

CUTTING OUT THE DUTIES: ENABLING INTELLIGENT CANADIAN RETAIL IN A GLOBAL MARKET

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Introduction

Digital technologies have not only offered drastic changes to the technology sector itself, but they are positively disrupting all sectors of the economy. They have changed the way we work and the nature of work itself, the reach of communication along with the way we interact, and ultimately, they have changed the way we live. As a result, these shifts have left our institutions, regulatory bodies and even international agreements in a race against time as they struggle to keep pace.

Enter the North American Free Trade Agreement (NAFTA). Established for the purpose of strengthening and solidifying tariff-free trade between Canada, Mexico and our largest trading partner the United States, NAFTA was ratified only one year prior to the first dot-com boom that ushered in Internet-enabled shifts in business operations on a global scale. Coming into effect in January 1994, with no built-in standards relevant to digital technologies and the commercial use of the Internet, less than a decade following its ratification, NAFTA was already behind the times. And as digital transformation continues to mold and reshape the economies of North America and the world, the gaps in the initial agreement are becoming increasingly evident.

Fast forward nearly 15 years later to 2017. NAFTA is up for renegotiation, and many would argue, for good reason. Highlighting the need for digital standards under the Agreement, growth in online commerce has climbed steadily in North America over the years, and continues to rise. In the US, Statistica estimates that ecommerce sales grew by a 9.4% from 2015 to 2016 alone. In Canada, similar results surfaced, with online sales increasing by 8.4% during the same period. Specific to Canada, KPMG's 2017 Global Online Consumer Report found that over 80% of Canadians have purchased at least one item online in the last three months. These respondents cited ease, convenience and variety as the main reasons for purchasing items online, and another 60% said they would buy online even more frequently if the process were easier. While traditional brick and mortar retailers still play a central role in the economies of both Canada and the US, the growth of online commerce cannot be ignored. More, with recent developments like the Comprehensive Economic and Trade Agreement (CETA) between Canada and the European Union entering into force on September 21st, 2017 – an agreement which will offer Canada favorable access to a market boasting economic activity of \$18 trillion, annually – we can only estimate that the presence of online retail in Canada will continue to expand. If we are committed to signing collaborative and outward-looking trade agreements like CETA that open new markets for domestic retailers, then we must also ensure that those very retailers are backed by policies that support their ability to participate. It's never been more important for us to shed protectionist values and engage new market opportunities to remain competitive in today's growing digital economy, and support the creation of well-paying jobs for Canadians.

The Strength and Growth of Online Retail

A central component of this economy, the emboldened popularity of online shopping is also clear when it comes to recent revenue scores of top retail companies. According to the STORES Top 100 Retailer list of 2016, Amazon – a company whose ballooning success has sparked a call for a second North American headquarters (HQ2) – has shown impressive results. Ranked 7th in terms of total revenue, Amazon outstripped traditional retail giants like Target, Macy's, TJX and several others.

