

Canada and the European Union: Prospects for a Free Trade Agreement

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This paper argues that there are significant potential economic gains to be obtained from an EU-Canada Free Trade Agreement. The evolution of trade between the US and Canada following the signing of CUSFTA in 1989 offers a good illustration of how trade might increase after an EU-Canada FTA, as the patterns and levels of protection between the EU and Canada today are very similar to the protection that existed between the US and Canada in 1989. Although many empirical studies fail to find support for 'trade diversion' created by NAFTA (or CUSFTA) at the expense of the EU and to the benefit of the US, there is some evidence of trade diversion when detailed regional trade is examined. If indeed trade diversion has occurred due to NAFTA, then an EU-Canada FTA is welfare-enhancing for Canada. For the EU, a potential FTA can level the playing field with the US and increase the competitiveness of European firms in the Canadian market.

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CANADA AND THE EUROPEAN UNION: PROSPECTS FOR A FREE TRADE AGREEMENT

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1. Introduction

A potential free trade agreement (FTA) between Canada and the EU came back onto the political agenda during the German EU Presidency, with its emphasis on the importance of transatlantic relations not only with the US but also with Canada. Quebec Premier Jean Charest has been a strong supporter of closer economic ties between Canada and the EU. In the past, a free trade agreement between Canada and the EU was seen as a way to stimulate neglected bilateral trade and investment relations, but both parties attached greater importance to multilateral trade agreements as the gains from the latter are far superior to any derived from a bilateral trade deal. Hence, the idea never materialised as both sides agreed that pursuing an FTA would undermine their perceived support for the DDA (Doha Development Agenda) negotiations taking place under the auspices of the WTO (World Trade Organisation).

One year after the EU-Canada summit in July 2007, talks on a free trade agreement are still on the agenda. Canadian politicians and officials are hopeful that negotiations can start as early as the next Canada-EU summit in Montreal in October 2008. Canadian Trade Minister David Emerson was quoted recently as saying that a trade deal would not only give Canada access to a huge and diverse democratic market with technological sophistication but could also offer Europe a stable supplier of energy. European diplomats and officials, however, are more cautious. A joint study by both sides is now underway to quantify the potential benefits and costs from an EU-Canada FTA.

Canada and the EU have a longstanding economic relationship that dates back to 1958 when Canada accredited its first ambassador to the then European Economic Communities (EEC). The Framework Agreement for Commercial and Economic Cooperation, signed with Canada in 1976, was the EEC's first framework cooperation agreement with an industrialised country. Under this agreement, Canada and the EEC accorded most-favoured nation (MFN) status to each other in all product categories and agreed on cooperating for "the development and prosperity of their respective industries, the encouragement of technological and scientific progress, the opening up of new sources of supply and new markets, the creation of new employment opportunities, the reduction of regional disparities, the protection and improvement of the environment, and to contribute to the development of their respective economies and standards of living".

Two decades later, the economic cooperation was strengthened with the approval of the EU-Canada Joint Declaration and Action Plan in 1996 and the EU-Canada Trade Initiative (ECTI) in 1998. The Action Plan set an agenda for joint action using the established instruments for cooperation. The Plan was organised into four chapters: economic and trade relations, foreign

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policy and security issues, transnational issues and fostering links. Moreover, the EU and Canada concluded several agreements covering the mutual recognition of conformity assessment, fisheries, veterinary issues, labelling of wines and spirits, competition, e-commerce, public procurement, services, atomic energy and nuclear research matters.

More recently, the EU and Canada adopted the Canada-EU Partnership Agenda, which identifies broad areas that would improve their bilateral relationship. The agenda included the Framework of the Canada-EU Trade and Investment Enhancement Agreement (TIEA), which sought to move beyond traditional market access issues, to include areas such as trade and investment facilitation, competition, mutual recognition of professional qualifications, financial services, e-commerce, temporary entry, small- and medium-sized enterprises, sustainable development, civil society consultation, and science and technology.¹ TIEA negotiations began in 2004, but it was decided in May 2006 to make continuation conditional on the results of the current round of WTO negotiations. In their joint communiqués, Canada and the EU declared themselves to share a commitment to broad trade policy objectives, notably the commitment to the successful conclusion of the Doha Round, the formation of a strong, open and rule-based international trading system and the promotion of sustainable development.

At the June 2007 Canada-EU Summit in Berlin, it was decided to re-launch the TIEA dialogue and further strengthen the bilateral economic integration and trade and investment flows. Both parties agreed “to enhance regulatory convergence and compatibility, by considering each other’s measures before adopting unique approaches”, a commitment that also exists in the context of the EU-US dialogue. A Regulatory Cooperation Agreement should therefore be concluded as soon as possible under the TIEA.²

The aim of this report is to present a general discussion on the economic rationale for a potential EU-Canada FTA. As a first step, we examine patterns of trade flows in goods and services and FDI between Canada and the EU in section 2. This is important to see whether the EU and Canada are natural trading partners or not. If the answer is positive, then trade diversion from a free trade agreement is said to be minimised. In section 3, tariff barriers to trade between the EU and Canada are examined in detail. Although tariffs on average are low thanks to past WTO rounds, aggregate categories and averages hide several tariff peaks. Section 4 proceeds with an examination of non-tariff barriers (NTBs), technical barriers to trade (TBTs) and sanitary and phytosanitary standards (SPS), and section 5 discusses key regulatory issues. Having established a general view of various forms of trade barriers, we present the arguments for and against an EU-Canada FTA in section 6. Section 7 offers conclusions.

2. EU and Canadian trade structures and foreign direct investment

General trade flows

One of the most striking differences between the trade patterns³ of the EU and Canada is undoubtedly the significant weight of the US as both an export and import market for Canada. As Table 1 shows, although the United States is the EU’s largest trading partner, it only accounts for roughly 23% of the EU’s exports and 13% of imports. For Canada, however, 82.5% of Canadian exports were sent to the United States in 2006, and almost 55.6% of its

¹ For background information on the Canada-EU TIEA, see <http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/eu-ue/index.aspx>.

² 2007 EU-Canada Summit Statement, Berlin, 4 June 2007.

³ Trade in goods and services.

imports came from the United States, according to statistics compiled by DG Trade of the European Commission.

With respect to Canada-EU trade, the table below shows that despite the dominance of the United States, the EU is Canada's second-largest trading partner. In terms of the EU, Canada was the 8th largest destination for exports, the 14th largest import partner and the 10th largest trading partner overall in 2006.

Table 1. The EU and Canada's top 10 trading partners, 2006

	European Union			Canada	
	(€mil)	%		(€mil)	%
World	2,516.6	100.0	World	609.6	100.0
US	444.4	17.7	US	421.9	69.2
China	255.1	10.1	EU	56.2	9.2
Russia	209	8.3	China	31.8	5.2
Switzerland	157.7	6.3	Japan	18.2	3.0
Japan	121.1	4.8	Mexico	15.1	2.5
Norway	117.2	4.7	Korea	6.7	1.1
Turkey	85	3.4	Norway	5.5	0.9
Korea	61.1	2.4	Algeria	3.9	0.6
India	46.4	1.8	Brazil	3.5	0.6
Canada	46.1	1.8	India	2.6	0.4

Source: DG Trade, European Commission.

The first set of two figures below shows how trade has evolved between Canada and the EU from 1980 to 2006.⁴ Canada's imports from the EU levelled off after the Canada-US Free Trade Agreement (CUSFTA) was signed in 1989, but they started increasing right after the North American Free Trade Agreement (NAFTA) went into effect in 1994. Imports from the EU have increased from 6.1 billion USD in 1980 to 47.8 billion USD in 2006, at an average growth rate of 8%. Canada's exports to the EU also increased over the last two decades at an average annual growth rate of 5%. Exports to the EU amounted to 9.2 billion USD in 1980 and 25.6 billion USD in 2006. The negative impact of CUSFTA on exports to the EU can be seen in the second set of graphs in Figure 1 below. However, the share of imports and exports to the EU as a percent of Canada's global trade reveals two important points: first in terms of imports, the share of the EU in Canada's total imports has been more or less stable, with a short period of increased openness during the time of CUSFTA. This can be explained as the classic impact of trade liberalisation: by liberalising trade, Canada became more open and hence attracted larger imports. Second, the share of the EU as Canada's export destination has been decreasing steadily over the years.

⁴ The reporting country is Canada.

Figure 1. Evolution of Canadian-EU trade, 1980-2006



Canada-EU member state trade flows

There is a wide dispersion in the trade pattern of the different member states with Canada. Canada has a large trade deficit with Germany and to a lesser degree with France, Italy and Sweden. Canada-UK trade is relatively balanced whereas the Netherlands, Belgium, Spain and Finland are net importers from Canada. Top export destinations within the EU are the United Kingdom, the Netherlands, Germany, France and Belgium. EU countries that export the most to Canada are Germany, the United Kingdom, France, Italy and Ireland.

