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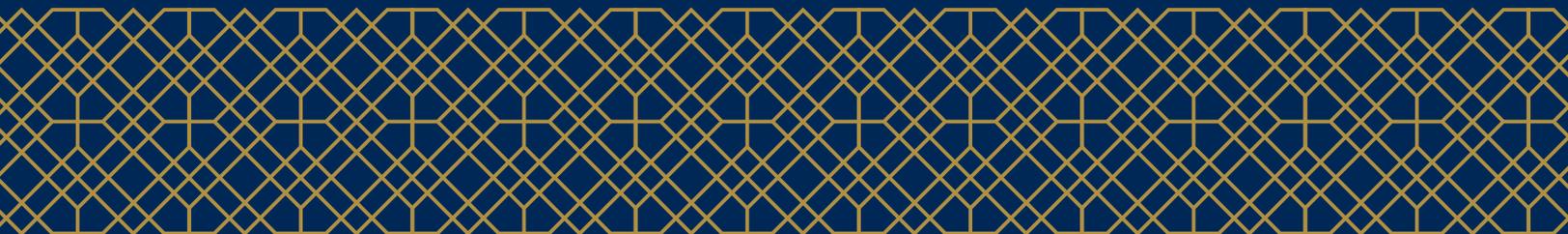


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From Suds to Buds

Canadian Premiers Need to
Make Internal Trade an
Immediate Priority

Summer 2018



About this Document

The Institute of Fiscal Studies and Democracy (IFSD) is a Canadian think-tank sitting at the nexus of public finance and state institutions. Fiscal ecosystems include governments, legislatures, the public administration and other key actors and institutions in our political and economic life. This ecosystem, rooted in hundreds of years of political history and economic development, is composed of an intertwined set of incentives, public and private information and a complex and sometimes opaque set of rules and processes based on constitutional law, legislative law, conventions and struggles for power. The actors within this system depend on one another as well as the robustness and transparency of information and processes, all underpinned by a society's standards of accountability. It is at this dynamic intersection of money and politics that the Institute of Fiscal Studies and Democracy @uOttawa aims to research, advise, engage and teach. The IFSD has been funded by the Province of Ontario to undertake applied research and student engagement in public finance and its intersection with public administration, politics and public policy. The IFSD undertakes its work in Canada at all levels of government as well as abroad, leveraging partnerships and key relationships with organizations such as the World Bank, OECD, IMF and US National Governors Association.

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First Printing: June 2018
No. 18005



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INTRODUCTION

Over the last few decades, Canadian provinces have become increasingly open to trade, both with other countries and with one another. Following a similar trend around the world, this increased openness has supported rising living standards, albeit with fundamental shifts in the employment and economic landscapes.

But while openness has increased, its pace has followed two very different tracks. International trade, for instance, has advanced rapidly on the back of trade agreements spearheaded by federal governments of all political stripes. Meanwhile, interprovincial trade has advanced at a much slower pace. And although progress has been made, most recently in the form of the 2017 [Canadian Free Trade Agreement](#) (CFTA), the recent judgment handed down by the [Supreme Court of Canada regarding the right of provinces to enact tariff-like barriers if they deem it beneficial](#) (in this case, regarding the taxation of beer) demonstrates that there remains a lot of work to be done in liberalizing internal trade in Canada. This judgment also leads to additional questions around taxation and regulation of the movement of cannabis across provincial borders once recreational consumption becomes legal.

