Canadian Manufacturers & Exporters

STALLED TRADE: GEARING UP CANADIAN EXPORTS

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Partner Message

DONALD MATTHEW
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We live in a time of disruption across the globe with the recent rise of protectionism and economic nationalism. Whether it be in the form of Brexit, fraught trade negotiations between the United States (U.S.) and China, or the implications of the recently negotiated update to NAFTA, it is important to remember that we live in a global economy driven by global supply chains. While it is necessary for businesses to scenario plan for the immediate future, it is also incumbent of both business and governments to focus on the long-term arc of global trade and economic development.

KPMG is a proud supporter of Canadian Manufacturers & Exporters (CME) and we are pleased to see the focus in putting forward strategic ideas to position Canada for the long term. While the recent negotiations on NAFTA – once ratified, the U.S.-Mexico-Canada Agreement (USMCA) – demonstrated how trade negotiations can cause significant strain between countries, this is the new normal in such negotiations. These North American trade negotiations ultimately came to a resolution on September 30, 2018 and we believe that is good for all three continental partners. While concessions were made on all sides, that is the nature of trade negotiations.

Indeed, trade across the globe is inter-related. While the USMCA is a North American focused agreement, it has far reaching implications in the broader context of global trade. For example, Article 32.10 of USMCA places restrictions on the ability of the three signatory countries to negotiate free trade with so-called “non-market” economies. What does this mean for Canada in any further negotiations with China? Is this a provision that will further restrict Canada’s ability to increase exports to countries whose commercial policies and practices run counter to market-driven economies? Or is this an opportunity for Canada to take an affirmative role in bringing down trade barriers for all of North America? Article 32.10 does not stop Canada from negotiating a free trade agreement with China. Rather, it states the U.S. and Mexico have an opportunity to comment and make suggestions along the way during that negotiation, reserving the right to ultimately withdraw for the USMCA within a six-month notice if they do not like the end result of such negotiations. The implications of this article are broad and, again, demonstrates the importance of this report to look at all aspects of trade for Canada.

KPMG in Canada believes that our country has an opportunity to be a leader in the global marketplace. If there is ever a time to plan for the future, this is it. Now is the time to capitalize on the expanding breadth of trade agreements that Canada has been so active in negotiating; to invest in programs that will help small and medium sized companies to better compete in the global marketplace; and to diversify the base of the Canadian economy by attracting a larger share of foreign direct investment.

Now is the time to lead!

Table of Contents

About the Authors 2

Partner Message 3

Executive Summary 6

Introduction 8

Background 9

Canada's Global Exports 11

Gearing up Canadian Exports: 17

Summary of Recommendations 34

Conclusion 35

Executive Summary

The recent renegotiation of the North America Free Trade Agreement (NAFTA) – now called the United States Mexico Canada Agreement (USMCA) – has shifted Canadian attitudes towards our economic relationship with the United States and forced us to think about trade in new ways. Calls for trade diversification to new markets have grown louder since renegotiations began. Many people in business, the media, and politics have questioned our ability to trade with a country they don't think can be relied upon to be stable and predictable.

However, as former US President John F Kennedy said: "Geography has made us neighbors. History has made us friends. Economics has made us partners. And necessity has made us allies." From a trade perspective, while it is easy to say we should diversify our trade, a shift away from the US, and North America more generally, may be possible, practical, or desirable.

Our close ties with the US has allowed Canada and its export-focused companies to dramatically expand trade through the 1980s and 1990s. That expansion accelerated investment and growth of domestic industries as they found new customers, new suppliers, and became more globally competitive. Canada's economy prospered as a result.

However, since the early 2000's Canada's export performance could be best described as anemic. While exports grew at double-digit rates through much of the 1990s, growth slowed to a crawl in the early 2000s. In fact, since 2001, our manufactured goods exports have grown by less than the annual rate of inflation.

Two massive events a few months apart in 2001 reshaped the way we trade; we have never recovered from the impact they have had on our international ambitions. The first of these was the 9/11 terror attacks against the United States. The second was China's accession to the World Trade Organization (WTO). At about the same time, the global share of foreign direct investment coming into Canada began to decline. A decade-and-a-half later, Canada still does not seem to have an effective plan to deal with these impacts. The results show.

For decades, and through successive governments, Canada's trade development strategy has focused on expanding market access through signing free trade agreements. To date, Canada has 14 active trade pacts with foreign governments and trade blocs; it is in the final stages of negotiating deals in South America; and it has its sights set on future agreements with the largest economies of Asia. At no other time in its history has Canada enjoyed such preferential access to the world's markets. Yet, despite such unprecedented access, Canada's position and influence in global trade continues to slide. Among G7 nations, only Japan has seen worse export growth than Canada since 2000.

Why does this matter? Canada is a small market with a small economy and small consumer base. Canadian companies need customers and suppliers from other markets to grow. That growth drives investment, job creation, and prosperity for all Canadians. The question is: How do we reinvigorate Canada's exports and expand our potential for future growth?

By no means is this an easy question to answer. Nor do we think we have all the answers. This paper focuses on some of the export challenges we face as a country and offers some practical solutions and a path forward. Specifically, we believe that industry and government should focus our resources on areas that offer the greatest likelihood of success. To that end, we have identified three export growth pillars:

1. Strengthening Canada's existing export foundations, with a focus on building from existing trade agreements, especially the USMCA, and leveraging our natural and existing strengths and resources;
2. Supporting the scale-up of small and medium-sized companies by developing stronger support programs to encourage domestic investment and expand international growth opportunities; and
3. Attracting foreign direct investment and global production mandates from large multi-national companies.

Executing on these three pillars is critical to unlocking Canada's export potential and to doubling value-added exports by 2030 – one of the primary objectives of our Industrie 2030 manufacturing strategy for Canada. It is also critical to meeting the federal government's objectives of building a stronger, more prosperous middle class and economic base across Canada.

Introduction

Exports and CME's Industrie 2030 initiative

Canadian Manufacturers & Exporters (CME) believes that a dynamic exporting sector is critical to our future success as a country. It is for this reason that increasing foreign sales was one of the five pillars of CME's Industrie 2030 strategy, and that one of the goals of that initiative was to double value-added exports by the year 2030.

The first step in achieving that goal was to outline the issues and challenges facing Canadian manufacturers and exporters in their drive to access new markets. The Industrie 2030 paper *Increasing Sales in Foreign and Domestic Markets* identified those challenges and developed a blueprint for a path forward.

This paper builds on that work. It puts forward a comprehensive export strategy for Canada – one that will end our 17-year run of below-average export growth and help our businesses reassert themselves on the international stage.

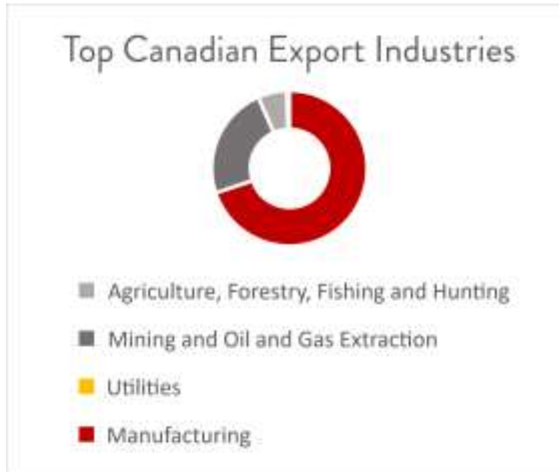
Background

Canada's Manufactured Goods Exports

Driven by exports, manufacturing is the largest business sector in Canada. Directly and indirectly, manufacturing accounts for one third of total Canadian economic activity and one quarter of Canadian employment. In direct terms, the sector accounts for 11 percent of Canada's GDP and 1.7 million jobs. These are high-skill, high-paying jobs, and often are the primary economic driver in smaller communities.

While rooted in communities across the country, manufacturing is truly a global endeavor. The historical myth that Canada is a nation of hewers of wood and drawers of water is just that: a myth. Since even before our country was founded, Canadians have been turning our natural resources into value-added products and selling them to customers at home and around the world. Manufacturing and exporting are inexorably linked, and it is manufacturing that ultimately drives Canada's export performance.

