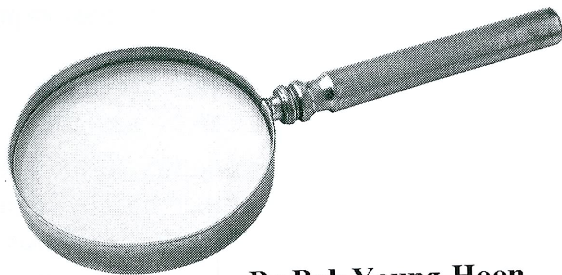
A Critique of the Role of the Export Development Corporation



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Introduction

The purpose of this paper is to investigate whether there is sufficient need for government intervention in the Canadian export market through export promotion. Presently, the main agency used for this purpose is the Export Development Corporation (EDC), a crown corporation, which assists the government in pursuing their goals of export growth, and diversification of trade patterns and of the range of products exported (Economic Council of Canada, Ottawa, 1982, 44). The EDC uses two financial instruments as means to achieve these objectives: credit insurance, and export credit. There are, however, financial institutions operating in the private market that can provide these two instruments. Why then, does government feel the need to keep operating the EDC since the international market in these types of services are better equipped to handle any inefficiencies that may exist? Relative to the private market, the EDC is thought of as being inefficient because essentially, the EDC is subsidizing exports at the expense of taxpayers. This expense manifests itself firstly in the form of taxpayer funding of the initial capital required to establish the EDC (approximately one billion dollars), and subsequently, in both offering export credit at rates below that of the market, and in direct subsidization of certain exports. It should be noted however, that the problem does not lie in the type of business that the EDC is carrying out since, facilities such as this ARE needed in order to reduce existing market failures (as will be discussed later on), but rather, it is the EDC's existence as a crown corporation that is in question. As was stated earlier, the one billion dollars that was initially invested to create the EDC came out of taxpayers' pockets; this would not have been so under a private organization. Added to this is the fact that, because the EDC is a crown corporation, they are exempt from many taxes that are paid by private sector firms, and also, any debt that they assume is ultimately a government liability (this debt which includes possible defaults on loans made by the EDC) and as such, once again comes out of the taxpayers' pocket. Taking into account both the arguments against the EDC, and at the same time realizing the possibility of a need for the service that they provide over that of the private market, I will show that there is no justification for the existence of the EDC. I will do this by firstly presenting some of the economic theory behind why export subsidies are viewed as being undesirable. I will then address market failures that may require this type of government intervention. Following this, I will present some arguments for and against the EDC, after which I will discuss the question of, "If other countries promote their exports, should Canada do the same?" I will then present my conclusion which will include some closing thoughts.

ECONOMIC THEORY - EXPORT SUBSIDIES

Export subsidies exist not because they are efficient and have net benefits to society, but rather, export subsidies are implemented mainly as the result of extensive lobbying by a small but concentrated group of individuals who derive large benefits from the use of such subsidies. However, the vast majority of society loses, but their individual loss is not enough to induce them to lobby against the subsidy. The inefficiency in employing the use of an export subsidy is evident when the overall effect is that the exporting country loses, the importing country gains, but on the whole, there is a net loss. I will now show how this inefficiency comes about.

Take the case of a large exporting country, A, and an importing country, B, trading commodity, C. If country A places an export subsidy on C, it will now be cheaperfor B to buy C from A and therefore the flow of C from A to B will increase. This will cause the supply of C in B to increase causing the price to fall. This will in turn raise B's demand for C, which will mean that the supply of C in A will fall and the price of C in A will rise. This rise in price of C in A reduces A's domestic demand for C and therefore raises their export supply. Diagram I illustrates this price effect.

Diagram 2 shows the welfare effects that are accompanied by these movements of prices, which were ultimately brought about by the implementation of the subsidy. P^{FT} is the price in the absence of subsidies or any other type of government intervention, P^A is the price paid by the exporting country, and P^B is the price paid by the importing country.

As is shown, when the subsidy is applied, the price of C to A increases from P^{FT} to P^A, and the price of C to B decreases from P^{FT} to P^B with the difference in prices P^A and Pb being equivalent to the size of the export subsidy.

