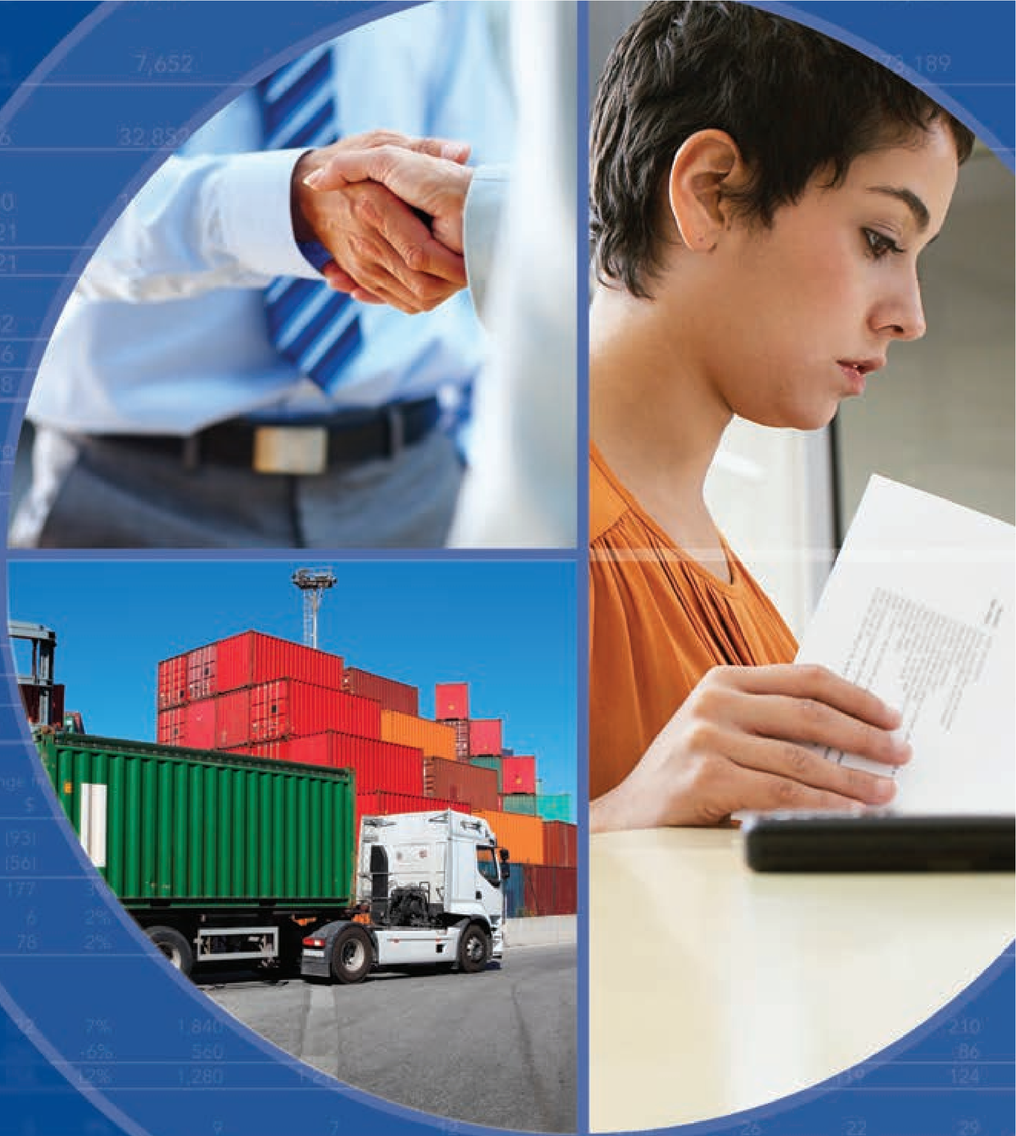

Issue Brief

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Canada's Global Trade Agenda: Opportunities for SMEs

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Canada’s Global Trade Agenda: Opportunities for SMEs

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Executive Summary

While exports fuelled Canada's economic growth heading into the 21st century, over the past decade, Canada's export performance has been lackluster, in large part due to the strength of the Canadian dollar, poor productivity growth compared to other countries, and what Canada exports and to whom it exports, with the latter having the most impact on Canadian exports.

As a result, there is a growing consensus in policy circles that Canadian businesses need to shift their focus away from slow-growing, developed markets such as the United States, towards fast-growing emerging markets, and that sustaining the country's future prosperity depends on companies' ability to meet the challenge of global competition.

This explains in part why the Canadian government has made the negotiation of comprehensive free trade agreements a cornerstone of their economic policy. Removing obstacles to trade and investment should provide expanded access to growing global opportunities for Canadian businesses.

This report starts by reviewing recent literature on this issue and notices an emerging consensus. Canada's economy must reduce its reliance on the U.S. market by growing business with other parts of the world experiencing higher economic growth rates.

Recent research also indicates that global production is increasingly organized through global value chains (GVCs) where each element in the chain is located where it makes the most economic sense. As a result, exports should no longer be considered as the main measure of a country's trade performance. Canadian foreign direct investment, foreign investment flowing to Canada, imports of business inputs, and sales by foreign affiliates of Canadian businesses are also important indicators of Canada's trade performance. By those measures, Canada's trade performance has been somewhat better in the last decade than its exports might indicate.

Data also shows that small and medium-sized enterprises (SMEs) have been relatively more successful than larger firms at taking advantage of growing opportunities in global markets. Growing the ranks of SMEs engaged in international trade could therefore play an important role in improving Canada's trade performance, especially in fast-growing emerging markets. It could also make a significant difference in diversifying trade beyond the manufacturing sector.

When benchmarking Canada's involvement in GVCs, recent research shows that while Canada is one of the world's most important exporters in absolute terms, the country lags in its ability to create value in GVCs in relative terms.

Having taken stock of the Canadian economy and Canadian SMEs' relative trade performance, both in historical terms and compared to other countries, the second half of this paper examines this issue from the perspective of Canadian SMEs. It first looks at the constraints they face in entering foreign markets and global supply chains, using recent surveys conducted among business executives. These constraints are both internal to the firm such as rising business costs and internal resource constraints, and external such as finding skilled labour, dealing with growing competition, finding market opportunities and reliable business partners, and accessing business financing.

This paper argues that improving Canada's trade performance will require growing the number of Canadian businesses engaged in international trade, and overcoming the constraints and obstacles faced by those already conducting business in global markets.

