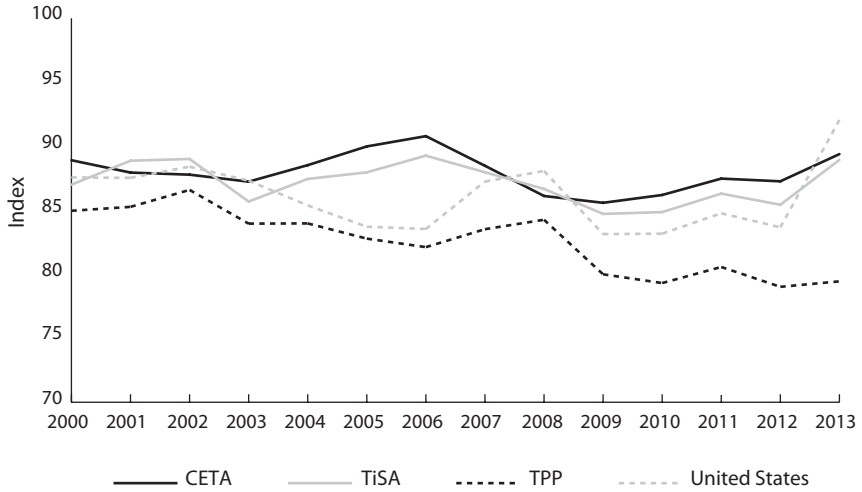
Note: A global gravity model is estimated for all of the trade relationship across the world using data for 2013, or the most recently available for the country from 2011 or 2012. This table shows only a selection of results for Canada.

benefit more from exporting in its areas of comparative advantage and from importing in its areas of comparative disadvantage (for further details, see Cadot, Carrère and Strauss-Kahn 2011). A higher score indicates that the country is better-suited as Canada's services trading partner, while a lower score indicates less potential to expand Canada's exports to these countries.³ As figure 1 shows, Canada's complementarity scores are high for all three trade agreements recently concluded or still in negotiations (generally in the 80s out of 100), which indicates that the country groupings in these trade deals are a reasonably good fit for Canada. A smaller point to note is that, although the good match between Canada and its CETA and TiSA partners has been relatively stable over the past decade, the services trade complementarities between Canada and its TPP partners — the United States aside — have declined slightly over this period.

A third perspective on Canada's services trade can be gained by estimating how its relative "services presence" differs with the countries in each trade agreement. For this purpose, figure 2 displays a trade intensity index that indicates if the value of trade between the partners is greater or smaller than expected based on their importance in world trade. Here, the index is measured by the share of

Figure 1

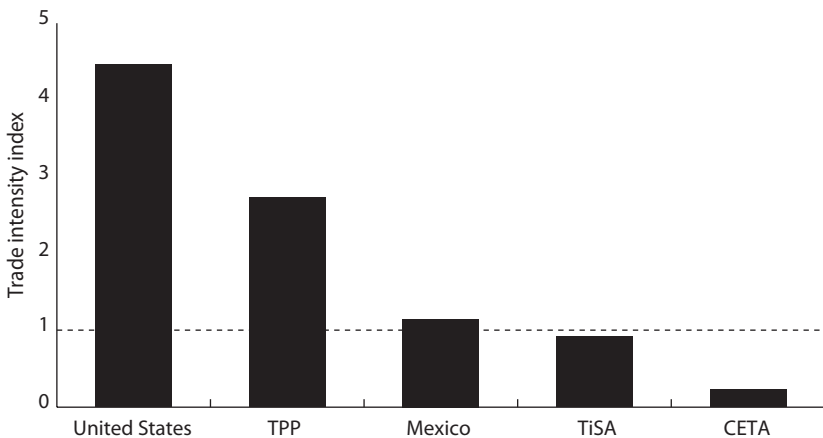
Trade complementarities between Canada and its partners in major proposed trade agreements, 2001-13



Source: Author's calculations based on World Bank Trade in Services Database.

Figure 2

Intensity of Canada's trade with NAFTA partners and partners in proposed major trade agreements, compared with world average, 2013



Source: Author's calculations based on World Bank Trade in Services Database.

Note: Excludes services exports markets of trading partners belonging to the same agreement.

