NAFTA: Raising Canada's Duty-Free Threshold on E-Commerce

- Among its many NAFTA negotiating objectives, the US government is seeking a significant increase in the Canadian and Mexican *de minimis* thresholds (DMT) for duty-free and tax-free courier imports. Given the rapid growth in global e-commerce, the proposed change could have far-reaching economic and fiscal implications.

- Some movement on the DMT may be a reasonable compromise in exchange for concessions elsewhere under NAFTA. However, the expected benefits to consumers and businesses from greater access to lower-cost imports and simplified customs clearance must be weighed against the potential cost to domestic retailers and government revenue.

- Raising Canada's DMT on the collection of duties from the current CAD 20 to CAD 200, while at the same time eliminating any exemption from sales taxes, would be a useful policy change. This could provide a valuable bargaining chip in the NAFTA renegotiations, benefit Canadian consumers and businesses, and create a more level playing field between domestic and foreign retailers, without implying any major changes to Canadian government revenue.

- Unilateral tariff reduction on select consumer products would also help to minimize the negative impact on domestic retailers; retailer savings would likely be passed on to consumers. Tariff relief could target areas where Canadian duties are high and domestic manufacturing is limited, such as apparel, linens, and footwear.

AN EMERGING NAFTA FLASHPOINT AND A CANADIAN COMPROMISE

Duty- and tax-free exemption limits on cross-border shipments have become a potential flashpoint in the renegotiation of the North American Free Trade Agreement (NAFTA). The US Trade Representative's (USTR) office has indicated that it wishes to see Canadian and Mexican thresholds raised to levels comparable to the US *de minimis* threshold (DMT) of USD 800; in the past, both Canada and Mexico have opposed such changes owing to concern about their potential impact on each country's local businesses. A reasonable compromise for Canada would be to raise its duty-free exemption on postal and express shipments to a level closer in line with other industrialized nations, while maintaining collection of sales taxes on the full value of these shipments. This should benefit both consumers and many small- and medium-sized enterprises (SMEs), maintain a relatively fair playing field for domestic retailers, and be fairly neutral from the perspective of government revenue. Broader import tariff reductions also should be considered.

BACKGROUND: A US NAFTA DEMAND

The US objectives for the renegotiation of NAFTA include an interest in seeing Canada and Mexico raise their DMT exemptions for express delivery shipments to a value comparable to the US level of USD 800. The US DMT was raised from USD 200 to USD 800 in March 2016.

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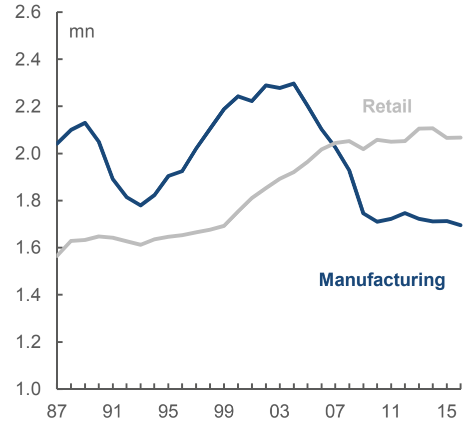
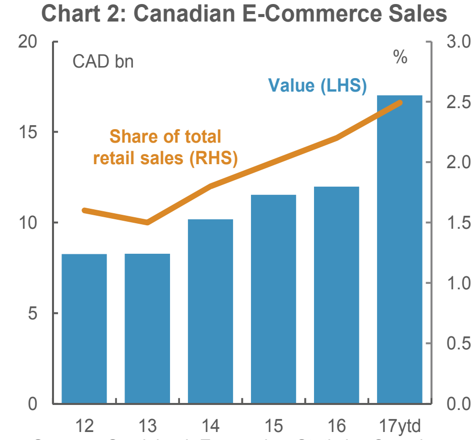
Chart 1: Canadian Employment



Sources: Scotiabank Economics, Statistics Canada.

Chart 2: Canadian E-Commerce Sales



Sources: Scotiabank Economics, Statistics Canada. Pre- and post-2016 data are not strictly comparable due to methodological changes.

The DMT is the value of postal and courier shipments that can be imported free of duties and taxes. Most consumer goods imported into Canada are already duty-free if they were manufactured in the US or Mexico and they qualified for duty-free access under NAFTA's rules of origin. Goods manufactured outside of NAFTA and other free-trade agreement (FTA) partners are subject to customs duties typically ranging from 5–20% (table 1). Most imported retail goods are also subject to federal and provincial sales taxes.