The paper reviews the factors SMEs focused on the domestic market most often quote when asked why they do not export, and the characteristics that SMEs with a higher degree of internationalization have in common. In light of that evidence, it appears that the services provided by organizations such as the Canadian Trade Commissioner Service, Export Development Canada, and the Business Development Bank of Canada can play an important role in helping non-exporting and non-trading SMEs internationalize their activities.

The paper then examines the barriers faced by SMEs already engaged in global markets, and identifies three types of constraints: barriers to trade and investment, barriers to acquiring business intelligence, and barriers to domestic competitiveness. It then proceeds to review their respective policy implications, and shows that international trade deals can play a meaningful role in providing a competitive advantage to Canadian businesses, and removing barriers to trade if they are comprehensive agreements that address the full range of barriers to the movement of goods, services, capital and people that SMEs face.

However, improving Canadian SMEs' trade performance will also require helping businesses acquire business intelligence, and improving their domestic competitiveness. The former will require a concerted approach between government, businesses and third-party organizations supporting SMEs to improve business knowledge of new markets, connect companies with specific market opportunities, and help them assess the risks and potential value. The latter will require overcoming Canada's longstanding productivity challenge, and improving access to financing, regulatory efficiency, logistics infrastructure and access to skilled labour. Together, these measures would complement the federal government's ambitious trade agenda and address the barriers to greater internationalization that SMEs report facing. Ongoing dialogue between government and SMEs will also help ensure that together, they can position Canada to take advantage of growing opportunities across the world.

Introduction

The issue of Canada's global economic performance has been attracting much attention recently — especially since the end of the last recession, as the Canadian economy still struggles to hit pre-recession export levels. There is a growing perception that Canadian businesses need to turn their attention to overseas markets and shift their business strategies to adapt to a new global environment. Factors driving this push to internationalization include the emergence of competition from new entrants into the world trading system, weaker demand from Canada's traditional export markets, and the fact that emerging markets account for more than half of global trade growth.

There is no doubt that the competition faced by Canadian businesses is fiercer than ever, both domestically and abroad. Firms are competing for market share, investment and production and services mandates with other firms around the world, and sometimes within their own corporate organization. This is especially true for SMEs. As shown by a recent study, 64 per cent of small businesses in the manufacturing sector already compete against multinational enterprises in their main market (Industry Canada, CME and McMaster University, 2011).

For a trade-dependent economy like Canada's, businesses' ability to compete and win against the best in the world is critical to the country's capacity to generate wealth and sustain increased standards of living for future generations of citizens. As the federal government pointed out in its 2012 report on *Canada's State of Trade*, exports account for 19.2 per cent of all jobs, with every job directly associated with exports supporting 1.9 total jobs in the economy. Exports also account for 26.1 per cent of Canada's gross domestic product (GDP) when calculated on a value-added basis (i.e. when removing the import content of gross exports).

Exports fuelled Canada's growth during the 1990s. Over that decade, Canada's merchandise exports more than doubled, growing from $148 billion in 1990 to $413 billion in 2000. However, since then, Canada's global share of merchandise exports has been declining markedly, from 4.5 per cent in 2000 to 2.7 per cent 10 years later (Statistics Canada, 2011a).

As Mark Carney, former governor of the Bank of Canada, put it in his farewell address, the challenge for Canada today is to "rotate the sources of growth toward net exports and business investment. Exports are currently more than $130 billion less than they would have been had this been a 'typical' postwar recovery."

As the new Governor Stephen Poloz also noted in his first public speech after taking office, building export momentum is critical for Canada's economy to sustain its recovery. In fact, he noted that Canadian exporters have been particularly hard-hit by the recession, and that manufacturing exporters have been the most profoundly affected as they have seen their ranks continue to shrink after the recession.

A recent Bank of Canada research paper (de Munnik, Jacob and Sze, 2012) sheds light on what caused this:

> "While Canadian firms have been facing competitiveness challenges in recent years resulting from the persistent strength of the Canadian dollar and poor productivity performance relative to major trade competitors, other factors such as to whom Canada sells its products and the products it sells, have also significantly affected the performance of Canadian exports. Over the past decade, the structure of the geographic market to which Canada exports, with a large weight on the relatively slow-growing U.S. market, and a small weight on other economies, particularly the fast-growing emerging market economies, has exerted the majority of the overall net negative impact on Canadian exports."

Because improving Canada's trade performance is so critical to the country's ability to continue to grow its economy, the federal government (with the support of the provinces) has embarked on what is arguably the most ambitious trade and investment liberalization agenda in the nation's history — and has made this a cornerstone of its economic policy.

This raises many important questions. Will trade deals be sufficient to help Canadian businesses take better advantage of growing demand in overseas markets? Will other economic policy measures be needed to boost Canadian business competitiveness and help firms succeed globally? If trade deals are part of the answer, what specifically must they do to address the needs of a majority of Canadian businesses? Trade and investment agreements can be an opportunity, by giving Canadian businesses improved access to opportunities that may not be available to competitors in other countries — or they can be a threat, if other countries negotiate their own trade deals faster than Canada does. They may also be a missed opportunity if they are one-sided deals that fail to address the trade barriers Canadian businesses face and instead, simply end further opening of the Canadian market to foreign competition. Ensuring commercially meaningful agreements requires both parties to address the real barriers faced by businesses.

Making sure Canada gets this right is critical, and getting this right requires making the needs of SMEs a key component of the government's strategy. Besides their relative importance to the Canadian economy, SMEs are an essential part of the solution to Canada's trade woes for two reasons.[1]

First, the emergence of GVCs as the prevailing model by which goods and services are being produced means that we should expect SMEs to play an increasingly important role in global trade. GVCs are international supply chains characterized by the fragmentation of activities involved in producing a good or a service, from conception to end-use, across sites and borders. Under this model, each activity that adds value to the production process can take place where it makes the most economic sense to do so. This fragmentation provides an opportunity for smaller firms to specialize, capitalize on their unique skills and grow, by entering GVCs from their home market. Also, with less than two per cent of Canadian SMEs currently exporting, there is much potential for growth by helping more of them enter new markets.

The second reason why SMEs are key to improving Canada's trade performance is that, in general, they have had more success in fast-growing markets beyond the U.S. and the European Union (EU). According to Industry Canada figures (Industry Canada, 2011a), small businesses (firms with fewer than 100 employees) account for a significant proportion of Canada's exports to markets beyond the U.S. and the EU — 40 per cent — compared to 20 per cent of Canada's exports to the U.S. and the EU. Small companies account for a particularly high proportion of Canadian exports in many large, growing markets, such as South Korea (52.8 per cent); India (65.1 per cent); Indonesia (44 per cent); Turkey (60.6 per cent); and Egypt (63.3 per cent).