Table 2. Canadian-EU member state trade flows (millions of Canadian dollars)

	Top EU destinations for Canadian exports			Top EU exporters to Canada			
	2005	2006	2007	2005	2006	2007	
United Kingdom	8,253	10,134	13,060	Germany	10,272	11,126	11,538
Netherlands	2,193	3,063	4,047	United Kingdom	10,417	10,864	11,471
Germany	3,237	3,955	3,883	France	4,995	5,186	5,088
France	2,537	2,882	3,126	Italy	4,586	4,911	5,074
Belgium	2,287	2,402	2,964	Ireland	2,054	2,556	2,464
Italy	1,927	1,883	2,568	Belgium	1,793	1,960	2,354
Spain	1,195	1,190	1,234	Sweden	2,296	2,355	2,100
Finland	433	474	716	Netherlands	1,528	1,591	1,765
Sweden	482	457	545	Austria	1,290	1,423	1,435
Denmark	290	313	499	Denmark	1,565	1,421	1,314

Source: Statcan.

In terms of the breakdown of goods traded, Canada essentially exports commodities to the EU, in return for oil and manufactured goods. Canada's top exports to the EU in 2007 were uranium, gold, nickel oxide sinters, unsorted diamonds and aircraft. The EU's top exports to Canada were crude oil and related refined products, medicines, motor vehicles and airplane parts (see the appendix for detailed information). The importance of crude oil exports to Canada may seem surprising in the context of the growing oil exploration in Western Canada (Alberta), but it is easier to ship North Sea oil to Eastern Canada than to get it overland from the West.

Canada-EU services trade

Services trade (exports plus imports) in the world has been growing by 8% on average since 1994, and it has increased from 2.2 trillion USD to 5.5 trillion USD from 1994 to 2006. The majority of services trade has been taking place among the developed countries as these countries have a comparative advantage in many services sectors. In 2005, the EU25 was the largest exporter and importer of services in the world, where it accounted for 28.3% of global exports and 24.7% of global imports. The EU was followed by the United States (19%), Japan (6.7%) China (4.4%) and Canada (3.3%).

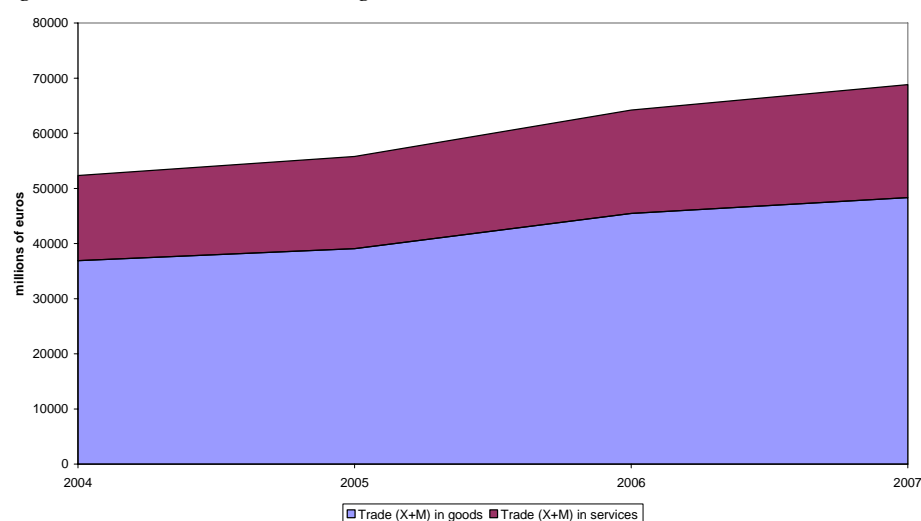
Table 3. Total trade in services for major trading countries, 2005 (€ million)

Country	Exports	Imports	Balance	Share of world (%)
EU25	406,292	349,357	56,935	25.9
United States	302,860	252,853	50,007	19
Japan	88,586	107,914	-19,328	6.7
China	59,805	67,354	-7,549	4.4
Canada	43,121	52,211	-9,090	3.3
Singapore	41,241	43,614	-2,373	2.9

Source: EU International Trade in Services, Eurostat, 2007.

In a bilateral context, services trade has also increased between the EU and Canada: total services trade increased by 33%, from €15.4 billion in 2004 to €20.5 billion in 2007. In 2007, total services trade between the EU and Canada accounted for 30% of total trade in goods and services, and services trade has been increasing at a similar rate to goods trade.

Figure 2. EU-Canada trade in goods and services, 2004-07



Source: Eurostat.

In terms of the geographical distribution of trade in services, the EU's top services trading partner is the United States, where total services trade between the two countries exceeded €238 billion in 2005. Following the United States, the EU's next largest services trading partners are Switzerland, Japan and Norway. Canada is the EU's seventh largest partner in services trade, with total trade equalling roughly €16 billion in 2005.

Table 4. Top EU25 services trading partners, 2005 (€ million)

Country	Exports	Imports	Balance	Total services trade
United States	122,872	115,967	6,905	238,839
Switzerland	49,565	36,677	12,888	86,242
Japan	19,969	11,871	8,098	31,840
Norway	15,117	9,668	5,449	24,785
China	11,109	8,848	2,261	19,957
Russia	11,444	8,125	3,319	19,569
Canada	8,474	7,642	832	16,116
Turkey	4,456	10,636	-6,180	15,092

Source: EU International Trade in Services, Eurostat, 2007.

The EU is Canada's second-largest trading partner after the United States. In 2005, Canada exported roughly €7.45 billion worth of services to the EU, while receiving imports of roughly €8.1 billion. This gave Canada a €650 million services trade deficit with the EU.

Table 5. Top Canadian services trading partners, 2005 (€ million)

Country	Exports	Imports	Balance	Total services trade
United States	23,836	29,844	-6,008	53,679
EU15	7,454	8,102	-648	15,557
Japan	960	1,502	-542	2,462
Bermuda	1,006	944	63	1,950
Hong Kong, China	569	1,130	-561	1,699
Barbados	690	731	-41	1,421
Mexico	403	779	-376	1,182
China	619	520	100	1,139
Switzerland	438	423	16	861

Source: Canadian Department of Foreign Affairs and International Trade, 2008.

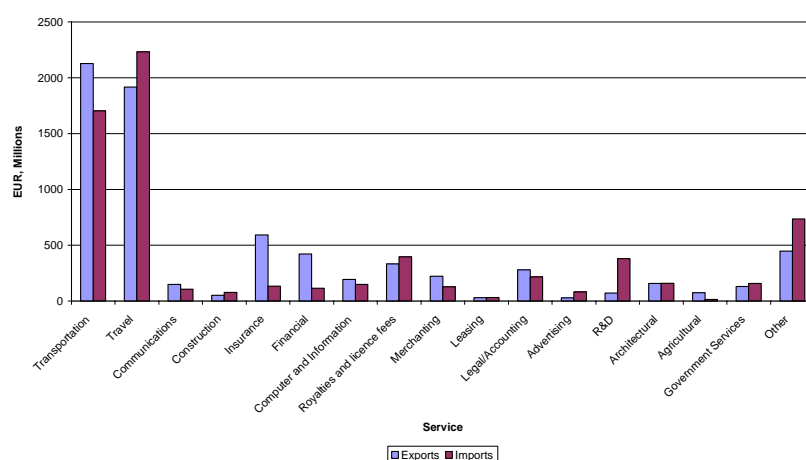
EU-Canada services trade is dominated by trade between Canada and the United Kingdom. Services trade between Canada and the United Kingdom accounts for roughly 35% of total Canada-EU services trade. Canada's next top EU trading partners are France, Germany, the Netherlands and Italy.

Table 6. Top EU15 services trading partners for Canada, 2005 (€ million)

Country	Exports	Imports	Balance	Total services trade
United Kingdom	4561	4211	350	8772
France	1617	1854	-237	3471
Germany	1594	1653	-59	3247
Netherlands	774	1176	-402	1950
Italy	450	996	-546	1446
Greece	344	1002	-658	1346
Ireland	554	300	254	854
Spain	388	345	43	733
Sweden	510	190	320	700
Belgium/Luxemburg	244	265	-21	509
Austria	161	229	-68	390
Denmark	232	113	119	345
Portugal	138	149	-11	287
Finland	79	193	-114	272
Poland	102	93	9	195

Source: Canadian Department of Foreign Affairs and International Trade, 2008.

Figure 3. EU services trade with Canada by sector, 2003



Source: Eurostat.

In terms of the sub-sectors of services, the above figure shows that services trade between the EU and Canada are dominated by services trade in transportation and travel services. The EU exported €2.1 billion of transportation services, €1.9 billion of travel services, €92 million of insurance services and €20 million of financial services. The EU was a net exporter of transportation, insurance, finance, legal/accounting, communication and agricultural services and a net importer of travel, royalties and license fees, construction, advertising, R&D, government and other services from Canada in 2003.

In analysing trade in services, it is seen that the EU is an important player for Canada. Not only is the EU the second-largest services trade partner for Canada, EU-Canada services trade is larger than Canada's service trade with its next eight partners combined. From the EU's perspective, although less significant, Canada is also an important services trade partner.

EU-Canada foreign direct investment

Canada is a net importer of EU foreign direct investment (FDI) and is among the top 10 FDI partners of the EU. By the end of 2006, FDI inward stocks in the EU (excluding intra-EU27 FDI) from around the world had reached €2.04 trillion. Among the source countries of FDI to the EU, Canada ranks in fourth place, with accumulated FDI stocks of €80 billion (approximately 4% of total inward FDI stocks in the EU). In return the EU has outward FDI stocks of €19 billion in Canada, roughly equivalent to 4% of total EU outward FDI stocks in the world. Canada is the third largest destination for EU FDI. In comparative terms, inward stocks of FDI in Canada from the EU are 13% of EU FDI stocks in the US, roughly proportional to the size of the two respective economies. However, the more important question is whether Canada invests as much in the US as it invests in the EU.