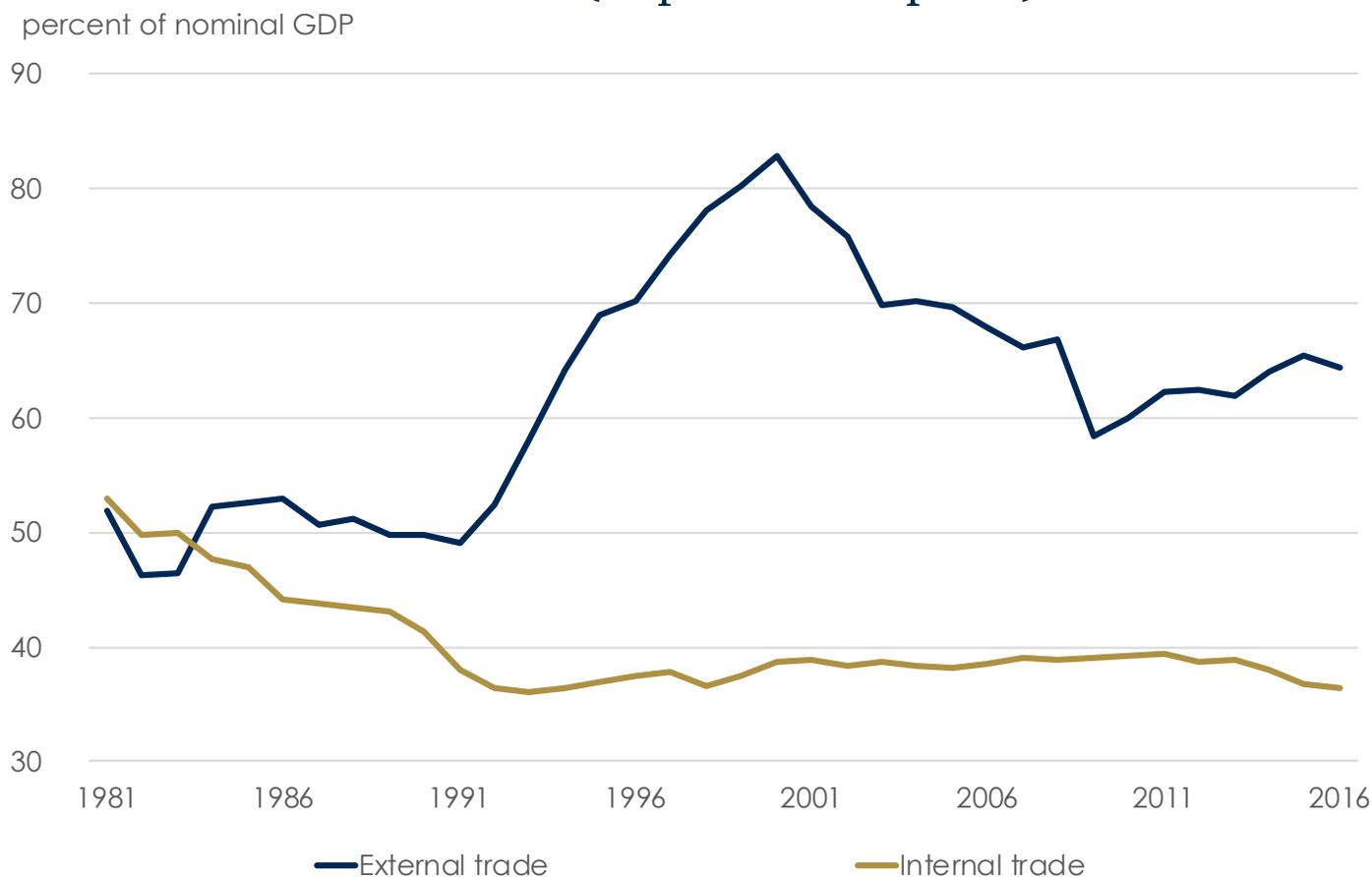
The upcoming Council of the Federation (COF) meeting in New Brunswick provides a good opportunity for Canadian Premiers to reaffirm their commitment to further reducing internal trade barriers in Canada. It is widely recognized that eliminating interprovincial barriers to trade increases economic activity and living standards. And, as such, Premiers should work to unwind the recent setbacks around the interprovincial sale of alcohol and to get ahead of the prospective follies around the sale and transportation of cannabis across provincial borders. But there is a lot more work that needs to be done than just addressing these high-profile issues, as many other long-standing barriers to internal trade remain unresolved. So, against the backdrop of continued free-trade negotiations with our neighbours to the south, what better time than Summer 2018 for Premiers to roll up their sleeves and get to work tearing down the walls preventing trade between provinces.

A BRIEF HISTORY OF INTERPROVINCIAL TRADE IN CANADA

Trade has long been on the minds of lawmakers in Canada. Beginning as early as the Constitution Act, 1867, the Parliament of Canada was given power over the regulation of trade and commerce, as well as the alteration and enforcement of customs and excise laws. Meanwhile, goods and services from one province are to “be admitted free into each of the other Provinces”. Further, the signatories to the Constitution agreed that the exports from one province should not be taxed at a higher rate than other goods produced and sold in the importing province.

But, at the Institute of Fiscal Studies and Democracy (IFSD), our ranks are more heavily populated by economists and accountants than by lawyers. And economists tend to see Canada’s role as a free-trading nation in the modern era really beginning with the Canada-U.S. Free Trade Agreement in 1988. This was followed by the North American Free Trade Agreement (NAFTA) in 1994. These international trade agreements, and others that have followed, have had profound implications for Canadians and the provinces in which they live. New markets were opened to Canadian companies and our country became a destination for the goods and investments of foreign countries. Indeed, supported by a soft Canadian dollar through the 1990s, international trade surged in the decade after these agreements were signed (Chart 1).