Canada's DMT for duty- and tax-free postal imports is currently set at CAD 20, one of the lowest thresholds among industrialized nations (table 2). Mexico's DMT is USD 300 for postal shipments and USD 50 for courier deliveries. Different country limits apply to cross-border personal travel exemptions.

Canadian and US e-retailers and express couriers have actively—and unsuccessfully—lobbied the Federal government for years to raise Canada's DMT. US trade negotiators pushed for an increase in Canada's DMT to USD 200 during the TPP negotiations, but this change did not make it into the draft TPP text. Earlier this year, Federal Finance Minister Bill Morneau took a pass on a request for an increase in Canada's DMT from a major consortium of e-retailers.

Meanwhile, the Retail Council of Canada (RCC) and Canadian Federation of Independent Business (CFIB) have advocated against raising the threshold, arguing it would put domestic retailers at a considerable competitive disadvantage to their international counterparts and result in job losses and foregone government revenue.

Mexican officials and business leaders also have voiced their concern over the proposal, fearing the move would prompt a flood of cheap imported manufactured goods from lower-cost emerging markets. Opposition is strongest to raising the import limit on goods produced outside of the NAFTA region.

Table 1
Canadian Customs Duties

	NAFTA-manufactured	Manufactured elsewhere
Apparel & footwear	0	up to 21%
Appliances	0	up to 9%
Automotive	0	up to 7%
Baby Items	0	up to 19%
Electronics & media	0	up to 7%
Home Furnishings	0	up to 19%
Food (ex. dairy & poultry)	0	up to 28%
Health & wellness	0	up to 7%
Jewellery	0	up to 9%
Movies, music, books	0	up to 6%
Outdoor living	0	up to 12%
Sports	0	up to 19%
Toys	0	up to 8%

Sources: Scotiabank Economics, CBSA Duty and Taxes Estimator.

A SNAPSHOT OF CANADA'S RETAIL INDUSTRY

Given the size of the Canadian retail sector, and the rapid growth in both domestic and international e-commerce, raising the DMT could have significant economic implications for Canada. There are more than 200,000 retail establishments in Canada, generating over CAD 550 bn in annual sales. The sector employs 2.1 mn Canadians, or 11% of the workforce. By comparison, Canada's manufacturing sector accounts for 1.7 mn workers (chart 1).

Canadian e-commerce sales totaled CAD 12 bn last year (chart 2). While it represented a relatively small 2.2% share of total retail sales in 2016, the channel is growing rapidly. Canadian online retail sales through the first six months of 2017 soared 42% from a year earlier, compared with a 7% rise among brick-and-mortar retailers. Canadian on-line purchases from foreign-located retailers are captured under postal imports, which totaled CAD 1.8 bn in 2015.

A 2016 Canada Post survey found that eight out of ten Canadians had made at least one online purchase in the prior year, with an average outlay of just over CAD 100. Apparel & accessories, books, music & videos, and consumer electronics were the

Table 2
International DMT Values for Express Shipments

	Duties	Taxes (Local currency)	Duties (USD)	Taxes (USD)
Canada	CAD 20	CAD 20	16	16
United States	USD 800	USD 800	800	800
Mexico	MXN 886/5,318*	MXN 886/5,318*	50/300*	50/300*
EU	EUR 150	EUR 22	177	26
UK	GBP 135	GBP 15	173	12
Japan	JPY 10,000	JPY 10,000	92	92
Australia	AUD 1,000	AUD 1,000*	790	790**

* Courier/postal shipments. **DMT to be eliminated as of July 2018.
Sources: Scotiabank Economics, Global Express Association.

most popular items purchased, though spending is also rising in emerging segments such as toys, hobbies & games, home improvement, and groceries. Just over half of Canada's online shoppers made at least one cross-border purchase, motivated by greater selection and/or lower prices. Purchases from US online merchants were most common (83%), followed by the Pacific Rim (42%) and Europe (16%).

BENEFITS AND COSTS OF RAISING THE DMT

A higher DMT exemption would be a big win for consumers, who could see substantial savings from the elimination of duties and taxes on foreign e-commerce purchases. Product choice and shopping convenience would be enhanced by easier access to the much larger US e-commerce market. US e-commerce sales totaled USD 390 bn last year, or 8% of total retail sales (chart 3), a much higher share than in Canada. The thinning of the border would likely foster greater domestic retail competition.