Table 7. Foreign direct investment in the EU and in Canada (€ million)

FDI stocks in the EU			FDI stocks from the EU		
Country	2006	% of total	Country	2006	% of total
All countries (excl. intra-EU27)	2,043,258	100.0%	All countries (excl. intra-EU27)	2,705,731	100.0%
United States	952,875	46.6%	United States	934,293	34.5%
Switzerland	245,194	12.0%	Switzerland	333,203	12.3%
Japan	99,145	4.9%	Canada	119,564	4.4%
Canada	80,804	4.0%	Brazil	88,001	3.3%
Norway	62,911	3.1%	Hong Kong	83,417	3.1%
Singapore	40,041	2.0%	Japan	75,516	2.8%
Australia	17,205	0.8%	Singapore	54,317	2.0%
Hong Kong	16,365	0.8%	Russian Federation	52,153	1.9%
Russian Federation	12,577	0.6%	Australia	50,587	1.9%

Source: Eurostat.

FDI stocks in Canada			FDI stocks from Canada		
Country	2006	% of total	Country	2006	% of total
All countries	284,841	100%	All countries	332,050	100%
United States	173,671	61%	United States	141,881	43%
EU25	66,245	23%	EU25	91,626	28%
Switzerland	8,947	3%	Barbados	24,366	7%
Japan	7,170	3%	Bermuda	9,899	3%
Brazil	5,965	2%	Australia	6,091	2%
Hong Kong	3,807	1%	Cayman Islands	5,584	2%

Source: Statcan.

Table 7 clearly shows the US dominance in both inward and outward FDI stocks of Canada. From Canada's perspective, the EU is the second largest FDI investor in terms of end-2006 FDI stocks; its share in total FDI inward stocks of Canada is 23%. The EU is also in second place after the US in terms of Canada's outward FDI stocks, accounting for 28% of its FDI outward

stocks in the world (2006). The large difference between the share of the US versus that of the EU in Canada's outward and inward FDI stocks warrants further examination.

On the basis of a simple exercise, one can ascertain whether the fact that the US is a disproportionately larger FDI partner compared to the EU is attributable to major determinants of FDI. According to gravity models of international trade, two countries' trade is directly proportional to the size of their respective economies (usually measured by the GDP of each partner) and inversely proportional to the distance between the two. Gravity models have become popular in recent years in determining the patterns of FDI as well. In very rough terms, the size of FDI flows (or stocks) should be proportional to the size of the EU and Canada and inversely proportional to the distance between the EU and Canada (*ceteris paribus*). One striking implication of this exercise is that a country of similar size to the EU (i.e. the US) should also trade in direct investment assets in similar magnitudes given its distance (minus the advantage of sharing a common border and language). In other words, based on market size, since the EU is approximately as large as the US (the EU27 GDP was exactly 1.11 times that of the US in 2006),⁵ one might question the fact that the EU receives only 65% of the total FDI that Canada invests in the US. However, given that the distance between the EU and Canada is twice that between the US and Canada,⁶ it is normal that the EU receives less FDI from Canada than the US. However, this simple exercise disregards many other factors that facilitate and/or hinder trade in assets. According to the empirical literature, a free trade agreement between two countries tends to encourage FDI.

In the absence of a free trade agreement that covers investment, many countries have signed bilateral investment treaties (BITs). The most important reason for signing such treaties is to ensure investor protection against arbitrary changes in the host country legislation, 'national treatment' of foreign investors and, in extreme cases, protection against expropriation.⁷ As a brief examination of the UNCTAD database on BITs reveals, Canada does not have any BITs with the EU15, but only with some new member states,⁸ which indicates that the investment environment in the EU15 is already secure and stable. However, there are still some restrictions on investment that hinder trade in assets between Canada and the EU. For example, there are foreign participation limitations on banking and financial services in Canada. A lack of SME logistical capacity to invest in the Canadian market is also mentioned as a barrier to investment in Canada by the Europeans (Dehousse et al., 2002). Canadian investment tax credits for scientific research available to Canadian companies but not to foreign companies discriminate against foreign investors. Similar tax incentives also exist in the EU. Therefore, harmonisation or the extension of a 'national treatment' clause as part of an FTA can increase FDI flows on both sides.

3. Tariff barriers

It is true that over the last decade, tariffs have been decreasing due to multilateral negotiations at the WTO level, and the average tariff rates on industrial goods in the developed countries are at an all-time low. For the EU25, the MFN applied tariffs rates were 5.4% on average (industrial

⁵ WEO database, IMF, April 2008.

⁶ That is, if one takes the UK as the economic centre of the EU. For Canada this may be acceptable since within the EU, the UK is Canada's main trading partner.

⁷ Although the incidence of expropriation has decreased dramatically since the 1970s, there still remain investor concerns over nationalisation even in the absence of a crisis, such as Bolivia's nationalisation of its gas and oil resources in 2006.

⁸ Poland, Czech Republic, Slovakia, Hungary, Latvia and Romania have signed BITs with Canada.

and agricultural goods), with 15.1% on agricultural commodities and only 3.9% on industrial goods, compared to Canada's tariff rates of 17.3% on agricultural goods and 3.9% on industrial goods. Table 8 presents EU and Canadian tariffs on imports, but note that the data are expressed as averages and may therefore hide tariff peaks that exist at a more disaggregate level.

Some 20.4% of Canada's exports to the EU are tariff-free, and the remaining 79.6% carry tariffs ranging from below 5% to over 25%, occasionally exceeding 200% in selective product lines. However, since exports in tariff-free lines constitute 74.1% of Canada's exports to the EU, technically a majority of EU-Canada trade is tariff-free (WTO, 2006). Again when one examines the tariff rates more closely for the top 25 products traded between the EU and Canada (see below), one might have the impression that most trade between the EU and Canada is tariff-free. This in turn may imply that the gains from an FTA would be moderate. This conclusion is based on simple trade theory: the more protectionist a country is, the higher the gains are from tariff liberalisation. This is also true if a country liberalises its trade unilaterally. From the table below, one can see that for Canada's top 25 exports to the EU, only unwrought aluminium faces tariffs, and for the top 25 exports of the EU to Canada, motor vehicles of engine capacity of 1500cc and above, auto parts, light oils and preparations, and a few other items face tariffs ranging between 5-10%. One thing that this exercise does not reveal is whether there are any tariffs applied by both sides that are prohibitively high such that those goods are not traded, or are under-traded.

Table 8. EU and Canadian tariffs on imports

Canada's exports to the EU – Top 25 products	Tariff applied by the EU
710812 - gold in unwrought form (non-monetary)	free
284410 - natural uranium and its compounds (incl alloys, dispersions, ceramic products etc.)	free
880240 - aircraft nes of an unladen weight (more than 15,000 kg)	free
710210 - diamonds - unsorted - not mounted or set	free
270112 - bituminous coal - whether or not pulverized but not agglomerated	free
750120 - nickel oxide sinters and other intermediate products of nickel metallurgy	free
851790 - parts of electrical apparatus for line telephone or line telegraphy	free
880230 - airplanes of an unladen weight (2,000 - 15,000 kg)	free
260112 - iron ores and concentrates, other than roasted iron pyrites - agglomerated	free
470321 - chemical woodpulp - soda or sulphate - coniferous, bleached	free
710231 - diamonds - non-industrial - unworked - not mounted or set	free
750210 - unwrought nickel - not alloyed	free
711230 - ash containing precious metal or precious-metal compounds	free
841191 - parts of turbo-jets or turbo-propellers	free
760110 - unwrought aluminum - not alloyed	6%
480100 - newsprint - in rolls or sheets	free
880330 - parts of airplanes or helicopters nes	free
271019 - other petroleum oils and oils obtained from bituminous minerals, other than crude; preparations nes	free
852520 - transmission/reception apparatus - for cb/amateur radios, fax, cellular phones, etc.	free
970110 - paintings, drawings and pastels executed by hand	free
440710 - lumber (thickness >6mm) - coniferous wood	free
851750 - modems and other apparatus for carrier-current line systems or for digital line systems nes	free
880529 - other air combat simulators and parts	free
300490 - medicaments nes - in dosage	free
100110 - durum wheat	free

Canada's imports from the EU – Top 25 products	Tariff applied by Canada
270900 - crude petroleum oils and oils obtained from bituminous minerals	free
300490 - medicaments nes - in dosage	free
870323 - motor vehicles - spark ignition - cylinder capacity 1500-3000 cc	6.1%
271011 - light oils and preparations	free - 5% - 8%
870324 - motor vehicles - spark ignition - cylinder capacity more than 3000 cc	6.1%
880330 - parts of airplanes or helicopters nes	free
293410 - heterocyclic compounds containing an unfused thiazole ring in the structure	6.5%
220421 - grape wines - other than sparkling (including fortified) - 2 litres or less	changes from 3.74 cents/lit to 17.2 cents/litre according to alcohol level \$1.10/litre + 15% if alcohol level exceeds 22.9%
841191 - parts of turbo-jets or turbo-propellers	free
870190 - other wheeled tractors nes	free
843149 - parts of cranes, work-trucks, shovels and other construction machinery	free
850300 - parts for electric motors, generators, generating sets and rotary converters	free
220300 - beer made from malt	free
841112 - turbo-jets - thrust exceeding 25 kn	free
848180 - taps, cocks, valves and other similar appliances, nes	free
300210 - antisera and other blood fractions - therapeutic, diagnostic, prophylactic uses	free
841199 - parts of gas turbines nes	free - 2%
293399 - benzimidazole-2-thiol	6.5%
870899 - other motor vehicle parts nes	free - 6%
870410 - dumpers designed for off-highway use	free
271019 - other petroleum oils and oils obtained from bituminous minerals, other than crude; preparations nes	free - 5% - 8%
300439 - hormones nes other than antibiotics or contraceptives - in dosage	free
490199 - printed books, brochures, directories and booklets (other than dictionaries and encyclopedias)	free
844319 - offset printing machinery - other type nes	free
300390 - medicaments (bulk) nes	free