This report examines the issue of improving Canada's trade performance by first looking at recent publications that shed some light on the issue. We then look at the constraints Canadian businesses face when trying to expand abroad, with a focus on SMEs; what can be done to grow the number of firms involved in international trade; and the views of current exporters on actions that can be taken to help accelerate the pace of growth of international activities. We also examine what these strategies could mean for Canada's trade agenda, and finally, we assess the need for other policy initiatives besides trade agreements that can help Canadian businesses succeed globally.

1 Research quoted in this paper uses various definitions of SMEs. Unless otherwise specified, Statistics Canada quoted in this paper considers as SMEs any business with fewer than 500 employees and $50 million in gross revenue. Businesses with fewer than 100 employees are deemed small, while those with 100-499 employees are considered medium-sized. Industry Canada research quoted in this paper uses Statistics Canada data with this breakdown, except for the *State of Advanced Manufacturing* report, which uses data from Statistics Canada's *Survey on Innovation and Business Strategy*. That survey defines small firms as those with 20 to 99 employees and at least $250,000 in annual revenues, and medium sized firms as those with 100 to 249 employees.

Survey of Literature

Several recent publications shed light on Canada's current trade performance in view of a changing global economy and also issue a call to action for Canada to shift its focus towards fast-growing emerging markets.

One of the most powerful and thought-provoking publications on this topic is Andrea Mandel-Campbell's 2007 book — *Why Mexicans Don't Drink Molson: Rescuing Canada from the Suds of Global Obscurity*. The book is a call to action for Canadians and Canadian business executives to embrace globalization, dare to venture off the beaten path and realize that global competition is required for Canada to succeed economically, as well as a harsh critique of the way Canadians do business. It makes a strong case for further liberalizing markets within Canada, and against a perceived complacency among Canadian business leaders.

More recently, Carleton University's Norman Paterson School of International Affairs (NPSIA) released *Winning in a Changing World*. This report argues that Canada is failing to keep pace with the dramatic changes taking place in the global economy, and makes a strong case for Canadians to reach out to emerging economies in Asia and elsewhere to secure the country's economic future.

The report was produced as part of NPSIA's *Securing Prosperity* initiative under the guidance of several leading policy experts, resulting in a series of recommendations for business, government and other key stakeholders to overcome this challenge. While recognizing that efforts have been made to improve Canada's trade performance, the authors view those attempts as having had limited success. In fact, their view is similar to Mandel-Campbell's when they say, "Unless Canada dramatically ups its game and changes the way it does business, it assuredly will not be a significant player in these new markets" and that "Canada must defeat the 'culture of comfort' that comes from an all-too-easy dependence on the United States [...]. Doing so is [...] vital to stimulating a more competitive business environment." What is especially interesting in the authors' series of recommendations is that they view the conclusion of trade agreements as only one piece of the puzzle. They also believe that changes to domestic policies in areas such as taxation, investment, infrastructure, skills development, regulatory regimes and government procurement are also needed for Canada to succeed in the global economy.

Besides these two publications and recent statements by Governors of the Bank of Canada, as noted earlier, several other research papers have made a similar case for Canada to turn its attention towards rapidly growing emerging markets. Two other reports are particularly worth noting.

One is CIBC Economics' *Stuck in Neutral: Canada Needs to Accelerate Exports to Emerging Markets*. This report shows that Canada's share of non-U.S. exports has been stuck at 25 per cent for the last four years. It does see a bright spot in that Canada has been able to make inroads into the Chinese market, as that country alone accounts for all of the growth in Canada's exports to developing markets in the last five years.

The second report is *Walking the Silk Road: Understanding Canada's Changing Trade Patterns,* published by The Conference Board of Canada's Global Commerce Centre. In addition to making the case that emerging markets are now critical to Canada's success, the report also points out that Canada's trade strengths are shifting from manufacturing towards services and natural resources, and that growing emerging markets and shrinking barriers are the main drivers of this trend (rather than currency shifts).

These reports primarily base their judgment that Canada is punching below its weight in world markets on the fact that the country's export performance has been dismal over the last 10 years. However, when one looks at integrative trade[2] —rather than simply exports — we see a different story.

As shown by Export Development Canada (EDC) in *Canada's Trade Performance,* while Canada's real exports have grown at a compounded annual rate of zero per cent from 2000 to 2011, over the same period, real imports grew by four per cent (with most of the growth coming from emerging markets). This 2012 report also shows the following: Canadian direct investment abroad grew at an average rate of 5.5 per cent per year (flows to emerging markets went from 10.9 per cent of Canada's foreign direct investment [FDI] in 2000, to 24.8 percent in 2010); and foreign affiliate sales grew at an average annual rate of 2.3 per cent (sales of affiliates of Canadian companies located in developing markets nearly tripled over that period, while those in the U.S. fell by four per cent).

On the issue of SMEs' trade performance, a publication that makes an interesting contribution is the Business Development Bank of Canada's (BDC) study, *What Happened to Canada's Mid-Sized Firms?*, released earlier this year. This study, based on original data obtained from Statistics Canada, demonstrates that Canada's mid-sized firms punch above their weight with regard to their impact on employment and GDP. BDC's analysis also shows that mid-sized firms in Canada face some major issues that prevent them from becoming large firms.

2 Integrative trade refers to the expansion of the traditional export model to include direct investment abroad, the integration of imported inputs into exports and the establishment of foreign affiliates.

We also know that SMEs are a large part of the limited success Canadian businesses have had in growing their presence in emerging markets. As stated in the introduction, SMEs are key to improving Canada's trade performance. In part, this is because they have been more successful at growing exports in emerging markets; because a great majority of them do not currently export meaning that even small increases in trade activity can have a significant economic impact; and because they are well positioned to take advantage of GVCs.

What all this recent research tells us is that there is a growing consensus among experts and policymakers that Canada, and Canadian businesses more specifically, need to reduce their reliance on the U.S. market and shift their attention to other parts of the world where economic growth will be increasingly focused. This is critical to boosting exports, improving Canada's trade performance, and securing the country's prosperity. In addition, we must now look beyond exports as a simple measure of Canada's trade performance. Inward and outward investment, imports of business inputs, and sales by foreign affiliates also play a critical role in ensuring Canadian businesses succeed in global markets. Finally, the data shows that SMEs have been relatively more successful at taking advantage of growing opportunities in global markets, and growing the ranks of SMEs engaged in trade activity is critical to improving Canada's economic performance.