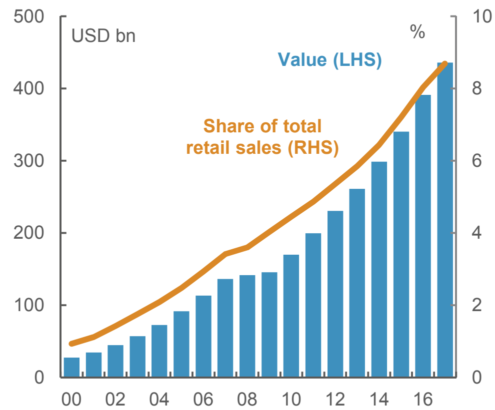
Raising the DMT on postal and express shipments would bring the duty- and tax-free allowance closer in line with the higher personal traveler exemptions more readily available to Canadians living close to the US border. Currently, Canadians are permitted to claim up to CAD 200 in goods without having to pay duty or taxes after a 24 hour absence from Canada, and CAD 800 after a 48 hour absence. Canadians who live far from the US border would be the most immediate beneficiaries of an increase in the DMT.

Many small- and medium-sized businesses also would likely welcome an enhanced DMT. Importing businesses and e-retailers in particular would benefit from cheaper low-value imports, reduced customs compliance costs, faster merchandise transit times, and easier product returns.

The negative impact of a higher DMT on Canadian retailers could, however, be substantial. They would likely lose domestic market share (both on- and off-line) to foreign online retailers. Exempting foreign online retailers from federal and provincial sales taxes on purchases below the DMT would give them a 5–15% cost advantage over domestic retailers, depending on the province of import. The price advantage Canadian retailers receive due to customs duties imposed on many imported consumer goods would also be reduced.

A higher DMT also could create an incentive for Canadian retailers to set up warehouses and distribution centres south of the border, from where they could ship items priced below the threshold to Canadian consumers both duty- and tax-free.

Chart 3: US E-Commerce Sales



Sources: Scotiabank Economics, US Census Bureau.

STRIKING A BALANCE

Some movement on the DMT during the NAFTA negotiations could be a reasonable compromise to generate concessions on other issues of vital interest to Canada. One option could be to raise the DMT exemption on collecting customs duties from CAD 20 to CAD 200. A DMT value of CAD 200 would be similar to the threshold in many other industrialized nations (table 2), and would better align the cost of assessing and collecting duties with the revenue raised. The Canadian Border Services Agency (CBSA) estimates there is no net revenue to the government from charging duties on postal shipments with a value of less than CAD 200.

At the same time, the federal government could set a zero DMT on the collection of sales taxes, which are relatively easily administered. This would put Canadian retailers on a more level playing field with foreign retailers. It would also minimize the potential loss in federal and provincial sales tax revenue that would result from a higher threshold.

Table 3

Canadian Customs Duties Revenues

Revenue generated per item	Number of tariff items	Estimated tariff revenue (CAD mn)
Total	7,097	5,432
CAD 0	3,869	0
CAD 1–CAD 100,000	1,973	26
CAD 100,000–CAD 1 mn	688	271
CAD 1 mn–CAD 5 mn	372	875
CAD 5 mn–CAD 25 mn	154	1,695
Greater than CAD 25 mn	41	2,564

Sources: Scotiabank Economics, Office of the Auditor General of Canada, Statistics Canada.

A two-tiered approach to the DMT that differentiates between duty and sales tax collection is in place in a number of other jurisdictions, including the EU and Australia. The EU low-value exemption is EUR 150 for customs duties, but only EUR 22 for the VAT (the EU has recently proposed reducing the latter to zero). Australia has a relatively high DMT of AUD 1,000 for the collection of customs duties, but has recently passed legislation to eliminate the low-value exemption for the GST (effective July 2018).

To minimize the negative impact of a higher DMT on domestic retailers, the government could unilaterally reduce tariffs on selected imported consumer products. Many products sold by Canadian retailers or distributed by Canadian wholesalers are imported and subject to customs tariffs. While average import-duty rates are low, they can be significant for some goods. This is primarily the case when goods are imported from countries with which Canada does not have an FTA, such as China and India. The vast majority of Canadian imports of apparel, linens, and footwear, for example, come from non-FTA partner countries and face customs duties of up to 20%.

The federal government could also consider broader tariff elimination, targeting products that generate little revenue, but add to business compliance costs. A recent tariff review by the Auditor General of Canada found that the bulk of tariff items generate relatively little government revenue (table 3). More than half of customs-duty revenues come from just three consumer goods categories: apparel, footwear, and vehicles and auto parts.

This combined approach—raising the DMT for duties, lowering it for sales taxes, and broader tariff elimination—would square well with the call by the Federal government's Advisory Council on Economic Growth to position Canada as a global trading hub in e-commerce and services.

