SPECIAL REPORT
TD Economics

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BOOSTING INTERPROVINCIAL TRADE CRITICAL TO ENSURING SUSTAINED GROWTH FOR SMALL BUSINESSES

Highlights

- Boosting interprovincial trade activity in Canada can raise economic prospects for SMEs across all regions. While Canada has recently made positive strides in knocking down international trade barriers, non-tariff barriers within Canada continue to impede on economic opportunities within its own borders.
- Industry Canada recently did a deep-dive on this issue by exploring the results from a Statistics Canada survey focused on SMEs. The findings are very much in line with other literature in this area. Firms engaged in interprovincial trade tend to be more growth oriented and innovative than those that do not. What's more, there is a strong correlation between SMEs that engage in interprovincial trade and export to international markets.
- The responsibility for knocking down barriers to trade is largely at the provincial level. A number of agreements within regions have been signed that build off the current Agreement on Internal Trade. That said, more needs to be done. The long-term benefits should make it a national priority. The good news is that provincial governments have taken notice of this issue and have shown a desire to act.

The past decade has delivered good local-market conditions on the whole for Canada's small and medium enterprises (SMEs). Extended booms in household and government spending, as well as housing markets, have been particular catalysts to top-line revenue growth. Admittedly, the period since the 2008-09 recession has been more challenging for the SME sector, especially in regions in Eastern and Central Canada. However, even in those regions, local economies for the most part have continued to grow on the back of continued domestic spending gains.

Looking ahead, the business prospects for small businesses may face some increased headwinds. Households and governments are likely to be constrained in their ability to spend amid high debt loads and the prospects for rising interest rates. Demographics are also likely to weigh on the potential for local economies to expand. In this environment, the need for businesses to take better advantage of opportunities outside of their own markets becomes critical.

Any reference to exporting immediately conjures up the notion of raising business ties with other countries. However, there continues to be surprisingly little attention paid to the need of SMEs to better capitalize on trade opportunities within Canada. In this report, we explore recent trends in interprovincial trade across the SME sector, leveraging some of the findings from a recent publication by Industry Canada. As we discuss, there are a number of barriers that appear to be holding back progress on this front, chief among them: a complex array of non-tariff barriers that persist across provinces.

Economic benefits of expanding trade within Canada

From a SME perspective, growing trade within Canada can make good business sense. Expanding

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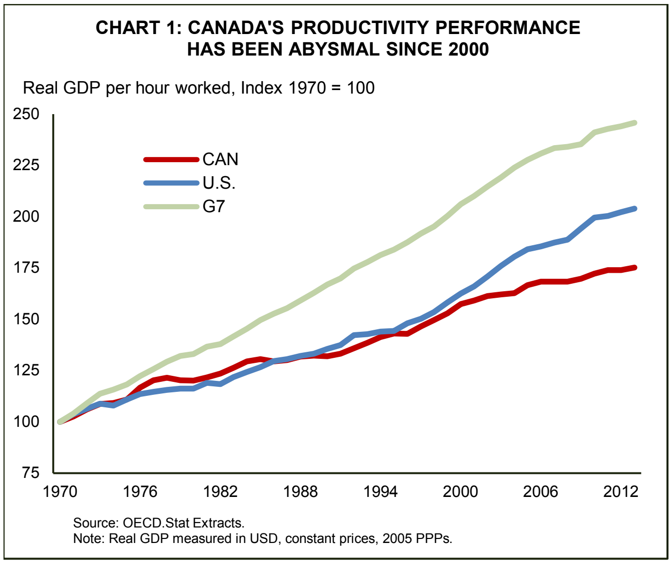


Source: OECD.Stat Extracts.
Note: Real GDP measured in USD, constant prices, 2005 PPPs.

trade to other markets can boost top-line growth, diversify revenue bases and lower costs through better economies of scale. Likewise, more outward-looking companies can benefit from lower import sourcing costs as well as greater access to talent. Unlike international trade, language and cultural differences across Canada are relatively small and do not present major challenges. There are also considerable indirect benefits. Case in point, raising interprovincial trade flows can boost nation-wide productivity, with the resulting income flowing back to local markets across the country.