As a first step, one can analyse average tariffs applied by both sides. The first of the two tables below, from the World Tariffs Profiles report of the WTO (2006) on Canadian and EU tariffs, reveals that both industrial and agricultural goods face tariffs under these broad categories. It is true for both Canada and the EU that tariffs are low(er) on industrial goods compared to agricultural goods, but even in industrial goods there may be MFN tariff peaks reaching 25 (22)%, for example on transport equipment in Canada (the EU). The tables below reveal that there are sensitive products on both sides where high tariffs exist, such as dairy products with an average MFN tariff rate of 248.6% (a peak of 349%) entering Canada or 53.8% average MFN rate (peak of 229%) entering the EU. Such tariff peaks are more prevalent in agricultural and fish and fish products mostly. However, there are tariff peaks in excess of 10% in every non-agricultural goods category both in Canada and the EU, excluding petroleum. Within each product category, there are many goods with zero tariffs as well as non-zero tariffs: for example, within the 'dairy products' category, all items have non-zero tariff rates, and hence the imports into Canada are nil and only 0.1% into the EU. This is one extreme example. Other sensitive items include clothing for both Canada and the EU, and textiles for the EU. Another interesting case is the example of the wood and paper industry. Products of the wood and paper industry entering the EU face low tariff rates (1.1% average with a peak of 10%) with 80.3% of products tariff-free that fall under this category. This simple exercise shows that EU-Canada trade is not

tariff-free and a simple correlation between average MFN rates and import shares indicate a negative relationship.⁹

Besides the economic cost of tariffs, they can also introduce uncertainty into trade. Although average tariffs on non-agricultural goods are low, each product category contains many sub-category products that have tariffs. This would require preparation of detailed paperwork to categorise the product to determine which tariff rate it falls under. As such, tariffs function as a significant bureaucratic hurdle that can increase the time it takes for a product to be exported. In fact, a 2006 survey by the Conference Board of Canada reported that 51% of Canadian exporters to the EU identified tariffs as a challenge, particularly for mechanical equipment, food and seafood.¹⁰

Table 9. Tariffs and imports by product groups in Canada and the European Communities

Canada									
Product groups	Final bound duties				MFN applied duties			Imports	
	AVG	Duty-free in %	Max	Binding in %	AVG	Duty-free in %	Max	Share in %	Duty-free in %
Animal products	33.2	42.0	680	100	29.6	64.1	681	0.4	62.6
Dairy products	220.4	0	349	100	248.6	0	349	0	0
Fruit, vegetables, plants	3.3	60.5	19	100	3.3	60.8	19	1.7	83.5
Coffee, tea	7.5	55.0	265	100	10.4	76.4	265	0.5	70.6
Cereals & preparations	20.3	15.9	277	100	20.1	32.2	277	1.0	20.8
Oilseeds, fats & oils	5.2	53.1	218	100	4.9	56.4	218	0.4	66.9
Sugars and confectionery	7.5	7.8	31	100	5.7	28.1	28	0.2	7.0
Beverages & tobacco	7.8	23.8	256	100	7.2	34.4	256	0.8	27.0
Cotton	0.8	90.0	8	100	0.5	90.0	5	0.0	95.3
Other agricultural products	7.1	73.1	600	100	6.9	79.4	600	0.4	50.7
Fish & fish products	1.2	75.5	11	100	1	79.3	11	0.6	78
Minerals & metals	2.7	50.4	16	99.5	1.7	67.9	16	12.6	70.3
Petroleum	6.9	0	8	50.0	2.7	58.7	8	6.5	98.3
Chemicals	4.4	27.5	11	100	2.8	50.2	16	10.8	40.0
Wood, paper, etc.	1.4	79.3	16	100	1.1	83.6	16	5.3	81.4
Textiles	10.6	9.8	18	100	6.9	45.0	18	1.8	10.9
Clothing	17.2	0.9	18	100	17.0	2.8	18	1.9	0.2
Leather, footwear, etc.	7.6	24.1	20	100	5.6	40.1	20	2.2	19.5
Non-electrical machinery	3.4	46.4	14	100	1.5	74.9	10	16.6	74.9
Electrical machinery	4.3	36.4	11	100	2.4	56.4	11	9.6	66.1
Transport equipment	5.6	28.1	16	94.3	5.8	40.7	25	20.2	11.8
Manufactures, n.e.s.	4	41.2	18	99.8	2.8	56.9	18	6.4	69.6

⁹ The correlation coefficient calculated for the EU is higher (-0.44) than that of Canada (-0.22) but both are negative, indicating that the higher the tariffs are the lower the import shares in those product categories. Both correlation coefficients are low. This is due to the aggregate nature of the data in the tables above. More disaggregate data would reveal a stronger negative correlation.

¹⁰ Conference Board of Canada (2006), "Lost over the Atlantic? The Canada-EU Trade and Investment Relationship", p. 17 (<http://sso.conferenceboard.ca/e-Library/temp/BoardWise2PHOGBPJDDDFHFGDIEABHPAPKI200842455126/174-06%20Canada-EU%20Trade%20Investment-RPT%20for%20web.pdf>).

European Communities									
Product groups	Final bound duties			MFN applied duties			Imports		
	AVG	Duty-free in %	Max	Binding in %	AVG	Duty-free in %	Max	Share in %	Duty-free in %
Animal products	26.7	20.6	219	100	25.4	23.2	219	0.5	16.2
Dairy products	56.9	0	264	100	53.8	0	229	0.1	0
Fruit, vegetables, plants	10.7	22.6	199	100	11.8	21.4	195	1.3	16.1
Coffee, tea	6.5	27.1	43	100	6.5	27.1	43	0.8	78.8
Cereals & preparations	29.1	6.3	139	100	25.6	5.8	139	0.4	2.6
Oilseeds, fats & oils	5.8	48.2	87	100	5.9	46.8	87	1.4	70.5
Sugars and confectionery	32.6	0	134	100	32.9	0	134	0.2	0
Beverages & tobacco	23.2	23.0	208	100	20.2	19.8	192	0.7	15.9
Cotton	0.0	100.0	0	100	0.0	100.0	0	0.1	100.0
Other agricultural products	5.1	66.4	125	100	5.3	64.8	125	0.6	71.5
Fish & fish products	11.2	10.7	26	100	10.3	15.9	26	1.3	5.8
Minerals & metals	2	49.5	12	100	1.9	50.7	12	17.2	70.5
Petroleum	2.0	50.0	5	100	2.7	31.1	5	21.0	95.3
Chemicals	4.6	20.0	13	100	4.6	20.2	17	9.6	45.5
Wood, paper, etc.	0.9	84.1	10	100	1.1	80.3	10	3.5	84.3
Textiles	6.5	3.4	12	100	6.6	3.1	12	2.7	2.1
Clothing	11.5	0	12	100	11.5	0	12	5.6	0
Leather, footwear, etc.	4.2	27.8	17	100	4.2	25.7	17	2.6	14.4
Non-electrical machinery	1.7	26.5	10	100	1.7	28.1	10	8.8	61.0
Electrical machinery	2.4	31.5	14	100	2.5	31.2	14	8.8	60.4
Transport equipment	4.1	15.7	22	100	4.1	17	22	6.2	18.6
Manufactures, n.e.s.	2.5	25.9	14	100	2.4	26.9	14	6.6	51.3

Source: WTO (2006), "World Tariff Profiles", Geneva.

The current structure of trade between the EU and Canada is endogeneously determined by tariff barriers (as well as non-tariff barriers), which are pervasive in all product categories. Hence, it is erroneous to conclude that there will be no gains from tariff liberalisation between EU and Canada. The gains from tariff elimination can be maximised if tariff peaks can also be removed on both sides; otherwise the gains will likely be small. Also a potential EU-Canada FTA should include agricultural goods eliminating tariffs on most products acknowledging sensitive items from both sides.

4. Non-tariff barriers, technical barriers to trade and sanitary and phytosanitary standards

Unquestionably one of the most important achievements of the WTO has been to lower tariff barriers as well as to bring certainty into the world trading system by binding tariffs at a certain level. As a result, especially for trade between developed countries, tariffs are no longer considered to be the main obstacle. Instead, non-tariff barriers (NTBs) – such as import licensing, customs valuation rules, pre-shipment inspection, rules of origin and investment

measures – technical barriers to trade (TBTs) in industrial goods and sanitary and phytosanitary standards (SPS) in agricultural products – such as domestic standardisation rules, double-testing, special labelling requirements and certification procedures – are believed to hinder trade more.