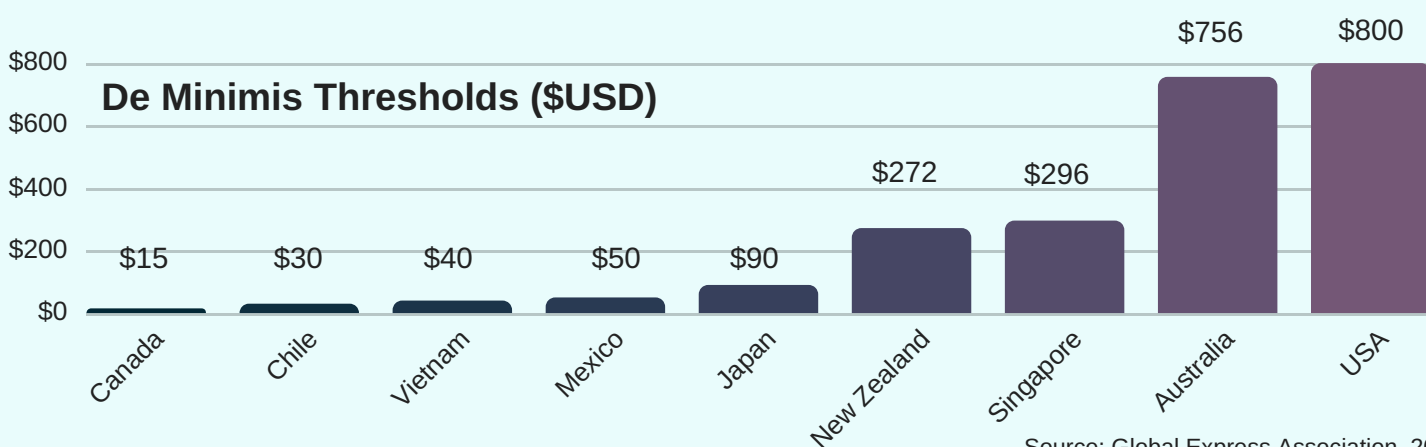


Not surprisingly, when it came to competing for online sales only, Amazon far superseded the proceeds of any company in the US. According to 2016 National Retail Federation figures, Amazon came in at nearly \$95 billion in sales that year alone, showing a growth of more than 19% since the year prior. Compare this to the runner up, Apple, whose annual online revenue totaled slightly more than 15% of Amazon's at \$17 billion, or to the US' largest traditional retail chains, Walmart and Target, totaling annual revenue of \$14.4 billion, and \$3.1 billion, respectively. By comparison, eBay, the largest runner up to Amazon for ecommerce confirmed annual revenue that surpassed many traditional retailers as well, totaling nearly \$9 billion during the same period.

Despite this immense growth in ecommerce on a global scale, the Canadian market today is still largely dominated by traditional brick and mortar retail. Statistics Canada estimates that ecommerce accounted for roughly 2.3% of all sales made in Canada during 2016. While it's clear that the traditional retail sector in Canada will not be replaced anytime soon by the online world, increasing digital adoption continues to expand, offering customers added variety and convenience. This will inevitably mean that the gap between businesses that embrace this digital transformation and those that do not will become increasingly evident. No greater example of this is notable than in the US - the world's leading ecommerce market. According to the US National Retail Federation, online sales are predicted to grow three times faster than the traditional retail sector by the end of 2017. While still holding a relatively small portion of the US retail market – just over 11% in 2016 - ecommerce is expected to show significant growth, while purchases completed in-person are projected to remain relatively stagnant. With forecasts like these, the writing is on the wall: retailers can either bolster their online marketplaces and compete for global consumer presence, or risk being left behind.

De Minimis in the Canadian Context: To Raise or Not to Raise

So where do we, in Canada, start? One key concept impacting both businesses and consumers in Canada when it comes to online retail is the threshold value of foreign goods that are subject to duties or taxes. Trade gurus refer to this as "de minimis" – a Latin expression meaning, literally translated: *trivial things*. A controversial issue, the Canadian de minimis threshold – one that has remained unchanged since the early 1980s – is subject to fractious debate. On one hand, some in the Canadian retail sector argue that a low de minimis is necessary to protect the Canadian marketplace – one that is considerably smaller than many of its global competitors. On the other hand, advocates for raising the de minimis indicate that increased online retail would help small businesses, boost productivity in other sectors of the economy such as the postal service or transportation, while simultaneously offering benefits to customers.



Source: Global Express Association, 2016.

Fearing adverse effects to the traditional retail market, some in the retail sector are currently leading the case in Canada against the de minimis increase. Arguing that increasing the de minimis thresholds to levels similar to our competitors would produce an exponential increase in online shopping, the sector suggests that this change would undoubtedly usher in negative consequences for Canadian retailers and their employees, while also reducing government revenue from duty and tax collection. Using this logic, they assert that a significant rise in the de minimis would not only fail to benefit Canadian companies, but would create a scenario in which foreign retailers would push Canadian retailers out of the market, altogether. However, considering that nearly half of all online orders in Canada already come from foreign retailers with the current \$20 threshold, the argument is somewhat of a hard sell.