Chart 1: Total Trade (Exports + Imports) in Canada

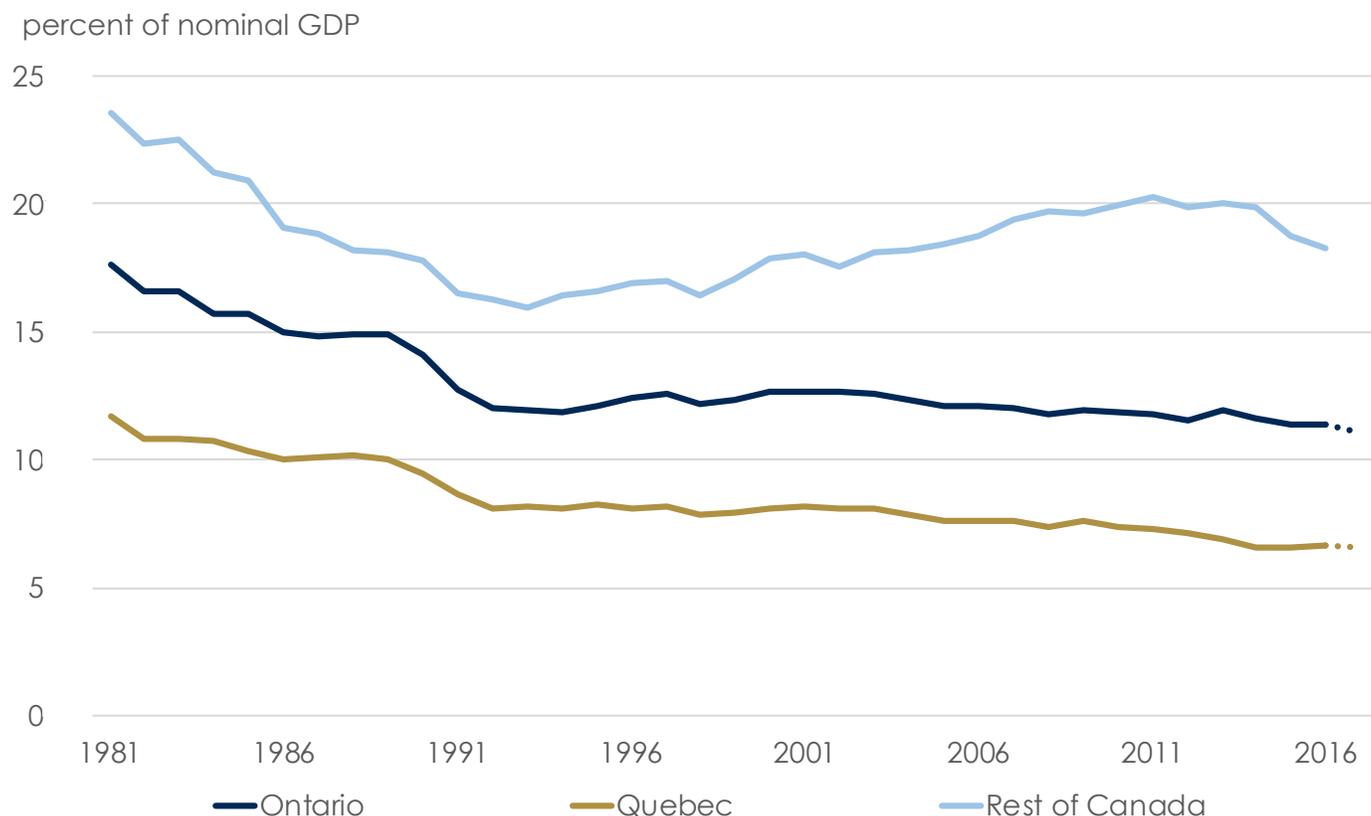


Sources: Statistics Canada, Institute of Fiscal Studies and Democracy.

Then, following Canada entering into the NAFTA, all of Canada's provinces and territories, as well as the federal government, signed on to the [Agreement on Internal Trade](#) (AIT) in 1995. The AIT was intended "to reduce and eliminate, to the extent possible, barriers to the free movement of persons, goods, services and investments within Canada and to establish an open, efficient and stable domestic market. All Parties recognize and agree that enhancing trade and mobility within Canada would contribute to the attainment of this goal." The AIT was subsequently amended fourteen times, with the final amendment, the Fourteenth Protocol of Amendment, being agreed to in February 2015.

This seems to have helped to stem the decline in internal trade (as a share of GDP) which persisted through the 1980s, although the advance in interprovincial trade that followed was more muted than for international trade through the 1990s (Chart 1). As was noted by [TD Economics in 2015](#), while international trade fell sharply as a share of GDP in Canada after the year 2000, internal trade continued to expand. But this trend reversed in the years following the 2009 recession, as external trade gradually returned to pre-recession levels (as a share of GDP) while internal trade fizzled. Notably, although internal trade in Ontario and Quebec tends to drive the aggregate number just given the sheer size of these two provinces, they have never served as a useful harbinger for internal trade in the rest of the country (Chart 2). More specifically, internal trade by the central Canadian provinces has experienced a trend decline as a share of GDP. This is despite Ontario and Quebec having run internal trade surpluses fairly consistently (due to services in Ontario and goods in Quebec). Meanwhile, interprovincial trade flourished in the rest of Canada during the more than two decades spanning from 1993 through 2014. Importantly, these dates represent the bookends of a very distinct period of Canadian economic history – the rise in the energy sector as a key driver of growth.