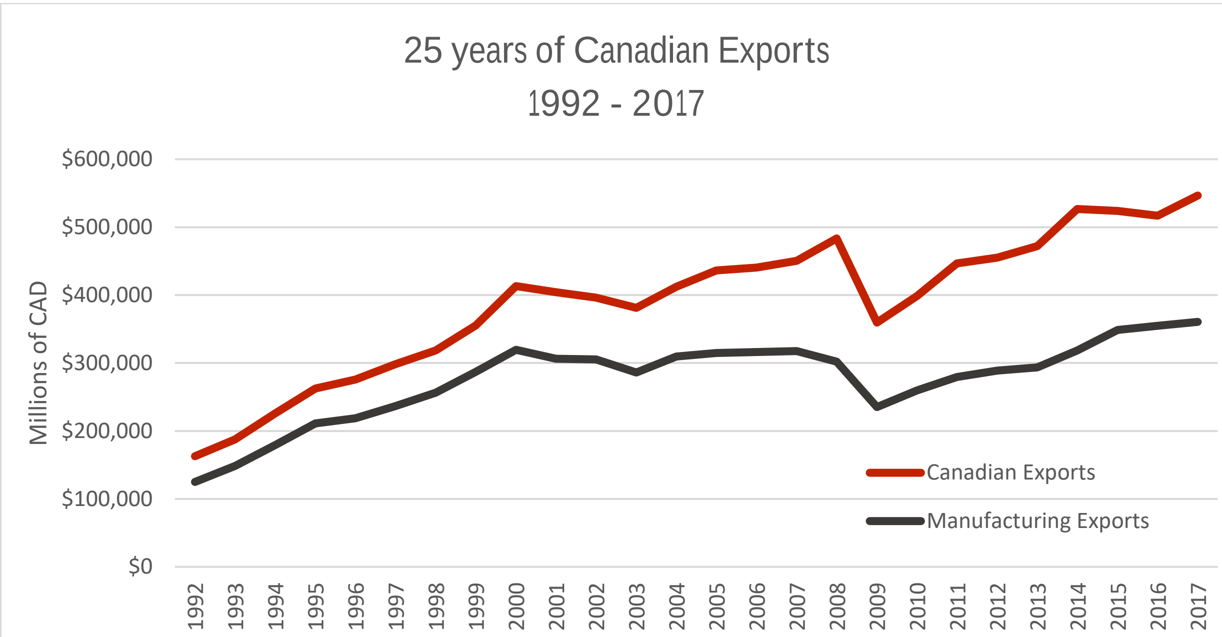
Today, value-added manufactured goods account for two thirds of Canada's overall exports. In part this is because manufacturers are globally integrated, selling both sub-components and finished goods to consumers, other businesses, and governments around the world. However, the primary reason why manufactured goods are such an important part of our trade mix is the integration of manufacturing supply chains across North America.



In fact, over 80 percent of Canada's international trade today is with our NAFTA partners. This is not an accident. It has developed over decades of strategic business decisions, government policy and planning. Companies have leveraged the unique assets of each NAFTA partner to make complex, innovative, and globally-competitive products.

Canada's Global Trade Volumes by Destination:

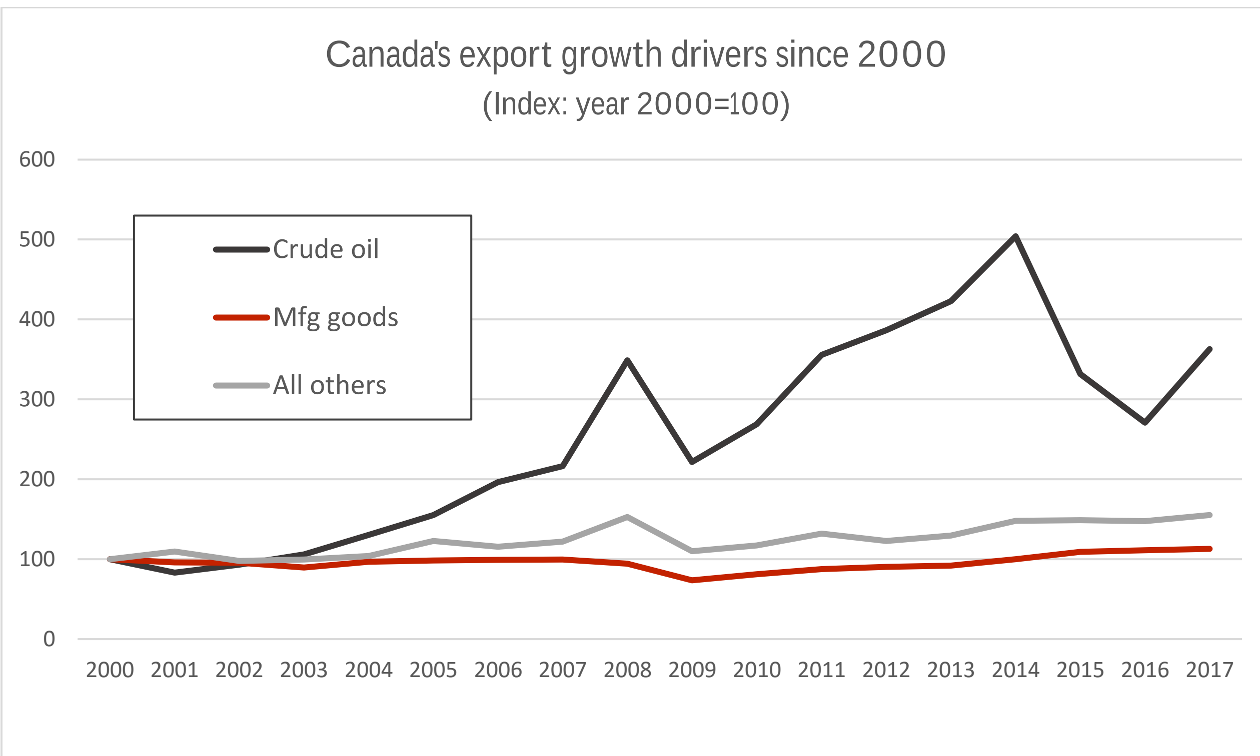
This integration has served Canada and Canadian manufacturers exceedingly well. Over the past 25 years – dating back to the immediate pre-NAFTA period – Canada's total exports (and manufactured goods exports) have risen dramatically. Since 1992, total exports have risen by about 235 percent, while manufacturing exports have risen by nearly 190 percent. Indeed 2017 was a record year for both total exports ($547 billion) and manufactured goods exports ($361 billion).



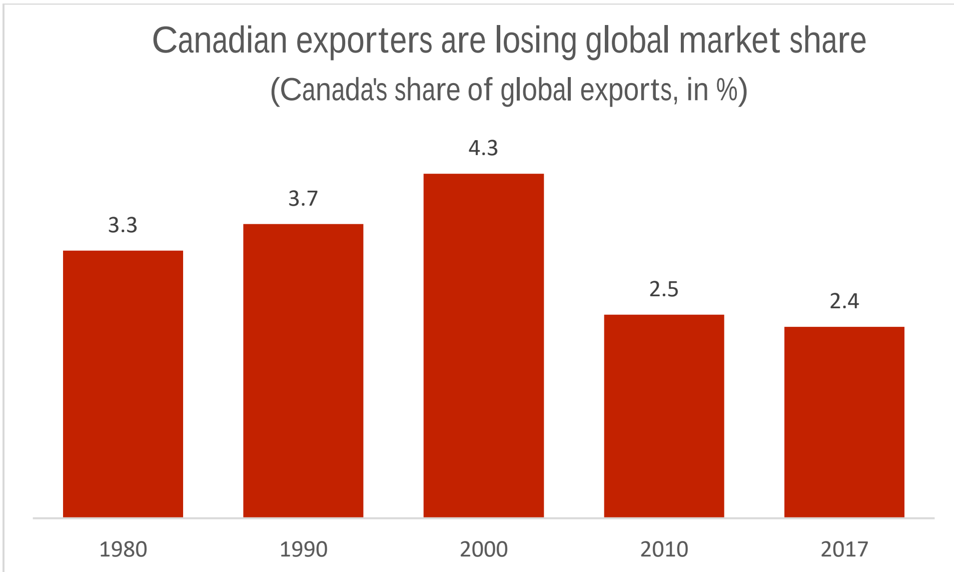
Canada's Global Exports

1. Underwhelming performance since the early 2000s.

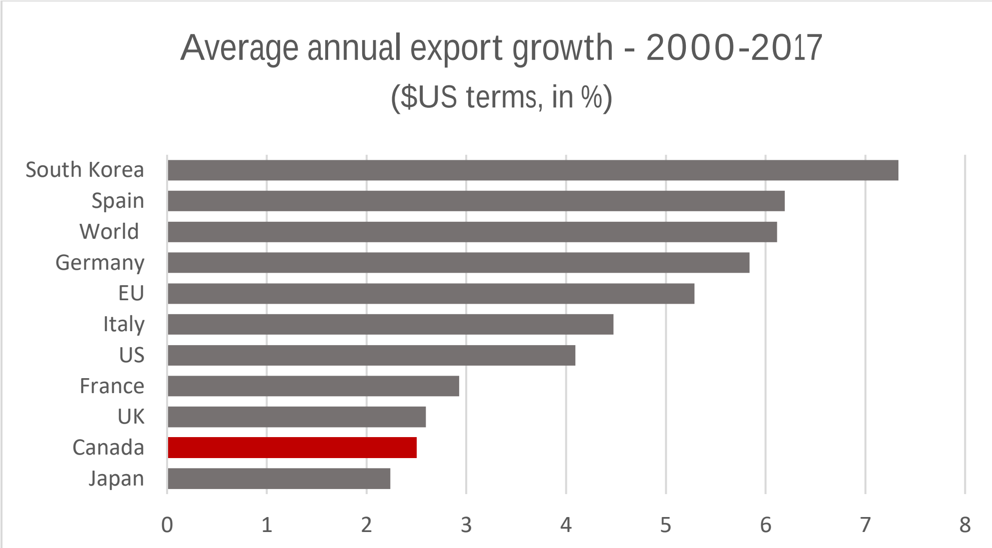
These records should be celebrated, but they are far from unambiguously positive. While value-added manufacturing exports account for nearly two-thirds of total exports, they are largely stagnant. After growing rapidly through the 1990s, manufactured goods exports have risen by less than one percent per year since 2000 – well below Canada's rate of inflation over that period. In fact, it is not just in manufactured goods that Canada's trade growth has been poor. Most of our trade gains since 2000 have been driven by higher volumes of crude oil exports.