Most of the recent research on the issue of Canada's trade performance has examined the matter from an economic policy perspective. However, Canada will be able to overcome this challenge of competing globally only if Canadian businesses, and SMEs more particularly, are willing and able to take on this challenge and take advantage of growing opportunities in emerging markets.

Therefore, for much of the rest of this paper, we will take a closer look at the issue from the firms' perspective — to see how they perform against firms in other countries; what can be done to get more SMEs to engage in international commerce; what barriers they face in growing their global presence; and how trade agreements and domestic policy changes can help them succeed in global markets.

Unpacking the Relationship Between Trade and Productivity

Numerous studies have shown a clear relationship between trade and productivity: that is, exporting firms have higher productivity levels than non-exporting firms. Moreover, research shows that firms achieve those high productivity levels before beginning export activity. Exporting does not appear to lead to improved productivity, but more productive firms make more successful exporters.

No examination of Canada's trade performance can avoid the subject of productivity, a topic of tremendous research and debate in its own right. By conventional measures, Canada's productivity has been relatively poor for decades and the country is in the bottom quartile of OECD countries for labour productivity growth. This raises the question, is our poor productivity performance holding back our international trade ambitions?

Successive Canadian governments have implemented a number of policy reforms to address the country's weak productivity, such as improvements to the tax system, moves to strengthen the country's fiscal position, generous public incentives for research and development, and pursuit of free trade agreements – all to little effect.

Clearly Canada needs to improve both its productivity and its international trade performance. But where do we begin?

Benchmarking Canadian SMEs

As noted earlier, the prevailing consensus is that Canada's global competitiveness has been deteriorating over the last decade, mostly due to the fact that Canadian businesses have been comfortable selling domestically or to the neighbouring U.S. market. More extensive research shows this is actually due to four factors: the strength of the Canadian dollar; poor productivity growth; the type of products Canadian businesses sell; and Canada's exports being tied to slow-growing markets such as the U.S., with the latter being the most significant factor. To succeed in the future, Canadian businesses will therefore need to improve their competitiveness in response to the high Canadian dollar, accelerate the pace of productivity growth, innovate, and take better advantage of growing demand in emerging markets.

As we have seen in the previous chapter, while at first glance, Canada's declining export share is seen as an indicator of Canada's poor trade performance, research into other elements of integrative trade beyond exports shows that Canada has performed somewhat better — and that while Canadian businesses have lost export market share, they have been able to grow their direct investment abroad, attract more direct investment to Canada, and grow the sales levels of their foreign affiliates. In fact, while much is made of Canada's export woes and its ongoing productivity challenge, it seems that Canadian exporters have used their capital efficiently by taking advantage of the strong Canadian dollar to invest overseas.

That being said, is this observation true for all Canadian businesses, or is there a difference between smaller and larger Canadian firms? Also, are the challenges outlined above unique to Canadian businesses, or are they similar to the experiences of companies in other industrialized economies in the world?

Canadian SMEs vs Large Enterprises

Over the last 10 years, while Canada's exports and global export market share have diminished, Canadian SMEs have actually increased their total exports. Small firms (with fewer than 100 employees) have increased their exports by 19.6 per cent over that period, and medium-sized firms (between 100 and 499 employees) have increased their exports by 15.1 per cent. Meanwhile, large businesses (with 500 or more employees) have seen their exports drop by 18.3 per cent over that period (Industry Canada, 2011b, Tables 1.2a and 1.2b).

It is also worth noting that according to the latest statistics, there are 41,710 small businesses engaged in international trade representing 87.5 per cent of all Canadian exporters. Together, these companies account for 44.8 per cent of the value of Canada's exports, a significant share (see Tables 2 and 3).

Table 1

Number of exporting establishments by employee class and exporter size (2009)

	Fewer than 50	50 to 99	100 to 199	200 and over	**Total**
	Number				
Less than $999,999	30,426	3,032	1,591	1,199	**36,248**
$1,000,000 to $24,999,999	5,728	1,902	1,309	974	**9,913**
$25,000,000 and Over	431	191	251	603	**1,476**
Total	**36,585**	**5,125**	**3,151**	**2,776**	**47,637**

Source: Statistics Canada, *A Profile of Canadian Exporters, 1996 to 2009.*

Table 2

Value of domestic exports by employee class and exporter size (2009)					
	Fewer than 50	50 to 99	100 to 199	200 and over	**Total**
	Millions of dollars				
Less than $999,999	5,172	694	342	247	**6,455**
$1,000,000 to $24,999,999	24,021	10,869	9,721	8,566	**53,177**
$25,000,000 and Over	70,954	35,695	26,084	136,754	**269,487**
Total	**100,147**	**47,258**	**36,147**	**145,567**	**329,119**

Source: Statistics Canada, *A Profile of Canadian Exporters,1996 to 2009.*

Table 3

Per cent of total value of domestic exports by employee class and exporter size (2009)					
	Fewer than 50	50 to 99	100 to 199	200 and over	**Total**
	Percent of total				
Less than $999,999	1.6%	0.2%	0.1%	0.1%	**2.0%**
$1,000,000 to $24,999,999	7.3%	3.3%	3.0%	2.6%	**16.2%**
$25,000,000 and Over	21.6%	10.8%	7.9%	41.6%	**81.9%**
Total	**30.4%**	**14.4%**	**11.0%**	**44.2%**	**100.0%**

Source: Statistics Canada, *A Profile of Canadian Exporters, 1996 to 2009.* Author's computation.

Finally, if we look at the exports of SMEs by sector (see Table 4), we observe that they account for a greater share of exporters in sectors outside of manufacturing. Given The Conference Board of Canada's assessment that the country's trade strengths are shifting from manufacturing towards services and natural resources, this signals further opportunities for SMEs.

While it is often thought that companies producing merchandise goods such as natural resources, manufactured goods or energy products can export more easily than companies in the services and construction industries, this evidence shows that SMEs in non-good-producing sectors can export. As services become more specialized, and as they become more disentangled from the products in which many of them were traditionally embedded, we are likely to see continued growth in services exports. However, it is difficult to track services exporters' performance — not just in Canada but in other countries as well — as statistical agencies around the world struggle to come up with reliable quality data to measure international trade in services. While goods can be measured in a variety of ways, including on a customs basis, by their nature, services are harder to track statistically.