Chart 2: Provincial Total Internal Trade (Exports + Imports)

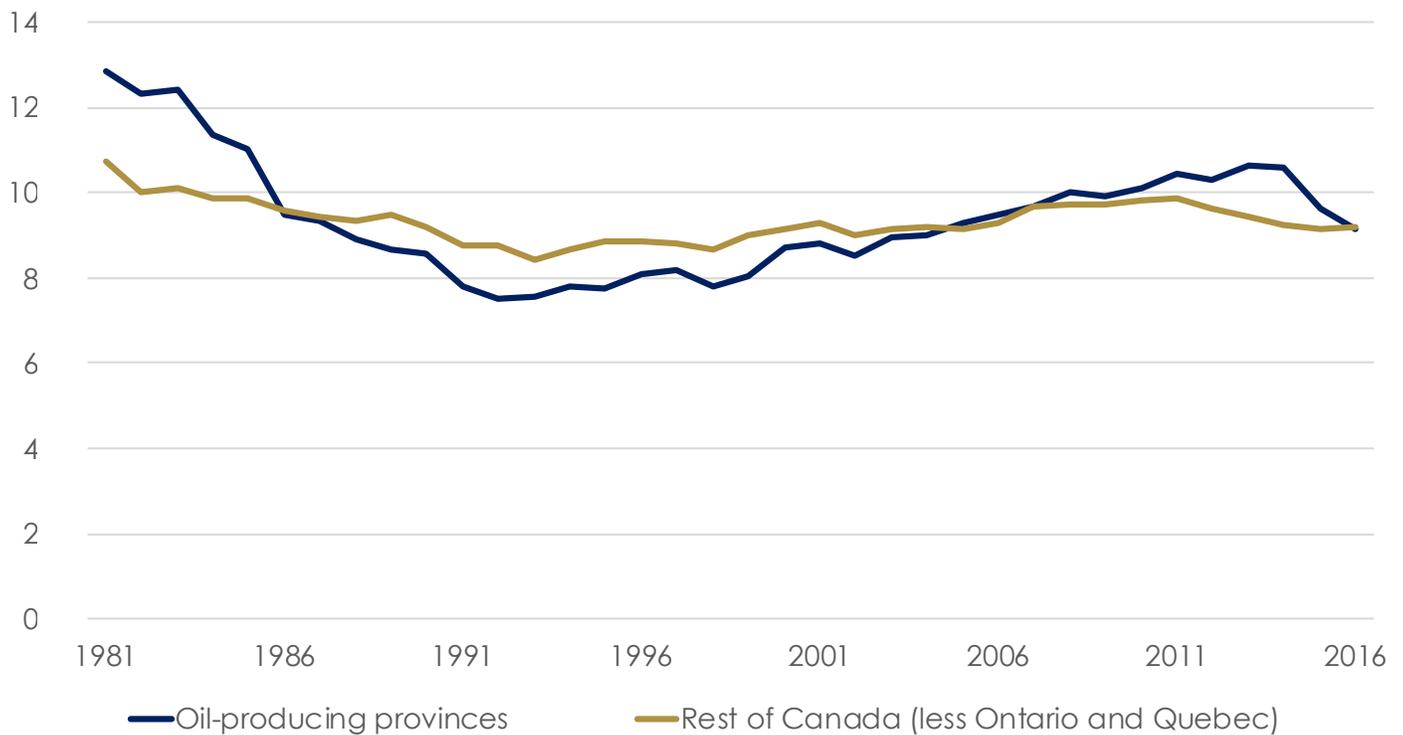


Sources: Statistics Canada, Government of Ontario, Government of Quebec, Institute of Fiscal Studies and Democracy.
Note: 2017 values for Ontario and Quebec are estimates from provincial governments.

But it wasn't just the oil-producing provinces that benefitted from the free-trade agreements and that led the rise in internal trade over this period (Chart 3). Indeed, from 1993 through 2011, internal trade steadily rose among provinces other than Ontario, Quebec, and those that are resource rich. However, those fortunes started to fade in 2012—a trend which has continued ever since. Not surprisingly, internal trade by oil-producing provinces peaked in 2014 and then declined along with the sharp drop in oil prices that began in that year.