Specifically, for Canadian exporters the main barriers appear to be with respect to packaging, labelling, certification (i.e. TBTs), and health and safety standards (i.e. SPS). For the EU, the main regulatory barriers involve obtaining sanitary approval for foodstuffs, regulations on spirits (i.e. SPS), labelling and packaging requirements for products and differences in technical and safety standards (TBTs). Below is a summary table of specific barriers to trade reported by EU exporters to Canada (2002).

*Table 10. Specific barriers for EU exports to Canada**

Product	Problem
All cheeses	The importation of cheese is limited to a quota of 20.5 million tonnes, which is insufficient and the quota management is not efficient. Veterinary certificates required for imports of EU cheese are difficult to obtain. Delays and burdensome procedures create important additional costs for exporters.
Butter	The quota for butter is considered insufficient. EU companies cannot gain market share on the Canadian market.
Prosciutto di Parma	Trademark “Parma” is owned by a Canadian company. EU companies cannot export their product using their EU geographical indication “Parma”. Additional costs reduce market share. Burdensome judicial procedures for the recognition of their geographical indications.
Various foodstuffs	Problems regarding specific labelling and packaging requirements for foodstuffs (nutritional labelling, more detailed product description requirements). Additional costs for EU companies. Packaging requirements - compulsory container size for some products, canned products requirements. Additional costs for EU companies obliged to use specific containers for Canada.
Wines and spirits	Discrimination in subsidies, as subsidies are alleged to be granted to domestic wines. Problems regarding the intellectual property protection for wines, spirits and European products with specific geographical denomination. Loss of market share.
Textiles, footwear, electrical products, recreational boats	Existence of high tariffs for these products hampers the access of EU products to the Canadian market.
Electrical products, cars, motorcycles	Technical standards: EU companies experienced additional delays and costs (standards difficult to obtain, costs to conform with the standards).
Pharmaceuticals and veterinary medicines	Approval procedure is very long. Additional costs and delays, because tests performed in the EU are not recognised.
Cosmetics	Differences in labelling requirements between the EU and Canada oblige EU companies to prepare new labels and to take on additional costs.
Chemical products	Labelling of chemical products is considered complex. Cost related to differences between EU and Canadian requirements.
Heaters, valves, pumps, faucets, hoods	According to EU companies, technical standards are not transparent and are difficult to obtain.

Barriers to investment	Problem
All general investment activities	SMEs do not always have the required logistical capacity to invest in the Canadian market

* The Conference Board of Canada has created a similar table that describes the specific restrictions on Canadian exports to the EU.

Source: Dehousse et al. (2002).

5. Regulatory barriers to trade

'Beyond the border' issues, such as regulatory barriers to trade, have also attracted considerable attention recently. One reason for this is that as developed countries are relatively more competitive in services, they are more and more interested in accessing new markets for their service providers. And since services are by their nature tariff-free, it is the divergence in domestic regulation that deters trade in services. Although both the EU and Canada have extensive GATS (General Agreement on Trade in Services) commitments, there are some issues raised as trade irritants. Below is a table on some barriers to trade in services reported by EU exporters to Canada (Dehousse et al., 2002).

Table 11. Barriers to trade in services

Service	Problem
Construction	The requirements for social insurance in Canada for temporary workers
Banking and finance	Limitations on foreign participation
Telecommunications	Limitations on foreign participation
All general services	Long delays in application procedures for visas and work permits Complicated requirements for obtaining a driving licence, which create difficulties for physical persons established in Canada The non-recognition of previous banking experience of companies is a problem for new companies wishing to establish in Canada

* The Conference Board of Canada has created a similar table that describes the specific restrictions on the export of Canadian services to the EU.

Source: Dehousse et al. (2002).

As mentioned above, part of the EU-Canada Partnership agenda includes the Framework of a Canada-EU Trade and Investment Enhancement Agreement (TIEA). The topics surrounding the TIEA give examples of the different regulatory barriers to trade between Canada and the EU. According to the Ministry of Foreign Affairs and International Trade of Canada, topics to be discussed in the TIEA include mutual recognition of professional qualifications, financial services, government procurement, e-commerce, temporary entry, small- and medium-sized enterprises, sustainable development, civil society consultation and science and technology.¹¹ With respect to all of these issues, the TIEA framework states that both Canada and the EU recognise that improving regulatory cooperation in these areas could facilitate trade and investment. For example, difficulties for temporary EU workers to obtain social insurance,

¹¹ Canada-EU TIEA (see <http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/eu-ue/index.aspx>).

visas, bank accounts and credit approvals, and driver's license recognition have been raised as so-called 'mode 4' issues hindering services trade.¹²

Below are five examples that demonstrate how regulatory divergence may affect Canada-EU trade. The first example deals with Canadian investment tax credits for scientific research. The second example, approval processes for pharmaceuticals, will show how increased cooperation could improve market access for both Canada and the EU. The final three examples involve the EU's Green Public Procurement Policies (GPP), the EU REACH Directive and EU withholding tax legislation, which will show how an FTA could improve Canadian exports and investment in the EU, if an FTA deals with regulatory issues including transparency.

i. Canadian investment tax credits for scientific research

As shown in section 2, the EU is a large contributor of FDI in Canada. Current Canadian policies with respect to investment tax credits could be improved for EU firms. One example is the Scientific Research and Experimental Development (SR&ED) tax incentive. The SR&ED tax incentives consist of three components: a corporate income tax reduction for research expenses (which lowers taxable income, and thus, payable taxes); an investment tax credit (which directly reduces taxes payable by the amount of the credit); and, in some instances, a tax refund (which can be used by companies that do not owe taxes but still incur R&D expenditures).¹³

Currently, the SR&ED tax credit is most easily obtained by Canadian Controlled Private Corporations (CCPC). As the Aerospace Industry Association of Canada (AIAC) notes:

A CCPC can benefit from: a) a higher level of tax credit (35% vs 20% for publicly traded firms); and b) the refundable nature of the tax credit (a CCPC can receive a cash refund of the unused portion even though the credit exceeds the amount of tax payable). [Because] tax credits earned by non-CCPC are not refundable, they can only be used to reduce the corporate income tax payable.¹⁴

According to the AIAC, foreign-based corporations do not receive the same tax benefits as CCPCs.¹⁵ A Canada-EU FTA that improves the access of EU firms operating in Canada to the SR&ED (and other) research and investment tax credits would be beneficial for the EU as many EU firms currently invest in the high technology sector in Canada. It should be noted that certain EU firms already have similar legislation regarding foreign firms investing in the EU. For example, foreign firms in the UK can receive a scientific R&D tax credit of up to 25%.¹⁶ Improving the access of EU firms to Canadian investment tax credits would encourage EU investment in Canada.

¹² Conference Board of Canada (2006), "Lost over the Atlantic? The Canada-EU Trade and Investment Relationship", p. 17 (available at <http://sso.conferenceboard.ca>).

See also Dehousse et al. (2002), "Business survey on conditions to access to the Canadian market", CEEI, December.

¹³ Parliamentary Information and Research Service (2006), "Scientific Research and Experimental Development: Tax Policy" (revised 27 July 2006), p. 1 and p. 3.

¹⁴ Aerospace Industries Association of Canada (2006a), "Call For Action", April, p. 9.

¹⁵ Aerospace Industries Association of Canada (2006b), "Improving the Effectiveness of the SR&ED Investment Tax Credits in Supporting Aerospace Technology Development and Commercialization", April.

¹⁶ BBC News (2002), "Foreign Firms Gain at Expense of UK plc's", 18 April (www.news.bbc.co.uk/2/hi/business/1936812.stm).

ii. Pharmaceuticals trade

The approval processes for pharmaceuticals in both Canada and the EU impede trade between the two nations. With respect to Canada, the average time that it takes for the government to approve a pharmaceutical is 672 days, compared to 459 days in the United States and 474 days in the EU. Part of the reason the process is so long in Canada is that in addition to Federal government approval, the provinces have a say. The length of time that it takes for pharmaceuticals to be approved in Canada erodes the patent lives of new products. This might be good for Canadian generics producers (which make up the bulk of the Canadian industry), but has negatively affected EU exports to Canada. In addition to approval times, reimbursement policies by provincial governments could be affecting the competitiveness of EU exports.