Table 4 – Exports by Industry Sector

Percent of Exports by Industry Sector			
Sector	**Small (<100)**	**Med. (100-499)**	**Large (500+)**
Agriculture, forestry, fishing and hunting	72.3	9.2	18.5
Mining, oil and gas extraction and utilities	13.6	8.6	77.8
Construction	71.3	23.7	5.1
Manufacturing	12.1	22.3	65.6
Wholesale Trade	70	20.9	9
Retail trade	79.1	3.9	17
Transportation and warehousing	N/A	100	N/A
Information and cultural industries	52.8	43.1	4.1
Finance and insurance	62.2	6.8	31
Business services	41.4	8	50.6

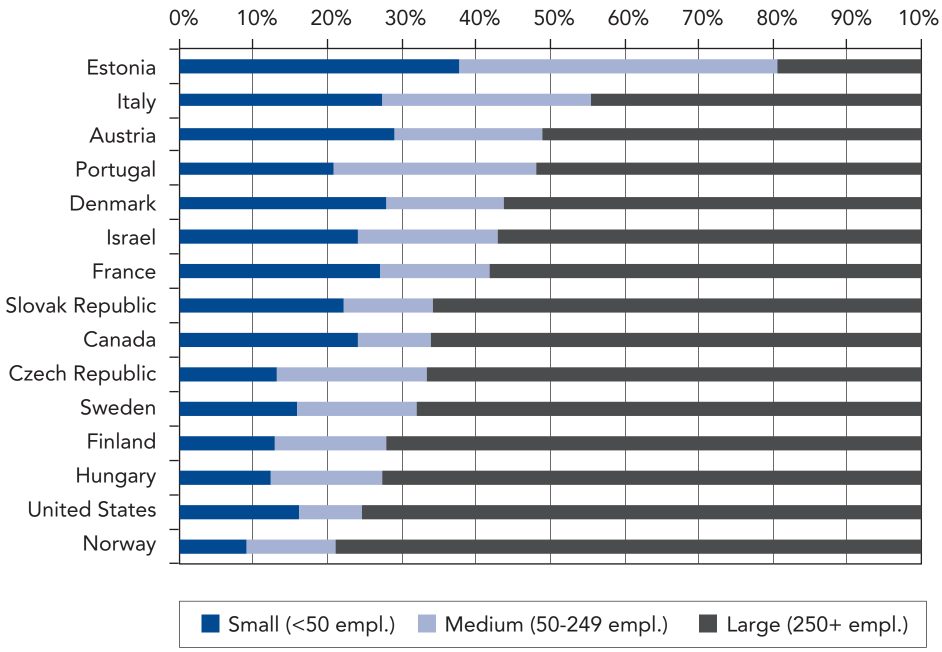
Source: Industry Canada, *Canadian Small Business Exporters – Special Edition of Key Small Business Statistics*, 2011.

It is also worth noting again that smaller Canadian companies have fared better than larger ones when it comes to expanding sales in fast-growing emerging markets. Other Statistics Canada data also indicates that the number of SMEs exporting to the U.S. market has been on a declining trend — while the number of SMEs exporting to markets beyond the U.S. and the EU has been on an upward trend in recent years.

When comparing Canadian SMEs against SMEs in other countries, the evidence is mixed. The Organisation for Economic Co-operation and Development (OECD) gathers data from countries providing such statistics, and publishes them in a comparative format. When examining the share of various countries' exports attributable to SMEs, Canada ranks 15th out of the 23 countries supplying such data — ahead of the U.S., which ranks second to last.

While this may seem to indicate that Canadian SMEs do not play as strong a role in the country's export performance as SMEs in other countries, it is important to remember that proximity to foreign markets has always been a strong determinant of whether SMEs engage in international trade. Businesses tend to trade with other companies in their geographic area. In that sense, smaller European countries should have more SMEs that export, due to the relatively small size of many of these countries and the proximity of large pools of customers in neighbouring countries. Another important factor is the size of the domestic market. SMEs in countries with large domestic markets, such as the U.S., have traditionally had fewer incentives to export, since they had more room to grow market share in their own domestic market. Given the growing importance of GVCs and the specialization of production, these factors' importance will likely diminish over time.

Table 5 – Exports by Size Class for Selected Countries, 2007



Source: Organization for Economic Co-operation and Development (OECD), *Exports by Size Class*.

The OECD also recently examined its member countries' participation in GVCs and published a report benchmarking Canada against OECD members; this report provides a more holistic view of Canada's performance relative to other countries (OECD, 2013b). As the report notes, "Countries' integration in the global economy is nowadays closely linked to their participation in global value chains."

The report confirms that Canada is the ninth-largest exporter in absolute terms, i.e. it has the ninth-largest share of the world export market. More importantly, it ranks Canada's participation in GVCs by looking at what percentage of its exports are part of GVCs, either because of upstream links — foreign inputs/value added included in Canada's exports — or because of downstream links — Canadian inputs/value added included in other countries' exports.

By this account, Canada ranks 37th out of 40 countries, in terms of its participation in GVCs. Two Canadian industries stand out for their higher level of participation: mining and transportation equipment. Mining scores higher because a significant part of Canada's mining production is processed and re-exported by firms in other countries, while transportation equipment stands out because a significant part of Canadian production uses imports sourced from other countries.[3]

3 The automotive sector is a good example, as it is embedded in North American value chains and sources most of its inputs from other countries.

Constraints Faced by Canadian SMEs

Having examined the relative performance of Canadian SMEs and knowing that it is critical for Canada's economic future that they succeed at further internationalizing their businesses, we now turn our attention to the constraints they face in entering foreign markets and global supply chains.

While economists and policy analysts make a strong case for Canadian businesses to shift their focus towards emerging markets, ultimately, the onus rests on Canadian businesses — the majority of which are SMEs —to roll up their sleeves and meet the challenge of global competition. If only for this reason, governments' policy response must take into account the constraints, challenges and issues businesses face.

A few recent surveys conducted among Canadian businesses tell us what they believe constrains their growth — both in general, and as it relates to foreign markets.

First, in its report on Canadian Small Business Exporters released in 2011, Industry Canada reports data from a 2007 Statistics Canada survey of approximately 25,000 businesses. This report indicates the top-five obstacles to business growth facing Canadian SMEs were (in order): rising business costs, finding qualified labour, increased competition, unstable customer demand and insurance premiums (see Table 6).

