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WORLD TRADE CENTRE
TORONTO

WHEN THE COSTS OUTWEIGH THE BENEFITS:

A Proposal for Selective Tariff Elimination

March 2020





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THE STATUS QUO

While import tariffs generate \$6 billion a year in tax revenue from Canadians, they cost the national economy an estimated \$20 billion each year through compliance costs and reduced economic activity.¹

Canada's Customs Tariff is a weighty 1,622-page document, detailing tax rates that Canadians must pay when importing goods from another country. Navigating this system is expensive and time-consuming, particularly for small businesses, and penalties for making a mistake are high.

For instance, goods are broken down into 3,738 different Harmonized System (HS6) codes, an international six-digit code system of classification. Canada then further subdivides these goods into a 10-digit code system, providing over 10,000 different possible classifications for a good. Each of those 10-digit codes can have over a dozen different associated tax rates, depending on the country of origin of the product.

Despite the complexity of the system, most tariff codes generate zero revenue for the government. Often, this is because the associated "Most Favoured Nation" (MFN) tariff

rate for that good has been set to zero. In Canada, 2,390 of the 3,738 HS6 classifications (or 64%) have an associated MFN rate of zero, allowing tariff-free importation of the products. In other cases, goods generate little tariff revenue for the federal government because the vast majority of those goods originate from countries with which Canada has a free-trade deal, such as the United States.

'Free trade,' however, isn't really free. To obtain the zero-rate, Canadian businesses must comply with a complex set of country-of-origin regulations. Several studies² have shown that the compliance costs of these regulations are in excess of 1% of the value of the imports. These compliance costs act as 'hidden tax,' paid by Canadian consumers, but generate no additional revenue for the government.

Overall, import tariffs cost both Canadian consumers and businesses, harming our nation's competitiveness by increasing input costs and drowning Canadian businesses in red tape. There is a pressing need to continue weighting any strategic benefit that specific import tariffs offer domestic industries against the costs associated with administering them.

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WHY IT'S TIME TO ACT

The federal government can boost the Canadian economy by identifying tariffs that generate relatively little revenue and setting their tariff rates to zero — and it can do this at a relatively little fiscal cost. Outlined below are five strong justifications for why the Canadian government should move forward with the unilateral elimination of tariffs.

1 SEND A SIGNAL TO THE REST OF THE WORLD: CANADA BELIEVES IN THE VALUE OF TRADE

We are living in an era of rising trade tensions, with countries threatening (and often imposing) extraordinary tariffs or other trade sanctions. As the past year's dampened global growth has demonstrated, trade uncertainty negatively impacts business confidence and investment. There is a rising trend towards nationalism and protectionism, which erodes exporter confidence, as well as undermines the open trading system that has played such a significant role in both increasing global prosperity and dramatically reducing poverty over recent decades.³

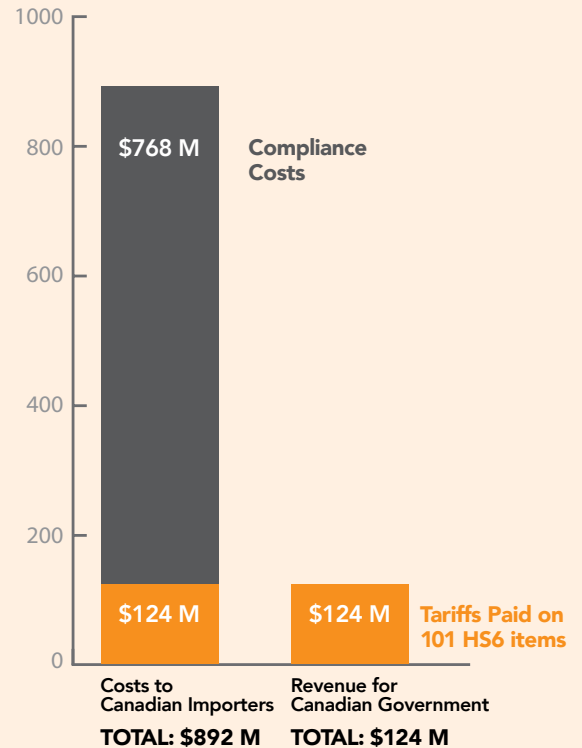
By unilaterally eliminating tariffs, Canada would send a powerful signal to the rest of the world — we believe in the value of free flow of goods and services between countries.