Canada's services exports to each of these agreements' trading partners, divided by share of the world's overall services exports to each of these agreements' collective markets. A value of more than 1 indicates that Canada's bilateral trade flows with these countries are larger than the world average and, thus, that Canada already has a higher-than-average services presence in these markets prior to the implementation of these agreements. In these results, the United States and Mexico are reported separately from the rest of the TPP partners in order to assess the potential incremental benefits of free trade with the others as an add on to the North American Free Trade Agreement. By this measure, Canada is already trading relatively intensely with its partners in the TPP overall. On the other hand, Canada exports slightly fewer services to TiSA countries, and far less to the European Union, than the world average.⁴

In sum, there is potential for Canada to expand its services exports to the United States and to several EU countries. However, although Canada is already quite active in the US market, it is much less so in the European Union, as seen in its low services trade intensity with its CETA partners relative to the global average. At the same time, Canada has quite a high trade complementarity with both the United States and the European Union. Finally, trade negotiations might open up the markets of some countries — including Israel and South Korea — that are not in either CETA or the TPP, but are negotiating TiSA. Indeed, in 2015, Canada implemented a new trade deal with South Korea and modernized its existing agreement with Israel.

CETA and what might be done without trade agreements

SINCE CANADA IS UNDERTRADING WITH EU COUNTRIES WITH RESPECT TO SERVICES exports, it makes sense to tackle, through the CETA negotiations, regulatory trade and market access policies in those countries that are hampering Canada's exports in areas where it has a comparative advantage. For example, Estonia has high restrictions in engineering and legal services, while Poland has nationality requirements in accounting and auditing, architecture and engineering. Ideally, CETA would address these and other issues that inhibit increasing trade and investment flows. As with any trade negotiation, however, CETA accords special treatment to "sensitive" sectors such as air transport, government and cultural services, telecoms and finance, leaving unchanged restrictions on many services in which Canada is quite productive.⁵

Imports matter, too, which is why Canada's services trade performance could be increased if it were to open up its own services markets by abolishing unnecessary regulations that raise costs in Canada and by reducing market access regulations for foreign services providers operating in Canada. Such moves not only would benefit sectors of the economy in which services are an important input; they would also reduce the significant adverse influence of regulatory measures at the border and behind-the-border on the productivity of the services sector itself (van der Marel 2012). Indeed, inputs such as transportation, finance and telecommunications are essential drivers of aggregate economy-wide productivity (Arnold et al. 2010; Arnold, Javorcik and Mattoo 2011). Better productivity in these sectors, in turn, could help Canada discover new export markets beyond those identified above as having high potential for its services trade.

In Canada, several services sectors — including transportation services and retail — enjoy high levels of protection from international competition. Most restrictions in these services are on foreign entry and investment. For instance, screening approvals for telecoms, cargo and passenger air transport and the distribution sector require that the foreign services provider demonstrate a positive net economic benefit when investments exceed certain thresholds. Domestic investors, in contrast, face no such tests. Under CETA, the screening procedure would remain, but the threshold would increase for EU members (from \$354 million to \$1.5 billion, excluding state-owned enterprises), and at least 25 percent of the board members of Canadian enterprises would have to be Canadian residents or citizens. Restrictions would also remain on the maximum equity share a foreign company can have in the telecoms sector (one-fifth) and on the maximum share of foreign ownership (one-third). Yet, if Canada wants to be truly competitive in services in global markets, it needs to negotiate away policy barriers in partner countries and abolish its own domestic restrictions. Although Canada and the European Union could still push for greater concessions in TiSA, it remains to be seen what that forum can deliver beyond simply locking in previous reforms (see Marchetti and Roy 2014).

Although abolishing regulatory barriers under CETA, the TPP or TiSA should help to lower the trade costs that Canadian firms and consumers face, having a services trade agreement in place does not guarantee to reduce such costs significantly (Miroudot and Shepherd 2014). Accordingly, Canada should seek other ways to lower its trade costs. For one, since regulatory policies within Canada itself affect the competitive environment for its exporters (Sáez et al.