Chart 3: Provincial Total Internal Trade (ex ON and QC)

percent of nominal GDP



Sources: Statistics Canada, Institute of Fiscal Studies and Democracy.

Notes: ON refers to Ontario and QC refers to Quebec. 'Oil-producing provinces' include Alberta, Saskatchewan, and Newfoundland & Labrador. 'Rest of Canada (less Ontario and Quebec)' includes British Columbia, Manitoba, New Brunswick, Nova Scotia, and Prince Edward Island, as well as the Yukon, Northwest, and Nunavut Territories.

Other side trade agreements were also made during this period to further liberalize internal trade in goods and services, notably the [Trade, Investment, and Labour Mobility Agreement \(TILMA\)](#). First signed between the Governments of Alberta and British Columbia in April 2006, the TILMA was amended three times, most recently in April 2009. "Under TILMA, British Columbia and Alberta have mutually recognized or reconciled the rules that hinder the free movement of goods, services and people. The Agreement has created a more open, competitive economy where goods, services, workers and investments can move more freely between the two provinces." This agreement later expanded in 2010 to also include Manitoba and Saskatchewan, the new agreement being dubbed the [New West Partnership Trade Agreement \(NWPTA\)](#). Having been fully implemented since July 2013, the signatory governments to the NWPTA "are the first jurisdictions in Canada to commit to full mutual recognition or reconciliation of their rules affecting trade, investment or labour mobility so as to remove barriers to the free movement of goods, services, investment, and people within and between" them. The first and only Protocol of Amendment to the NWPTA was signed in January 2015, and was introduced by July 2015.

But these regional agreements and amendments to decades-old multilateral agreements were not seen as sufficient by legislators and experts alike. For instance, [a June 2016 Report of the Standing Senate Committee on Banking, Trade and Commerce](#) (the Senate Committee) stated that, "Almost 150 years after our country was formed, far too many unnecessary regulatory and legislative differences exist among Canada's jurisdictions. These differences create "walls" that prevent the free flow of people, goods, services and investments between provinces/territories. They also increase costs for

Canadian businesses, many of which are struggling to expand and compete in a fiercely competitive global marketplace.” To address this imminent need to act, the Senate Committee provided seven recommendations to support a more robust internal trade regime in Canada, including a renewed AIT.

Then, in July 2017, a new agreement on internal trade was born with the signing of CFTA. Agreed to by the federal and all provincial-territorial governments, the CFTA was similar in spirit to the ATI but with some fundamental changes which improved its flexibility. For instance, as per the Senate Committee recommendation and similar to recent bilateral international trade agreements, the CFTA was negotiated on the basis of a negative list approach. This means that all people, goods, services and investment are free to move across provincial borders unless they are explicitly exempt, leading to a shorter list of exemptions. That said, while the list of exemptions may be shorter than in the past, [some commentators](#) were quick to point out that the better part of half of the CFTA’s 350 pages were taken up by exemptions. Compare that to Australia, also a federation, which reached a similar internal trade agreement (the [Mutual Recognition Act](#) (MRA)) 25 years ago but its list of exemptions took up a paltry 17 pages.

Keep in mind, the timing of the CFTA was no coincidence. According to the [Financial Post](#), “The new trade deal with the European Union, the Canada-EU Comprehensive Economic and Trade Agreement, opens government procurement to trans-Atlantic competition. Had Canada’s internal trade deal failed to open up government procurement, European bidders would have had better access to bid for Canadian government contracts... “Without the new Canadian Free Trade Agreement, we could have seen a circumstance where EU companies were getting greater access to the Canadian market than homegrown companies,” said Brad Duguid, Ontario’s minister of economic development and growth, who was chair of the negotiations. “That just didn’t make sense to any of us.””

Fast forward to 2018, and the optimism around interprovincial trade has soured somewhat as a result of the recent judgment handed down by the [Supreme Court of Canada in the context of applying penalties to people bringing beer across provincial borders](#). Without going into the weeds of the ruling, particularly as none of the beancounters at the IFSD are lawyers, the Supreme Court of Canada said that, “The historical context supports the view that, at a minimum, [s. 121](#) prohibits the imposition of charges on goods crossing provincial boundaries — tariffs and tariff like measures. But the historical evidence nowhere suggests that provinces would lose their power to legislate under [s. 92](#) of the [Constitution Act, 1867](#) for the benefit of their constituents even if that might have impacts on interprovincial trade.” [According to one legal scholar close to this decision](#), “In its decision, the Court gave with one hand and took away with the other. It held that Section 121 applies both to tariffs and “tariff-like” measures that increase the price of goods imported from outside a province. So far, so good... However, the Court went on to hold that the restriction of cross-border trade must be the primary purpose of a measure in order for it to be invalid under Section 121. A tariff-like measure (or even perhaps an outright tariff) may be upheld as long as it is rationally connected to a broader legislative scheme aimed at an objective other than restricting trade. Any objective within a government’s jurisdiction would seem to qualify, including simply enhancing general welfare.”

