Further, as tariffs have been substantially reduced and largely abolished, trade costs associated with transport and distribution services now appear larger than remaining tariff duties (Table C-5). For instance, in the 1960s, the wholesale and transport costs accounted for 9.5 per cent of total Canadian merchandise exports, similar to the 9.3 per cent level of custom duties. In the 1990s, however, average duty rates on total imports dropped to 4.6 per cent, while wholesale and transport costs stood at 8.2 per cent (the custom duty rate fell to 2.6 per cent in 1997, while wholesale and transportation rates combined were 7.8 per cent in the same year). Given the importance of these services components in total trade costs, liberalization in services might be the next key step in promoting greater merchandise trade.

Table C-5. Ad valorem, wholesale, and transport rates for Canadian exports and duty rates for total Canadian imports (per cent)

	Wholesale	Transport	Duties
1965-69	2.8	6.7	9.3
1970-79	2.7	5.7	7.6
1980-89	3.2	5.3	6.8
1990-97	4.1	4.1	4.6

The home-market effect

Having examined the time-series pattern of trade costs, the following section summarizes some econometric estimations to quantify the impact of changes in trade costs on Canada's merchandise trade pattern using the gravity or economic geography model. In particular, it tests a hypothesis of whether or not declines in trade costs have helped "reverse" the home-market effect, strengthening the advantage of smaller countries in producing differentiated products. Table C-6 shows that the estimated coefficient for home-income is 1.08, higher than that of foreign-income of 0.72. This result appears to confirm the reverse of the "home-market effect"[7].

Table C-6. Estimation results for exports of differentiated products

Dependent variable: Exports of differentiated products				
The Method of Instrumental Variables:				
Instrument list: Canada GDP, wholesale, transport, and time				
1965-97	Canada GDP	Foreign GDP	Duties	
	1.08	0.72	-0.51	$R^2 = 0.99$
	(2.54)	(1.74)	(-3.98)	

Conclusions

Evidence presented here suggests that falling transport costs and expanding distribution services could offset the location advantage of larger countries, leading to the expansion of production and exports of high-valued differentiated products from smaller countries. Thus, freer trade, particularly in the services sectors, could further strengthen smaller countries' advantages by enhancing their market access to a large market.

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[1] Obstfeld, Maurice and Kenneth Rogoff "The Six Major Puzzles in International Macroeconomics: is There a Common Cause?" NBER Working Paper 7777, Cambridge, MA.

[2] In the Canadian input-output tables, there are seven "trade margins" distinguished: retail, wholesale, tax, transport, gas, storage, and pipelines. These are extra trade-related costs that are attached to Canadian merchandise exports. This paper will focus on transport and wholesale margins only.