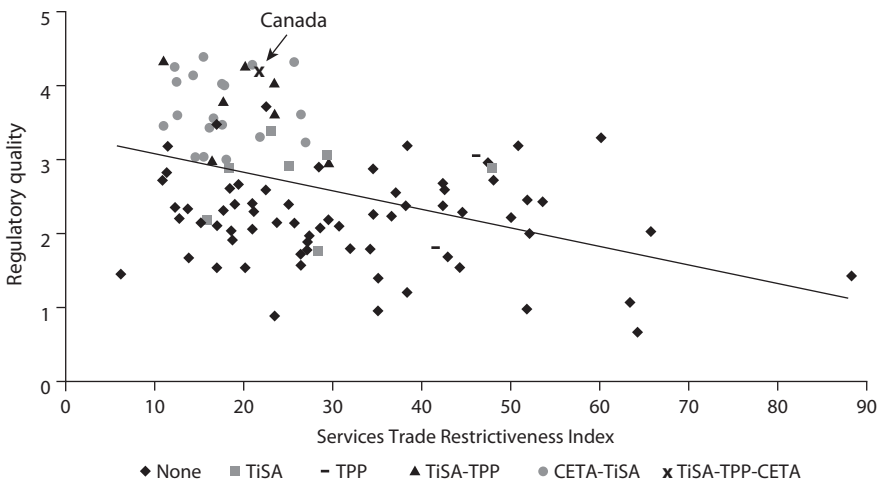
2015; Nordås and Rouzet 2015), reducing restrictions on services trade — which are nondiscriminatory and impact both imports and exports — would improve Canada’s export performance. Such a move could also improve other domestic policies. For instance, with more liberal services markets, Canada would face pressure to increase both its level of human capital (including entrepreneurial ability) and the quality of infrastructure for services, such as telecommunication networks, that facilitate the delivery of services across borders, and to maintain a strong rule of law to ensure foreign confidence in using Canadian services that are contract-sensitive.

Admittedly, these “enabling” factors of services trade are broad and cannot be easily adjusted in the short run, but they nonetheless could promote services trade in the long run. They are also related to a country’s comparative advantage. For instance, Canada has a comparative advantage in business services, which are often complex and require a longer start-up time before workers are fully trained in their jobs. These services are even more sensitive to some of Canada’s domestic economic and structural endowments. Business services not only require strong human capital, but also sound domestic institutions that can enforce contracts between buyers and suppliers. These services often need to be tailored to the needs of individual consumers, and since services are intangible, tailored characteristics are harder to define in contracts. Other important enabling factors that a government can implement are an attractive business environment, improved trade-related infrastructure for services such as logistics services — which, in turn, could help global supply chains function more smoothly — and a better domestic governance framework that regulates services markets.

Undoubtedly, it is essential that the regulatory framework for services markets work well, most obviously because services are regulation-intensive. This requires strong, independent regulators who reduce trade restrictions and implement complementary policies — including competition policy — for open market development after trade liberalization takes place (van der Marel 2016). As figure 3 shows, on average, countries with better overall regulatory quality (countries higher up the vertical axis) also tend to have lower levels of services trade restrictions (countries farther to the left on the horizontal axis). From a global perspective, Canada is relatively well placed, as it exhibits a lower-than-average level on the Services Trade Restrictiveness Index compiled by the

World Bank (which differs from that of the OECD) and governs its markets in a highly competitive manner by comparison. Canada's trading partners in CETA, TiSA and the TPP vary widely in their levels of both regulatory services restrictions and regulatory quality. Most CETA countries have only minor restrictions in place, while their regulatory governance structures are, on the whole, relatively good, making the European Union an attractive services trade partner for Canada. Services are nonetheless an important component of the proposed agreement, which deals with competition policy (Chapter 17) and state enterprises and national monopolies (Chapter 18) in its support of the tradability of services. Again, however, various services sectors are excluded, including audio-visual services (in the European Union), cultural services (in Canada) and financial services and air transport services (on both sides). Notably, in air transport services, Canada would retain not only its high restrictions on foreign entry, but also its many barriers that inhibit competition. These services are essential to Canada's overall trade competitiveness, and ideally should be addressed in the TiSA negotiations, though this might be unlikely.

Figure 3

Relationship between regulatory quality and services trade restrictions, 2009-12


Source: World Bank Services Trade Restrictiveness Index; World Bank Governance Indicators.

Note: The data for the Services Trade Restrictiveness Index are from 2009, the data for regulatory quality are from 2012.