And while Canadian exporters did well within NAFTA in the 1990s, many are struggling within the broader global context, especially since 2000. As a result, Canada is declining in importance as a trading nation. According to the World Trade Organization (WTO), Canada accounted for 4.3 percent of global exports in 2000. By 2017, that share had fallen to just 2.4 percent.



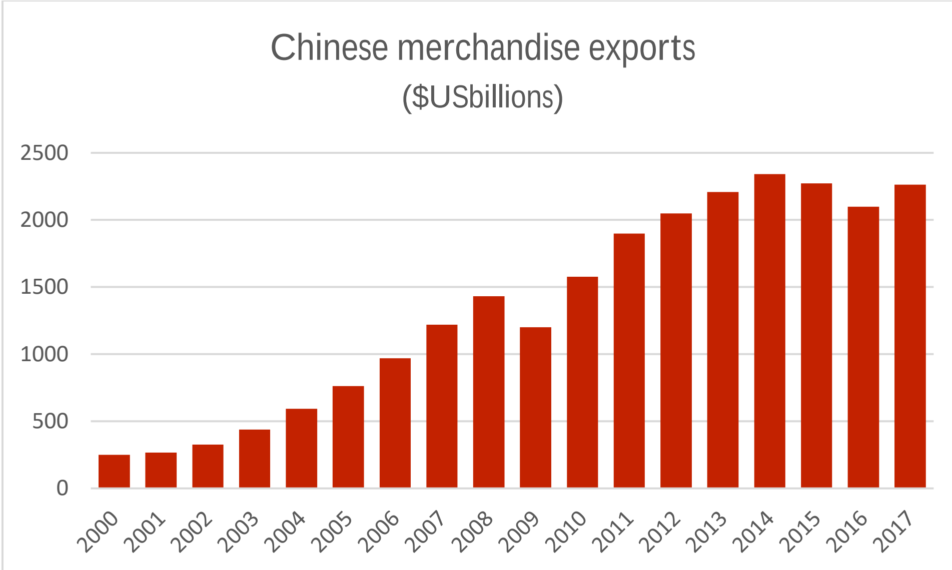
Canada's poor record on export growth since 2000 stands in sharp contrast to most other advanced economies. Over the last 17 years, Canadian exports have risen by an average of just 2.5 percent per year (in $US terms) – even with the dramatic increase in crude oil shipments over that time. Meanwhile, global trade has expanded at an average rate of 6.1 per cent per year. South Korea has seen export growth of 7.3 percent per year; Germany, 5.8 percent; and the US, 4.1 per cent. In fact, across in the G7, only Japan has a worse export performance since 2000.



Canada's trade challenges can be traced back to two major, but unrelated, events in the early 2000s. The first of these was the 9/11 terrorist attacks in the United States. That event fundamentally changed Canada's trading relationship with the US. Previously, our relationship with the US was about trade and economic integration – from the Defense Production Sharing Agreement, to the Auto Pact, to the Canada-US free trade agreement, to NAFTA. Governments on both sides of the border worked collaboratively to facilitate trade and minimize interference.

Post 9/11, security became paramount. Governments demanded more information, more reports, and more compliance with security programs. The cost for businesses increased. But more than that, trade uncertainty and unpredictability grew. For many companies, it simply became easier to supply their US-based customers out of the US. And for many smaller Canadian businesses, the US border suddenly became a major hurdle to international expansion. Some companies made the leap. Some failed. Many others did not even try.

The second event happened in December 2001: China joined the WTO. At the time, China was an emerging country in global trade, exporting just over US$266 billion in goods around the world – within range of the US$260 billion in Canadian exports that year. Just six years after WTO accession, China's merchandise exports surpassed US$1.0 trillion and by 2012, they had passed US$2.0 trillion. Today, Chinese companies export about US$2.26 trillion in goods, while Canadian exports are worth just US$421 billion.



Most nations were not prepared for the impact from China unleashing its industrial and export capacity on the world. Canada, however, seemed more affected than most. As exports from China exploded, simple math tells us that the proportion of total exports from other countries will fall. However, other industrialized economies did a much better job of preserving their global market share. While Canada's share of global exports fell by 45 per cent from 2000 to 2017, the US's share fell by 28 per cent, and the EU's by just 12 per cent.

2. Unprepared for global competition

Compared to most other advanced economies, Canada and its export-focused industries appear to have been simply unprepared for China's rise. But what makes Canada unique in this regard? As argued in our Industrie 2030 reports, CME believes there are two specific contributing issues: business size; and capital investment levels.

On the first point, Canadian companies are, on average, smaller than those in other jurisdictions. In fact, as was noted in our Industrie 2030 reports, 75 percent of Canadian manufacturers are small companies with fewer than 10 employees. In the US, just 58 percent of companies have fewer than 10 employees. While all companies start out small – and there is nothing inherently wrong with being small – size does limit a company's ability to go global. Smaller companies simply have fewer internal resources available to research and capitalize on international opportunities.

The second issue – business investment – is perhaps the bigger of the two challenges as it directly undercuts Canadian businesses' ability to compete in global markets. As detailed in CME's recent report on competitive business taxation entitled Restoring Canada's Tax Advantage: The Need for Tax Reform, Canadian companies invest significantly less in their operations than their competitors in the US, EU or elsewhere. In fact, US manufacturers will invest, on average, six times more in their operations than their Canadian counterparts. As a result of our poor investment track record (in technology, products and people), Canadian companies are less productive than their international peers; it costs more to produce a unit of output here than in most other advanced economies.

3. All free trade agreements are not created equal

Canada's answer to floundering export success was to focus on signing new free trade agreements (FTAs). Over the past 15 years, successive governments have signed trade pacts with various markets in Europe, Asia and Latin America. Today, Canadian exporters have preferential trade access to 44 countries around the world, including the US and the 28 current members of the EU. Our trade agreements allow businesses to access countries that account for 66 per cent of all global economic activity.

The Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) agreement, once implemented, will provide additional access to 7 new markets (Mexico, Peru and Chile are covered under existing agreements), including, most notably, Australia and Japan. Exploratory discussions or formal negotiations have taken place with several other countries around the world.

Signing an FTA is generally seen as positive step towards increasing trade and, therefore, economic growth. However, it only achieves that outcome if domestic companies actually increase their exports as a result. Canada's record in taking advantage of FTAs is inconsistent, especially when it comes to exports of value-added manufactured goods.

For its part, NAFTA was an unambiguous success on that front. The agreement sparked remarkable growth in manufacturing and overall exports after it came into effect. It led to an increase in Canadian exports to the US and Mexico of almost 120 percent to well over $400 billion today.

However, Canada's success with other FTAs have not come close to meeting this mark. It is true that exports to some FTA partner countries have risen significantly, but often from such a low base that the overall impact on the Canadian economy has been negligible. For example, exports to Chile (75 percent growth to $725 million), Costa Rica (130 percent to $144 million), and Peru (100 percent to $764 million) have all grown considerably, but they remain modest trading partners at best. Many other FTAs with smaller economies saw minimal growth or in some cases declines in export volumes.

In the cases of FTA with larger economies like the EU and South Korea, Canada has seen reasonable export growth, but those gains have been offset by massive increases in imports and widening trade deficits. The EU currently runs a nearly $25 billion trade surplus with Canada, while South Korea has a $6.25 billion advantage.

In an era of global supply chains, it is unreasonable to expect that Canada have balanced trade or a trade surplus with each of its major trading partners. However, the gap between export performance and import penetration is concerning, as it has resulted in massive and growing trade deficits in value-added goods. In 2000, Canada's manufacturing trade balance was roughly even – our trade surplus with the United States was offset by a trade deficit with Asia and other markets around the world. Since then, however, our positive trade balance with the US has eroded and our negative balance with other countries has ballooned. In 2017, Canada's manufacturing trade deficit reached a record $136 billion.