2 TARIFFS IMPOSE SIGNIFICANT COMPLIANCE COSTS TO BUSINESSES, ESPECIALLY SMES

Several studies⁴ have examined the compliance costs to businesses of importing goods tariff free under a trade deal and have found the costs to be in excess of 1% of the value of the shipment. These costs almost entirely disappear if the MFN tariff rate for these goods is set to 0% instead.

CONSIDER THE FOLLOWING EXAMPLE:

There were goods in a set of 432 different HS6 tariff classifications where Canada imported a total of \$76.8 billion worth of goods in 2018, and paid the federal government only \$124M million in tariff revenues, for an effective tax rate of 0.16%ⁱ. This effective tax rate was so low because the vast majority of those imports come from countries with which Canada offers preferential treatment to or has a free-trade deal with. Using a low 1% compliance cost estimate, that \$76.8 billion worth of imports cost businesses \$768 million in compliance costs on top of the \$124 million in tariffs they paid the government.



i. We identify tariffs associated with the Cleantech industry using Statistics Canada's definition. 150.statcan.gc.ca/n1/daily-quotidien/190218/dq190218b-eng.html

The compliance burden is such that it often means that companies don't even use preferential rates in trade deals - opting instead to avoid the paperwork and just pay the higher tariff.⁵ There are economies of scale when it comes to record-keeping and the navigation of complex rules-of-origin regulations that come with free trade. Smaller businesses are far more likely than larger ones to simply pay the MFN tariff rate than try to gain preferential tariff treatment under a free-trade deal. As a result, small business disproportionately benefits when the MFN tariff rates are set to zero.

Canadian businesses also spend millions of dollars each year on court costs to determine the tariff classification and tax rate for their products. Should a bouncy chair for toddlers be considered a toy or a chair? Are espresso machines the same thing as coffee makers? These are the kinds of existential questions answered by the Canadian International Trade Tribunal, in order to determine the tariff classification for a product and, subsequently, how much tax the importer must pay. If there were no import tariffs on these products to begin with, then there would be no need for companies to fight a classification in court, wasting time and resources.

3 REPRIORITIZE BORDER RESOURCES

Ciuriak and Xiao (2014) also found that in 2013-14, CBSA planned to spend \$75 million on the collection of border taxes and management of free-trade agreements. These costs are expected to be lowered by setting additional MFN tariff rates to zero, along with a reduction in the \$2.5 million budget for the Canadian International Trade

Tribunal. While the savings are not likely to be substantial in absolute terms, this is spending and attention that could be better allocated towards more important priorities at the border, such as health and safety.

4 MANY TARIFFS WERE PUT IN PLACE TO PROTECT CANADIAN INDUSTRIES THAT NO LONGER EXIST

In 2018, there were goods from 54 different HS6 codes that contained active tariffs, where Canadian producers exported \$0 worth of made-in-Canada goods, since those products are no longer manufactured in Canada. These include goods such as hair clippers and photographic film, which were once produced in Canada but no longer are. The tariff on crude palm oil, a product not produced in Canada, netted the federal government a grand total of \$983 in revenue while imposing over \$3,000 in compliance costs to Canadian importers. It is clear this type of tariff serves no public policy purpose.

5 TARIFFS ON INPUTS OF PRODUCTION ARE HARMING SOME OF OUR FASTEST GROWING INDUSTRIES

Many of the tariffs imposed by Canada are not on consumer goods, but rather inputs that our manufacturers use in their products. Not surprisingly, a recent Bank of Canada study⁶ finds that tariffs on intermediate goods are particularly harmful to the country imposing the tariff. While the federal government is working on making Canada's cleantech manufacturing industry a global leader, it is imposing tariffs on the thermostats, pumps and hoses that those manufacturers use in the products.ⁱⁱ These tariffs are a tax on our cleantech manufacturers' future success.

ii. For our "non-FTA countries", we exclude any country with which Canada has a trade agreement with or provides any other form of preferential tariff to.