A recent Industry Canada report (SME Profile: Interprovincial Trade)[1] explored this issue using Statistics Canada's 2011 Survey on Financing and Growth of Small and Medium Enterprises. The study focused on the performance of SMEs that engage in trade relative to those that concentrate exclusively on their own local market. The report found a strong correlation between SMEs that engage in interprovincial trade and those that export to international markets. While this result may simply reflect the fact that these SMEs are naturally trade oriented, it could also suggest that trade within Canada can act as a launching pad for firms to develop best practices tied to trade before they expand to international waters. Moreover, for SMEs that are reluctant to export abroad, a natural starting point would be to tap into other provincial markets where language and cultural differences are not a major hurdle.

Consistent with other research, the report also finds that firms engaged in interprovincial trade tend to be more growth oriented and innovative than those that do not. These traits can be tied to improved productivity, an area that Canada's economy has been sorely lacking (see Chart 1).

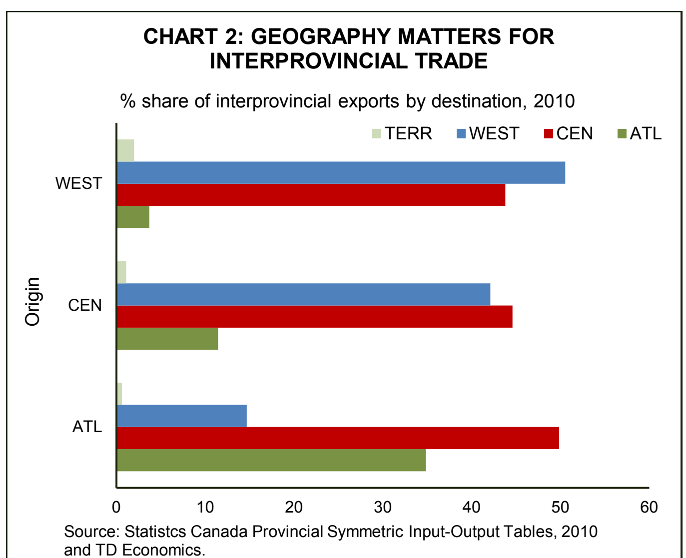
More SMEs appear to be engaging in business across provincial borders

Compared to doing business in other countries, the Industry Canada report revealed that about twice as many SMEs in Canada trade internally. However, this translates to only about one in five small businesses conducting trade with other markets in Canada. Regionally, about one in three Manitoba SMEs trade with other provinces, with a relatively high share of businesses in B.C. (21%) and Atlantic Canada (21%) engaging in interprovincial trade.

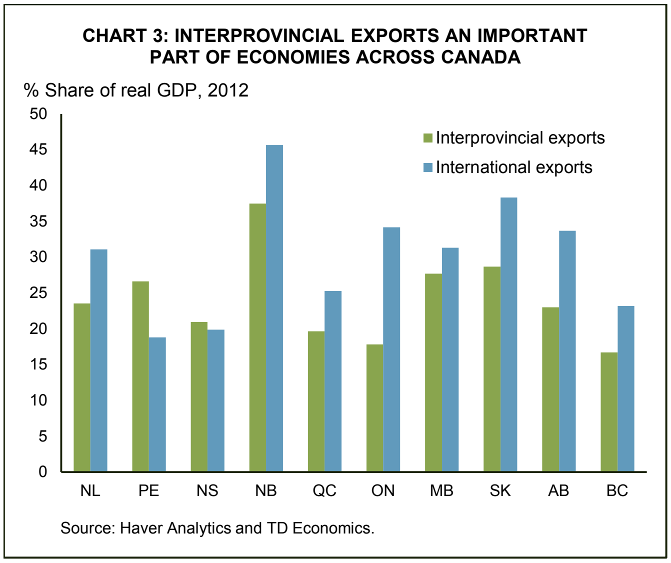
Furthermore, this proportion appears to be growing. While detailed data are lacking at the SME level, Statistics Canada figures on interprovincial trade in goods and services for both large and small businesses point to a moderate average annual growth rate of just over 2% per year in real (after-inflation) interprovincial exports over the past decade. This compares favourably to total Canadian international exports, which advanced by less than 1% per year over the same period.

The faster growth rate in interprovincial trade is largely a function of two factors. First, Canada's domestic economy outperformed that of the United States and Europe, its two largest export markets. Second, and as importantly, the surge in the Canadian dollar from around 63 U.S. cents in 2002 to parity in recent years negatively affected Canadian businesses' competitiveness in the U.S. market.