Table 6 – Obstacles to Business Growth

Perceived Obstacles to Business Growth (Per cent of firms)			
		SME Exporters	**SME Non-Exporters**
External to the firm	Finding qualified labour	50%	40%
	Instability of consumer demand	40%	32%
	Government regulations	28%	28%
	Environmental regulations/compliance	9%	12%
	Increased competition	47%	39%
Internal to the firm	Obtaining financing	21%	17%
	Management capacity	13%	11%
	Rising business costs	56%	56%
	Insurance premiums	40%	34%

Source: Industry Canada, *Canadian Small Business Exporters – Special Edition of Key Small Business Statistics*, 2011.

In 2008, The Conference Board of Canada also released an insightful summary and analysis of various SME surveys conducted by third parties, such as the Canadian Federation of Independent Business (CFIB), UPS Canada and others (Macmillan, 2008). This analysis concluded that the most critical challenges Canadian SMEs face when addressing the international marketplace are:

1. Identifying good market opportunities;
2. Finding reliable business partners;
3. Managing supply-chain relationships and the demands of complying with quality control and systems requirements;
4. Getting access to financing;
5. Handling authentication and security;
6. Protecting intellectual assets and business information; and
7. Overcoming trade and regulatory barriers.

More recently, Canadian Manufacturers & Exporters (CME) released the results of its annual *Management Issues Survey*.[4] The survey asked companies to identify the most significant external challenges they currently face to growing sales in foreign markets. Besides the top answer — foreign competition — for all other external challenges reported by companies, governments can (and often already do) either provide programs and services (i.e. the Trade Commissioner Service) or adopt policy instruments (i.e. trade agreements) to help businesses overcome those challenges. We will review those over the next few pages.

4 The survey was conducted in the third quarter of 2012 among 649 business executives – 58 per cent of these executives represented companies with fewer than 100 employees; 61 per cent represented companies with less than $25 million in annual sales; and three quarters had manufacturing as their company's primary line of business.

Table 7 – Most Significant External Challenges to Growing Sales in Foreign Markets

Source: Canadian Manufacturers & Exporters (CME), *2012-13 Management Issues Survey.*

Supporting Canadian SMEs to Succeed Globally

The growing consensus is that for Canada to succeed in the 21st century economy, businesses need to ensure they are globally competitive and must shift their focus towards fast-growing markets overseas.

While the perceived role of businesses is clear in this context, what role do governments have to play? Most believe that the logical response for governments is to eliminate the barriers to international trade that Canadian businesses face — and that doing this requires government to negotiate agreements that liberalize international trade and investment. This is, in fact, where the federal government has been focusing its efforts.

However, if we are to grow the number of Canadian businesses that currently engage in international trade — only 1.4 per cent of small businesses currently export[5] — it is doubtful that trade agreements alone will have a meaningful effect on SMEs' willingness and ability to start internationalizing their activities.

In addition, even though trade deals can address some important constraints Canadian companies currently face, these deals by themselves might not be sufficient to allow SMEs to overcome their challenges in growing business abroad. For example, to identify good market opportunities; find reliable business partners; manage supply chain relationships; access financing; provide proper logistics infrastructure; or deal with corruption — other policy instruments will be required. The government could respond to those challenges through its updated Global Commerce Strategy, by boosting and improving the services provided by the government's international trade portfolio partners (i.e. the Trade Commissioner Service, Export Development Canada and the Canadian Commercial Corporation), and through other means.

The next few pages examine these issues in greater detail, namely: how we can grow the number of firms engaged in global business and help address the barriers faced by Canadian SMEs through government policy, such as trade agreements and other types of policies that Canadian businesses need to succeed in international markets.

5 Industry Canada, Canadian Small Business Exporters – Special Edition of Key Small Business Statistics, 2011.

Helping more Canadian SMEs to Internationalize

By all accounts, the proportion of small companies that export is relatively small. According to Industry Canada, a majority of Canadian exporters (86 per cent) are small businesses, but a minority of small Canadian businesses (1.4 per cent) are exporters.

Given that SMEs have had relatively more success in emerging markets than larger firms — and with such a small proportion of small businesses exporting — it appears that growing the proportion of firms that export should be a desirable policy objective.

The Conference Board of Canada (Macmillan, 2008) examined that question by looking at relevant third-party surveys and policy analyses. Their analysis leads to the conclusion that SMEs' reluctance to internationalize is due to a combination of factors, the most important ones being that:

- They do not perceive their products or services as exportable;
- They perceive foreign markets as too risky;
- They do not feel they have the skill or resource capability to internationalize;
- They are not interested in expanding their customer base because they wish to stay small and keep their operations "manageable."

Complementary research done by The Conference Board (Fischer and Reuber, 2008) notes that SMEs that succeed in achieving a high or higher degree of internationalization have the following characteristics:

- They face significant foreign competition in their home market;
- They operate in a local industry cluster with a moderate concentration of competitors;
- They are technology-based and/or have a tangible product that serves a niche market;
- They are innovative relative to competitors in their industry;
- They are partly owned by external investors such as other corporations or venture capitalists, rather than wholly owned by management or management's family;
- They have well-developed business networks based on close connections to competitors, customers, suppliers, distributors and/or partners;
- They have managers with international experience and/or international networks; and
- Their managers perceive internationalization as an opportunity and are committed to seizing that opportunity.

The good news is that governments already provide resources to companies seeking to overcome the challenges of growing their exports. The Trade Commissioner Service and EDC both provide services to help companies assess risk. Organizations such as the Forum for International Trade Training provide training through colleges and universities across the country. Various educational institutions provide training to help executives acquire international business skills. Some governments provide match funding to companies looking to expand internationally (albeit, there are fewer such programs remaining), and to industry associations to organize trade missions. Canadian post-secondary institutions attract students from around the world, many of whom have the skills and local-market knowledge needed to succeed in emerging markets.

More could be done, however, to help change the perception many business executives have that their products or services may not be "exportable". It is certainly true that many products and services have less export potential. That being said, business models can be exported through franchising; products and processes can be indirectly exported through franchising; firms can expand through investing abroad or attracting foreign investment to Canada; and ideas, concepts, design, engineering and know-how can all be exported. While some government agencies provide consulting services to SMEs that may help them consider various expansion modes (the BDC and the Industrial Research Assistance Program are two examples, and several provincial governments also provide advisory services to SMEs), a more targeted approach might be warranted to help SMEs overcome this barrier and to explore other means of expanding their business, besides exporting.