SELECTION CRITERIA

In 2018, there were 3,738 HS6 tariff codes, of which 1,348 were “active” (that is, they had effective tariff rates above zero). In order to determine which of the 1,348 to set the MFN rate to zero, we have chosen a set of three decision rules:

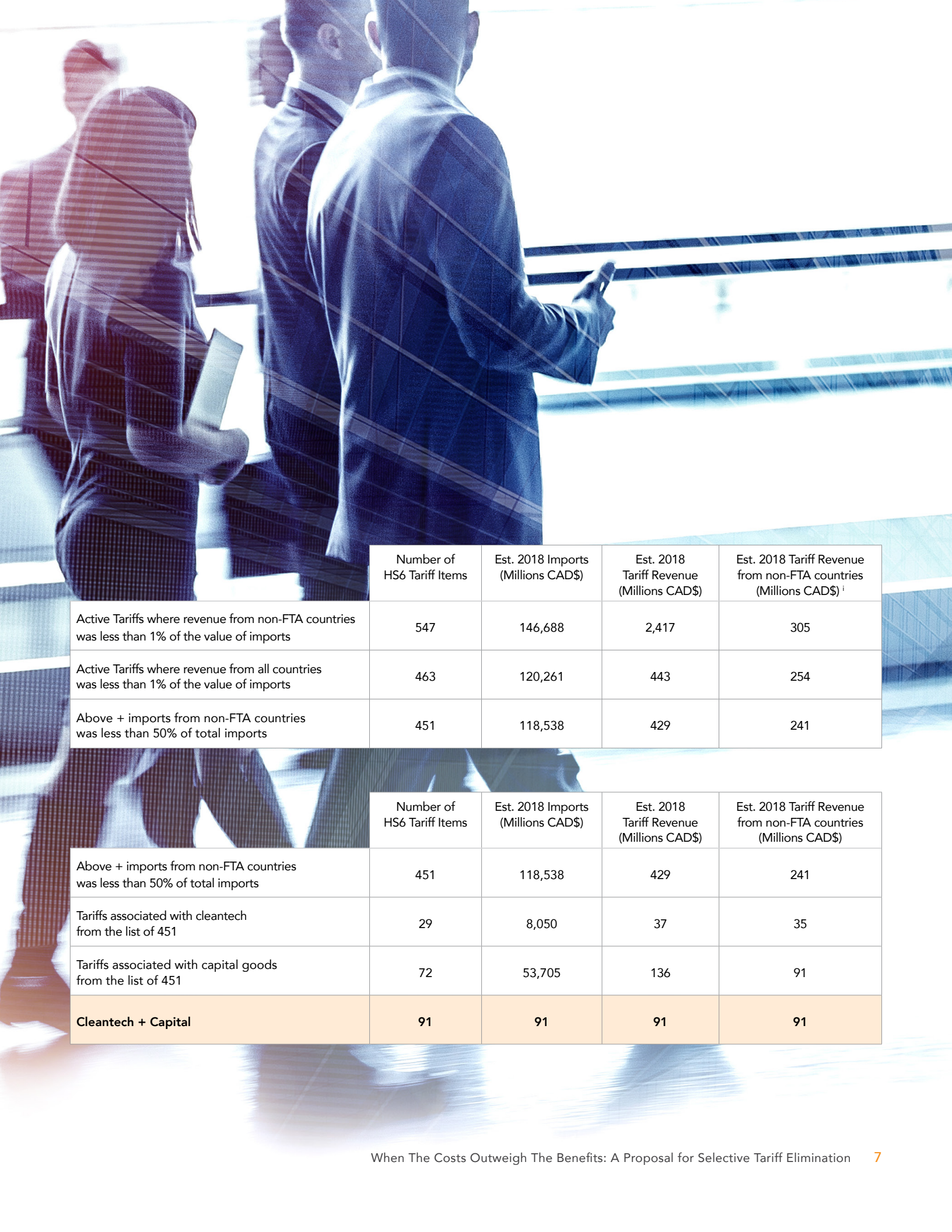
1. There are roughly three dozen countries with which Canada does not have a trade deal and does not offer preferential trade treatment. These countries include China, India, Brazil and Argentina, countries with which Canada may one day attempt to sign a trade agreement. Therefore, only eliminating tariffs where less than half of our total imports are from these three dozen countries is considered.
2. Limit tariff elimination to HS6 tariff codes where the effective tariff rate is less than 1%. It is important to note that not all tariff elimination from CETA, CUSMA and CPTPP trade deals are yet into effect, and that these tariff rates will be reduced once those deals are fully implemented. As a result, the analysis considers only tariff revenue from those countries in point 1 where Canada does not have a free-trade deal or other form of preferential trade protection.
3. To retain tariffs that are needed to protect Canadian businesses, any tariff associated with supply management is not considered. Furthermore, any