THE ECONOMIC CASE FOR INCREASED INTERNAL TRADE IN CANADA

Of course, the argument for what constitutes an enhancement to ‘general welfare’ is often in the eye of the beholder, and the views of politicians, economists, lawyers, and others frequently differ. What follows will be a discussion of the evidence on the economic benefits from reducing barriers to internal trade in Canada, with the legal considerations left to the lawyers.

Currently, one of the most widely cited pieces of research on reducing internal barriers in Canada is by Lukas Albrecht and Trevor Tombe, entitled [Internal Trade, Productivity, and Interconnected Industries: A Quantitative Analysis](#). Published in the *Canadian Journal of Economics* in September 2016, the authors found that “inter-provincial trade is an important contributor to Canada’s GDP and welfare, though there are significant costs to such trade. Reducing inter-provincial trade costs by 10% yields aggregate gains of 0.9%; eliminating our preferred estimates of costs, gains average between 3-7% – equivalent to real GDP gains between \$50-\$130 billion. Finally, as policy reforms are often sector-specific, we liberalize sectors one at a time and find gains are largest in highly interconnected industries.” Table 1 illustrates which industries have the highest share of exports, both interprovincial and international, as a share of output.

Albrecht and Tombe (2016) go on to say that, “If inter-provincial trade costs were completely eliminated, an implausible but illustrative experiment, aggregate gains for Canada exceed 50%. Moreover, we consistently find poor regions gain more from liberalization than rich regions.” So, both the economic and welfare gains from internal trade liberalization are substantial, with the gains going disproportionately to the poorest provinces in Canada by allowing them to reap the benefits of their comparative advantage. Building on the observations in Charts 1 through 3, Table 2 demonstrates that it is some of the smaller provinces that have the largest share of interprovincial exports relative to output.

The International Monetary Fund (IMF) also weighed in to the debate on the economic benefits to Canadians of interprovincial product market reforms, citing a range of estimated GDP level effects of 0.05 to 7 percent (survey of studies) in its [2017 Article IV consultation with Canada](#). Moreover, the IMF’s own work, in [Chapter 3 of its April 2016 World Economic Outlook](#), found that major legislative/regulatory reform in network industries could increase the level of Canadian GDP by about 1.5 percent four years after the reform. Citing a wide body of research, the IMF stated that, “Staff research and other studies have shown that reducing barriers to product market competition, improving the innovation framework, increasing access to post-secondary education, and active labor market policies, bring sizable productivity gains that could help reverse the declining trend in Canada’s long-term growth.”

Of note, [Corrine Luu of the Organization for Economic Cooperation and Development](#) (OECD) also weighed into this discussion in 2016, saying, “Competition could also be increased by lowering barriers to interprovincial trade and the movement of labour, which act to fragment Canada’s already small domestic market.” Echoing the findings of Albrecht and Tombe (2016), Luu (2016) found that lowering barriers to interprovincial trade would help to strengthen competition in network sectors and the internal market in Canada. “Improving regulatory conditions, efficiency and/or cost competitiveness could yield more productive outcomes in these sectors, as well as in downstream industries.”

Table 1: Exports as a Share of Output, by Industry (2014)

	Interprovincial Exports	International Exports	Total Exports
Mining	14%	46%	60%
Wholesale	26%	19%	45%
Transportation and Warehousing	16%	21%	37%
Manufacturing	11%	26%	37%
Agriculture, Forestry, Fishing and Hunting	12%	24%	37%
Administrative and Support and Waste Management and Remediation Services	18%	10%	28%
Information	16%	6%	22%
Finance and Insurance	16%	4%	20%
Professional, Scientific and Professional Services	16%	4%	20%
Accommodation and Food Services	10%	9%	18%
Arts, Entertainment and Recreation	9%	7%	16%
Educational Services	5%	10%	15%
Other Services (except Public Administration)	10%	0%	10%
Utilities	2%	5%	7%
Real Estate Rental and Leasing	3%	1%	5%
Health Care and Social Assistance	2%	0%	2%
Retail	0%	1%	1%
Construction	0%	0%	0%
Public Administration	0%	0%	0%
Average	10%	16%	26%

Sources: Statistics Canada, Institute of Fiscal Studies and Democracy.

Note: This largely replicates and updates Table 1(b) in Albrecht and Tombe (2016), albeit by NAICS codes instead of ISIC codes. Totals may not add due to rounding.