From the diagram it can be seen that

1. In the exporting country A, there is a decrease in consumer surplus of (a + b), an increase in producer surplus of (a + b + c) and a decrease in government revenue of (b + c + d + f + g + h). This results in a net loss in A's welfare of (b + d + f + g + h). This reflects the previously stated fact that the benefits of the subsidy in the exporting country accrue to the small group of special interest lobbyists (the producers) at the expense of the more dispersed majority of society (the consumers). The benefits of the producers come about because the increase in price allows them to increase their producer surplus as well as enjoy increased profits and/or payments to fixed costs. Similarly, consumers lose because of the increase in price, which lowers the amount of consumer surplus in the market. In addition to this loss in consumer surplus, consumers (who are assumed to also be taxpayers) may also lose through the government subsidization of these exports. This is true whether this loss is realized through the raising of taxes, which would be accompanied by a change in spending patterns of consumers, or, if the loss is realized through government cut backs on other publicly provided goods.
2. In the importing country B, there is an increase in consumer surplus of

(E + F + G) and a decrease in producer surplus of (E + F). This results in a net gain to B of G. As with the exporting country (but in the opposite direction), consumer surplus increases because of the fall in price of both domestically produced and foreign produced C. The producers in B suffer however because the highest price that they can now receive has fallen, therefore reducing their producer surplus. There is a net loss to the World's welfare of (F + H + b + d). (Suranovic 27 October 2002)

MARKET FAILURES

It is generally agreed upon that markets should be allowed to operate freely. However, this view is based on the assumption that there are no market failures that produce inefficiencies, which ultimately warrant[5]some form of government intervention. Keeping this in mind, we can attempt to apply this to the market for export promotion and the EDC. There are two possible markets where a deficiency may exist and thus call for government intervention: the credit insurance market, and the export finance market.

The main failure that exists in the market for credit insurance is simply in the non-existence a private market offering this service. There is only one private company operating in Canada, the American Credit Indemnity (ACI). However, the ACI insures only accounts receivable related to the sales of goods between Canada and the United States. This does not exhibit the same difficulties that exist when exporting to other countries. This inability of the private market to meet the demand for export insurance is obvious and therefore partially justifies government intervention. "Partially" because, government intervention should be regarded as "second best" since a better option would be to attempt to induce the formation of a private market. Why though, have the private markets not responded to this demand for export insurance? Could it be because there are uninsurable risks? Is the cost of gathering information on foreign purchasers high? One possibility is the fact that in order to enter a field of this magnitude, a large amount of capital would be needed in order to honour any claims. Despite this, it has been shown that the EDC is very profitable, which, being that there are no legal barriers to entry into the export insurance industry, should encourage companies to enter into the market. This may indicate that another possible reason for the lack of presence of private companies is the already existing presence of a large dominant company such as the EDC.

With respect to the export finance market, there are two sources of market failure. Firstly, there is a lack of Canadian banks in certain parts of the world, and, since Canadian institutions are more apt to finance and support exports from Canada, this leads to a loss in potential trades. Secondly, there exists a "public good" problem. When an institution invests in the gathering of information in order to rate a potential foreign firm, the loan will only be made if that foreign firm is deemed to have low default risk. This being the case, when loans are made to foreign firms, a signal is sent to the market that this particular foreign firm is not a high credit risk. Consequently, other providers of export credit will be tempted to "free-ride" on this information, the cost of which will be borne by one institution. As a result

there will be an under-supply of the search for this information and therefore an under-supply of export credit on the market.

IN FAVOUR OF THE EDC

Having identified the above market failures as validation for government intervention we can try to present normative reasons for the existence of the EDC, and also, to recognize the ways in which it has filled gaps that exist in international trade.

The main reasoning behind the EDC's promotion of trade should be in order to have access to a bigger market. Canada's market is limited, and as such, if production is constrained so as to only meet domestic demand, there won't be full utilization of economies of scale, which could potentially bring the cost of production down.

Another argument for the existence of the EDC is that it assists in increasing the countries with which Canada exports. There is a direct relation linking the geographical distance between two countries and the difficulties that exist in trade patterns between these two countries. Taking this relationship into account, the EDC's commitment to trade diversification is illustrated in the period 1969 to 1980, during which time, the majority of its insured exports were to Central and South America, Antilles, and Europe (whereas only approximately 11% of its insured exports were to the United States), and approximately 38% of it's loan authorizations went to Asia. (Economic Council of Canada, Ottawa, 1982, 54)

IN OPPOSITION TO THE EDC

There have been many arguments against the EDC and its practices. The first of these continues the argument against subsidization. In this case, because subsidization is granted from a public agency there is a tendency to apply for these subsidies independentof whether or not it is actually critical to the execution of the transaction. As a result, there is careless usage of subsidies, which ultimately leads to inefficiencies.

Another problem with the EDC is in their dominant presence in the export insurance market. This market is not regulated in any way but the very nature of the EDC presents an obstacle to entry by the private sector.

SHOULD CANADA FOLLOW SUIT?