As one might expect, trade flows are generally stronger within regional blocs compared to those across regions (see Chart below). Moreover, in Western Canada – where economic growth has been running at a nation leading pace – growth in interprovincial exports has been particularly



Source: Statistcs Canada Provincial Symmetric Input-Output Tables, 2010 and TD Economics.



feverish. Western Canadian companies have also benefitted from the establishment of the New West Partnership Agreement between British Columbia, Alberta and Saskatchewan with the aim of creating Canada's largest, barrier-free internal market.

Some provinces are more reliant on interprovincial exports than exports to other countries. For example, in P.E.I., Nova Scotia and Manitoba, interprovincial exports either surpass or are almost equal to international exports as share of total real GDP. On the flipside, provinces such as Ontario, Alberta and Saskatchewan continue to benefit more from international trade.

From a sectoral perspective, about two-thirds of Canadian interprovincial exports are concentrated in manufacturing, finance and real estate services, mining/oil and gas and transportation and warehousing sector. Chart 4 shows that services trade activity has been on the rise since the early-2000s, led by increased interprovincial exports of finance, insurance and real estate and leasing, professional and transportation and warehousing services. Over the past decade, the services share of interprovincial exports have increased in six provinces, with the western boom in interprovincial exports largely being a services story.

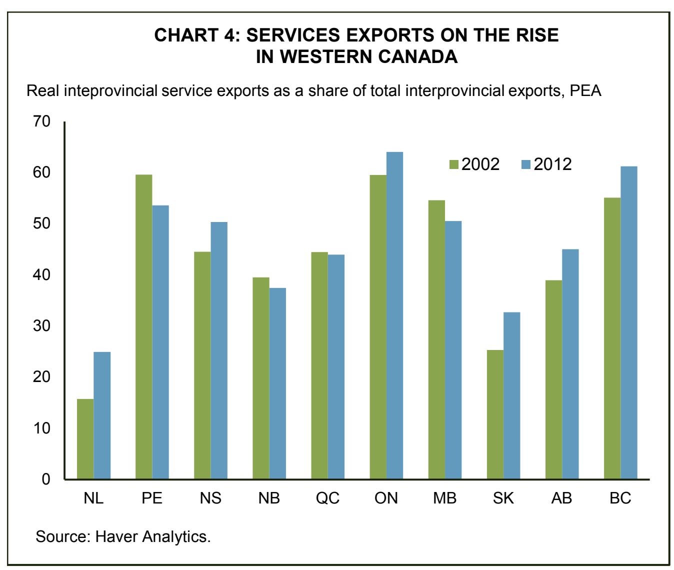
At the other end of the spectrum, the goods-producing industries have not fared as brightly. Much spotlight has been shone on the loss of competitiveness of central Canada's large manufacturing sector in international markets. However, interprovincial manufacturing exports have also underperformed. The level of nominal gross output in the manufacturing sector destined for interprovincial trade was only 4% higher in 2010 (the latest data available) compared to 2004. The comparable figure for international factory exports was a near 20% decline. This is not to say that there were not some pockets of growth. For example, Saskatchewan (+54%), B.C. (+20%) and New Brunswick (+22%) all recorded solid gains in manufacturing interprovincial exports over that time period. However, on the aggregate, it appears that increased competition – notably from Asia – has been a challenge for producers at home.

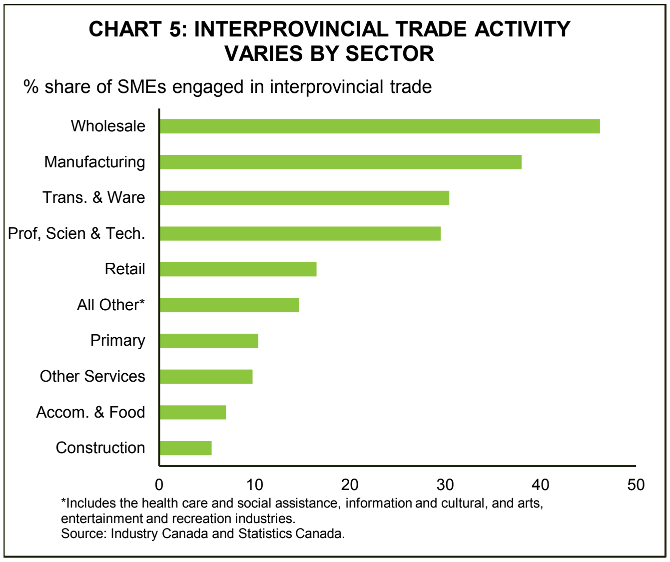
According to Industry Canada, almost half of SMEs surveyed in the wholesale trade sector undertook interprovincial trade activities – the highest across all industries. This was followed by 38% in manufacturing and 30% in transportation and warehousing. The construction sector recorded the lowest share (5.6%). The report cites that this likely reflects the local nature of construction activities and the red tape that exists in the sector.