goods where the effective tariff rate is 5% or more are excluded, as these are typically goods that are only partly exempted from free-trade deals. Together, these conditions identify most of the tariffs that are used to protect Canadian producers, though a handful may be missed by this method.

Using these criteria, 451 of the 1,348 active HS6 items are identified as candidates for tariff elimination that generate little relative revenue for the federal government and have no apparent strategic value. In 2018, Canadians imported \$142.8 billion worth of these goods and paid the federal government \$429 million in tariff revenue, with only \$241 million originating from countries with which we currently don't have a trade deal with or offer preferential trade status to. The \$241 million figure is closer to the true fiscal cost of this tariff elimination, as the tariff revenue from these items will decline significantly once the Canada-European Union Comprehensive Economic and Trade Agreement (CETA) and Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) are fully implemented.

We recognize that the immediate elimination of 451 tariff items at a fiscal cost of \$429 million may prove challenging, despite the associated long-term economic benefits. As a result, we advocate that the federal government prioritize by eliminating the following 101 tariffs which are associated with the cleantech and manufacturing sectors.ⁱⁱⁱ

iii. In our list of 101, we eliminated any tariff items where Canada's exports exceed two-thirds of the two-way trade value for that good, as we believe these may have strategic value for the government.



	Number of HS6 Tariff Items	Est. 2018 Imports (Millions CAD\$)	Est. 2018 Tariff Revenue (Millions CAD\$)	Est. 2018 Tariff Revenue from non-FTA countries (Millions CAD\$) ⁱ
Active Tariffs where revenue from non-FTA countries was less than 1% of the value of imports	547	146,688	2,417	305
Active Tariffs where revenue from all countries was less than 1% of the value of imports	463	120,261	443	254
Above + imports from non-FTA countries was less than 50% of total imports	451	118,538	429	241

	Number of HS6 Tariff Items	Est. 2018 Imports (Millions CAD\$)	Est. 2018 Tariff Revenue (Millions CAD\$)	Est. 2018 Tariff Revenue from non-FTA countries (Millions CAD\$)
Above + imports from non-FTA countries was less than 50% of total imports	451	118,538	429	241
Tariffs associated with cleantech from the list of 451	29	8,050	37	35
Tariffs associated with capital goods from the list of 451	72	53,705	136	91
Cleantech + Capital	91	91	91	91