Before concluding, I would like to briefly address the debate concerning the justification of subsidies on Canadian exports based on the reasoning that other countries are subsidizing their exports. As has been theoretically shown, export subsidies have an overall negative effect on welfare made up of the algebraic sum of a net loss in welfare to the exporting country and a smaller net gain to the importing country. With this in mind, why would any country want to provide an export subsidy? This would be a valid question in a perfect world. In reality, however, this is not the international environment that we face; instead, we are faced with an environment in which other players don't follow this rationalization and as such, the result that followed from previously discussed sound economic principles do not fully apply (i.e. it may be beneficial to offer export subsidies). It should be taken into consideration though that "...if all of the major exporting countries subsidized their exports to a similar extent, no single country would benefit; yet all would

bear the costs" (Economic Council of Canada, Ottawa, 1982, 58). This is a grim situation and one that would hopefully be corrected quickly by rulings from such agencies as the World Trade Organization (WTO) and the Organization for Economic Cooperation and Development (OECD). Until then, however, it is probably in our best interest for Canada to follow suit while at the same time being careful not to surpass the assistance offered by other countries to their nation's exporters.

CONCLUSION

After taking all of the aforementioned into consideration, I have come to the conclusion that there is not sufficient evidence to justify the existence of a crown corporation such as the EDC. In my view, all of the stated market failures do not require government intervention, but rather, can be solved by way of encouraging the private sector to enter into the market. This would no doubt increase efficiency by allowing the actual demand for Canadian exports to be reflected in the real price of exporting that good, which comprise both the cost of production and the price of the risk associated with the transaction. In this way, society may benefit by encouraging transitions to better social conditions in order to reduce the risk portion of the price, and thus reduce the overall price of the good.

An interesting point that should be noted in favour of the EDC is that in attempting to diversify the countries with which Canada exports they are indirectly working towards a humanitarian cause by providing financial assistance to many more less-developed countries (LDC's) than would take place in a purely private industry.

Other than this however, any arguments for the existence of the EDC can be found falacious. Firstly, in providing export assistance for the sake of diversifying Canada's exports it can be argued that this should not be necessary. In the first place, Canada should only be exporting those good in which it has a comparative advantage and, should not attempt to produce some "supported" comparative advantage by relying on government assistance. Related to this argument (for the EDC) is, that by diversifying Canada's exports, the Canadian economy would be less vulnerable to the swings of demand in specific export markets. Once again going back to the argument of, "Which industries does Canada have a comparative advantage?" The aim should not be to artificially support our industries but rather for them to support themselves, and this is done by having a comparative advantage. If not then resources would be wasted in helping industries in which scarce resources aren't being used to achieve maximum benefit. A better plan would be to focus on the industries in which there exists a comparative advantage, and work to lower the costs that exist in these industries, thereby increasing their return. This does not in any way imply subsidizing these industries, since, based on the fact that these are industries in which we have a comparative advantage, there should be no need for subsidization.

One last point to make is that, by existing as a government agency, the EDC basically operates with a safety net, that is, they function knowing that at the end of the day, if all else fails, the government will be there to cover their loses. As a result, this may lead the EDC to take on more risk than should

reasonably be assumed. The cost which is ultimately passed on to the taxpayer. It was estimated that, during the 1990's, the cost of deadbeat loans resulting from such risky loans amounted to approximately $800-million dollars (Adams 2000, C19).

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Diagram 1

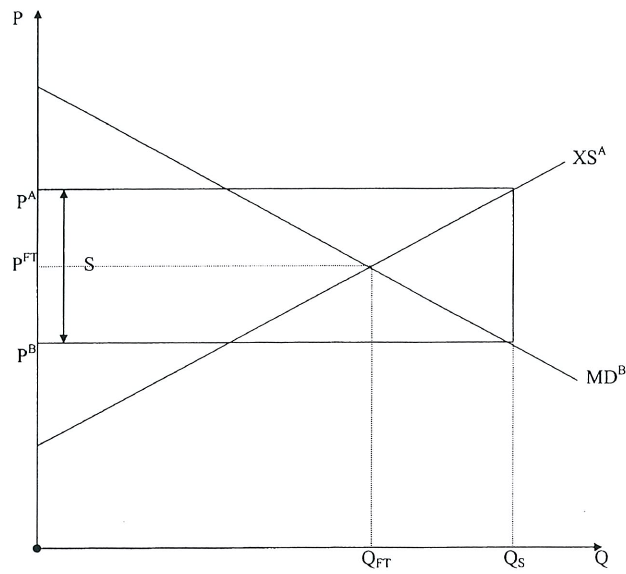

Diagram 2