Trade deficits with individual countries are not important, but this general trend is cause for real concern. Canada, and Canadian companies, are simply not competitive enough to take advantage of the opportunities created by trade liberalization agreements. Foreign competition is undercutting our sales success both at home and in international markets.

Gearing up Canadian Exports:

Three key pillars to exporting success

The previous analysis reveals that Canada is leaving money on the global trade table. While our overall exports have increased modestly, we are losing ground to other countries. Worse still, value-added exports in manufacturing are falling further and further behind.

Clearly, we need to do more to fix this problem than just sign additional new trade agreements. For a number of cultural, structural, and policy reasons, Canadian manufacturing companies are not taking full advantage of existing FTAs; neither are they generating the export results that we might expect. When such a major component of the Canadian economy is underperforming to this degree, all Canadians lose out.

In short, Canada needs a new strategy and a fresh approach to trade policy that helps companies better take advantage of overseas export opportunities and boosts economic performance at home. CME believes that this strategy should focus on the following core elements:

1. Strengthening Canada's existing export foundations, with a focus on building from existing trade agreements, especially the USMCA, and leveraging our natural and existing strengths and resources;
2. Supporting the scale-up of small- and medium-sized companies by developing stronger support programs to encourage domestic investment and expand international growth opportunities; and
3. Attracting foreign direct investment and global production mandates from large multi-national companies.

1. **Strengthening Canada's existing export foundations**

Despite Canada's stagnant export performance, we have considerable strengths upon which to build an export strategy for the country. As a starting point, we have our existing trade agreements that provide Canadian companies preferential access to two-thirds of the global economy. There are also considerable government resources available, at the provincial and national levels, to support trade.

However, while these appear to check many of the right boxes on paper, they have clearly not been enough to create meaningful export gains given Canada's trade performance over the last 17 years.

CME believes that a combination of steps is needed to strengthen this foundation. We need to build off of and strengthen our existing export tools; as well as adopt a few proven concepts and best practices that have worked in other jurisdictions.

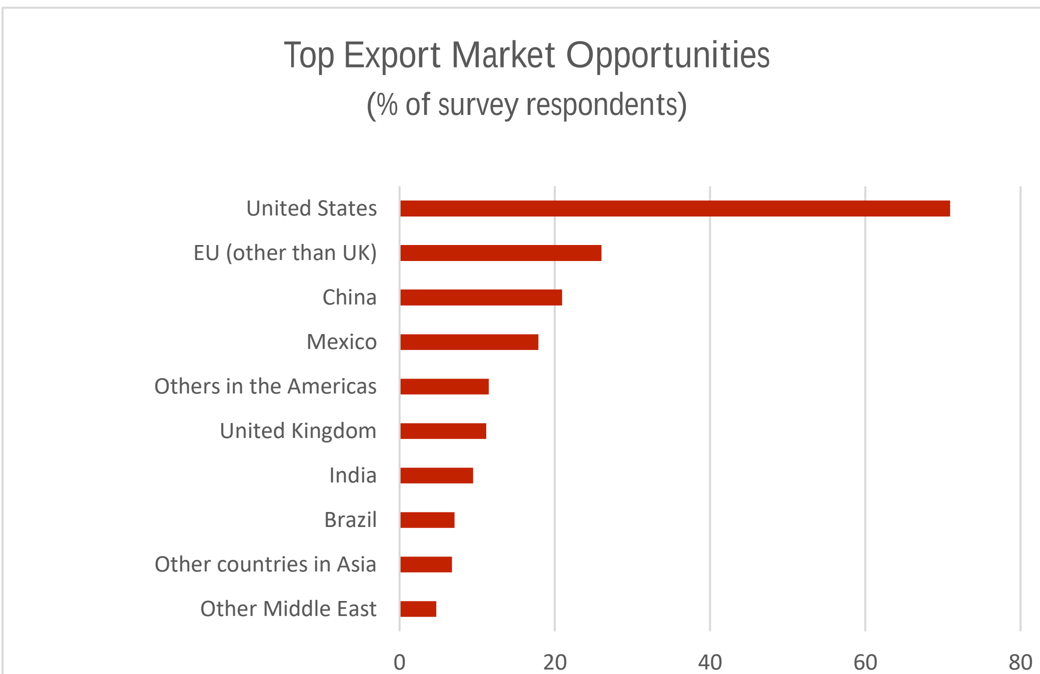
a. Leverage the USMCA

Any attempt to weaken our trade relationship with our North American partners, or to diversify trade away from the United States, would be terrible economic and trade policy for Canada. Not only is the US our largest trading partner, but that economic relationship is central to Canadian companies' ability to compete and succeed globally.

Unlike Canada's other trade relationships which are primarily about competing for market access, our partnership with the US and Mexico is about working together to compete against the rest of the world. Three fundamental facts distinguish our collective North American trade from our trade with outside economies. First, the largest volume of Canada's cross-border trade with Mexico and the US is largely sub-assembly– smaller parts that go into larger goods. Second, a majority of that trade is intra-firm – companies trading between parent offices and other establishments. And third, not only do we share a geographic region, we also largely share a common language, culture, and legal and regulatory structure that makes doing business much easier.

It is for these reasons, along with the fact that the US is the largest and wealthiest single market in the world, that Canadian companies are so focused on that market above all others. CME's 2018 Management Issues Survey (MIS) results underscore how important the US market is for our domestic companies. Fully 94 per cent of respondents identified the US as one of their most important export markets, while 71 per cent said that the US holds the greatest opportunities for future growth.

In both current sales and future opportunities, the US far outranks all other export destinations for Canadian businesses. As such, rather than looking to move beyond our trade relationship with the US and diversify trade away from that country, Canada should be looking to build from that relationship to enable export growth with other countries. This is something we believe the new USMCA can help accomplish, provided it passes all legislative and political process over the coming months



For the most part, the USMCA retains all the core features and articles of NAFTA. It also updates the agreement to reflect 21st century business realities and includes new chapters to address important issues such as competitiveness and the environment. Below is a high-level summary of what is in the USMCA.

If, and when, the USMCA comes into force, it will become the anchoring agreement that will guide Canada's future trade agenda. Rather than diversifying away from the US, Canadian companies must leverage the combined strength of the North American economic region to boost exports locally and internationally.

To start, the Canadian government should focus its efforts on getting those companies who are not yet exporting to begin their export journeys within North America. As noted above, of all the export markets around the world, the US shares the most in common with our own. That makes the transition much easier for the over 95 percent of Canadian companies who do not yet export. Expanding available resources – whether funding supports or institutions like the Trade Commissioner Service (TCS) – are critical to helping smaller companies make that leap. These points are covered in more detail, below.

What's New

- New competitiveness, environment, digital trade, and labour chapters
- Increased de minimis thresholds
- New IP rules for biologics and patents
- Updated regulatory practices chapter
- More content requirements for autos
- 16-year sunset clause reviewed every 6 years
- Government procurement based on WTO rules

What's the same

- Dispute resolution chapters 19 & 20 stay (11 to be phased out)
- Temporary entry of business professionals

What's Novel

- Limits on trade deals with non-market economies
- 232 tariff protections for autos

Globally, Canadian companies must better leverage the integrated North American economic region and supply chains to boost their international competitive position. Lost in the headlines of the USMCA deal are the new elements of the agreement that seek to enhance North America as a regional trading bloc. Chapter 26 on competitiveness could become a significant tool for Canadian trade interests. It will coordinate tri-partite efforts to enhance trade and investment within the continent, in addition to increasing economic integration between the three countries. There are even special mentions within this chapter on enhancing the participation of small- and medium-sized enterprises (SMEs) and other groups. But most interestingly, Chapter 26 champions a collective-action approach to dealing with global trade threats such as dumping and currency manipulation. In addition to Chapter 26, the USMCA also adds in several new sections which should also boost export opportunities, including on digital trade, trade facilitation, and regulatory cooperation. These were all top priorities identified by Canadian manufacturers during the negotiations.