Ongoing impediments to SMEs succeeding in other markets

Despite the volumes growth that has been recorded in recent years, there appear to be ongoing challenges that are holding SMEs back from engaging in trade in other provinces and regions. These impediments range from the perceptions of SMEs themselves, to ongoing impediments to trade across provincial boundaries.

There is a dearth of research in Canada surrounding what has been holding SMEs back from better engagement in interprovincial trade. Most of the literature highlights the impediments that constrain a company's ability to export to other countries. However, it wouldn't be a stretch to argue that similar factors may be at play in preventing businesses from expanding their markets in general. Canadian finan-





cial institutions are armed with the resources, products and services to help small businesses grow their businesses as they expand into new markets, both interprovincial and international. According to the Conference Board of Canada[2], factors that contribute to reduced international trade by SMEs include:

- The firm believes that the product or service offered is not exportable.
- The firm perceives foreign markets as too risky.
- The firm does not feel it has the skill set or resource capability to internationalize.
- The firm is not interested in expanding its customer base because of a desire to stay small and keep its operations manageable.

The Industry Canada report surveyed SMEs in terms of what barriers hold them back from expanding their operations (see Chart 6). Perhaps not surprisingly, a relatively high proportion of SMEs (about one-third) cite government regulation as an obstacle for growth. What's more, businesses in the primary sector were even more likely to identify government regulation as a barrier - especially among SMEs engaged in interprovincial trade. This can at least partly explain the lacklustre internal trade activity seen in this sector. Government regulation also represented a significant barrier to growth in the transportation and warehousing as well as the accommodation and food services sectors.

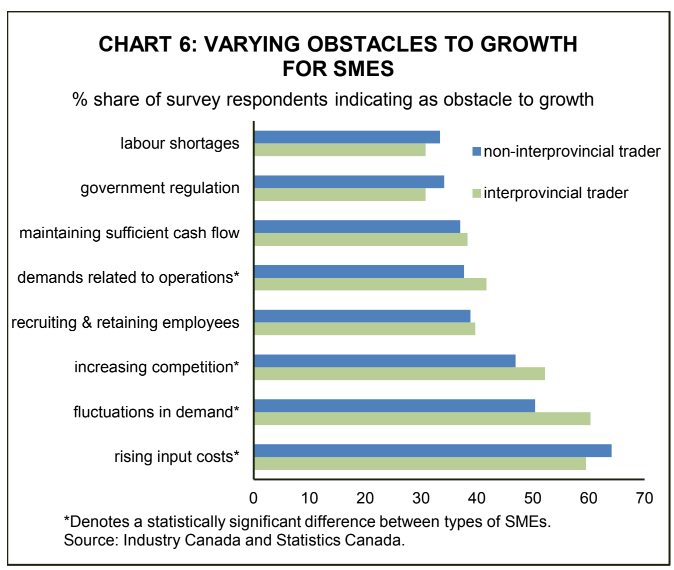
Location is also an important factor. For example, a shortage of labour was commonly cited as an impediment to growth. Among the regions, a higher share of interprovincial traders located in Atlantic Canada identified labour shortages as a key challenge to growth growth relative to firms focused on local markets. This likely reflects the acute demographic challenges facing the region coupled with the strong out-migration on account of economic underperformance. Rigid labour mobility standards only magnify this problem in Canada. For example, a lack of coordination in the apprenticeship system makes it difficult for apprentices to complete their training outside their home province and pursue opportunities in other regions of Canada[3].

There is a lot of commonality in the obstacles faced by all SMEs – both interprovincial and non-interprovincial traders – and the perceived severity of these challenges. However, a higher share of SMEs engaged in interprovincial trade identified increased competition as well as fluctuations in demand as obstacles to expansion. A by-product of bringing down trade barriers is increased competition. While at a micro level increased competition can impose a challenge for firms, consumers do stand to benefit from lower consumer prices. Industry Canada also explains that it is likely that firms that undertake business activities outside their own local market are subject to more regional and cultural factors that can impact demand.

On the other side of the coin, rising input costs are a more pressing concern for non-interprovincial traders. This result should be viewed as a motive for businesses to pursue interprovincial trade. Indeed, expanding to markets outside provincial borders can help businesses benefit from lower import sourcing costs.