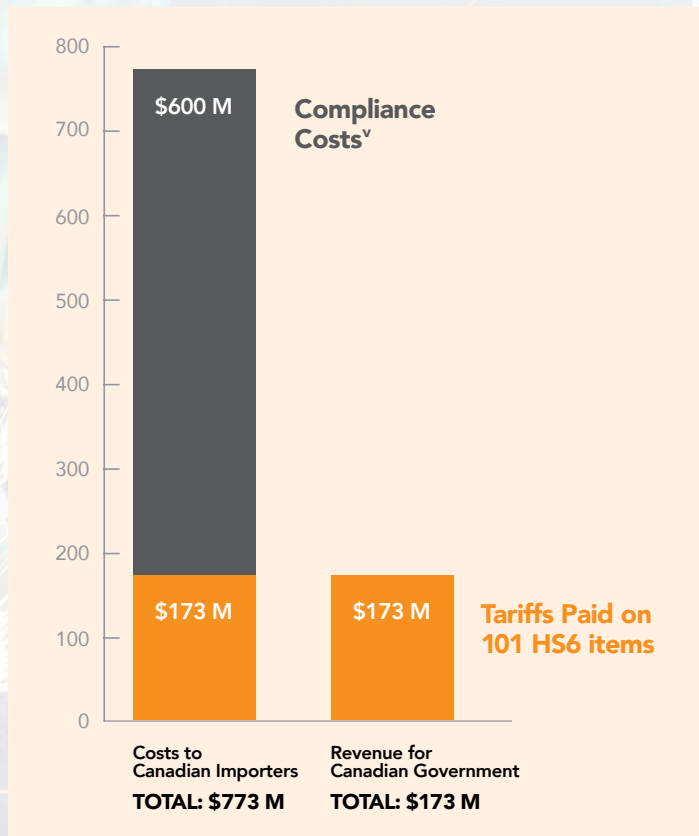


THE PROPOSAL: TARIFFS 101

Given that these tariffs cost Canadians nearly a billion dollars in compliance costs every year, we believe the federal government should eliminate most, if not all, of these 451 different HS6 classifications by setting their MFN tariff rate to zero. As a starting point, we advocate that the government eliminate 101 tariffs in two priority sectors: cleantech and manufacturing.^{iv}

In 2018, Canadians paid \$173 million in tariffs on \$62 billion worth of imports, for an effective tax rate of 0.28%. Eliminating these tariffs (by setting the MFN rate to zero) would not only save importers \$173 million in tariffs paid, but an additional \$600 million in compliance costs.

Doing so would cement Canada's status as a free trade leader, as well as save businesses time and money, redistribute border resources to priority areas and support growing local industries.



Why Manufacturing?

Manufacturing is an integral part of the Canadian economy, generating approximately \$174 billion of our GDP, employing more than 1.7 million Canadians and representing more than two-thirds of our merchandise exports.⁷

The creation of the Next Generation Manufacturing Supercluster (NGen) highlights the importance of manufacturing to Ontario in particular. Across diverse sectors — such as automotive, advanced materials, aerospace, food processing, equipment manufacturers and many others — manufacturing has long formed the backbone of the Toronto region's prosperity. Combined with our world-leading research and innovation clusters, manufacturing will continue to have an important role to play in the new economy.

The government's investment of \$950 million in the supercluster initiative, including NGen, is testament to its significance. Making it easier and cheaper for manufacturers to bring in the capital goods they need would further support NGen's work and the sector more broadly.

Why Cleantech?

While manufacturing is an established industry undergoing transformation, cleantech is an emerging and rapidly growing sector. It has experienced an export growth rate of 40.8% between 2007 and 2017 (with a federal target of reaching \$20 billion in exports by 2025), as well as a growth in imports of 39.8% over the same time.⁸ It is also already a significant employer in Canada — accounting for more than 282,000 jobs today. Forecasts suggest that the sector will grow four times faster than the industrial average over the next 20 years reaching more than half a million jobs by 2030.⁹

With the transition to a low-carbon economy and the growing importance of energy-efficient retrofits, removing low-yielding tariffs will help increase the cleantech sector's competitiveness, as well as make the low-carbon transition cheaper for businesses and consumers. Eliminating these tariffs would also compliment the work of the Regulatory Reconciliation and Cooperation Table (RCT) 2019-2020 work plan, which includes the alignment of "Household appliance energy efficiency standards" to reduce interprovincial trade barriers.

iv. The complete list of tariff codes can be found in the Appendix. v. Compliance costs estimated at 1% of all items where "country of origin" protection used.

THE CASE FOR SELECTIVE ELIMINATION

While eliminating all tariffs by setting the MFN rate to zero would substantially reduce compliance costs for firms and boost the economy, it poses three significant challenges:

1. Canada will want to sign free trade deals with other countries in the future and it needs to save some tariffs 'in reserve' to use as bargaining chips in those negotiations.
2. Overall, the federal government collects over \$6 billion a year in tariff revenue and eliminating all tariffs would place a significant fiscal burden on the federal budget.
3. Some tariffs, most notably the ones on supply managed goods, are necessary to protect Canada's current system of production.

Taking into consideration the challenges above, we are proposing selective, not total, tariff elimination where all three of these conditions are met:

1. Tariffs have limited strategic value in a trade negotiation;
2. Tariffs raise little revenue for the government, relative to the compliance costs they impose on businesses; and,
3. Tariffs do little to protect Canadian businesses and industries.