As such, the new USMCA, provided it is implemented as negotiated, should provide a boost for Canadian export performance by strengthening integrated manufacturing across the region and increasing our ability to compete globally

b. **Maximize Canada's other free trade agreements**

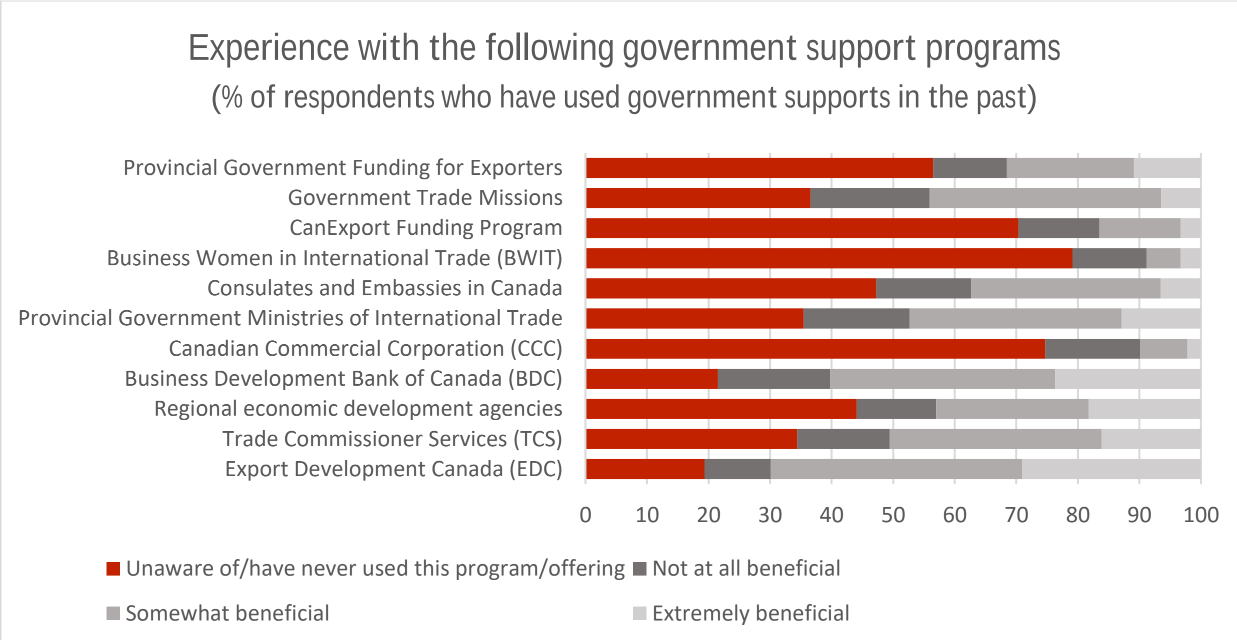
Over the past 20 years, various Canadian governments have believed that signing new free trade agreements would bolster the strength of Canadian companies through enhanced competition, increased exports to the new markets, and more and better job creation at home.

This is a theory that CME generally supports. However, as noted above, the reality is that most FTAs have led to limited export growth into the new markets and a substantial increase in imports. We believe the causes are three-fold: FTAs are not supporting business realities; there are insufficient government support programs; and companies are unable to overcome structural barriers to trade.

First, if we are to substantially increase exports, Canada should be signing FTAs with countries where there are natural business linkages and pre-existing trade flows. Simply signing an FTA does not mean companies are interested or able to do business in that region or country. Canada's history in trade agreements reinforces this reality. While there has been some success in growing exports through new FTAs, the results have been limited.

As shown earlier, Canadian exporters are primarily focused on enhancing their North American business relationships for export growth. Well behind the NAFTA region for both current sales and future expansion is the EU and China. The EU is high on the priority list due to historical connections and the recently implemented Canada-EU Comprehensive Economic and Trade Agreement (CETA). China is high on the list because of the enormous market opportunity, although it is questionable if Canadian companies can succeed in that market given the vast cultural, scale, and legal differences that separate our countries.

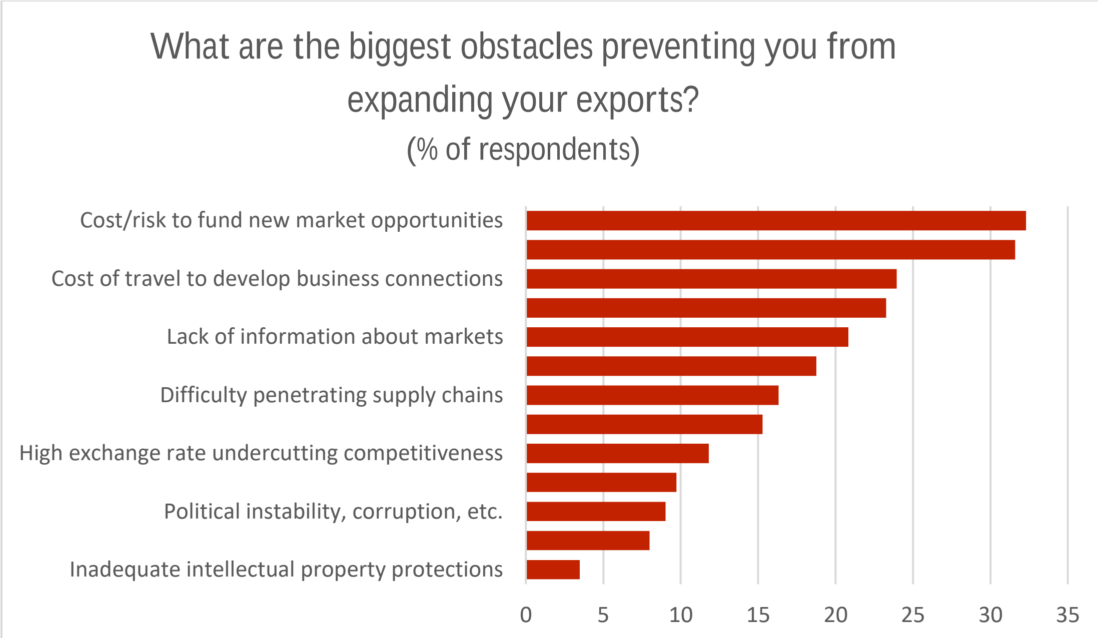
Second, FTAs must be backed by substantial government support programs focused on the new markets. Today, while Canada and its provinces have myriad export support programs, most are unknown or unappreciated by Canadian companies. As part of CME's 2018 Management Issues Survey, we asked companies about their use of, and experience with, a variety of government export programs including Export Development Canada (EDC), Business Development Canada (BDC), the Trade Commissioner Service, and a variety of others. As shown below, in most cases the programs were either unknown to exporters or not useful to them. In fact, 46 per cent of survey respondents had never availed themselves of government support programs, tools or agencies in the past.



Of those who had used at least one government support in the past, the lack of awareness of the suite of government services was still low. Only three services – EDC, BDC and the TCS – scored higher than 50 per cent in term of satisfied users. This is not to say that the other support programs are not useful; rather, they are largely unknown to the broader export industry.

To reverse these numbers, several actions are needed. To start, government export programs should be consolidated and streamlined to make it easier for companies to access and understand them. In addition, the service offerings should have better funding. The TCS, for example, offers outstanding services to companies who can access their expertise. Unfortunately, many companies note that the TCS is difficult to connect with because of their limited resources and company/sector expertise.

Finally, government support programs should be focused on the biggest barriers to exporting. As the following responses from CME's MIS shows, the biggest obstacles to exporting are the cost and risk associated with opening new markets, followed closely by concerns over competitiveness and production capacity. While the latter issue will be discussed further below, the primary issue of cost and risk is a major concern for growing exports and can be addressed by making changes to current programs. The CANEXPORT program for example, which covers some costs for travel and trade show attendance for new exporters has been reported to be extremely difficult for companies to navigate and should be revamped. There are restrictive timelines for application and use of funds, limited markets in which the program is offered, and an overall costly and time-consuming bureaucratic process for securing supports.



The final area to address in leveraging existing FTAs is how government and industry must work together to better identify market opportunities and eliminate barriers to export. Companies face a myriad of other barriers to foreign markets, ranging from a general lack of information about the available opportunities, to difficulty in penetrating foreign supply chains, to regulatory barriers that restrict market access. Governments should increase funding to industry associations to educate industry more generally on market opportunities and to execute foreign trade missions. Further, industry and government should partner to identify and address all specific restrictive regulatory practices in foreign countries and hold those governments accountable through the mechanisms offered in the relevant FTA – including dispute settlement, and regulatory cooperation provisions.

c. Implement tax reform that focuses on investment in capacity, productivity, and exports

As our MIS results show, two of the most significant obstacles to export success are actually domestic constraints – the ability of companies to compete internationally; and a lack of production capacity. As detailed in CME's paper *Restoring Canada's Advantage: The Need for Tax Reform*, we argue that a lack of business investment has eroded Canadian companies' competitiveness at home and abroad, and is undermining Canada's overall economic performance. The goal, therefore, should be to make Canada's business environment more competitive so that our manufacturers and exporters are better able to stand toe-to-toe with their global peers. Specifically, we recommend lowering corporate tax rates; incentivizing spending on machinery and equipment; and enhancing foreign direct investment (more on this later).