On the contrary, Andrea Stairs, eBay Canada's managing director argues that raising the de minimis would actually benefit Canadian small businesses, rather than harm them. “[Canadian] sellers don't trade internationally the same way that their larger multi-national counterparts do [...] leaving smaller Canadian ecommerce retailers unable to compete with the US sellers' access to low-volume international supply chains.” Often, products that support Canadian small business innovation are simply not available in Canada, and companies who import these supplies or products are particularly stunted in their efforts to either scale up or commercialize as a result of high duties and taxes. Moreover, by paying more than their US counterparts for supplies, Stairs argues that Canadian businesses are increasingly required to compete for buyers by reducing profit margins. This puts Canadian companies looking to increase their market presence at a particular disadvantage in relation to foreign counterparts.

At the consumer level, trends indicate that more and more Canadians are choosing to shop online. As a result, for this group, which may end up paying 30% in duties and taxes on top of their purchases, many of the advantages of raising the de minimis threshold are obvious. In 2016 alone, despite the year closing at average FX rates of 0.75 USD and 0.68 EUR – some of the lowest rates seen over the course of the last decade – the frequency of online shopping done by Canadian consumers for foreign goods was still substantial. That year, Statistics Canada reports that nearly half (40%) of the \$19.2 billion in Canadian ecommerce sales were from foreign retailers.

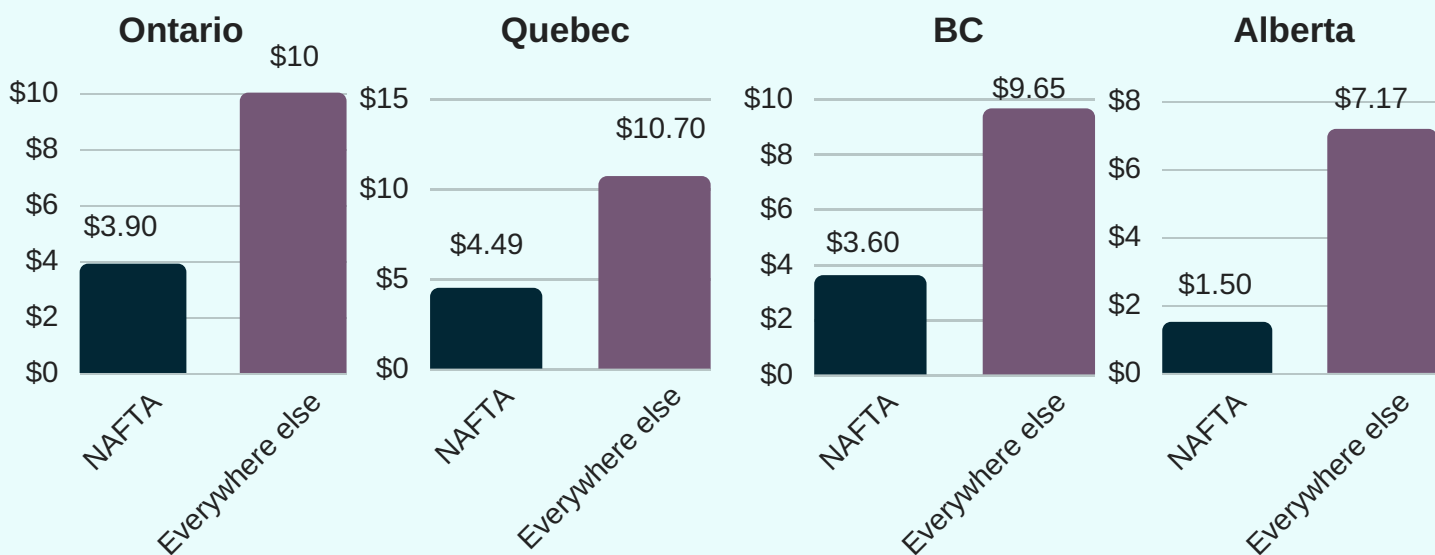
Increasingly, Canadian consumers are showing their discontent with this policy. Current polls suggest that the majority of Canadians are actually in favor of raising the de minimis limit. In a study conducted by the Canadian American Business Council, 76% of Canadians were found to be in favor of raising the duty-free limit to \$200 - a figure still well-below the US' current de minimis limit of \$800 and roughly on par with the EU's limit of €150.