Helping Seasoned Global Traders

While helping more SMEs to internationalize is important, it is also critical to address the constraints faced by the 41,710 businesses with fewer than 100 employees that currently export, so they can further grow their business globally.

In its annual survey, CME also asked business executives to indicate their most significant external challenges when trying to expand their business globally (see Table 8).

Again, adding to what we saw in the previous section, we can identify three specific types of constraints that businesses face: barriers to trade and investment; barriers to acquiring business intelligence; and barriers to domestic competitiveness. We look at the policy implications of each set of barriers in the following pages.

Table 8 – Most Significant Constraints to Expanding Global Business

Source: Canadian Manufacturers & Exporters (CME), *2012-13 Management Issues Survey.*

Policy Implications

1. Trade policy implications: reducing barriers to trade and investment

In recent surveys of Canadian businesses, a significant proportion of firms indicate that overcoming regulatory barriers to trade and investment is a major constraint.

These barriers include:

- Import tariffs levied by other countries that make Canada's exports less price-competitive;
- Import quotas that limit the volume of products that Canadian firms can export;
- Regulations and standards that protect domestic industries;
- Preferential procurement practices adopted by foreign governments, which discriminate against Canadian goods and services (e.g. Buy American measures in the U.S.);
- Weak rules to protect intellectual assets, proprietary knowledge or commercial intelligence;
- Security and customs requirements that are often opaque and complex, and add to the cost of doing business;
- Restrictions on the movement of business people that limit their ability to enter another country regularly to conduct business; and,
- Rules that block or restrict Canadian businesses' ability to invest in foreign markets, either directly or by acquiring another firm.

The existence of these regulatory constraints explains the recent trend governments have followed in negotiating comprehensive trade agreements that address the entire range of barriers to the movement of goods, services, capital and people. While trade agreements negotiated by Canada and other countries have traditionally focused on liberalizing trade in goods, the next generation of agreements — the Comprehensive Economic and Trade Agreement between the EU and Canada and the Trans-Pacific Partnership are good examples — increasingly seeks not only to open trade in goods but also facilitate the movement of services, capital and people, and to address "behind the border" issues, such as regulatory standards, customs and logistics issues.

International trade agreements also respond to more than the need to eliminate trade barriers; they can also help overcome the challenge expressed by 47 per cent of the companies surveyed by CME —competition from third countries. If Canada is able to conclude preferential trade agreements faster than other countries, or negotiate better deals than those obtained by other countries, Canadian companies will gain a competitive advantage over foreign competitors. This explains, in part, why Canada was eager to join the Trans-Pacific Partnership. Being left out of a comprehensive trade deal that may very well become the blueprint for liberalizing trade in the Asia-Pacific region and that includes the U.S., could have a negative impact on Canadian businesses' ability to compete against U.S. firms in parts of that region. This is also a reason why Canada is looking forward to concluding its trade negotiations with the EU. If Canada concludes its deal before the U.S. does, Canadian firms would gain an edge over American competitors. It is also a likely reason why the negotiations have taken longer to conclude than expected— Canadian negotiators want to ensure they obtain the best possible deal and avoid the situation where the U.S. and other countries reach a better deal in the future, putting Canadian businesses at a competitive disadvantage.

The federal government and the provinces, therefore, should continue to pursue an aggressive trade liberalization agenda through the negotiation of comprehensive economic and trade agreements that significantly facilitate the flow of goods, services, capital and skills, and address the concerns expressed by business. Despite these agreements taking more time and resources to be negotiated, they deliver more value to Canadian businesses and should be preferred over more traditional trade agreements focused on tariff elimination. Moreover, additional efforts should be made to encourage direct contact between trade negotiators and SMEs on an ongoing basis —at both strategic and technical levels — to ensure each negotiating team has detailed and up-to-date information on issues faced by Canadian firms in foreign markets. Engaging SMEs will become especially important, as negotiations try to tackle more complex "behind the border" issues.

Canada's Free Trade and Foreign Investment Protection and Promotion Agreements and Negotiations (as of July 11, 2013)

Free Trade Agreements (FTAs) in Force

- Agreements under the World Trade Organization (WTO)
- North American Free Trade Agreement (NAFTA) – United States and Mexico
- Canada-Israel FTA
- Canada-Chile FTA
- Canada-Costa Rica FTA
- Canada-European Free Trade Association FTA (Iceland, Liechtenstein, Norway and Switzerland)
- Canada-Peru FTA
- Canada-Colombia FTA
- Canada-Jordan FTA
- Canada-Panama FTA

FTAs - Negotiations Concluded

- Canada-Honduras FTA

FTAs - Ongoing Negotiations

- Canada-European Union Comprehensive Economic and Trade Agreement (CETA)
- Trans-Pacific Partnership Negotiations (TPP) (Australia, Brunei, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, United States, and Vietnam)
- Canada-India Comprehensive Economic Partnership Agreement Negotiations (CEPA)
- Canada-Japan FTA Negotiations
- Canada-Morocco FTA Negotiations
- Canada-Ukraine FTA Negotiations
- Canada-Caribbean Community (CARICOM) FTA Negotiations (Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, Saint Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago
- Canada-Dominican Republic FTA Negotiations
- Canada-Singapore FTA Negotiations
- Canada-Central America Four (CA4) FTA Negotiations (Honduras, Guatemala, Nicaragua, El Salvador)

Free Trade Agreements (FTAs) - Ongoing Negotiations (continued)

- Canada-South Korea FTA Negotiations

Exploratory Discussions

- Exploratory Discussions for the Modernization of the Canada-Israel FTA
- Exploratory Discussions for a Canada-Thailand FTA
- Canada-MERCOSUR Exploratory Trade Discussions (Argentina, Brazil, Paraguay, Uruguay and Venezuela)

Foreign Investment Promotion and Protection Agreements (FIPA) in Force

- Argentina; Armenia; Barbados; Costa Rica; Croatia; Czech Republic; Ecuador; Egypt; Hungary; Jordan; Latvia; Lebanon; Panama; Peru; Philippines; Poland; Romania; Russian Federation; Slovak Republic; Thailand; Trinidad and Tobago; Ukraine; Uruguay; Venezuela.

FIPAs – Negotiations Concluded

- Bahrain; Benin; Cameroon; China; Kuwait; Madagascar; Mali; Nigeria; Senegal; Tanzania; Zambia.

Ongoing FIPA Negotiations

- Albania; Burkina Faso; Côte d'Ivoire; Ghana; Guinea; India; Indonesia; Kazakhstan; Moldova; Mongolia; Pakistan; Serbia; Tunisia; Vietnam.