Conclusion

CETA, THE TPP AND TiSA HAVE NOT ACTUALLY BEEN IMPLEMENTED YET, SO THEIR benefits have yet to be realized. Nonetheless, these expected benefits can be described as follows: Canadian services firms would have greater access to the markets of agreement signatories, leading to greater economic benefits. In return, Canada would face greater competition at home from services suppliers based in the trading partner countries, leading to lower prices and more choice for consumers. Since some disruptions and skill adjustments likely would occur, the Canadian government should help smooth this adjustment process by implementing effective skills reallocation policies, given that services are particularly labour intensive. Canada could also do much beyond trade agreements to improve the overall competitiveness of its services sector by increasing skills and information and communications technology infrastructure, and by creating a more efficient logistics structure.

Even with the implementation of these agreements, Canada has to be aware of the potential effects of other proposed deals, notably the Transatlantic Trade and Investment Agreement (TTIP), currently under negotiation between the European Union and the United States, Canada's biggest partner in the North American Free Trade Agreement (NAFTA) and the market for the bulk of Canada's services exports. Even though the likely outcome of the TTIP agreement is not yet known — at the time of writing, expectations are not high (see Francois, Hoekman and Nelson 2015) — the possibility of preference erosion away from NAFTA is a concern. Canadian firms, which already encounter tough competition in the US market (Messerlin 2015), would face still tougher competition there from EU companies if a meaningful TTIP agreement on services were put in place. That said, the services dimension of NAFTA is relatively deep, which should buffer Canadian firms against some of the effects of a deeper TTIP agreement. Similarly, a relatively deep CETA would give Canadian firms an “insurance policy” against tougher competition in the EU market in the event of subsequent agreements between the European Union and other countries.

In the near term, one way for Canada to avoid preference erosion as a consequence of a deep TTIP agreement is to rely on “ratchet mechanisms” that would emulate whatever policies the European Union and the United States subsequently

agree to. Gains could also be realized by establishing effective regulatory councils — of which the Regulatory Cooperation Forum created under CETA is a good example. In the long term, preference erosion could be reduced by pushing for the TTIP to be an open agreement, which would allow other countries to join later if they so desired. Canada and Mexico would be natural candidates to join such an open agreement, given the tightly integrated North American market. Finally, looking ahead at the remainder of the TiSA negotiations, Canada could push for additional market access beyond just locking in the status quo, which would be beneficial for all of the agreement's signatories.

Appendix: Canada's partners in key services trade negotiations

Comprehensive Economic and Trade Agreement (CETA)

- Austria
- Belgium
- Bulgaria
- Canada
- Croatia
- Cyprus
- Czech Republic
- Denmark
- Estonia
- France
- Finland
- Germany
- Greece
- Hungary
- Ireland
- Italy
- Latvia
- Lithuania
- Luxembourg
- Malta
- Netherlands
- Poland
- Portugal
- Romania
- Slovakia
- Slovenia
- Spain
- Sweden
- United Kingdom

Trans-Pacific Partnership (TPP)

- Australia
- Brunei
- Canada
- Chile
- Japan
- Malaysia
- Mexico
- New Zealand
- Peru
- Singapore
- United States
- Vietnam

Trade in Services Agreement (TiSA)

- Australia
- Canada
- Chile
- Colombia
- Costa Rica
- European Union (28 members)
- Hong Kong
- Iceland
- Israel
- Japan
- Liechtenstein
- Mauritius
- Mexico
- New Zealand
- Mauritius
- Norway
- Pakistan
- Panama
- Peru
- South Korea
- Switzerland
- Taiwan
- Turkey
- United States

Notes

1. Statistics Canada, CANSIM database, table 380-0064.
2. See Tinbergen (1962) for the original analysis, or Head and Mayer (2014) for a more recent summary of the extensive literature that followed.
3. More specifically, the trade complementary index would be zero in the extreme case where Canada exported no services that the other countries imported; the index would increase progressively up to the maximum possible score of 100, which indicates ideal trading partners.
4. Also note that Canada's relatively low level of services trade with the European Union depresses trade intensity with both CETA members and TiSA members, since the European Union is a part of both agreements.
5. To provide some examples: EU members such as Estonia have qualification and residency restrictions for legal services. In Poland, audit firms may be established only in certain Polish legal forms, and the government can adopt or maintain any measure with regard to the establishment of placement services of office support personnel. In Austria, foreign accountants, auditors, bookkeepers and tax advisors must pass local examinations and experience requirements and cannot exceed 25 percent of the capital shares and voting rights.

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