As part of broader corporate tax reform, Canada should restructure its existing tax incentive structure to support export potential. Specifically, governments should consider adjusting the corporate tax system so that companies pay a lower tax rate on profits generated from foreign sales. To encourage trade diversification, the reduction could be greater for exports to non-US destinations.

d. Create government/industry Trade & Export Councils

Currently, no high-level forum exists where exporters and government can meet to discuss trade issues both with their peers and with government decision-makers. At one time, Canada had a series of consultative groups called SAGITs (Sectorial Advisory Groups on International Trade). These fora provided industry with the opportunity to offer input into government export strategies and programs. Government, in turn, benefited from a direct understanding of industry trends, concerns, and priorities. These SAGITs were abandoned in the early 2000s. They should be modernized and reconstituted.

In addition, we recommend that the Prime Minister create a senior-level export council, modelled on that of former President Obama's Export Council, to act as the principal national advisory committee on international trade. This group could provide direct input on government policies and programs that: affect trade performance; promote export expansion; and provide a forum for discussing and resolving trade-related problems.

e. Leverage Canada's natural strengths

Far too often, government growth strategies focus on trying to create new businesses and opportunities rather than on leveraging our best assets. Canada's trade strategy is no different. Government policies in the past have sometimes prioritized gaining access to new markets that do not necessarily fit Canada's business realities and strengths. They have also focused on developing or promoting new products or sectors that are considered to be desirable, but where Canada has little or no expertise. This is not to say that we should not be developing new and innovative sectors but focusing our policy energy on following trends and creating the next big thing is not a sound business strategy.

What is a sound business strategy is to focus on doing even better at the things we do well already. For Canada, this means leveraging our natural resources, and developing export markets for strong domestic industries that have untapped export potential.

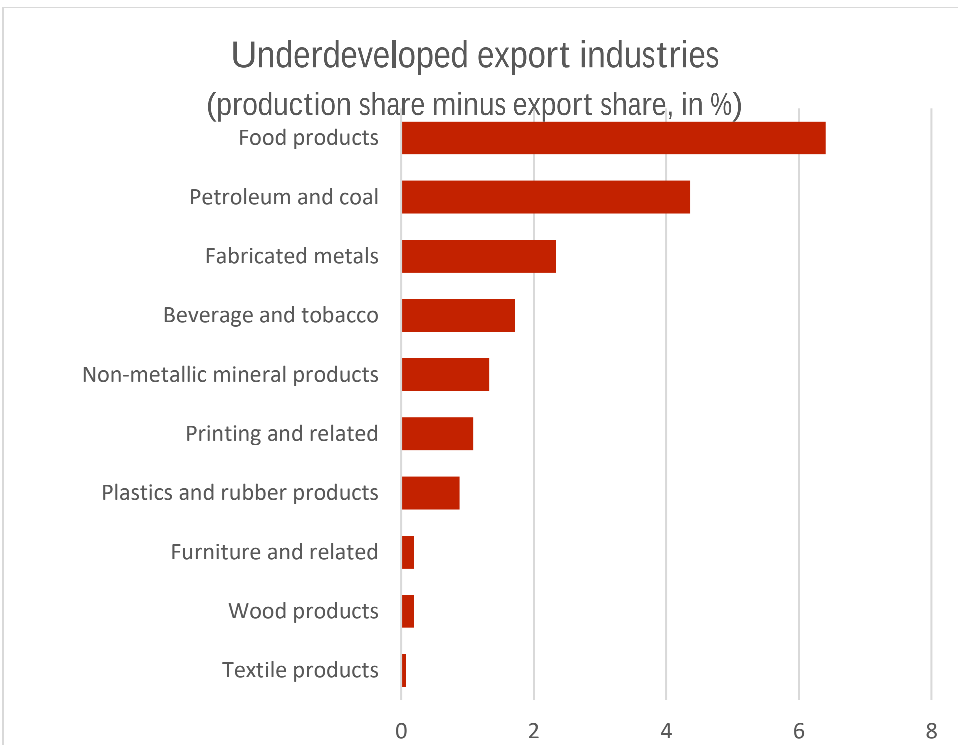
Canada is a resource-rich country. Led by crude oil, natural resources have been driving our export growth over the last 15 years. While the world wants what Canada produces, exporting raw materials is only part of the opportunity. There are tremendous opportunities to develop more value-added industries around the resource sector and capture a larger share of the economic benefit that our resource endowments represent.

This is not to suggest that it is always feasible or practical to add value prior to export. While it might be economically preferable to refine Canadian crude oil at home prior to export, the realities of the refining industry and wide variations in fuel content standards around the world means that it usually makes more sense to locate refineries close to the markets they serve.

We are not suggesting a forced upgrading strategy. Rather, Canada should identify those sectors where value-added opportunities exist, and then focus on two things: removing economic and policy barriers that are inhibiting that activity; and providing greater incentives for domestic processing. Some options include reducing royalties payable on non-renewable resource extraction, improving regulatory approval processes, and expanding government investment supports.

As a next step, Canada should identify and focus on those sectors tied to our natural strengths but who underperform in exports and focus our efforts on boosting their exports. The figure below shows the industries where domestic production levels are high (as a percentage of overall manufacturing activity), but the share of total manufacturing exports is low.

Topping the list is Canadian food processing. Canada's food producers account for roughly 15 percent of total manufacturing output but only 9 percent of manufacturing exports. By contrast, the auto sector also accounts for 15 percent of output but 22 percent of exports.



In a world that places a premium on safe and high-quality food, Canada has a sterling reputation for producing exactly that. We should therefore be focusing our efforts on how better to meet that demand and make inroads into capturing a greater share of that high-value market. The best types of policies that advance this goal are broad-based. They encourage investment in value-added production in Canada; they boost business spending on productivity-enhancing machinery and equipment; and they make Canada an attractive destination for foreign investors.

2. Scaling SMEs to get them ready to go global

Canada has an industrial structure problem that is limiting our ability to expand into global markets. Our manufacturers – and our business community in general – skews heavily towards small companies compared to other countries. As noted earlier, about 75 per cent of all manufacturing establishments in Canada have fewer than 10 employees or no permanent payroll. By comparison, in the United States only 58 per cent have fewer than 10 employees.

This gap impacts Canada's trade performance. Generally speaking, small companies have fewer resources and less in-house expertise compared to medium- or large-sized companies. A 200-person company simply has many more people available to perform various roles related to business development, or even securing government supports, compared to a 10-person operation. This is not to take away from the skills of those employed at the latter. But that constraint makes it far more difficult to explore new foreign market opportunities.

While Canada needs a specific strategy focused on company scale-up and growth – and there have been some encouraging steps in this regard stemming from the work of the Minister of Innovation, Science and Economic Development's Economic Strategy Tables – part of this effort must focus on improving the export-readiness and export capability of our small companies. That component has been largely missing to date. To move closer to an SME export support strategy, we believe the following elements should be prioritized.

a. Create an Export Concierge Program

The relatively low uptake of government trade assistance programs demonstrated in CME's Management Issues Survey underscores the fact that SMEs lack the internal resources to explore those options. Many companies either are not aware of the programs that could help them grow or lack the time and dedicated resources to pursue them.

CME believes that a private-sector-led, government supported, concierge service could help bridge this divide between SMEs and government programs. The concierge service would play two important roles. First, it would assess companies' export potential, connect them to the range of government support programs available, and assist them in navigating the application process. Second, it would provide direct advice and guidance on export opportunities and strategies. Such an approach would leverage the industry expertise of trade associations and improve the uptake of valuable government support programs. This concierge service should be funded by federal and provincial governments, and operated by industry associations that have national, regional, and sector-specific expertise.

b. Establish export mentorship councils

Again because of their size, SMEs do not have the internal resources to develop professional relationships with trade experts and trade peers. As a result, SMEs often remain isolated from one another and do not benefit from the informal networks that could enable them to grow. Developing a global business mindset requires years of effort. Exposing SMEs to this culture through networking and mentorship opportunities is key to achieving this goal. This is where leveraging Canada's not-for-profit business association network could again be useful.

To increase formal business support networks, trade associations such as CME could establish export mentorship councils across Canada to connect SMEs to peer companies, so they can learn from each other and from experienced export leaders. Export mentoring would create private sector support networks for SME exporters and leverage private sector assets and experts to support new and/or nascent exporters. The end result would be a stronger, more connected network of Canadian SME exporters.

c. Create a National Manufacturing Export Accelerator Program

To help address stagnant manufacturing exports, and to encourage SMEs to export more, Canada needs to improve the basic export-readiness of manufacturers. To assist with this, CME proposes the creation of a National Manufacturing Export Accelerator Program similar to Canada's existing Technology Accelerator Program and comparable trade programs delivered by TAP Canada. This program would focus on preparing successful applicants for new markets and address company-specific barriers to exporting. These barriers include gaps in training, technology, productivity, access to value or supply chains, or financing. The Export Accelerator program would be delivered by the private sector with support from the federal government.

d. Create a SMART export grant program

Building off the highly successful Smart Productivity program that CME has run in partnership with FEDDEV Ontario since 2010, the government could establish a SMART export grant program to directly fund SME exporters.