The federal government already has a strong record of this unilateral and selective approach to eliminating tariffs.

Over the past 20 years, the government carried out unilateral tariff elimination in four separate budgets to lower costs for businesses and help boost competitiveness. The most ambitious round was in Budgets 2009 and 2010, which unilaterally eliminated tariffs on imported machinery, equipment and manufacturing inputs. Together, more than 1,800 tariffs were eliminated, saving businesses \$450 million in annual duties.¹⁰ It also made Canada the first tariff-free zone for industrial manufacturers in the G-20.

Budget 2013 saw the elimination of tariffs on some sporting goods and baby clothes, with an estimated \$79 million a year in savings for businesses. Finally, Budget 2016 eliminated tariffs on a number of inputs used in the agriculture and agri-food sectors.

Given the positive impact the elimination of tariffs has and can continue to have, the government can build on this progress by proactively eliminating the proposed 101 'themed' tariffs, saving businesses more than \$ 773 million dollars annually, and prioritize a low-yield tariffs review to develop further recommendations for unilateral tariff elimination in consultation with relevant industries.

By eliminating these proposed 101 tariffs, we can save businesses more than \$773 million dollars every year.





APPENDIX: 101 TARIFF CODES & DESCRIPTIONS

TARIFFS ASSOCIATED WITH CLEANTECH

PRODUCT CODE	PRODUCT DESCRIPTION
340219	Organic surface-active agents, (excl. soap), ne
340290	Washing and cleaning preparations, not put up f
391732	Tubes, pipes and hoses, not reinforced, without
391739	Other tubes, pipes and hoses, nes
392510	Reservoirs... and similar containers, capacity
392520	Doors, windows and their frames and thresholds
392690	Other articles of plastics, nes
440290	Wood charcoal
460129	Mats, matting and screens of vegetable material
680800	Panels, boards etc of veg fbr,straw etc agglomer
680919	Plaster boards etc not ornamental faced or rein
761090	Structures & parts,alum,eg plate,rods etc,for str
761290	Containers, alum, cap <300L, lined or heated, n
761699	Articles of aluminium, nes, for example casting
841319	Pumps fitted or designed to be fitted with a me
841581	Air cond mach nes inc a ref unit and a valve fo
841869	Refrigerating or freezing equipment nes
841919	Instantaneous or storage water heaters, non-ele
847989	Machines & mechanical appliances nes having ind
850720	Lead-acid electric accumulators nes
850730	Nickel-cadmium electric accumulators
850780	Electric accumulators, nes
851610	Electric instantaneous or storage water heaters
853080	Electrical signalling, safety or traffic contro
870590	Special purpose motor vehicles nes
900190	Prisms, mirrors & other optical elements of any
901530	Surveying levels
902511	Thermometers & pyrometers, not combined with other
902890	Parts and accessories for gas, liquid or electr