With respect to the EU, the approval process for pharmaceuticals falls under the jurisdiction of the member state health departments and the European Medicines Agency (EMA). The EMA is the EU's first step in creating a harmonised policy for the approval process of pharmaceuticals. As the EMA was only created in 2004, its authority is limited to certain types of pharmaceuticals. In an effort to improve trade between the US and EU, the Pharmaceutical Research Manufacturers of the US have lobbied the US Food and Drug Administration to improve its relationship with the EMA. If an FTA was to result in increased information-sharing between Canada and the EU, this would benefit two-way trade. It should be noted that Canada and the EU have already cooperated on pharmaceutical trade issues with the signing of the mutual recognition agreement – the Medicinal Goods Manufacturing Practices Compliance Certification Agreement.¹⁷

iii. The EU REACH Directive

The REACH Directive is an EU measure that attempts to improve the EU environment by regulating chemicals used in the production of products. REACH is one aspect of the EU's New Chemicals Policy (NCP), which replaces 40 pieces of EU legislation regarding chemicals and the environment with one directive that covers all aspects of EU chemicals policy. As the name suggests, REACH includes three main parts: Registration, Evaluation and Authorisation. Registration requires manufacturers (both domestic and foreign) to obtain relevant information on their substances and to employ methods contained in that data to manage the substances safely. Evaluation, which is undertaken by the European Chemicals Agency (ECHA), is the task of testing new industry products for health risks, as well as checking compliance of industries already involved in the selling of registered products. ECHA also has the job of coordinating substance evaluation to investigate the perceived risk of certain chemicals that are not yet required to be registered. Products and substances that are found to be of very high concern will be made subject to authorisation, which requires applicants to demonstrate that the risks associated with the products are adequately controlled and that the socio-economic benefits of the use of these substances outweigh the risks. Under the authorisation scheme, applicants must also analyse whether there are safer alternatives to the substances. If there are adequate substitutes, applicants must prepare substitution plans for these substances. It should be noted that the European Commission may at any time amend or withdraw any authorisation procedure if a suitable substitute becomes available. Also, should a substance fail to pass an authorisation, its use will be restricted by the Commission.

The REACH Directive affects Canadian trade because many of its natural resource exports to the EU such as iron ore, zinc and nickel contain small impurities that are considered dangerous by REACH. Because Canada trades these minerals in large quantities, the absolute volume of

¹⁷ This agreement resulted in the recognition that medicines packaged in Canada would be allowed to enter the EU without re-inspection at the border and vice versa.

the impurities is above REACH's one tonne limit. Although no econometric studies have been performed on the likely trade effects of REACH on Canadian exports, a study by the Minerals Council of Australia found that REACH could result in a decrease of Australian lead, zinc and nickel exports to the EU by between 21.1-71.5%, 20.3-73.4% and 25.8-75.2%, respectively, by 2010.¹⁸ Also in the US, the Transatlantic Economic Council expressed concern that REACH implementation is "causing serious problems for the export of US chemical products".¹⁹

It should be noted that the actual effects of REACH are still unknown and the Directive is very new (the law entered into force on 1 June 2007 and the obligation to register began in June 2008). If Canadian exporters of iron ore, zinc and nickel are required to register chemicals and have them authorised, this process will increase production costs for Canadian firms, which could cause a loss of competitiveness compared to substitute products that are not subject to REACH.

A Canada-EU FTA will likely have little effect on the REACH Directive, as it is currently under implementation. Nevertheless, an FTA that improved regulatory cooperation could prevent future EU directives from having negative impacts on Canadian natural resources or other exports, as already exists in the context of the EU-US dialogue with the Regulatory Cooperation Forum, instituted in January 2006.

iv. The Green Public Procurement policies of the EU

The Green Public Procurement (GPP) policies²⁰ of the EU are designed to reduce pollution by increasing both the demand for and supply of 'green' products. GPPs are still in their infancy in the EU, but are expected to become more prevalent in the next 5-10 years. GPPs may have a negative effect on Canadian forest products to the EU as they could result in restrictions on Canadian forest products containing certain chemicals. In addition, GPPs allow EU countries to rate a foreign country's manufacturing processes in forest products. The results of the GPP is that EU member states now have the right, and are even encouraged, to discriminate against products that they feel may pose a problem to human, plant or animal health. Although there are no specific agreements on the environment at the WTO level, sustainable development and the environment are among the fundamental goals of the WTO as indicated in the Marrakesh Agreement which established the WTO. Accordingly, the WTO allows member states to take trade-related measures to protect the environment provided that these measures are not used as tools for protectionism.

Examples from Belgium and Denmark suggest the possible negative effects of the EU GPPs on Canadian forest product exports. In the case of Belgium, the country has rated Canada's forest products manufacturing processes as second rate, meaning that certain Canadian forest products could possibly be restricted from the Belgium market unless these processes are changed. The decision by the Belgian authorities could place Canadian producers at a disadvantage compared to producers from other countries that were given first-rate certifications by the Belgian authorities.²¹

¹⁸ Minerals Council of Australia (2005), "REACH Factsheet", May (http://www.minerals.org.au/__data/assets/pdf_file/0005/8591/REACH_FACTSHEET_050512.pdf).

¹⁹ Transatlantic Economic Council (TEC) (2008), Joint Statement of the European Commission and the US, 13 May.

²⁰ GPPs are part of an EU initiative, but can be adopted in different ways by member states. As a consequence, the effects of GPP policies will vary depending on the member state.

²¹ From the Belgian website for GPPs (www.guidedesachatsdurables.be.fr/productfiles/home.asp).

With respect to Denmark, that country's GPP criteria require that certain 'socio-economic' conditions be met in order for a producer to be considered 'acceptable'. An issue for Canada is that in order for the Danish socio-economic requirement to be fulfilled, the government must ensure that "property and land tenure rights as well as legal, customary and traditional rights related to forest land and the utilisation of forest resources be clarified, recognised and respected". In addition to this, governments must ensure that "*appropriate* mechanisms for resolving disputes between timber production operators logging in the forests and local people should be laid down".²² Although the Danish GPP policy has not yet become binding legislation, it could result in restrictions on Canadian producers operating in areas with native populations where there are outstanding land disputes or other issues with respect to property rights.

The GPP policies demonstrate a perfect example of a country undertaking a policy in order to regulate one part of the economy, but which indirectly impacts international trade and supply chains. Such policies also remind us that the regulatory environment can evolve over time. This requires that an EU-Canada FTA should not only cover regulatory cooperation and transparency, but it should also take into account the changing nature of the regulatory environment to avoid becoming outdated.

v. Taxation procedures and securities legislation

Canadian investment and financial services trade in the EU is hindered by two main regulatory obstacles: taxation procedures and differing legislation in issuing and trading securities. These barriers not only increase the costs for firms involved in commerce between Canada and the EU, but complex regulatory procedures and lack of mutual recognition also discourage firms from being active in each other's markets, and thus reduce transatlantic trade.

With respect to taxation procedures, Canadian firms are faced with two hindrances: withholding taxes and taxation procedures on limited partnerships. Withholding taxes are the amount that are withheld by a paying agent on interest and dividend income, and paid to the tax authorities. If withholding taxes are credited against tax liabilities of the company in its home country, the withholding tax has no effect on cross-border trade. However, according to studies by the Canada Europe Round Table for Business (CERT) as well as the C.D. Howe Institute, Canadian firms operating in the EU are often not given the opportunity to credit EU withholding taxes, which increases the tax burden. Within the EU and the European Economic Area (EEA), this has been tackled in the parent/subsidiary Directive (90/435/EEC) and interest/royalty Directive (2003/49/EC), but this does not apply to third countries, with the exception of Switzerland. At international level, bilateral tax treaties may reduce the incidence of double taxation, but they differ largely across countries. As regards partnerships, they are also subject to withholding tax, although the tax can in theory be reduced to a treaty rate if an application is made. This process is quite onerous for limited partnerships as they generally deal with limited amounts of investments. Also, the regulation makes limited partners less competitive compared to domestic corporations, which are not subject to the withholding tax.

In terms of differing legislation in the issuance and trading of securities, increased cooperation between Canada and the EU would simplify what is currently a complex process for firms, and reduce the overall cost of transatlantic trade. Currently, securities issuance rules, stock exchange authorisation and brokers trading rules in Canada and the EU are not mutually recognised. The result is that a security issued in one jurisdiction may not be acceptable for public offer in another, brokers have no direct access to trade on exchanges in the other's jurisdiction and

²² From draft version of the Danish GPP policy (www.skovognatur.dk/NR/rdonlyres/EDDB0EC5-E2FC-494B-880F-D47635696A83/39935/draft_19_30_5.pdf).

exchanges cannot open their market.²³ Although no study has been done from a Canadian perspective, a study by Benn Steil (2002) concluded that full transatlantic integration between the United States and the EU would result in a 9% reduction in the cost of capital and a 60% reduction in transaction costs for listed companies. The study also found that the cost reductions for consumers would also lead to an increase in trading volume of roughly 50%.²⁴

It should be added that the EU and Canadian financial markets are not completely integrated in the areas of taxation and securities market regulation. Canada's differing provincial tax and securities regulatory structures as well as Canada-US integration (Canada has already aligned its investment procedures with the United States in order to facilitate increased cooperation between Canadian and American firms)²⁵ will also make it difficult for Canada and the EU to cooperate on financial markets and tax matters. Nevertheless, a Canada-EU FTA could help to lay the foundation for increased cooperation in securities markets, analogous to the EU-US financial market regulatory dialogue.

6. Economic arguments for an EU-Canada FTA

Trade theory postulates that there would be positive welfare gains to accrue to the EU and Canada from tariff elimination (provided that trade creation is greater than trade diversion), especially in those product categories where there are tariff peaks, both in agriculture and non-agricultural goods. In addition to tariffs, effective removal of NTBs, TBTs, SPS and regulatory barriers to trade in services and investment can bring substantial additional gains.

The arguments *for* an EU-Canada FTA, in this paper, are based only on economic grounds. First, from an EU perspective, Canada is a good FTA partner. As outlined in the Commission Communication *Global Europe: Competing in the World* (European Commission, 2006), the new trade policy of the EU was to provide market access to European firms in markets that are relatively closed in order to increase the competitiveness of the EU to meet the Lisbon Agenda goals. Hence the *Global Europe* Communication identified a number of potential FTA partners for the EU based on the following criteria:

- Countries or regions with large market potential (market size usually measured by GDP multiplied by the growth rate) and
- Countries with high tariff and non-tariff barriers.