Other Key Initiative

- China: Economic Complementarities Study and Deepening of Trade and Economic Relations

For an updated list consult: http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/index.aspx.

2. Market development implications: helping businesses gather business intelligence

In addition, Canadian businesses, especially SMEs, consistently say that acquiring key business intelligence is a major constraint to their international expansion.

Every business executive in the country likely knows that emerging markets are forecasted to grow at faster rates than the Canadian or U.S. economy in the near future. Doing something about the opportunities in emerging markets, however, requires companies to know about specific opportunities, and to be able to reasonably assess their commercial value and the risks associated with pursuing them.

If governments are serious about helping SMEs overcome this challenge, a more concerted approach among all levels of government will be required. This coordination should include third parties such as trade associations and other organizations providing services in this area. This more organized, coordinated approach should enhance companies' ability to overcome key obstacles, which include:

- Lack of expertise or knowledge of new markets, both internally and externally;
- Difficulties identifying market opportunities;
- Lack or difficulty identifying qualified local business partners;
- Difficulties associated with managing exchange rates; and,
- Difficulties assessing and addressing the risks associated with security and political instability.

3. Domestic policy implications: improving Canada's economic competitiveness

Many of the challenges and constraints Canadian businesses say they face when doing business beyond Canada are domestic in nature. Considering Canada's lingering productivity challenge, this is not surprising. These are both limitations within the company, such as human, financial or operational resource constraints —and limitations within the domestic economy tied to those internal constraints, such as:

- *Financial constraints*

  A significant share of companies report that access to financing is an obstacle to growth. Governments have a role to play in continuing to ensure the availability of business financing for competitive companies at competitive rates.

In addition, with internal financial constrains often cited as a barrier to growth, governments must ensure they constantly monitor taxation levels and ensure Canada's tax rates and structure do not put Canadian businesses at a competitive disadvantage (or even better, provide a competitive advantage to Canadian businesses). Taxation not only impacts the international growth of domestic firms, but also impacts Canada's ability to attract and retain foreign investment.

Tax incentives should also focus on productivity and competitiveness-enhancing measures, such as capital investment, skills development, research and development, and innovation.

- *Streamlined and efficient regulatory regimes*
  SMEs repeatedly indicate in surveys that the cost and competitiveness impact of domestic regulations are key issues. Governments must continue to intensify their efforts through red-tape reduction initiatives; streamlining regulatory approvals — for example for product approvals and major projects; encouraging industry-led self-certification efforts when possible; and adopting a "trusted-trader" risk management approach in a broader range of policy areas.

- *World-class logistics infrastructure*
  Given the distant nature of overseas markets and the growing importance of GVCs, it is critical that Canadian companies are able to get their goods to market on time and at competitive prices. The competitiveness of Canada's logistics infrastructure, including roads, bridges, ports, airports, railways and pipelines, is in that sense, critical.

- *Skills development*
  For many SMEs looking to meet foreign demand through exports, not being able to source the skills they need to grow production limits their growth.

  At the same time, SMEs that succeed internationally often attribute their success to their people's experience and know-how.

  Governments at all levels must work with employers, key stakeholders in the skills training sector, and educational institutions at the national, provincial and local levels to increase the availability of workers with the skills employers need. Given the chronic lack of skilled labour in key sectors and regions of the economy, Canada's immigration, visa and foreign workers policies must also be focused on meeting both the short- and long-term needs of Canadian employers.

  Special attention should also be given to developing the skills needed for international business, such as foreign-language skills and international trade training.

Finally, all levels of government will need to do more to assess the economic impact of legislation, regulations and policies and consider alternative ways of reaching the same policy objectives at lower costs for business. This matters for all businesses, but in particular, for SMEs and for firms that say corporate organization impedes their ability to expand global business. This latter group includes many Canadian subsidiaries of foreign-based corporations. These establishments typically have a particular production or research mandate, such as producing a specific good for specific markets. As a result, they have little control over sales and marketing, and can only influence investment decisions by ensuring they have competitive cost structures, productivity levels and skilled labour. These firms are already engaged in global business, in that they are the product of a foreign company investing in Canada. For these companies, the four types of measures outlined above are critical for them to secure investments in the future.

Conclusion

The federal government's current agenda of free trade negotiations is ambitious, both in volume and scope. Among the numerous negotiations underway, the Comprehensive Economic and Trade Agreement with the EU and the Trans-Pacific Partnership in particular, are agreements that will expand access to large markets and go well beyond traditional trade pacts in achieving new levels of ambition and comprehensiveness. But as this paper has illustrated, additional resources and policy measures will likely be required to enable Canadian businesses to fully capitalize on the opportunities presented by the new market access gained through trade agreements.

As this paper demonstrates, Canada's SMEs can play a large role in expanding and diversifying Canada's international trade. Of course, it must be acknowledged that the majority of small business operators have a limited desire to expand internationally for a variety of legitimate reasons. But for those that do have high-growth potential, accessing larger markets beyond Canada's borders may be the only way to achieve those goals. As well, with such a tiny proportion of SMEs currently involved in export activity, even small increases in this number can have a significant economic impact.

SMEs, which often lack the internal resources and international networks that larger firms may have, are even more reliant on services and programs offered by government agencies, trade associations and other external partners in order to gather market intelligence, access financing, identify potential partners, navigate regulatory impediments, and overcome all of the other challenges involved in expanding beyond their familiar markets.

Further research of the SME sector will improve our understanding of the specific challenges these businesses face in seizing opportunities in new markets. As well, ongoing dialogue between government and SMEs will help to ensure that policy responses are appropriately designed to address the real needs of export- and trade-oriented SMEs.

A Final Word from CGA-Canada: Invitation to Comment

Over the years, CGA-Canada has produced a number of studies exploring the challenges and opportunities facing Canada's SME sector. This paper marks the beginning of a project to better understand how the country's SMEs can capitalize on international opportunities. Over the coming months, we will consult with small business owners and managers about their experiences with international trade and will publish a summary of those findings.

We are also interested in hearing from you, especially if you can provide the SME perspective. What are the challenges and barriers you have encountered when exploring new markets? What lessons did you learn? What resources or programs would have helped you to succeed? How has your decision to export enabled you to grow your business, become more productive, or lead your business in unexpected new directions?

To share your experiences or inquire about this project, contact James Richardson at jrichardson@cga-canada.org. CGA-Canada will not publish your information without permission.

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