Grants would be given to qualifying SMEs who would then be expected to match the government's investment. The money would be directly targeted towards helping them develop an export business strategy, an international marketing strategy, training of export staff, or other export services that would support the exporter in going global. The overall goal of these targeted grants would be to promote and increase global exports from Canadian SMEs.

e. Create an Export Jobs Tax Incentive

As already stated, limited staff resources are a major challenge for SMEs. Exporting, or even market research and development requires specific knowledge and expertise. One way to help overcome this barrier is to assist SME scale-up by providing direct tax incentives to hire staff specifically for export market development. In the 2018 MIS, manufacturers expressed an openness to consider a wide range of export-assistance incentives, including direct tax credits. Encouraging SMEs to hire the help they need would build internal capacity and lead to a higher likelihood of them exporting more.

f. Help SMEs go digital

According to the WTO, the vast majority of technology-enabled small firms are exporters (97 per cent on average and up to 100 per cent in some countries). By comparison, only a small percentage of traditional SMEs export – between 2 percent and 28 percent for most countries.

Therefore, with the aim of helping SMEs export, governments should provide special incentives to grow SMEs' online presence. This could be as simple as providing funding for expert web design and the construction of e-commerce platforms. Again, the idea is to help SMEs by providing them with resources they do not currently have. The payoff in this instance would be a way to fast-track export development by enabling small manufacturers to sell their goods around the world.

g. Increase business-to-business linkages

One of the simplest, and most often overlooked, ways to boost export sales for smaller businesses is to leverage the existing supply chains of larger companies. Large multinational companies have complex global supply chains with thousands of suppliers feeding operations around the world. Canada is privileged to have many large companies across a wide range of major global industrial sectors operating domestically. Each of these large companies has deep local supply chains that include hundreds, and in some cases thousands, of suppliers.

But while the local supply chain is strong, smaller companies seldom participate in the multinational company's larger global supply chains. In cases where they have – like in the auto and aerospace sectors – those supply chain companies have grown to be large, successful global players in their own right.

Canada should aim to replicate this success in other industries. The focus should be on supporting SME expansion into global value chains in sectors where Canada has natural advantages. Priority should also be placed on strengthening connections between local SMEs and our few Canadian-owned multinational companies. These larger companies can provide strategic support and pull for smaller companies looking to go global.

To achieve this goal, action is needed in several areas. These include closer cooperation between the federal government and industry associations like CME to strengthen domestic match-making capabilities. Government support for company scale-up also feeds into this objective. Finally, more work is needed to better educate and inform Canadian SMEs about global supply chain opportunities.

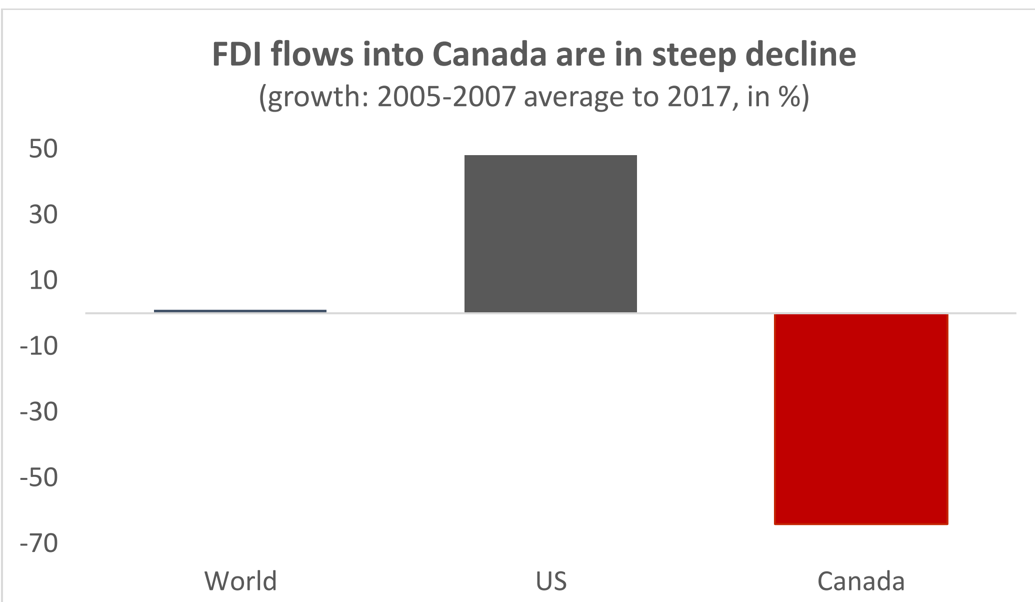
3. Attracting Foreign Direct Investment and Global Production Mandates

Helping small companies increase their exports or even make their first foreign sale – is a critical step towards expanding Canada's global reach, not to mention encouraging our small businesses to expand production and grow. At least as important, however, is attracting more foreign direct investment to Canada.

Foreign Direct Investment (FDI) is a major driver of export growth. The reason for this is simple: most global investment comes from large multinational companies looking for a production platform from which to make goods and then sell them around the world. This is especially true for a country like Canada, where the domestic market is too small to warrant strategic investments to reach local customers.

The benefits of attracting FDI are many. First, new investment creates jobs for Canadians. It also generates new supply chain opportunities for local SMEs. For those smaller businesses, access to the supply chain of a major multinational company can represent their first step into the larger export market. Finally, since foreign businesses are typically major exporters, that means that domestic production vastly exceeds consumption, thus generating exports and additional economic growth.

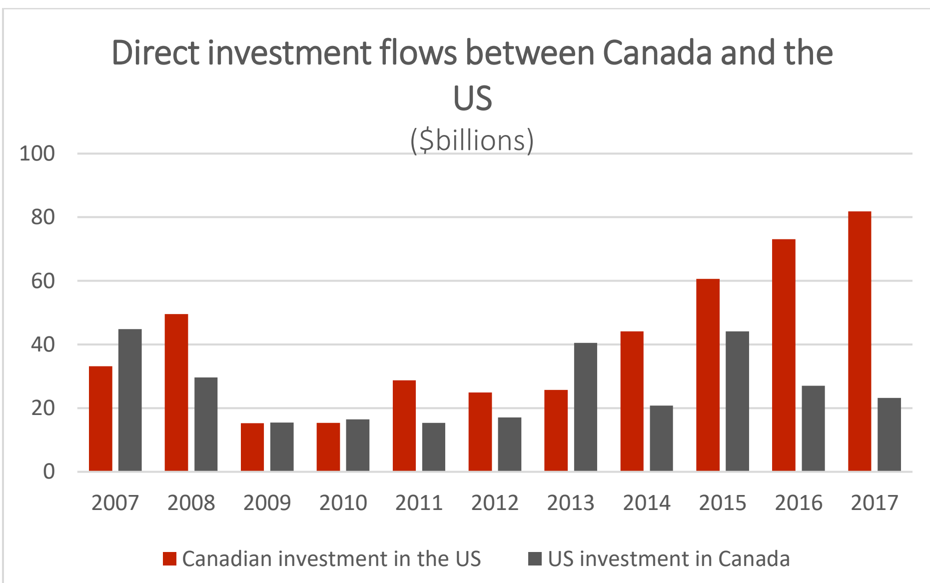
Canada has several advantages as an investment destination. Chief among them is our proximity and preferential access to the US market. While NAFTA renegotiations created no small amount of uncertainty, the prospect of renewed stability and preserved access through the USMCA is a major selling point for foreign investors. Similarly, Canada's network of free trade agreements offers foreign investors enhanced access to the European Union, Mexico and South Korea, as well as several other markets around the world. However, this advantage is clearly not enough. Canada's record on attracting FDI is not only poor, it is in steep decline. According to data from the United Nations World Investment Report (WIR), global FDI flows in 2017 were one percent higher than they were in the immediate pre-financial crisis period (2005 to 2007). In Canada, however, investment flows dropped by more than 64 percent over that same period. Meanwhile, the US has seen a 48 percent increase in FDI.



Data on investment flows between Canada and the United States only further highlight the problem. In 2013, Canada was a net beneficiary of direct investment flows between the two countries. US businesses invested $40.6 billion in Canada that year, compared to $25.7 billion in Canadian investments south of the border. Just four years later, US investment in Canada has dropped by nearly half, while Canadian businesses are pouring money into US-based operations. Canadian investment in the US has more than tripled since 2013, rising to $81.9 billion in 2017.

This decline in foreign investment into Canada is a major reason why our export performance has been so poor in recent years. It is a trend that needs to be reversed if Canada is to regain its lost position on the global economic stage.