Opponents to de minimis increases claim that, aside from producing some consumer benefits, raising it will negatively impact Canadian retailers and government revenue streams, alike. Proponents of de minimis increases like eBay Canada's managing director Andrea Stairs assert the opposite – instead suggesting that we are far overdue for a change in this realm and that Canada's current de minimis threshold is actually a “*money-losing endeavor for taxpayers*”. Needless to say, there are varying opinions on both sides, each with their own points of validity. However, at the end of the day, what really matters is how any potential change will impact Canadians, the government and Canadian businesses.

Duties on Low-Value Items: Is it Really Worth It?

One relevant consideration for all three groups – that is, government, consumers and businesses – is asserting whether or not we are actually generating substantial duties and taxes to outstrip the cost of compliance needed to impose them. A quick analysis of applicable duties and taxes from the Canadian Border Services Agency highlights an interesting observation. Here, for example, a \$30 piece of men’s clothing apparel shipped to Ontario from a NAFTA country, the applicable taxes (no duties due to NAFTA) are \$3.90. Likewise, if that same \$30 item is shipped from a country outside of NAFTA, the duties and sales tax total \$10. While these costs vary across provinces and item categories, for low-value items such as this, it’s entirely possible that the price of assessing duties and taxes– including the time and cost of allocating government resources to undergo customs valuation procedures – can outweigh the revenue gained from the penalties themselves. In the above example, can we truly say with certainty that the time and resources required to assess a \$10 fee on a \$30 item shipped from China to Canada will actually be worth it?

Duties and Sales Tax - \$30 Men's Clothing Item

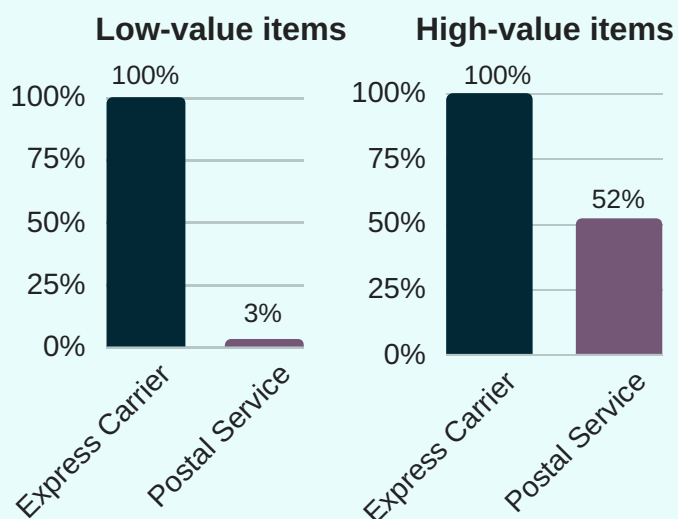


Source: Canada Border Service Agency, 2017.

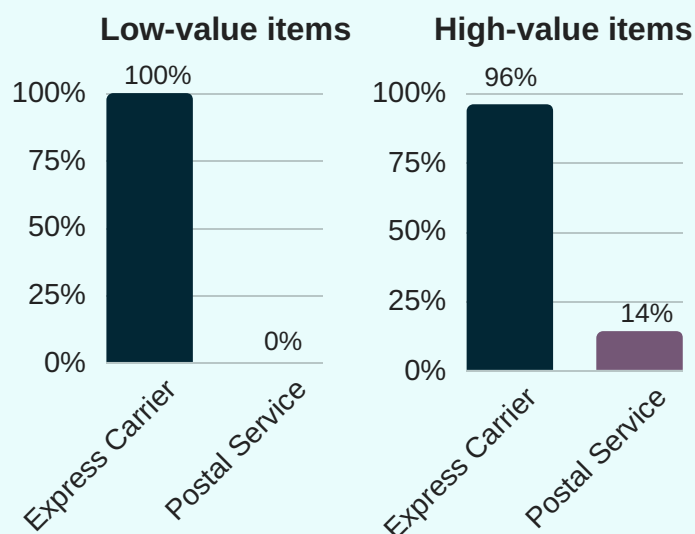
How Much are we Actually Raking In? Customs Compliance