Table 2: Exports as a Share of Output, by Province (2014)

	Interprovincial Exports	International Exports	Total Exports
New Brunswick	16%	21%	37%
Prince Edward Island	15%	11%	27%
Manitoba	15%	13%	28%
Saskatchewan	13%	22%	35%
Nova Scotia	11%	9%	20%
Newfoundland and Labrador	11%	21%	32%
Alberta	11%	19%	29%
Quebec	10%	14%	24%
Ontario	9%	17%	26%
British Columbia	9%	12%	22%
Average	10%	16%	26%

Sources: Statistics Canada, Institute of Fiscal Studies and Democracy.

Note: This largely replicates and updates Table 1(a) in Albrecht and Tombe (2016). Totals may not add due to rounding.

Then came the April 2017 announcement of the impending CFTA. The [Bank of Canada](#) looked at this agreement and determined that a 10% reduction in interprovincial trade barriers starting in 2018 (allowing for a one-year implementation delay) would raise the forecasted potential GDP growth rate by an average of 0.2 percentage points annually. As a result, the level of potential GDP would be 0.6% higher by 2020 than it would have been in the absence of these internal trade barrier reductions, or about an additional [\\$25 billion per year](#).

The CFTA came in the nick of time, as anti-trade rhetoric coming out of the U.S. Administration raised the risk that trade with the United States could slow materially. Indeed, the Bank of Canada estimated in the same report that increasing global protectionism in the form of a 20% tariff imposed by the United States on imports from all regions of the world could lower Canadian potential output growth by 0.3 percentage points on average annually. By 2020, this would leave the level of potential output 1.0% lower than it would otherwise be. And as Canada has very little influence on the actions other countries will take in regard to trade policy, this highlights the imminent need for an intensified focus on reducing internal trade barriers.

This again harkens back to the example of Australia. To quote [John Ivison in the Financial Post](#), “A review of the MRA by the Australian Productivity Commission in 2009 found that interstate trade as a share of gross state product increased for all territories by 5% to 7.7% between 2001/2 and 2005/6. The policy was so successful that New Zealand even asked to join in the scheme.” Indeed, [according to Australia’s Department of Industry, Innovation and Science](#), “the Trans-Tasman Mutual Recognition Act 1997 applies the mutual recognition principles relating to the sale of goods and the registration of occupations between Australia and New Zealand.” And while these internal trade agreements do not translate exactly to the Canadian context, it speaks to the fact that the direction of the impact on economic benefits of reducing internal trade barriers is jurisdiction agnostic.

Of course, there are always going to be naysayers around the benefits of the CFTA, saying that it doesn’t go far enough, and that is surely true. But it does take steps in the right direction. Dr. Trevor Tombe outlined some of the more notable changes in the CFTA in an [April 2017 Maclean’s article](#). Specifically, he highlighted the fact that the “The agreement establishes a number of working groups, panels, forums, and a “Regulatory Reconciliation and Cooperation Table.”... The various groups will examine current rules, recommend changes, facilitate negotiations, codify deals, and monitor progress, all to smooth out our regulatory differences.” He went on to highlight that “Provinces have also agreed to limit their ability to bias government purchasing in favour of local firms.” Finally, Dr. Tombe pointed to the good news that “subsidies and other incentives to favour local business will be increasingly more difficult.”

Now, keep in mind that the CFTA wasn’t all good news, as the penalties were minor, there were 135 pages of exemptions, and future progress was tied to working groups that had uncertain prospects. While applauding the signing of the CFTA, the IMF also weighed with concerns, saying in the 2017 Article IV consultation that, “The devil, nevertheless, is in the details and much work remains to make the CFTA as broad as possible, notably by including energy, address the distortionary agricultural supply management regimes, and establish a pan-Canadian council to harmonize legislation and regulations.” More recently, the [IMF’s Staff Concluding Statement of the 2018 Article for Mission to Canada](#) again referred to the need for increased internal trade, stating that in the face of increased global trade protectionism, “Federal and provincial governments should do more to reduce inter-provincial barriers to trade and the free-movement of skilled labor. Regulatory red-tape remains substantial despite CFTA.” But, certainly, the CFTA was an important step in the right direction to

increasing economic activity and living standards across the country.

THE WAY FORWARD ON INTERPROVINCIAL TRADE

So, while the economic case for interprovincial trade is clear, the recent Supreme Court decision to uphold the right of provinces to legislate “for the benefit of their constituents even if that might have impacts on interprovincial trade” suggests that the legal one is not. Provinces desire to keep their taxing authority within their own borders, and if it comes at the expense of trade across provincial borders, so be it. It’s easy to understand why, with billions of dollars in alcohol tax revenues potentially at stake in the recent Supreme Court case specifically, never mind the substantial tax take from tobacco and, in the not too distant future, cannabis.