The first step is recognizing that the market access opportunities created by free trade agreements is clearly not enough to attract FDI to Canada. Investment has fallen even as market access has risen. There are more fundamental issues that need to be addressed if Canada is to regain its position as an attractive investment destination. There are five specific areas where priority action is needed and several other areas where changes are necessary to compete globally and drive innovation and investment.



a. Improve the business cost environment in Canada

This issue has been covered earlier and does not require much elaboration. Businesses choose to locate their production facilities and other operations in markets where they see the greatest potential return on investment. This means that the local business cost environment plays a key role in shaping their investment decisions. Factors like a competitive tax regime, access to skilled labour, high-quality trade-related transportation infrastructure, a low regulatory burden, and the availability of specific investment incentives all factor into a business's decision on where to invest.

As noted in CME's recent report on business tax competitiveness, the cost of doing business in Canada is high and our relative tax competitiveness is eroding. Combined with issues like long approval timelines for major projects, these issues are a key reason why foreign investment is passing Canada by. If we are to reverse the trend of declining FDI in Canada, direct and immediate action is needed to improve the business cost structure in this country – beginning with the tax and regulatory system.

b. Develop a national FDI strategy

In March 2018, the Government of Canada created a new national agency, Invest in Canada, mandated to position Canada as a premier destination for foreign investment. The agency's goal is to promote Canada to potential investors, and also to make it easier for global businesses to access information, resources and incentives to locate in this country.

As Invest in Canada establishes itself, it is essential that one of its first tasks be to develop a national FDI strategy for Canada. The aim of this national strategy should be to simplify and coordinate all the disparate initiatives offered by provinces and cities and roll them into one coherent national strategy. The strategy should also emphasize new investment to spur the commercialization of technologies. It should also focus on helping Canada expand its global trading relationships

However, the impact of an investment attraction agency will be limited unless it demonstrates and showcases unique selling points that distinguish Canada from other industrialized countries. The Invest in Canada website points to a number of selected statistics and programs that paint Canada in a positive light. However, every other advanced economy in the world could do the same. Canada needs to develop and promote a truly standout value proposition if it is to succeed at attracting significant new FDI to this country.

c. Modernize Canadian FDI rules and processes

Foreign investments in Canada beyond a certain size require federal government approval through the *Investment Canada Act*. In 2008, a Competition Policy Review Panel chaired by Lynton Wilson recommended changes to the Act to help attract more investment to the country. The Panel found that many policies still in place lack basic rationale and are unnecessarily hindering inbound FDI.

Canada's "net benefit" test was one of them. Under the *Investment Canada Act*, foreign investors seeking to acquire Canadian companies exceeding a certain value threshold must demonstrate net benefits to Canada for the sale to be permitted. The problem is that the test involves somewhat vague criteria, including points like "the compatibility of the investment with national industrial, economic and cultural policies." Moreover, the Government of Canada also states that some "net benefit" factors will be given more weight than others, depending on the nature and circumstances of the investment.

Without a clear sense of what constitutes a "net benefit," prospective investors face a considerable degree of uncertainty about whether to follow through with the application process. Along the lines of the Wilson report, we recommend that the "net benefit" test be replaced. Instead of requiring a company to demonstrate a net benefit to Canada, the onus should be put on the government to demonstrate and explain why they should reject the FDI. This change would still allow the government to block investments that contradicts a stated set of national objectives (security, culture, etc.) but would also liberalize the authorization process and diminish the risk foreign investors would take investing in Canada.

d. Reform Canada's R&D incentive programs

Canada currently incentivizes companies to invest in research and development through a combination of federal and provincial programs. The Scientific Research and Experimental Development Tax Incentive (SR&ED) acts as the anchor program and is complemented by a coterie of provincial incentive programs. These programs are helpful, however they have administrative flaws that result in underuse and diminishing returns.

For this reason, the federal government should undertake a major reform of SR&ED administration. This reform should focus on two main objectives: removing the administration of the SR&ED program from the Canada Revenue Agency and housing it with the Ministry of Innovation, Science, and Economic Development Canada; and establishing better coordination with provincial programs with the aim of simplifying the application process for users.

As an additional point, it is critical that the present refundability of SR&ED credits be expanded to large companies. At present, if a small business fails to make a profit in a given year, it can carry over its SR&ED deductions to future years. Large companies do not have this ability. In many other countries, however, R&D tax incentives do not discriminate on the basis of company size. This feature of the SR&ED program reduces Canada's attractiveness as a research and development center for foreign companies and discourages SR&ED uptake by large businesses generally. Allowing all companies to carry over eligible tax refunds will strengthen corporate returns in Canada, attract more large-scale FDI to the country, and lead to increased innovation, production and exports.

e. Implement a Patent Box system

If Canada is to prioritize attracting high-value, technologically-advanced and innovative foreign investment, we need to improve our business incentives for commercializing research and intellectual property (IP). R&D assistance programs help spur the first stage in the innovation process, but the later stages need support as well so that new ideas turn into new products and processes.

Patent box regimes support the later stages of the innovation lifecycle by rewarding commercialization and production of goods in Canada. It does so by reducing the business tax payable on income earned from the commercialization of a broad range of IP.

A patent box system would achieve two export-related goals. First, it would spark the creation of new, innovative products that would generate sales opportunities around the world for domestic businesses. And second, it would create another incentive for foreign companies to locate their high-end innovation and commercialization activities in Canada. This would generate high-paying jobs for Canadians, supply chain opportunities for local businesses, and new avenues for export. Quebec, BC and Saskatchewan have implemented variations of a patent box program. This idea should be adopted by all other provincial and federal governments.

Summary of Recommendations

Here is a summary of CME's recommendations, based on our three pillars, for gearing up Canada's exports

Pillar 1: Strengthening Canada's existing export foundations, with a focus on building from existing trade agreements, especially the USMCA, and leveraging our natural and existing strengths and resources.

- Leverage the USMCA to boost integrated manufacturing
- Maximize Canada's other free trade agreements by supporting exporters
- Implement tax reform that focuses on investment in capacity, productivity, and exports
- Create government/industry Trade & Export Councils to coordinate strategy
- Leverage Canada's natural strengths by promoting business investment

Pillar 2: Scaling up small- and medium-sized companies to support them going global through stronger support programs for domestic investment as well as international growth opportunities;

- Create an Export Concierge Program to link SMEs to government assistance
- Establish export mentorship councils
- Create a National Manufacturing Export Accelerator Program to train SMEs
- Create an Export Jobs Tax Incentive
- Help SMEs enhance their online presence
- Increase business-to-business linkages to large company supply chains

Pillar 3: Attracting foreign direct investment and global production mandates from large multinational companies.

- Improve the business cost environment in Canada
- Develop a national FDI strategy
- Modernize Canadian FDI rules and processes
- Reform Canada's R&D incentive programs
- Implement a Patent Box system to help commercialize research and IP

Conclusion

For the past fourteen months Canada was locked in an intense renegotiation of NAFTA – the agreement anchoring our North American and global trade. This forced Canada to re-examine its current state of trade, with the subsequent discussion focused on the need to diversify our trade away from the US market. Lost in that discussion was the question of *why* Canada and the US are so interconnected. The reality is, we don't simply trade with the US and Mexico, we build things together with them. This key fact is the starting point upon which we built our plan to enhance Canadian exports and trade.

This paper identified the main structural, economic, and policy challenges that are holding back Canadian exports. Canada's trade woes are a combination of forced and unforced errors. Clearly, we could not control the effects of a rising China and of global terrorism in the early 2000s. But, we do control our response to these challenges and to our self-made domestic barriers to trade.

For decades and through successive governments, Canada's main response to these challenges has been to focus on reducing global market access barriers through the signing of free trade agreements. CME supports these efforts, but the evidence shows that it is clearly not enough. In spite of unprecedented access to markets around the world, Canada's export performance has been one of the worst of any advanced economy.

This does not have to be our fate. CME believes that, using the new USMCA as a foundation, we can build a long-term export strategy that results in meaningful trade gains and ensures our collective prosperity for decades to come. We believe this strategy should be based on three pillars:

1. Strengthening Canada's existing export foundations, with a focus on building from existing trade agreements, especially the USMCA, and leveraging our natural and existing strengths and resources;
2. Scaling up small- and medium-sized companies to support them going global through stronger support programs for domestic investment as well as international growth opportunities; and
3. Attracting foreign direct investment and global production mandates from large multinational companies.

Executing on these three pillars is critical to maximizing Canada's export potential and to meeting CME's Industrie 2030 objective of doubling value-added exports by 2030. It will also be critical in meeting the government's objectives of building a stronger, more prosperous middle class and economic base across Canada.

This paper can act as a starting point for achieving these goals. Tackling the challenges above will require an all-of-government and an all-of-Canada effort. But success comes with the reward of positioning Canada to capitalize on global market opportunities for decades to come.