Adding further insight into the notion that a low de minimis increases government revenue, research conducted by the Copenhagen Economics Institute has suggested that this very concept may be little more than a popular theory. The study analyzed 200 parcels being shipped to Canada – half shipped via postal operators (i.e. national postal services) and the other half shipped using express carriers (i.e. UPS, FedEx). Of these parcels, 120 were low value shipments (approx. \$30 CAD) and the other 80 were high value (approx. \$200 CAD). While the rate of sales tax and duty collection was overall considerably higher with private carriers, the study identified drastic discrepancies in compliance with customs procedures when it came to national postal services, especially in relation to low-value items. Showcasing the most significant results out of the sample size, postal carriers assessing low-value items were found to have levied the appropriate sales taxes 3% of the time, and appropriate duties 0% of the time.

Sales Tax Levy Frequency



Import Duty Levy Frequency



Source: Copenhagen Economics Institute, 2017.

Where Do We Go From Here?

Therefore, while in theory, the imposition of a low de minimis on foreign items imported into Canada is meant to protect domestic businesses and generate revenues from taxes and duties, inconsistent collection practices function to produce the opposite effect. Estimating the loss of revenue on an annual basis, the study found that these inconsistent practices cause Canada to forego an average of \$1.3 billion a year in duties, taxes and brokerage charges – and this is not counting the loss of funds from resource allocation to conduct these activities. Knowing this, can we truly justify investing more resources to correct compliance failures across the board? Should we raise the de minimis threshold and reallocate customs resources to higher-value items only? Or should we try something in between? One in-between approach may involve creating an option similar to what exists in the European Union. This would mandate raising the de minimis threshold for duties – say to \$200 – while leaving the threshold for sales taxes as is (\$20). Under this scenario, consumers would have greater options and incentives for buying online, while the government would still reap the rewards of sales tax revenues, similar to when purchasing items in a store.

There are many issues currently at play in the debate over raising the Canadian de minimis threshold. From the impact on tax revenues, to the effect on Canadian small businesses and consumers, the subject can be looked at from several different lenses – each with their own set of potential incentives and drawbacks. Yet, while we are unlikely to see drastic revisions like the US call to raise Canada's de minimis threshold to \$800 USD (more than \$1,000 CAD), it's increasingly clear that some kind of change is necessary.

In an age where technological growth and creativity has allowed for an ecommerce company to top the list of the world's most innovative companies, and its CEO to top the list of the world's wealthiest people, Canada has the opportunity to redefine itself. We have the chance to lead progress, rather than to just go along with it; and to drive new standards, rather than simply adhere to current ones because they're there. But no matter how we approach our role and our responsibilities in this increasingly connected world, the need to remain competitive in the global market is key; and shaping policies that put both Canadian consumers and businesses first should be our top priority.

Recommendations

- 1** In an age where digital technology is quickly reshaping business, policymakers should strive to shape and support trade policies that incentivize Canadian retailers to compete in the global market.
- 2** With highly polarizing issues such as de minimis, where possible, policymakers should consider middle-ground approaches. In this case, a compromise similar to that in the EU (duty threshold raised to \$200, but sales tax threshold stays at \$20) may be one solution.
- 3** Policymakers, in combination with industry and academia, should focus on conducting more research into the direct economic impacts of changing de minimis thresholds on Canadians, Canadian businesses and government revenue streams.