But, at a time when trade protectionism around the world is on the rise, it is more important than ever to focus on reaping the benefits of open provincial borders. And grasping at protectionist measures on internal trade in Canada is in no way supporting increased economic growth and living standard, but is instead pouring cold water on the optimism that came out of the signing of the CFTA.

And it’s not only economists that want to see internal trade barriers come down. A [survey of 1,103 Canadians conducted by Ipsos Public Affairs in November 2017](#) found that “Nearly all (86%) disagree with provinces protecting their alcohol-sale monopolies by fining citizens who buy wine or beer from other provinces”. Meanwhile, “most agree (and a majority strongly agree) that Canadians should be allowed to: Bring any legally purchased product from one province to another (89%); Order any legal product from anywhere in the country (88%); Order wine directly from a winery in other provinces (84%); Bring any amount of beer or wine they buy in one provinces into another province (78%)”. Further, “Free trade is seen as a national unity issue: nine in ten Canadians (88%) say there should be free trade between the provinces “because we are one country.” A majority see reducing trade barriers between provinces as being good for consumers (81%) and Canadian businesses (77%).”

Small business has also come out strongly in support of a further reduction on interprovincial trade barriers. In 2017, shortly after the announcement of the CFTA, the Canadian Federation of Independent Business (CFIB) published a [press release](#) celebrating the agreement and saying that the “CFTA is a huge accomplishment”. It also laid out five immediate priority areas for the newly-formed Regulatory Reconciliation and Cooperation Table (RCT) to tackle. These include: simplify corporate registration; mutually recognize food inspections; align transportation regulations; create common professional and trade licensing; and improve mutual recognition of worker’s compensation and occupational health and safety.

So, knowing that the majority of citizens and businesses want to see increased free trade between provinces, what can be done? There are no easy options, unfortunately, and those that exist are all political.

One possibility is comprehensive mutual recognition. According to Dr. Tombe in his [April 2017 Maclean’s article](#), this would entail a “simple rule that whatever is allowed by one province is allowed by all.” Of course, this is a tough sell, as no province or territory would reasonably want to give up their subsovereignty over determining their own regulations. And if the federal government opens that can of worms, it could have quite the fight on its hands. But given that we have seen provinces agree to such measures in the past in both the TILMA and NWPTA, this suggests that there may be some hope for moving in this direction if politicians can get on the same page. And, again, mutual

recognition was key to the success of the Australian internal trade agreement.

In the case of tax rates specifically, there may be room for further harmonization, particularly as it pertains to relatively homogenous goods such as alcohol and tobacco. Cannabis will ultimately be included among this group of vices as well, and you can bet that efforts to get the best price by arbitraging provincial tax regimes will start on the day consumption becomes legal. Indeed, harmonizing tax rates on alcohol across provinces would have rendered the recent case taken to the Supreme Court moot, as tax differences on the same good (in this case beer) would no longer have been a factor in the decision to purchase alcohol in one province or another. And the benefits of harmonization go well beyond tax regimes, applying to the breadth of differential regulatory regimes and professional requirements that exist in this country.

Finally, while mutual recognition and a further harmonization of tax rates may seem a bridge too far for Premiers at this juncture, at a minimum they should look to further strengthen the existing CFTA. For example, maximum monetary penalties could be increased or become cumulative in nature, and the dispute settlement process could be further streamlined. Performance targets on a further reduction in the exemptions on the negatives list in the CFTA could be set for future negotiations. Even more ambitious, Premiers could consider setting notional targets for internal trade, e.g. some percent of GDP by 2025, to highlight the importance of making further gains and to keep focus on continuous improvement.

CONCLUSION

While perfect harmonization around provincial tax regimes may be untenable today, it is difficult to see how this could lead to a worse outcome for Canadians than our current situation. Indeed, it's been shown that reducing these non-tariff barriers to trade, and others trade barriers like them, would lead to greater welfare for us all. But provincial-territorial governments must make tearing down these barriers a priority, and come to the table prepared to reduce the unnecessary red tape holding back business investment and living standards. Indeed, if the recent Supreme Court decision has made one thing clear, it is that reducing barriers to internal trade will be a political exercise as opposed to a legal one. And what better time than the Council of the Federation meeting this summer in New Brunswick for Premiers to make significant reductions to interprovincial trade barriers a priority.

Dr. Trevor Tombe said, in reference to the CFTA, "While the deal doesn't tear down internal trade walls immediately, it chips away at them and, for good measure, distributes pickaxes to many groups empowered to use them. Steadily, gradually, and one crack at a time, the walls will hopefully come down" in his [April 2017 Maclean's article](#). And as Leonard Cohen so eloquently put in his song *Anthem*, "There is a crack in everything ... That's how the light gets in". Hopefully, enough light will ultimately shine through cracks in the walls impeding interprovincial trade that we as a country will be able to see the light. We will all be better off for it.

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