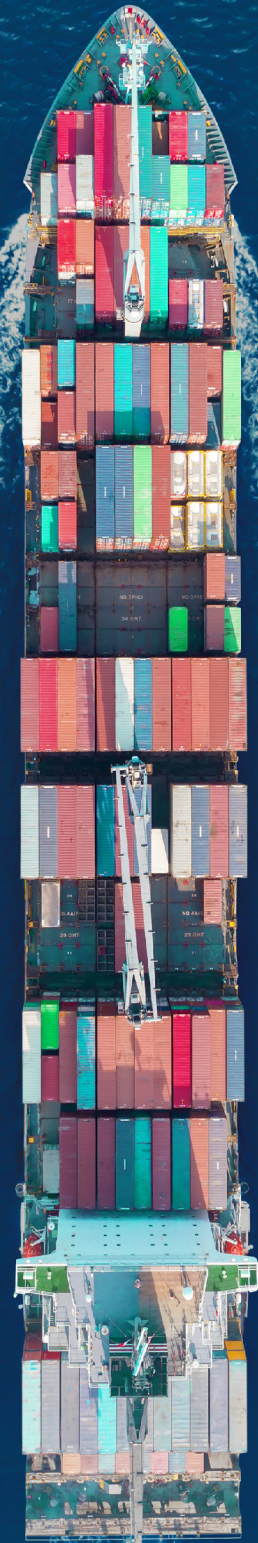
TARIFFS ASSOCIATED WITH CAPITAL GOODS

PRODUCT CODE	PRODUCT DESCRIPTION
730230	Switch blades, crossing frogs, point rods & oth
732219	Radiators and parts thereof, iron or steel, oth
732290	Air heaters, hot air distributors, iron or steel&
761210	Containers, collapsible tubular, aluminium
841311	Pumps with or w/o a meas device for disp fuel/l
841582	Air cond mach nes, inc a refrigerating unit
841810	Combined refrigerator-freezers, fitted with sep
841850	Other refrigerating or freezing chests, cabinets
841891	Furniture designed to receive refrigerating or
842410	Fire extinguishers, whether or not charged
845130	Ironing mach & presses (including fusing presse
845140	Washing, bleaching or dyeing machines (o/t mach
847621	Automatic goods-vending machines, nes
847681	Automatic goods-vending machines, nes
847689	Automatic goods-vending machines, nes
850660	Electro-magnets nes and parts of heading No 85.
851230	Sound signalling equipment
851240	Windscreen wipes, defrosters and demisters
851769	Apparatus, for carrier-current line systems, ne
851829	Loudspeakers, nes
851840	Audio-frequency electric amplifiers
852712	Radio remote control apparatus
853990	Parts of electric filament or discharge lamps,U
860110	Rail locomotives powered from an external sourc
860120	Rail locomotives powered by electric batteries
860310	Self-propelled railway cars powered from an ext
860390	Self-propelled railway cars nes
860400	Railway maintenance-of-way service vehicles
860500	Railway passenger and special purpose coaches,
860630	Railway cars, self-discharging, other than tank
860699	Railway cars nes
860800	Signalling devices for railways, waterways and
870110	Pedestrian controlled tractors
870120	Road tractors for semi-trailers (truck tractors
870210	Diesel powered buses with a seating capacity of
870290	Buses with a seating capacity of more than nine

PRODUCT CODE	PRODUCT DESCRIPTION
870421	Diesel powered trucks with a GWW not exceeding
870422	Diesel powered trucks with a GWW exc five tonne
870423	Diesel powered trucks with a GWW exceeding twen
870431	Gas powered trucks with a GWW not exceeding fiv
870432	Gas powered trucks with a GWW exceeding five to
870490	Trucks nes
870510	Mobile cranes
870520	Mobile drilling derricks
870540	Mobile concrete mixersW
870600	Chassis fitted with engines for the vehicles of
870710	Bodies for passenger carrying vehicles
870810	Bumpers and parts for motor vehicles
870821	Safety seat belts for motor vehicles
870829	Parts and accessories of bodies nes for motor v
870830	Parts and accessories of bodies nes for motor v
870840	Tansmissions for motor vehicles
870850	Drive axles with differential for motor vehicle
870880	Shock absorbers for motor vehicles
870891	Radiators for motor vehicles
870892	Mufflers and exhaust pipes for motor vehicles
870893	Clutches and parts for motor vehicles
870894	Steering wheels, steering columns and steering
870895	Steering wheels, steering columns and steering
870899	Motor vehicle parts nes
870919	Work trucks not electrically powered
871620	Trailers for agricultural purposes
871631	Tanker trailers and semi-trailers
871639	Trailers nes for the transport of goods
871690	Trailer and other vehicle parts nes
890110	Cruise ships, excursion boats etc principally d
901050	Projection screens
901480	Navigational instruments and appliances nes
901710	Drafting tables and machines, whether or not au
961900	Tailors' dummies/lay figures; automata and oth
970110	Paintings, drawings and pastels executed by hand
970190	Collages and similar decorative plaques

ENDNOTES

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2. Including Cadot et al. (2002), Kunimoto and Sawchuck (2006) and Anson et al. (2005).
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8. Statistics Canada. 150.statcan.gc.ca/n1/daily-quotidien/181217/dq181217d-eng.html
9. Clean Energy Canada. "The Fast Lane: Tracking the Energy Revolution 2019." October 2019. cleanenergycanada.org/report/the-fast-lane-tracking-the-energy-revolution-2019/
10. Budget 2013. budget.gc.ca/2013/doc/plan/chap3-2-eng.html



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