As indicated in Table 12, Canada is used as a comparator to some of the EU's new FTA partners such as Korea, India and ASEAN. Compared to these countries/regions, Canada is smaller in market potential and is relatively much less protectionist. However, the US and Canada trade was also mostly tariff-free and open before CUSFTA was signed and entered into force in 1989. Still, the trade that was flowing freely from Canada to the US increased approximately 40% over the five years following the agreement. In addition, the imports that saw tariff reductions in excess of 5% saw trade increase dramatically to approximately twice its 1989 level by 1994 (Clausing, 2001).

²³ This may be changing, however. The Quebec Financial Markets Authority recently authorised the London Stock Exchange to place its screens and offer its stock directly to banks and brokers in Quebec.

²⁴ B. Steil (2002), "Building a Transatlantic Securities Market", International Securities Markets Association, Zurich, pp. 28-30.

²⁵ W.A. Dymond and M. Hart (2000), "Dreams and Delusions: The continuing allure of a Canada-EU free trade agreement", July, p. 17.

Table 12. Market potential and key economic indicators

	Market potential* (2005-25)	GDP (2005, €billions)	Annual average growth rates (2005-25)
China	204	1573	6.6
Japan	74	3920	1.6
India	58	607	5.5
ASEAN	57	714	4.9
South Korea	45	598	4.7
Mercosur	35	677	3.6
Canada	28	714	2.6

* Market potential = Economic size x growth.

Source: European Commission (2006).

As can be seen in Table 13, protection rates between Canada and the US were not negligible. In 1989, only 22.3% of Canadian exports to the US were tariff-free. One significant improvement from 1989 to 1994 is the reduction in the tariffs category of rates greater than 5%. According to the World Tariff Profiles report (2006), 99.2% of tariff lines are now duty-free for Canadian exports to the US, compared with only 20.4% to the EU. A comparison between Tables 13 and 14 shows that US protection rates in 1989 were similar to the levels of protection in the EU today. This implies that there may be similar gains from an EU-Canada FTA.

Table 13. The pattern of protection in 1989 and 1994 (for US imports from Canada)

	1989		1994	
	% of observations	% of imports	% of observations	% of imports
Free trade	22.3	62.6	26.7	62.7
Tariffs under 5%	45.0	33.8	60.0	36.6
Tariffs between 5 and 10%	20.8	3.1	9.3	0.6
Tariffs between 10 and 25%	10.2	0.5	3.7	0.1
Tariffs over 25%	1.6	0.0	0.2	0.0

Source: K. Clausing (2001), "Trade Creation and Trade Diversion in the Canada-US FTA", *Canadian Journal of Economics*.

Table 14. European Union tariff profile

Frequency distribution	Duty-free	0 <= 5	5 <= 10	10 <= 15	15 <= 25	25 <= 50	50 <= 100	> 100
Agricultural products	Tariff lines (in %)							
Final bound	32.5	9.1	15.1	11.7	10.1	10.9	7.6	0.9
MFN applied	2006 31.1	9.2	15.9	12.2	11.2	10.0	6.3	1.1
Non-agricultural products								
Final bound	28.4	37.1	26.6	6.9	0.9	0.0	0	0
MFN applied	2006 28.6	36.4	27.3	6.8	0.8	0.0	0	0

Source: WTO (2006), World Tariff Profiles.

As indicated in Figure 1 in section 2, both exports and imports of Canada to the EU have been increasing in value, but the shares of Canadian exports to the EU decreased dramatically despite an increase in the share of EU imports. This shows that Canadian exports have become more concentrated in the US and in some emerging market economies, at the expense of the EU. A study by Cameron & Loukine (2001) shows that an FTA between the EU and Canada may increase Canadian exports to the EU by 2.5 billion Canadian dollars and imports from the EU by 7 billion Canadian dollars, due to tariff elimination. Another recent study by Leblond (2007) also finds similar results.

Some might argue that the main motivation for an EU-Canada FTA may be to counteract the 'trade diversion' that was created by NAFTA (and CUSFTA) at the expense of the EU and to the benefit of the US. As argued by Viner (1950), the welfare effect of joining a preferential trading area (PTA) such as NAFTA is ambiguous. As a special case of a PTA, an FTA may cause both 'trade creation' which is welfare enhancing and 'trade diversion' which is welfare reducing. If Canada has started importing good A from the US instead of importing it from the EU, even though the EU was the more efficient producer of that good, then NAFTA must have caused some trade diversion. If trade diversion is larger than trade creation, then NAFTA can be said to have been welfare reducing for Canada. However, as an examination of the empirical literature shows, it is difficult to ascertain the exact magnitude of trade diversion (see e.g. Clausing, 2001; Krueger, 1999) (or creation) as this would require considerable and detailed information on trade patterns of the EU and the US with Canada, including information on intra-industry trade and trade in intermediate goods. One empirical example indicating trade diversion created by NAFTA is provided by Wall (2003). He points out that although the overall estimated effect of NAFTA on EU-Canada trade has been positive, at the regional level, both Eastern and Western Canada experienced large decreases in imports from Europe.

One of the most difficult aspects of an FTA with Canada for the EU is that EU trade policy is still committed to the Doha Development Agenda (DDA) within the WTO (as also is Canada). Hence starting negotiations with a major developed country before the conclusion of this round may send the wrong signal. However, some kind of deal is expected in the DDA by the end of the year, even though the results are not going to be far-reaching. Hence if the negotiations start after the DDA, they may also cover ground that was not sufficiently dealt with within the DDA.

Despite the positive aspects described above, there are some arguments against a Canada-EU FTA. One, from the Canadian perspective, suggests that because the Canadian economy is so deeply integrated into the North American economy, any arrangement with the EU that would have any serious impact (i.e. involve regulatory convergence) would compromise more important regulatory agreements with the United States.

The Canadian economy is indeed heavily dependent on the economy of the United States, but recent developments have shown that there are reasons for Canada to diversify its exports. The recent rise in the Canadian dollar has made Canadian exports less attractive to US consumers, which is illustrated by the reduced Canadian exports to the United States in recent years. In addition, an appreciation in the value of the euro has coincided with the weakening of the US dollar, which has increased the attractiveness of the EU market as a destination for Canadian exports. In an increasingly diverse international currency market, it might be in the best interest of Canadian exporters to diversify, as this could help to make Canadian firms more resilient to business cycles in the United States. From an international policy point of view, concluding a trade agreement with another trade bloc may be a useful way to signal to US policy-makers this deliberate choice of Canadian policy-makers to underpin the diversification.

In summary, the case for an EU-Canada FTA should be based on economic gains. The effects of removing tariff and non-tariff barriers, TBTs, SPSs and regulatory barriers to trade have been discussed above. Arguments against an EU-Canada FTA are generally motivated by political

considerations and are therefore beyond the scope of this paper. It can be concluded, however, that if large economic gains can be expected, this may drive the political agenda in the direction of more support for an EU-Canada FTA.

7. Conclusions

The main discussions in this report can be summarised in four points. First, an examination of trade flows and FDI positions in section 2 has demonstrated that both in terms of trade and FDI the EU is a significant trading partner for Canada; and to a lesser extent, Canada is a relatively important trading partner for the EU. Second, this paper has shown that although average MFN tariffs are low, there are many tariff lines with duties. In fact, in terms of tariffs, the level of protection in the EU market today is similar to the levels of protection in the US in 1989 when CUSFTA was signed. In addition to tariff barriers, there are many non-tariff barriers as well as technical barriers to trade in industrial goods and sanitary and phytosanitary standards in agricultural goods that impede trade between the EU and Canada.

Third, as highlighted in the *Global Europe* Communication, any FTA that the EU negotiates has to be 'WTO+', including services and investment liberalisation. As indicated in the sections on NTBs and regulatory barriers to trade, there are many trade irritants that can be tackled through an FTA between the EU and Canada to further liberalise trade in services and investment. Finally, the argument *for* an EU-Canada FTA should be based on economic motivations, rather than political reasoning. Political reasoning without an economic rationale will not get far. However, even if the economic rationale has low political support in the beginning, that support may increase if the benefits can be shown to outweigh the costs.

In this paper, we argue that there are significant economic gains from a potential EU-Canada FTA. The evolution of trade between the US and Canada after the signing of CUSFTA in 1989 is a good example to show how trade might increase. First, the patterns and levels of protection between the EU and Canada today are very similar to the protection that existed between the US and Canada when CUSFTA was signed. Second, as mentioned in section 6, even though a large percentage of trade between the US and Canada was free before CUSFTA, as is the case for EU and Canada today, there has been an increase of 40% in trade in goods that were already tariff-free. For those goods, where there has been more than a 5% reduction in tariffs, trade has doubled in the five years following CUSFTA. The positive effect of tariff liberalisation of an EU-Canada FTA on exports-imports is also supported by the results of some empirical studies as mentioned in the previous sections. Finally, it should be noted that these potential gains only take into account tariff liberalisation. Experience and quantitative analysis (e.g. using CGE models) suggest that there should be further gains from the removal of NTBs, and from services and investment liberalisation.