BOLSTERING CUSTOMS COMPLIANCE

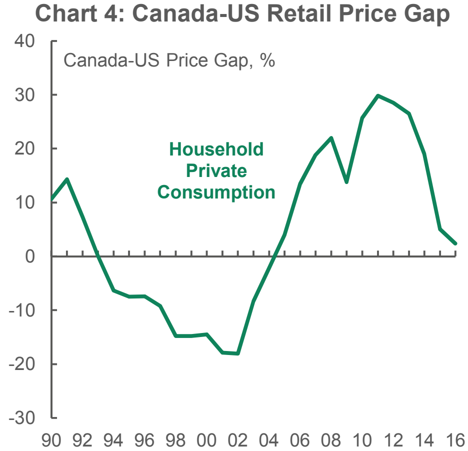
The ability to consistently enforce customs compliance has become more challenging alongside the significant increase in the number of imported parcels in recent years. A recent experimental survey by Copenhagen Economics found strong customs compliance on e-commerce shipments into Canada when sent via express operators (e.g., FedEx, UPS), but low compliance when sent via national postal operators. Compliance was found to be much lower for low-value shipments (CAD 30–60) than high-value (CAD 185–235).

Any moves to amend Canada's customs rules should include a review of customs compliance to ensure fairness and efficiency between postal and courier providers, and to minimize the loss of government revenues from non-compliance. Increased investment in staff resources and systems technologies may be needed. Effective customs clearance procedures are also essential to enforce import restrictions on controlled, prohibited, and counterfeit items.

NARROWING THE CANADA-US PRICE GAP

Increased duty-free exemptions and tariff reductions on consumer goods imports have been suggested as a means toward narrowing the retail price differential between Canada and the US for similar products. Yet, evidence of a Canada-US price gap is mixed. One broad, theoretical measure of relative price levels shows little evidence of a retail-sector-wide Canada-US price gap. Based on OECD estimates of purchasing power parity for private household consumption, the Canadian price of a common representative basket of consumer goods and services in 2016 was roughly equivalent to that in the United States (chart 4). The price gap has narrowed steadily since 2012, which suggests that wholesalers and retailers have been unable to pass-through much of the inflationary impact of a weakening Canadian dollar on import costs. However, notable price level differences may persist in specific product categories.

Chart 4: Canada-US Retail Price Gap



Sources: Scotiabank Economics, OECD.

Yet, in a small, albeit unscientific, survey of consumer goods prices for identical products from a major US-based retailer that offers both physical and online sales in Canada and the United States, we found that Canadian retail prices (in USD terms) are, on average, about 10% higher than in the United States. Office supplies, toys, baby items, and footwear tended to be more expensive in Canada, while some electronics, household appliances, and media were similarly or even modestly lower priced. In the case of products that were significantly cheaper in the United States, the gap reflected, in part, the greater use of promotional discounts from the US list price, which itself points to greater domestic retail competition south of the border.

A number of factors contribute to higher retail prices in Canada, including higher labour and regulatory costs. For instance, the relatively smaller size and scale of the Canadian retail sector may reduce Canadian retailers' bargaining power with foreign manufacturers and wholesalers. Lower population density and higher fuel prices derived from tax differentials also contribute to higher transportation costs. The average price of a litre of gasoline in Canada in July was USD 86.1cents versus 62.1 in the US.

The cost advantage to Canadian consumers of purchasing from a US retailer in many instances is more than offset once sales taxes (5–15%), duties (usually 0% if manufactured in NAFTA or other FTA partners, but averaging 5–20% for goods from other countries), brokerage fees (CAD 10–25 per parcel), foreign exchange transaction fees (around 2.5%), and higher cross-border shipping rates have been imposed.

CONCLUSION: A COMBINED APPROACH MAKES SENSE

The re-opening of NAFTA and the US focus on e-commerce in its negotiating objectives together provide a natural opportunity to revisit the *de minimis* threshold for duties and sales taxes on shipments into Canada. Raising the DMT for Canadian duties from CAD 20 to CAD 200 would generate immediate benefits for Canadian consumers and businesses by lowering costs, widening choices, and increasing competition. At the same time, setting the DMT for sales taxes on inbound shipments at zero would make the playing field between Canadian and foreign retailers more level. Additionally, lowering tariffs on selected consumer products combined with tariff elimination in product categories that raise little revenue would lower retailers' import costs and reduce compliance costs for Canadian business—savings that would likely be passed on to consumers. Altogether, this combined package of offsetting reforms would generate benefits for Canadian consumers and business, while also providing Canada a useful point on which to pursue concessions from the US elsewhere in the NAFTA negotiations.