Provincial governments need to knock down barriers to trade

Much of the onus of boosting internal trade lies on the doorstep of provincial governments. Explicit trade barriers



within Canada are not permitted. That said, a number of non-tariff barriers tied to regulatory differences between provinces impede on the trade of goods and services across regions. The most common impediments relate to labour mobility, government procurement and business regulation. Firms wanting to engage in trade outside their own provincial borders must incur higher costs associated with additional measures. The agriculture and transportation industries are often cited as the sectors most stunted by this regulatory environment. A good example is differences between the federal and provincial meat inspection programs in Canada. Interprovincial trade in animal products can only take place between federally approved facilities. As such, plants that only have provincial accreditation can only operate within a province. What's more, specific sanitary and labelling requirements also impede on trade of agricultural products[4].

Most regions in Canada have recognized the inefficiencies tied to non-tariff barriers to trade and have signed agreements that build off of the somewhat "toothless" 1995 Agreement on Internal Trade (AIT)[5]. As already noted, the New West Partnership Trade Agreement (NWPTA) marked a significant step forward. Among the improvements relative to the AIT, the NWPTA includes a longer list of regulated professions, lower bidding thresholds for procurement, and more efficient dispute settlement process. Another advantage of NWPTA is that it uses "negative lists" – meaning the agreement covers all items except those specifically omitted from the agreement. However, it is recognized that the AIT covers many different regions that have complex and competing interests which makes it challenging to implement such an approach[6].

Other provincial trade agreements in Canada include: the Ontario-Quebec Trade and Cooperation Agreement (TCA), New Brunswick-Nova Scotia Partnership Agreement on Regulation and the Economy (PARE) and the Atlantic Procurement Agreement (APA). In general, these accords provide a more efficient dispute settlements process and lower bidding thresholds for government procurement.

The annual Premier's meeting in late August also highlighted how interprovincial trade has become a focal point for policy discussion across Canada. At the meeting, the Premiers agreed to continue to strengthen and modernize the AIT. What's more, a steering committee led by Premiers Selinger, Wall, Wynne and McNeil will report back within six months their findings including concrete actions on enhancing labour mobility[7].

Bottom Line

Canada's ongoing efforts in growing and diversifying its international trade basket through the signing of free trade agreements should be applauded. Increased access to new or growing markets helps to ensure that Canada is not as overly reliant on the U.S. market for export demand over the medium-term. However, taking full advantage of domestic markets should be as much of a priority.

Recent research has pointed to a direct link between SMEs that engage in interprovincial trade and expand their practices internationally. Firms that trade across Canada are also growth oriented, innovative and productive. As such, Canada should adopt the same expansive policy it has taken in diversifying its international export basket within its own borders.

The Agreement on Internal Trade (AIT) does provide a "first step" in promoting internal trade relations in Canada, but left many obstacles. It is time for Canada to knock down the impediments that persist. There is no doubt that it will be a challenging process given the diversity across provinces and competing interests. However, the long-term benefits should make it a national priority. The good news is that provincial governments have taken notice of this issue and have shown a desire to act.

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End Notes

1. Pierce, Andrea, "SME Profile: Interprovincial Trade", Industry Canada, November 2013. Industry Canada's analysis was based on Statistics Canada's Survey on Financing and Growth of Small and Medium Enterprises. The target population for the survey was private sector, for profit SMEs employing under 500 employees and generating annual revenues between $30,000 and $50,000,000 in 2011. Excluded from the target population were government organizations, schools, hospitals, subsidiaries, co-operatives, and financing and leasing companies.
2. Macmillan, Kathleen, "Canadian SMEs and Globalization — Success Factors and Challenges. The Conference Board of Canada, May 2008. Note as captured by survey data.
3. "One Canada One National Economy: Modernizing Internal Trade in Canada", Government of Canada, August 2014.
4. Coulibaly, Aicha L., "Does the Agreement on Internal Trade Do Enough to Liberalize Canada's Domestic Trade in Agri-food Products?", Library of Parliament Background Paper, August 2010.
5. The AIT was the first domestic agreement to establish rules for trade within Canada and came into force in 1995. Its purpose is to reduce and eliminate, to the extent possible, barriers to the free movement of persons, goods, services and investment within Canada and establish an open, efficient, and stable domestic market.
6. Capitalizing on Canadian Markets, Alberta Government, May 2014.
7. "Premiers will lead comprehensive renewal of Agreement on Internal Trade" The Council of the Federation Press Release, August 29, 2014.