The right policy approach to an EU-Canada FTA is to acknowledge that a trade deal would be welfare enhancing for Canada. Even though, as mentioned in previous sections, there is scarce empirical evidence that either CUSFTA or NAFTA has caused any trade diversion, in reality it is possible to find more evidence that some trade has been diverted away from the EU. As it is very difficult to get information on the detailed patterns of trade between countries like Canada, the US and the EU where intra-industry trade and trade in intermediate goods dominate, it is difficult to measure the exact extent of trade diversion. In a previous section, it was shown that EU exports to Canada have in fact increased since 1980 from 10% (of Canada's world imports) to 14% in 2006. However, even though the EU's overall exports to Canada increased in value and share, such aggregate figures can hide trade diversion that might have occurred at a disaggregate level as suggested by the Wall study.

The benefits from an EU-Canada FTA have to be large enough to divert Canadian exporters' attention away from the US to the EU. It was shown above that although Canadian exports to the EU increased in value terms, there has been a dramatic decrease in shares from over 14% in 1980 to 7% in 2006. If an FTA removes most non-zero EU tariffs as well as NTBs, TBTs and SPS and brings services and investment liberalisation, the gains may be large enough for Canadian exporters to diversify away from the US. On the EU side, even though exports to Canada have been increasing both in value and market share, tariff liberalisation alone can increase EU competitiveness vis-à-vis the US. The EU faces significant levels of protection in Canada, where 56.5% of tariff lines are free, but 34% of tariff lines have duty rates above 5% in industrial goods.

On a product-by-product case, a rough rule of thumb is that there is a case for an EU-Canada FTA despite Canada's close ties with the US if the gains from removing the tariffs are larger than the cost of transport to the EU. As explained above, Canada's motivations for diversification away from the US are warranted. For the EU, however, the most crucial aspect of a potential FTA with Canada is that it will level the playing field between the EU and the US. The increased competitiveness of the US due to its FTA with Canada and its long-standing market shares due to its first-mover advantages will be hard to pull away from, but not impossible. In fact, Canada's motives for diversification and the EU's challenge to increase market share in the presence of a strong US are perfectly compatible.

Significant disagreements have arisen even before the start of the negotiations over the tariff liberalisation schedules for agricultural products. The European side has voiced concern over the fact that agricultural goods are going to be a major problem. It is very important that agriculture is included in trade negotiations as there are significant economic gains to both sides from trade liberalisation. If the EU can negotiate tariff liberalisation in agricultural products with Chile, Mexico, South Africa and now with Korea, it should be able to do so with Canada as well. If agriculture is left out of a potential FTA with Canada, this would send contradictory and protectionist signals to other (especially developing) countries as European trade Commissioner Peter Mandelson had just warned against protectionist tendencies in the current environment of increasing food prices and concerns over food security. One possible path may be for the EU to follow two-track negotiations with Canada: one set of fast-track negotiations to conclude tariff liberalisation in industrial goods, removal of NTBs and services and investment liberalisation, and another, slower track of negotiations on tariff liberalisation schedules on agri-foodstuffs.

Regarding concerns over the support (or lack of support) for multilateral negotiations, they may find their own solution. One way or another, the Doha round must be finalised by the end of this year. If negotiations can wait until after the DDA is completed, this would take the pressure off the pro camp, and weaken the hand of the opposition.

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Appendix

Top Canadian exports to the EU

Top 15 products (HS6 Codes)

Canadian dollars (millions)

	2005	2006	2007
284410 – Natural Uranium and its compounds	885	1,303	3,367
710812 - Gold in unwrought form	1,897	3,069	2,911
750120 - Nickel Oxide Sinters	505	732	1,394
710210 - Unsorted Diamonds	1,263	1,032	1,215
880240 – Aircraft NES of an Unladen Weight (more than 15,000 kg)	439	1,215	1,122
750210 - Nickel, Unwrought, Not Alloyed	426	403	967
760110 - Unwrought Aluminium - Not Alloyed	176	355	726
270112 - Bituminous Coal	841	799	714
710231 - Diamonds, Non-Industrial - Unworked	381	521	575
851770 - Parts of Tel Sets	-	-	573
711230 - Ash containing Precious Metal	342	400	549
260112 - Iron Ores and Concentrates, Other than Iron Pyrates	539	561	522
480100 - Newsprint, in rolls or sheets	479	328	514
470321 - Chemical Woodpulp	733	540	512
880230 - Airplanes of an Unladen Weight (2,001 - 15,000 kg)	263	588	419

Top EU exports to Canada

Top 15 products (HS6 Codes)

Canadian dollars (millions)

	2005	2006	2007
270900 - Crude Petroleum oils	4,354	5,099	5,079
300490 - Medicaments NES in Dosage	3,439	4,099	4,137
271011 - Light Petroleum oil Preparations (Including Gasoline)	1,629	2,152	1,762
870323 - Motor Vehicles, Cylinder Capacity 1501-3000 cc	1,389	1,690	1,738
870324 - Motor Vehicles, Cylinder Capacity +3000 cc	927	1,249	1,375
880330 - Parts of Airplanes or Helicopters NES	938	940	860
220421 - Grape Wines - Other than sparkling	595	689	743
293410 - Heterocyclic Compounds containing an Unfused Thiazole Ring in the Structure	78	800	613
841191 - Parts of Turbo-jets or Turbo-propellers	474	604	573
841112 - Turbo-jets Thrust exceeding 25 KN	350	248	460

843149 - Parts of Cranes, Work Trucks, Construction Machinery	289	315	367
300210 - Anticera and other Blood Fractions	172	230	322
271019 - Heavy Petroleum oil Preparations	355	222	320
841199 - Parts of Gas Turbines NES	269	216	303
220300 - Beer made from Malt	242	261	297

Top Canadian Exports to EU Member States

Top Canadian exports to the United Kingdom

Canadian dollars (millions)

	2005	2006	2007
710812 - Gold	1,888	3,068	2,887
284410 - Natural Uranium	281	761	2,145
750120 - Nickel	499	732	1,393
710210 - Unsorted Diamonds	738	484	588
711230 - Ash Containing Precious Metals	333	391	535
880240 - Aircrafts NES (more than 15,000 kg)	121	348	435

Top Canadian exports to the Netherlands

Canadian dollars (millions)

	2005	2006	2007
760110 - Unwrought Aluminum	161	355	611
284410 - Natural Uranium and its compounds	159	208	532
750210 - Nickel	109	137	453
270112 - Bituminous Coal	92	143	113
970110 - Paintings and Drawing (by hand)	107	85	106
271019 - Heavy Petroleum oil Preparations	131	193	103

Top Canadian exports to Germany

Canadian dollars (millions)

	2005	2006	2007
260112 - Iron Ores and Concentrates, agglomerated	324	350	236
260111 - Iron Ores and Concentrates, non-agglomerated	92	91	204
270112 - Bituminous Coal	189	233	186
284410 - Natural Uranium and its Compounds	162	69	155
260300 - Copper ores and Concentrates	0	78	151
841191 - Parts of Turbo-Jets	96	125	124

Top Canadian exports to France**Canadian dollars (millions)**

	2005	2006	2007
284410 - Natural Uranium and its compounds	282	265	536
841112 - Turbo Jets	148	123	205
880330 - Parts of Airplanes or helicopters	137	140	153
841122 - Turbo Propellers	26	51	90
300220 - Vaccines - Human Uses	75	98	88
480100 - Newsprint - in rolls or sheets	60	69	86

EU Member State Top Exports to Canada**Top German exports to Canada****Canadian dollars (millions)**

	2005	2006	2007
870323 - Motor Vehicles Cylinder Capacity 1501-3000 cc	867	1,105	1,245
300490 - Medicaments in Dosage	609	799	925
870324 - Motor Vehicles Cylinder Capacity +3000 cc	584	723	835
844313 - Offset Printing Machinery	-	-	111
850231 - Electric Generating sets - Wind Powered	4	97	107
841191 - Parts of Turbo Jets	76	78	105

Top UK exports to Canada**Canadian dollars (millions)**

	2005	2006	2007
270900 - Crude Petroleum Oils	3,648	3,937	4,377
300490 - Medicaments NES - in Dosage	617	903	782
880330 - Parts of Airplanes or Helicopters	759	654	629
841112 - Turbo Jets	130	186	398
841199 - Parts of Gas Turbines	231	179	247
870324 - Motor Vehicles Cylinder Capacity +3000 cc	157	218	218

Top French exports to Canada**Canadian dollars (millions)**

	2005	2006	2007
300490 - Medicaments in Dosage	377	502	509
220421 - Grape Wines	282	313	325
300390 - Medicaments (Bulk) NES	118	157	173

880330 - Parts of Airplanes	93	80	105
330499 - Beauty or Make up Preparations NES	87	83	102
330300 - Perfumes and Toilet Waters	79	77	86

Top Italian exports to Canada

Canadian dollars (millions)

	2005	2006	2007
220421 - Grape Wines	206	253	281
300490 - Medicaments NES in Dosage	174	200	151
841989 - Other Non-Domestic Machinery, Plant or Laboratory Equipment for Heat Treatment of Materials	7	7	127
271011 - Light Petroleum Oil Preparations (including Gasoline)	161	254	119
690890 - Tiles and Ceramic	95	92	95
848180 - Taps, Cocks Valves and other Similar Appliances	76	79	81

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